

Module 2

Introducing Financial Statements and Transaction Analysis

| Learning Objectives – coverage by question | | | | | |
|---|------------|-----------------|-----------|----------|--------|
| | True/False | Multiple Choice | Exercises | Problems | Essays |
| LO1 – Describe information conveyed by the financial statements. | 1-11 | 1-15 | 1-8 | 1-8 | 1-3 |
| LO2 – Explain and illustrate linkages among the four financial statements. | 12-14 | 16-24 | 8-10 | 8-10 | 4 |
| LO3 – Illustrate use of the financial statement effects template to summarize accounting transactions. | 15 | 25-30 | 11-15 | 11-15 | - |

Module 2: Introducing Financial Statements and Transaction Analysis

True/False

Topic: Definition of an Asset

LO: 1

1. In order for an asset to be reported on the balance sheet, it must be owned by the company and be expected to provide future benefits.

Answer: False

Rationale: Assets reported on the balance sheet must be owned OR CONTROLLED by the company and must be expected to provide future benefits. These benefits can relate to the expected receipt of cash or another asset, or the expected decrease in a liability.

Topic: Historical Cost

LO: 1

2. Assets are reported on the balance sheet at their current market value.

Answer: False

Rationale: Assets are generally reported at historical costs. An exception is marketable securities.

Topic: Book vs. Market Value

LO: 1

3. The book value of stockholders' equity (the amount reported on the balance sheet) is most typically equal to the market value of the equity of a company.

Answer: False

Rationale: Book value and market value differ for many reasons, including reporting assets at historical costs instead of current market value, and differences between the accounting periods in which transactions are recognized in the financial statements and when the value implications of those transactions are recognized by the capital markets.

Topic: Reporting of Assets and Liabilities

LO: 1

4. Assets are listed on the balance sheet in order of liquidity and liabilities are listed in order of maturity.

Answer: True

Rationale: Assets are reported in the order that they are generally expected to be converted into cash. Receivables are, thus, reported before inventories, and inventories before PPE. Liabilities are reported in order of maturity, with current liabilities expected to be paid within one year and long-term liabilities expected to be paid over a longer period of time.

Topic: Unrecorded Assets

LO: 1

5. In addition to purchased assets like inventories and equipment, companies also may report on their balance sheets intangible assets such as the value of a brand name.

*Answer:*True

*Rationale:*Companies *may* report intangible assets if they acquired them in an arms' length transaction. But if the intangible was not purchased, if it was internally generated it may not be included on the balance sheet because its future economic benefits cannot be reliably measured. So, all internally generated intangible assets are excluded from the balance sheet under GAAP.

Topic: Liabilities

LO: 1

6. Liabilities and equities are both claims against the assets of a company.

*Answer:*True

Rationale: Both liabilities and equity are claims against the assets. In the event of default of a company, liabilities are settled first against the assets of the company. The owners, however, still have an interest in the remaining assets.

Topic: Unearned Revenue and Revenue Recognition Principle

(more challenging – involves unearned revenue and recognition thereof.)

LO: 1

7. A customer's prepayment for services not yet rendered is initially recorded as unearned revenue (a liability). Then, at the end of the accounting period, the unearned revenue is moved from the balance sheet to the income statement. This is an example of the revenue recognition principle.

*Answer:*False

*Rationale:*Unearned revenue is recorded for customer prepayments. But it is only moved to the income statement when the services have been rendered and not automatically at the end of the accounting period.

Topic: Revenue Recognition Principle and Cash

LO: 1

8. According to the revenue recognition principle, companies are required to record revenue when cash is received as this provides the most objective evidence for the auditors.

*Answer:*False

*Rationale:*The revenue recognition principle states that revenue may be recognized in the income statement when it is earned and realized or realizable. Cash is objective but not necessary for revenue to be earned.

Topic: Accrual Accounting for Expenses

LO: 1

9. Under accrual accounting principles, the cost of inventory should be reported as an expense in the income statement when it is sold, regardless of when it was purchased.

*Answer:*True

*Rationale:*Under accrual accounting, the cost of inventory is reported as expense in the period in which it is used up, typically at the point of sale. Purchased inventories that have not yet been sold are reported as assets, notwithstanding whether or not they have been paid for.

Topic: Statement of Cash Flows

LO: 1

10. The statement of cash flows has two main sections: cash flows from operating activities and cash flows from investing activities.

*Answer:*False

*Rationale:*The statement of cash flows has three sections: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities

Topic: Net working Capital

LO: 1

11. Net working capital = Current assets + current liabilities

*Answer:*False

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

Topic: Articulation in General

LO: 2

12. Articulation refers to the concept that financial statements are linked to each other and linked across time.

*Answer:*True

Rationale: Balance sheets are linked over time because the permanent accounts' closing balance last period becomes the opening balance in the current period. The statements are linked to each other via cash (statements of cash flow and balance sheets), via retained earnings (income statements and balance sheets), and via equity accounts (statements of stockholders' equity and balance sheets).

Topic: Articulation in General

LO: 2

13. The income statements of the prior and current year are linked via the balance sheet.

Answer: False

Rationale: The balance sheets of the prior and current year are linked via the income statement.

Topic: Articulation of Retained Earnings

LO: 2

14. Retained earnings articulate across time which means that last period's retained earnings plus current period net income (or loss) is equal to the current period's retained earnings.

*Answer:*False

*Rationale:*Last period's retained earnings plus current period net income (or loss) less any dividends paid, is equal to the current period's retained earnings.

Topic: Preparing Financial Statements

LO: 3

15. Preparing financial statements involves two steps: recording transactions during the period and adjusting records to ensure all events are properly recorded.

Answer: True

*Rationale:*Both steps are required to prepare accrual based financial statements.

Multiple Choice

Topic: Reporting of Assets

LO: 1

1. Assets are recorded in the balance sheet in order of:
 - A) Market Value
 - B) Historic Value
 - C) Liquidity
 - D) Maturity
 - E) None of the above

Answer: C

Rationale: Liquidity refers to the ease of conversion to cash. Current Assets are to be used during the current operating cycle. Non-current assets, like equipment and goodwill are reported after current assets. Market value and historic value refer not to the order but to the valuation of assets. Maturity refers to the order in which liabilities are recorded in the balance sheet.

Topic: Current Assets

LO: 1

2. Which of the following are included in current assets?
 - A) Prepaid rent
 - B) Taxes payable
 - C) Automobiles
 - D) Common stock
 - E) None of the above

Answer: A

Rationale: Taxes payable is a liability, automobiles is not a current asset but a long-term one, and common stock is an equity.

Topic: Net Working Capital – Numerical calculations required

LO: 1

3. In 2013, Southwest Airlines had negative net working capital of \$(1,220) million and current assets of \$4,456 million. The firm's current liabilities are:
 - A) \$4,533 million
 - B) \$5,676 million
 - C) \$1,220 million
 - D) \$3,236 million
 - E) There is not enough information to calculate the amount.

Answer: B

Rationale: Net working capital = current assets – current liabilities.

Current liabilities = Current assets – Net working capital

Current liabilities = \$4,456 – \$(1,220)

Current liabilities = \$5,676 million

Topic: Net Working Capital – Numerical calculations required

LO: 1

4. In 2013, Delphi Automotive PLC had current assets of \$5,752 million and current liabilities of \$3,894 million. The firm's net working capital is:
- A) \$1,858million
 - B) \$5,752 million
 - C) \$(1,858) million
 - D) \$9,646 million
 - E) None of the above

Answer:A

*Rationale:*Net working capital = current assets – current liabilities.

Net working capital = \$5,752– \$3,894

Net working capital = \$1,858 million.

Topic: Net Working Capital – Numerical calculations required

LO: 1

5. In 2013, Kohl's Corporation had net working capital of \$11,370million and current liabilities of \$2,535million. The firm's current assets are:
- A) \$ 8,836 million
 - B) \$ (8,836)million
 - C) \$13,905million
 - D) \$ 2,535 million
 - E) None of the above

Answer:C

*Rationale:*Net working capital = current assets – current liabilities.

\$11,370 = current assets – \$2,535

Current assets = \$13,905

Topic: Liabilities

LO: 1

6. Which one of the following is *not* a current liability?
- A) Taxes payable
 - B) Accounts payable
 - C) Wages payable
 - D) Wage expense
 - E) None of the above

Answer:D

Rationale: Wage expense is an income statement account, not a balance sheet account. It is not a current liability.

