

CHAPTER 2

A FURTHER LOOK AT FINANCIAL STATEMENTS

SUMMARY OF QUESTIONS BY STUDY OBJECTIVE AND BLOOM'S TAXONOMY

Item	SO	BT	Item	SO	BT	Item	SO	BT	Item	SO	BT	Item	SO	BT
True-False Statements														
1.	1	K	12.	3	C	23.	5	K	34.	7	K	45.	7	K
2.	1	K	13.	3	C	24.	5	K	35.	7	C	46.	7	K
3.	1	K	14.	3	K	25.	5	C	36.	7	K	47.	7	K
4.	1	K	15.	4	K	26.	6	K	37.	7	K	48.	7	K
5.	1	C	16.	4	C	27.	6	K	38.	7	C	49.	7	C
6.	1	K	17.	4	K	28.	6	K	39.	7	K	50.	7	K
7.	1	C	18.	4	K	29.	7	K	40.	7	K	51.	7	C
8.	2	K	19.	4	K	30.	7	K	41.	7	K	52.	7	C
9.	2	C	20.	5	K	31.	7	K	42.	7	K	53.	7	K
10.	2	K	21.	5	K	32.	7	C	43.	7	K	54.	7	K
11.	3	K	22.	5	K	33.	7	K	44.	7	K	55.	7	K
Multiple Choice Questions														
56.	1	K	83.	4	AP	110.	4	C	137.	4	AP	163.	7	K
57.	1	K	84.	4	AP	111.	4	K	138.	4	AP	164.	7	C
58.	1	K	85.	1	AP	112.	4	K	139.	4	AP	165.	7	C
59.	1	K	86.	1	AP	113.	4	K	140.	5	K	166.	7	C
60.	1	K	87.	1	AP	114.	4	K	141.	5	K	167.	7	K
61.	1	K	88.	1	AP	115.	4	C	142.	5	K	168.	7	C
62.	1	K	89.	1	AP	116.	4	C	143.	5	K	169.	7	C
63.	1	K	90.	4	AP	117.	4	K	144.	5	AP	170.	7	C
64.	1	K	91.	4	AP	118.	4	K	145.	5	AP	171.	7	C
65.	1	K	92.	2	K	119.	1	AP	146.	6	K	172.	7	K
66.	1	K	93.	2	AP	120.	4	AP	147.	6	K	173.	7	C
67.	1	K	94.	2	AP	121.	4	AP	148.	6	K	174.	7	C
68.	1	K	95.	2	K	122.	4	AP	149.	7	K	175.	7	K
69.	1	K	96.	2	K	123.	2	AP	150.	7	K	176.	7	K
70.	1	K	97.	2	C	124.	4	AP	151.	7	K	177.	7	K
71.	1	K	98.	3	K	125.	4	AP	152.	7	K	178.	7	K
72.	1	AP	99.	3	K	126.	4	AP	153.	7	K	179.	7	C
73.	1	K	100.	3	C	127.	2	AP	154.	7	K	180.	7	K
74.	1	K	101.	3	C	128.	4	AP	155.	7	K	181.	7	K
75.	1	AP	102.	3	C	129.	4	K	156.	7	K	182.	7	K
76.	1	AP	103.	3	AP	130.	4	K	157.	7	K	183.	7	K
77.	1	AP	104.	3	AP	131.	4	K	158.	7	K	184.	7	K
78.	4	AP	105.	3	AN	132.	4	C	159.	7	K	185.	7	C
79.	4	AP	106.	3	AN	133.	4	C	160.	7	K	186.	7	C
80.	1	AP	107.	4	K	134.	4	C	161.	7	K	187.	7	K
81.	1	AP	108.	4	K	135.	4	C	162.	7	K	188.	7	K
82.	1	AP	109.	4	K	136.	4	AP						
Brief Exercises														
189.	1	AP	191.	3	C	193.	7	K	195.	7	C	197.	7	C
190.	2	AP	192.	4	AP	194.	7	K	196.	7	C	198.	7	K
Exercises														
199.	1	AP	201.	2	AP	203.	1, 2,		205.	2, 4	AP	207.	2, 4,	
200.	1	K	202.	1, 2,			4	AP	206.	2, 4	AP		5	K
				3	AP	204.	2, 4	AP				208.	2, 4	AP

Completion Statements														
209.	6	K	211.	7	K	213.	4	K	215.	4	K	216.	5	K
210.	7	K	212.	7	K	214.	1	K						
Matching														
217.	1-7	K												
Short Answer Essay														
218.	7	C	220.	7	C	222.	7	K	224.	4	E	225.	7	E
219.	7	C	221.	7	K	223.	1, 4	K						

SUMMARY OF STUDY OBJECTIVES BY QUESTION TYPE

<u>S.O. 1</u>		<u>S.O. 2</u>		<u>S.O. 3</u>		<u>S.O. 4</u>		<u>S.O. 4</u>	
<u>Item</u>	<u>Type</u>	<u>Item</u>	<u>Type</u>	<u>Item</u>	<u>Type</u>	<u>Item</u>	<u>Type</u>	<u>Item</u>	<u>Type</u>
1.	TF	8.	TF	11.	TF	15.	TF	205.	Ex
2.	TF	9.	TF	12.	TF	16.	TF	206.	Ex
3.	TF	10.	TF	13.	TF	17.	TF	207.	Ex
4.	TF	92.	MC	14.	TF	18.	TF	208.	Ex
5.	TF	93.	MC	98.	MC	19.	TF	213.	C
6.	TF	94.	MC	99.	MC	78.	MC	215.	C
7.	TF	95.	MC	100.	MC	79.	MC		
56.	MC	96.	MC	101.	MC	83.	MC		
57.	MC	97.	MC	102.	MC	84.	MC		
58.	MC	123.	MC	103.	MC	90.	MC		
59.	MC	127.	MC	104.	MC	91.	MC		
60.	MC	190.	Be	105.	MC	107.	MC		
61.	MC	201.	Ex	106.	MC	108.	MC		
62.	MC	202.	Ex	191.	Be	109.	MC		
63.	MC	203.	Ex	202.	Ex	110.	MC		
64.	MC	204.	Ex			111.	MC		
65.	MC	205.	Ex			112.	MC		
66.	MC	206.	Ex			113.	MC		
67.	MC	207.	Ex			114.	MC		
68.	MC	208.	Ex			115.	MC		
69.	MC					116.	MC		
70.	MC					117.	MC		
71.	MC					118.	MC		
72.	MC					120.	MC		
73.	MC					121.	MC		
74.	MC					122.	MC		
75.	MC					124.	MC		
76.	MC					125.	MC		
77.	MC					126.	MC		
80.	MC					128.	MC		
81.	MC					129.	MC		
82.	MC					130.	MC		
85.	MC					131.	MC		
86.	MC					132.	MC		
87.	MC					133.	MC		
88.	MC					134.	MC		
89.	MC					135.	MC		
119.	MC					136.	MC		
189.	Be					137.	MC		
199.	Ex					138.	MC		
200.	Ex					139.	MC		
202.	Ex					192.	Be		
203.	Ex					203.	Ex		
214.	C					204.	Ex		

<u>S.O. 5</u>		<u>S.O. 6</u>		<u>S.O. 7</u>		<u>S.O. 7</u>	
<u>Item</u>	<u>Type</u>	<u>Item</u>	<u>Type</u>	<u>Item</u>	<u>Type</u>	<u>Item</u>	<u>Type</u>
20	TF	26.	TF	29.	TF	163.	MC
21.	TF	27.	TF	30.	TF	164.	MC
22.	TF	28.	TF	31.	TF	165.	MC
23.	TF	146.	MC	32.	TF	166.	MC
24.	TF	147.	MC	33.	TF	167.	MC
25.	TF	148.	MC	34.	TF	168.	MC
140.	MC	209.	C	35.	TF	169.	MC
141.	MC			36.	TF	170.	MC
142.	MC			37.	TF	171.	MC
143.	MC			38.	TF	172.	MC
144.	MC			39.	TF	173.	MC
145.	MC			40.	TF	174.	MC
207.	Ex			41.	TF	175.	MC
216.	C			42.	TF	176.	MC
				43.	TF	177.	MC
				44.	TF	178.	MC
				45.	TF	179.	MC
				46.	TF	180.	MC
				47.	TF	181.	MC
				48.	TF	182.	MC
				49.	TF	183.	MC
				50.	TF	184.	MC
				51.	TF	185.	MC
				52.	TF	186.	MC
				53.	TF	187.	MC
				54.	TF	188.	MC
				55.	TF	193.	Be
				149.	MC	194.	Be
				150.	MC	195.	Be
				151.	MC	196.	Be
				152.	MC	197.	Be
				153.	MC	198.	Be
				154.	MC	210.	C
				155.	MC	211.	C
				156.	MC	212.	C
				157.	MC		
				158.	MC		
				159.	MC		
				160.	MC		
				161.	MC		
				162.	MC		

Note: TF = True-False C = Completion Ex = Exercises
 MC = Multiple Choice Be = Brief Exercise

The chapter also contains one set of twelve Matching questions and six Short-Answer Essay questions.

