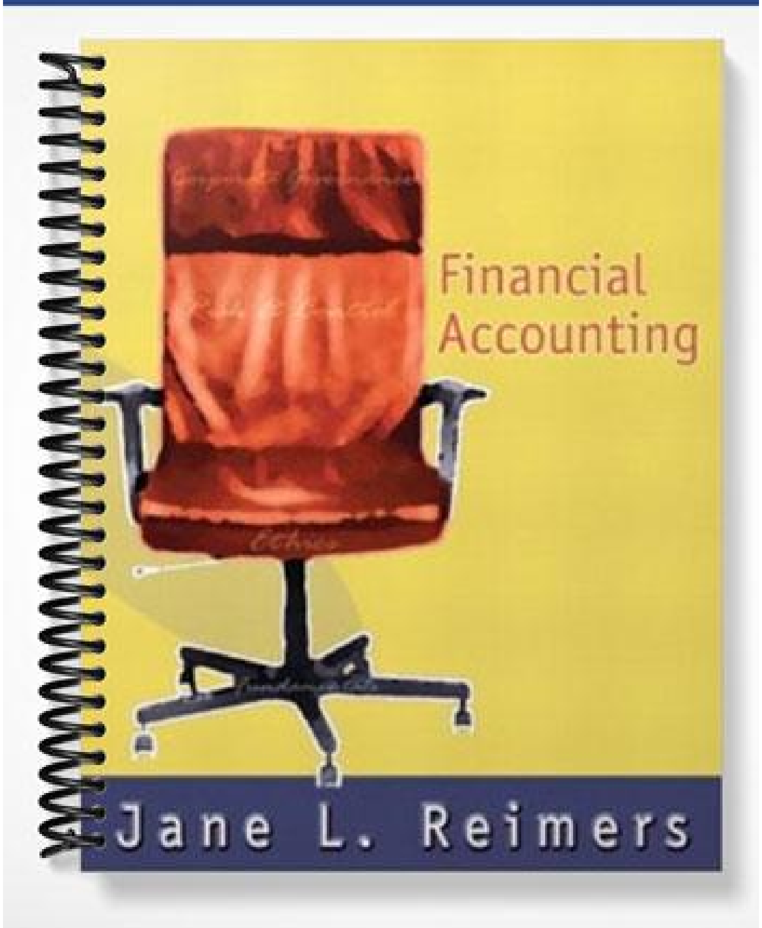
TEST BANK



Chapter 2
Preparing Financial Statements and Analyzing Business Transactions

Multiple-Choice Questions

1. The primary objective of financial reporting is to provide
   a. external users with financial statements
   b. the SEC with audited financial statements
   c. information which will help people make decisions
   d. the FASB with annual financial statements\

   c (easy / LO: 1 / knowledge)

2. Which of the following would *not* be considered a transaction that requires recording in the accounting records of a business?
   a. The purchase of merchandise on account
   b. The sale of the business's common stock to an investor
   c. The bank reconciliation performed by the bookkeeper
   d. The purchase of merchandise for cash

   c (moderate / LO:1 / comprehension)

3. Accounting information that is has been developed primarily for use by external users is referred to as
   a. financial accounting
   b. managerial accounting
   c. cost accounting
   d. not-for-profit accounting

   a (easy / LO: 1 / comprehension)

4. Financial information provided to external users is presented to these users in the form of a(n)
   a. performance report
   b. trial balance
   c. financial statement
   d. analyst report

   c (moderate / LO: 1 / comprehension)

5. A business transaction is
   a. another term for the accounting equation
   b. the recording process of an accounting system
   c. a completed exchange involving an economic exchange
   d. the reporting phase of an accounting system

   c (easy / LO:1 / comprehension)

6. The economic assumption states that economic events
   a. of different businesses can be combined together if all of the entities are corporations
   b. of sole proprietorships can include the personal transactions of its owner
   c. must be reported to the Financial Accounting Standards Board and the Securities and Exchange Commission
   d. of every business must be separately identified and must not include any personal transactions of its owner

   d (easy / LO: 1 / comprehension)

7. It is assumed that the activities of Southwest Airlines can be distinguished from those of American Airlines because of the
   a. going-concern assumption
   b. time period assumption
   c. economic entity assumption
   d. monetary unit assumption

   c (easy / LO: 1 / knowledge)

8. The time period assumption states that the economic life of a business can be divided into
   a. equal time periods for financial reporting
   b. cyclical time periods for financial reporting
   c. a twelve-month period for financial reporting
   d. meaningful time periods for financial reporting

   d (easy / LO: 1 / knowledge)

9. The assumption that a business can continue to remain in operation in the future is the
   a. time period assumption
   b. historical cost assumption
   c. going-concern assumption
   d. continuing-concern assumption

   c (easy / LO: 1 / knowledge)

10. The time period assumption is the basis for
    a. dividing the activities of a business into a series of time periods that are meaningful for accounting and reporting purposes
    b. keeping the company’s business transactions separate from the owner’s transactions
    c. recording the company’s assets at its historical cost
    d. dividing the transactions of a business into twelve equal months following the calendar year

    a (moderate / LO: 1 / knowledge)

11. Which of the following statements is false?
    a. Assets are recorded at cost and the cost is based on the value of the asset at the time of its acquisition.
    b. Historical cost is the original cost of an asset acquired by a company.
    c. Historical cost is considered to be more relevant than market value is for most assets because the cost is verifiable and factual.
    d. Assets acquired by a company must be adjusted to their market value at the end of every accounting period.

    d (difficult / LO: 1 / knowledge)

12. The FASB identified four qualities that must exist for accounting information to be considered useful. These four qualities are that the information must be
    a. relevant, reliable, verifiable and consistent
    b. relevant, reliable, comparable and consistent
    c. reliable, comparable, verifiable and accurate
    d. reliable, comparable, verifiable and consistent

    b (easy / LO: 1 / knowledge)

13. The quality of accounting information which allows data companies to compare their financial results to another company’s results is
    a. reliable
    b. comparable
    c. understandable
    d. predictable

    b (easy / LO: 1 / knowledge)

14. The quality of accounting information which allows the data for a company's financial statements to be compared from one accounting period to another is
    a. reliable
    b. comparable
    c. relevant
    d. consistent

    d (easy / LO: 1 / comprehension)

15. Information that is important and timely, with the potential to influence decisions is called
    a. reliable
    b. comparable
    c. consistent
    d. relevant

    d (moderate / LO: 1 / comprehension)

16. When a company uses the same accounting methods from period to period, the information is said to be
    a. comparable
    b. consistent
    c. reliable
    d. relevant

    b (easy / LO: 1 / knowledge)

17. A balance sheet
    a. provides external users with all of the financial information that they need in order to make business decisions
    b. shows the assets, liabilities and stockholder's equity of a business entity at a particular point in time
    c. shows the assets, liabilities and stockholder's equity of a business entity at their current market value
    d. shows how much income the entity earned for a particular period of time

    b (moderate / LO: 2 / knowledge)

18. A classified balance sheet
    a. categorizes the assets and liabilities as current or non-current
    b. records assets at market value and liabilities and stockholder's equity at historical cost
    c. categorizes liabilities and stockholder's equity as current or non-current
    d. records assets at historical cost and liabilities and stockholder's equity at market value

    a (moderate / LO: 2 / comprehension)

19. A current asset is
    a. an asset that is currently being used to produce a product or service
    b. classified as a current asset based on the income statement
    c. expected to be converted to cash or used to earn revenue in the next fiscal year
    d. an asset that has been purchased by an entity which has a life greater than one year

    c (moderate / LO: 2 / comprehension)

20. Which of the following is not properly classified as a current asset?
    a. Land
    b. Accounts receivable
    c. Supplies
    d. Cash

    a (easy / LO: 2 / comprehension)

21. Current Liabilities are defined as obligations that the company will
    a. settle over an extended period of time
    b. never settle
    c. settle with current assets
    d. settle with equity

    c (easy / LO: 2 / knowledge)

22. Shareholder equity is made up of which of the following two components?
    a. Liabilities and Equity
    b. Common Stock and Equity
    c. Paid in Capital and Retained Earnings
    d. Retained Earnings and Liabilities

    c (moderate / LO: 2 / comprehension)

23. Which of the following is *not* a way to create equity in a company?
   a. An investor borrows money from a bank.
   b. An investor purchases stock in a large corporation.
   c. A corporation records a large profit for the year.
   d. An owner of a company deposits money into the business checking account.

   a (difficult / LO: 2 / comprehension)

24. As a general rule, revenue is recognized at the point of sale or when the good or service is delivered to the customer. To which of the following transactions does this rule apply?
   a. Services are provided to customers on an installment basis and collection is doubtful.
   b. Services are provided to customers on account with payment due in 15 days.
   c. A customer pays an attorney a retainer fee for services to be provided over the next six months.
   d. A customer puts a down payment on a vehicle so that the dealership can place a special order.

   b (moderate / LO: 3 / comprehension)

25. Companies like Quiznos sell franchises to individuals. Peter Adams purchased a franchise from Quiznos and paid the franchise fee, which is valid for 10 years. When should Quiznos recognize the revenue from the franchise fee?
   a. As soon as the franchise fee is received
   b. At the end of the 10 year period
   c. Over the period during which Quiznos provides the services (i.e. 10 years)
   d. Never

   c (difficult / LO: 3 / analysis)

26. All of the following transactions *except* which appropriately apply the matching principle?
    a. Sales commissions are recorded as an expense in the same month that the revenue is recorded for that particular sale.
    b. Telephone expense is recorded in March even though the actual telephone bill (which covers the period March 1 to March 31) wasn't received until April.
    c. An insurance policy which covers a twelve month period from January 1 to December 31 is expensed entirely in the month of January.
    d. An insurance policy which covers a twelve month period is expensed evenly over the twelve month policy period.

    c (difficult / LO: 3 / application)

27. The matching principle matches
    a. assets with liabilities
    b. expenses with revenues
    c. investors with businesses
    d. creditors with businesses

    b (easy / LO: 3 / comprehension)

28. Under the accrual basis of accounting
    a. cash must be paid before an expense can be recorded
    b. a transaction must be technically complete before it can be recorded
    c. cash must be received before a revenue can be recorded
    d. a transaction must be virtually complete before it can be recorded

    d (moderate / LO: 3 / comprehension)

29. Revenue from the sale of merchandise is normally recognized at the
    a. earlier of two dates, when an exchange is actually made or when the earnings process is complete
    b. date of the sale, regardless of whether the merchandise is delivered
    c. date the payment is made if the sale was made on account
    d. date of sale, if sold for cash or the date when payment is made if sold on credit

    a (moderate / LO: 3 / application)

30. Earnings per share are calculated by dividing
    a. dividends by net income
    b. net income by average number of shares outstanding
    c. net sales by net income
    d. net sales by average number of shares outstanding

    b (easy / LO: 3 / comprehension)

31. Adams Company had the following selected balances on its balance sheet and income statement at the end of 2006:

Current Assets	$ 6,000	Net Income	$ 7,000
Total Sales	2,000	Stockholders Equity	25,000
Average Assets	38.000	Total Liabilities	3,000
Total Assets	28,000	Average Common shares Outstanding	8,000

Based on the information above, what is Adams' earnings per share?
    a. $0.250
    b. $0.875
    c. $3.500
    d. $3.125

    b (difficult / LO: 3/ application)

32. A measure of liquidity is the
    a. current ratio
    b. current assets
    c. earnings per share
    d. debt to total assets ratio

    a (easy / LO: 8 / knowledge)

33. Which of the following transactions would cause an increase in both the assets and stockholders' equity of a company?
    a. The purchase of land with cash obtained from a bank loan
    b. The recording of revenue for services provided to a customer on account
    c. The collection of an accounts receivable which was the result of services provided on account
    d. The purchase of goods from a vendor on account

    b (difficult / LO: 4 / comprehension)

34. Which part of the statement of cash flows generally reports cash from the current, day-to-day activities of a business?
   a. Investing activities
   b. Operating activities
   c. Financing activities
   d. Revenue activities

   b (easy / LO: 5 / knowledge)