Topic: Stockholders' Equity

LO: 1

7. Which of the following is included as a component of stockholders' equity?
- A) Buildings
 - B) Retained earnings
 - C) Prepaid property taxes
 - D) Accounts payable
 - E) Dividends

*Answer:*B

*Rationale:*Retained earnings is a component of stockholders' equity. Dividends affect retained earnings but they are not reported as a separate component.

Topic: Recognition of Costs as Expense

LO: 1

8. As inventory and property plant and equipment on the balance sheet are consumed, they are reflected:
- A) As a revenue on the income statement
 - B) As an expense on the income statement
 - C) As a use of cash on the statement of cash flows
 - D) On the balance sheet because assets are never consumed
 - E) Both B and C because the financial statements articulate

*Answer:*B

*Rationale:*As assets are consumed (used up), their cost is transferred to the income statement as expenses. Cash is not involved so C and E are incorrect.

Topic: Income Statement

LO: 1

9. Interest expense appears in which financial statement?
- A) Statement of stockholders' equity
 - B) Balance sheet
 - C) Income statement
 - D) Statement of cash flows
 - E) All of the above

*Answer:*C

*Rationale:*Expenses, including interest expense, appear in the income statement.

Topic: Gross Profit – Numerical calculations requiredLO: 1

10. During fiscal 2013, Mattel had sales of \$6,484,892, total expenses of \$5,580,948 and gross profit of \$3,478,883. What was Mattel's cost of sales for 2013? (\$ in thousands)
- A) \$2,102,065 thousand
 - B) \$5,580,948 thousand
 - C) \$3,006,009 thousand
 - D) \$ 903,944 thousand
 - E) There is not enough information to calculate the cost of sales.

*Answer:*C

*Rationale:*Sales – Cost of sales = Gross profit
\$ 6,484,892 – Cost of sales = \$3,478,883
Cost of sales = \$3,006,009 thousand

Topic: Net Income – Numerical calculations required

LO: 1

11. During fiscal 2013, Kohl's had sales of \$19,279, Cost of merchandise sold of \$12,289, and gross profit of \$6,990. What was net income for 2013? (\$ in millions)
- A) \$ 6,990 million
 - B) \$12,289million
 - C) \$ 5,299 million
 - D) \$19,279million
 - E) There is not enough information to calculate the amount.

*Answer:*E

*Rationale:*Sales – Total expenses = Net income. There is no information about total expenses, so we cannot compute net income.

Topic: Net Income – Numerical calculations requiredLO: 1

12. During 2013, Skechers U.S.A., Inc. had Sales of \$1,846.4million, Gross profit of \$818.8 million and Selling, general, and administrative expenses of \$730.7million. What was Skechers' Cost of sales for 2013?
- A) \$1,115.7million
 - B) \$1,027.6 million
 - C) \$ 88.1 million
 - D) \$1,549.5 million
 - E) There is not enough information to calculate the amount.

*Answer:*B

*Rationale:*Sales – Cost of sales = Gross profit
\$1,846.4 – Cost of sales = \$818.8.
Cost of sales = \$1,027.6million

**Topic: Components of Financial Statements – Numerical calculations required
(more challenging, total assets not given)**

LO: 1

13. In its December 31, 2013 financial statements, Harley-Davidson reported the following (in millions):

| Long-term Assets | Current Liabilities | Long-term Liabilities | Total Liabilities | Equity |
|------------------|---------------------|-----------------------|-------------------|---------|
| \$5,416 | \$ 2,510 | \$ 3,886 | \$6,396 | \$3,009 |

At December 31, 2013, current assets amount to:

- A) \$2,510 million
- B) \$3,989 million
- C) \$6,396million
- D) \$5,519 million
- E) None of the above

*Answer:*B

*Rationale:*Total assets = Total liabilities + Equity.
Total assets – long-term assets = current assets.
Current assets = \$6,396 + \$3,009 – \$5,416.
Current assets = \$3,989 million

Topic: Components of Financial Statements – Numerical calculations required

LO: 1

14. In 2013, Nordstrom, Inc. reported the following (in millions):

| Current Assets | Current Liabilities | Long-term Liabilities | Equity |
|----------------|---------------------|-----------------------|---------|
| \$5,081 | \$2,226 | \$3,950 | \$1,913 |

What amount did Nordstrom report as total assets?

- A) \$ 4,139 million
- B) \$ 3,950 million
- C) \$ 7,307 million
- D) \$13,170 million
- E) None of the above

*Answer:*E

*Rationale:*Total assets = Total liabilities + Equity

Total assets = \$2,226 + \$3,950+ \$1,913 = \$8,089 million.

This amount is not given in the problem.

Topic: Components of Financial Statements – Numerical calculations required

LO: 1

15. In 2013, Caterpillar Inc. reported the following (in millions):

| Current Assets | Lont-term Assets | Current Liabilities | Total Liabilities |
|----------------|------------------|---------------------|-------------------|
| \$38,335 | \$46,561 | \$27,297 | \$64,018 |

What amount did Caterpillar report as equity in 2013?

- A) \$36,721 million
- B) \$20,878million
- C) \$84,896million
- D) \$17,457million
- E) None of the above

*Answer:*B

*Rationale:*Total assets = Total liabilities + Equity

\$38,335 + \$46,561 = \$64,018 + Equity.

Equity = \$20,878 million.

Topic: Articulation of Statement of Retained Earnings with Income Statement– Numerical calculations required

LO: 2

16. During fiscal year-end 2013 2013, Kohl's Corporation reports the following (in \$ millions): net income of \$986, retained earnings at the end of the year of \$10,878 and retained earnings at the beginning of the year of \$10,195. Assume that there were no other retained earnings transactions during fiscal 2013.

What dividends did the firm pay in fiscal year ended February 2, 2013?

- A) \$ 683 million
- B) \$1,669 million
- C) \$ 303 million
- D) \$-0-
- E) There is not enough information to calculate the amount.

Answer:C

*Rationale:*Retained earnings, 2013 = Retained earnings, 2012 + Net Income – Dividends.

Dividends = Retained earnings, 2012 + Net Income – Retained earnings, 2013

Dividends = \$10,195 + \$986– \$10,878 = \$303 million

Topic: Articulation of Statement of Retained Earnings with Balance Sheet – Numerical calculations required

LO: 2

17. Caterpillar Inc. reports net income for 2013 of \$ 3,789 million, retained earnings at the end of the year of \$31,854 million, and dividends during the year of \$1,493 million.

What was the company's retained earnings balance at the start of 2013?

- A) \$29,558 million
- B) \$30,361 million
- C) \$28,065million
- D) \$26,572 million
- E) There is not enough information to calculate the amount.

Answer:A

*Rationale:*Retained earnings, 2013 = Retained earnings, 2012 + Net Income – Dividends.

\$31,854 = Retained earnings, 2012 +\$3,789 – \$1,493.

Retained earnings at the start of the year were \$29,558 million.

Topic: Articulation of Statement of Retained Earnings with Balance Sheet – Numerical calculations required

LO: 2

18. Pfizer Inc., a pharmaceutical company, reported net income for fiscal 2013 of \$22,003 million, retained earnings at the start of the year of \$54,240 million and dividends of \$6,511 million. If there were no other transactions during the year that affected retained earnings, what was the balance of retained earnings at the end of the year?

- A) \$ 69,732 million
- B) \$ 38,748 million
- C) \$124,926 million
- D) \$ 47,729 million
- E) There is not enough information to calculate the amount.

Answer:A

Rationale: Retained earnings, 2013 = Retained earnings, 2012 + Net Income – Dividends.

Retained earnings, 2013 = \$54,240 + \$22,003- \$6,511. Ending retained earnings = \$69,732 million.

Topic: Articulation of Statement of Retained Earnings with Income Statement– Numerical calculations required

LO: 2

19. Intel reports retained earnings at the end of fiscal 2013 of \$35,477 million and retained earnings at the end of fiscal 2012 of \$32,138 million. The company reported dividends of \$4,479 million and other transactions with shareholders that reduced retained earnings during the year by \$1,802 million.

How much net income did the firm report in fiscal 2013?

- A) \$3,339 million net income
- B) \$3,339 million net loss
- C) \$9,620 million net income
- D) \$9,620 million net loss
- E) None of the above

*Answer:*C

*Rationale:*Retained earnings, 2013 = Retained earnings, 2012 + Net Income – Dividends +/- Other transactions.

$$\$35,477 = \$32,138 + \text{Net income} - \$4,479 - \$1,802.$$

$$\text{Net income} = \$9,620 \text{ million income.}$$

Topic: Articulation of Statement of Cash Flows with Balance Sheet– Numerical calculations required

LO: 2

20. In its fiscal 2013 annual report, Nike, Inc. reported cash of \$3,337 million at year end. The statement of cash flows reports the following (in millions):

| | |
|------------------------------------|---------|
| Net cash from operating activities | \$3,027 |
| Net cash from investing activities | (1,067) |
| Net cash from financing activities | (940) |

What was the balance in Nike's cash account at the start of fiscal 2013?