CHAPTER STUDY OBJECTIVES

1. **Identify the sections of a classified balance sheet.** In a classified balance sheet, companies classify assets as current assets; long-term investments; property, plant, and equipment; or intangibles. They classify liabilities as either current or long-term. A stockholders' equity section shows common stock and retained earnings.
2. **Identify and compute ratios for analyzing a company's profitability.** Profitability ratios, such as earnings per share (EPS), measure aspects of the operating success of a company for a given period of time.
3. **Explain the relationship between a retained earnings statement and a statement of stockholders' equity.** The retained earnings statement presents the factors that changed the retained earnings balance during the period. A statement of stockholders' equity presents the factors that changed stockholders' equity during the period, including those that changed retained earnings. Thus, a statement of stockholders' equity is more inclusive.
4. **Identify and compute ratios for analyzing a company's liquidity and solvency using a balance sheet.** Liquidity ratios, such as the current ratio, measure the short-term ability of a company to pay its maturing obligations and to meet unexpected needs for cash. Solvency ratios, such as the debt to total assets ratio, measure the ability of an enterprise to survive over a long period.
5. **Use the statement of cash flows to evaluate solvency.** Free cash flow indicates a company's ability to generate cash from operations that are sufficient to pay debts, acquire assets, and distribute dividends.
6. **Explain the meaning of generally accepted accounting principles.** Generally accepted accounting principles are a set of rules and practices recognized as a general guide for financial reporting purposes. The basic objectives of financial reporting is to provide information that is useful for decision making.
7. **Discuss financial reporting concepts.** To be judged useful, information should possess these qualitative characteristics relevance, reliability, comparability, and consistency.

The *monetary unit assumption* requires that companies include in the accounting records of the economic entity only transaction data capable of being expressed in terms of money. The *economic entity assumption* states that economic events can be identified with a particular unit of accountability. The *time period assumption* states that the economic life of a business can be divided into artificial time periods and that meaningful accounting reports can be prepared for each period. The *going concern assumption* states that the enterprise will continue in operation long enough to carry out its existing objectives and commitments.

The *cost principle* states that the companies should record assets at their cost. The *full disclosure principle* dictates that companies disclose circumstances and events that matter to financial statement users.

The major constraints are materiality and conservatism.

TRUE-FALSE STATEMENTS

1. Cash and supplies are both classified as current assets.
2. Long-term investments appear in the property, plant, and equipment section of the balance sheet.
3. A liability is classified as a current liability if it is to be paid within the coming year.
4. Stockholders' equity is divided into two parts: common stock and retained earnings.
5. It is possible for an asset to be a current asset even though the expected conversion of that asset into cash is to be longer than one year or the normal operating cycle.
6. The investment category on the balance sheet normally includes investments that are intended to be held for a short period of time (less than one year).
7. The main difference between intangible assets and property, plant and equipment is the length of the asset's life.
8. Profitability means having enough funds on hand to pay debts when they fall due.
9. Earnings per share is calculated by dividing net income minus preferred stock dividends for the period by the average number of common shares outstanding during the period.
10. Earnings per share measures the net income earned on each share of common stock.
11. The retained earnings statement describes the changes in retained earnings during the period.
12. The retained earnings statement is more comprehensive than the statement of shareholders equity.
13. Revenues have the effect of increasing retained earnings.
14. Most companies use a retained earnings statement rather than a statement of stockholders' equity.
15. The excess of current assets over current liabilities is called working capital.
16. The current ratio takes into account the composition of current assets.
17. Solvency ratios measure the short-term ability of the company to pay its maturing obligations.
18. The debt to total assets ratio measures the percentage of assets financed by creditors.
19. Two primary objectives of management are to achieve profitability and liquidity.
20. Companies get cash from just two sources: operating activities and financing activities.
21. Both investors and creditors have an interest in a company's ability to generate favorable cash flows.
22. The statement of cash flows is divided into two sections corresponding to investing activities and financing activities.
23. The statement of cash flows discloses significant events related to the operating, investing, and financing activities of a business.
24. Free cash flow is cash from operations less dividends.

25. Long term creditors consider a high free cash flow amount an indication of solvency.
26. The primary accounting standard-setting body in the United States is the Securities and Exchange Commission.
27. Generally accepted accounting principles are rules and practices that are recognized as a general guide for financial reporting purposes.
28. GAAP stands for generally accepted accounting procedures.
29. To be reliable, accounting information should predict future events, confirm prior expectations, and be reported on a timely basis.
30. In order for information to be relevant, it must be reported on a monthly basis.
31. For information to be useful, it must be both relevant and reliable.
32. Consistent use of the same accounting principles and methods is necessary for meaningful analysis of trends within a company.
33. A major function of management is to provide the accountant with relevant and useful information.
34. The advantage of accounting information is that it provides exact and completely reliable measures.
35. Consistency in accounting means that a company uses the same generally accepted accounting principles from one accounting period to the next accounting period.
36. The convention of consistency pertains to the use of the same accounting principles by firms in the same industry.
37. The time period assumption states that the business will remain in operation for the foreseeable future.
38. If a building is offered for sale at \$100,000 and the buyer pays \$95,000 cash for it, the buyer would record the building at \$100,000.
39. The most generally accepted value used in accounting is market value.
40. For accounting purposes, business transactions should be kept separate from the personal transactions of the stockholders of the business.
41. The economic entity assumption states that economic events can be identified with a particular unit of accountability.
42. The economic entity assumption states that assets should be recorded at their cost.
43. The monetary unit assumption states that transactions that can be measured in terms of money should be recorded in the accounting records.
44. The monetary unit assumption has led to an increase in the notes to financial statements.
45. The going concern assumption is that the business will continue in operation long enough to carry out its existing objectives and commitments.
46. When preparing financial statements, the accountant assumes that the business will stay in business for the foreseeable future.
47. Full disclosure of all important facts aids in overcoming the limitations of accounting information.

48. The economic entity assumption is that an enterprise will remain in operations for the foreseeable future.
49. A common application of the materiality constraint is in the valuing of inventory at market value if market value is below cost.
50. Materiality and conservatism are two constraints in accounting.
51. The concept of materiality requires a large company to record the purchase of a \$10 wastepaper basket as an asset and depreciate it over its useful life.
52. The concept of materiality permits a large company to report amounts in its financial statements to the nearest thousand of dollars.
53. Conservatism in accounting means the accountant should understate assets and income.
54. A material item is one that is likely to affect a user's decision.
55. The conservatism constraint should not be used when the accountant is confident of a particular measure.

Answers to True-False Statements

1. T	13. T	25. T	37. F	49. F
2. F	14. F	26. F	38. F	50. T
3. T	15. T	27. T	39. F	51. F
4. T	16. F	28. F	40. T	52. T
5. F	17. F	29. F	41. T	53. F
6. F	18. T	30. F	42. F	54. T
7. F	19. T	31. T	43. T	55. F
8. F	20. F	32. T	44. F	
9. T	21. T	33. F	45. T	
10. T	22. F	34. F	46. T	
11. T	23. T	35. T	47. T	
12. F	24. F	36. F	48. F	

MULTIPLE CHOICE QUESTIONS

56. In a classified balance sheet, assets are usually classified as:
 - a. current assets; long-term assets; property, plant, and equipment; and intangible assets.
 - b. current assets; long-term investments; property, plant, and equipment; and common stocks.
 - c. current assets; long-term investments; tangible assets; and intangible assets.
 - d. current assets; long-term investments; property, plant, and equipment; and intangible assets.
57. On a classified balance sheet, marketable securities are classified as
 - a. an intangible asset.
 - b. property, plant, and equipment.
 - c. a current asset.
 - d. a long-term investment.

-
58. A current asset is
- the last asset purchased by a business.
 - an asset which is currently being used to produce a product or service.
 - usually found as a separate classification in the income statement.
 - expected to be converted to cash or used in the business within a relatively short period of time.
59. Which of the following is **not** classified properly as a current asset?
- Supplies
 - Marketable securities
 - A fund to be used to purchase a building within the next year
 - A receivable from the sale of an asset to be collected in two years
60. An intangible asset
- derives its value from the rights and privileges it provides the owner.
 - is worthless because it has no physical substance.
 - is converted into a tangible asset during the operating cycle.
 - cannot be classified on the balance sheet because it lacks physical substance.
61. Which of the following is **not** considered an asset?
- Equipment
 - Dividends
 - Accounts receivable
 - Inventory
62. Trademarks would appear in which balance sheet section?
- Intangible assets
 - Investments
 - Property, plant, and equipment
 - Current assets
63. Liabilities are generally classified on a balance sheet as
- small liabilities and large liabilities.
 - present liabilities and future liabilities.
 - tangible liabilities and intangible liabilities.
 - current liabilities and long-term liabilities.
64. Which of the following would **not** be classified as a long-term liability?
- Current maturities of long-term debt
 - Bonds payable
 - Mortgage payable
 - Lease liabilities
65. Which of the following is not a current liability?
- Wages payable
 - Accounts payable
 - Taxes payable
 - Bonds payable

66. Office equipment is classified on the balance sheet as
- a current asset.
 - property, plant, and equipment.
 - an intangible asset.
 - a long-term investment.
67. It is **not** true that current assets are resources that are expected to be
- realized in cash within one year.
 - sold within one year.
 - consumed within one year.
 - acquired within one year.
68. The operating cycle of a company is the average time that is required to go from cash to
- sales in producing revenues.
 - cash in producing revenues.
 - inventory in producing revenues.
 - accounts receivable in producing revenues.
69. On a classified balance sheet, companies usually list current assets
- in alphabetical order.
 - with the largest dollar amounts first.
 - in the order in which they are expected to be converted into cash.
 - in the order of acquisition.
70. Intangible assets are
- listed directly under current assets on the balance sheet.
 - not listed on the balance sheet because they do not have physical substance.
 - listed after property, plant, and equipment.
 - listed as a long-term investment on the balance sheet.
71. Which statement about long-term investments is not true?
- They will be held for more than one year.
 - They are not currently used in the operation of the business.
 - They include investments in stock of other companies and land held for future use.
 - They can never include cash accounts.