35. Which part of the statement of cash flows generally reports activities that affect stockholders' equity?
   a. Investing activities
   b. Operating activities
   c. Financing activities
   d. Stockholders equity

   c (easy / LO: 4 / knowledge)

36. Which part of the statement of cash flows generally reports activities that generally affect long-term assets?
   a. Investing activities
   b. Operating activities
   c. Financing activities
   d. Stockholders equity

   a (easy / LO: 5 / knowledge)

37. The statement of cash flows is useful to a manager in
   a. evaluating the past operations of the business
   b. planning for future investing activities
   c. planning for future financing activities
   d. all of the above

   d (moderate / LO: 5 / comprehension)

38. Which of the following items present additional information to an investor which clarifies and expands upon the information presented in the company's financial statements?
   a. The auditor's report
   b. The notes to the financial statements
   c. The management discussion and analysis report
   d. The investor's analysts report

   b (easy / LO: 6 / knowledge)

39. The information needed to determine whether a company is using different accounting methods than those of its competitors would be found in the
    a. auditor's report
    b. balance sheet
    c. notes to the financial statements
    d. management and discussion and analysis report

    c (easy / LO: 6 / knowledge)

40. An item is considered to be material if the
    a. cost associated with reporting the item is greater than its benefits
    b. item was purchased for a large sum of money
    c. item has a life longer than one year
    d. item is large enough to influence an investor's decision

    d (moderate / LO: 7 / knowledge)

41. Wal-Mart currently holds thousands of VHS tapes in its inventory. Because of the introduction of digital entertainment, the market value of these tapes has dropped drastically. If you were to appropriately apply the conservatism constraint, how should Wal-Mart record the VHS tapes inventory?
    a. Wal-Mart should adjust the VHS inventory value down to the current market value.
    b. Wal-Mart should do nothing as the VHS inventory is currently recorded at its historical cost.
    c. Wal-Mart should adjust the VHS inventory down to zero.
    d. Wal-Mart should just throw the VHS tapes away and only purchase DVDs in the future.

    a (difficult / LO: 7 / analysis)

42. Chaffin Consulting performed consulting services during June 2006 on account and collections for these services were not received until August 2006. What effect did performing these services on June 2006 have on the accounting equation?
    a. Increase in assets and decrease in stockholder's equity
    b. Increase in assets and increase in stockholder's equity
    c. Decrease in assets and decrease in stockholder's equity
    d. Decrease in assets and increase in stockholder's equity

    b (moderate / LO: 3 / comprehension)

43. Which of the following statements is true?
   a. The effect of every transaction is an increase or a decrease in one or more of the accounting equation elements.
   b. Both sides of the accounting equation must be equal.
   c. Stockholder’s equity is increased when a company makes a profit.
   d. All of the above are true.

   d (moderate / LO: 4 / comprehension)

44. Borrowing money from a local bank would
   a. increase assets and increase stockholder’s equity
   b. increase liabilities and increase stockholder’s equity
   c. increase assets and decrease stockholder’s equity
   d. increase assets and increase liabilities

   d (moderate / LO: 7 / comprehension)

The next three questions are based on the following example. Turner Company had the following transactions occur in May of 2006:

1. Started the business with $50,000 in exchange for common stock
2. Borrowed $20,000 from the local bank
3. Collected revenue earned from a customer in the amount of $5,000
4. Paid a vendor $1,000 for inventory purchased
5. Purchased office supplies for cash in the amount of $1,000
6. Sold stock to new investors for $5,000
7. Paid the bank $10,000 for the loan in transaction # 2

45. Based on the information above, Turner Company’s total assets on May 31, 2006 would be
   a. $70,000
   b. $68,000
   c. $65,000
   d. $80,000

   a (moderate / LO: 7 / application)

46. Based on the information above, Turner Company’s total stockholder’s equity on May 31, 2006 would be
   a. $80,000
   b. $70,000
   c. $60,000
   d. $55,000

   c (moderate / LO: 7 / application)

47. Based on the information above, Turner Company's total liabilities on May 31, 2006 would be
    a. $20,000
    b. $10,000
    c. $8,000
    d. $5,000

    b (moderate / LO: 7 / application)

48. For each transaction recorded in an accounting system, the two basic equalities that must be maintained at all times are
    a. Assets = Liabilities + Equity and Net Income = Revenue + Expenses
    b. Assets + Liabilities = Equity and Net Income = Revenue – Expenses
    c. Assets – Equity = Liabilities and Net Income = Revenue – Expenses
    d. Assets + Equity = Liabilities and Net Income = Revenue + Expenses

    c (easy / LO; 7 / knowledge)

49. Which of the following transactions *would not* affect stockholder's equity?
    a. Sale of goods to a customer on account
    b. Sale of stock to an investor
    c. Collection of accounts receivable
    d. Payment of a dividend to stockholders on record

    c (moderate / LO: 7 / knowledge)

50. When are ratios most useful for analysis?
    a. When they are compared with other companies in different industries
    b. When they are compared with historical ratios of the same company
    c. When they are not compared to any other company
    d. None of the above are correct

    b (easy / LO: 8 / knowledge)

51. The current ratio measures
    a. profitability
    b. solvency
    c. equity
    d. liquidity

    d (easy / LO: 8 / knowledge)

52. Potts Company reported the following data:

Total Assets	$48,000	Total Liabilities	$80,000
Total Current Assets	10,000	Total Current Liabilities	20,000
Property Plant & Equip	30,000	Notes Payable	15,000
Cash	4,000	Accounts Payable	4,000

Based on the information above, the current ratio was:

a. 0.60
b. 2.40
c. 0.50
d. 2.00

c (moderate / LO: 8 / application)

53. What effect will the payment of a cash dividend have?

a. Increase the current ratio
b. Decrease the current ratio
c. Have no affect on the current ratio
d. None of the above

b (difficult / LO: 8 / application)

54. A potential adverse occurrence or unwanted event that could be damaging to an accounting information system is called a

a. control
b. threat
c. loss
d. risk

d (easy / LO: 9 / knowledge)

55. Which of the following is accomplished by a corrective control?

a. Identifying the cause of a problem
b. Correcting the resulting errors
c. Modifying the system to prevent future occurrences of the problem
d. All of the above

d (moderate / LO: 9 / application)

56. Duplicate checking of calculations is an example of a ________________ control and adherence to procedures to evaluate and resubmit rejected transactions is an example of a ___________________control.

a. Corrective; detective
b. Detective; corrective
c. Preventive; corrective
d. Detective; preventive

b (moderate / LO: 9 / application)

57. There are different types of internal controls available to an organization. The controls that deter problems before they arise are called
    a. preventive controls
    b. corrective controls
    c. detective controls
    d. internal controls

    a (easy / LO: 9 / knowledge)

Use the following information to answer the next three questions
Wange Consulting reports the following account balances as of July 31, 2006:

Accounts Payable	$ 18,000	Trade Accounts Receivable	$ 14,000
Plant Equipment	180,000	Common Stock	340,000
Cash	130,000	Office Equipment	54,000
Land	360,000	Mortgages Payable due 5 yrs	285,000
Retained Earnings	80,000	Salaries Payable	15,000

58. Based on the account detail provided by Wange Consulting, what were the company's total current assets on July 31, 2006?
    a. $198,000
    b. $738,000
    c. $144,000
    d. $130,000

    c (moderate / LO: 7 / application)

59. Based on the account detail provided by Wange Consulting, what were the company's total current liabilities on July 31, 2006?
    a. $303,000
    b. $365,000
    c. $18.000
    d. $33,000

    d (moderate / LO: 7 / application)

60. Based on the account detail provided by Wange Consulting, what was the company's current ratio on July 31, 2006 (rounded to two decimal places)?
    a. 7.22
    b. 4.36
    c. 6.00
    d. 1.38

    b (moderate / LO: 8 / application)

Use the following information to answer the next four questions.

Boyd Company made the following transactions during 2006.

1. Started the business with $3,000 cash in exchange for common stock
2. Provided services to a client for $2,000 on account
3. Incurred $800 worth of operating expenses on account
4. Collected $900 cash from the customer from transaction #2
5. Paid $750 cash on accounts payable from transaction #3
6. Paid $50 dividend to the stockholders on record

The average number of outstanding shares at the end of 2006 was 20.

61. Based on the transactions provided by Boyd Company, what is the amount of net income that would be reported on the company's income statement for the year ending December 31, 2006?
    a. $450
    b. $1,200
    c. $1,350
    d. $2,100

    b (moderate / LO: 7 / application)

62. Based on the information provided by Boyd Company, what were the company's earnings per share in 2006?
    a. $22.50
    b. $60.00
    c. $67.50
    d. $105.00

    b (moderate / LO: 8 / application)

63. Based on the transactions provided by Boyd Company, what would net cash provided by operating activities be on the company's cash flow statement for the year ending December 31, 2006?
    a. $550.00
    b. $500.00
    c. $400.00

d. $150.00

d (moderate / LO: 7 / application)

64. Based on the transactions provided by Boyd Company, what would net cash provided by financing activities be on the company's cash flow statement for the year ending December 31, 2006?
    a. $3,000
    b. $2,950
    c. $2,250
    d. $2,200

    b (moderate / LO: 7 / application)

65. The balance sheet of Shuford Company contained the following account balances on December 31, 2006:

Cash	$100	Marketable Securites	$200
Office Equipment	800	Common Stock	600
Accounts Payable	300	Retained Earnings	???

Based on the account balances above, what must the balance in retained earnings be?
    a. $200.00
    b. $400.00
    c. $ – 0 –
    d. $500.00

    a (moderate / LO: 7 / application)

Use the following information to answer the next two questions:
Fruit-O Company shows the following selected account balances on its balance sheet as of May 31 2006:

Accounts Payable	$31,000	Accounts Receivable	$57,000
Cash	15,000	Patent	50,000
Inventory	69,000	Long-term Investments	80,000
Mortgage Payable (due in 15 years)	100,000	Unearned Revenue	2,000
		3-month Certificate of Deposit	40,000
Salaries Payable	2,000	Property Plant & Equipment	670,000
Notes Payable (due in 2 years)	28,000	Notes Payable (due in 3 mos.)	30,000
Prepaid Insurance	1,000		

66. Based on Fruit-O Company's account balances as of May 31, 2006, what were the company's current liabilities?
    a. $63,000
    b. $33,000
    c. $61,000
    d. $65,000

    d (moderate / LO: 7 / application)

67. Based on Fruit-O Company's account balances as of May 31, 2006, what were the company's current assets?
    a. $142,000
    b. $112,000
    c. $113,000
    d. $182,000

    d (moderate / LO: 7 / application)

68. Holland Company was begun when the owner invested $15,000 in the business. As a result of this transaction
    a. assets decreased and liabilities increased
    b. equity decreased and liabilities increased
    c. assets increased and equity increased
    d. equity increased and liabilities increased

    c (easy / LO: 7 / application)

69. Holland Company provided services to a customer for $6,000 cash. As a result of this transaction
    a. total assets increased and total equity is unchanged
    b. total equity decreased and total assets decreased
    c. total assets increased and total equity increased
    d. total equity increased and total assets decreased

    c (moderate / LO: 7 / application)

70. Holland Company paid dividends to its stockholders in the amount of $3,000. As a result of this transaction

    a. assets decreased, equity decreased and net income is unaffected
    b. equity increased, liabilities decreased and net income increased
    a. assets decreased, liabilities decreased and net income decreased
    b. equity decreased, liabilities increased and net income decreased

    a (moderate / LO: 7 / application)

71. Holland Company acquired office equipment in exchange for the company's common stock. As a result of this transaction
    a. assets increased, liabilities increased and cash flow from investing activities increased
    b. assets increased, equity increased and cash flow from financing activities is unaffected
    c. assets increased, liabilities increased and cash flow from investing activities decreased
    d. assets increased, liabilities increased and cash flow from financing activities increased

    b (difficult / LO: 7 / comprehension)

72. The ending retained earnings balance in Parker Real Estate increased by $430,000 from the beginning of the year. During the year, Parker Corporation paid a dividend of $150,000. Based on the information provided, what was Parker's net income for the year?
    a. $280,000
    b. $580,000
    c. $300,000
    d. There is not enough information given to determine net income.

    b (difficult / LO: 7 / application)

73. At the beginning of the accounting period, Parker Corporation had assets of \$820,000 and liabilities of \$340,000. During the year, assets increased by \$40,000 and liabilities decreased by \$8,000. Based on the information provided, the total amount of stockholder's equity at the end of the accounting period was
    a. \$480,000
    b. \$536,000
    c. \$1,102,000
    d. \$528,000

    d (difficult / LO: 7 / application)

74. If as an investor, you wanted to know how much net income a corporation distributed as dividends to its shareholders, which financial statement would you examine?
    a. Balance sheet
    b. Income statement
    c. Statement of cash flows
    d. Statement of retained earnings

    d (difficult / LO: 7 / application)

75. The operating section of the cash flow statement is often believed to be the most important part of the cash flow statement because it shows an investor how much
    a. dividends were paid to the stockholders
    b. outside financing was needed to keep the operations of the business going
    c. net cash increased or decreased during the period
    d. cash was generated from the company's primary operations and how that cash was used to pay operating expenses

    d (moderate / LO: 7 / application)

Matching Questions

The technical accounting terms introduced in this chapter are listed below:

Relevant	Historical Cost Principle	Current Ratio
Comparability	Economic Entity Assumption	EPS Ratio
Time Period Assumption	Preventive Control	Reliability
Detective Control	Accrual Basis Accounting	Consistency
Corrective Control	Matching Principle	Materiality

Match each of the following statements with the term from above that it describes.