- A) \$3,027 million
- B) \$1,020 million
- C) \$2,317 million
- D) \$4,357million
- E) None of the above

*Answer:*C

*Rationale:*Cash at end of year = Cash at beginning of year + Change in cash during the year.

$$\$3,337 = \text{Cash at beginning of year} + \$3,027 - \$1,067 - \$940 = \$2,317 \text{ million}$$

Topic: Articulation of Statement of Cash Flows with Balance Sheet– Numerical calculations required

LO: 2

21. In its fiscal 2013 balance sheet, JetBlue Airways Corporation, reported cash of \$225 million at year-end. The statement of cash flows reports that cash increased by \$43 million during the year and that net cash flow from operating activities was \$758 million.

What was the cash flow from investing activities during the year?

- A) \$533 million cash outflow
- B) \$715 million cash inflow
- C) \$533 million cash inflow
- D) \$715 million cash outflow
- E) There is not enough information to determine the amount.

*Answer:*E

*Rationale:*Change in cash during the year = Cash from operations + Cash from investing + Cash from financing. We are only given two of the four amounts.

Topic: Articulation of Statement of Cash Flows with Balance Sheet– Numerical calculations required

LO: 2

22. In its fiscal yearended February 2, 2013 balance sheet, Big Lots, Inc., reported cash and cash equivalents at the start of the year of \$68,547 thousand. By the end of the year, the cash and cash equivalents had decreased to \$60,581thousand. The company's statement of cash flows reported cash from operating activities of \$281,133 thousand, cash from financing activities of \$(158,742) thousand.

What amount did the company report for cash from investing activities?

- A) \$122,391 thousand cash inflow
- B) \$ 7,966 thousand cash outflow
- C) \$130,357 thousand cashinflow
- D) \$130,357 thousand cash outflow
- E) None of the above.

*Answer:*D

*Rationale:*Cash at end of year = Cash at start of year + Cash from operations + Cash from investing + Cash from financing.

$\$60,581 = \$68,547 + \$281,133 + \text{Cash from investing} + \$(158,742).$

Cash from investing is an outflow of \$130,357 thousand.

Topic: Articulation of Statement of Cash Flows with Balance Sheet– Numerical calculations required

LO: 2

23. In its fiscal year ended February 1, 2013 balance sheet, Dell Inc. reported cash of \$13,852million at the beginning of the year. The statement of cash flows reports the following (in millions):

| | |
|------------------------------------|---------|
| Net cash from operating activities | \$3,283 |
| Net cash from investing activities | (3,316) |
| Change in cash during the year | (1,283) |

What did Dell report for “Net cash from financing activities” during fiscal year ended 2013?

- A) \$1,250 million cash inflow
- B) \$1,250 million cash outflow
- C) \$2,033 million cash inflow
- D) \$2,033million cash outflow
- E) None of the above

*Answer:*B

*Rationale:*Change in cash during the year = Cash from operations + Cash from investing + Cash from financing.

$\$(1,283) = \$3,283 - \$3,316 + \text{Cash from financing.}$

Cash from financing = $\$(1,250)$ million

Topic: Articulation of Statement of Cash Flows

LO: 2

24. A statement of cash flows usually does not include which of the following?

- A) Net income
- B) Increase in accounts receivable
- C) Contributed capital
- D) Depreciation expense
- E) None of the above

*Answer:*C

*Rationale:*Contributed capital is a balance sheet account and is not included in the statement of cash flows. Changes in the contributed capital account would be included, however, in the financing section of the statement of cash flows.

Topic: Effects of Accruals (more challenging)

LO: 3

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

- A) Increase liabilities and decrease earned capital
- B) Decrease liabilities and increase earned capital
- C) Increase expenses and increase liabilities
- D) Decrease assets and decrease liabilities

*Answer:*A

*Rationale:*An accrual of wages expense produces an increase in wages payable and a decrease in retained earnings (an equity account), resulting from the decrease in profit. Accruing wages does increase expenses and increase liabilities (answer C) but the question asked about the effect on the balance sheet.

Topic: Transaction Effects on the Financial Statements

LO: 3

26. How would cash collected on accounts receivable affect the balance sheet?
- A) Increase liabilities and decrease equity
 - B) Decrease liabilities and increase equity
 - C) Increase assets and decrease assets
 - D) Increase assets and increase equity

*Answer:*C

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

Topic: Transaction Effects on the Financial Statements (more challenging)

LO: 3

27. How would a sale of \$400 of inventory on credit affect the balance sheet if the cost of the inventory sold was \$160?
- A) It would increase noncash assets by \$400 and increase equity by \$400
 - B) It would decrease noncash assets by \$160 and decrease equity by 160
 - C) It would increase cash by \$400 and increase equity by \$400
 - D) Both A and B, above happen simultaneously
 - E) None of the above

*Answer:*D

Rationale: The sale on credit is an account receivable, a noncash asset that increases revenue and therefore increases equity (answer A). The sale also involves reducing inventory by \$160, a noncash asset, which is an expense and therefore a decrease to equity of \$160 (answer B). Therefore both A and B are correct so the answer is D.

Topic: Transaction Effects on the Financial Statements (more challenging)

LO: 3

28. How would a purchase of \$300 of inventory on credit affect the income statement?
- A) It would increase liabilities by \$300
 - B) It would decrease retained earnings by \$300
 - C) It would increase assets by \$300
 - D) Both A and C, above
 - E) None of the above

*Answer:*E

*Rationale:*The purchase on credit increases both accounts payable and inventory, which are balance sheet accounts. It would, therefore, have no effect on the income statement.

Topic: Financial Statement Effects Template

LO: 3

29. Examine the financial statements effects template below. Then select the answer that best describes the transaction.

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|-------------|---------------|---|----------------|---|-------------|---|------------------|---|----------------|-----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Rev-enues | - | Expenses | = | Net Income |
| ?? | -300 | | 300 | = | | | | | | | - | | = | |

- A) Repay accounts payable of \$300 with cash
- B) Collect cash for accounts receivable of \$300
- C) Purchase inventory of \$300 on account
- D) Purchase inventory of \$300 for cash
- E) None of the above

Answer:D

*Rationale:*The purchase of inventory for cash decreases cash by \$300 and increases inventory, a noncash asset, by \$300.

Topic: Financial Statement Effects Template (more challenging)

LO: 3

30. Examine the financial statements effects template below. Then select the answer that best describes the transaction.

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|-------------|---------------|---|----------------|---|-------------|---|------------------|---|----------------|-----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Rev-enues | - | Expenses | = | Net Income |
| ?? | -120 | | 600 | = | 480 | | | | | | - | | = | |

- A) Repay accounts payable of \$120, net
- B) Record accounts receivable of \$600 and cash collected of \$120
- C) Purchase inventory of \$600 partly on account
- D) Purchase \$600 of equipment on account
- E) None of the above

Answer:C

*Rationale:*The purchase of \$600 inventory partly on account implies that the rest is purchased for cash. Cash decreases by \$120 and accounts payable (a liability) increase for the balance of \$480.

Exercises

Topic: Financial Statement Accounts

LO: 1

1. Identify the financial statements in which you would find each of the items listed below. Some items may appear on more than one statement. Indicate all financial statements that apply to each item.