72. These are selected account balances on December 31, 2007.

Land (location of the corporation's office building)	\$100,000
Land (held for future use)	150,000
Corporate Office Building	600,000
Inventory	200,000
Equipment	450,000
Office Furniture	100,000
Accumulated Depreciation	300,000

What is the total amount of property, plant, and equipment that will appear on the balance sheet?

- \$1,300,000
- \$1,100,000
- \$1,600,000
- \$950,000

73. What is the order in which assets are generally listed on a classified balance sheet?
- current and long-term
 - current; property, plant and equipment; long-term investments; intangibles
 - current; property, plant and equipment; intangibles; long-term investments
 - current; long-term investments; property, plant and equipment, intangibles
74. Which of the following is not an alternative means of expressing ratio relationships?
- proportion
 - qualitative
 - rate
 - percentage

Use the following information to answer questions 75–79:

Benton Office Supplies
Balance Sheet
December 31, 2007

Cash	\$ 65,000	Accounts Payable	\$ 70,000
Prepaid Insurance	30,000	Salaries Payable	10,000
Accounts Receivable	50,000	Mortgage Payable	<u>90,000</u>
Inventory	70,000	Total Liabilities	\$160,000
Land held for investment	75,000		
Land	90,000		
Building	\$100,000	Common Stock	\$120,000
Less Accumulated		Retained Earnings	<u>250,000</u>
Depreciation	<u>(20,000)</u>	Total stockholders' equity	<u>\$370,000</u>
Trademark	<u>70,000</u>	Total Liabilities and	
Total Assets	<u>\$530,000</u>	Stockholders' Equity	<u>\$530,000</u>

75. The total dollar amount of assets to be classified as current assets is
- \$290,000.
 - \$215,000.
 - \$180,000.
 - \$145,000.
76. The total dollar amount of assets to be classified as property, plant, and equipment is
- \$320,000.
 - \$170,000.
 - \$245,000.
 - \$190,000.
77. The total dollar amount of assets to be classified as investments is
- \$0.
 - \$150,000.
 - \$75,000.
 - \$180,000.
78. The total amount of working capital is
- \$135,000.
 - \$295,000.
 - \$75,000.
 - \$60,000.

79. The current ratio is
- 1.94 : 1.
 - 1.57 : 1.
 - 3.14 : 1.
 - 2.69 : 1.

Use the following information to answer questions 80–84:

Acme Auto Supplies
Balance Sheet
December 31, 2007

Cash	\$	60,000	Accounts Payable		\$ 65,000
Prepaid Insurance		40,000	Salaries Payable		10,000
Accounts Receivable		50,000	Mortgage Payable		<u>90,000</u>
Inventory		70,000	Total Liabilities		\$165,000
Land held for investment		80,000			
Land		95,000			
Building	\$100,000		Common Stock		\$120,000
Less Accumulated			Retained Earnings		<u>250,000</u>
Depreciation	<u>(30,000)</u>	70,000	Total stockholders' equity		<u>\$370,000</u>
Trademark		<u>70,000</u>	Total Liabilities and		
Total Assets		<u>\$535,000</u>	Stockholders' Equity		<u>\$535,000</u>

80. The total dollar amount of assets to be classified as current assets is
- \$220,000.
 - \$150,000.
 - \$300,000.
 - \$180,000.
81. The total dollar amount of assets to be classified as property, plant, and equipment is
- \$315,000.
 - \$245,000.
 - \$165,000.
 - \$195,000.
82. The total dollar amount of assets to be classified as investments is
- \$0.
 - \$150,000.
 - \$80,000.
 - \$180,000.
83. The total amount of working capital is
- \$155,000.
 - \$145,000.
 - \$60,000.
 - \$150,000.
84. The current ratio is
- 1.86 : 1.
 - 2.00 : 1.
 - 3.38 : 1.
 - 2.93 : 1.

85. L2 Corporation has assets of \$2.7 million, common stock of \$702,000, and retained earnings of \$428,000. What are the creditors' claims on their assets?
- \$2,426,000
 - \$1,130,000
 - \$1,570,000
 - \$2,974,000
86. M3 Corporation has assets of \$1.35 million, common stock of \$351,000, and retained earnings of \$214,000. What are the creditors' claims on their assets?
- \$1,213,000
 - \$ 565,000
 - \$ 785,000
 - \$1,487,000

Use the following information to answer questions 87–91:

Cain Auto Supplies
Balance Sheet
December 31, 2007

Cash	\$	50,000	Accounts Payable		\$ 55,000
Prepaid Insurance		30,000	Salaries Payable		10,000
Accounts Receivable		40,000	Mortgage Payable		<u>90,000</u>
Inventory		70,000	Total Liabilities		\$155,000
Land held for investment		80,000			
Land		75,000			
Building	\$110,000		Common Stock		\$120,000
Less Accumulated			Retained Earnings		<u>250,000</u>
Depreciation	<u>(20,000)</u>	90,000	Total stockholders' equity		<u>\$370,000</u>
Trademark		<u>70,000</u>	Total Liabilities and		
Total Assets		<u>\$525,000</u>	Stockholders' Equity		<u>\$525,000</u>

87. The total dollar amount of assets to be classified as current assets is
- \$270,000.
 - \$120,000.
 - \$190,000.
 - \$130,000.
88. The total dollar amount of assets to be classified as property, plant, and equipment is
- \$335,000.
 - \$255,000.
 - \$205,000.
 - \$165,000.
89. The total dollar amount of assets to be classified as investments is
- \$0.
 - \$155,000.
 - \$80,000.
 - \$185,000.

90. The total amount of working capital is
- \$205,000.
 - \$125,000.
 - \$50,000.
 - \$80,000.
91. The current ratio is
- 1.85 : 1.
 - 2.92 : 1.
 - 4.15 : 1.
 - 1.07 : 1.
92. A measure of profitability is the
- current ratio.
 - debt to total assets ratio.
 - earnings per share.
 - working capital.
93. For 2007 Mossland Corporation reported net income of \$28,000; net sales \$400,000; and average share outstanding 6,000. There were no preferred stock dividends. What was the 2007 earnings per share?
- \$4.67
 - \$0.25
 - \$66.67
 - \$14.86
94. For 2007 Landford Corporation reported net income of \$30,000; net sales \$400,000; and average share outstanding 6,000. There were no preferred stock dividends. What was the 2007 earnings per share?
- \$4.66
 - \$0.20
 - \$66.67
 - \$5.00
95. Earnings per share are calculated by dividing
- gross profit by average common shares outstanding.
 - (net income less preferred stock dividends) by average common shares outstanding.
 - net income by average common shares outstanding.
 - net sales by average common shares outstanding.
96. The three ways that ratios can be expressed are
- as a percentage, a rate, and as a simple proportion.
 - as a dollar amount, a rate, and as a proportion.
 - as a decimal, a whole number, and as a proportion.
 - not known.
97. Which of the following statements is true?
- Earnings per share is an internal measure and is not used by shareholders.
 - The denominator used in computing earnings per share represents the shares of common stock outstanding on the last day of the accounting period.
 - Net income is not adjusted when computing earnings per share.
 - By comparing earnings per share of a single corporation over time, a shareholder can evaluate the corporation's relative earnings performance.

-
98. Most companies use a(n) _____ rather than a retained earnings statement.
- balance sheet
 - income statement
 - statement of cash flows
 - statement of stockholders' equity
99. Dividends appear on
- the retained earnings statement only.
 - the income statement only.
 - both the retained earnings statement and the balance sheet.
 - the balance sheet only.
100. Issuing new shares of common stock will
- increase retained earnings.
 - decrease retained earnings.
 - increase common stock.
 - decrease common stock.
101. Declaring a cash dividend will
- increase retained earnings.
 - decrease retained earnings.
 - increase common stock.
 - decrease common stock.
102. Reporting a net income of \$95,000 will
- increase retained earnings.
 - decrease retained earnings.
 - increase common stock.
 - decrease common stock.
103. Liondale Corporation had beginning retained earnings of \$2,292,000 and ending retained earnings of \$2,499,000. During the year they issued common stock totaling \$141,000. What was their net income for the year?
- \$207,000
 - \$ 66,000
 - \$348,000
 - \$273,000
104. Morten Corporation had beginning retained earnings of \$764,000 and ending retained earnings of \$833,000. During the year they issued common stock totaling \$47,000. What was their net income for the year?
- \$69,000
 - \$22,000
 - \$116,000
 - \$91,000