76. ____________________ describes information that is accurate, verifiable and unbiased and therefore a faithful representation of a firm's financial performance.

Reliability (LO: 1 / knowledge)

77. A control that is administered to help prevent errors in an accounting system is known as a(an) ______________________.

Preventive control (LO: 9 / knowledge)

78. Information that is __________________ is useful to decision makers because it helps them to evaluate the firm's past performance and to predict its future performance.

Relevant (LO: 1 / knowledge)

79. _________________ ___________________ _________________refers to the way that an organization recognizes revenues and expenses. Revenues are recognized when they are earned and expenses are recognized when they are incurred.

Accrual Basis Accounting (LO: 1 / knowledge)

80. The assumption that financial statements of a firm contain financial information related to that firm only is known as the ____________ _______________ __________________.

Economic Entity Assumption (LO: 1 / knowledge)

81. Accountants divide the life of a business into time periods so that they can prepare performance reports for those periods. These time periods must be meaningful and must be consistently applied. This is a description of the _______________ ___________________ _____________________.

Time Period Assumption (LO: 1 / knowledge)

82. Current assets divided by current liabilities is known as the ___________ ________________ and is a measure of a company's liquidity.

Current ratio (LO: 8 / knowledge)

83. ______________ ___________________ ________________ is the measuring of assets at their cost at the time of the purchase.

Historical Cost Principle (LO: 1 / knowledge)

84. A ratio that analysts watch carefully and that is computed using net income and the average number of shares outstanding is referred to as the __________ ratio.

EPS (LO: 3 / knowledge)

85. Performing bank reconciliations on a company's checking account each month is a control known as a ___________________ ________________.

Detective Control (LO: 9 / knowledge)

True/False Questions

86. Accrual accounting uses the economic substance of the transactions to determine when to include the revenue on the income statement instead of using the exchange of cash.

True (easy / LO: 3 / knowledge)

87. Any business event that might affect the future profitability of the company and that would make a difference to the financial statements must be disclosed.

True (easy / LO: 1 / knowledge)

88. The matching principle states that the activities of an entity should be kept separate from those of its owner.

False (easy / LO: 1 / knowledge)

89. When a business takes out a bank loan, it causes an increase in total assets and an increase in stockholders' equity.

False (moderate / LO: 7 / knowledge)

90. If a company has assets of $75,000 and stockholder's equity of $35,000, then its liabilities must be $110,000.

False (moderate / LO: 7 / knowledge)

91. The historical cost principle assumes that all assets of a business are reported at their "cost" which is the amount that was paid for them at the time of purchase.

True (easy / LO: 1 / knowledge)

92. Every company must use accrual basis accounting.

False (moderate / LO: 1 / knowledge)

93. If there is any question about how to account for a transaction, the accountant must select the method that will least likely overstate income or assets.

True (moderate / LO: 1 / knowledge)

94. The current ratio takes into consideration all assets and all liabilities.

False (easy / LO: 8 / knowledge)

95. In calculating net income, you take total revenue and subtract expenses and dividends.

False (moderate / LO: 3 / knowledge)

96. The matching principle is the basis used in creating the income statement.

True (moderate / LO: 3 / knowledge)

97. If a transaction is virtually complete, then it must be recorded in the accounting records.

True (moderate / LO: 1 / knowledge)

98. The statement of retained earnings includes the changes to all of the equity accounts.

False (easy / LO: 4 / knowledge)

99. The cash flow statement discloses significant events relating to the operations, investing and financing activities of the business.

True (easy / LO: 5 / knowledge)

100. An investing activity on the cash flow statement includes any cash received from a bank loan.

False (moderate / LO: 5 / comprehension)

101. The balance sheet is related to the income statement in that a company's net income is a separate equity account which appears on the equity section of the balance sheet.

False (moderate / LO: 2 / comprehension)

102. The current ratio is a measure of a company's liquidity.

True (easy / LO: 8 / comprehension)

103. The risks associated with financial information are often called control risks.

False (moderate / LO: 9 / knowledge)

104. The current ratio is an example of a liquidity ratio.

True (moderate / LO: 8 / knowledge)

105. An example of a detective control is requiring all employees to show their badge before entering the corporate building.

False (moderate / LO: 9 / comprehension)

106. An example of a corrective control is requiring accounting staff to analyze and fix errors found on exception reports.

True (moderate / LO: 9 / comprehension)

107. Performing account reconciliations each month on a receivable account is *not* an example of a detective control.

False (easy / LO: 9 / knowledge)

108. A classified balance sheet categorizes assets and liabilities as current and non-current.

True (easy / LO: 2 / knowledge)

109. The full disclosure principle covers the inclusion of accompanying notes to the financial statements that provide additional information to an investor.

True (moderate / LO: 6 / knowledge)

110. Contributed capital refers only to the amount invested by owners.

True (moderate / LO: 4 / comprehension)

Essay Questions

111. What is the Sarbanes-Oxley Act and how does it improve the accuracy of information provided about a company's financial statements?

Answer:

The Sarbanes-Oxley Act requires that the annual report that public companies submit to the Securities and Exchange Commission include separate reports on the effectiveness of their internal controls. It helps to ensure that a company has policies and procedures (internal controls) in place to ensure that assets are protected and transactions are recorded accurately. It holds management to a higher standard because the report is made available to all financial statement users.

(difficult / LO: 9 / Knowledge, Comprehension) Accounting in the News

112. Accounting information must possess four qualities in order for the FASB to consider it to be useful. List the four characteristics and briefly define each.

Answer:

Relevant - describes information that is important and timely with the potential to influence decisions
Reliable – describes information that is accurate, verifiable, and unbiased and therefore a faithful representation of a firm's financial performance
Comparable – describes information that can be compared across firms because they use the same accounting principles
Consistent – the use of the same accounting principles and methods from period to period

Under generally accepted accounting principles, the assets owned by an organization are reported in the balance sheet at their historical cost (the price paid at date of purchase). Identify and briefly explain two additional accounting assumptions, other than the historical cost principle, that involve the valuation or measurement of assets.

(moderate / p7-10 / knowledge)

Answer:

Monetary unit assumption – only items that can be measured in monetary units are included on the financial statements.

Separate entity assumption – financial statements of a firm contain financial information related to that firm only (they do not include any financial information about the owner or other organizations)

(difficult / LO: 1 / application/evaluation)

113. What is the separate entity assumption and why is it important for financial statement reporting? What is another term for this assumption?

Answer:

The separate entity assumption is applied to ensure that the financial statements of a company contain financial information related *only* to that company. It ensures that there is no co-mingling of owners' personal records or other company records in the financial statements of the business. It is important that a business only report the assets, liabilities and equity for that business. The personal assets, liabilities and equity of the owners must be kept separate from that of the business. The financial information provided in the financial statements should pertain only to that business and not to that of any other parties (owners, other businesses, investors, etc).

Another term for this assumption is the economic entity assumption.

(difficult / LO: 1/ knowledge/comprehension)

114. In April, Doc Construction purchased $40,000 worth of lumber on account from Timber Lumber Company. The lumber was used in the construction of Deb Littlefield's home in Westtown, VA, and the home was finished and ready for "move-in" in April. Timber Lumber Company sold the lumber to Doc with the payment terms due in 90 days (payment due in June). Doc paid for the lumber in June along with his other normal operating expenses. Based on the scenario above, in which month should the lumber be recognized in the accounting record as an expense? What accounting principle provides the justification for your answer?

Answer:

Doc Construction must record the lumber expense in April, the month in which the lumber was consumed and the revenue for the construction job earned. The matching principle states that expenses are recognized in the same period as the revenue they helped generate; this is the accounting principle that justifies expensing the lumber in April.

(moderate / LO: 3/ knowledge)

115. The term "earnings per share" (EPS) represents the portion of a company's earnings that is allocated to each share of common stock. Managers, analysts and investors place a great deal of emphasis on this ratio. How is EPS calculated in its most simple form? Provide a simple example demonstrating how EPS is calculated. Why does EPS matter and how is it used by investors and analysts?

Answer:

EPS can be calculated by simply dividing net income earned in a given period by the average number of shares outstanding (the average is used because the number of shares outstanding fluctuates). Assume XYZ company reports $4 million dollars of income for the year and over the same time frame had an average of 10 million shares outstanding. In this case, EPS would be $.40, calculated by dividing $4 million by 10 million shares. EPS is a carefully scrutinized metric that is often used as a gauge of a company's profitability per unit of shareholder ownership. As such, EPS is a key driver of share prices. Investors and analysts often use it to compare the results of two companies.

(moderate / LO: 8 / comprehension)

116. The financial statements of all public companies include a set of accompanying notes. These notes are an integral part of the statements and are required by GAAP. What information do these notes provide to the user of the financial statements? What principle requires these notes?

Answer:

The notes to the financial statements are required by GAAP and provide information about any circumstances or events that would make a difference to the users of the statements. The principle that is being applied is called the full disclosure principle. The notes to the financial statements describe the accounting methods that the company has chosen to use and they provide details that explain the numbers found on the financial statements.

(difficult / LO: 6 / knowledge/comprehension)

117. Equity can be viewed as a source of assets. In fact, equity is composed of two distinct sources of assets. What are these two sources? Give three examples of transactions that would affect each of these sources.

Answer:

One source of equity might come from the owners of the business. If the company is a corporation, then common stock would be issued to the owner in exchange for some asset (cash or property). This type of equity is also known as contributed capital. Another source of equity is obtained through the company's earnings activities. If a company is able to make a net profit, then that profit can be used in two ways: the business can distribute the profit back to the owners or they can retain the profit in the business. If the profit is kept in the business, it is recorded as retained earnings.

Examples of transactions affecting equity include:

1. An owner starts a business by depositing cash into the business checking account.
2. A business sells common stock to an investor.
3. A business makes a distribution to the owners (i.e. dividends).
4. A business earns revenue for services performed.
5. A business incurs expenses for goods purchased.
6. A business sells an asset for a profit.

(difficult / LO: 7 / knowledge/comprehension/application)

118. When investors or creditors ask how your company is doing, there are several financial reports that you can give them so that they can assess your company's financial performance. One such financial report is a Classified Balance Sheet. How is a classified balance sheet displayed in terms of assets? Provide some examples. How about liabilities? Provide some examples. What kind of information can be derived from this statement? What can it tell an investor or creditor about a company's financial performance?

