

Study Guide

Financial Accounting

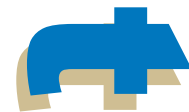
by

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About the Author

Jim Burcicki holds a B.S. in Accounting from King's College, graduating magna cum laude as an adult learner. He began as a bookkeeper for a hospitality group that included three 2,000-person banquet facilities, a Best Western, and historical landmark hotels. After obtaining his degree, Jim worked as an accounting software consultant for a large, regional public accounting firm. He installed customized accounting software in businesses with revenues ranging from \$5 million to \$150 million. Jim currently teaches business programs as a Senior Instructor at Penn Foster College. Jim is a proud veteran of the United States Army, having served from 1977 to 1981.

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YOUR COURSE

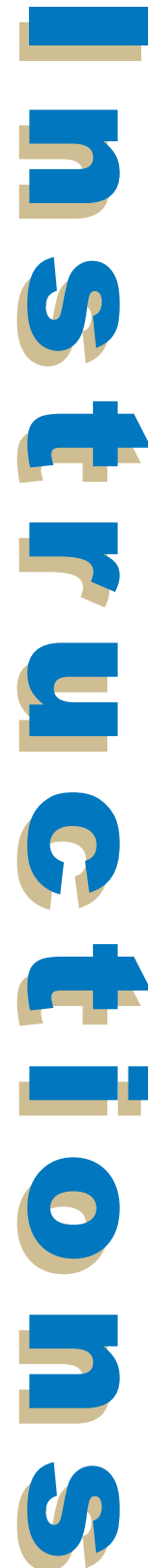
Welcome to accounting, doorway to a world of possibilities! You've chosen to study a vibrant, thought-provoking subject that's full of challenges and opportunities. Best of all, you'll find that the key ideas discussed in this course are useful in many careers and in your personal life as well.

Let's consider an example. One important lesson you can learn from your study of accounting is to keep the big picture in mind. Here's a question demonstrating this concept: Toni Tiller bought a pony for \$50 and sold it for \$60. Later she bought the pony back for \$70 and sold it to someone else for \$80. How much did Toni make on the pony?

We'll return to this discussion in a minute. Before we do, let's turn our attention to this study guide. It's designed to help you develop an understanding of financial accounting in conjunction with your textbook, *Financial Accounting*. There are four lessons in the study guide, each containing three assignments. Each assignment concludes with suggested exercises and problems selected from the textbook, as well as a self-check. The answers to these textbook problems are found in the *Financial Accounting Solutions Supplement*, located on your My Courses page.

You're responsible for your success in this course. Here are three tips that may help you achieve that success:

1. *Know your learning style.* Are you a visual learner, an audio learner, or a kinesthetic learner? Do you learn best by seeing examples, hearing explanations, or experiencing hands-on activity? If you don't know, you might want to check out various websites or library books that offer free evaluations. Once you're determined your learning style, tailor your study habits to your best advantage. If you're a visual learner, pay special attention to the charts, graphs, exhibits, and financial statements in the text. Audio learners might consider recording key points and listening to them while commuting or during other quiet times. If hands-on is your style, work through the examples in the text using pencil and paper.



2. *Assume you'll receive an A in the course.* Give yourself permission to succeed at the outset. Sit down before you start the course and write a letter to your instructor dated several months in the future that describes in detail what you did to achieve your A. Any time you feel your motivation faltering during the course, remind yourself that you're an A student. Remember, whether you think you can or think you can't, you're right.
3. *Keep the big picture in mind.* Let's finish our discussion of Toni Tiller. Was your answer \$10? Or did you do the big-picture accounting and determine that the correct answer is \$20? If you answered \$10, let's work through the solution: Add the amounts Toni paid for the pony ($\$50 + \$70 = \$120$). Add what she received when she sold the pony ($\$60 + \$80 = \$140$). Now calculate the difference between what she earned and what she spent ($\$140 - \$120 = \$20$).

Whatever your motivation for choosing to study accounting, you have an exciting future ahead of you. May your achievements be matched by your pleasure in realizing them.

OBJECTIVES

When you complete this course, you'll be able to

- Understand important accounting principles and concepts in order to prepare basic financial statements
- Understand the fundamentals of bookkeeping while using the general journal, general ledger, and trial balance to prepare financial statements
- Understand adjustments and closing entries to prepare financial statements and a post-closing trial balance
- Understand periodic and perpetual inventory systems; accounting for the purchases and sales of inventory; and how to account for shipping, freight, and other selling expenses in preparation of a multi-step income statement and classified balance sheet

- Account for inventory, the use of different inventory costing methods, and their effects on financial statements
- Understand the role of ethics in accounting, the use of internal controls, and the major provisions of the International Financial Reporting Standards (IFRS)
- Understand cash and accounts receivable and the methods and internal controls for reporting on the balance sheet
- Understand, account for, and report various long-term assets on the balance sheet
- Distinguish between different liabilities and account for and report current liabilities and long-term debt on the balance sheet
- Understand the treatment of stock as paid-in capital, dividends, and retained earnings in the stockholders' equity section of the balance sheet
- Prepare a statement of cash flows using the direct and indirect methods and evaluate the company's performance as it relates to cash
- Perform a horizontal and vertical analysis of financial statements and compute various financial ratios

COURSE MATERIALS

Your Financial Accounting course provides you with the materials listed below.

1. This study guide, which includes
 - A lesson assignments page that lists the schedule of assigned readings in your textbook
 - Self-checks and answers that allow you to measure your understanding of the course material

2. Your course textbook, *Financial Accounting*, Third Edition, by Robert Kemp and Jeffrey Waybright, which contains your assigned readings, exercises, and problems
3. *Financial Accounting Solution Manual*, located as a supplement on your My Courses page

MYACCOUNTINGLAB

Throughout the *Financial Accounting* textbook, you'll notice references to MyAccountingLab. MyAccountingLab is a textbook supplement that allows instructors to assign questions that can be completed in an Excel-simulated environment.

MyAccountingLab isn't part of the Financial Accounting course. Ignore any textbook references to MyAccountingLab.

If you wish to supplement your learning by acquiring MyAccountingLab, you'll need to contact the publisher directly to purchase the supplemental material. Since the questions aren't being assigned, Penn Foster won't be able to provide support for MyAccountingLab.

A STUDY PLAN

This study guide is intended to help you achieve the maximum benefit from the time you spend on this course. It doesn't replace the textbook in any way. It serves as an introduction to material that you'll read in the book and as an aid to assist you in understanding this material.

This study guide provides your assignments in four lessons. Each lesson contains three assignments, a set of textbook problems and exercises for each assignment, a self-check for each assignment, and a comprehensive examination on the material covered in the lesson. Be sure to complete all work related to a lesson before moving on to the next lesson.

For each lesson, do the following:

1. Read the introduction to the lesson in this study guide.
2. Read the assigned pages in your textbook.
3. Complete the self-check in this study guide for each assignment in the lesson. *Remember: Do not* send your answers to the self-checks to the school.
4. Determine your own progress by comparing your answers for the self-checks to the answers given in the answer section of this study guide.
5. Complete the suggested exercises and problems selected from your textbook.
6. Determine your own progress by comparing your answers for the exercises and problems to the answers given in the *Financial Accounting Solution Manual*.
7. Review the material covered in the lesson to prepare for the lesson examination.

Now you're ready to begin Lesson 1. When you've finished the assigned readings and self-checks and are confident that you have a good grasp of the material covered, complete the graded project for Lesson 1. This graded project serves as the exam for Lesson 1. Lessons 2–4 have multiple-choice examinations that you'll access via your My Courses page.

At any point in your studies, you can email your instructor for further information or clarification of your study materials. Your instructor's guidance and suggestions should be very helpful to you as you progress with your course.

Take some time now to review the lesson assignments. Then, begin your study of financial accounting with Lesson 1, Assignment 1.

Good luck and have fun!

NOTES

Lesson 1: Business, Accounting, and You

For:	Read in the study guide:	Read in the textbook:
Assignment 1	Pages 9–12	Chapter 1
Assignment 2	Pages 15–18	Chapter 2
Assignment 3	Pages 21–24	Chapter 3
Graded Project 061579 Material in Lesson 1		

Lesson 2: Accounting for Merchandising

For:	Read in the study guide:	Read in the textbook:
Assignment 4	Pages 50–53	Chapter 4
Assignment 5	Pages 57–61	Chapter 5
Assignment 6	Pages 65–68	Chapter 6
Examination 061580 Material in Lesson 2		

Lesson 3: The Value of Money

For:	Read in the study guide:	Read in the textbook:
Assignment 7	Pages 72–77	Chapter 7 and Appendix B
Assignment 8	Pages 80–86	Chapter 8
Assignment 9	Pages 89–92	Chapter 9
Examination 061581 Material in Lesson 3		

Lesson 4: Corporations

For:	Read in the study guide:	Read in the textbook:
Assignment 10	Pages 96–99	Chapter 10
Assignment 11	Pages 104–106	Chapter 11
Assignment 12	Pages 109–112	Chapter 12
Examination 061582 Material in Lesson 4		

Note: To access and complete any of the examinations for this study guide, click on the appropriate **Take Exam** icon on your My Courses page. You should not have to enter the examination numbers. These numbers are for reference only if you have reason to contact Student Services.

Business, Accounting, and You

Assignment 1 introduces three types of business and the entities used in creating these businesses. *Generally Accepted Accounting Principles (GAAP)* and *International Financial Reporting Standards (IFRS)* are shown to govern the standards, practices, and reporting of accounting information. The accounting equation, transactions, and financial statements (and their relationship to each other) are discussed.

Assignment 2 introduces the concept of double-entry bookkeeping and fundamentals for analyzing, journalizing, and posting transactions as they occur in business.

Assignment 3 shows the adjusting and closing process in preparation of an adjusted trial balance to be used to prepare financial statements.

When you complete this lesson, you'll be able to

- Understand important accounting principles and concepts in order to prepare basic financial statements
- Understand the fundamentals of bookkeeping while using the general journal, general ledger, and trial balance to prepare financial statements
- Understand adjustments and closing entries to prepare financial statements and a post-closing trial balance

ASSIGNMENT 1: INTRODUCTION TO ACCOUNTING

Read Assignment 1 in this study guide. Then read Chapter 1 in your textbook, *Financial Accounting*.

Why Study Accounting?

An often-asked question is “Why do I need to take accounting? I’m not going to be an accountant.” Accounting teaches the language of business. Students receive report cards at school.



Financial statements are the report cards for businesses. Everything that happens in a business is quantified on a financial statement. If business professionals don't know how the numbers are put together and used, how can they run their business effectively? The numbers should provide an objective look at the health of a company at a specific point in time.

What Is Accounting?

Accounting is keeping score of what's happening in the business. This is known as *financial accounting*, and the results are reported on the *financial statements*. The financial statements allow investors and creditors to make investment decisions, suppliers and customers to determine the financial condition of the company, and managers to make corrections and better decisions concerning the operations of the business.

How Are Businesses Organized?

There are three common types of businesses—service, merchandising, and manufacturing. The organization of the business can be set up as a sole proprietorship, partnership, corporation, or limited liability company. Each has advantages and disadvantages. Exhibit 1-1 in the textbook summarizes the different types of business organizations.

What Accounting Principles and Concepts Govern the Field of Accounting?

The *Financial Accounting Standards Board (FASB)* set the principles that govern how we report financial information, called the *Generally Accepted Accounting Principles (GAAP)*. The *International Financial Reporting Standards (IFRS)* were created for businesses located in countries that didn't have their own accounting standards.

How Is the Accounting Equation Used to Record Business Transactions?

The basic *accounting equation* states that the assets must equal the liabilities plus the owner's equity. This sets the basic framework for accounting. For example, assets can be broken down into current assets and long-term assets. Liabilities can be broken down into current liabilities and long-term liabilities. Equity can be broken down into common stock and retained earnings. Each of these can be broken down even further. It's important to build a framework (a structure) in your mind as to where everything goes and how they're interrelated. As transactions occur in a business, they're recorded in these categories of accounts. For example, if you invest capital in the form of cash, then the assets and equity increase, keeping the accounting equation in balance.

What Do Financial Statements Report, and How Are They Prepared?

The four most common financial statements are

1. *Balance sheet*—A statement that shows what a company owns (assets), what it owes (liabilities), and what the owners can claim (owner's equity) as of a particular date
2. *Income statement*—A statement that shows how much a company has earned (revenue) and spent (expenses) for a period of time
3. *Statement of retained earnings*—A statement that shows how owner's equity has changed over a period of time. (Don't be confused by the introduction of the term *stockholders' equity*. In a corporation, owner's equity is called stockholders' equity because the owners hold stock certificates. But the definition is the same; a stockholder is an owner.)
4. *Statement of cash flows*—A statement that accounts for the cash position of a company as of a particular date

Every business has a balance sheet and income statement. The statement of retained earnings and statement of cash flows are optional. Also, additional statements can be created as needed. For example, a manufacturing concern will have statements of manufactured goods. There isn't a set number of statements that a particular business may have, but all businesses will have the first two.

Exhibit 1-2 in the textbook illustrates the relationship between the first three financial statements. The net income from the income statement is shown as a line item on the statement of retained earnings. The retained earnings is shown as a line item on the balance sheet.

Before moving on to your next assignment, work through the following accounting exercises and practice problems. When you've completed the work, check your answers against the answers provided on your My Courses page. Then, take some time to complete *Self-Check 1*.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 1

At the end of each assignment, you'll be asked to complete selected exercises and practice problems from the text as a review of what you've learned. We urge you to complete the exercises and problems, as accounting is best learned by doing. The more you practice, the more proficient you'll become.

1. Short Exercises S1-2 through S1-14 (pages 30–33)
2. Exercises (Group B): E1-23B through E1-30B (pages 37–39)
3. Problems (Group B): P1-36B through P1-40B (pages 44–47)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 1

At the end of each section of *Financial Accounting*, you'll be asked to pause and check your understanding of what you've just read by completing a "Self-Check" exercise. Answering these questions will help you review what you've studied so far. Please complete *Self-Check 1* now.

1. Which statement is *false*?
 - a. The proprietorship form of business organization protects the personal assets of the owners from creditors of the business.
 - b. A proprietorship has a single owner.
 - c. Accounting is the information system that measures business activities, processes that information into reports, and communicates the results to decision makers.
 - d. The FASB determines how accounting is practiced in the United States.
2. The primary objective of financial reporting is to
 - a. present information in an ethical manner.
 - b. provide information useful to managers in making daily decisions.
 - c. provide information to the federal government.
 - d. provide information useful for investment and lending decisions.
3. Wilbur Corp. operates a fishing tackle shop. The company needs to borrow money to expand; therefore, it prepared financial statements to present to the banker. Wilbur Corp. obtained appraisals of all the assets of the business to ensure that the balance sheet would reflect the most current value of the assets. Wilbur Corp. has violated which principles or concepts?
 - a. Reliability principle
 - b. Cost principle
 - c. Going-concern principle
 - d. Stable-monetary-unit concept
4. Which statement is *false*?
 - a. Assets are economic resources that are expected to benefit future periods.
 - b. Expenses are decreases in stockholders' equity that result from delivering goods and services to customers.
 - c. Revenues are assets that represent economic benefits.
 - d. Liabilities are economic obligations to outsiders.
5. A payment on account
 - a. decreases assets.
 - b. increases liabilities.
 - c. increases stockholders' equity.
 - d. increases assets.

(Continued)



Self-Check 1

6. Which transaction increases stockholders' equity?
- a. Collection of an account receivable
 - b. Issuance of common stock for cash
 - c. Payment of salaries
 - d. Cash purchase of land
7. A balance sheet reports the
- a. assets, liabilities, and stockholders' equity on a particular date.
 - b. difference between revenues and expenses during the period.
 - c. change in the retained earnings during the period.
 - d. cash receipts and cash payments during the period.
8. If assets increase \$40,000 during the period and liabilities decrease \$8,000 during the period, stockholders' equity must have
- a. increased \$32,000.
 - b. decreased \$48,000.
 - c. decreased \$32,000.
 - d. increased \$48,000.
9. The following is information about the assets and liabilities at the end of 2013 and 2014:

	2013	2014
Assets	\$75,000	\$90,000
Liabilities	36,000	45,000

If net income was \$1,500 and there were no dividends, how much did equity increase from new stock issuances?