105. At December 31, 2007 Shorts Company had retained earnings of \$2,184,000. During 2007 they issued stock for \$98,000, and paid dividends of \$34,000. Net income for 2007 was \$402,000. The retained earnings balance at the beginning of 2007 was:
- \$2,552,000
 - \$1,816,000
 - \$1,914,000
 - \$2,454,000
106. At December 31, 2007 Long Company had retained earnings of \$1,092,000. During 2007 they issued stock for \$49,000, and paid dividends of \$17,000. Net income for 2007 was \$201,000. The retained earnings balance at the beginning of 2007 was:
- \$1,276,000
 - \$908,000
 - \$957,000
 - \$1,227,000
107. The relationship between current assets and current liabilities is important in evaluating a company's
- profitability.
 - liquidity.
 - market value.
 - solvency.
108. Which of the following is a measure of liquidity?
- Working capital
 - Profit margin
 - Earnings per share
 - Debt to equity ratio
109. Current assets divided by current liabilities is known as the
- working capital.
 - current ratio.
 - profit margin.
 - capital structure.
110. The most important information needed to determine if companies can pay their current obligations is the
- net income for this year.
 - projected net income for next year.
 - relationship between current assets and current liabilities.
 - relationship between short-term and long-term liabilities.
111. A short-term creditor is primarily interested in the _____ of the borrower.
- liquidity
 - profitability
 - consistency
 - solvency

112. The current ratio is
- current assets plus current liabilities.
 - current assets minus current liabilities.
 - current assets divided by current liabilities.
 - current assets times current liabilities.
113. Working capital is calculated by taking
- current assets plus current liabilities.
 - current assets minus current liabilities.
 - current assets divided by current liabilities.
 - current assets times current liabilities.
114. Working capital is a measure of
- consistency.
 - liquidity.
 - profitability.
 - solvency.
115. Long-term creditors are usually most interested in evaluating
- liquidity and profitability.
 - consistency and profitability.
 - liquidity and solvency.
 - consistency and solvency.
116. A liquidity ratio measures the
- income or operating success of a company over a period of time.
 - ability of a company to survive over a long period of time.
 - short-term ability of a company to pay its maturing obligations and to meet unexpected needs for cash.
 - percentage of total financing provided by creditors.
117. Working capital is
- calculated by dividing current assets by current liabilities.
 - used to evaluate a company's liquidity and short-term debt paying ability.
 - used to evaluate a company's solvency and long-term debt paying ability.
 - calculated by subtracting current assets from current liabilities.
118. The ability of a business to pay obligations that are expected to become due within the next year or operating cycle is
- leverage.
 - liquidity.
 - profitability.
 - wealth.
119. Based on the following data, what is the amount of current assets?

Accounts payable.....	\$31,000
Accounts receivable.....	50,000
Cash.....	15,000
Intangible assets.....	50,000
Inventory.....	69,000
Long-term investments.....	80,000

Long-term liabilities.....	100,000
Marketable securities.....	40,000
Notes payable.....	28,000
Plant assets.....	670,000
Prepaid expenses.....	1,000

- a. \$ 96,000
- b. \$175,000
- c. \$106,000
- d. \$105,000

120. Based on the following data, what is the amount of working capital?

Accounts payable.....	\$32,000
Accounts receivable.....	57,000
Cash.....	20,000
Intangible assets.....	50,000
Inventory.....	69,000
Long-term investments.....	80,000
Long-term liabilities.....	100,000
Marketable securities.....	40,000
Notes payable (short-term).....	28,000
Plant assets.....	670,000
Prepaid expenses.....	1,000

- a. \$127,000
- b. \$151,000
- c. \$170,000
- c. \$148,000

Use the following balance sheet and income statement information to answer questions 121–124:

Current assets	\$ 7,000	Net income	\$ 12,000
Current liabilities	4,000	Stockholders' equity	27,000
Average assets	40,000	Total liabilities	9,000
Total assets	30,000		

Average common shares outstanding was 10,000

121. What is the total amount of working capital?

- a. \$1,000
- b. \$7,000
- c. \$2,000
- d. \$3,000

122. What is the current ratio?

- a. 1.75 : 1
- b. 1.6 : 1
- c. 0.57 : 1
- d. 2 : 1

123. What is the earnings per share?
 a. \$3.60
 b. \$4.00
 c. \$1.20
 d. \$0.83
124. What is the debt to total assets?
 a. 22.5 percent
 b. 13 percent
 c. 75 percent
 d. 30 percent

Use the following balance sheet and income statement information to answer questions 125–128:

Current assets	\$ 9,000	Net income	\$ 12,000
Current liabilities	4,000	Stockholders' equity	27,000
Average assets	44,000	Total liabilities	6,000
Total assets	30,000		

Average common shares outstanding was 10,000

125. What is the total amount of working capital?
 a. \$9,000
 b. \$7,000
 c. \$5,000
 d. \$2,000
126. What is the current ratio?
 a. 1.75 : 1
 b. 2.00 : 1
 c. 0.44 : 1
 d. 2.25: 1
127. What is the earnings per share?
 a. \$1.20
 b. \$2.00
 c. \$0.83
 d. \$0.44
128. What is the debt to total assets?
 a. 13.6 percent
 b. 20 percent
 c. 75 percent
 d. 27.3 percent
129. The debt to total assets ratio is computed by dividing
 a. long-term liabilities by total assets.
 b. long-term liabilities by average assets.
 c. total liabilities by total assets.
 d. total liabilities by average assets.

130. A useful measure of solvency is the
- current ratio.
 - earnings per share.
 - return on assets ratio.
 - debt to total assets ratio.
131. Which of the following is **not** considered a measure of liquidity?
- Current ratio
 - Working capital
 - Debt to total assets ratio
 - Each of the above are liquidity measures
132. Which measure would a long-term creditor be least interested in reviewing?
- free cash flow
 - debt to total assets ratio
 - current ratio
 - solvency measure
133. M Corporation has a debt to total assets ratio of 73%. This tells the user of M's financial statements
- M is getting a 27% return on its assets.
 - There is a risk that M cannot pay its debts as they come due.
 - 73% of the assets are financed by the stockholders.
 - Based on this measure, the user should not invest in M.
134. Sun Company is a retail store. Due to competition, it is having trouble selling its products. Thus, inventory has been building up. Sun's current ratio has not changed for the past three years, in spite of the inventory build up. Which of the following statements is true?
- As long as the current ratio remains constant, there is no need for concern.
 - The composition of current assets and current liabilities does not matter.
 - The management of Sun should consider the affect of slow moving inventory on its liquidity.
 - Since inventory is a current asset, any increases should automatically cause the current ratio to rise.
135. How can a company improve its current ratio?
- Work with a creditor to reclassify some current debt into long-term debt
 - Use cash to reduce current liabilities
 - Nothing can ethically be done to improve the current ratio
 - Use excess cash to buy new equipment

Use the following information to answer questions #136 and 137.

Simpson Corporation has current assets of \$1,250,000 and current liabilities of \$750,000.

136. If they pay \$250,000 of their accounts payable what will their new current ratio be?
- 2.0:1
 - 1.7:1
 - 2.5:1
 - 1.25:1

137. If they issue \$100,000 of new stock what will their new current ratio be? (rounded)
- a. 1.8:1
 - b. 1.6:1
 - c. 1.5:1
 - d. 1.7:1

Use the following information to answer questions #138 and 139.

Teckstar Corporation has current assets of \$1 million and current liabilities of \$750,00.

138. If they pay \$250,000 of their accounts payable what will their new current ratio be?
- a. 1.5:1
 - b. 2.0:1
 - c. 2.0:1
 - d. 1.25:1
139. If they issue \$100,000 of new stock what will their new current ratio be? (rounded)
- a. 1.47:1
 - b. 1.29:1
 - c. 1.18:1
 - d. 1.33:1
140. The statement of cash flows begins with cash flows from
- a. financing activities.
 - b. investing activities.
 - c. operating activities.
 - d. solvent activities.
141. Free cash flow provides an indication of a company's ability to
- a. generate cash to invest in new capital expenditures.
 - b. generate net income.
 - c. generate cash to pay dividends.
 - d. both a and c.
142. Free cash flow represents
- a. cash provided by operations less adjustments for capital expenditures and dividends
 - b. a measurement of a company's cash generating ability
 - c. a measure of solvency
 - d. all of the above
143. Which financial statement is used to determine cash generated from operations?
- a. income statement
 - b. statement of operations
 - c. statement of cash flows
 - d. retained earnings statement

144. In 2007 Bombay Corporation had cash receipts of \$21,000 and cash disbursements of \$12,000. Their ending cash balance at December 31, 2007 was \$33,000. What was their beginning cash balance?
- \$24,000
 - \$30,000
 - \$45,000
 - \$42,000
145. In 2006 Bombay Corporation had cash receipts of \$14,000 and cash disbursements of \$8,000. Their ending cash balance at December 31, 2006 was \$22,000. What was their beginning cash balance?
- \$16,000
 - \$20,000
 - \$30,000
 - \$28,000
146. Generally accepted accounting principles
- are accounting rules formulated by the Internal Revenue Service.
 - are sound in theory but rarely used in real life.
 - are accounting rules that are recognized as a general guide for financial reporting.
 - have eliminated all errors in accounting.
147. The agency of the United States Government that oversees the U.S. financial markets is the
- Internal Revenue Service
 - Security Exchange Commission
 - Financial Accounting Standards Board.
 - International Auditing Standards Committee.
148. What organization issues U.S. accounting standards?
- Security Exchange Commission.
 - International Accounting Standards Committee.
 - International Auditing Standards Committee.
 - Financial Accounting Standards Board.
149. Which one of the following is **not** a qualitative characteristic of useful accounting information?
- Relevance
 - Reliability
 - Conservatism
 - Comparability
150. All of the following are characteristics of accounting information **except**
- Reliability.
 - Comparability.
 - Relevance.
 - Flexibility.