The possible choices are:

- B : Balance sheet
 SE : Statement of Stockholders' Equity
 I : Income Statement
 CF : Statement of Cash Flows

| <u>Financial Statement Item</u> | <u>Financial Statement</u> |
|------------------------------------|----------------------------|
| a. Office building | _____ |
| b. Trademarks | _____ |
| c. Dividends | _____ |
| d. Proceeds of sale of investments | _____ |
| e. Repayments of bank loan | _____ |
| f. Treasury stock | _____ |

Answer:

| <u>Financial Statement Item</u> | <u>Financial Statement</u> |
|------------------------------------|----------------------------|
| a. Office building | B |
| b. Trademarks | B |
| c. Dividends | CF and SE |
| d. Proceeds of sale of investments | CF |
| e. Repayments of bank loan | CF |
| f. Treasury stock | B |

Topic: Financial Statement Accounts

LO: 1

2. Identify the financial statements in which you would find each of the items listed below. Some items may appear on more than one statement. Indicate all financial statements that apply to each item. The possible choices are:

- B : Balance sheet
- SE : Statement of Stockholders' Equity
- I : Income Statement
- CF : Statement of Cash Flows

| <u>Financial Statement Item</u> | <u>Financial Statement</u> |
|---------------------------------|----------------------------|
| a. Land | _____ |
| b. Proceeds from sale of land | _____ |
| c. Prepaid insurance expense | _____ |
| d. Insurance expense | _____ |
| e. Revenue | _____ |
| f. Unearned revenue | _____ |

Answer:

| <u>Financial Statement Item</u> | <u>Financial Statement</u> |
|---------------------------------|----------------------------|
| a. Land | B |
| b. Proceeds from sale of land | CF |
| c. Prepaid insurance expense | B |
| d. Insurance expense | I |
| e. Revenue | I |
| f. Unearned revenue | B |

Topic: Balance Sheet Relations

LO: 1

3. Compute the missing amounts for Nike Inc. for 2013 and 2012, in the table below:

| (\$ millions) | 2013 | 2012 |
|------------------------|---------|----------|
| Total assets | ? | \$15,465 |
| Contributed capital | \$5,187 | \$4,644 |
| Earned capital | \$5,969 | ? |
| Total Liabilities | \$6,428 | \$5,084 |
| Liabilities and equity | ? | \$15,465 |

Answer:

| (\$ millions) | 2013 | 2012 |
|------------------------|-----------------|----------------|
| Total assets | \$17,584 | \$15,465 |
| Contributed capital | \$5,187 | \$4,644 |
| Earned capital | \$5,969 | \$5,737 |
| Total Liabilities | \$6,428 | \$5,084 |
| Liabilities and equity | \$17,584 | \$15,465 |

Topic: Balance Sheet Accounts

LO: 1

4. Identify the following as a component of Assets (A), Liabilities (L), or Equity (E)

| <u>Financial Statement Item</u> | <u>A / L / E</u> |
|---------------------------------|------------------|
| a. Prepaid property taxes | _____ |
| b. Unearned revenue | _____ |
| c. Notes payable | _____ |
| d. Retained earnings | _____ |
| e. Trademark | _____ |
| f. Common stock | _____ |
| g. Accounts payable | _____ |

Answer:

| <u>Financial Statement Item</u> | <u>A / L / E</u> |
|---------------------------------|------------------|
| a. Prepaid property taxes | <u> A </u> |
| b. Unearned revenue | <u> L </u> |
| c. Notes payable | <u> L </u> |
| d. Retained earnings | <u> E </u> |
| e. Trademark | <u> A </u> |
| f. Common stock | <u> E </u> |
| g. Accounts payable | <u> L </u> |

Topic: Reporting of Assets

LO: 1

5. Indicate the order of appearance on the balance sheet of the assets listed on the left.

| <u>Asset</u> | <u>Balance sheet order</u> |
|---------------------|----------------------------|
| Equipment | |
| Accounts receivable | |
| Cash | |
| Inventory | |
| Goodwill | |

Answer:

| <u>Asset</u> | <u>Balance sheet order</u> |
|---------------------|----------------------------|
| Equipment | 4 |
| Accounts receivable | 2 |
| Cash | 1 |
| Inventory | 3 |
| Goodwill | 5 |

Topic: Reporting of Liabilities and Equity

LO: 1

6. Indicate the order of appearance on the balance sheet of the liabilities and equity accounts listed on the left.

| <u>Liability / Equity</u> | <u>Balance sheet order</u> |
|---------------------------|----------------------------|
| Bonds payable | |
| Retained earnings | |
| Accounts payable | |
| Contributed capital | |

Answer:

| <u>Liability / Equity</u> | <u>Balance sheet order</u> |
|---------------------------|----------------------------|
| Bonds payable | 2 |
| Retained earnings | 4 |
| Accounts payable | 1 |
| Contributed capital | 3 |

Topic: Balance Sheet Accounts

LO: 1

7. For each of the following financial statement items, indicate the correct balance sheet classification, from the list below. You may use each balance sheet classification item only once.

Balance sheet classification

- a. Current asset
- b. Long term asset
- c. Current liability
- d. Long term liability
- e. Equity
- f. None of the above

| <u>Financial statement item</u> | <u>Balance sheet classification</u> |
|---------------------------------|-------------------------------------|
| Interest payable | _____ |
| Treasury stock | _____ |
| Insurance expense | _____ |
| Goodwill | _____ |
| Note payable, due in 2020 | _____ |
| Prepaid insurance expense | _____ |

Answer:

| <u>Financial statement item</u> | <u>Balance sheet classification</u> |
|---------------------------------|-------------------------------------|
| Interest payable | c. Current liability |
| Treasury stock | e. Equity |
| Insurance expense | f. None of the above |
| Goodwill | b. Long term asset |
| Note payable, due in 2020 | d. Long term liability |
| Prepaid insurance expense | a. Current asset |

Topic: Accounting Concepts and Articulation of Financial Statements**LO: 1, 2**

8. Match the following principles of financial accounting to their definitions:

- | | |
|---|---|
| a. Financial statements are linked within and across time | 1) Revenue recognition principle |
| b. Revenue and expenses are recognized when a cash transaction is completed | 2) Articulation of financial statements |
| c. Revenue is recognized when earned | 3) Cash basis accounting |
| d. Recognizes revenue when earned and expenses when incurred, even if no cash is received or paid | 4) Accrual accounting |

Answer:

- a. 2) Articulation of financial statements
 b. 3) Cash basis accounting
 c. 1) Revenue recognition principle
 d. 4) Accrual accounting

Topic: Articulation of Retained Earnings Account**LO:2**

9. Caterpillar Inc.'s statement of stockholders' equity for 2013 and 2012 shows the following amounts. Fill in the missing items to show how retained earnings articulate across the years.

| (\$ millions) | 2013 | 2012 |
|--------------------------------------|-----------------|-----------------|
| Retained earnings, beginning of year | ? | \$25,219 |
| Net income for the year | 3,789 | ? |
| Dividends | ? | (1,319) |
| Other | --- | (23) |
| Retained earnings, end of year | <u>\$31,854</u> | <u>\$29,558</u> |

Answer:

| (\$ millions) | 2013 | 2012 |
|--------------------------------------|-----------------|-----------------|
| Retained earnings, beginning of year | \$29,558 | \$25,219 |
| Net income for the year | 3,789 | 5,681 |
| Dividends | (1,493) | (1,319) |
| Other | --- | (23) |
| Retained earnings, end of year | <u>\$31,854</u> | <u>\$29,558</u> |

**Topic: Preparation of Financial Statements and Income Statement / Balance Sheet Articulation
(more challenging – requires preparation of two financial statements)**

LO:2

10. Super Style Clothing begins operations in November. During the month the company receives \$36,000 from a shareholder for common stock and gets a \$4,000 loan from a bank. The company buys \$32,000 of inventory for cash and sells half of the inventory for \$28,000 on credit. The company had no other transactions in November. Fill in the missing amounts below.

| Income Statement For the Month of November | |
|---|-------|
| Sales | _____ |
| Cost of sales | _____ |
| Net income | _____ |

| Balance Sheet At the End of November | |
|---|-------|
| Cash | _____ |
| Accounts receivable | _____ |
| Inventory | _____ |
| Total assets | _____ |
| Accounts payable | _____ |
| Bank loan | _____ |
| Total liabilities | _____ |
| Contributed capital | _____ |
| Retained earnings | _____ |
| Total equity | _____ |
| Total liabilities and equity | _____ |

Answer:

| Income Statement For the Month of November | |
|---|----------|
| Sales | \$28,000 |
| Cost of sales | 16,000 |
| Net income | \$12,000 |

| Balance Sheet At the End of November | |
|---|----------|
| Cash | \$ 8,000 |
| Accounts receivable | 28,000 |
| Inventory | 16,000 |
| Total assets | \$52,000 |
| Accounts payable | \$ 0 |
| Bank loan | 4,000 |
| Total liabilities | 4,000 |
| Contributed capital | 36,000 |
| Retained earnings | 12,000 |
| Total equity | 48,000 |
| Total liabilities and equity | \$52,000 |

Topic: Financial Statement Effect Template

LO:3

11. Consider the three transactions shown in the financial statement effects template, below. Match each transaction to the descriptions below.