Answer:

Assets on the balance sheet are categorized as either current (less than one year or one operating cycle) or non-current (greater than one year or one operating cycle) and are displayed in terms of liquidity (a measure of how easily an asset can be converted into cash). Examples of current assets are cash, accounts receivable and inventory. Examples of non-current assets include property, plants, equipment and long-term investments.
Liabilities are also classified as current or non-current. Examples of current liabilities include accounts payable, unearned revenue and the current portion of notes payable. Examples of non-current liabilities include mortgage payable, bonds payable and long-term portion of notes payable.
A balance sheet is a way to show off the success of your business. It is a documented report of your company's assets and obligations as well as the residual ownership claims against its equity at any given point in time. It is a cumulative record that reflects the results of all recorded accounting transactions since the organization was formed. It provides investors with the company's net worth on any given date. With a properly prepared balance sheet, you can determine if your organization has more or less value than the previous period, know if your debts are higher or lower and know if your working capital is higher or lower. By analyzing the balance sheet, an investor can determine your organization's ability to meet short-term obligations. In addition, the balance sheet can determine a company's solvency or its ability to pay *all* current and long-term debts as they come due.

(moderate / LO: 2 / knowledge)

119. What is the going-concern assumption and why is it so important for the preparation of the balance sheet? How is this assumption related to the full-disclosure principle and the historical cost principle?

Answer:

The going-concern assumption is used to determine if a company will remain in business for the foreseeable future. Determining whether or not a company will remain in business is important for the balance sheet because it addresses asset valuation issues. If a business is expected to operate into the foreseeable future, amounts presented on the balance sheet will be based on historical cost. If there is doubt as to whether the company will remain in business, then the assets and liabilities of the business may have to be adjusted to their liquidation values, and the full-disclosure principle must be applied as this information that would make a difference to a potential investor.

(difficult / LO: 1 / knowledge/comprehension/application)

120. Explain accrual basis accounting and identify two accounting principles that support this method.

Answer:

Accrual basis accounting refers to the way companies recognize revenue and expenses. Revenue must be recorded when it is *earned* regardless of when cash is exchanged and expenses must be recorded when *incurred* regardless of when cash is exchanged. Two principles that support this method are the revenue recognition principle and the matching principle. The revenue recognition principle states that revenue must be recognized when it is earned and when collection is reasonably assured. The matching principle states that expenses must be recognized in the same period as the revenue they helped to generate.

(difficult / LO: 1 / knowledge/comprehension)

121. What is the historical cost principle and why is it so important for balance sheet reporting? Assume that a company purchases land for $120,000 cash at a time when the market value of the property appraised at $150,000. How should this transaction be recorded in the accounting records?

Answer:

The historical cost principle assumes that assets will be recorded at their original cost to the company, which is important for balance sheet reporting since historical cost is verifiable and objective. If the cost principle were not applied, it could lead to assets and liabilities being reported at subjective values (i.e. market values), which could, in turn, lead to manipulations of the balance sheet amounts.

Based on the example given, the land should be recorded in the accounting records at $120,000 or at its original cost.

(easy / LO: 1 / knowledge)

Problems

122. Johnson Company began operations on January 1, 2006. On that date, $20,000 was invested in the business in exchange for common stock. In addition, Johnson borrowed $15,000 from WAXO Bank. During the year, the company provided services to its customers and received $23,000 cash. Johnson also purchased land that cost $25,000, paid salaries to its employees in the amount of $10,000 and made a cash dividend to the owners in the amount of $8,000. Note: all transactions are cash transactions.

Required:

1. Record each of these transactions in the accounting equation.
2. Prepare an income statement and a balance sheet for Johnson Company for the year ending December 31, 2006.

Answer:

		Assets		=	**Liabilities**	+	**Equity**		
Event	OA IA FA	Cash	Land		Notes Payable		Common Stock	Retained Earnings	Description
1	FA	20,000					20,000		
2	FA	15,000			15,000				
3	OA	23,000						23,000	Revenue
4	IA	(25,000)	25,000						
5	OA	(10,000)						(10,000)	Salaries Exp
6	FA	(8,000)						(8,000)	Dividend
7									
8									
Total		15,000	25,000		15,000		20,000	5,000	
		40,000							40,000

Johnson Company
Income Statement
For the year ending December 31, 2006

Revenue		$ 23,000
Expenses:		
Salaries Expense	10,000	
Total Expenses		10,000
Net Income		$ 13,000

Johnson Company
Balance Sheet
As of December 31, 2006

Assets:		
Current Assets:		
Cash	$ 15,000	
Non-Current Assets:		
Land	25,000	
Total Assets		$ 40,000
Liabilities:		
Non-Current Liabilities:		
Notes Payable		$ 15,000
Total Liabilities		
Shareholders' Equity		
Common Stock	20,000	
Retained Earnings	5,000	
Total Shareholders Equity		25,000
Total Liabilities & Shareholders Equity		$ 40,000

(moderate / LO: 7 / application)

123. Johnson Company began operations on January 1, 2006. On that date, $20,000 was invested in the business in exchange for common stock. In addition, Johnson borrowed $15,000 from WAXO Bank. During the year, the company provided services to its customers and received $23,000 cash. Johnson also purchased land that cost $25,000, paid salaries to its employees in the amount of $10,000 and made a cash dividend to the owners in the amount of $8,000.

Required:

1. Record each of these transactions in the accounting equation and classify each transaction as an OA (operating activity), IA (investing activity) or FA (financing activity).
2. Prepare a cash flow statement and statement of changes in shareholders' equity for Johnson Company for the year ending Dec 31, 2006.

Answer:

		Assets		=	**Liabilities**	+	**Equity**		
Event	OA IA FA	Cash	Land		Notes Payable		Common Stock	Retained Earnings	Description
1	FA	20,000					20,000		
2	FA	15,000			15,000				
3	OA	23,000						23,000	Revenue
4	IA	(25,000)	25,000						
5	OA	(10,000)						(10,000)	Salaries Exp
6	FA	(8,000)						(8,000)	Dividend
7									
8									
Total		15,000	25,000		15,000		20,000	5,000	
		40,000							40,000

Johnson Company
Statement of Changes in Shareholders' Equity
For the year ending December 31, 2006

Beginning Common Stock January 1, 2006	$ -
Contributions during the year	20,000
Ending Common Stock	20,000
Retained Earnings January 1, 2006	$ -
Add Net Income	13,000
Deduct Dividends	8,000
Retained Earnings December 31, 2006	$ 5,000
Total Shareholders' Equity	$ 25,000

Johnson Corporation
Statement of Cash Flows
For the year ending December 31, 2006

Cash Provided by Operating Activities:		
Cash collected from customers	$ 23,000	
Cash paid for operating expenses	(10,000)	
Net Cash provided by operating activities		13,000
Cash Provided by Investing Activities		
Cash paid for Land	(25,000)	
Net Cash provided by Investing activities		(25,000)
Cash Provided by Financing Activities		
CashContributions from Owner	20,000	
Cash proceeds from bank loan	15,000	
Cash dividends paid to stockholders	(8,000)	
Net Cash provided by Financing Activities		27,000
Net Change in cash		15,000
Beginning cash balance		-
Ending cash balance		$ 15,000

(moderate / LO: 7 / application)

124. Howard Company started a consulting business on January 1, 2006 by investing $37,000 cash in exchange for common stock in the business. In addition to the owner's investment, Howard Company took out a bank loan in the amount of $45,000 in order to start operations. During the year, the company provided consulting services to its customers and received $42,000 cash. During the year, the company paid $5,000 for salaries and used $3,000 worth of office supplies, which had been purchased for cash that year. In addition, they paid rent in the amount of $16,000 cash. At the end of the year, the owners were paid a dividend in the amount of $9,000. Howard also loaned Park Company $5,000 as Howard is friends with the owner of Park Company.

Required:

1. In which section of the cash flow statement would the loan to Park Company be recorded?
2. List each transaction that would be reported in the operating section of the cash flow statement. Calculate the net cash provided by operating activities.
3. List each transaction that would be reported in the financing section of the cash flow statement. Calculate the net cash provided by financing activities.
4. What would Howard Company have in total assets at the end of the year?
5. What would the ending balance in retained earnings be at the end of the year?
6. What would the ending cash balance be at the end of the year?

Solution:

Event	OA, IA, FA	Cash	Notes Receivable	Supplies	Notes Payable	Unearned Revenue	Common Stock	Retained Earnings	Description
1	**FA**	37,000					37,000		
2	**FA**	45,000			45,000				
3	**OA**	42,000						42,000	Revenue
4	**OA**	(5,000)						(5,000)	Salaries
5	**OA**	(3,000)						(3,000)	Supplies
6	**OA**	(16,000)						(16,000)	Rent
7	**FA**	(9,000)						(9,000)	Dividend
8	**IA**	(5,000)	5,000						
Total		86,000	5,000	0	45,000	0	37,000	9,000	
		91,000					46,000		91,000

1. The loan to Park Company would be recorded as an investing activity.
2. Operating activity includes revenue earned ($42,000) and expenses paid ($5,000 salaries, $3,000 supplies and $16,000 rent). Total net cash provided by operating activities = $18,000 inflow.

3. Financing activity would include the investment from the owner ($37,000), the bank loan ($45,000) and the dividend paid ($9,000). Total cash provided by financing activities = $73,000.
4. Total assets amount to $91,000.
5. The retained earnings total $9,000.
6. The ending cash balance amounts to $86,000.

(moderate / LO: 7 / application)

125. Fill in the missing information for the classified balance sheet below:

Classified Balance Sheet
As of December 31, 2006

Assets:			Current Liabilities:		
Current Assets			Accounts Payable		
Cash	$ 85,000		Salaries Payable	10,000	
Accounts Receivable					
Inventory	75,000				
			Total Current Liabilities		$ 85,000
Total Current Assets					
			Long-term Liabilities:		
			Long-term Notes Payable		
Property, Plant & Equipment			Total Liabilities		210,000
Equipment, Net					
Long-Term Investment	25,000		Stockholders' Equity:		
			Common Stock		
Total Property, Plant & Equipment		250,000	Retained Earnings	65,000	
			Total Stockholders' Equity		
Total Assets			Total Liabilities & Stockholders' Equity		435,000

Solution:

Classified Balance Sheet
As of December 31, 2006

Assets:			Current Liabilities:		
Current Assets			Accounts Payable	$ 75,000	
Cash	$ 85,000		Salaries Payable	10,000	
Accounts Receivable	25,000				
Inventory	75,000		Total Current Liabilities		$ 85,000
Total Current Assets		$185,000			
			Long-term Liabilities:		
			Long-term Notes Payable		125,000
Property, Plant & Equipment			Total Liabilities		210,000
Equipment, Net	225,000				
Long-Term Investmer	25,000		Stockholders' Equity:		
			Common Stock	160,000	
Total Property, Plant & Equipment		250,000	Retained Earnings	65,000	
			Total Stockholders' Equity		225,000
Total Assets		$435,000	Total Liabilities & Equity		$435,000

(moderate / LO: 7 / analysis)

126. The following items were taken from the Gacko's 2006 balance sheet on December 31, 2006.

Office Equipment, net	$55,000	Prepaid Rent	$ 3,600
Accounts Payable	32,000	Common Stock	200,000
Cash	20,000	Building, net	300,000
Unearned Revenue	9,800	Inventory	230,000
Accounts Receivable	35,000	Notes Payable (due in 5 years)	220,000
Retained Earnings	269,800	Salaries Payable	32,000
Land	120,000		

Required:

a. Prepare a classified balance sheet.

Answer:

Gacko Company
Classified Balance Sheet
As of December 31, 2006

Assets:			Current Liabilities:		
Current Assets:			Accounts Payable	$ 32,000	
Cash	$ 20,000		Salaries Payable	32,000	
Accounts Receivable	35,000		Unearned Revenue	9,800	
Inventory	230,000		Total Current Liabilities		$ 73,800
Prepaid Rent	3,600				
Total Current Assets		$ 288,600	Long-term Liabilities:		
			Notes Payable		220,000
Property, Plant & Equipment			Total Liabilities		293,800
Office Equipment, Ne	55,000				
Building, Net	300,000		Stockholders' Equity:		
Land	120,000		Common Stock	200,000	
Total Property, Plant & Equipment		475,000	Retained Earnings	269,800	
			Total Stockholders' Equity		469,800
Total Assets		$ 763,600	Total Liabilities & Equity		$763,600

(moderate / LO: 2 / application)

127. The following transactions took place in 2006 by Danielle Corp. For each transaction, identify how each item would be classified on the statement of cash flows (OA – operating activities, IA – investing activities, FA – financing activities, NA – not applicable). Note that all transactions are for cash.