-
151. Two of the major characteristics that make accounting information useful are
 - a. Relevance and reliability.
 - b. Verifiability and timeliness.
 - c. Comparability and flexibility.
 - d. Understandability and consistency.

 152. The convention of consistency refers to consistent use of accounting principles
 - a. among firms.
 - b. among accounting periods.
 - c. throughout the accounting periods.
 - d. within industries.

 153. The characteristic of consistency relates most closely to
 - a. relevance.
 - b. materiality.
 - c. comparability.
 - d. reliability.

 154. Adherence to the procedure of choosing the accounting method that will be least likely to overstate assets and income is an example of the constraint of
 - a. relevance.
 - b. reliability.
 - c. conservatism.
 - d. comparability.

 155. In order for accounting information to be relevant, it must
 - a. have very little cost.
 - b. help predict future events or confirm prior expectations.
 - c. not be reported to the public.
 - d. be used by a lot of different firms.

 156. Accounting information should be verifiable in order to enhance
 - a. comparability.
 - b. reliability.
 - c. consistency.
 - d. relevance.

 157. Accounting information is relevant to business decisions because it
 - a. has been verified by external audit.
 - b. is prepared on an annual basis.
 - c. confirms or corrects prior expectations.
 - d. is neutral in its representations.

 158. If accounting information has relevance, it is useful in making predictions about
 - a. future IRS audits.
 - b. new accounting principles.
 - c. foreign currency exchange rates.
 - d. the future events of a company.

159. Relevant accounting information
- is information that has been audited.
 - must be reported within the operating cycle or one year, whichever is longer.
 - has been objectively determined.
 - is information that is capable of making a difference in a business decision.
160. Which of the following is **not** a qualitative characteristic associated with reliability?
- Verifiable
 - Conservatism
 - Neutral
 - Faithful representation
161. Accounting information should be neutral in order to enhance
- reliability.
 - consistency.
 - comparability.
 - relevance.
162. Qualitative characteristics associated with relevant accounting information are
- consistency, faithful representation, and timely.
 - predict future events, confirm prior expectations, and timely.
 - neutral, predict future events, and reliability.
 - consistency and materiality.
163. Qualitative characteristics associated with reliable accounting information are
- verifiable, materiality, and timely.
 - faithful representation, materiality, and neutral.
 - neutral, verifiable, and faithful representation.
 - relevance, faithful representation, and verifiable.
164. Which of the following statements is **not** true?
- Comparability means using the same accounting principles from year to year within a company.
 - Reliability is the quality of information that gives assurance that it is free of error or bias.
 - Relevant accounting information must be capable of making a difference in the decision.
 - The FASB's overriding criterion is that the accounting rule adopted should be the one that generates the most useful financial information for making a decision.
165. A company can change to a new method of accounting if management can justify that the new method results in
- more meaningful financial information.
 - a higher net income.
 - a lower net income for tax purposes.
 - less likelihood of clerical errors.
166. An item is considered material if
- it doesn't cost a lot of money.
 - it is of a tangible good.
 - it is likely to influence the decision of an investor or creditor.
 - the cost of reporting the item is greater than its benefits.

-
167. The practice of large corporations reporting all financial statement amounts to the nearest thousand dollars is an example of the application of
- consistency.
 - conservatism.
 - full disclosure.
 - materiality.
168. Selecting the method or procedure that yields less net income is an application of
- consistency.
 - conservatism.
 - full disclosure.
 - materiality.
169. Expensing the purchase of a waste paper basket with an estimated useful life of 10 years is an application of
- materiality.
 - consistency.
 - going concern.
 - economic entity.
170. The writing down of inventory to market follows the constraint of
- consistency.
 - materiality.
 - full disclosure.
 - conservatism.
171. A practical decision to expense small capital expenditures rather than record them as property, plant, and equipment and depreciate them probably is made on the basis of the characteristic of
- consistency.
 - materiality.
 - full disclosure.
 - conservatism.
172. Which of the following is a constraint in accounting?
- Comparability
 - Conservatism
 - Consistency
 - Relevance
173. To determine the materiality of an account, an accountant would compare it with any of the following except
- total assets.
 - total liabilities.
 - total employees.
 - net income.

174. A common application of the conservatism constraint is the use of the
1. straight-line depreciation method for plant assets.
 2. lower of cost or market method for inventories.
 3. FIFO method for inventory valuation.
- a. 1
 - b. 2
 - c. 3
 - d. 1 and 2
175. The time period assumption states that the economic life of a business can be divided into
- a. equal time periods.
 - b. cyclical time periods.
 - c. artificial time periods.
 - d. perpetual time periods.
176. The going concern assumption underlies the
- a. cost principle.
 - b. monetary unit assumption.
 - c. time period assumption.
 - d. full disclosure principle.
177. The going concern assumption is inappropriate when
- a. the business is just starting up.
 - b. liquidation appears likely.
 - c. market values are higher than costs.
 - d. the business is organized as a proprietorship.
178. Which accounting assumption assumes that an enterprise will continue in operation long enough to carry out its existing objectives and commitments?
- a. Monetary unit assumption
 - b. Economic entity assumption
 - c. Time period assumption
 - d. Going concern assumption
179. It is assumed that the activities of Ford Motor Corporation can be distinguished from those of General Motors because of the
- a. going concern assumption.
 - b. economic entity assumption.
 - c. monetary unit assumption.
 - d. time period assumption.
180. The going concern assumption assumes that the business
- a. will be liquidated in the near future.
 - b. will be purchased by another business.
 - c. is in a growth industry.
 - d. will remain in operation for the foreseeable future.

-
181. The economic entity assumption states that economic events
- of different entities can be combined if all the entities are corporations.
 - must be reported to the Securities and Exchange Commission.
 - of a sole proprietorship cannot be distinguished from the personal economic events of its owners.
 - of every entity can be separately identified and accounted for.
182. The concept that a business has a reasonable expectation of remaining in business for the foreseeable future is called the
- economic entity assumption.
 - monetary unit assumption.
 - time period assumption.
 - going concern assumption.
183. Which of the following is **not** an accounting assumption?
- Integrity
 - Going concern
 - Time period
 - Economic entity
184. The time period assumption states
- the business will remain in operation for the foreseeable future.
 - the life of a business can be divided into artificial time periods and that useful reports covering those periods can be prepared.
 - every economic entity can be separately identified and accounted for.
 - only those things that can be expressed in money are included in the accounting records.
185. The ACE Company has five plants nationwide that cost \$300 million. The current market value of the plants is \$500 million. The plants will be reported as assets at
- \$200 million.
 - \$800 million.
 - \$300 million.
 - \$500 million.
186. The Tac Company has four plants nationwide that cost \$400 million. The current market value of the plants is \$300 million. The plants will be reported as assets at
- \$400 million.
 - \$800 million.
 - \$300 million.
 - \$500 million.
187. The cost principle requires that when assets are acquired, they be recorded at
- market value.
 - the amount paid for them.
 - selling price.
 - list price.

188. Valuing assets at their market value rather than at their cost is inconsistent with the:
- economic entity assumption.
 - cost principle.
 - time period assumption.
 - full disclosure principle.

Answers to Multiple Choice Questions

56. d	75. b	94. d	113. b	132. c	151. a	170. d
57. c	76. b	95. b	114. b	133. b	152. b	171. b
58. d	77. c	96. a	115. c	134. c	153. c	172. b
59. d	78. a	97. d	116. c	135. a	154. c	173. c
60. a	79. d	98. d	117. b	136. a	155. b	174. b
61. b	80. a	99. a	118. b	137. a	156. b	175. c
62. a	81. c	100. c	119. b	138. a	157. c	176. a
63. d	82. c	101. b	120. a	139. a	158. d	177. b
64. a	83. b	102. a	121. d	140. c	159. d	178. d
65. d	84. d	103. a	122. a	141. d	160. b	179. b
66. b	85. c	104. a	123. c	142. d	161. a	180. d
67. d	86. c	105. b	124. d	143. c	162. b	181. d
68. b	87. c	106. b	125. c	144. a	163. c	182. d
69. c	88. d	107. b	126. d	145. a	164. a	183. a
70. c	89. c	108. a	127. a	146. c	165. a	184. b
71. d	90. b	109. b	128. b	147. b	166. c	185. c
72. d	91. b	110. c	129. c	148. d	167. d	186. a
73. d	92. c	111. a	130. d	149. c	168. b	187. b
74. b	93. a	112. c	131. c	150. d	169. a	188. b

BRIEF EXERCISES

BE. 189

A list of financial statement items for Luxmann Company includes the following:

Accounts receivable	\$14,500	Prepaid insurance	\$3,400
Cash	\$18,400	Supplies	\$1,800
Short-term investments	\$6,200		

Prepare the current assets section of the balance sheet listing the items in the proper sequence.

Solution 189 (5 min.)

LUXMANN COMPANY
Balance Sheet (PARTIAL)

Assets	
Current Assets	
Cash	\$ 18,400
Short-term investments	6,200
Accounts receivables	14,500
Supplies	1,800
Prepaid insurance.....	<u>3,400</u>
Total Current Assets	\$44,300

BE. 190

The following information (in millions of dollars) is available for Jones Sportswear for 2007:

Sales revenue	\$6,300	Net income	\$504.6
Stock price per share	\$18.45	Preferred stock dividend	\$0

Average shares outstanding 420.5 million

Compute the earnings per share for Jones Sportswear.