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|-------------|---------------|---|----------------|---|-------------|---|------------------|---|----------------|----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| #1 | 160 | | | = | | | | | 160 | 160 | - | | = | 160 |
| #2 | | | 160 | = | | | | | 160 | 160 | - | | = | 160 |
| #3 | 160 | | -160 | = | | | | | | | - | | = | |

- a. Services of \$160 were performed for cash
- b. Inventory of \$160 was purchased for cash
- c. Services of \$160 were performed on credit
- d. Accounts receivable of \$160 were collected from customers

| Transaction | Description (a, b, c, or d) |
|-------------|-----------------------------|
| #1 | |
| #2 | |
| #3 | |

Answer:

| Transaction | Description (a, b, c, or d) |
|-------------|-----------------------------|
| #1 | a |
| #2 | c |
| #3 | d |

Topic: Financial Statement Effect Template

LO:3

12. Consider the three transactions shown in the financial statement effects template, below. Match each transaction to the descriptions that follow.

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|-------------|---------------|---|----------------|---|-------------|---|------------------|---|----------------|-----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Rev-enues | - | Expenses | = | Net Income |
| #1 | -150 | | 150 | = | | | | | | | - | | = | |
| #2 | -150 | | | = | | | | | -150 | | - | 150 | = | -150 |
| #3 | | | | = | 150 | | | | -150 | | - | 150 | = | -150 |

- a. Services of \$150 were performed for cash.
- b. Inventory of \$150 was purchased for cash.
- c. Wages of \$150 were accrued at the end of the period.
- d. Wages of \$150 were paid in cash.

| Transaction | Description (a, b, c, or d) |
|-------------|-----------------------------|
| #1 | |
| #2 | |
| #3 | |

Answer:

| Transaction | Description (a, b, c, or d) |
|-------------|-----------------------------|
| #1 | b |
| #2 | d |
| #3 | c |

Topic: Effects of Transactions on Balance Sheet Accounts

LO: 3

13. Miguel decided to open a lemonade stand on Saturdays. Match Miguel's business activities to the following balance sheet items. (Note: each balance sheet item can only be used once).

- | | |
|---|------------------------|
| a. Borrow \$200 from Dad to be repaid in two years | 1) Long-term liability |
| b. Buy tent from neighbor, at a garage sale | 2) Accounts payable |
| c. Buy lemons, sugar and (secret ingredient) grapefruit | 3) Accounts receivable |
| d. The items in (c) will not be paid for until next month | 4) Long-term asset |
| e. At the end of a hard working day, Miguel has \$500 in his pocket | 5) Inventory |
| f. Mr. Wisner, a potential customer had no cash with him. Miguel agrees to let Mr. Wisner pay \$2 next Monday | 6) Cash |

Answer:

- a. 1) Long-term liability
- b. 4) Long-term asset
- c. 5) Inventory
- d. 2) Accounts payable
- e. 6) Cash
- f. 3) Accounts receivable

Topic: Financial Statement Effects

LO:3

14. Consider the transactions listed on the left. Match them to the financial statement effects listed on the right.

| <u>Transaction</u> | <u>Financial statement effect</u> |
|--------------------------------------|---|
| a. Sell common stock for cash _____ | 1. Decrease assets and decrease equity |
| b. Pay accounts payable _____ | 2. Decrease liabilities and decrease assets |
| c. Repurchase common stock _____ | 3. Increase assets and decrease assets |
| d. Purchase inventory for cash _____ | 4. Increase assets and increase equity |

Answer:

| <u>Transaction</u> | |
|--------------------------------------|----------|
| a. Sell common stock for cash _____ | <u>4</u> |
| b. Pay accounts payable _____ | <u>2</u> |
| c. Repurchase common stock _____ | <u>1</u> |
| d. Purchase inventory for cash _____ | <u>3</u> |

Topic: Financial Statement Effects

LO:3

15. Consider the transactions listed on the left. Match them to the financial statement effects listed on the right.

| <u>Transaction</u> | <u>Financial statement effect</u> |
|---|---|
| a. Pay wages with cash _____ | 1. Increase assets and increase liabilities |
| b. Repay bank loan _____ | 2. Decrease liabilities and decrease assets |
| c. Prepay insurance expense _____ | 3. Decrease assets and decrease equity |
| d. Receive prepayment from customer _____ | 4. Decrease assets and increase assets |

Answer:

| <u>Transaction</u> | |
|---|----------|
| a. Pay wages with cash _____ | <u>3</u> |
| b. Repay bank loan _____ | <u>2</u> |
| c. Prepay insurance expense _____ | <u>4</u> |
| d. Receive prepayment from customer _____ | <u>1</u> |

Problems

Topic: Analyzing Balance Sheet Accounts

LO: 1

- Selected balance sheet amounts for Harley Davidson Inc. for five recent years follow. Compute the missing balance sheet amounts for each of the five years.

| (\$ millions) | Current Assets | Long-term Assets | Total Assets | Current Liabilities | Long-term Liabilities | Total Liabilities | Equity |
|---------------|----------------|------------------|--------------|---------------------|-----------------------|-------------------|---------|
| 2009 | 4,341.9 | | 9,155.5 | | 4,779.2 | 7,047.4 | 2,108.1 |
| 2010 | 4,066.6 | 5,364.1 | | 2,013.8 | 5,210.0 | 7,223.8 | |
| 2011 | | 5,132.0 | 9,674.2 | 2,698.6 | 4,555.3 | | 2,420.3 |
| 2012 | 4,050.9 | 5,119.8 | | 1,503.1 | 5,110.0 | 6,613.1 | |
| 2013 | | 5,416.2 | 9,405.0 | 2,509.6 | 3,885.9 | | 3,009.5 |

Answer:

| (\$ millions) | Current Assets | Long-term Assets | Total Assets | Current Liabilities | Long-term Liabilities | Total Liabilities | Equity |
|---------------|----------------|------------------|----------------|---------------------|-----------------------|-------------------|----------------|
| 2009 | 4,341.9 | 4,813.6 | 9,155.5 | 2,268.2 | 4,779.2 | 7,047.4 | 2,108.1 |
| 2010 | 4,066.6 | 5,364.1 | 9,430.7 | 2,013.8 | 5,210.0 | 7,223.8 | 2,206.9 |
| 2011 | 4,542.2 | 5,132.0 | 9,674.2 | 2,698.6 | 4,555.3 | 7,253.9 | 2,420.3 |
| 2012 | 4,050.9 | 5,119.8 | 9,170.7 | 1,503.1 | 5,110.0 | 6,613.1 | 2,557.6 |
| 2013 | 3,988.8 | 5,416.2 | 9,405.0 | 2,509.6 | 3,885.9 | 6,395.5 | 3,009.5 |

Topic: Analyzing Balance Sheet Accounts

LO: 1

- Selected balance sheet amounts for Nordstrom Inc. for four recent years follow. Compute the missing balance sheet amounts for each of the four years.

| (\$ millions) | Current Assets | Long-term Assets | Total Assets | Current Liabilities | Long-term Liabilities | Total Liabilities | Equity |
|---------------|----------------|------------------|--------------|---------------------|-----------------------|-------------------|--------|
| 2010 | 4,054 | 2,525 | | 2,014 | 2,993 | | 1,572 |
| 2011 | 4,824 | 2,638 | | | 3,562 | 5,441 | |
| 2012 | 5,560 | | 8,491 | 2,575 | | 6,535 | 1,956 |
| 2013 | 5,081 | 3,008 | | 2,226 | 3,950 | | 1,913 |

Answer:

| (\$ millions) | Current Assets | Long-term Assets | Total Assets | Current Liabilities | Long-term Liabilities | Total Liabilities | Equity |
|---------------|----------------|------------------|--------------|---------------------|-----------------------|-------------------|--------------|
| 2010 | 4,054 | 2,525 | 6,579 | 2,014 | 2,993 | 5,007 | 1,572 |
| 2011 | 4,824 | 2,638 | 7,462 | 1,879 | 3,562 | 5,441 | 2,021 |
| 2012 | 5,560 | 2,931 | 8,491 | 2,575 | 3,960 | 6,535 | 1,956 |
| 2013 | 5,081 | 3,008 | 8,089 | 2,226 | 3,950 | 6,176 | 1,913 |

Topic: Preparing a Balance Sheet from a List of Accounts**LO: 1**

3. Use the accounts below for Stanley Black and Decker to prepare a balance sheet at December 28, 2013. (\$ millions)

| | |
|------------------------------|-----------|
| Contributed capital | 4,878.6 |
| Cash | 496.2 |
| Long-term debt | 3,799.4 |
| Accounts receivable | 1,633.0 |
| Other current assets | 354.3 |
| Other long-term assets | 11,081.1 |
| Current liabilities | 3,221.0 |
| Inventory | 1,485.2 |
| Other long-term liabilities | 2,634.2 |
| Property plant and equipment | 1,485.3 |
| Retained earnings | 3,484.9 |
| Other equity | (1,483.0) |