1. Purchase of office equipment ____________
2. Sale of goods on account ____________
3. Sale of common stock ____________
4. Sale of merchandise for cash ____________
5. Payment of telephone bill ____________
6. Payment of dividends ____________
7. Purchase of goods on account ____________
8. Collection of accounts receivable ____________
9. Net income ____________
10. Sale of merchandise on account ____________
11. Obtained cash from bank loan ____________
12. Proceeds from sale of land ____________

Answer:

1. Purchase of office equipment ____IA_____
2. Sale of goods on account ____NA____
3. Sale of common stock ____FA____
4. Sale of merchandise for cash ____OA____
5. Payment of telephone bill ____OA____
6. Payment of dividends ____FA____
7. Purchase of goods on account ____NA____
8. Collection of accounts receivable ___OA_____
9. Net income ___NA_____
10. Sale of merchandise on account ___NA_____
11. Obtained cash from bank loan ___FA_____
12. Proceeds from sale of land ___IA_____

(easy / LO: 5 / knowledge)

128. Henner Real Estate Incorporated was established in 2006 and recorded the following transactions:

1. Invested $20,000 cash in the business in exchange for common stock
2. Borrowed $10,000 cash from the bank due in 5 years
3. Received $15,000 cash for commissions from the sale of a house
4. Loaned Peachtree Real Estate $3,000 due in 2 years
5. Purchased Land for $20,000 cash to be used for a new office
6. Paid $6,000 for rental of office space currently being used
7. Purchased $500 worth of office supplies for cash (none were used at the end of the year)
8. Paid a dividend to the owners in the amount of $2,000
9. Made a principal payment to the bank for $3,000 for the loan taken in transaction #2 (ignore interest expense)
10. Paid salaries amounting to $4,000

Required:

1. Set up an accounting equation worksheet similar to the one below and record each transaction.
2. Prepare the four basic financial statements from the worksheet.

	Cash Flow	Assets			=	Liabilities			Equity		
Event	OA IA FA	Cash				Notes Payable			Common Stock	Retained Earnings	Description
Beg Bal											
1											

Answer:

1.

		Assets		=		Liabilities +	Equity		
Event	OA IA FA	Cash	Office Supplies	Notes Receivable	Land	Notes Payable	Common Stock	Retained Earnings	Description
1	FA	20,000					20,000		
2	FA	10,000				10,000			
3	OA	15,000						15,000	Revenue
4	IA	(3,000)		3,000					
5	IA	(20,000)			20,000				
6	OA	(6,000)						(6,000)	Rent Expense
7	OA	(500)	500						
8	FA	(2,000)						(2,000)	Dividend
9	FA	(3,000)				(3,000)			
10	OA	(4,000)						(4,000)	Salaries Expense
Total		6,500	500	3,000	20,000	7,000	20,000	3,000	
		30,000					30,000		

2.

Henner Real Estate Incorporated
Balance Sheet
As of December 31, 2006

Assets:		
Current Assets:		
Cash	$ 6,500	
Office Equipment	500	
Total Current Assets		$ 7,000
Non-Current Assets:		
Notes Receivable	3,000	
Land	20,000	
Total Non-Current Assets		23,000
Total Assets		$ 30,000
Non-Current Liabilities:		
Notes Payable		$ 7,000
Total Liabilities		
Common Stock	20,000	
Retained Earnings	3,000	
Total Shareholders Equity		23,000
Total Liabilities & Shareholders Equity		$ 30,000

Henner Real Estate Incorporated
Income Statement
For the year ending December 31, 2006

Commission Revenue		$ 15,000
Expenses:		
Rent Expense	6,000	
Salaries Expense	4,000	
Total Expenses		10,000
Net Income		$ 5,000

Henner Real Estate Incorporated
Statement of Retained Earnings
For the year ending December 31, 2006

Retained Earnings January 1, 2006		$ -
Add Net Income	5,000	
Deduct Dividends	(2,000)	
Retained Earnings December 31, 2006	$ 3,000	

Henner Real Estate Incorporated
Statement of Cash Flows
For the year ending December 31, 2006

Cash at the beginning of the year		$ -
Operating Activities:		
Cash collected from customer	15,000	
Paid rent	(6,000)	
Purchased supplies for cash	(500)	
Paid salaries	(4,000)	
Total Operating Activities		4,500
Investing Activities:		
Loaned cash	(3,000)	
Purchased land for cash	(20,000)	
Total Investing Activities		(23,000)
Financing Activities:		
Issue common stock	20,000	
Borrow cash	10,000	
Paid dividends	(2,000)	
Made a principal loan payment	(3,000)	
Total Financing Activities		25,000
Net Change in Cash		6,500
Ending Cash Balance		$ 6,500

(moderate / LO: 7 / synthesis)

129. BWW's has hired a high school graduate to perform its bookkeeping functions. The following balance sheet was presented by the bookkeeper to the owner of the company as of May 31, 2006:

BWW Company
Balance Sheet
As of May 31, 2006

Assets:		Liabilities:	
Cash	$ 20,000	Accounts Payable	$ 32,000
Inventory	230,000	Retained Earnings	269,800
Office Equipment, Net	55,000	Salaries Payable	32,000
Building, Net	300,000	Long-term Notes Payable	200,000
Land	120,000	Short-term Notes Payable	20,000
		Total Liabilities	553,800
Total Assets	$ 725,000	Stockholder's Equity	
		Unearned Revenue	9,800
		Accounts Receivable	35,000
		Prepaid Rent	3,600
		Common Stock	200,000
		Total Stockholder's Equity	$ 248,400

Your father owns the business and you recently graduated from college with a degree in accounting. Your father thinks there may be a problem with the balance sheet, so he asks you to take a look at it.

Required:

1. Identify the errors in the balance sheet.
2. Prepare a classified balance sheet in proper form.
3. Calculate the current ratio from the corrected balance sheet. Interpret this ratio as if you were an investor interested in investing in BWW.

Answer:

1.

BWW Company
Balance Sheet
As of May 31, 2006

Assets:		Liabilities:	
Cash	20,000	Accounts Payable	32,000
Inventory	230,000	Retained Earnings	269,800
Office Equipment, Net	55,000	Salaries Payable	32,000
Building, Net	300,000	Long-term Notes Payable	200,000
Land	120,000	Short-term Notes Payable	20,000
		Total Liabilities	553,800
Total Assets	725,000	Stockholder's Equity	
		Unearned Revenue	9,800
		Accounts Receivable	35,000
		Prepaid Rent	3,600
		Common Stock	200,000
		Total Stockholder's Equity	248,400

This is an equity account

This is a liability account

These two accounts are asset accounts

2.

BWW Company
Classified Balance Sheet
As of May 31, 2006

Assets:			Current Liabilities:		
Current Assets			Accounts Payable	$ 32,000	
Cash	$ 20,000		Salaries Payable	32,000	
Accounts Receivable	35,000		Unearned Revenue	9,800	
Inventory	230,000		Short-term Notes Payable	20,000	
Prepaid Rent	3,600		Total Current Liabilities		$ 93,800
Total Current Assets		$ 288,600			
			Long-term Liabilities:		
			Long-term Notes		200,000
Property, Plant & Equipment			Total Liabilities		293,800
Office Equipment, Ne	55,000				
Building, Net	300,000		Stockholders' Equity:		
Land	120,000		Common Stock	200,000	
Total Property, Plant & Equipment		475,000	Retained Earnings	269,800	
			Total Stockholders' Equity		469,800
Total Assets		$ 763,600	Total Liabilities & Equity		763,600

3. Current Ratio = $288,600/$93,800 = 3.077

If I were an investor, I would not be concerned with BWW's current ratio as it shows that there are enough current assets to meet the company's current liabilities. Most companies strive for a current ratio that is greater than one as any value above one demonstrates that there are enough current assets to pay off current liabilities. However, to get a better "feel" for the company's liquidity, an investor must look at historical ratio calculation, industry standards and competitor information.

(moderate / LO: 7, 8 / analysis)

130. The following account balances were drawn from the records of Holland and Company on December 31, 2006:

Cost of Sales	$1,721	Sales Commission Expense	$115
Payroll Expenses	166	Unearned Revenue	1
Interest Expense	40	Accounts Payable	20
Net Sales	2,768	Other Admin Expenses	4
Interest Income	2	Accounts Receivable	3
Inventory	30	Income Tax Expense	25

Required:

1. Prepare an income statement in proper form for Holland and Company for the year ending December 31, 2006.
2. If Holland decided to give a dividend of $30 to its stockholders, how would this affect the income statement?
3. Assuming that Holland has an average of 20 shares outstanding, compute the company's earnings per share (EPS). As an investor, what can you conclude from this ratio?

Answer:

1.

Holland & Company
Income Statement
For the year ending December 31, 2006

Net Sales		$ 2,768
Cost of Goods Sold		1,721
Gross Margin		1,047
Selling & Administrative:		
Commissions Expense	115	
Payroll Expense	166	
Other Admin Expenses	4	
Total Selling & Admin Expenses		285
Total Operating Income		762
Interest Income		2
Interest Expense		(40)
Net Income Before Taxes		724
Income Tax Expense		(25)
Net Income		$ 699

2. Dividends do not affect net income. There are two things that a company can do with its profit: it can retain the profit and re-invest it in the business or it can distribute it in the form of a dividend to its shareholders. Although dividends decrease retained earnings, they do not go on the income statement; instead, they are shown on the retained earnings statement.

   EPS = $699/20 = $34.95 per share. As an investor, I would be interested in the EPS because it can provide me with some indication as to whether or not the company would be able to pay any dividends. It also serves as an indicator of whether or not the company's stock value will have future increases.

(moderate / LO: 7, 8 / application)

131. Jezzie Company had the following cash transactions in 2006:

1. The owner invested $8,000 in the company in exchange for common stock.
2. Rent was paid for $1,000.
3. Services were provided to customers in the amount of $35,000 cash.
4. A bank loan was obtained for $14,000.
5. Salary expenses were paid in the amount of $500.
6. A building was purchased for $15,000 cash.
7. Other operating expenses were paid in the amount of $2,000.
8. The company purchased a Certificate of Deposit for $1,000.
9. $750 worth of dividends was paid to the investors.
10. The bank was paid $250 in interest for the outstanding loan.
11. Repaid $2,000 of the principal balance on the bank loan.

At the beginning of 2006, Jezzie Company had $2,500 cash in the bank.

Required:

1. Classify each transaction as either an operating, investing or financing activity.
2. Using the classifications from #1, prepare the statement of cash flows in proper form.
3. Why do decision makers in business need a statement of cash flows? What kinds of information does it provide the user?

Answer:

1. The owner invested $8,000 in the company. **FA**
2. Rent was paid for $1,000. **OA**
3. Services were provided to customers in the amount of $35,000. **OA**
4. A bank loan was obtained for $14,000. **FA**
5. Salary expenses were paid in the amount of $500. **OA**
6. A building was purchased for $15,000. **IA**

7. Other operating expenses were paid in the amount of $2,000. **OA**
8. The company purchased a Certificate of Deposit for $1,000. **IA**
9. $750 worth of dividends was paid to the investors. **FA**
10. The bank was paid $250 in interest for the outstanding loan. **OA**
11. Repaid $2,000 of the principle balance on the bank loan. **FA**

Jezzie Company
Statement of Cash Flows
For the year ending December 31, 2006

Cash Provided by Operating Activities:		
Cash collected from customers	35,000	
Cash paid for operating expenses	(3,500)	
Cash paid for interest	(250)	
Net Cash provided by operating activities		31,250
Cash Provided by Investing Activities		
Cash paid for building	(15,000)	
Cash paid for certificate of deposit	(1,000)	
Net Cash provided by Investing activities		(16,000)
Cash Provided by Financing Activities		
Cash contribution from owner	8,000	
Cash proceeds from bank loan	14,000	
Cash repayment to bank	(2,000)	
Cash dividends paid to stockholders	(750)	
Net Cash provided by Financing Activities		19,250
Net Change in cash		34,500
Beginning cash balance		2,500
Ending cash balance		37,000

3. Although the income statement shows how well a business is doing on an accrual basis, it does not show what is happening with cash. Understanding the cash flows of a business is extremely important to decision makers and can provide information such as to whether the company has enough money to pay its current bills, if it has money that it can invest in long-term assets or if it will need to seek external sources for funding should it decide to expand.