- a. \$40,500
 - b. \$45,000
 - c. \$6,000
 - d. \$4,500
10. The amount of net income shown on the income statement also appears on the
- a. statement of financial position.
 - b. balance sheet.
 - c. statement of retained earnings
 - d. statement of cash flows.

Check your answers with those on page 117.

ASSIGNMENT 2: ANALYZING AND RECORDING BUSINESS TRANSACTIONS

Read Assignment 2 in this study guide. Then read Chapter 2 in your textbook, *Financial Accounting*.

How Are Accounts Used to Keep Business Transactions Organized?

The books of accounting for a business are very similar to the chapters of a textbook. And, just as textbook has a table of contents that lists the chapters of the textbook, the accounting books for a business have a chart of accounts. On the *chart of accounts* are the following categories:

1. Assets
2. Liabilities
3. Stockholders' Equity
4. Revenues
5. Expenses

Each category is further broken down into *general ledger accounts*, like subsections. The accounting “book” titled *Assets* would have accounts like *Cash* and *Accounts Receivable*. In the general ledger account “Cash,” information about cash is entered, just as information is written in a chapter of a textbook.

What Are Debits, Credits, and T-Accounts?

The definition of a debit isn't plus or minus. It isn't increase or decrease. A *debit* is simply what's on the left. This is the same with a credit. A *credit* is what's on the right. A debit or credit must be considered in context. The context is what's considered the *normal balance*, which simply is what increases that category of accounts—a debit or credit.

The normal balance of an asset is a debit. The normal balance of a liability is a credit. The normal balance of equity is a credit. The normal balance of a revenue account is a credit. The normal balance of an expense account is a debit.

Double-entry accounting requires that every transaction affects at least two general ledger accounts. The transaction must affect at least one debit and at least one credit. The sum of the debits must always equal the sum of the credits.

Therefore, if you're going to increase an asset account (the normal balance of an asset is a debit), then you must debit that account. Using a double-entry accounting means you must make a credit somewhere else because debits must equal credits. That means whichever account you choose, you'll credit that account. If choosing a liability account, know that you'll be increasing the liability account because the normal balance of a liability account is a credit (which increases that account).

Notice that the asset is a debit. Also, notice that the liability is a credit. If increasing the liability using a credit, then to decrease it, use a debit. This is why debits and credits don't have the definition of increase or decrease, plus or minus. If increasing the asset using a debit, and you'd decrease a liability using a debit. The debit depends on its context or the normal balance of the category of account.

To see this more clearly, *T-accounts* are used. The middle of page 56 of the textbook shows a T-account. The debit is on the left, and the credit is on the right. If the account was an asset, the debit would go on the left. If the account was a liability, the debit would still go on the left. However, the meaning of each account changes based on the normal balance. If it's an asset, the asset will increase on the debit

side. If it's a liability, the liability will increase on the credit side, which means it will decrease on the debit side.

Exhibit 2-1 illustrates the categories of accounts and T-accounts, showing whether the account increases or decrease by using a debit or credit for that type of account.

How Are the General Journal and General Ledger Used to Keep Track of Business Transactions?

All transactions that occur in a business are *journalized*, or recorded in a journal. Remember, there are two parts to every transaction—a debit and a credit. There can be more than one debit or more than one credit for each transaction. However, the debits must equal the credits.

After a transaction has been journalized, it must be posted into the *general ledger accounts*. This can be thought of as rearranging the information. For example, if you have 1,000 transactions spread out over 200 pages in a journal and you want to know what the balance of your cash account is, it would be time-consuming to go through each page and transaction to come up with the effects on the cash account. By posting the 1,000 transactions into the general ledger, all of the transactions that affect the cash account are posted in one place. The information is easier to assimilate because you're looking only at the cash transactions. Exhibit 2-2 of the text shows an example of a transaction that was entered into a journal and posted to its corresponding general ledger accounts. Looking at the general ledger accounts reveals the transactions that affected that account and the balance in the account.

How Is a Trial Balance Prepared, and What Is It Used For?

The information in the general ledger can be further simplified into a general ledger trial balance. A *trial balance* is nothing more than a listing of the accounts and the balances in those accounts. Exhibit 2-3 in the textbook provides an example of a trial balance. From the trial balance, steps can be taken to correct any information that's in error or needs adjustment, and the financial statements can be prepared.

Page 72 of the text provides an illustration with eight steps that shows the process from analyzing a transaction through creating a post-closing trial balance. Follow and understand where you are in each step of the process. Beginning students often get lost as to what they should be doing next. Refer to this illustration often. Remember, you must build a framework in your mind as to what you must be doing with the accounting information.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 2

1. Short Exercises S2-2 through S1-14 (pages 78–82)
2. Exercises (Group B): E2-23B through E2-30B (pages 86–89)
3. Problems (Group B): P2-37B through P2-42B (pages 93–96)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 2

1. Which of the following is/are an example of a liability account?
 - a. Service revenue
 - b. Rent expense
 - c. Accounts payable
 - d. All of the above
2. Oliver Company collected \$2,250 on account. The effect of this transaction on the accounting equation is
 - a. to increase assets and decrease liabilities.
 - b. nothing. It has no effect on total assets.
 - c. to increase assets and increase stockholders' equity.
 - d. to decrease assets and decrease liabilities.
3. Which statement is *true*?
 - a. Decreases in assets and increases in revenues are recorded with a debit.
 - b. Increases in liabilities and decreases in stockholders' equity are recorded with a credit.
 - c. Increases in both assets and dividends are recorded with a credit.
 - d. Decreases in liabilities and increases in expenses are recorded with a debit.
4. Note Payable has a normal beginning balance of \$30,000. During the period, new borrowings total \$63,000, and the ending balance in Note Payable is \$41,000. Determine the payments on loans during the period.
 - a. \$8,000
 - b. \$52,000
 - c. \$134,000
 - d. \$22,000
5. Which statement is *not* correct?
 - a. The account is a basic summary device used in accounting.
 - b. A business transaction is recorded first in the journal and then posted to the ledger.
 - c. The ledger is a chronological listing of all transactions.
 - d. The debit entry is recorded first in a journal entry; the credit entry follows.
6. Which account has a normal credit balance?
 - a. Rent Expense
 - b. Common Stock
 - c. Service Revenue
 - d. Both b and c

(Continued)



Self-Check 2

7. The journal entry to record the payment to a supplier of \$890 on account is
- a. Accounts Payable, \$890; Cash \$890.
 - b. Cash, \$890; Accounts Receivable, \$890.
 - c. Cash, \$890; Accounts Payable, \$890.
 - d. Supplies, \$890; Cash, \$890.
8. The ending Cash account balance is \$57,600. During the period, debit postings equal \$124,300. If credit postings during the period total \$135,100, then the beginning Cash amount must have been
- a. \$68,400.
 - b. \$46,800.
 - c. \$181,900.
 - d. \$10,800.
9. Use the following selected information for the Callie Company to calculate the correct credit column total for a trial balance:

Accounts receivable	\$7,200
Accounts payable	6,900
Building	179,400
Cash	15,800
Common stock	64,000
Salary expense	56,100
Salary payable	3,600
Service revenue	190,500
Dividends	6,500

- a. \$201,000
 - b. \$265,000
 - c. \$321,400
 - d. \$271,500
10. The *incorrect* trial-balance debit column total is \$58,700. During the period, a \$1,000 debit to Accounts Receivable was posted as \$100. What is the trial-balance debit column total after this error is corrected?
- a. \$57,600
 - b. \$59,800
 - c. \$57,800
 - d. \$59,600

Check your answers with those on page 117.

ASSIGNMENT 3: ADJUSTING AND CLOSING ENTRIES

Read Assignment 3 in this study guide. Then read Chapter 3 in your textbook, *Financial Accounting*.

How Does a Company Accurately Report Its Income?

GAAP requires that revenue is recognized when it's earned, regardless of when the cash is received. This is known as the *revenue recognition principle*, and the journal entries used to record these transactions are known as *accrual entries*.

A corollary to this is the *matching principle*, which states that expenses should be matched with the revenues they earned. However, if cash is received prior to the recognition of revenue or cash is paid prior to the recognition of an expense, this is known as a *deferral*.

Accounting for revenue when it's earned but not paid for follows the use of accrual accounting, which GAAP requires. However, some businesses use *cash-basis accounting* and record the transactions when the cash is received, regardless of when the sale occurred.

What Is the Role of Adjusting Entries, and When Are They Prepared?

Adjusting entries are journal entries used to ensure that the revenue recognition and matching principles are followed.

There are two types of adjusting entries made for accruals:

1. Unrecorded revenues
2. Unrecorded expenses

There are two types of adjusting entries made for deferrals:

1. Unearned revenues
2. Prepaid expenses

Adjusting entries are usually prepared at the end of an accounting period. A business starts the accounting period with a beginning trial balance that shows the balances in the general ledger accounts at the start of the period. Transactions occur throughout the accounting period and are journalized and posted to the general ledger accounts.

At the end of the accounting period, an *unadjusted trial balance* is created. The accounts are examined, and adjustments are made for any errors that may have occurred, for accruals, and for deferrals. These adjustments are journalized and posted to the respective general ledger accounts. From these new balances, an *adjusted trial balance* is generated.

How Are Financial Statements Prepared from an Adjusted Trial Balance?

Review Exhibit 3-3 in your textbook. It presents an example of an adjusted trial balance. This is a list of the general ledger accounts and their balances. Each account falls into one of the five categories of accounts—assets, liabilities, equity, revenues, or expenses. The accounts and balances are placed on the appropriate financial statement.

The *balance sheet* (Exhibit 3-6 in the textbook) reflects the assets, liabilities, and equity accounts. The *income statement* (Exhibit 3-4) reflects the revenues and expenses. The *statement of retained earnings* (Exhibit 3-5) shows the changes in retained earnings based on the net income/loss from the income statement.

How Does a Company Prepare for a New Accounting Period?

The general ledger accounts on the balance sheet are referred to as *permanent accounts*. This means that the accounts reflect the balance in the accounts from the beginning of the business up until the balance sheet is dated.

The accounts on the income statement are known as *temporary accounts*. They reflect the balances in the accounts for a period of time (the *accounting period*).

After the adjusted trial balance has been created, if you add together all of the asset accounts, the total of the liability accounts, and the total of the equity accounts, you'll find that the accounting equation is out of balance. It's out of balance by the difference between the revenues and expenses (net income/loss) from the income statement and any effect from dividends. To bring the accounting equation back into balance and to start the new accounting period with zero balances in the temporary accounts, *closing entries* must be made. Pages 118—120 in your textbook illustrate the process for making closing entries for the temporary accounts.

Once the closing entries are journalized and posted to the general ledger accounts, the only accounts with balances in them are the assets, liabilities, and equity accounts. A *post-closing trial balance* is then generated, and the balances from these accounts are the beginning balances for the next accounting period.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 3

1. Short Exercises S3-2 through S3-13 (pages 127–130)
2. Exercises (Group B): E3-28B through E3-41B (pages 135–141)
3. Problems (Group B): P3-48B through P3-P53B (pages 146–151)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.

Before moving on to Lesson 2, go to the My Courses page to access the instructions for the graded project for Lesson 1. When you've completed the project and uploaded your work to be graded, return to this study guide to begin Lesson 2.



Self-Check 3

1. During 2014, Bustamante Co. incurred a salary expense of \$240,000. Beginning and ending Salary Payable was \$4,000 and \$8,000, respectively. In 2013, Bustamante paid salaries of
 - a. \$248,000.
 - b. \$240,000.
 - c. \$236,000.
 - d. \$244,000.
2. On October 1, 2014, the Jernigan Company paid \$4,800 for a one-year insurance policy. On December 31, 2014, the adjusting entry would include a
 - a. debit to Insurance Expense, \$3,600.
 - b. credit to Insurance Payable, \$1,200.
 - c. credit to Prepaid Insurance, \$1,200.
 - d. debit to Insurance Expense, \$4,000.
3. Failure to record an adjusting entry for an accrued expense will result in the following:

Liabilities	Net Income
a. understated	overstated
b. overstated	understated
c. understated	no effect
d. no effect	understated
4. An adjusting entry could contain all of the following *except* a
 - a. debit to Unearned Revenue.
 - b. credit to Cash.
 - c. debit to Interest Receivable.
 - d. credit to Salary Payable.
5. The 2014 income statement showed Rent Expense of \$6,100. The related balance sheet account, Prepaid Rent, had a beginning balance of \$1,400 and an ending balance of \$1,200. The amount of cash paid for rent during 2014 is
 - a. \$6,100.
 - b. \$1,200.
 - c. \$6,300.
 - d. \$5,900.

(Continued)



Self-Check 3

Table 3-1
Lemon Car Rental, Inc.
Unadjusted Trial Balance
December 31, 2014

Cash	\$7,450	
Prepaid insurance	1,600	
Equipment	19,000	
Accumulated Depreciation		\$4,200
Accounts Payable		5,000
Common Stock		10,000
Retained Earnings		5,600
Dividends	6,000	
Rental Revenue		23,400
Insurance Expense		7,000
Salary Expense		4,000
Repair Expense	3,150	
	\$48,200	\$48,200
Adjusting entries include:		
(1) Prepaid insurance used	\$1,600	
(2) Depreciation	1,300	
	\$2,900	

6. Refer to Table 3-1 above. The credit column of the adjusted trial balance should total
- a. \$45,300.
 - b. \$49,300.
 - c. \$49,500.
 - d. \$51,100.
7. Refer to Table 3-1. After posting adjusting entries, net income
- a. will be \$6,350.
 - b. will be \$9,250.
 - c. will be \$7,950.
 - d. can't be determined from the given information.

(Continued)



Self-Check 3

8. Which of the following is a permanent account?
- a. Dividends
 - b. Prepaid Insurance
 - c. Insurance Expense
 - d. Service Revenue
9. The entry required to close dividends at the end of the period should include a
- a. debit to Retained Earnings.
 - b. credit to Retained Earnings.
 - c. credit to Cash.
 - d. debit to Dividends.
10. Which groups of accounts *correctly* appear on the post-closing trial balance?
- a. Rent Expense, Prepaid Rent, Retained Earnings
 - b. Dividends, Equipment, Accumulated Depreciation
 - c. Service Revenue, Interest Receivable, Note Payable
 - d. Retained Earnings, Cash, Unearned Revenue

Check your answers with those on page 118.

PROJECT GOAL

The goal of this graded project is to create the following financial statements for J & L Accounting, Inc.:

- Balance sheet
- Income statement
- Statement of retained earnings
- Post-closing trial balance

The financial statements must be created in one Microsoft Word document (.doc or .docx file). Alternatively, an Excel workbook may be used (.xls or .xlsx file). The Word or Excel file will be uploaded for grading.

INSTRUCTIONS

Read the following instructions thoroughly before beginning your work. This will help you to become familiar with what is involved in the project. Some students start on the project right away, thinking they'll save time. Those students tend to get stuck and spend more time working through the project than is necessary. The material you need to know in order to complete the project has been covered in the textbook and the assigned exercises and problems. If you understand the chapters and completed the assigned homework problems, you should have no problem with the project.

The project is to be done by hand with a pencil and paper. Use the blank forms provided. At the end of the project, you'll be given instructions for creating and uploading the financial statements in a Word or Excel file for grading.

Note: The formatting of financial statements is important. They follow Generally Accepted Accounting Principles (GAAP), which creates a uniformity of financial statements for analyzing. This allows for an easier comparison, as all businesses follow GAAP. Therefore, the financial statements should be created exactly the same way shown or referenced in the textbook. Failure to do so will result in a loss of points.

The project references “debits equaling credits.” This is a fundamental principle of accounting that mustn’t be violated. Doing so is *not acceptable under any circumstance*. Debits not equaling credits allows for “cooking of the books,” which is presenting false information. It also allows for embezzlement, which is theft by management or employees. If debits don’t equal credits, the cause may be a lack of understanding of accounting principles, such as those presented in the textbook and assigned homework problems, or a lack of focus and concentration when making journal entries, posting to ledger accounts, or completing math. Remember—instructors are available to help you with material you may be struggling with. Mistakes of the lack-of-focus variety are best corrected by going back over the work until the error is found.

The accounting equation must balance on the balance sheet. This is another fundamental principle of accounting that can’t be violated and if so is *completely unacceptable*. When the equation doesn’t balance and the numbers are “fudged,” this is easily detectable by someone who knows accounting. If your debits equal your credits and you understand which general ledger accounts belong on which financial statements, then the accounting equation should balance. It’s really all about understanding the concepts and applying that understanding.