Answer:

| Stanley Black and Decker | |
|---------------------------------|--------------------------|
| Balance Sheet | |
| At December 28, 2013 | |
| (\$ millions) | |
| Cash | \$496.2 |
| Accounts receivable | 1,633.0 |
| Inventory | 1,485.2 |
| Other current assets | 354.3 |
| Current assets | <u>3,968.7</u> |
| Property plant and equipment | 1,485.3 |
| Other long-term assets | 11,081.1 |
| Total assets | <u><u>\$16,535.1</u></u> |
| Current liabilities | \$3,221.0 |
| Long-term debt | 3,799.4 |
| Other long-term liabilities | 2,634.2 |
| Total liabilities | <u>9,654.6</u> |
| Contributed capital | 4,878.6 |
| Retained earnings | 3,484.9 |
| Other equity | (1,483.0) |
| Total equity | <u>6,880.5</u> |
| Total liabilities and equity | <u><u>\$16,535.1</u></u> |

Topic: Preparing an Income Statement from a List of Accounts**LO: 1**

4. Use the accounts below for Stanley Black and Decker to prepare an income statement for the year ended December 28, 2013. (\$ millions)

| | |
|---|-----------|
| Cost of goods sold | \$7,068.3 |
| Sales | 11,001.2 |
| Other operating expenses | 497.8 |
| Selling, general and administrative expenses | 2,700.9 |
| Income tax expense | 69.3 |
| Interest and other nonoperating expenses, net | 147.6 |
| Net (loss) earnings from discontinued operations | (28.0) |
| Net (loss) attributable to noncontrolling interests | (1.0) |

Answer:

| Stanley Black and Decker | |
|---|------------|
| Income Statement | |
| For the year ended December 28 2013 | |
| (\$ millions) | |
| Sales | \$11,001.2 |
| Cost of goods sold | 7,068.3 |
| Gross profit | \$3,932.9 |
| Selling, general and administrative expenses | 2,700.9 |
| Other operating expenses | 497.8 |
| Operating income | 734.2 |
| Interest and other nonoperating expenses | 147.6 |
| Earnings from continuing operations before income taxes | 586.6 |
| Income taxes | 69.3 |
| Earnings from continuing operations | 517.3 |
| Loss attributable to noncontrolling interests | (1.0) |
| Net loss from discontinued operations | (28.0) |
| Net earnings | \$490.3 |

**Topic: Preparing a Balance Sheet and Income Statement from a List of Accounts
(more challenging – company reports net loss and accumulated deficit)**

LO: 1

5. Use the accounts below for Delphi Corporation for December 31, 2013 to prepare an income statement and a balance sheet. (\$ millions)

| | |
|-----------------------------|---------|
| Contributed capital | \$1,702 |
| Cost of sales | 13,567 |
| Cash | 1,393 |
| Long-term liabilities | 3,719 |
| Accounts receivable | 2,662 |
| Other current assets | 604 |
| Other long-term assets | 2,079 |
| Other current liabilities | 1,299 |
| Other operating expenses | 1,212 |
| Other nonoperating expenses | 161 |
| Inventory | 1,093 |
| Accounts payable | 2,595 |
| Property, net | 3,216 |
| Retained earnings | 1,209 |
| Sales | 16,463 |
| Tax expense | 256 |
| Equity income, net of tax | 34 |
| Other equity | 523 |

Answer:

| |
|---|
| Delphi Corporation Income Statement For the Year Ended December 31, 2013 (\$ millions) |
|---|

| | |
|---------------------------------------|-----------------------|
| Sales | \$16,463 |
| Cost of sales | <u>13,567</u> |
| Gross profit | 2,896 |
| Other operating expenses | <u>1,212</u> |
| Operating income | 1,684 |
| Other nonoperating expenses | <u>161</u> |
| Income before taxes and equity income | 1,523 |
| Tax expense | (256) |
| Equity income, net of tax | <u>34</u> |
| Net income | <u><u>\$1,301</u></u> |

Continued next page

continued

| Delphi Corporation | |
|------------------------------|------------------------|
| Balance Sheet | |
| At December 31, 2013 | |
| (\$ millions) | |
| Cash | \$1,393 |
| Accounts receivable | 2,662 |
| Inventory | 1,093 |
| Other current assets | 604 |
| Current assets | <u>5,752</u> |
| Property, net | 3,216 |
| Other long-term assets | 2,079 |
| Total assets | <u><u>\$11,047</u></u> |
| Accounts payable | \$2,595 |
| Other current liabilities | 1,299 |
| Current liabilities | <u>3,894</u> |
| Long-term liabilities | 3,719 |
| Total liabilities | <u>7,613</u> |
| Contributed capital | 1,702 |
| Retained earnings | 1,209 |
| Other equity | 523 |
| Total equity | <u>3,434</u> |
| Total liabilities and equity | <u><u>\$11,047</u></u> |

Topic: Market to Book Value and Unrecorded Intangible Assets

LO: 1

6. Below are selected balance sheet and market data for three shoe companies. (\$ millions)

| Company | Company Year End | Assets | Liabilities | Number of shares outstanding (in millions) | End of year stock price (per share) |
|--------------------------|------------------|--------|-------------|--|-------------------------------------|
| Nike, Inc. | May31, 2013 | 17,584 | 6,428 | 894 | \$61.08 |
| Skechers, USA, Inc. | Dec. 31, 2013 | 1,409 | 429 | 51 | \$33.13 |
| Brown Shoe Company, Inc. | Feb. 2, 2013 | 1,171 | 745 | 43 | \$16.94 |

- Calculate the market capitalization of each company.
- Calculate the market to book ratio for each company.
- Comment on differences you observe.

Answer:

a. and b.

| Company | Book Value of Equity (Assets – Liabilities) | Market Capitalization (Shares outstanding × stock price) | Market to book ratio |
|--------------------------|---|--|----------------------|
| Nike, Inc. | 11,156 | 54,606 | 4.89 |
| Skechers, USA, Inc. | 980 | 1,690 | 1.72 |
| Brown Shoe Company, Inc. | 426 | 728 | 1.71 |

- Nike has a market to book ratio of 4.89, the highest among the three companies. This means that Nike's economic value exceeds its GAAP book value by a factor of nearly five. This is due to the fact that significant, valuable intangible assets are omitted from Nike's GAAP balance sheet. GAAP does not allow firms to capitalize (add to their balance sheets) the value of self-generated intangible assets. Nike's brand name and the "swoosh" symbol will bring future economic benefits – assets that the market clearly values. At the other end, Brown Shoe Company and Skechers both have a market to book just below 2.0 which means that their brand names, while still valuable, are not significant enough to boost their stock price. Note that it would also be possible for a company to have a book value of equity that exceeds its market value. This would mean that the market undervalues this company, relative to GAAP, perhaps because the company's earning power is low.

Topic: Preparing a Balance Sheet and Income Statement (same transactions as in Problem 15 but without financial statement effects template).

LO: 1

7. AnkaCompany begins the month of November with \$12,000 in cash and \$12,000 in contributed capital. During the month, the company has seven transactions. Analyze the transactions and prepare an income statement and balance sheet for November.

- The owner invests an additional \$20,000 cash in the business.
- The company purchases inventory for \$4,000 on credit.
- The company sells all the inventory for \$8,000 on account.
- The company collects \$1,000 of the accounts receivable.
- The company pays \$1,000 on the account payable.
- Employees earn \$1,200, to be paid next month.
- The company pays dividends of \$800.