(moderate / LO: 5,7 / comprehension/application/ analysis)

132. The following account balances were drawn from the records of Holland and Company on December 31, 2006:

Cost of Sales	$1,721	Sales Commission Expense	$115
Payroll Expenses	166	Unearned Revenue	1
Interest Expense	40	Accounts Payable	20
Net Sales	2,768	Other Admin Expenses	4
Interest Income	2	Accounts Receivable	3
Inventory	30	Income Tax Expense	25
Beginning Retained Earnings	250	Dividends paid	15

Required:

Prepare a Retained Earnings statement for the period ending December 31, 2006 in proper form.

Answer:

Holland & Company
Statement of Retained Earnings
For the year ending December 31, 2006

Retained Earnings January 1, 2006	$	250
Add Net Income		699
Deduct Dividends		(15)
Retained Earnings December 31, 2006	$	934

(easy / LO: 4, 7 / application)

133. The following ending account balances were provided by Gourmet Coffee Company for December 31, 2006:

Cash	$ 45,000	Net Income	$ 5,500
Accounts Payable	120,000	Common Stock	200,000
Long-term Notes Payable	350,000	Dividends	3,000
Equipment, Net	400,000	Salary Expense	20,000
Accrued Expenses Payable	50,000	Retained Earnings	130,000
Inventory	200,000	Accounts Receivable	180,000
Long-term Investment	25,000		

Required:

1. Using the account balances provided, prepare a classified balance sheet for Gourmet Coffee Company as of December 31, 2006.
2. Calculate the current ratio and interpret the solution.

Answer:

Gourmet Coffee Company
Classified Balance Sheet
As of December 31, 2006

Assets:			Current Liabilities:		
Current Assets			Accounts Payable	$120,000	
Cash	$ 45,000		Accrued Expenses Payable	50,000	
Accounts Receivable	180,000				
Inventory	200,000				
			Total Current Liabilities		$ 170,000
Total Current Assets		$ 425,000			
			Long-term Liabilities:		
			Long-term Notes Payable		350,000
Property, Plant & Equipment			Total Liabilities		520,000
Equipment, Net	400,000				
Long-Term Investment	25,000		Stockholders' Equity:		
			Common Stock	200,000	
Total Property, Plant & Equipment		425,000	Retained Earnings	130,000	
			Total Stockholders' Equity		330,000
Total Assets		$ 850,000	Total Liabilities & Equity		$850,000

2. Current Ratio = $425,000/$170,000 = 2.5.

Most companies strive for a current ratio that is greater than one as it shows that it has enough current assets to pay off its current liabilities. Therefore, based on the results of the calculation, it would be fair to say that the Gourmet Coffee Company is liquid and will be able to meet its current debts as they become due. However, to get a better “feel” for the company’s liquidity, an investor must look at historical ratio calculations, industry standards and competitor information.

(moderate / LO: 2, 7, 8 / application)

134. An inexperienced accounting intern at Smith and Smith Company prepared the following income statement for the month of October, 2006:

Smith & Smith Company
Income Statement
As of December 31, 2006

Revenues:		
Unearned Revenue	50,000	
Services provided to customers	73,000	
Accounts Receivable	3,500	
Common Stock	21,000	
Loan from Bank	17,500	
Total Revenues		$ 165,000
Expenses:		
Payments on Long-term Debt	40,000	
Operating Expenses	26,000	
Dividends	5,000	
Equipment Purchase	19,000	
Income Tax Payable	2,400	
Income Tax Expense	3,600	
Total Expenses		96,000
Net Income		$ 69,000

Required:

1. Identify the errors made by the intern and prepare an income statement in proper form.

Answer:

Smith & Smith Company
Income Statement
For the year ending December 31, 2006

Revenues:		
Service Revenue		$ 73,000
Expenses:		
Operating Expenses	26,000	
Income Tax Expense	3,600	
Total Expenses		29,600
Net Income		$ 43,400

(moderate / LO: 3, 7 / analysis)

135. The Balance Sheet accounts for Microsoft Corporation for the year ending June 30, 2003 and 2002 are shown below (in millions):

Microsoft Corporation
Balance Sheets
(In millions)

	June 30, 2002	June 30, 2003
Assets		
Cash	$ 3,016	$ 6,438
Short-term investments	35,636	42,610
Accounts receivable, net	5,129	5,196
Inventories	673	640
Deferred income taxes	2,112	2,506
Other current assets	2,010	1,583
Property and equipment, net	2,268	2,223
Equity and other investments	14,191	13,692
Goodwill	1,426	2,946
Intangible assets, net	243	566
Other long-term assets	942	1,171
Total assets	$67,646	$79,571
Liabilities and stockholders' equity		
Accounts payable	$ 1,208	$ 1,573
Accrued compensation	1,145	1,416
Income taxes	2,022	2,044
Short-term unearned revenue	5,920	7,225
Other current liabilities	2,449	1,716
Long-term unearned revenue	1,823	1,790
Deferred income taxes-non current	398	1,731
Other long-term liabilities	501	1,056
Common stock	31,647	35,344
Retained earnings	20,533	25,676
Total liabilities and stockholders' equity	$67,646	$79,571

Note: Common shares issued and outstanding 10,718 and 10,771

Require:

1 What were Microsoft's total current assets for 2002 and 2003?
2. What were Microsoft's total current liabilities for 2002 and 2003?
3. Compute the current ratio for 2002 and 2003.
4. What information do these ratios provide?

Answer (in millions):

1. Current assets 2002 – $48,576, 2003 – $58,973
2. Current Liabilities 2002 – $12,744, 2003 – $13,974
3. Current ratio 2002 – 3.81 2003 – 4.22
4. The current ratio is a measure of a company's short-term debt-paying ability. The ratio for Microsoft improved from 2002 to 2003 and upon reviewing the accounts used in the calculation, one can see that there was a significant increase in cash from 2002 to 2003. Upon quick review, one would say that Microsoft appears to be solvent.

(moderate / LO: 2, 7, 8 / comprehension)

136. A condensed statement of cash flows for Microsoft Corporation for the years ending June 30, 2002 and 2003 are shown below.

Microsoft Corporation
Cash Flows Statements
(In millions)

	Year Ended June 30	
	2002	2003
Operations		
Net cash from operations	$14,509	$15,797
Common stock issued	1,497	2,120
Common stock repurchased	(6,069)	(6,486)
Common stock dividends	0	(857)
Additions to property and equipment	(770)	(891)
Acquisition of companies	0	(1,063)
Purchases of investments	(89,386)	(89,621)
Maturities of investments	8,654	9,205
Sales of investments	70,657	75,157
Net change in cash	(908)	3,361
Effect of exchange rates on cash and equivalents	2	61
Beginning Cash Balance	3,922	3,016
Ending Cash Balance	$3,016	$6,438

Required:

1. Calculate the net cash provided by investing activities for 2002 and 2003.
2. Did Microsoft purchase any long-term equipment in 2002? 2003?
3. Calculate the net cash provided by financing activities for 2002 and 2003. Did Microsoft pay any dividends to its shareholders in 2002? 2003?
4. By how much did cash increase from 2002 to 2003? From where was the cash generated?

Answer (in millions):

See schedule below:

1. Investing Activities 2002 – ($10,845), 2003 – ($7,213)
2. 2002 – acquired property plant and equipment for $770 2003 – acquired property plant and equipment for $891.
3. Financing activities 2002 – ($,4,572), 2003 – ($5,223).
   In 2002, no dividends were paid and in 2003 dividends in the amount of $857 were paid.
4. Cash increased by $3,422 from 2002 to 2003. The cash was generated from the operations of the business.

Microsoft Corporation
Cash Flows Statements
(In millions)

	Year Ended June 30	
	2002	2003
Operations		
Net income	$7,829	$9,993
Net cash from operations	$14,509	$15,797
Financing		
Common stock issued	1,497	2,120
Common stock repurchased	(6,069)	(6,486)
Common stock dividends	0	(857)
Net cash used for financing	($4,572)	($5,223)
Investing		
Additions to property and equipment	(770)	(891)
Acquisition of companies, net of cash acquired	0	(1,063)
Purchases of investments	(89,386)	(89,621)
Maturities of investments	8,654	9,205
Sales of investments	70,657	75,157
Net cash used for investing	($10,845)	($7,213)
Net change in cash and equivalents	(908)	3,361
Effect of exchange rates on cash and equivalents	2	61
Cash and equivalents, beginning of year	3,922	3,016
Cash and equivalents, end of year	$3,016	$6,438

(moderate / LO: 5, 7 / comprehension)

137. The following accounting equation worksheet shows the transactions for Brock Incorporated for the year ending December 31, 2006.

Event	OA, IA, FA	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Notes Payable	Unearned Revenue	Common Stock	Retained Earnings	Description
1		40,000							40,000		
2		(2,000)								(2,000)	Rent
3				500		500					
4		5,000								5,000	Revenue
5		(7,000)			7,000						
6			7,500							7,500	Revenue
7		20,000					20,000				
8		(3,600)								(3,600)	Salaries
9		3,500	(3,500)								
10		8,000								8,000	Revenue
11		(3,000)								(3,000)	Dividend
12		(100)								(100)	Interest
13		(4,000)					(4,000)				
14		5,000						5,000			
15				(200)						(200)	Supplies
Total		61,800	4,000	300	7,000	500	16,000	5,000	40,000	11,600	

Required:

1. Analyze each transaction and provide a short description of each.
2. Identify each transaction affecting cash as either an OA (operating activity), IA (investing activity) or FA (financing activity) in the space provided on the worksheet.
3. What were Brock's total assets for the year?
4. What were Brock's total liabilities for the year?
5. What was Brock's total equity for the year?

Answer:

1.

1	Owner invested money in the business
2	Paid cash for rent
3	Purchased supplies on account
4	Received cash for services earned
5	Purchased equipment for cash
6	Earned revenue on account (due from customer)
7	Borrowed cash from the bank
8	Paid salaries to employees
9	Received money from customer (see #6)
10	Received cash for services earned
11	Paid a cash dividend to stockholders
12	Paid interest to bank
13	Paid part of the principal from the bank loan
14	Received cash for services not yet performed
15	Expensed some of the supplies used in the period

2.

Event	OA, IA, FA	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Notes Payable	Unearned Revenue	Common Stock	Retained Earnings	Description
1	**FA**	40,000							40,000		
2	**OA**	(2,000)								(2,000)	Rent
3				500		500					
4	**OA**	5,000								5,000	Revenue
5	**IA**	(7,000)			7,000						
6			7,500							7,500	Revenue
7	**FA**	20,000					20,000				
8	**OA**	(3,600)								(3,600)	Salaries
9	**OA**	3,500	(3,500)								
10	**OA**	8,000								8,000	Revenue
11	**FA**	(3,000)								(3,000)	Dividend
12	**OA**	(100)								(100)	Interest
13	**FA**	(4,000)					(4,000)				
14	**OA**	5,000						5,000			
15				(200)						(200)	Supplies
Total		61,800	4,000	300	7,000	500	16,000	5,000	40,000	11,600	

3. Total assets $73,100
4. Total Liabilities $21,500
5. Total Equity $51,600

(moderate / LO: 5, 7 / comprehension)

138. The following accounting equation worksheet shows the transactions for Brock Incorporated for the year ending December 31, 2006:

Event	OA, IA, FA	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Notes Payable	Unearned Revenue	Common Stock	Retained Earnings	Description
1		40,000							40,000		
2		(2,000)								(2,000)	Rent
3				500		500					
4		5,000								5,000	Revenue
5		(7,000)			7,000						
6			7,500							7,500	Revenue
7		20,000					20,000				
8		(3,600)								(3,600)	Salaries
9		3,500	(3,500)								
10		8,000								8,000	Revenue
11		(3,000)								(3,000)	Dividend
12		(100)								(100)	Interest
13		(4,000)					(4,000)				
14		5,000						5,000			
15				(200)						(200)	Supplies
Total		61,800	4,000	300	7,000	500	16,000	5,000	40,000	11,600	

Required:

1. Prepare an income statement for the year ending December 31, 2006.
2. Prepare a statement of retained earnings for the year ending December 31, 2006.
3. Prepare a balance sheet for the year ending December 31, 2006.