The following financial statements are provided from the prior accounting period for J & L Accounting, Inc.:

- a) Post-closing trial balance
- b) Balance sheet
- c) Income statement
- d) Statement of retained earnings

J & L Accounting, Inc.
Post-Closing Trial Balance
December 31, 2014

ACCOUNT TITLE	BALANCE	
	DEBIT	CREDIT
Cash, Business Checking	20,500.00	
Accounts Receivable		
Prepaid Rent		
Vehicles	48,000.00	
Accumulated Depreciation, Vehicles		12,000.00
Equipment	3,600.00	
Accumulated Depreciation, Equipment		600.00
Accounts Payable		
Common Stock		38,000.00
Retained Earnings		21,500.00
Dividends		
Service Revenue		
Advertising Expense		
Rent Expense		
Office Supplies Expense		
Telephone Expense		
Utilities Expense		
Depreciation Expense		
TOTALS	72,100.00	72,100.00

J & L Accounting, Inc.
Balance Sheet
As of December 31, 2014

ASSETS

Cash, Business Checking		20,500.00
Accounts Receivable		0.00
Prepaid Rent		0.00
Vehicles	48,000.00	
Less: Accumulated Depreciation, Vehicles	<u>12,000.00</u>	36,000.00
Equipment	3,600.00	
Less: Accumulated Depreciation, Equipment	<u>600.00</u>	<u>3,000.00</u>
TOTAL ASSETS		<u><u>59,500.00</u></u>

LIABILITIES

Accounts Payable	0.00
TOTAL LIABILITIES	0.00

STOCKHOLDERS' EQUITY

Common Stock	38,000.00
Retained Earnings	<u>21,500.00</u>
TOTAL STOCKHOLDERS' EQUITY	<u><u>59,500.00</u></u>

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u><u>59,500.00</u></u>
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J & L Accounting, Inc.
Income Statement
For the Month Ending December 31, 2014

REVENUES

Service Revenue	10,275.00
-----------------	-----------

EXPENSES

Advertising Expense	2,300.00
---------------------	----------

Rent Expense	1,000.00
--------------	----------

Office Supplies Expense	300.00
-------------------------	--------

Telephone Expense	750.00
-------------------	--------

Utilities Expense	3,200.00
-------------------	----------

Depreciation Expense	1,100.00
----------------------	----------

TOTAL EXPENSES	<u>8,650.00</u>
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NET INCOME	<u><u>1,625.00</u></u>
-------------------	-------------------------------

J & L Accounting, Inc.
Statement of Retained Earnings
For the Month Ending December 31, 2014

Retained Earnings, December 1, 2014	19,875.00
Add: Net Income	1,625.00
Subtotal	<u>21,500.00</u>
Less: Dividends	<u>0.00</u>
Retained Earnings, December 31, 2014	<u><u>21,500.00</u></u>

1) Using the following blank forms (make as many copies as necessary), set up the general ledger accounts for the general ledger and insert the beginning balances for the accounts from the post-closing trial balance. The balances from the post-closing trial balance become the beginning balances of the accounts for the next account period.

DATE		ITEM	POST REF.	DEBIT	CREDIT	BALANCE	
						DEBIT	CREDIT

2) Journalize the following transactions in the general journal using the following blank form (make as many copies as needed). When making journal entries, each individual journal entry's debits should equal its credits. (The amount for a journal entry can be incorrect or the entry can be incorrect. However, the debits still have to equal the credits even though the entry is incorrect. If the journal entry is incorrect, it can be corrected later when making adjusting/correcting journal entries. For example, if the amount is supposed to be \$1,100, and for some reason the amount of \$1,010 is recorded, this is acceptable—although incorrect, it can be corrected later.) The total of the debits must always equal the total of the credits for each journal entry—*always*. This is a fundamental GAAP that cannot be violated.

- a. On January 1, 2015, a payment in cash for \$12,000 is made for prepaying rent for the entire year 2015.
- b. On January 4, 2015, accounting services are performed and payment is received in cash for the amount of \$1,900.
- c. On January 9, 2015, a payment in cash for advertising is made in the amount of \$850.
- d. On January 10, 2015, office supplies are purchased in the amount of \$75 with cash.
- e. On January 14, 2015, accounting services are performed and payment is received in cash for the amount of \$2,725.
- f. On January 20, 2015, the telephone bill for the amount of \$660 is received and paid with cash.
- g. On January 20, 2015, the utilities bill for \$2,925 is received. The bill won't be paid until it is due on February 15, 2015.
- h. On January 27, 2015, accounting services are performed on account in the amount of \$3,750.
- i. On January 28, 2015, a payment in cash for \$1,500 is made for a bill from an advertising agency.

- 3) Post the general journal entries from the journal to the corresponding general ledger accounts, paying particular attention to the posting being made (debit or credit). Use the Post Ref. column to ensure that each line item of the journal entries is posted correctly to each general ledger account. Posting from the journal to the general ledger is nothing more than rearranging the information. If the debits equal the credits for a particular journal entry and the information is posted correctly, the total of the debits should equal the total of the credits in the general ledger.
- 4) Calculate the balances in the general ledger accounts. (Use an Excel spreadsheet or a printing calculator, and run the numbers several times for accuracy. Often, debits won't equal credits on the trial balance because a hand-held calculator is used and the math is done only once. Using a hand-held calculator can introduce errors. This is why an Excel spreadsheet is recommended. However, if a hand-held calculator is all that's available to you, be sure to do the math enough times that you know the calculations are accurate.) To calculate the balances in the ledger accounts, you'll need to do the following:
 - 1) Add the debits.
 - 2) Add the credits.
 - 3) Subtract the larger amount from the other, or, alternatively, keep the running balance of the amount in the account and whether it's a debit or credit on the ledger.
- 5) Create an unadjusted trial balance from the balances in the general ledger accounts. (Once again, be very careful when doing the math. When calculating the totals of the debit and credit columns, they should be equal. If not, do not continue until the debits equal the credits. An error has been made and must be found and corrected from the previous steps.) See page 129 of the text for an example of an unadjusted trial balance. Use the following blank form.

[illegible]

- 6) Journalize the following adjusting journal entries in the general journal, being sure that the debits equal the credits:
 - a. Calculate and make the adjustment for the amount of pre-paid rent that has been used.
 - b. Make an adjusting journal entry in the amount of \$1,000 for depreciation of the vehicles.
 - c. Make an adjusting journal entry in the amount of \$100 for depreciation of the equipment.
- 7) Post the adjusting journal entries to the respective general ledger accounts, again being sure that the postings are to the correct debit or credit side and that the Post Ref. column is used.
- 8) Calculate the new balances in the general ledger accounts. Create an adjusted trial balance from the balances in the general ledger accounts using the same blank form provided in step 5 when you created the unadjusted trial balance. See Exhibit 3-3 on page 114 in your textbook for an example of an adjusted trial balance. Make sure the math is correct and that the debit column is equal to the credit column. If not, don't continue until the error has been found.
- 9) Create the income statement for J & L Accounting, Inc. using the information from the adjusted trial balance. Use the following blank form to create the income statement. Its format should be the same as the format used for the statement provided at the beginning of the project for the prior accounting period.

- 10) Create the closing journal entries in the general journal to close the revenue, expense, and dividend accounts to the retained earnings account, paying attention to debits equaling credits.
- 11) Post the closing journal entries to the respective general ledger accounts.
- 12) Calculate the balances in the general ledger accounts.
- 13) Create a post-closing trial balance from the balances in the general ledger accounts using the same blank form that was provided in step 5 when you created the unadjusted trial balance. The post-closing trial balance should be in the same format as the post-closing trial balance provided at the beginning of the project for the prior accounting period. Make sure the math is correct and that the debit column is equal to the credit column. If not, don't continue until the error has been found.
- 14) Create the balance sheet for J & L Accounting, Inc. using the information from the post-closing trial balance. If the debits equal the credits from the previous work and the closing entries were made properly, then the accounting equation should balance on the balance sheet. If the assets don't equal the liabilities plus stockholders' equity, an error has been made that needs to be corrected. The balance of the accounting equation is another fundamental GAAP principle that can't be violated. Use the following form to create the balance sheet. Its format should be the same as the format of the statement provided at the beginning of the project for the prior accounting period.

- 15) Create the statement of retained earnings for J & L Accounting, Inc. using the ending balance from the statement of retained earnings from the prior period and the net income from the income statement for the January accounting period. (No dividends were paid out during the month of January.) Follow the same format from the statement of retained earnings at the beginning of the graded project for the prior accounting period using the blank form on the following page.

Having created the balance sheet, the income statement, the statement of retained earnings, and the post-closing trial balance on the blank forms that were provided, the financial statements must now to be typed up in a Microsoft Word document and saved as a .doc or .docx file. Microsoft Excel can also be used (saving the file with the extension .xls or .xlsx). Each financial statement should be on its own page (or worksheet). The name of the file should include your student ID number and the graded project exam number, such as “21512345_061579.docx” as an example.

Insert tables in the Word document if you feel you need them to format the financial statements. Alternatively, space and tab in Word to get the formatting of the statements set up correctly. Formatting is important. Also, keep in mind that points will be deducted for incorrect capitalization, spelling, underlining and double underlining, as well as for improper headings, dates, indentations, and columns.

Create all of the financial statements in **one file**. Submission of more than one file will result in the project being returned as ungraded. Submission of only one file is important for tracking and grading purposes.

Images or scanned images of the financial statements pasted into a Word document will also result in the project being returned as ungraded. This prevents the ability to “mark up” the file, and financial statements that are handwritten are generally considered unprofessional.

Only the financial statements are required. Submitted journals, ledgers, or unadjusted/adjusted trial balances will *not* be evaluated.

PLAGIARISM

Plagiarism is taking any part of a published piece of work and using it as your own.

Plagiarism is unacceptable at Penn Foster College. This is a reminder of the expectation to which all Penn Foster College students are held. Per your Student Handbook, students are expected to conduct themselves with the highest academic and ethical standards. Failure to do so results in disciplinary action.

GRADING CRITERIA

The grading criteria for the project are as follows:

The *formatting* of the four financial statements is worth 10 points each for a total of **40 points** ($4 \times 10 = 40$).

An out-of-balance accounting equation on the balance sheet will result in a loss of 10 points for the formatting of the balance sheet even though other formatting issues may be correct.

Debits not equaling credits on the post-closing trial balance will result in a loss of 10 points for formatting of the post-closing trial balance even though other formatting issues may be correct.

Also, not having made closing journal entries as reflected on the post-closing trial balance will result in a loss of 10 points for formatting of the post-closing trial balance even though other formatting issues may be correct.

Calculations on the financial statements are based on 18 balances from the general ledger accounts. One is for the beginning retained earnings balance on the statement of retained earnings, and one is for the correct ending retained earnings balance on the statement of retained earnings. This amounts to a total of 20 figures ($18 + 1 + 1 = 20$). Each is worth 3 points for a total of **60 points** ($20 \times 3 = 60$).

Thus, the formatting of the financial statements (worth 40 points total) plus the figures used for the financial statements (worth 60 points total) provide 100 points for the project.

Formatting	40 points
Figures	<u>60 points</u>
Total Points	100 points

If a project receives a failing grade (less than 70 points), the project will have to be reworked and resubmitted for final grading. The highest grade that can be obtained on a retake is a 70, which is passing.

SUBMITTING YOUR PROJECT

Once you've completed the project and your **one file** is ready to be submitted, follow the instructions below. Be sure to check your work, and be sure to upload the correct file. Once the file is uploaded, it will be graded "as is" and can't be resubmitted.

You can submit your graded project online.

Save a final version of your project. Be sure to include your name, student number, and exam number in the header or the footer of your saved document. The graded project number is **061579**.

1. Go to **www.pennfoster.edu** and log in.
2. Go to My Courses.
3. Click on **Take Exam** next to the lesson you're working on.
4. Enter your email address in the box provided. (*Note: This information is required for online submission.*)
5. Attach your file as follows:
 - a. Click on the **Browse** box.
 - b. Locate the file you wish to attach.
 - c. Double-click on the file.
 - d. Click on **Upload File**.
6. Click on **Submit Files**.

Be sure to keep a backup copy of your completed assignment.

Good luck with the project!

NOTES

Accounting for Merchandising

Assignment 4 describes the supply chain of a merchandising business and the use of periodic and perpetual inventory systems. Accounting for shipping, purchase discounts, and purchase returns and allowances are covered. Preparations of single-step and multi-step financial statements are illustrated.

Assignment 5 examines the accounting for inventory using the specific-identification, FIFO, LIFO, and average cost methods. Accounting principles and concepts that affect inventory, such as the consistency principle, accounting conservatism, the materiality concept, the full-disclosure principle, and the lower-of-cost-or-market rule, will be explained.

Assignment 6 discusses the importance of ethics in business and accounting and the use of internal controls to prevent fraud and embezzlement. The major requirements of the *Sarbanes-Oxley Act (SOX)* are presented, and distinctions between internal and external audits are made.

When you complete this lesson, you'll be able to

- Understand periodic and perpetual inventory systems, accounting for the purchases and sales of inventory and how to account for shipping, freight, and other selling expenses in preparation of a multi-step income statement and classified balance sheet
- Account for inventory, the use of different inventory costing methods, and their effects on financial statements
- Understand the role of ethics in accounting, the use of internal controls, and the major provisions of the International Financial Reporting Standards (IFRS)



ASSIGNMENT 4: ACCOUNTING FOR A MERCHANDISING BUSINESS

Read Assignment 4 in this study guide. Then read Chapter 4 in your textbook, *Financial Accounting*.

What Are the Relationships among Manufacturers, Wholesalers, Retailers, and Customers?

Exhibit 4-1 of the textbook illustrates the relationships among wholesalers, retailers, and customers. While customers can at times purchase products directly from the manufacturer, this generally happens only when the customers are located close to the manufacturer. Otherwise, a *distribution channel* is created so that the manufacturer can sell its products beyond the local vicinity.

How Do Periodic and Perpetual Inventory Systems Differ?

Keeping track of the value of inventory on an ongoing basis is known as using a *perpetual inventory system*. At any given time, you know the value of the inventory. This method is used for easy-to-track inventories, such as automobiles and large-ticket items.

Periodic inventory systems value the inventory periodically, most often at the end of an accounting period. A physical count of the inventory is taken, and the value is determined. This method is best used when there are numerous products to be accounted for, such as in department stores or grocery stores. The inventory on the books is adjusted to reflect this valuation. Page 161 in your textbook shows the basic formula for determining the cost of goods sold.

How Do You Account for the Purchase of Inventory?

When inventory is purchased—whether using cash, credit, or on account—the purchase is recorded using an inventory account. However, two additional accounts can be used: *purchase returns and allowances* and *purchase discounts*. The purpose of these accounts is to record returns, allowances, and discounts separate from the actual sales amount.

For example, you buy 100 sweaters for \$100 each, for a total of \$10,000. However, \$1,500 of the sweaters are the incorrect color and must be returned. You would make the entry to your books against the Purchase Returns and Allowance account. Your books would show a purchase for the \$10,000 and a return for \$1,500, for a net effect of \$8,500. Why would you record your entries like this? Control. If you use only the inventory account, the balance in the account after the return would show \$8,500. For this one transaction, you're familiar with the return. But what if you're a large retailer with multiple locations? It may be very difficult to know what's being returned. By having different accounts, you can see that the returns may be unusually high and that there may be a problem that must be addressed.

How Do You Account for the Sale of Inventory?

Accounting for the sale of inventory is similar to purchasing inventory. It's just the opposite side of the same coin. If you understand one, you can easily understand the other.

When you make a sale, you're making an entry against a sales revenue account. If what you sold is returned or an allowance is made, you would make an entry against the Sales Returns and Allowances account. If there's a discount, you make an entry to Sales Discounts.

Once again, you're recording these entries this way for control. For example, you own a car dealership, and your salespeople qualify for a bonus if they sell 10 cars in a

month. John has sold nine cars, and it's the last day of the month. He needs one more car to qualify for the bonus. He telephones a friend and convinces her to buy a car so that he can get the bonus. John reassures his friend that she can return the car the next month, and for her troubles, they'll split the bonus. If you used only the Sales Revenue account, at the end of the following month you wouldn't know that the car was returned and that John shouldn't have received the bonus. However, a flag would go up when recording the return in the Sales Return and Allowance account, and the reason for the return would lead you to know that John didn't really qualify for the bonus.