Solution 190 (5 min.)

$$\text{Earnings per share} = \frac{\$504.6 - 0}{420.5} = \$1.20$$

BE. 191

For each of the following events affecting the stockholders' equity of Brooks, indicate whether the event would: increase retained earnings (IRE), decrease retained earnings (DRE), increase common stock (ICS), or decrease common stock (DCS).

- _____ 1. Declared a cash dividend.
- _____ 2. Issued new shares of common stock.
- _____ 3. Reported net loss of \$40,000
- _____ 4. Reported net income of \$20,000.

Solution 191 (5 min.)

1. DRE 2. ICS 3. DRE 4. IRE

BE. 192

These selected condensed data are taken from a recent balance sheet of Barnes Porporia (in millions of dollars).

Cash	\$ 2.2
Accounts receivable	10.4
Inventories	18.0
Other current assets	<u>11.1</u>
Total current assets	\$ 41.7
Total current liabilities	\$ 24.8

Additional information: Current liabilities at the beginning of the year were \$35.6 million.

What are (a) the working capital, and (b) the current ratio?

Solution 192 (5 min.)

- a. \$16.9 (\$41.7 – \$24.8)
- b. 1.68: 1 (\$41.7/\$24.8)
- c. 3.85 times {116.4/[(24.8 + 35.6)2]}

BE. 193

Insert the qualitative characteristics listed below that are associated with relevance and reliability.

Confirm Prior Expectations
Verifiable
Neutral

Timely
Faithful Representation
Predict Future Events

RELEVANCE

RELIABILITY

1. _____
2. _____
3. _____

1. _____
2. _____
3. _____

Solution 193 (5 min.)

RELEVANCE

RELIABILITY

1. Confirm Prior Expectations
2. Predict Future Events
3. Timely

1. Verifiable
2. Faithful Representation
3. Neutral

BE. 194

The following terms relate to the characteristics of useful information. Match the key letter of the correct term with the descriptive statement below.

- | | |
|---------------------|----------------------------|
| a. Provide feedback | e. Faithful representation |
| b. Neutral | f. Timely |
| c. Predict | g. Verifiability |
| d. Relevant | h. Reliability |

- _____ 1. Accounting information cannot be selected, prepared, or presented to favor one set of interested users over another.
- _____ 2. Providing information before the decision is made.
- _____ 3. Providing information that can be confirmed or duplicated by independent parties.
- _____ 4. Providing information that would make a difference in a business decision.
- _____ 5. Provide information that is factual.
- _____ 6. Helping evaluate prior decisions.

Solution 194 (5 min.)

- | | | |
|------|------|------|
| 1. b | 3. g | 5. e |
| 2. f | 4. d | 6. a |

BE. 195

For each of the independent situations described below, list the qualitative characteristic or constraint that has been violated, if any. List only one term for each case.

1. Facklam Company is in its third year of operation and has yet to issue financial statements.
2. Rodman Corporation has selected the FIFO inventory costing method during the current year. Last year it used the LIFO method and next year it plans to change to the average cost method.
3. Harris Company is carrying inventory at its current market value of \$110,000. The inventory had an original cost of \$135,000.
4. Strong Company expenses some office equipment that is inexpensive even though it has a useful life that exceeds 1 year.

Solution 195 (5 min.)

- | | |
|---------------------------------------------|--------------------------------|
| 1. Relevance (timely) | 3. No violation (conservatism) |
| 2. Consistency (qualitative characteristic) | 4. No violation (materiality) |

Be. 196

Each of the following statements is justified by a concept or convention of accounting. Write the letter in the blank next to each statement corresponding to the concept involved.

- a. Consistency
- b. Materiality
- c. Full disclosure
- d. Conservatism

- _____ 1. A company uses the lower of cost or market to value inventories.
- _____ 2. This characteristic best enhances comparability of financial statements between years.
- _____ 3. A merger agreed on just after the balance sheet date nevertheless is reported in the notes to the financial statement.
- _____ 4. A large company rounds its financial statement figures to the nearest thousand.

Solution 196 (5 min.)

1. d 2. a 3. c 4. b

Be. 197

Each of the following statements is justified by a characteristic or constraint of accounting. Write the letter in the blank next to each statement corresponding to the characteristic or constraint involved.

- | | |
|------------------|----------------|
| a. Comparability | d. Consistency |
| b. Materiality | e. Relevance |
| c. Conservatism | f. Reliability |

- _____ 1. A company uses the same accounting principles from year to year.
- _____ 2. A company uses lower of cost or market to value inventory.
- _____ 3. A company decides to expense capital items that cost less than \$500 each.
- _____ 4. All factors that could affect a decision will be considered.
- _____ 5. Outside documents will be used to verify transactions whenever possible.

Solution 197 (5 min.)

1. d 2. c 3. b 4. e. 5. f

Be. 198

Presented below are the basic assumptions and principles underlying financial statements.

- a. Cost principle
- b. Economic entity assumption
- c. Full disclosure principle
- d. Going concern assumption
- e. Monetary unit assumption
- f. Time period assumption

Identify the basic assumption or principle that is described below.

- _____ 1. The economic life of a business can be divided into artificial time periods.
- _____ 2. The business will continue in operation long enough to carry out its existing objectives.
- _____ 3. Assets should be recorded at their cost.
- _____ 4. Economic events can be identified with a particular unit of accountability.
- _____ 5. Circumstances and events that make a difference to financial statement users should be disclosed.
- _____ 6. Only transaction data that can be expressed in terms of money should be included in the accounting records.

Solution 198 (5 min.)

- 1. f 4. b
- 2. d 5. c
- 3. a 6. e

EXERCISES**Ex. 199**

The following information is available for Juxton Company for the year ended December 31, 2007:

Accounts payable	2,700
Building not currently used	9,500
Accumulated depreciation, equipment	4,000
Retained earnings	16,000
Common stock	4,800
Intangible assets	2,500
Notes payable (due in 5 years)	7,500
Accounts receivable	1,500
Cash	2,600
Short-term investments	1,000
Land	10,000
Equipment	7,500
Long-term investments	400

Instructions

Use the above information to prepare a classified balance sheet for the year ended December 31, 2007.

Solution 199 (20 min.)

JUXTON COMPANY
Balance Sheet
December 31, 2007

Assets			
Current Assets			
Cash	\$ 2,600		
Short-term investments	1,000		
Accounts receivables	<u>1,500</u>		
Total Current Assets			\$5,100
Investments			
Building not currently used	9,500		
Long-term investments	<u>400</u>		
Total Investments			\$9,900
Property, Plant, and Equipment			
Land	\$10,000		
Equipment	\$7,500		
Less Accumulated depreciation, equipment	<u>4,000</u>	<u>3,500</u>	
Total Property, plant and equipment			\$13,500
Intangible assets			<u>2,500</u>
Total Assets			<u>\$31,000</u>

Solution 199 (cont.)

Liabilities and Stockholders' Equity

Current Liabilities		
Accounts payable		\$ 2,700
Long-term liabilities		
Notes payable.....		<u>7,500</u>
Total Liabilities		<u>\$10,200</u>
Stockholders' equity		
Common stock.....	4,800	
Retained earnings.....	<u>16,000</u>	
Total stockholders' equity.....		<u>20,800</u>
Total liabilities and stockholders' equity.....		<u>\$31,000</u>

Ex. 200

The following lettered items represent a classification scheme for a balance sheet, and the numbered items represent data found on balance sheets. In the blank next to each account, write the letter indicating to which category it belongs.

- A. Current assets
- B. Investments
- C. Property, plant, and equipment
- D. Intangible assets
- E. Current liabilities
- F. Long-term liabilities
- G. Stockholders' equity
- H. Not on the balance sheet

Solution 200 (20 min.)

- | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p>_____ 1. Accumulated Depreciation</p> <p>_____ 2. Common Stock</p> <p>_____ 3. Interest Expense</p> <p>_____ 4. Salary Payable</p> <p>_____ 5. Retained Earnings</p> | <p>_____ 6. Inventory</p> <p>_____ 7. Patents</p> <p>_____ 8. Prepaid Interest</p> <p>_____ 9. Mortgage Payable</p> <p>_____ 10. Land Held for Investment</p> |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------|

1. C 2. G 3. H 4. E 5. G 6. A 7. D 8. A 9. F 10. B

Ex. 201

The Caltor Company gathered the following condensed data for the year ended December 31, 2007:

Cost of goods sold	\$ 710,000
Net sales	1,279,000
Administrative expenses	239,000
Interest expense	68,000
Dividends paid	38,000
Selling expenses	45,000

Instructions

Prepare an income statement for the year ended December 31, 2007.

Solution 201 (10 min.)