Answer:

Brock Incorporated
Balance Sheet
As of December 31, 2006

Assets:		
Current Assets:		
Cash	$ 61,800	
Accounts Receivable	4,000	
Supplies	300	
Total Current Assets		$ 66,100
Non-Current Assets:		
Equipment		7,000
Total Assets		$ 73,100
Liabilities:		
Current Liabilities:		
Accounts Payable	500	
Unearned Revenue	5,000	
Total Current Liabilities		$ 5,500
Non-Current Liabilities		
Notes Payable		16,000
Total Liabilities		21,500
Shareholders' Equity		
Common Stock	40,000	
Retained Earnings	11,600	
Total Shareholders' Equity		51,600

Brock Incorporated
Income Statement
For the year ending December 31, 2006

Revenue		$ 20,500
Expenses:		
Rent Expense	$ 2,000	
Salaries Expense	3,600	
Interest Expense	100	
Supplies Expense	200	
Total Expenses		5,900
Net Income		$ 14,600

Brock Incorporated
Statement of Retained Earnings
For the year ending December 31, 2006

Retained Earnings January 1, 2006		$ -
Add Net Income		14,600
Deduct Dividends		(3,000)
	6	$ 11,600

(moderate / LO: 2, 3, 7 / application)

139. The following accounting equation worksheet shows the transactions for Brock Incorporated for the year ending 2006:

Event	OA, IA, FA	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Notes Payable	Unearned Revenue	Common Stock	Retained Earnings	Description
1		40,000							40,000		
2		(2,000)								(2,000)	Rent
3				500		500					
4		5,000								5,000	Revenue
5		(7,000)			7,000						
6			7,500							7,500	Revenue
7		20,000					20,000				
8		(3,600)								(3,600)	Salaries
9		3,500	(3,500)								
10		8,000								8,000	Revenue
11		(3,000)								(3,000)	Dividend
12		(100)								(100)	Interest
13		(4,000)					(4,000)				
14		5,000						5,000			
15				(200)						(200)	Supplies
Total		61,800	4,000	300	7,000	500	16,000	5,000	40,000	11,600	

Required:

1. Prepare a statement of cash flows for the year ending December 31, 2006.
2. Was cash generated from the operations of the business? From where was most of the cash generated? As an investor how would you interpret this information?
3. Did Brock Incorporated make any long-term investments for the business?

Answer:

Brock Incorporated
Statement of Cash Flows
For the year ending December 31, 2006

Cash from Operations		
Cash collected from customers	21,500	
Cash paid for operating expenses	(2,000)	
Cash paid to employees	(3,600)	
Cash paid for interest	(100)	$15,800
Cash from Investing		
Cash paid for equipment		(7,000)
Cash from Financing		
Contribution from owners	40,000	
Cash Proceeds from loan	20,000	
Cash payment on loan	(4,000)	
Cash paid for dividends	(3,000)	53,000
Net Increase in cash		61,800
Beginning cash balance		0
Ending Cash Balance		61,800

2. Yes, there was $15,800 generated from the main operations of the business. However, the majority of the cash came from external financing (the owners and the bank). Since this is the company's first year of operations, it is not uncommon to see the financing activities generate most of the cash. As an investor, I would watch to make sure that more cash is generated from operations than from financing in the future.
3. Yes, it appears that Brock purchased equipment in the amount of $7,000 during 2006.

(moderate / LO: 5, 7 / application)

140. Foremant Company would like to adopt the following internal controls in its organization. Identify each control as either a preventive, detective or corrective control.

a. Periodic bank reconciliations
b. Separating the duties of those employees who handle cash and those who record the cash entries in the accounting records
c. Maintaining backup copies of all accounting transactions off site
d. Renumbering all sales invoices used by the company
e. Maintaining a chart of accounts (list of all accounts used by the organization)
f. Retina scanning for all employees entering a top secret research and development facility
g. Resubmission of transactions that were rejected
h. Having an internal auditor (accountant) review the financial statements for accuracy
i. Hiring only qualified accounting personnel

Answer:

a. Detective
b. Preventive
c. Corrective
d. Preventive
e. Preventive
f. Preventive
g. Corrective
h. Detective
i. Preventive

(moderate / LO: 9 / comprehension)

141. The following items were taken from the accounting records of Bowser Incorporated for the year ending December 31, 2006:

Accounts Payable	$ 55,000	Accounts Receivable	$ 11,000
Equipment, Net	182,000	Advertising Expense	21,000
Cash	65,000	Common Stock	90,000
Administrative Expense	12,000	Dividends	15,000
Insurance Expense	3,000	Notes Payable (long-term)	70,000
Prepaid Insurance	6.000	Rent Expense	17,000
Retained Earnings (beg)	12,000	Salaries Expense	32,000
Service Revenue	135,000	Office Supplies	4,000
Supplies Expense	6,000	Unearned Revenue	9,000
Salaries Payable	3,000		

Required:

1. Prepare an income statement for Bowser Incorporated in proper form.

2. Calculate the balance of retained earnings that would appear on the balance sheet for Bowser Incorporated as of December 31, 2006 by preparing a retained earnings statement.
3. Prepare a classified balance sheet for Bowser Incorporated as of December 31, 2006.
4. Compute the current ratio and earnings per share assuming that the average shares outstanding for 2006 were 10,000.

Solution:

Bowser Incorporated		
Income Statement		
For the year ending December 31, 2006		
Service Revenue		$ 135,000
Expenses:		
Advertising Expense	21,000	
Administrative Expense	12,000	
Insurance Expense	3,000	
Rent Expense	17,000	
Salaries Expense	32,000	
Supplies Expense	6,000	
Total Expenses		91,000
Net Income		$ 44,000
Bowser Incorporated		
Statement of Retained Earnings		
For the year ending December 31, 2006		
Retained Earnings January 1, 2006		$ 12,000
Add Net Income		44,000
Deduct Dividends		(15,000)
Retained Earnings December 31, 2006		$ 41,000

Bowser Incorporated
Classified Balance Sheet
As of December 31, 2006

Assets:			Current Liabilities:		
Current Assets			Accounts Payable	$ 55,000	
Cash	$ 65,000		Salaries Payable	3,000	
Accounts Receivable	11,000		Unearned Revenue	9,000	
Supplies	4,000				
Prepaid Insurance	6,000		Total Current Liabilities		$ 67,000
Total Current Assets		$ 86,000			
			Long-term Liabilities:		
			Long-term Notes Payable		70,000
Property, Plant & Equipment			Total Liabilities		137,000
Equipment, Net	182,000				
			Stockholders' Equity:		
			Common Stock	90,000	
Total Property, Plant & Equipment		182,000	Retained Earnings	41,000	
			Total Stockholders' Equity		131,000
Total Assets		$ 268,000	Total Liabilities & Equity		268,000

Current Ratio = 86,000/67,000 = 1.28
EPS = 44,000/10000 = 4.40

(moderate / LO: 2,4, 7, 8 / application)

142. The Classy Collections Company engaged in the following transactions during 2007: note – assume all transactions are cash transactions:

1. The business acquired $600 cash from the issue of common stock.
2. The Company borrowed $2,000 from a bank.
3. The Company earned $300 worth of revenues.
4. Expenses amounted to $200.
5. Dividends amounted to $25.

During 2008 Classy Collections Company engaged in the following transactions:

1. The business acquired an additional $250 cash from the issue of common stock.
2. The Company repaid $150 of its debt to the bank.
3. Revenues amounted to $550.
4. Expenses were $300.
5. Dividends amounted to $50.

Required:

1. Using the accounting equation worksheet, record each transaction for the year 2007 and calculate the balances in each account.
2. Determine the amount of net income that would appear on the income statement for Classy Collections for the year ending December 31, 2007.
3. For 2008, prepare an additional accounting equation worksheet recording each transaction that occurred in 2008 (note – don't forget to bring over the balances in each account from 2007 – the ending balances from one period become the beginning balances for the next period). Calculate the ending balances in each account.
4. Determine the amount of net income that would appear on the income statement for Classy Collections for the year ending December 31, 2008.

Answer:

1.

	Assets		**=**	**Liabilities**	**+**	**Equity**		
Event	OA IA FA	Cash		Notes Payable		Common Stock	Retained Earnings	Description
1	FA	600				600		
2	FA	2,000		2,000				
3	OA	300					300	Revenue
4	OA	(200)					(200)	Expenses
5	FA	(25)					(25)	Dividends
Total		2,675		2,000		600	75	

2. Net Income = Revenue ($300) – Expenses ($200) = $100

3.

		Assets	=	Liabilities	+	Equity		
Event	OA IA FA	Cash		Notes Payable		Common Stock	Retained Earnings	Description
Beg Bal		2,675		2,000		600	75	
1	FA	250				250		
2	FA	(150)		(150)				
3	OA	550					550	Revenue
4	OA	(300)					(300)	Expenses
5	FA	(50)					(50)	Dividends
Total		300		(150)		250	200	

4. Net Income = Revenue $550 – Expenses $300 = $250

(moderate / LO: 3, 7 / application)

143. The balance sheet for Johnson Corporation as of December 31, 2006 is shown below.

Johnson Corporation
Balance Sheet
As of 12/31/2006

Cash	$260,000	Accounts Payable	$100,000
Accounts Receivable	76,000		
Certificate of Deposit	50,000		
Prepaid Rent	1,500		
Supplies	19,000	Contributed Capital	390,000
Land	400,000	Retained Earnings	339,500
Truck,Net	23,000		
Total Assets	829,500	Total Liab. & Equity	829,500

During 2007, the following transactions occurred:

1. On January 1, sold land for $400,000
2. On March 31, borrowed $10,000 from the bank
3. On April 15, purchased computer for $6,000
4. Performed services for customers on account during the year for $250,000
5. Collected $275,000 cash from accounts receivable
6. Incurred and paid operating expenses of $175,000 during the year
7. Took an inventory of supplies – $4,000 of supplies remained as of December 31
8. Distributed $20,000 cash to the owners

Required:

1. Using the accounting equation worksheet, record each transaction for the year 2007 and calculate the balances in each account. Note that the ending balances on the balance sheet become your beginning balances on your accounting equation for each account.
2. Indicate whether each cash transaction affects the Operating Activities, Investing Activities or the Financing Activities section of the Statement of Cash Flows.
3. Prepare a formal statement of cash flows for the year ending December 31, 2007.

Solution:

		Assets								=		Liabilities	+	Equity		
Event	OA IA FA	Cash	Accounts Receivable	Prepaid Rent	CD	Supplies	Land	Truck	Computer		Accounts Payable	Notes Payable		Contributed Capital	Retained Earnings	Description
Beg Bal		260,000	76,000	1,500	50,000	19,000	400,000	23,000			100,000			390,000	339,500	
1	IA	400,000					(400,000)									
2	FA	10,000										10,000				
3	IA	(6,000)							6,000							
4			250,000												250,000	Revenue
5	OA	275,000	(275,000)													
6	OA	(175,000)													(175,000)	Expenses
7						(15,000)									(15,000)	Supplies Expense
8	FA	(20,000)													(20,000)	Dividend
9																
10																
Total		744,000	51,000	1,500	50,000	4,000	0	23,000	6,000		100,000	10,000		390,000	379,500	
		879,500														879,500

3.