Answer:

| Anka Company Income Statement For the Month of November | |
|--|-----------------------|
| Sales | \$8,000 |
| Cost of sales | 4,000 |
| Gross profit | <u>4,000</u> |
| Wages expense | 1,200 |
| Net income | <u><u>\$2,800</u></u> |

| AnkaCompany Balance Sheet At End of November | |
|---|------------------------|
| Cash | \$31,200 |
| Accounts receivable | 7,000 |
| Total assets | <u>\$38,200</u> |
| Accounts payable | \$3,000 |
| Wages payable | 1,200 |
| Total liabilities | <u>4,200</u> |
| Contributed capital | 32,000 |
| Retained earnings | 2,000 |
| Total equity | <u>34,000</u> |
| Total liabilities and equity | <u><u>\$38,200</u></u> |

Topic: Reconciling Statement of Cash Flows – Articulation of Accounts over Time

LO: 1, 2

8. Following is cash flow information for Harley Davidson Inc. for three recent years. Prepare the statements of cash flow for 2011 through 2013.

| (in thousands) | 12/31/2013 | 12/31/2012 | 12/31/2011 |
|----------------------|------------|------------|------------|
| Cash from operations | | 801,458 | 885,291 |
| Cash from investing | (568,867) | (261,311) | (63,542) |
| Cash from financing | (409,752) | (998,959) | (316,732) |
| Cash at end of year | 1,066,612 | | 1,526,950 |

Answer:

| Harley Davidson Inc. Statement of Cash Flows For year ending December 31 | | | |
|--|--------------------|--------------------|--------------------|
| (in thousands) | <u>2013</u> | <u>2012</u> | <u>2011</u> |
| Cash from operations | \$977,093 | 801,458 | 885,291 |
| Cash from investing | (568,867) | (261,311) | (63,542) |
| Cash from financing | (409,752) | (998,959) | (316,732) |
| Increase (decrease) in cash during the year | (1,526) | (458,812) | 505,017 |
| Cash at beginning of year | 1,068,138 | 1,526,950 | 1,021,933 |
| Cash at end of year | <u>\$1,066,612</u> | <u>\$1,068,138</u> | <u>\$1,526,950</u> |

Topic: Articulation of Retained Earnings**LO: 2**

9. Following is information for Snap-On Incorporated, for three recent years. Reconcile the retained earnings account for the three-year period.

| (in millions) | |
|--------------------------------------|---------|
| Retained earnings, December 31, 2013 | 2,324.1 |
| Net income, 2013 | 350.3 |
| Net income, 2012 | 306.1 |
| Net income, 2011 | 276.3 |
| Dividends*, 2013 | 93.2 |
| Dividends*, 2012 | 82.8 |
| Dividends, 2011 | 76.7 |

*includes "dividend reinvestment plan and other" amounts of 1.3 (2012) and 1.2 (2013)

Answer:

| Snap-On Incorporated Statement of Retained Earnings For Year Ending December 31 | | | |
|---|------------------|------------------|------------------|
| (in millions) | <u>2013</u> | <u>2012</u> | <u>2011</u> |
| Retained earnings, beginning of year | \$2,067.0 | \$1,843.7 | \$1,644.1 |
| Net income (loss) for the year | 350.3 | 306.1 | 276.3 |
| Dividends declared | (93.2) | (82.8) | (76.7) |
| Retained earnings, end of year | <u>\$2,324.1</u> | <u>\$2,067.0</u> | <u>\$1,843.7</u> |

Topic: Articulation of Retained Earnings

LO: 2

10. Following is information for Goodyear Tire & Rubber Company for three recent years. Reconcile the retained earnings account for the three-year period.

(in millions)

| | |
|--------------------------------------|-----|
| Retained earnings, December 31, 2010 | 866 |
| Net income, 2013 | 629 |
| Net income, 2012 | 212 |
| Net income, 2011 | 343 |
| Dividends, 2013 | 41 |
| Dividends, 2012 | 29 |
| Dividends, 2011 | 22 |

Answer:

| Goodyear Tire & Rubber Company Statement of Retained Earnings For year ending December 31 | | | |
|---|----------------|----------------|----------------|
| (in millions) | <u>2013</u> | <u>2012</u> | <u>2011</u> |
| Retained earnings, beginning of year | \$1,370 | \$1,187 | \$866 |
| Net income (loss) for the year | 629 | 212 | 343 |
| Dividends | (41) | (29) | (22) |
| Retained earnings, end of year | <u>\$1,958</u> | <u>\$1,370</u> | <u>\$1,187</u> |

Topic: Recording Transactions in Financial Statement Effects Template (no \$ amounts)

LO: 3

11. Use “+/-” to indicate how each of the following transactions affects the financial statement effects template below. If both an increase and decrease occur, place a “+/-” in the column.

1. Owner invests cash into the business in exchange for stock.
2. Recognizes account receivable for services provided.
3. Pays account payable with cash.
4. Buys land with cash.
5. Buys plant equipment on credit.
6. Borrows money by taking out loan at bank.

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|-------------|---------------|---|----------------|---|-------------|---|------------------|---|----------------|----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| 1. | | | | = | | | | | | | | | = | |
| 2. | | | | = | | | | | | | | | = | |
| 3. | | | | = | | | | | | | | | = | |
| 4. | | | | = | | | | | | | | | = | |
| 5. | | | | = | | | | | | | | | = | |
| 6. | | | | = | | | | | | | | | = | |

Answer:

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|-------------|---------------|---|----------------|---|-------------|---|------------------|---|----------------|----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| 1. | + | | | = | | | + | | | | | | = | |
| 2. | | | + | = | | | | | + | + | - | | = | + |
| 3. | - | | | = | - | | | | | | | | = | |
| 4. | - | | + | = | | | | | | | | | = | |
| 5. | | | + | = | + | | | | | | | | = | |
| 6. | + | | | = | + | | | | | | | | = | |

Topic: Recording Transactions in Financial Statement Effects Template (shorter, with \$ amounts)

LO: 3

12. Record each transaction (in \$) in the financial statements effects template below.

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|--|---------------|---|----------------|---|-------------|---|------------------|---|----------------|----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| Purchase \$2,000 of inventory on credit | | | | = | | | | | | | | | = | |
| Pay \$500 cash for rent expense | | | | = | | | | | | | | | = | |
| Collect \$8,000 cash for accounts receivable | | | | = | | | | | | | | | = | |
| Pay \$4,500 cash toward accounts payable | | | | = | | | | | | | | | = | |

Answer:

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|--|---------------|---|----------------------|---|---------------|---|------------------|---|-----------------------------|----------|---------------------|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| Purchase \$2,000 of inventory on credit | | | +2000 (Inventory) | = | +2000 (AP) | | | | | | | | = | |
| Pay \$500 cash for rent expense | -500 | | | = | | | | | -500 (Retained earnings) | | +500 (Rent exp.) | | = | -500 |
| Collect \$8,000 cash for accounts receivable | +8000 | | -8000 (AR) | = | | | | | | | | | = | |
| Pay \$4,500 cash toward accounts payable | -4500 | | | = | -4500 (AP) | | | | | | | | = | |

Topic: Using the Financial Statement Effects Template (longer, with \$ amounts)

LO: 3

13. Record the following transactions in the financial statement effects template below:

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|--|---------------|---|----------------|---|-------------|---|------------------|---|----------------|----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| Purchase \$1,000 of inventory on credit | | | | = | | | | | | | | - | | = |
| Sell all inventory for \$3,000 on credit | | | | = | | | | | | | | - | | = |
| Collect \$1,000 cash from customers | | | | = | | | | | | | | - | | = |
| Purchase \$2,500 of equipment | | | | = | | | | | | | | - | | = |
| Pay \$7,000 on a note payable that came due | | | | = | | | | | | | | - | | = |
| Pay \$500 cash interest on borrowings | | | | = | | | | | | | | - | | = |
| Record depreciation of \$500 | | | | = | | | | | | | | - | | = |
| Record \$1,400 of employee wages earned but unpaid | | | | = | | | | | | | | - | | = |
| Pay \$300 dividend | | | | = | | | | | | | | - | | = |

Answer:

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|--|---------------|---|---|---|---------------------------|---|------------------|-------------------------------|----------------|------------------|---|-------------------------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| Purchase \$1,000 of inventory on credit | | | +1,000 (Inventory) | = | +1,000 (AP) | | | | | | - | | = | |
| Sell all inventory for \$3,000 on credit | | | +3,000 (AR) -1,000 (Inventory) | = | | | | +2,000 (Retained Earnings) | | +3,000 (Rev.) | - | +1,000 (COGS) | = | +2,000 |
| Collect \$1,000 cash from customers | +1,000 | | -1,000 (AR) | = | | | | | | | - | | = | |
| Purchase \$2,500 of equipment | -2,500 | | +2,500 (Equipment) | = | | | | | | | - | | = | |
| Pay \$7,000 on a note payable that came due | -7,000 | | | = | -7,000 (Note Payable) | | | | | | - | | = | |
| Pay \$500 cash interest on borrowings | -500 | | | = | | | | -500 (Retained Earnings) | | | - | +500 (Interest Exp.) | = | -500 |
| Record depreciation of \$500 | | | -500 (Equipment) | = | | | | -500 (Retained Earnings) | | | - | +500 (Depn Exp.) | = | -500 |
| Record \$1,400 of employee wages earned but unpaid | | | | = | +1,400 (Wages Payable) | | | -1,400 (Retained Earnings) | | | - | +1,400 (Wage Exp.) | = | -1,400 |
| Pay \$300 dividend | -300 | | | = | | | | -300 (Dividends) | | | - | | = | |