CALTOR COMPANY
Income Statement
For the Year Ended December 31, 2007

Revenues

Net sales		\$1,279,000
-----------------	--	-------------

Expenses

Cost of goods sold	\$710,000	
Selling expenses	45,000	
Administrative expenses	239,000	
Interest expense	<u>68,000</u>	
Total expenses		<u>1,062,000</u>

Net income		<u>\$ 217,000</u>
-------------------------	--	--------------------------

Ex. 202

The following items are taken from the financial statements of Sutch Company for 2007:

Accounts Payable	\$ 15,000	
Accounts Receivable	11,000	
Accumulated Depreciation—Video Equipment	28,000	
Advertising Expense	21,000	
Cash	24,000	
Common Stock	90,000	
Depreciation Expense	12,000	
Dividends	15,000	
Insurance Expense	3,000	
Note Payable (due 2010)	70,000	
Prepaid Insurance	6,000	
Rent Expense	17,000	
Retained Earnings (beginning)	12,000	
Salaries Expense	34,000	
Salaries Payable	3,000	
Service Revenue	145,000	
Supplies	4,000	
Supplies Expense	6,000	
Video Equipment	210,000	

Instructions

- (a) Calculate the net income.
- (b) Calculate the balance of Retained Earnings that would appear on a balance sheet at December 31, 2007

- (c) Prepare a classified balance sheet for Sutch Company at December 31, 2007 assuming the note payable is a long-term liability.
- (d) Compute the current ratio, debt to total assets ratio, and earnings per share value. The average number of shares outstanding for 2007 was 10,000.

Solution 202 (20 min.)

(a) Net income = \$52,000: (\$145,000 – \$21,000 – \$12,000 – \$3,000 – \$17,000 – \$34,000 – \$6,000)

(b) Retained Earnings, January 1	\$12,000	
Add: Net Income	<u>52,000</u>	
	64,000	
Less: Dividends	<u>15,000</u>	
Retained Earnings, December 31	<u>\$49,000</u>	

(c) SUTCH COMPANY
Balance Sheet
December 31, 2007

Assets		
Current assets		
Cash	\$ 24,000	
Accounts receivable	11,000	
Supplies	4,000	
Prepaid insurance	<u>6,000</u>	
Total current assets		45,000
Property, plant, and equipment		
Video equipment	\$210,000	
Less: Accumulated depreciation—video equipment	<u>28,000</u>	<u>182,000</u>
Total assets		<u>\$227,000</u>
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$ 15,000	
Salaries payable	<u>3,000</u>	
Total current liabilities		18,000
Long-term liabilities		
Note payable		<u>70,000</u>
Total liabilities		88,000
Stockholders' equity		
Common stock	\$90,000	
Retained earnings	<u>49,000</u>	<u>139,000</u>
Total liabilities and stockholders' equity		<u>\$227,000</u>

- (d) Current ratio: \$45,000 ÷ \$18,000 = 2.5:1
- Debt to total assets ratio: \$88,000 ÷ \$227,000 = 38.8%
- Earnings per share: \$49,000 ÷ 10,000 = \$4.90

Ex. 203

The following items are taken from the financial statements of Maxon Company for 2007:

Accounts Payable	\$18,500
Accounts Receivable	4,000
Accumulated Depreciation	4,800
Bonds Payable	18,000
Cash	24,000
Common Stock	25,000
Cost of Goods Sold	13,000
Depreciation Expense	4,800
Dividends	5,300
Equipment	48,000
Interest Expense	2,500
Patents	7,500
Retained Earnings, January 1	16,000
Salaries Expense	5,200
Sales Revenue	36,500
Supplies	4,500

Instructions

- (a) Prepare an income statement and a classified balance sheet for Maxon Company.
- (b) Compute the following ratios and values:
1. Current ratio
 2. Debt to total assets ratio
 3. Working capital
 4. Earnings per share (Maxon's average number of shares outstanding during the year was 5,000.)

Solution 203 (25 min.)

(a)

MAXON COMPANY
Income Statement
For the Year Ended December 31, 2007

Sales revenues		\$36,500
Cost of goods sold		<u>13,000</u>
Gross profit		23,500
Operating expenses		
Depreciation expense	\$4,800	
Salaries expense	<u>5,200</u>	<u>10,000</u>
Income from operations		13,500
Other expenses and losses		
Interest expense		<u>2,500</u>
Net income		<u>\$ 11,000</u>

Solution 203 (cont.)

MAXON COMPANY
Balance Sheet
December 31, 2007

<u>Assets</u>		
Current assets		
Cash	\$24,000	
Accounts receivable	4,000	
Supplies	<u>4,500</u>	
Total current assets		32,500
Property, plant, and equipment		
Equipment	\$48,000	
Less: Accumulated depreciation—Equipment	<u>4,800</u>	43,200
Intangible assets		
Patents		<u>7,500</u>
Total assets		<u><u>\$83,200</u></u>
<u>Liabilities and Stockholders' Equity</u>		
Current liabilities		
Accounts payable		\$18,500
Long-term liabilities		
Bonds payable		<u>18,000</u>
Total liabilities		36,500
Stockholders' equity		
Common stock	\$25,000	
Retained earnings	<u>21,700*</u>	<u>46,700</u>
Total liabilities and stockholders' equity		<u><u>\$83,200</u></u>

*Retained earnings = \$21,700 (\$16,000 + \$11,000 – \$5,300).

- (b) 1. Current ratio: $\$32,500 \div \$18,500 = 1.76:1$
 2. Debt to total assets ratio: $\$36,500 \div \$83,200 = 43.9\%$
 3. Working capital $\$32,500 - \$18,500 = \$14,000$
 4. Earnings per share ($\$11,000 \div 5,000$) = \$2.20

Ex. 204

The following data are taken from the financial statements of Prone, Inc. as of the end of the year 2007. The data are in alphabetical order.

Accounts payable	\$ 28,000	Net income	\$ 48,000
Accounts receivable	66,000	Other current liabilities	17,000
Cash	54,000	Total assets	250,000
Gross profit	160,000	Total liabilities	200,000
Income before income taxes	54,000	Wages payable	5,000

Additional information: The average common shares outstanding during the year was 40,000. The stock price at December 31, 2007.

Instructions

Compute the following:

- (a) Current ratio. (c) Earnings per share.
 (b) Working capital. (d) Debts to total assets ratio.

Solution 204 (5 min.)

- (a) Current ratio = Current assets ÷ Current liabilities = \$120,000 ÷ \$50,000 = 2.4 : 1
 (b) Working capital = Current assets – Current liabilities = \$120,000 – \$50,000 = \$70,000
 (c) Earnings per share = Net income–Preferred Stock dividends ÷ Average common shares outstanding = \$48,000 ÷ 40,000 = \$1.20
 (d) Debts to total assets ratio = Total debt ÷ Total assets = \$200,000 ÷ \$250,000 = 80%

Ex. 205

Use the following data to calculate the liquidity and profitability ratios listed below.

Average common shares	10,000	Current liabilities	100,000
Capital expenditures	20,000	Net income	\$ 21,000
Cash provided by operations	28,000	Net sales	150,000
Dividends paid	5,000	Total liabilities	105,000
Current assets	150,000	Total assets	175,000

Instructions

Compute the following:

- (a) Current ratio. (d) Debt to total assets ratio.
 (b) Working capital. (e) Free cash flow.
 (c) Earnings per share.

Solution 205 (15 min.)

- (a) Current ratio = Current assets ÷ Current liabilities = \$150,000 ÷ \$100,000 = 1.5 : 1
 (b) Working capital = Current assets – Current liabilities = \$150,000 – \$100,000 = \$50,000
 (c) Earnings per share ratio = (Net income – Preferred stock dividends) ÷ Average common share outstanding = \$21,000 ÷ 10,000 = \$2.10
 (d) Debt to total assets ratio = Total debt ÷ Total assets = \$105,000 ÷ \$175,000 = 60%
 (e) Free cash flow = Cash provided by operations – Capital expenditures – Dividends paid = \$28,000 – \$20,000 – \$5,000 = \$3,000.

Ex. 206

The following data are taken from the financial statements of Dellmont Company. The data are in alphabetical order.

Accounts payable	\$ 28,000	Net sales	500,000
Accounts receivable	65,000	Other current liabilities	20,000
Average common shares O/S	20,000	Salaries payable	7,000
Cash	56,000	Stockholders' equity	169,000
Gross profit	190,000	Total assets	325,000
Net income	\$ 50,000		

Instructions

Compute the following:

- (a) Current ratio. (d) Debt to total assets ratio.
 (b) Working capital.
 (c) Earnings per share.

Solution 206 (10 min.)

- (a) Current ratio = Current assets ÷ Current liabilities
 = \$121,000 ÷ \$55,000 = 2.2 : 1
- (b) Working capital = Current assets – Current liabilities
 = \$121,000 – \$55,000 = \$66,000
- (c) Earnings per share = Net income ÷ Average common shares outstanding
 = \$50,000 ÷ 20,000 = \$2.50
- (d) Debt to total assets ratio = Total debt ÷ Total assets
 = \$156,000 ÷ \$325,000 = 48%
 (Total debt = Total assets – Stockholders' equity = \$325,000 – \$169,000)

Ex. 207

For each of the ratios listed below, indicate by the appropriate code letter, whether it is a liquidity ratio, a profitability ratio, or a solvency ratio.

Code:

- L = Liquidity ratio
 P = Profitability ratio
 S = Solvency ratio

- ___ 1. Price-earnings ratio
 ___ 2. Free cash flow
 ___ 3. Debt to total assets ratio
 ___ 4. Earnings per share
 ___ 5. Current ratio

Solution 207 (5 min.)

- P 1. Price-earnings ratio
S 2. Free cash flow
S 3. Debt to total assets ratio
P 4. Earnings per share
L 5. Current ratio

Ex. 208

The following information is available from the annual reports of Lucky Company and Broke Company.