How Do You Account for Freight Charges and Other Selling Expenses?

Exhibit 4-4 of the textbook illustrates the concepts of *FOB shipping point* and *FOB destination*. These concepts show who pays for shipping and when title of the merchandise passes from seller to buyer. Often, product is shipped using a shipping company, such as a trucking company. Who pays for the freight? When does the title pass? The answers to these questions are negotiated between the buyer and seller or are assumed as a standard practice in the industry.

The seller sells ice cream machines. The terms of the sale is using FOB destination. The ice cream machine is loaded onto a truck, and the truck drives to the loading dock of the seller. The guy who drives the tractor-trailer pushes the machine to the edge of the trailer. The seller's employees inspect the machine and find that the side of the machine is damaged. Who's responsible for the damages? The seller. The seller is responsible because the terms were FOB destination. This shows that the title would pass to the buyer at the destination, which occurs when the machine is taken off the truck. As long as the machine is still on the truck, the machine is still in transit.

How Do You Prepare a Merchandiser's Financial Statements?

There are two formats to be used when preparing an income statement—single-step and multi-step. Previous chapters of the text used a *single-step format*. Merchandiser's income statements are prepared using the multi-step format.

Multi-step income statements allow for more accurate analysis of financial information. Exhibit 4-6 presents the relationship between financial statements using a multi-step income statement. Particular attention should be paid to the structure of the statements (the structure being headings, subheads, accounts, indentations, and calculations). Understanding the structure of the statements allows an accountant to more easily read statements from different businesses since they're all based on GAAP and FASB principles and concepts.

Focus on Decision Making: Ratios

Gross profit is a key metric in evaluating merchandising operations. Expressed as a percentage, the *gross profit percentage* allows a uniform standard to be able to make comparisons.

Current ratio provides creditors, investors, and suppliers with a tool to be able to evaluate whether a business can meet its obligations when they come due. Will the business have the cash to pay its current liabilities?

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 4

1. Short Exercises S4-2 through S4-13 (pages 185–188)
2. Exercises (Group B): E4-25B through E4-35B (pages 191–193)
3. Problems (Group B): P4-43B through P4-49B (pages 198–201)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 4

1. Which of the following statements is *true*?
 - a. $\text{Gross profit} - \text{Cost of goods sold} = \text{Net sales}$
 - b. $\text{Net sales} + \text{Gross profit} = \text{Cost of goods sold}$
 - c. $\text{Gross profit} = \text{Net sales} - \text{Cost of goods sold}$
 - d. $\text{Net sales} + \text{Cost of goods sold} = \text{Gross profit}$
2. J.P.'s Convenience Store purchased merchandise for \$800, terms 2/10 n/30, FOB shipping point. The supplier prepaid the \$20 freight and added it to the invoice. J.P.'s later returned \$100 of the merchandise. The entry to record the payment of the invoice within the discount period would include all of the following except
 - a. a credit to Inventory, \$14.40.
 - b. a debit to Accounts Payable, \$720.
 - c. a credit to Cash, \$706.
 - d. that all of the above would be included.
3. The entry to record the sale of \$100 of merchandise with terms of 2/10 n/30 will include a debit to
 - a. Sales for \$98.
 - b. Cash for \$100.
 - c. Accounts Receivable for \$100.
 - d. Sales Discounts for \$2.
4. Lawson Co. had a \$72,000 beginning inventory and a \$78,000 ending inventory. Sales were \$480,000, purchases of merchandise were \$258,000, merchandise returned was \$15,000, discounts taken were \$12,000, and transportation costs were \$18,000. Cost of goods sold for the period was
 - a. \$243,000.
 - b. \$207,000.
 - c. \$147,000.
 - d. \$255,000.
5. The Inventory account has a debit balance of \$30,000 on December 31. A physical count reveals that the merchandise on hand is \$29,000. The entry to adjust the inventory on December 31 would include a credit to
 - a. Cost of Goods Sold, \$1,000.
 - b. Inventory, \$1,000.
 - c. Accounts Payable, \$1,000.
 - d. Retained Earnings, \$1,000.

(Continued)



Self-Check 4

6. Would Gross Profit, Operating Income, and Net Income appear on a single-step income statement?

	Gross Profit	Operating Income	Net Income
a.	No	No	Yes
b.	Yes	Yes	Yes
c.	No	Yes	Yes
d.	Yes	No	No

Table 4-1	
Selling expenses	\$20,000
Cost of goods sold	160,000
Sales	245,000
General expenses	40,000
Interest expense	2,000
Sales returns and allowances	5,000

7. Refer to Table 4-1. On a multi-step income statement, operating income is
- | | |
|--------------|--------------|
| a. \$25,000. | c. \$18,000. |
| b. \$20,000. | d. \$85,000. |
8. The gross profit percentage (rounded) is
- | | |
|---------|---------|
| a. 35%. | c. 67%. |
| b. 65%. | d. 33%. |

(Continued)



Self-Check 4

Table 4-2
Roxanne Wilson, Attorney, P.A.
Balance Sheet
December 31, 2014

Assets		Liabilities	
Cash	\$ 405	Accounts payable	\$ 320
Accounts receivable	560	Salary payable	20
Supplies	15	Unearned revenue	110
Prepaid insurance	60	Note payable (due in 5 years)	<u>415</u>
Equipment	\$400	Total liabilities	865
Less: Acc. depr.	<u>45</u>		
	355	Stockholders' Equity	
Land	<u>400</u>	Common Stock	600
Total assets	<u>\$1,795</u>	Retained Earnings	330
		Total Liabilities & Stockholders' Equity	<u>\$1,795</u>

9. Refer to Table 4-2 above. Calculate the current ratio for Roxanne Wilson, Attorney, P.A.

- a. 1.20
- b. 3.10
- c. 2.31
- d. 2.08

10. Which of the following is *false*?

- a. Net sales = Sales revenue – Sales returns and allowances – Sales discounts
- b. Current ratio = Current liabilities/Current assets
- c. Gross profit percentage = Gross profit/Net sales
- d. Sales – Cost of goods sold = Gross profit

Check your answers with those on page 119.

ASSIGNMENT 5: INVENTORY

Read Assignment 5 in this study guide. Then read Chapter 5 in your textbook, *Financial Accounting*.

What Inventory Costing Methods Are Allowed?

There are four costing methods allowed by GAAP:

1. Specific identification
2. First-in, first-out (FIFO)
3. Last-in, first-out (LIFO)
4. Average cost

Which costing method should be used? As with many things in accounting, it all depends on what makes sense and/or the objectives of the business. For example, an automobile dealership would use the specific-identification method because each and every automobile can be identified.

If your business makes M&Ms, specific identification isn't sensible. Using another method makes more sense. Which one? That depends on how you want the financial information presented and analyzed. The inventory is the same no matter which method is used. The inventory's value will change based on the costing method used.

How Are the Four Inventory Costing Methods Applied?

Using the *specific-identification* costing method, inventory items are specifically labeled, and the actual cost of each item sold is assigned to the Cost of Goods Sold account, making the valuation of inventory relatively easy. This method is also not widely used.

FIFO, *LIFO*, and the *average cost methods* effectively track the inventory costs using a perpetual inventory record. Exhibit 5-3 of the textbook provides an example of using FIFO on a perpetual inventory record. Exhibit 5-5 provides an example of LIFO, and Exhibit 5-7 shows the average cost method.

Comparing the three methods, the exhibits show that the ending inventory is \$100 when using FIFO. The ending inventory is \$85 when using LIFO, and the ending inventory is \$97 using the average cost method. Which is correct? They all appear to be. However, the correct one is the method that the business chooses to use for its costing method. If Northwest Outfitters chooses to use LIFO, then the others would be incorrect.

What Effect Do the Different Costing Methods Have on Net Income?

The costing method chosen affects the cost of goods sold. The cost of goods sold affects the gross profit. The gross profit affects the net income. Lastly, a business is taxed based on the net income (an often-overlooked consideration). Exhibit 5-9 of the textbook provides the benefits for each costing method. Exhibit 5-10 provides an example of each method and its effect on the gross profit.

In looking at the figures, it would appear that a business could do an analysis and choose whichever benefits the business the most for any given period of time. This would violate the *consistency principle* mandated by GAAP. GAAP requires a business to use the same accounting methods and procedures from period to period. Therefore, a business should make a decision as to which method it will use regardless of the variances from period to period. However, this doesn't mean that a business can't change methods. It can change its costing method if it can be justified. Changing methods occurs very rarely, and changing methods twice is almost nonexistent.

What Else Determines How Inventory Is Valued?

GAAP also uses the *conservatism accounting principle*, which records information using a cautious approach. This is applied in inventory valuation using the *lower-of-cost-or-market (LCM)* rule. Exhibit 5-11 of the textbook provides an example of valuing inventory at the LCM. Each inventory item can be valued at the cost (what was actually paid for the item) or the market (the price currently will be on the open market as a replacement cost). According to LCM, whichever is lower—the cost or the market—will determine which price will be used.

GAAP uses another principle called *materiality*. If your business has thousands of items (for example, an electrical parts supply company), keeping track of the market and what the business paid for each item as the price fluctuates can be a daunting, inefficient, and time-consuming task. The concept of materiality states that “a company must perform strictly proper accounting only for items that have a material effect on the company’s financial statement. An item is considered to have a material effect when it would cause someone to change a decision; stated differently, a material amount is any amount that’s large enough to make a difference to a user of the financial statements.”

How Is Inventory Reported on the Balance Sheet?

Inventory is reported on the balance sheet as a current asset but not a quick asset (it can’t easily be converted to cash). The reporting of the costing method must also be reported (adhering to the *full-disclosure principle*). It’s usually included in the footnotes of the financial statements.

How Do Inventory Errors Affect the Financial Statements?

Exhibit 5-12 of the textbook illustrates the effect of an inventory accounting error. Common errors most often occur when taking a physical inventory. These errors can include improperly counting the inventory, double-counting items, not counting a section or forgetting about incoming items shipped FOB shipping point, and failing to write down damaged or obsolete goods.

If an error occurs in one period, it corrects itself in the next period, assuming the same errors aren't made a second time. Exhibit 5-13 of the textbook shows how an error corrects itself over two accounting periods.

Is It Possible to Estimate the Value of Inventory If the Inventory Is Accidentally Destroyed?

Estimates can be created using the *gross profit method*. By rearranging the ending inventory and cost of goods sold, a good estimate can be made from the existing financial information available. Exhibits 5-14 and 5-15 of the text provide the step used to make the estimate calculation and give an example using the steps.

Focus on Decision Making: Ratios

The inventory turnover rate calculates how often the inventory is turned over (sold) during a given period of time. Control over inventory is important and costly. If inventory is just sitting there because it isn't being sold, that's money and space tied up in the business that can be used more profitably with something else.

Often owners, mostly small-business owners, don't want to be bothered with "the numbers." They run their businesses by the seat of their pants. They're generally also the most

likely to complain that they don't make enough money. This can be seen in the small businesses found in flea markets. You'll often see several vendors who sell the same thing, like dishes or picture frames. They sell them for next to nothing and often can't sell them at all. The products sit on the shelves for months or years. The vendors won't get rid of them because they "paid for them" and "they'll sell eventually!" If these vendors paid attention to inventory turnover, they'd see that the turnover rate is next to nothing or zero! Or they have 50 die-cast racecars in stock but sell only one or two each week. If they paid attention to the *inventory turnover rate*, they would know that they have too much money tied up in inventory that's just taking up space. They could have taken that money and space, bought something else, and made more money.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 5

1. Short Exercises S5-2 through S5-15 (pages 232–235)
2. Exercises (Group B): E5-28B through E5-39B (pages 240–244)
3. Problems (Group B): P5-48B through P5-55B (pages 247–250)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 5

1. Which statement is *false*?
 - a. When prices are constant, the ending inventory value will be the same regardless of the inventory method chosen.
 - b. Under the last-in, first-out method, the cost of goods sold is based on the oldest purchases.
 - c. FIFO costing is consistent with the physical movement of inventory for most companies.
 - d. The specific-unit-cost method is appropriate for items that differ from unit to unit.

Hermione Co. reported the following information:

Table 5-1				
	Units	Unit Cost	Total Cost	Units Sold
Beginning inventory (Jan. 1)	4	\$400	\$1,600	
Sale (Mar. 1)				3
Purchase (Apr. 15)	4	405	1,620	
Sale (June 22)				3
Purchase (Oct. 11)	<u>2</u>	425	<u>850</u>	
Total	<u>10</u>		<u>\$4,070</u>	6
Units in ending inventory	4			

2. Refer to Table 5-1. Assume that Hermione uses perpetual LIFO. The cost of the ending inventory is
 - a. \$1,700.
 - b. \$1,670.
 - c. \$1,655.
 - d. \$1,600.
3. Refer to Table 5-1. Assume that Hermione uses perpetual average costing. The average cost of a unit sold on June 22 is
 - a. \$400.
 - b. \$402.50.
 - c. \$404.
 - d. \$405.

(Continued)



Self-Check 5

4. Refer to Table 5-1. Assume that Hermione uses perpetual FIFO. The entry to record the March 1 credit sale at a sale price of \$800 per unit would include all of the following *except* a
- a. credit to Inventory, \$2,400.
 - b. debit to Cost of Goods Sold, \$1,200.
 - c. debit to Accounts Receivable, \$2,400.
 - d. credit to Sales Revenue, \$2,400.
5. Refer to Table 5-1. Assume that Hermione uses periodic FIFO. The cost of goods sold for the period is
- a. \$2,470.
 - b. \$2,410.
 - c. \$1,660.
 - d. \$1,600.
6. In a period of rising prices, which method will yield the highest net income, lowest inventory cost, and lowest amount of income taxes?

	Highest Net income	Lowest Inventory	Lowest Income Taxes
a.	LIFO	LIFO	LIFO
b.	FIFO	LIFO	FIFO
c.	FIFO	LIFO	LIFO
d.	LIFO	FIFO	LIFO

7. The appropriate value for inventory on the balance sheet is
- a. the sale price.
 - b. the cost determined by using LIFO, FIFO, average cost, or specific unit cost.
 - c. market cost.
 - d. b or c, whichever is lower.
8. A company used FIFO in 2012, switched to LIFO in 2013, and switched back to FIFO in 2014. Which accounting principle or concept has been violated?
- a. The disclosure principle
 - b. The objectivity principle
 - c. The time-period concept
 - d. The consistency principle

(Continued)



Self-Check 5

9. An understatement of the ending inventory in 2014 will have which effects on cost of goods sold and net income in 2014?

Cost of Goods Sold	Net Income
a. overstated	understated
b. overstated	overstated
c. understated	overstated
d. understated	understated

10. H. Potter Co. estimates its inventory by the gross profit method. Potter's gross profit averages 40%. Potter reports the following information:

Beginning inventory	\$450,000
Net purchases	200,000
Net sales revenue	350,000

The estimated cost of the ending inventory is

- | | |
|---------------|---------------|
| a. \$210,000. | c. \$240,000. |
| b. \$440,000. | d. \$250,000. |

Check your answers with those on page 120.

ASSIGNMENT 6: THE CHALLENGES OF ACCOUNTING: STANDARDS, INTERNAL CONTROL, AUDITS, FRAUD, AND ETHICS

Read Assignment 6 in this study guide. Then read Chapter 6 in your textbook, *Financial Accounting*.

What Are the Rules that Govern Accounting?

Rules that govern financial accounting fall under two different categories: Generally Accepted Accounting Principles (GAAP) in the United States and generally accepted accounting principles for around the world, known as International Financial Reporting Standards (IFRS).

Accountants use the generally accepted accounting principles to keep financial information understandable, relevant, and reliable. In the United States, the creation and implementation of GAAP is governed by the Financial Accounting Standards Board (FASB), the Securities and Exchange Commission (SEC), and Accounting Standards Codification (ASC).

Internationally, the creation and implementation of IFRS is governed by the International Accounting Standards Board (IASB), which sets the standards of the IFRS.

Why are there two sets of rules? Although shipping between continents did occur, the vast majority of business was done within a nation or between neighboring nations. Accounting rules and standards were set to accommodate business as it was being carried out within a region.