Johnson Corporation
Statement of Cash Flows
For the year ending December 31, 2007

Cash Provided by Operating Activities:		
Cash collected from customers	$ 275,000	
Cash paid for operating expenses	(175,000)	
Net Cash provided by operating activities		$ 100,000
Cash Provided by Investing Activities		
Cash Received for sale land	400,000	
Cash paid for computer	(6,000)	
Net Cash provided by Investing activities		394,000
Cash Provided by Financing Activities		
Cash proceeds from bank loan	10,000	
Cash dividends paid to stockholders	(20,000)	
Net Cash provided by Financing Activities		(10,000)
Net Change in cash		484,000
Beginning cash balance		260,000
Ending cash balance		$ 744,000

(moderate / LO: 5, 7 / application)

144. A condensed income statement for Target and Wal-Mart for the year ending January 1, 2004 is shown below. Use the financial information to answer the following questions:

CONSOLIDATED RESULTS OF OPERATIONS (i.e. Income Statement)	Target	Wal-Mart
(results are shown in millions)	2004	2004
Sales	$45,682	$ 256,329
Other Income	1,157	2,352
Total revenues	46,839	258,681
Cost of sales	31,445	198,747
Selling, general and administrative expense	11,793	44,909
Operating Income	3,601	15,025
Net interest expense	570	832
Earnings from continuing operations before income taxes	3,031	14,193
Provision for income taxes	1,146	5,118
Earnings from continuing operations	1,885	9,075
Non-operating Income & Expenses, Net	1,313	(21)
Net earnings	$3,198	$9,054
Average Number of Shares Outstanding	903.8	4,363.0

Required:

1. EPS is used by investors and analysts to gauge a company's profitability per unit of shareholder ownership and to compare companies in the same industry. Using the financial information provided above, calculate the EPS for Target and Wal-Mart.
2. How can EPS help you compare Target and Wal-Mart's financial performance?
3. As you can see by reviewing the condensed income statement, Wal-Mart's Sales are much higher than Target's. Is this an indication that Wal-Mart would be a better company to invest in than Target would be? Explain.

Answer:

1. EPS Target = $3,198/903.8 = $3.54 per share
   Wal-Mart = $9,054/4363 = $2.08 per share
2. When comparing the financial performance of two companies in the same industry, using the "raw numbers" given in the income statement ignores the fact that the two companies may undoubtedly have a different number of outstanding shares. Therefore, it makes more sense to look at earnings per share (EPS) for use as a comparison tool.
3. Even though Wal-Mart has higher sales and a higher net income than target, the overall EPS is significantly lower than that of Target. If EPS were the only variable that an investor was evaluating to determine whether to invest in a company, then

Target would look more attractive to the investor than Wal-Mart would. However, it is important to note here that EPS is only one of the many variables that an investor should look at. As we progress through the course, students will be exposed to many more ratios that they can use in their analysis.

(moderate / LO: 8 / comprehension)

145. The following transactions apply to Craun company for 2006:

1. Issued stock to investors for $75,000.
2. Purchased an office building for $105,000 by issuing a note to WACO Bank. The market value of the building at the time of purchase was $125,000.
3. Received $7,000 cash from a customer for services to be performed in 2007.
4. Earned $30,000 from services performed in 2006 all of which was received from the customer.
5. Incurred and paid $4,500 worth of operating expenses for 2006.
6. Paid $2,400 for an insurance policy that covers the business from January 1, 2007 through December 31, 2007.
7. Purchased $3,000 computer for $2,500 cash. The $500 savings was due to a special dealer discount that was given.
8. Paid dividends to the stockholders in the amount of $6,000.

Required:

1. Record each transaction in an accounting equation worksheet.
2. Review each transaction and identify the accounting principle or accounting assumption that apply.

Answer:

		Assets				=	Liabilities		+	Equity		
Event	OA IA FA	Cash	Prepaid Ins	Office Building	Computer		Unearned Revenue	Notes Payable		Common Stock	Retained Earnings	Description
Beg Bal												
1	FA	75,000								75,000		
2				105,000				105,000				
3	OA	7,000					7,000					
4	OA	30,000									30,000	Revenue
5	OA	(4,500)									(4,500)	Expenses
6	OA	(2,400)	2,400									
7	IA	(2,500)			2,500							
8	FA	(6,000)									(6,000)	Dividends
9												
10												
Total		96,600	2,400	105,000	2,500		7,000	105,000	0	75,000	19,500	
		206,500										206,500

Transaction #

1. Monetary unit assumption – cash value of common stock sale
2. Historical cost principle – market value of the asset is not taken into consideration when recording the sale but is recorded at its cost or the price paid for the asset
3. Revenue recognition principle – since revenue can only be recognized when it is earned, the cash received for the services becomes a liability until it is earned in 2007
4. Revenue recognition principle – revenue is recorded in the period in which it is earned
5. Matching principle – expenses are recognized in the period in which they generate the revenue
6. Matching principle – the insurance premium paid does not get expensed until 2007 as that is the period which it covers
7. Historical cost principle – the asset has to be recorded at cost regardless of whether a discount was given
8. Monetary unit assumption – dividend can be measured in monetary units and must be included in the financial statements

(moderate / LO: 1, 7 / comprehension)

146. For each of the controls described below, identify whether they are primarily a preventive, detective or corrective control.

1. Perform credit check on potential customer
2. Create budget variance reports for management to help identify possible problems
3. Require employees to use passwords to access the company's computer network
4. Management observes the distribution of payroll checks
5. On-line ordering system returns an error message when a customer inputs a product code that doesn't exist
6. Provide all employees with keys that will allow them to only enter the building for which they are authorized
7. Install a quality control team to improve the organization's production activities

Answer:

1. Preventive
2. Detective
3. Preventive
4. Preventive
5. Detective
6. Preventive
7. Corrective

(moderate / LO: 9 / comprehension)

147. On March 1, 2006, Delfia began Delfia Consulting with an initial investment of $6,925 in exchange for common stock. On March 31, 2006, the business records showed the following account balances:

Accounts Payable	$ 400	Office Equipment	$4,875
Accounts Receivable	2,050	Dividends	350
Cash	3,000	Rent Expense	1,500
Consulting Revenue	5,400	Salaries Expense	1,200
Notes Payable	500	Utilities Expense	250
Common Stock	6,925		

Required:

a. From the account balances given above, prepare the March Income statement in proper form.

Answer:

a.

Delfia Consulting
Income Statement
For the month ending March 31, 2006

Consulting Revenue		$ 5,400
Expenses:		
Rent Expense	1500	
Salaries Expense	1200	
Utilities Expense	250	
Total Expenses		$ 2,950
Net Income		$ 2,450

(moderate / LO: 3, 7 / application)

148. On March 1, 2006, Delfia began Delfia Consulting with an initial investment of $6,925 in exchange for common stock. On March 31, 2006, the business records showed the following account balances:

Accounts Payable	$ 400	Office Equipment	$4,875
Accounts Receivable	2,050	Dividends	350
Cash	3,000	Rent Expense	1,500
Consulting Revenue	5,400	Salaries Expense	1,200
Notes Payable	500	Utilities Expense	250
Common Stock	6,925		

Required:

a. From the account balances given above, prepare the Retained Earnings Statement for the month ending March 31, 2006. Note: you will have to compute net income).

Answer:

a.

Delfia Consulting
Statement of Retained Earnings
For the year ending March 31, 2006

Retained Earnings March 1, 2006	$ -
Add Net Income	2,450
Deduct Dividends	350
Retained Earnings March 31, 2006	$ 2,100

(moderate / LO: 4, 7 / application)

149. On March 1, 2006, Delfia began Delfia Consulting with an initial investment of $6,925 in exchange for common stock. On March 31, 2006, the business records showed the following account balances:

Accounts Payable	$ 400	Office Equipment	$4,875
Accounts Receivable	2,050	Dividends	350
Cash	3,000	Rent Expense	1,500
Consulting Revenue	5,400	Salaries Expense	1,200
Long Term Notes Payable	500	Utilities Expense	250
Common Stock	6,925		

Required:

a. From the account balances provided above, prepare the balance sheet for the month ending March 31, 2006 in proper form. Note: You will have to compute the March 31, 2006 ending owner's equity balance to complete the statement.

Answer:

a.

Delfia Consulting
Statement of Retained Earnings
For the year ending March 31, 2006

Retained Earnings March 1, 2006	$ -
Add Net Income	2,450
Deduct Diviends	350
Retained Earnings March 31, 2006	$ 2,100

Delfia Consulting
Balance Sheet
As of March 31, 2006

Assets:		
Current Assets:		
Cash	$ 3,000	
Accounts Receivable	2,050	
Total Current Assets		$ 5,050
Non-Current Assets		
Office Equipment		4,875
Total Assets		$9,925
Liabilities:		
Current Liabilities:		
Accounts Payable	$ 400	
Non-Current Liabilities:		
Notes Payable	500	
Total Liabilities		900
Shareholders' Equity:		
Common Stock	$ 6,925	
Retained Earnings	2,100	
Total Shareholders Equity		9,025
Total Liabilities & Shareholders Equity		$ 9,925

(moderate / LO: 2,3,7 / application)

150. All public companies that file on a national stock exchange must file an annual report with the Securities and Exchange Commission. In that annual report, the company must include an income statement, balance sheet, cash flow statement and a statement of changes in owner's equity. In addition to these statements, the company must provide notes to the financial statements which are meant to provide additional information concerning the statements. As a user of these financial statements, you may have several questions concerning the company. The following is list of questions that a user may ask. Identify where the user would be able to find the answer to each question from the information provided in the annual report. Use the following abbreviations for each answer: IS (income statement), BS (balance sheet), CF (cash flow statement), SE (statement of changes in shareholders' equity) and NT (notes to the financial statements). Identify all that apply.

1. How much cash was distributed to the owners in the form of a dividend?
2. What was the total revenue earned by the company?
3. How much cash was collected from the company's customers?
4. How much does the company owe in long-term debt?
5. How much was invested in the company by the owners?
6. What inventory method is the company using?
7. Has the company acquired any long-term assets (i.e. property, plant and equipment)?
8. What type of claims does the company have against its assets?

Answer:

1. CF, SE
2. IS
3. CF
4. BS
5. BS, SE
6. NT
7. BS, CF
8. BS

(moderate / LO: 2, 3, 4 , 5 / knowledge)

151. The Chandelier Corporation is a small privately owned corporation that sells lighting equipment. The company has grown significantly in the past year and now needs to hire a bookkeeper to take care of the accounts receivable functions. The duties of the bookkeeper will include billing the customer, collecting the mail and recording customer payments, monitoring past due accounts and preparing monthly reports. The owner of Chandelier is excited about hiring additional staff to help him out, however he is concerned with losing control over the company's cash. He therefore has you, his accountant give him some advice on what kind of controls he can put in place to reduce any risks that he might encounter.

Required:

a. Identify any preventive, detective or corrective controls that Chandelier can have in place prior to hiring the new bookkeeper that will help reduce his risk of loss.

Preventive –

1. Provide customer with a pre-numbered remittance advice for all payments
2. Have separate individual open mail and record payments in a ledger, then forward the payments on to the bookkeeper

Corrective –

1. Reconcile invoices to customer accounts

Detective –

1. Have accountant review customer accounting records each quarter
2. Have owner review all accounts receivable reports at the end of each month
3. Have owner or accountant reconcile the bank account each month

(difficult / LO: 9 / comprehension)

	Level 1 Easy Knowledge	Level 2 Moderate Comprehension	Level 3 Moderate Application	Level 4 Difficult Analysis Synthesis Evaluation	Totals
Multiple Choice Questions	1, 7, 8, 9, 10, 11, 12, 13, 16, 17, 21, 32, 34, 35, 36, 38, 39, 40, 48, 49, 50, 51, 54, 57	2, 3, 4 5, 6, 14, 15, 18, 19, 20, 22, 23, 24, 27, 28, 29, 30, 33, 37, 42, 43, 44, 71	26, 31, 45, 46, 47, 52, 53, 55, 56, 58, 59, 60, 61, 62, 63, 64, 65, 66, 67, 68, 69, 20, 72, 73, 74, 75	25, 41	**75**
True/False Questions	86, 87, 88, 89, 90,91, 92, 93, 94, 95, 96, 97, 98, 99, 103, 104, 107, 108, 109	100, 101, 102, 105, 106, 110			**25**
Problems	127, 150	131, 135, 136, 137, 140, 144, 145, 146, 151	122, 123, 124, 126, 130, 132, 133, 138, 139, 141, 142, 143, 147, 148, 149	125, 128, 129, 134	**30**
Matching Questions	76, 77, 78, 79, 80, 81, 82, 83, 84,85				**10**
Essay Questions	113, 114, 116, 118, 121	111, 115, 117, 119, 120	112		**11**

Totals **151**