	(amounts in millions)	
	<u>Lucky</u>	<u>Broke</u>
Sales	\$26,510	\$34,512
Gross profit	6,610	8,887
Net income	565	1,271
Current assets	11,712	28,447
Beginning total assets	17,102	33,130
Ending total assets	22,088	36,167
Current liabilities	7,966	14,950
Total liabilities	16,136	31,222
Average common shares outstanding	125	240
Preferred stock dividends paid	-0-	-0-

Instructions

- (a) For each company, compute the following ratios:
- Current ratio
 - Debt to total assets ratio
 - Earnings per share
- (b) Based on your calculations, discuss the relative liquidity, solvency, and profitability of the two companies.

Solution 208 (12 min.)

(a)	<u>Lucky</u>	<u>Broke</u>
1. Current ratio	1.47:1 (\$11,712 ÷ \$7,966)	1.90:1 (\$28,447 ÷ \$14,950)
2. Debt to total assets ratio	73% (\$16,136 ÷ 22,088)	86% (\$31,222 ÷ \$36,167)
3. Earnings per share	\$4.52 (\$565 ÷ 125)	\$5.30 (\$1,271 ÷ 240)

- (b) Based on the current ratio, Broke is more liquid than Lucky since its current ratio (1.90:1) is 29% higher than Lucky's ratio (1.47:1). However, Lucky would be considered more solvent than Broke since its debt to total assets ratio (73%) is 15% lower than Broke's debt ratio (86%). A lower debt to total assets ratio indicates a company is more solvent and better able to survive over a long period of time.

Broke is more profitable than Lucky since its earnings per share and is higher than Lucky's respective values. Broke's earnings per share (\$5.30) is 17.3% higher than Lucky's value.

COMPLETION STATEMENTS

209. The rules and practices that are recognized as general guides for financial reporting are called _____.
210. In accounting, _____ results when different companies use the same accounting principles.
211. The constraint of _____ refers to items in financial statements that are likely to influence the decision of a reasonably prudent investor or creditor.
212. The constraint of _____ means that when preparing financial statements, a company should choose the accounting method that will be least likely to overstate assets and income.
213. The earnings per share value is calculated by dividing net income – preferred stock dividends by _____.
214. Assets that are expected to be converted to cash or used in the business within a relatively short period of time are called _____.
215. The _____ is current assets divided by current liabilities.
216. A measurement to provide additional insight regarding a company's cash-generating ability is _____.

Answers to Completion Statements

209. generally accepted accounting principles
210. comparability
211. materiality
212. conservatism
213. average common shares outstanding
214. current assets
215. current ratio
216. free cash flow

MATCHING

217. Match the items below by entering the appropriate code letter in the space provided.

- | | |
|----------------------|-------------------------------|
| A. Relevance | G. Working capital |
| B. Liquidity ratios | H. Current ratio |
| C. Comparability | I. Earnings per share |
| D. Consistency | J. Solvency ratios |
| E. Intangible assets | K. Economic entity assumption |
| F. Free cash flow | L. Materiality |

- ___ 1. Measures of the ability of the enterprise to survive over a long period of time.
- ___ 2. Current assets divided by current liabilities.
- ___ 3. Information that has a bearing on a decision.
- ___ 4. Economic events can be identified with a particular unit of accountability.
- ___ 5. An item important enough to influence a prudent investor.
- ___ 6. Same accounting principles and methods used from year to year within a company.
- ___ 7. Cash from operating activities less capital expenditures and cash dividends.
- ___ 8. Noncurrent assets that do not have physical substance.
- ___ 9. (Net income – preferred stock dividends) divided by average common shares outstanding.
- ___ 10. Different companies using the same accounting principles.
- ___ 11. Measures of the short-term ability of the enterprise to pay its maturing obligations.
- ___ 12. The excess of current assets over current liabilities.

Answers to Matching

- | | | | |
|------|-------|-------|-------|
| 1. J | 2. H | 3. A | 4. K |
| 5. L | 6. D | 7. F | 8. E |
| 9. I | 10. C | 11. B | 12. G |

SHORT-ANSWER ESSAY QUESTIONS

S-A E 218

Relevance and reliability are two characteristics of useful accounting information.

- a) Briefly define each term.
- b) Why are these characteristics important to users of financial statements?

Solution 218

Relevance represents the quality of information that makes a difference in a decision. In other words, the user has information that is meaningful for the decision at hand. Relevance includes information that helps predict future events and provides feedback about prior predictions.

Reliability represents the quality of information that provides assurance that it is free of error and bias. In other words, the information can be relied upon because it is objective and accurate. Reliability includes a faithful representation of what is being reported and neutral accounting information.

Relevance and reliability are important to the users of financial statements because these users do not have first hand knowledge of the operations of the business. In order for these users to make decisions, they must have assurances that the information provided by the company is relevant – makes a difference and reliable – means what the company says. Without these assurances, the users cannot have confidence in the information provided to them.

S-A E 219

You and the CEO of your company are waiting on an elevator. You are going to the 25th floor and the CEO is going to the 35th floor. The CEO says “What is the difference between consistency and comparability?” You have two minutes to respond. What will you say?

Solution 219

You have asked an excellent question and I am glad to respond. Consistency means that a company uses the same accounting principles and methods each year. Decision makers can work with accounting information, knowing that the company is consistently applying with the principles and methods it has chosen. This is why it is so important that we carefully make these choices. There are procedures for making changes and communicating those changes to financial statement users.

Comparability allows users to compare accounting information of different companies. The financial statement footnotes identify many of the principles and procedures that companies use. Comparisons can be made for companies within certain industries or other groupings.

S-A E 220

Comparability and consistency are qualitative characteristics that make accounting information useful for decision-making purposes. Briefly explain the difference between these two characteristics and explain how they are related to each other.

Solution 220

Comparability results when different companies use the same accounting principles and methods, while consistency results when one company uses the same principles and methods from year to year. The two characteristics are related because information must possess relevance, reliability, comparability, and consistency to achieve the highest level of decision usefulness. In addition, accounting information for two entities cannot be comparable unless both companies practice consistency in their choice of principles and methods.

S-A E 221

List the four characteristics of useful information.

Solution 221

To be useful, information should possess these qualitative characteristics: relevance, reliability, comparability and consistency.

S-A E 222

What are four of the six characteristics that explain relevance and reliability?

Solution 222

When information is relevant it helps predict future events, it provides feedback about prior expectations and it must be timely. For information to be reliable it must be: verifiable or provable, a faithful representation or factual, and neutral where information cannot be selected, prepared, or presented to favor one set of interested users over another.

S-A E 223

Please give the definition of current assets, current liabilities and the current ratio.

Solution 223

Current assets are cash or other resources that are reasonably expected to be realized in cash or sold or consumed in the business within one year or the operating cycle, whichever is longer. Current liabilities are obligations reasonably expected to be paid from the existing current assets or through the creation of other current liabilities within the next year or operating cycle, whichever is longer. The current ratio is a measure used to evaluate a company's liquidity and short-term debt paying ability, computed by dividing current assets by current liabilities.

S-A E 224 (Ethics)

Many bonus plans are based upon the attainment of some specified short-term goal. For example, sales personnel at Metal Crafters are given a bonus of 5% of the amount by which their sales exceed \$100,000. Sometimes the attainment of these goals is achieved by methods detrimental to the long-term needs of the company. Sales representative Lisa Allen, for example, finds herself tempted to court certain customers that place large orders, even though she knows they may not be able to pay. She complains that the bonus system itself is unethical.

Required:

Is a bonus system like the one at Metal Crafters unethical? Explain.

Solution 224

The bonus system described is not necessarily unethical, but it may be short-sighted. When employees are able to identify and address larger concerns (such as Lisa's identification of the problem regarding the ability of a customer to pay) then such issues should probably become part of the system of bonuses. It is very difficult to set a bonus plan that allows for all contingencies, however. Since sales representatives are hired to generate sales, they most often are rewarded based on generating sales. Some of the future events, such as customers defaulting on payments, may not be the fault of the sales representative. For Lisa Allen to create sales by soliciting customers with a poor payment record would be unethical on her part. She is required to use integrity, even when the possibility exists of her not using it, and even when she might gain by not using it.

S-A E 225 (Communication)

Sunshine Sugar grows sugar cane in Florida, California, and Hawaii. Its investment in land to grow sugar exceeds \$2 million. Currently, land whose original cost was more than \$300,000 in Florida is threatened by plans to flood the Everglades to reclaim the wetlands. Sunshine plans to fight vigorously to keep its land in production, particularly because most of the rest of its land is in California, which is threatened by water shortages. The land in Florida is also significantly more productive than that in California, and the wages paid to workers to process the sugar cane are substantially less. Current plans include litigation to prevent government seizure of the land, an extensive public education campaign, and intense lobbying efforts.

Required:

Sunshine has determined that a footnote disclosure should be made in the financial statements to alert the investors of the threat to the land. Carefully consider how much of the above information is appropriate for inclusion in the footnote. Write the footnote.

Solution 225

NOTE: A portion of the most valuable land owned by the company is the subject of plans by the Environmental Protection Agency to flood the Florida Everglades to "reclaim" the so-called wetlands. The company is working with the United States Department of Agriculture and other agencies to prevent this result. The company will be spending money to educate the public about this issue. Currently, land costing around \$300,000 is at risk.

Usually the details of exactly why the land is so valuable to the company are not appropriate for inclusion. Footnotes need not be emotional or dramatic, either. There should be a systematic listing of at least the minimum amount the public has a right to know—how much land is at risk, and the nature of the risk.