With international trade increasing due to new technologies (better ships, trains, trucks, airplanes, computer systems, and the Internet), the world is becoming a smaller place. Exhibit 6-1 in the textbook presents some the differences in the treatment of concepts between GAAP and the IFRS.

Interestingly, yet not surprisingly, the United States is beginning to consider switching from GAAP to IFRS in order to be more amenable and competitive on the international stage.

What Is Internal Control?

An *internal control* is a system that helps to reduce the perceived opportunity in the *fraud triangle* (discussed in the next section). The complexity and effectiveness of an internal control system consists of the following elements:

- The control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

With the elements in place, internal controls help a business to

- Safeguard assets
- Operate efficiently and effectively
- Ensure proper reporting of financial information
- Ensure compliance with applicable laws and regulations

What Is Fraud and Who Commits It?

Fraud is the use of deception for personal gain. Two of the more common types of fraud are *management fraud* and *employee embezzlement*. Management fraud typically involves management knowingly reporting financial information inaccurately. Employee embezzlement is the misappropriation of business assets by employees.

Three factors must exist for fraud to occur:

1. Perceived pressure
2. Rationalization
3. Perceived opportunity

Exhibit 6-2 of the textbook illustrates the fraud triangle. The fraud triangle consists of three factors. If one of the factors is missing, the risk of fraud is greatly diminished.

What Is a Certified Public Accountant (CPA)?

Graduates earning a bachelor's degree in accounting may elect to go into the public or private sector. Accountants in the public sector typically work for public accounting firms for a while, then go on to pass the CPA exam in order to obtain the designation of *Certified Public Accountant (CPA)*. CPAs are licensed by a state and serve the general public by auditing businesses and reporting whether they're in line with GAAP. CPAs are required to complete extensive education and practice in the field of business and accounting. CPAs generally work in several areas of interest, specializing in those areas. The CPA is independent of the business.

Exhibit 6-3 of the textbook illustrates a typical organizational chart of a large business and how the CPA, as an external auditor, relates to the management of that business. CPAs can perform two types of audits. An *external audit* assures users that the financial statements conform to GAAP. An *internal audit* relates to a company's compliance with laws and regulations. Exhibit 6-4 of the textbook describes the four different types of audit opinions and the impact that the independent CPA provides:

1. Unqualified
2. Qualified
3. Adverse
4. Disclaimer

An example of an accountant in the private sector is a cost accountant working for a manufacturer of jet engine parts. An accountant in the private sector generally selects an area of business that's of interest to him or her and works within that area for many years, becoming very familiar with this

area. Not only would this accountant know cost accounting, but he or she would also become very familiar with machining methods and the materials used.

What Are the Legal and Ethical Responsibilities of Accountants?

At one time, a CPA's opinion was uncontestable. However, after the fallout of several accounting scandals due to the reporting of unethical behavior by whistleblowers, Congress passed the *Sarbanes-Oxley Act (SOX)* in 2002 to raise ethical behavior and restore the public's trust in corporate America. The Sarbanes-Oxley Act allowed for the establishment of the *Public Company Accounting Oversight Board (PCAOB)*, which is a private sector, nonprofit corporation that oversees auditors of publicly traded companies. It reports to the SEC.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 6

1. Short Exercises: S6-1 through S6-14 (pages 277–281)
2. There are no Exercises or Problems for this assignment.

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 6

1. An effective internal control system is designed to achieve all of the following *except* to
 - a. ensure compliance with applicable laws and regulations.
 - b. promote operational efficiency.
 - c. ensure accurate, reliable accounting records.
 - d. ensure that management makes good decisions.
2. Fraudulent financial reporting usually refers to
 - a. employee embezzlement.
 - b. management fraud.
 - c. internal controls.
 - d. risk assessment.
3. Which of the following is *not* an element of the fraud triangle?
 - a. Control activities
 - b. Rationalization
 - c. Perceived opportunity
 - d. Perceived pressure
4. Which of the following is *not* a control activity?
 - a. Mandatory vacations
 - b. Competent personnel
 - c. Adequate documents and records
 - d. Unrestricted access
5. The foundation for all other elements of internal control is
 - a. monitoring.
 - b. risk assessment.
 - c. the control environment.
 - d. control activities.
6. Which function should *not* be given to any one employee?
 - a. Authorizing transactions
 - b. Keeping accounting records
 - c. Maintaining custody of assets
 - d. All of the above
7. Limitations on the effectiveness of an internal control system include
 - a. collusion.
 - b. mandatory vacations.
 - c. separation of duties.
 - d. monitoring.

(Continued)



Self-Check 6

8. Staff size in a small company could limit the company's ability to implement which internal control activity?
- a. Competent personnel
 - b. Adequate separation of duties
 - c. Security measures
 - d. Proper authorization
9. The organization responsible for the oversight of the auditors of public companies is
- a. the Financial Accounting Standards Board (FASB).
 - b. the International Accounting Standards Board (IASB).
 - c. the Public Company Accounting Oversight Board (PCAOB).
 - d. Congress.
10. International Financial Reporting Standards (IFRS)
- a. are a principles-based system.
 - b. differ in accounting treatment from U.S. GAAP for many items.
 - c. will never be adopted by the United States.
 - d. are both a and b.

Check your answers with those on page 120.

The Value of Money

Assignment 7 covers the concepts of the time value of money from Appendix B. A brief discussion of sales—cash, credit-card sales, debit-card sales, and sales on account—is presented. Internal controls over cash receipts and payments are discussed, as well as bank reconciliations. Next, accounts receivables are covered to include the different types of receivables, the two methods for recording uncollectible accounts (direct write-off and allowance methods), and two methods for estimating uncollectible accounts expense (percentage of sales and the aging method).

Assignment 8 explains the three categories of long-term assets and how to determine the costs of various plant assets. Three methods of depreciation—straight-line, units-of-production, and double-declining balance—are illustrated. A discussion of partial-year depreciation and using an accelerated method for tax purposes is presented. Capital expenditures versus revenue expenditures and treatment of gains and losses on disposal of plant assets are covered.

Assignment 9 introduces three categories of liabilities: known, estimated, and contingent. Current liabilities that are known are presented. Then estimated liabilities using warranties are illustrated. Guidelines for three categories of contingent liabilities—probable, reasonably possible, and remote—are discussed. Long-term liabilities, such as notes payable, bonds payable, and leases, are introduced, with an in-depth treatment of bonds to include issuing bonds at par, discounts or premiums, and adjusting entries.

When you complete this lesson, you'll be able to

- Understand cash and accounts receivable and the methods and internal controls for reporting on the balance sheet
- Understand, account for, and report various long-term assets on the balance sheet
- Distinguish between different liabilities and accounts for and report current liabilities and long-term debt on the balance sheet



ASSIGNMENT 7: TIME VALUE OF MONEY, CASH AND RECEIVABLES, AND PETTY CASH

Read Assignment 7 in this study guide. Then read Chapter 7 and Appendix B in your textbook, *Financial Accounting*.

Future Value

Appendix B on page 689 in your textbook defines *future value* as “the amount that a given sum of money will be ‘worth’ at a specified time in the future, assuming a certain rate of interest.” Exhibit B-1 provides a Future Value of \$1 factor table, and Exhibit B-2 provides a Future Value of Annuity of \$1 factor table. The future value can be calculated for a *lump-sum amount* or for an *annuity* (payments). Page 691 of your textbook also shows the formula used to calculate future value.

Present Value

Present value is defined on page 692 in your textbook as “the value on a given date of a future amount, adjusted to reflect the time value of money.” Exhibit B-3 provides a Present Value of \$1 factor table, and Exhibit B-4 provides a Present Value of Annuity of \$1 factor table. The present value can be calculated for a lump-sum amount or for an annuity (payments). Page 692 of the textbook also shows the formula used to calculate present value.

What Are the Different Types of Sales?

Sales are almost always made using cash or some type of credit. Credit falls into three categories: (1) *credit-card sales*, (2) *debit-card sales*, and (3) *sales on account* (extending credit to a customer or client).

What Internal Control Procedures Should Be Used for Cash?

Cash in a business can either be a receipt or disbursement. Cash receipts come into the business via two broad categories: (1) over the counter and (2) receipts through the mail. Exhibit 7-1 of the textbook shows how cash can be controlled when it comes through the mail. Cash that comes over the counter should also have measures in place to account for it, such as sequentially numbered cash receipts books and cash registers that provide receipts for every transaction.

Cash disbursements can be controlled by a system of purchase orders and receiving reports. Exhibit 7-2 in your textbook illustrates the documents used to control cash purchases.

Cash entering the business should be deposited in a bank account. Cash leaving the business should be tracked using checks. This allows for an important internal control—the *bank reconciliation*. Exhibit 7-3 shows the basic format of a bank reconciliation and items that typically appear on the reconciliation.

There are two sides to bank reconciliations—the *bank side* and the *book side*. The book side (usually the business check register) is out of balance (the ending figures don't match) with the bank statement at the end of the month. To reconcile the two, look for the differences and record what's found on one side to the other. For example, when looking at the book side, the bank charges that are assessed aren't usually known until you look at the bank statement. Your book side doesn't show the bank charge, but it's on the bank statement; therefore, you must record the bank charge from the statement in your book side or check register. Conversely, you write a check on the last day of the month and record it in your check register. The check hasn't had time to clear the bank and isn't shown on the bank statement; therefore, you record the check on the bank statement as if it had cleared the bank. When all of the differences between the two have been recorded, the balances should match. At first, doing bank reconciliations can be confusing. When you become accustomed to what transactions to look for, bank reconciliations become relatively easy. Pages 296–299 of the textbook

provide a representative illustration of bank reconciliations and the more commonly found adjustments to be made. Also, on the back of most paper bank statements are step-by-step instructions for doing bank reconciliations.

How Is Cash Reported on the Balance Sheet?

Reporting of cash on a balance sheet is shown as “Cash” or under the account “Cash and Cash Equivalents.” *Cash* is anything that a bank will take as a deposit.

How Do You Account for Receivables?

There are two types of receivables—accounts receivable and notes receivable. Both are lines of credit that the business extends to a customer or client. Credit/debit cards are also lines of credit, but they’re third-party lines of credit. That means a credit-card company or bank pays the business and assumes the risk at the time of the purchase. With an accounts receivable or notes receivable, the business bears the risk directly at the time of the purchase. *Accounts receivable* are short-term loans (usually for 30 days or less). *Notes receivable* are for loans of a longer duration and are usually accompanied by the signing of some sort of promissory note.

Good internal controls, such as credit checks, allow a business to sell more items than it would if it accepted only cash for transactions. However, even with good controls, not all debts will be collectible. Some must be written off as a bad debt or loss to the business.

How Do You Account for Bad Debts?

Two methods are used to account for uncollectible accounts: (1) the direct write-off method and (2) the allowance method. Under the *direct write-off method*, the bad debt will be written off as soon as it’s determined that the debt will no longer be collected. Using the direct-write off method allows for some control by the business over its receivables. For

example, after pursuing a company who hasn't paid its bill for over a year, the business "knows" that it will never receive the money. However, it may keep this bad debt on the books for a while, always claiming that it "might" be able to receive payment. The business will wait for a profitable year when it must pay taxes on that profit. It will then opt to write off the uncollectible account, which increases expenses and reduces income, therefore allowing the business to pay less in taxes.

Under the *allowance method*, an estimate of uncollectible amounts is made, and a running total is adjusted for every accounting period. Estimates are calculated using the *percent-of-sales method* or the *aging method*. Whichever method is used, an estimate is made as to how much won't be collected for the period of time. This amount is recorded as an allowance for doubtful accounts to offset the accounts receivable account and expensed as a bad-debt expense for uncollectible accounts. At the end of the next period, an estimate is made again, and the difference between what's on the books and the new estimate is recorded. Exhibit 7-8 of the textbook summarizes the different entries used for the direct write-off method and the allowance method.

How Are Accounts Receivables Reported on the Balance Sheet?

Accounts receivables are shown as a net realizable value on the balance sheet. Page 308 of the textbook illustrates two common ways in which the receivables are reported.

How Do You Account for Notes Receivable?

Notes receivable are often made in the form of a *promissory note*. Exhibit 7-9 in your textbook shows a sample promissory note and its components. Notes receivable reflect not only the face amount (the amount borrowed) but also an interest amount. (Loans include compensation in the form of interest.) Therefore, interest revenue must also be accrued.

Focus on Decision Making: Ratios

Page 313 of the textbook shows the formula for the quick ratio, or acid-test ratio, along with the accounts receivable turnover ratio. The *acid-test ratio* shows whether a business would be able to pay for all of its current liabilities if they were to become payable immediately. This differs from the current ratio in that the current ratio determines if there are enough current assets to cover the current liabilities; the acid-test ratio is used to determine if the business can convert its assets immediately to be able to cover its current assets. Cash is cash. Accounts receivable are debts owed (generally within 30 days), and the receivables can be asked to pay for their debt immediately for a business to raise cash if there's an emergency. However, inventory, which is a current asset, isn't so easily converted to cash and isn't considered in a quick-ratio calculation.

Just as it's important to understand a business's inventory turnover ratio, it's also important to understand its *accounts receivable turnover ratio*. A business doesn't want to keep its money tied up in receivables owed to the business. It wants the receivables paid as soon as possible to use the cash for other purposes.

What Is a Petty Cash Fund?

Appendix 7A of the textbook (pages 347–349) explains setting up and replenishing a petty cash fund. A *petty cash fund* is used for minor cash transactions that would be too cumbersome to write a check for. For example, a business doesn't want to give its salesman, who's on the road, a blank check to carry around to be able to buy gas for his car. Petty cash expedites the transaction by having the salesman pay for the gas and then turn over the gas receipt as proof of the amount in exchange for cash, which comes out of the petty cash fund.

The fund is initially started by writing a check for cash with a specific amount in mind. This amount is called the *imprest amount*, and it doesn't change in the general ledger petty cash account. The cash is kept in a secure place with a system of controls over it. Cash isn't taken unless it's replaced

with a receipt. After a period of time, the cash will need to be replenished. This is when a check is written for the total amount of the receipts. Remember, the receipts plus the cash available should always equal the imprest amount. The check is cashed, and the cash is replenished in the fund. The check is attached to all of the receipts, and a journal entry is made for the various expenses that the receipts represent.

The imprest amount of the petty cash fund can be changed up or down as the business sees fit. However, an amount is quickly settled upon and usually won't be changed again.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 7

1. Exercises EB-1A through EB-3A (page 695)
2. Short Exercises S7-2 through S7-17 (pages 320–325)
3. Exercises (Group B): E7-31B through E7-41B (pages 330–334)
4. Problems (Group B): P7-50B through P7-55B (pages 340–342)
5. Short Exercise S7A-2 (page 350)
6. Exercise (Group B): E7A-6B (page 351)
7. Problem (Group B): P7A-8B (page 352)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 7

Data Co. has asked you to assist in the preparation of a bank reconciliation at the end of July. Answer questions 1–3 using the following code letters to indicate how the item described would be reported on the bank reconciliation.

- a. Add to the bank statement balance.
 - b. Deduct from the bank statement balance.
 - c. Add to the book balance.
 - d. Deduct from the book balance.
 - e. Doesn't belong on the bank reconciliation.
1. ____ Note and interest collected by the bank for the company, \$500 (plus \$25 interest).
 2. ____ Deposit in transit, \$400.
 3. ____ Check number 662 written for \$730 was incorrectly recorded by the bank as \$370.
 4. If a bank reconciliation includes an NSF check for \$45, the journal entry to record this reconciling item would include
 - a. a credit to Cash.
 - b. a debit to Cash.
 - c. a credit to Accounts Receivable.
 - d. no entry.
 5. All of the following are procedures that should be followed for cash received by mail *except* that
 - a. all incoming mail should be opened by a high-level, trusted employee.
 - b. the debit to the Cash account should match the bank deposit.
 - c. the controller should compare the day's cash receipts to the bank deposit.
 - d. the remittance advices should be sent to the accounting department.
 6. All of the following are internal controls over cash payments *except* that
 - a. all payments should be made by check.
 - b. before payment is made, it should first be authorized by the treasurer.
 - c. the invoice should be compared with a copy of the purchase order and receiving report.
 - d. small payments should be made from a petty cash fund.

(Continued)



On December 31, 2014, Zeb Company reported the following amounts and account balances (before adjustments):

7. Refer to Table 7-1. Zeb Company estimates that its uncollectible account expense is $2\frac{1}{2}\%$ of net sales. The uncollectible account expense for 2014 should be

8. Refer to Table 7-1 above. Zeb Company uses an aging schedule to estimate uncollectible accounts. The aging of accounts receivable and the percentage of each category that's estimated to be uncollectible is:

The balance in the allowance for uncollectible accounts after the adjustment should be

9. The December 31, 2013, balance sheet of Miller Company reported the following information:

During 2014, a \$520 account receivable from Alexis Co. is written off. As a result,

- (Continued)



Self-Check 7

10. On July 7 a 5%, 90-day, \$2,600 note receivable is accepted from a customer for the sale of farm equipment. Which of the following is *correct*?

	Due Date	Maturity Value
a.	10/4	\$2,600.00
b.	10/5	\$2,730.00
c.	10/5	\$2,632.50
d.	10/6	\$2,632.50

Check your answers with those on page 120.

ASSIGNMENT 8: LONG-TERM AND OTHER ASSETS

Read Assignment 8 in this study guide. Then read Chapter 8 in your textbook, *Financial Accounting*.

What Are the Different Types of Long-Term Assets?

There are three different types of long-term assets:

1. Plant assets or fixed assets
2. Intangible assets
3. Natural resources

Exhibit 8-1 in your textbook shows the types of assets and their cost allocation methods—depreciation, amortization, or depletion.

How Is the Cost of a Plant Asset Calculated?

Plant assets are broken down into five broad categories:

1. Land
2. Land improvements
3. Buildings
4. Machinery/equipment
5. Furniture/fixtures

GAAP requires the use of the cost principle when determining the cost of a fixed asset. The amount paid for a fixed asset is the amount paid to acquire the asset and any amounts paid to prepare it for its intended use.

For example, you own a plumbing company and have five plumbers working for you. Each requires his own van. You've staggered the purchase of the vans over time so that you don't need to purchase everyone a van within a short period of time. You're considering hiring another new plumber, so you shop around for new and used vans. You learn that a stripped-down, new van of the size that you need costs around \$45,000. You also spot a three-year-old used van for \$8,000. The only problem is that it needs some work—a new transmission and tires (due to needing an alignment). The new transmission will cost \$3,000; the tires and alignment will cost \$500.

You decide that it's worth taking a chance on the used van. When the van is in the shop, you also decide to have a tune-up done, change the oil, change the air filter, check the fluids, hoses, and belts, and have the mechanic give the vehicle a once-over to get the van ready for the road. The additional work costs \$200. When complete, you've put into this vehicle $\$8,000 + \$3,000 + \$500 + \200 , for a total of \$11,700.

If you purchased the new van, the entry to your books for the purchase would be \$45,000. With the purchase of the used van, the entry to your books would be \$11,700. This represents the amount you need to acquire the van and any amounts necessary to prepare it for its intended use.

The van is ready. You hire the new plumber, and he starts on Monday. Monday isn't a good day. The new plumber has two local calls to make. On his third call, which is far away, he radios in to your dispatcher and informs her that the water-fluid light came on. He pulled over on the highway, only to find that the engine is leaking all over the pavement. It looks like the water pump broke.

Of course, the van will be towed, and the water pump will be replaced at an additional cost of \$1,100. When the bookkeeper receives the invoice for the water pump repair, she wants to know how to enter it on the books. Would it go under the asset, or should she expense it? She doesn't know which because you just purchased the van and put the costs from the other invoices for the transmission, tires, and general maintenance repairs as part of the asset.

The answer to her question is that it should go under automobile maintenance expense. As soon as the vehicle was used for its intended purpose (put into production), any costs associated with preparation for its intended use ended. Any costs incurred after that are to be expensed.

Now, consider the consequences. If the repair for \$1,100 is expensed, then at the end of the year, the net profit for the business will be reduced by the \$1,100 and a subsequent reduction in the amount paid in taxes. If the repair went against the cost of the van, the \$1,100 would be added to the \$11,700 and the full \$12,800 would be depreciated using whatever method had been chosen for that van (straight-line depreciation or unit-of-production). (For tax purposes, MACRS would be used.) Eventually the \$1,100 would be expensed using depreciation, just not all at one time.

How Are Plant Assets Depreciated?

Depreciation is comprised of three factors—cost, estimated *useful life* of the asset, and *residual value* (an estimate of how much the asset will be worth at the end of the depreciation period). These make up the basis for the most commonly used depreciation methods, which your textbook describes in more detail.

The most-often used depreciation methods include:

- Straight-line
- Units-of-production (UOP)
- Double-declining balance (DDB)

Page 360 of the textbook shows the formula for calculating straight-line depreciation. Pages 361 and 362 show the formulas for the UOP depreciation method and the DDB method, respectively.

When comparing the methods, all will end up depreciating the asset by the same amount. Which one should be used? The method chosen should match the way the asset helps to produce revenue. For example, a computer should use straight-line depreciation because it's constantly in use over an accounting cycle. A machine used to stamp gold coins would be depreciated using units-of-production because the machine will produce a certain number of coins regardless of whether it takes three years or seven years to do it. The choice to use double-declining balance would be made for income tax purposes. It more closely resembles the accelerated depreciation method MACRS used in calculations for income tax. It isn't generally used for financial reporting.

You've already learned about GAAP, which matches expenses with revenues. When depreciating an asset, what happens if the asset is going to be depreciated over five years using the straight-line depreciation method but the asset isn't bought until the middle of the year? If the asset is depreciated in full for the first year but has been on the books for only one-half year, this doesn't conform to the matching principle. Page

364 of the textbook provides the formula for using a partial year's depreciation, and Exhibits 8-7 and 8-8 illustrate examples of new depreciation schedules.

Although it isn't common, the useful life of a depreciable asset can also be changed. Page 366 in your textbook shows the formula for making the change. Exhibit 8-9 illustrates a new depreciation schedule reflecting the change.

To record the depreciation entry, a *contra-account* to the asset—accumulated depreciation—is used. Similarly, for an intangible asset, accumulated amortization is used. For natural resources, accumulated depletion is used, and the offsetting entry goes to an expense account.

How Are Costs of Repairing Plant Assets Recorded?

There are three types of repairs:

1. Ordinary
2. Extraordinary
3. Betterments

Ordinary repairs can be thought of as revenue expenditures, and *extraordinary repairs* can be thought of as capital expenditures. In our previous example for recording a used van as an asset, the transmission, tires, and alignment are considered capital expenditures (extraordinary repairs), while the water pump is considered a revenue expenditure (ordinary repair) because the repair expense produces revenue.

Betterments increase an asset's capacity or production. Additions to existing buildings are a common example.

What Happens When an Asset Is Disposed?

The most common ways for an asset to be disposed of are by throwing it away, selling it, or exchanging it for another asset. Pages 368 and 369 in your textbook list the steps to dispose of an asset. The three situations on pages 369–371 serve as examples:

1. Record “what you got”
2. Record “what you gave up”
3. Record any gain or loss recognized on the transaction

Regardless of the method of disposal, make sure that the depreciation of the asset is current before making the calculations and recording the entries for the disposal.

How Do You Account for Intangible Assets?

Intangible assets are assets that can't be touched, such as patents, copyrights, trademarks, brand names, franchises, licenses, and goodwill. The allocation for costing an intangible asset to an expense is called *amortization*, which is another name for *depreciation*. Fixed assets depreciate. Intangible assets amortize. The methods of calculation are the same.

How Are Natural Resources Accounted For?

Natural resources are assets that come from the earth, such as metal, oil, and timber. Natural resources use the *depletion* method. Page 373 of the textbook shows the formula for depletion as an expense per unit.

What Are the Other Types of Long-Term Assets?

Two common long-term assets that don't fall into the previous categories are *marketable securities* and real estate that may be held for resale and isn't depreciated.

How Are Long-Term Assets Reported on the Balance Sheet?

Exhibit 8-10 of the textbook illustrates an example of the long-term asset section of a balance sheet. Long-term assets follow the current assets. The structure of the asset section of the balance sheet is the current assets followed by the long-term assets followed by the other long-term assets. They sum up to obtain the total for the assets. The accounts are listed from the most liquid to the least liquid.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 8

1. Short Exercises S8-2 through S8-17 (pages 382–386)
2. Exercises (Group B): E8-32B through E8-45B (pages 390–393)
3. Problems (Group B): P8-54B through P8-59B (pages 397–399)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 8

1. Adams Company purchased land, an office building, and some manufacturing equipment for \$775,000. The appraised value of the land, building, and equipment were \$373,100, \$427,700, and \$109,200, respectively. What was the debit to the Building account to record the purchase?
 - a. \$427,700
 - b. \$303,333
 - c. \$258,333
 - d. \$364,250

Table 8-1

On January 1, 2013, Lunsford Equipment Company purchased a new computerized security system for \$130,000. It expects to use the system for five years, after which it can be sold for \$6,500.

2. Refer to Table 8-1 above. What is the book value of the equipment on December 31, 2014, if Lunsford uses the straight-line method of depreciation?
 - a. \$49,400
 - b. \$74,100
 - c. \$80,600
 - d. \$105,300
3. Refer to Table 8-1. If Lunsford uses the double-declining-balance method of depreciation, what is depreciation expense for 2014?
 - a. \$31,200
 - b. \$29,640
 - c. \$83,200
 - d. \$52,000
4. Refer to Table 8-1. Lunsford uses the straight-line method of depreciation and sells the equipment for \$30,000 at the end of the five years. The journal entry to record the sale will include which of the following?
 - a. \$31,200 credit to Equipment
 - b. \$5,300 credit to Gain on the Sale of Equipment
 - c. \$98,800 debit to Accumulated Depreciation
 - d. \$1,200 credit to Loss on the Sale of Equipment
5. Refer to Table 8-1. Assume that Lunsford uses straight-line depreciation. After recording two full years of depreciation, it decides that the system will last a total of six years, rather than five. Residual value at the end of six years will be \$8,000. What is 2015 depreciation expense?
 - a. \$16,525
 - b. \$18,150
 - c. \$24,200
 - d. \$20,150

(Continued)



Self-Check 8

6. In 2014, Mountain Ore, Inc. paid \$8,250,000 for land with an estimated 600,000 tons of ore. Mountain Ore plans to sell the land for \$300,000 when all of the ore has been extracted. In 2014, 24,000 tons of ore were mined and sold. What is depletion expense for the year?
- a. \$318,000
 - b. \$330,000
 - c. \$300,000
 - d. \$325,000
7. Speedy Deliveries Services owns and operates a fleet of delivery vehicles. Which of these is/are considered an ordinary repair by Speedy?
- a. Major engine overhaul
 - b. Replacement of dead battery
 - c. Addition of hydraulic lift to back of truck
 - d. Both b and c are ordinary repairs.
8. Which statement is *false*?
- a. Land is never depreciated.
 - b. An asset's residual value and useful life must be estimated in order to compute depreciation.
 - c. At the end of its useful life, the remaining book value of an asset will always equal its fair-market value.
 - d. The units-of-production method is most appropriate for an asset that wears out due to physical use.
9. Which of the following is/are accounted for as intangible assets?
- a. Land improvements
 - b. Goodwill
 - c. Land
 - d. All of the above are intangible assets.
10. Which statement is *true*?
- a. Straight-line depreciation is most often used for tax purposes.
 - b. The units-of-production method results in lower depreciation and therefore higher net income in the years when an asset is more productive.
 - c. Double-declining-balance depreciation results in the greatest amount of depreciation expense recorded over the asset's life.
 - d. Double-declining-balance depreciation creates a cash advantage over straight-line depreciation because higher amounts of depreciation are deducted early in the life of an asset, allowing tax savings to be invested.

Check your answers with those on page 121.

ASSIGNMENT 9: CURRENT LIABILITIES AND LONG-TERM DEBT

Read Assignment 9 in this study guide. Then read Chapter 9 in your textbook, *Financial Accounting*.

What Is the Difference between Known, Estimated, and Contingent Liabilities?

Liabilities can be broken down into known, estimated, and contingent liabilities. *Known liabilities* are known obligations with known amounts. *Estimated liabilities* are known obligations with unknown amounts. *Contingent liabilities* are liabilities from past events contingent upon future events.

How Do You Account for Current Liabilities of a Known Amount?

Current liabilities are known liabilities due within one year. The most common current liability is accounts payable. However, notes payable (payable within one year), sales tax payable, and accrued liabilities—such as wages, payroll taxes, interest, and income taxes—are also common liabilities.

Unearned revenues (also called *deferred revenues*) are also current liabilities when a business receives cash in advance of providing goods or services. Common unearned revenue is unearned rent revenue. Shopping malls and other commercial establishments generally require payment for rented space upfront in the form of a lease. This revenue is unearned rent revenue and is treated the same way as prepaid accounts on the assets side. Prepaid expenses and unearned revenues are two sides of the same coin. If you know how to account for one, you know how to account for the other—very much like accounts receivable and accounts payable.

Notes payable that have terms longer than one year, such as a mortgage payable, are long-term liabilities. However, for analysis purposes (using ratios such as the acid-test ratio or current ratio), the current portion of the long-term liability is calculated and reported on the balance sheet.

How Do You Account for Current Liabilities of an Uncertain Amount?

According to the matching principle, the expense must be recorded in the same period as the revenue. With *warranties*, the expense is incurred when the sale is made and not when the claim is settled. The warranty claims must be estimated because the amount of the expense is unknown for a specific period of time.

How Do You Account for a Contingent liability?

Contingent liabilities represent a potential, rather than an actual, obligation. Examples of contingent liabilities are pending legal action, potential fines, and loan guarantees. Exhibit 9-1 of the textbook outlines the accounting treatment of the likelihood of an obligation occurring as remote, possible, and probable.

How Do You Account for Long-Term Debt?

Common long-term debt falls into three categories:

1. Notes payable
2. Bonds payable
3. Leases payable

A typical *notes payable* is a mortgage that's paid off through installment payments, including interest. Exhibit 9-2 illustrates an amortization schedule for a mortgage.

Bonds payable come in a variety of types, such as term bonds, serial bonds, secured bonds, unsecured bonds, convertible bonds, and callable bonds. The U.S. government issues T-bonds, or treasury bonds. A local government may issue municipal bonds. Even a college or university may “float” a bond to raise funds for a project as an alternative to other financing options.

Bonds all work the same way. The buyer of the bond puts up some money in return for a lump sum at a future date. Bonds are often sold in \$1,000 amounts, and the buyer generally also receives interest payments at specified intervals. The amount the buyer pays for the bond is determined by taking the present value of a lump sum (\$1,000 for a \$1,000 bond) and adding it to the present value of the annuity payments (the interest payments received). If the interest rate is 12%, the buyer purchases the bond knowing that the rate of return on the bond will be 12% on his money. Bonds are purchased because they’re viewed as a low-risk investment, compared with the stock market or many other investment alternatives.

Bonds can also be traded just like stocks. Bonds purchased at their face value are considered to be issued at *par value*. If the price of the bond goes up, then it’s being sold at a *premium*. If the value goes below par, then it’s sold at a *discount*. Exhibit 9-3 illustrates the relationship between the stated interest rate (par) and the market interest rate and how it affects the sales price of the bond.

Leases payable are classified as either operating leases or capital leases. *Operating leases* are rental agreements used for the purpose of operating the business, such as renting an automobile for a few days because the salesman for the company was in an accident. *Capital leases* are leases designed to purchase an asset, such as leasing a new car for a new salesman with the intent of purchasing the automobile.

How Are Liabilities Reported on the Balance Sheet?

Exhibit 9-4 of the textbook illustrates the liability section of the balance sheet. It's broken up into its two components—current liabilities and long-term debt.

Focus on Decision Making: Ratios

The formula for the *debt ratio* is provided on page 423 of the textbook. It shows the percentage of a company's assets that would be required to pay off its liabilities. From an investor's standpoint, this is important. If a business *liquidates* (goes out of business), the assets are sold off. The proceeds then pay off the liabilities. Any money left over is finally distributed to the investors. Therefore, if the debt ratio is favorable by a large percentage—the assets cover the liabilities by a large percentage—the investor will feel more comfortable.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 9

1. Short Exercises S9-2 through S9-15 (pages 430–433)
2. Exercises (Group B): E9-27B through E9-37B (pages 436–439)
3. Problems (Group B): P9-46B through P9-51B (pages 443–446)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 9

1. Which of the following is *not* a current liability of known amount?
 - a. Accrued interest payable
 - b. Accounts payable
 - c. Unemployment taxes that haven't been paid
 - d. Liability for warranty repairs
2. On April 1, Tribbiani, Inc. borrowed \$25,000 on a three-month, 8% note payable to purchase inventory. The entry to record the issuance of the note should include a credit to
 - a. Notes Payable for \$25,000.
 - b. Interest Payable for \$6,000.
 - c. Notes Payable for \$25,600.
 - d. Interest Payable for \$1,500.
3. A \$20,000, 9%, 90-day note payable was issued on December 1. If interest is paid at maturity, the adjusting entry on December 31 will include a
 - a. debit to Interest Expense for \$450.
 - b. debit to Interest Expense for \$150.
 - c. credit to Cash for \$150.
 - d. credit to Cash for \$1,800.
4. Warranty expense should be recorded in the period that the product is
 - a. repaired.
 - b. sold.
 - c. paid for.
 - d. used.
5. Following is a list of account balances at the end of the year:

Estimated Warranty Payable	\$1,000
Notes Payable (due in three annual installments)	6,000
Retained Earnings	15,000
Interest Payable	200
Accounts Payable	11,500
Payroll Tax Expense	2,500
Unearned Commissions	4,500

The *correct* amount of current liabilities that would be reported on the balance sheet is

 - a. \$14,700.
 - b. \$21,700.
 - c. \$19,200.
 - d. \$18,700.
6. The proper accounting treatment for a contingent liability that's probable is that the contingent liability should be
 - a. recorded as an expense (or loss) and an actual liability.
 - b. described in a note to the financial statements.
 - c. ignored.
 - d. recorded as an asset and an actual liability.

(Continued)



Self-Check 9

7. Which statement about bonds is *false*?
- a. Bonds represent a liability of the corporation.
 - b. A bondholder is a creditor of the corporation.
 - c. The carrying amount is determined by subtracting the premium from the maturity value.
 - d. The straight-line method is the simplest way to amortize a premium or discount.

Table 9-1

The Simpson Corporation issued 8%, 10-year-term bonds on January 1, 2014, with a face value of \$1,000,000. Interest is payable semi-annually on June 30 and December 31. The bonds were issued for \$875,378 to yield an effective annual rate of 10%. Simpson uses the straight-line method of amortization.

8. Refer to Table 9-1 above. The journal entry to record the issuance of the bonds will include a
- a. credit to Bonds Payable for \$875,378.
 - b. debit to Cash for \$1,000,000.
 - c. debit to Discount on Bonds Payable for \$124,622.
 - d. debit to Interest Payable \$124,622.
9. Refer to Table 9-1 above. Which amount of discount (rounded) should be amortized for the first interest period?
- a. \$14,985
 - b. \$6,231
 - c. \$4,985
 - d. \$3,769

Table 9-2

LeBlanc Co. has a monthly payroll of \$150,000. Income taxes withheld from employees amount to \$45,000. The FICA tax rate is 8%, and the FUTA tax is 6.2% on the first \$7,000, with 5.4% paid to the state and 0.8% paid to the federal government. Health insurance premiums of \$6,000 were deducted from the employees' pay and will be remitted to the insurance company by LeBlanc. All wages are subject to all taxes.

10. Refer to Table 9-2 above. The credit to Salary Payable for the monthly payroll should be
- a. \$87,000.
 - b. \$77,700.
 - c. \$150,000.
 - d. \$86,566.

Check your answers with those on page 121.

Corporations

Assignment 10 discusses the treatment of stock and explains the difference between common and preferred stock. The assignment also covers accounting for stock, including issuing common stock at par or at a premium, issuing no-par stock, issuing stock with a stated value, issuing stock for assets other than cash, and issuing preferred stock. Accounting for dividends and treasury stock is also discussed, as well as the effects the treatment of stock has on the stockholders' equity section of the balance sheet.

Assignment 11 discusses the basic concepts and purposes of the statement of cash flows, including the use of the direct and indirect methods. Adjustments necessary to the operating, investing, and financing sections of the statement of cash flows are illustrated, and the presentation of the financial statement is shown.

Assignment 12 provides an extensive study of the three elements of financial statement analysis—horizontal, vertical, and ratio analysis. Continuing operations, discontinued operations, extraordinary gains and losses, and cumulative effects of changes in accounting principles are discussed. Earnings per share is introduced, along with various liquidity ratios, asset management ratios, solvency ratios, probability ratios, and market analysis ratios.

When you complete this lesson, you'll be able to

- Understand the treatment of stock as paid-in capital, dividends, and retained earnings in the stockholders' equity section of the balance sheet
- Prepare a statement of cash flows using the direct and indirect methods and evaluate the company's performance as it relates to cash
- Perform a horizontal and vertical analysis of financial statements and compute various financial ratios



ASSIGNMENT 10: CORPORATIONS: PAID-IN CAPITAL AND RETAINED EARNINGS

Read Assignment 10 in this study guide. Then read Chapter 10 in your textbook, *Financial Accounting*.

How Are Corporations Organized?

Exhibit 10-2 of the textbook shows some of the advantages and disadvantages of forming a corporation. To form a corporation, the founders file *articles of incorporation* with the state. Once approved, the corporation sells stock (capital stock) using stock certificates to fund the business.

What Makes Up the Stockholders' Equity of a Corporation?

The equity in a corporation is made up of *paid-in capital* (money received from the sale of stock) and *retained earnings* (the profit from the operation of the business). There are two types of stock—*common stock* and *preferred stock*.

Stock can be issued at par value, stated value, and no-par value. Stock issued at par value is assigned a *par value* (usually a very low amount, such as \$0.10 up to \$1). *Stated value* is similar to par value except that par value of the stock is assigned when the articles of incorporation are filed; stated value is assigned at a later date when the business decides to issue stock. For example, a business will assign a par value to the stock in the amount of \$1 when the articles of incorporation are filed. However, the business may later decide to issue additional stock and state its value at \$15 per share. Stock can also be issue at no-par value.

How Is the Issuance of Stock Recorded?

Pages 456–458 of the textbook show the journal entries used for issuing common stock at par, above par, no par, and no par with a stated value. They also provide an example entry for issuing stocks for assets other than cash and an entry when preferred stock is used.

How Are Cash Dividends Accounted For?

Dividends are a distribution of cash to the shareholders. There are three dates that are important pertaining to dividends:

1. Declaration date
2. Date of record
3. Payment date

The *declaration date* is the date that the board of directors announces the intention to pay a dividend. Anyone who holds shares as of a specified date (*date of record*) will receive a dividend that will be paid on the payment date.

Payments of dividends can become complicated if there's an issuance of preferred stock. If there's only common stock, the amount of the dividend is distributed equally among the number of shares of common stock that are outstanding. However, preferred stock takes precedence over common stock. The terms of the preferred stock can be just about anything—from a specified amount or a percentage to cumulative or noncumulative, which creates additional complications when the dividend payments are *in arrears* (owed and not paid).

For example, there are 10,000 shares of preferred stock at \$10 par value, and they get a 30% preferred dividend rate that's cumulative (*cumulative* means that the dividend will accumulate over time if it isn't paid and will be paid first when a dividend is finally paid out). This amounts to \$30,000 (10,000 shares \times \$10 par \times 30% = \$30,000) for this year. If

no dividend is declared this year, the \$30,000 is carried over to the next year (in arrears) because it's cumulative. Next year, the preferred stockholders are entitled to the \$30,000 in arrears plus the \$30,000 for the current year, for a total of \$60,000. If the company decides to pay a dividend of only \$45,000, the entire \$45,000 will go to the preferred shareholders, who will still be \$15,000 in arrears ($\$60,000 - \$45,000 = \$15,000$) going into the next year. If the company instead decides to pay a dividend of \$100,000, the preferred shareholders would get their entire \$60,000, and the remaining \$40,000 ($\$100,000 - \$60,000 = \$40,000$) would go to the common stockholders.

How Are Stock Dividends and Stock Splits Accounted For?

Stock dividends are a distribution of stock as a dividend instead of using cash for the dividend. Issuing a stock dividend doesn't affect the total amounts of assets, liabilities, or stockholders' equity. It rearranges the equity accounts, leaving the total equity unchanged. Each shareholder would have the number of shares he or she owns increased by the percentage of the stock dividend.

Stock splits are fundamentally different from stock dividends. They increase not only the number of shares outstanding but also the number of shares authorized and issued. Exhibit 10-4 of the textbook shows the difference in stockholders' equity before and after a stock split. For a 2:1 stock split, the number of shares a stockholder owns doubles, but the par value is cut in half.

How Is Treasury Stock Accounted For?

A company may decide to purchase back some of its shares of stock. The reacquisition of stock is called *treasury stock*. The treasury stock can then be either resold or retired (no longer available). When the treasury stock is resold, journal entries affect the paid-in capital account and retained

earnings, depending on whether the stock is sold above or below cost. Exhibit 10-7 of the textbook shows a revised stockholders' equity section of the balance sheet to reflect transactions made for treasury stock.

How Is Stockholders' Equity Reported on the Balance Sheet?

For smaller companies, stockholders' equity often resembles Exhibit 10-7 of the textbook. However, equity for a large corporation is much more complicated. Often, the stockholders' equity section of the balance sheet contains summaries with a note referencing a statement of stockholders' equity. Exhibit 10-8 of the textbook shows one example. Because of the complexity of equity, statements of stockholders' equity often look different but all follow GAAP principles and show the significant changes in the various equity categories.

Focus on Decision Making: Ratios

Page 472 of the textbook provides the formula for the *return on stockholders' equity*. Calculating the returns allows for comparisons between investment options, such as other companies, or even other investment vehicles, such as money-market accounts or certificates of deposit. If a money-market account offers a 4% return, a certificate of deposit offers a 5.25% return, and an investment in XYZ Company offers a 7% return on common stockholders' equity, it may make the most sense to invest in the company because it offers the highest return.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 10

1. Short Exercises S10-2 through S10-14 (pages 477-481)
2. Exercises (Group B): E10-32B through E10-46B (pages 487-492)
3. Problems (Group B): P10-55B through P10-60B (pages 497-500)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 10

1. The journal entry to record a 10% stock dividend when market value is greater than par includes
 - a. a credit to Dividends Payable.
 - b. a debit to Retained Earnings.
 - c. a credit to Paid-In Capital in Excess of Par.
 - d. both b and c.
2. Which of the following is *not* part of stockholders' equity?
 - a. The principal amount of the bonds issued
 - b. Par value of the shares of preferred stock issued
 - c. The amount paid in by investors that's in excess of the par value
 - d. The earnings that have been reinvested in the business

Table 10-1

On December 31, 2012, the Witherspoon Co. reported the following in its comparative financial statements:

	12/31/2012	12/31/2011
10% Cumulative preferred stock, \$50 par, 4,000 shares authorized and 2,000 shares issued	\$ 100,000	\$ 100,000
Common stock, \$2 par, 20,000 shares authorized and 8,000 (20X9) and 6,000 (20X8) shares issued and outstanding	16,000	12,000
Paid-in capital in excess of par—common	<u>176,000</u>	<u>168,000</u>
Total paid-in capital	292,000	280,000
Retained earnings	<u>280,000</u>	<u>220,000</u>
Total stockholders' equity	<u>\$572,000</u>	<u>\$500,000</u>

3. Refer to Table 10-1 above. Assume Witherspoon had *not* paid any dividends from 2009 to 2011. In 2012, Witherspoon declared cash dividends of \$96,000 to both the preferred and common stockholders. The total dividend received by the common stockholders (assuming the number of preferred shares didn't change) was
 - a. \$96,000.
 - b. \$56,000.
 - c. \$66,000.
 - d. \$86,000.

(Continued)



Self-Check 10

4. Refer to Table 10-1 above. The entry to record the issuance of 1,000 shares of common stock for \$40 per share would be

a.

Cash		2,000	
	Common Stock		2,000

b.

Cash		40,000	
	Common Stock		2,000
	Paid-in Capital in Excess of Par		38,000

c.

Cash		40,000	
	Common Stock		40,000

d.

Cash		40,000	
	Common Stock		10,000
	Gain on Sale of Stock		30,000

5. Refer to Table 10-1 above. Witherspoon issued 2,000 shares in exchange for land valued at \$45,000. Which statement is *false*?
- a. Total paid-in capital increases \$41,000.
 - b. Stockholders' equity increases \$45,000.
 - c. Assets increase \$45,000.
 - d. Retained earnings aren't affected.

(Continued)



Self-Check 10

6. Which statement about cash dividends is *false*?
- a. Dividends become a liability on the declaration date.
 - b. The payment of dividends reduces stockholders' equity.
 - c. Chronologically, the relevant dates for dividends occur in this order—declaration date, date of record, payment date.
 - d. Dividends in arrears aren't liabilities.
7. Holders of preferred stock do *not* normally have
- a. preference in terms of dividends.
 - b. preference in terms of assets on liquidation.
 - c. full voting rights.
 - d. ownership interest in the corporation.
8. On March 1, Argueta Company had 100,000 shares of its \$100 par-value common stock issued and 65,000 shares outstanding. On March 31, Argueta Co. declared and distributed a 15% stock dividend. On October 1, the Company declared a 4-for-1 stock split. How many shares of common stock were outstanding on December 31?
- a. 400,000
 - b. 299,000
 - c. 320,000
 - d. 260,000
9. On January 1, Lizzie Company authorized 250,000 shares of \$10 par-value common stock. On February 1, 50,000 shares are issued at \$18 per share. On October 31, 5,000 shares of the stock are purchased from shareholders at a price of \$25 per share. What is the balance in common stock on December 31?
- a. \$500,000
 - b. \$900,000
 - c. \$375,000
 - d. \$450,000

(Continued)



Self-Check 10

10. Legacy Inc. purchased 3,000 shares of its own \$5 par-value common stock for \$43 per share. Later, Legacy sold 800 shares of the treasury stock for \$49 per share. The entry to record the sale of the treasury stock is

a.

Cash		39,200	
	Treasury Stock		34,400
	Paid-In Capital from Treasury Stock Transactions		4,800

b.

Cash		39,200	
	Treasury Stock		34,400
	Gain on Sale of Stock		4,800

c.

Cash		39,200	
	Treasury Stock		39,200

d.

Cash		39,200	
	Common Stock		34,400
	Stock		34,400
	Stock Transactions		4,800

Check your answers with those on page 122.

ASSIGNMENT 11: THE STATEMENT OF CASH FLOWS

Read Assignment 11 in this study guide. Then read Chapter 11 in your textbook, *Financial Accounting*.

What Is the Statement of Cash Flows?

The *statement of cash flows* reflects the cash inflows and outflows in a business. Financial statements use the *accrual accounting method*. This method allows for entries that don't affect cash. For example, making an adjusting entry for depreciation doesn't affect cash. However, it does affect the net income/loss for the business. The statement of cash flows clarifies the cash position of the company and helps investors and creditors to predict future cash flows, evaluate management decisions, and predict the company's ability to pay for debts and dividends. It's divided into three types of business activities: (1) operating activities, (2) investing activities, and (3) financing activities.

What Are the Differences among Operating, Investing, and Financing Activities?

Operating activities reflect the day-to-day operations of the business. There are two ways to format operating activities on the statement of cash flows—the direct method and the indirect method. *Investing activities* reflect any investments a business makes, such as investments in long-term assets. *Financing activities* reflect changes in the business's long-term liabilities and equity. Exhibit 11-2 in your textbook illustrates the relationships among operating, investing, and financing activities.

How Is the Statement of Cash Flows Prepared Using the Indirect Method?

Exhibit 11-3 in your textbook shows the formatting for the indirect method on the statement of cash flows. Exhibit 11-4 shows the financial statements. Students often have difficulty understanding the creation of the cash flow statement. One way to learn the statement is to remember the structure. It has three sections—operating, investing, and financing. Understand the purpose for each section. For example, if you come across a transaction that has to do with a long-term asset, then chances are it may affect the investing activities section of the statement. Entries for amortization or depletion affect the operations of the business and would probably go under operating activities.

Under each activity in Exhibit 11-3 is a list of the more common adjustments necessary for that activity. Take some time and try to become very familiar with them. They're your "go to" adjustments, and you'll use them regularly. When you come across something that isn't on the list, always keep in mind the effect on cash. This is the overriding principle—how does the transaction affect cash?

Pages 514–520 in your textbook examine the various adjustments that affect cash from the financial statements shown in Exhibit 11-4. Exhibit 11-6 provides the statement of cash flows based on the adjustments. Become very familiar with why an adjustment needs to be made, how it's made, and where it goes on the statement of cash flows. While no statement should be considered a cookie-cutter template, these exhibits provide a good example of the very common adjustments that are found in the majority of financial statements.

How Is the Statement of Cash Flows Prepared Using the Direct Method?

Exhibit 11-8 of the textbook provides the format for the *direct-method* statement of cash flows. It uses the same information from the financial statements in Exhibit 11-4 for the *indirect method*. Exhibit 11-9 of the textbook provides the statements of cash flows using the direct method. The same process and thinking that applies to the indirect method applies to the direct method. The difference is the format of the information in the operating activities section.

Focus on Decision Making: Free Cash Flow and the Cash Conversion Cycle

The statement of cash flows is used to calculate the free cash flow of the business. The formula is presented on page 527 of the textbook. Free cash flow anticipates the cash available from operations after paying for investments in long-term assets and dividends.

Previous chapters covered inventory turnover and accounts receivable and accounts payable turnover. The cash conversion cycle uses these three ratios. Page 528 of the textbook provides the formula for the cash conversion cycle, which is the amount of time cash is tied up in the business. The importance of the *cash conversion cycle* is that it lets you know how long the cash is tied up so that it can be used for something else.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 11

1. Short Exercises S11-2 through S11-12 (pages 533–538)
2. Exercises (Group B): E11-23B through E11-30B (pages 543–546)
3. Problems (Group B): P11-37B through P11-42B (pages 551–555)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 11

1. Which of the following is *correct* in describing the statement of cash flows?
 - a. The principal purpose of a statement of cash flows is to measure the profitability of a business that uses the cash basis of accounting.
 - b. In the long run, it's more important for a business to generate positive cash flows from investing activities than from operating activities.
 - c. The statement shows the sources and uses of cash during the period.
 - d. A statement of cash flows is organized into two sections—cash receipts and cash payments.
2. Investing activities would *not* include
 - a. collection of a note receivable.
 - b. purchase of equipment.
 - c. investment of cash by owners.
 - d. sale of land at a loss.
3. Cash flow from operating activities (direct method) would *not* include
 - a. payment of principal amount owed to the bank.
 - b. payment of interest on a bank loan.
 - c. payment to suppliers for inventory.
 - d. receipt of dividends on an investment.
4. If accounts receivable increases during the period, then
 - a. cash collections from customers are equal to sales revenue.
 - b. sales revenue is less than cash collections from customers.
 - c. cash flow from investing activities increases.
 - d. sales revenue is greater than cash collections from customers.
5. The following information related to Arnold Sales, Inc., is for the year ended June 30:

Collections from customers	\$72,800
Sales on credit	70,000
Cost of goods sold	42,000
Payments to inventory suppliers	40,600
Operating expenses	9,100
Payments for operating expenses	9,800
Interest and taxes paid	3,500
Depreciation expense	1,240

Net cash flow from operating activities, using the direct method, would be

- a. \$17,540.
- b. \$18,900.
- c. \$20,260.
- d. \$14,040.

(Continued)



Self-Check 11

6. The beginning and ending balances of income tax payable are \$11,300 and \$12,800, respectively. If income tax expense is \$108,000, how much income tax was paid?
- a. \$106,500
 - b. \$109,500
 - c. \$119,300
 - d. \$95,200
7. Zee Company sold machinery with a cost of \$20,000 and accumulated depreciation of \$8,000 for an amount that resulted in a loss of \$3,000. Which amount should Zee Company report on the statement of cash flows as "proceeds from sale of plant assets"?
- a. \$9,000
 - b. \$17,000
 - c. \$15,000
 - d. \$12,000
8. An example of a noncash investing and financing activity that's disclosed in a supplementary schedule accompanying the statement of cash flows is
- a. recording depreciation expense.
 - b. selling land in exchange for a note receivable.
 - c. declaring, but not paying, a cash dividend.
 - d. making a credit sale.
9. Using the following information for Dublin Corporation, calculate net cash flows from operating activities by the indirect method:
- | | |
|---------------------------------|-----------|
| Net income | \$152,000 |
| Depreciation expense | 64,000 |
| Increase in accounts receivable | 4,000 |
| Decrease in inventory | 9,000 |
| Increase in accounts payable | 10,000 |
| Gain on sale of land | 35,000 |
- a. \$166,000
 - b. \$346,000
 - c. \$196,000
 - d. \$184,000
10. When using the indirect method, all of the following adjustments would be needed to reconcile net income to net cash flow from operating activities *except*
- a. subtracting an increase in inventory.
 - b. adding an increase in accounts payable.
 - c. adding a decrease in prepaid rent.
 - d. subtracting a decrease in accounts receivable.

Check your answers with those on page 122.

ASSIGNMENT 12: FINANCIAL STATEMENT ANALYSIS

Read Assignment 12 in this study guide. Then read Chapter 12 in your textbook, *Financial Accounting*.

What Is Financial Analysis?

In Assignment 1 of this study guide, we asked the question “Why do I need to know about accounting if I’m not going to be an accountant?” The answer is that the financial statements are the report card for the business. The process of taking the information from the financial statements and analyzing it determines whether performance is poor, breakeven, or outstanding.

Financial analysis involves using a business’s financial statements and other information to evaluate whether a business is creating value. The process consists of five steps:

1. Understand a business’s model and strategy.
2. Understand the environment in which the business operates.
3. Analyze the content of the financial statements and other information, making adjustments if desired.
4. Analyze the business’s operations.
5. Use the financial analysis to make a decision.

What Measures Does Someone Use to Analyze the Performance of a Business?

Financial statement analysis is generally presented in two different formats:

1. Vertical analysis
2. Horizontal analysis

Vertical analysis helps in the evaluations of a company's performance by representing each item on a financial statement as a percentage of another item. For example, the cost of goods sold and the gross profit on the income statement can be presented as a percentage of the net sales. Exhibits 12-5 and 12-6 of the textbook illustrate an example of an income statement and balance sheet using vertical analysis.

How can this help a business? Let's use the restaurant Red Lobster as an example. Food costs are important, and prices can fluctuate every day. Red Lobster doesn't change the prices on their menu every day to reflect these changes. The price of their lobster dinner will generally remain fixed unless there's a dramatic change in the cost of lobster. The retail price of a lobster dinner is a result of a markup on the food cost by a percentage amount. (The restaurant industry aims to meet a standard gross profit percentage of 26% in order to cover overhead costs.) The cost of goods sold figure by itself doesn't reveal much information. However, as a percentage of net sales (using vertical analysis), the cost of goods sold can show whether the food costs are going up or down. From there, the restaurant can make the appropriate adjustments. At certain times of the year, the cost of lobster goes up, and at other times of the year, it goes down. If lobster prices go up, the cost of goods sold percentage goes up; the gross profit percentage goes down in comparison to other periods of time if the retail price of lobster remains the same.

Horizontal analysis is the study of percentage changes in the line items on financial statements when compared with other similar time periods. For example, a comparison can be made between this year and last year. While financial statements for one time frame provide useful information for ratio analysis, they don't show trends that can be seen or deduced using horizontal analysis. Performing a horizontal analysis reveals the dollar amount change between the periods and the trend percentage the amount represents. Exhibits 12-7 and 12-8 of the textbook illustrate horizontal analysis for the income statement and balance sheet, respectively.

Once the numbers are created, looking at a variety of ratios can answer the following five key questions:

1. Is the business a going concern?
2. How is the business earning a net income or loss?
3. Where is the business getting its money and can it pay its debt obligations?
4. How is the business investing its money and is it using its assets effectively?
5. Is the business generating enough net income to reward the stockholders for the use of their money?

How Do You Put Everything Together to Make Decisions?

Exhibit 12-10 provides the ratios used to analyze and answer the five key questions that were just outlined. This analysis can then be used to form good business decisions.

No one ratio is the best for analyzing a business's performance. To form an opinion of the performance and health of a business—or to determine how a business can be improved—all of the ratios must be considered together.

When interpreting the information, red flags do become apparent. The following red flags are a cause for concern:

- Decreased cash flow
- Inability to collect receivables
- Buildup of inventory
- Movement of sales, inventory, and receivables
- Earnings problems
- Too much debt

Valuable information is generated from the use of ratios. It takes a bit of time to grasp all of the information, but with experience, you'll become more familiar with the operations of a business and what the information on the financial statement represents.

TEXTBOOK EXERCISES AND PROBLEMS FOR ASSIGNMENT 12

2. Short Exercises S12-1 through S12-10 (pages 595–597)
3. Exercises (Group B): E12-21B through E12-30B (pages 601–605)
4. Problems (Group B): P12-37B through P12-42B (pages 610–615)

Check your answers in the *Financial Accounting Solutions Supplement* that is found on your My Courses page.



Self-Check 12

1. Which statement related to corporations is *correct*?
 - a. Extraordinary items on the income statement include items that are either unusual or infrequent.
 - b. Comprehensive income equals net income less dividends.
 - c. Discontinued operations should be shown net of tax.
 - d. Preferred stock dividends don't affect earnings per share.
2. Which statement is *true*?
 - a. Vertical analysis of the income statement shows all amounts as a percentage of net sales.
 - b. Trend percentages are a form of vertical analysis.
 - c. Vertical analysis is often used to predict future performance.
 - d. In calculating a percentage change in gross profit, the difference between gross profit for the two years is divided by gross profit of the later year.
3. The Labb Company computes common-size percentages for its income statement. Based on the following data, which percentage would be shown on the income statement for cost of goods sold?

Total assets	\$1,090,000
Net sales	706,000
Net income	84,100
Cost of goods sold	240,000

 - a. 22%
 - b. 34%
 - c. 35%
 - d. 2.85%
4. Financial statement analysis
 - a. is most useful if performed for a single year at a time.
 - b. helps investors determine a company's ability to generate enough cash to pay long-term debt as it matures.
 - c. helps creditors evaluate the current market price of a stock.
 - d. helps investors predict the amount of dividends they're likely to receive in the future.
5. Which of the following helps measure a company's ability to pay its current liabilities?
 - a. The debt ratio
 - b. The current ratio
 - c. Working capital
 - d. Both b and c

(Continued)



Self-Check 12

6. How would the issuance of common stock affect cash, the current ratio, and the rate of return on common stockholders' equity?

Rate of Return on Common Stocks

- | Cash | Current Ratio | Stockholders' Equity |
|--------------|---------------|----------------------|
| a. Decrease | No effect | Decrease |
| b. No effect | Increase | No effect |
| c. Increase | Increase | Decrease |
| d. Increase | Increase | Increase |
7. Shelton Corporation was organized on January 1 of the current year with 100,000 shares of \$25 par-value common stock authorized; 50,000 shares were issued on that date. The annual preferred stock dividend would be \$20,000. Net income for the year was \$420,000. What were the earnings per share reported on the income statement for the current year?
- | | |
|-----------|------------|
| a. \$4.20 | c. \$8.00 |
| b. \$6.00 | d. \$12.00 |

(Continued)



Self-Check 12

Table 12-1

Presented here are the comparative balance sheet and income statement for the Davenport Company.

Balance Sheet
December 31, 2013 and 2014

Assets	2014	2013
Cash	\$ 32,000	\$ 5,600
Accounts receivable	48,000	60,000
Inventory	82,500	104,400
Property, plant, and equipment	<u>272,500</u>	<u>405,000</u>
Total	<u>\$435,000</u>	<u>\$575,000</u>
Liabilities and Stockholders' Equity		
Accounts payable	\$ 45,000	\$ 44,000
Accrued expenses payable	15,000	12,000
Bonds payable	75,000	150,000
Common stock, no par	247,500	307,500
Retained earnings	<u>52,500</u>	<u>61,500</u>
Total	<u>\$435,000</u>	<u>\$575,000</u>

Income Statement
For the Year Ended December 31, 2014

Sales	\$720,000
Cost of goods sold	<u>432,000</u>
Gross margin	288,000
Operating expenses	<u>225,000</u>
Operating income	63,000
Interest expense	<u>9,000</u>
Income before income tax	54,000
Income tax expense	<u>12,000</u>
Net income	<u>\$42,000</u>

(Continued)



Self-Check 12

8. Using the information in Table 12-1 on the previous page, what is the rate of return on assets for 2014?
- | | |
|----------|----------|
| a. 11.7% | c. 8.3% |
| b. 10.1% | d. 12.5% |
9. Using the information in Table 12-1 on the previous page, what is the inventory turnover for 2014?
- | | |
|--------------|--------------|
| a. 4.6 times | c. 4.1 times |
| b. 8 times | d. 6.5 times |
10. Using the information in Table 12-1 on the previous page, what is the current ratio for 2014?
- | | |
|---------|---------|
| a. 2.71 | c. .31 |
| b. .37 | d. 1.20 |

Check your answers with those on page 123.

Self-Check 1

1. a
2. d
3. b
4. c
5. a
6. b
7. a
8. d
$$+40,000 = -8,000 + (+48,000)$$
9. d

Year 2013 Assets 75,000 =
Liabilities 36,000 + Owner's Equity 39,000

Year 2014 Assets 90,000 =
Liabilities 45,000 + Owner's Equity 45,000

2014 Owner's Equity 45,000 –
2013 Owner's Equity 39,000 =
6,000 change in Owner's Equity

6,000 Owner's Equity –
1,500 Net Income – 0 Dividends =
4,500 change in Equity
10. c

Self-Check 2

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

Beginning balance 30,000 + borrowing 63,000 – ending
balance 41,000 = 52,000 payments on loans
5. c

Answers

6. d

7. a

8. a

Ending balance 57,600 – debits 124,300 + credits
135,100 = 68,400 beginning balance

9. b

Accounts payable 6,900 + common stock 64,000 + salary
payable 3,600 + service revenue 190,500 = 265,000

10. d

(1000 debit – 100 posting = 900 debit error) + 58,700 =
59,600

Self-Check 3

1. c

Beginning salary 4,000 + salaries expense 240,000
– ending salary 8,000 = 236,000

2. c

4,800 divided by 12 = 1,200
A credit to Prepaid Insurance of 1,200 is made for the
period ending December 31, 2014.

3. a

4. b

5. d

Beginning balance prepaid rent 1,400 – ending balance
prepaid rent 1,200 = 200

Rent expense 6,100 – 200 = 5,900

Rent expense less the adjustment of 200 made for the
prepaid rent adjusting entries means that 5,900 was
actually paid in cash for rent expense throughout the
year.

6. c

$48,200 + 1,300$ adjusting entry to accumulated depreciation = 49,500

The entry would be a debit to depreciation expense and a credit to accumulated depreciation.

Prepaid insurance would have an adjusting entry of a debit to Insurance expense and a credit to Prepaid Insurance, which wouldn't affect the credit column of the trial balance.

7. a

Rental Revenue 23,400 – Insurance Expense 8,600
(after the adjusting entry = $7000 + 1,600$) –
Salary Expense 4,000 – Repairs Expense 3,150 –
Depreciation Expense 1,300
(after the adjusting entry = $0 + 1,300$) = 6,350

8. b

9. a

10. d

Self-Check 4

1. c

2. a

3. c

4. a

5. b

6. a

7. b

8. d

9. c

10. b

Self-Check 5

1. b
2. c
3. c
4. a
5. b
6. c
7. d
8. d
9. a
10. b

Self-Check 6

1. d
2. b
3. a
4. d
5. c
6. d
7. a
8. b
9. d
10. c

Self-Check 7

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

- 5. a
- 6. b
- 7. d
- 8. a
- 9. a
- 10. c

Self-Check 8

- 1. d
- 2. c
- 3. a
- 4. c
- 5. b
- 6. a
- 7. b
- 8. c
- 9. b
- 10. d

Self-Check 9

- 1. d
- 2. a
- 3. b
- 4. b
- 5. c
- 6. a
- 7. c
- 8. c
- 9. b

10. a

Self-Check 10

1. d

2. a

3. b

4. b

5. a

6. b

7. c

8. b

9. a

10. a

Self-Check 11

1. c

2. c

3. a

4. d

5. b

6. a

7. a

8. b

9. c

10. d

Self-Check 12

1. c
2. a
3. b
4. d
5. d
6. c
7. c
8. b
9. a
10. a