Topic: Using the Financial Statement Effects Template (longer, with \$ amounts)

LO: 3

14. Record the following transactions in the financial statement effects template below:

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|--|---------------|---|----------------|---|-------------|---|------------------|---|----------------|----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| Issued stock for \$40,000 | | | | = | | | | | | | | | = | |
| Paid \$1,850 for rent | | | | = | | | | | | | | | = | |
| Performed services for \$2,500 cash | | | | = | | | | | | | | | = | |
| Performed services for \$14,000 on account | | | | = | | | | | | | | | = | |
| Paid \$1,750 cash wages | | | | = | | | | | | | | | = | |
| Received \$12,000 cash on account | | | | = | | | | | | | | | = | |
| Paid \$550 dividends | | | | = | | | | | | | | | = | |

Answer:

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|--|---------------|---|-----------------|---|-------------|---|---------------------------|--------------------------------|-------------------|----------|-----------------------|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| Issued stock for \$40,000 | +40,000 | | | = | | | +40,000 (Common Stock) | | | | | | = | |
| Paid \$1,850 for rent | -1,850 | | | = | | | | -1,850 (Retained Earnings) | | | +1,850 (Rent Exp.) | | = | -1,850 |
| Performed services for \$2,500 cash | +2,500 | | | = | | | | +2,500 (Retained Earnings) | +2,500 (Rev.) | | | | = | +2,500 |
| Performed services for \$14,000 on account | | | +14,000 (AR) | = | | | | +14,000 (Retained Earnings) | +14,000 (Rev.) | | | | = | +14,000 |
| Paid \$1,750 cash wages | -1,750 | | | = | | | | -1,750 (Retained Earnings) | | | +1,750 (Wage Exp.) | | = | -1,750 |
| Received \$12,000 cash on account | +12,000 | | -12,000 (AR) | = | | | | | | | | | = | |
| Paid \$550 dividends | -550 | | | = | | | | -550 (Dividend) | | | | | = | |

**Topic: Using the Financial Statement Effects Template
(more challenging – requires transaction analysis and financial statement preparation)
(same transactions as in Problem 7 but with financial statement effects template).**

LO: 3

15. Anka Company begins the month of November with \$12,000 in cash and \$12,000 in contributed capital. Record the following transactions for the month of November, in the financial statement effects template below, for Anka Company. Then, total the accounts and prepare an income statement and balance sheet for November.

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|--|---------------|---|----------------|---|-------------|---|------------------|---|----------------|-----------|---|----------|---|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Rev-enues | - | Expenses | = | Net Income |
| Balance, Nov. 1 | | | | = | | | | | | | - | | = | |
| Invest \$20,000 cash in the business | | | | = | | | | | | | - | | = | |
| Purchase inventory for \$4,000 on credit | | | | = | | | | | | | - | | = | |
| Sell all of the inventory for \$8,000 on account | | | | = | | | | | | | - | | = | |
| Collect \$1,000 of the account receivable | | | | = | | | | | | | - | | = | |
| Pay \$1,000 on the account payable | | | | = | | | | | | | - | | = | |
| Employees earn \$1,200, to be paid next month | | | | = | | | | | | | - | | = | |
| Pay dividends of \$800 | | | | = | | | | | | | - | | = | |

Answer:

| Transaction | Balance Sheet | | | | | | Income Statement | | | | | | | |
|--|---------------|---|-----------------------------------|---|------------------------|---|----------------------------|---|----------------|---------------|---------------------|--------------|--------|------------|
| | Cash Asset | + | Noncash Assets | = | Liabilities | + | Contrib. Capital | + | Earned Capital | Revenues | - | Expenses | = | Net Income |
| Balance Nov.1 | 12,000 | | | = | | | 12,000 | | | - | | = | | |
| Invest \$20,000 cash in the business | +20,000 | | | = | | | +20,000 (Common Stock) | | | - | | = | | |
| Purchase inventory for \$4,000 on credit | | | +4,000 (Inventory) | = | +4,000 (AP) | | | | | - | | = | | |
| Sell all of the inventory for \$8,000 on account | | | +8,000 (AR) -4,000 (Inventory) | = | | | +4,000 (Retained Earnings) | | | +8,000 (Rev.) | - | +4000 (COGS) | = | +4000 |
| Collect \$1,000 of the account receivable | +1,000 | | -1,000 (AR) | = | | | | | | - | | = | | |
| Pay \$1,000 on the account payable | -1,000 | | | = | -1,000 (AP) | | | | | - | | = | | |
| Employees earn \$1,200, to be paid next month | | | | = | +1,200 (Wages Payable) | | -1,200 (Retained Earnings) | | | - | +1,200 (Wages Exp.) | = | -1,200 | |
| Pay dividends of \$400 | -800 | | | = | | | -800 (Dividend) | | | - | | = | | |
| Bal. Nov. 30 | 31,200 | | 7,000 | = | 4,200 | | 32,000 | | 2,000 | 8,000 | - | 5,200 | = | 2,800 |

| Anka Company Income Statement For the Month of November | |
|---|----------|
| Sales | \$8,000 |
| Cost of sales | 4,000 |
| Gross profit | 4,000 |
| Wages expense | 1,200 |
| Net income | \$ 2,800 |

| Anka Company Balance Sheet At End of November | |
|---|----------|
| Cash | \$31,200 |
| Accounts receivable | 7,000 |
| Total assets | \$38,200 |
| Accounts payable | \$3,000 |
| Wages payable | 1,200 |
| Total liabilities | 4,200 |
| Contributed capital | 32,000 |
| Retained earnings | 2,000 |
| Total equity | 34,000 |
| Total liabilities and equity | \$38,200 |

Essay Questions

Topic: Statement of Cash Flows

(more challenging – involves assessing nature of changes in working capital accounts.)

LO: 1

1. The statement of cash flows for Snap-On Incorporated for the year ended December 28, 2013, includes the following items (excerpts only):

| (in \$ millions) | 2013 | 2012 |
|--|--------|--------|
| Cash flows from operating activities: | | |
| Net earnings | 359.7 | 314.6 |
| Depreciation | 51.2 | 50.2 |
| Change in accounts receivable; (increase) decrease | (42.0) | (43.4) |
| Change in accounts payable; increase (decrease) | 8.4 | 16.6 |
| Net cash provided by operating activities | 392.6 | 329.3 |

- Why does Snap-On add back depreciation to compute net cash provided by operating activities? Is depreciation a source of cash?
- Snap-On reports cash flows associated with accounts receivable. In 2012, this item is a cash outflow of \$43.4 million and in 2013 this item is a cash outflow of \$42.0million. Explain why this item is on the statement.
- Did Snap-On accounts payable increase or decrease during 2013? How do you know?

Answer:

- Snap-On adds back depreciation to undo the effect it had on the income statement. In 2013, Snap-On deducted \$51.2million depreciation in computing net income. Depreciation is a non-cash expense so Snap-On did not actually use \$51.2 million cash to pay depreciation expense. Thus, to determine how much cash was generated, net income is too low by the depreciation amount of \$51.2 million. The depreciation add-back is NOT a source of cash as some mistakenly believe. Cash is, ultimately, generated by profitable operations, not by depreciation.
- Snap-On reports changes in its accounts receivable during the year. When accounts receivable decrease during the year it means that cash was collected. This source of cash is reported as a cash inflow. When accounts receivable increase it means that cash was not collected on those accounts. This shows up on the statement of cash flows as a use of cash (as in 2012 and 2013).
- Accounts payable increased during 2013 because the line item for accounts payable shows a cash inflow. This reflects expenses that have been deducted to arrive at net income, but have not yet been paid in cash, therefore an add back to net income.

Topic: Statement of Cash Flows**LO: 1**

2. The statement of cash flows for Snap-On Incorporated for the year ended December 28, 2013, includes the following items (excerpts only). Explain why the company's net earnings are not the same as its net cash provided by operating activities.

| (in \$ millions) | <u>2013</u> | <u>2012</u> |
|--|-------------|-------------|
| Cash flows from operating activities: | | |
| Net earnings | 359.7 | 314.6 |
| Depreciation | 51.2 | 50.2 |
| Change in accounts receivable; (increase) decrease | (42.0) | (43.4) |
| Change in accounts payable; increase (decrease) | 8.4 | 16.6 |
| Net cash provided by operating activities | 392.6 | 329.3 |

Answer:

The balance sheet and income statements are prepared using accrual accounting, in which revenues are recognized when earned and expenses when incurred. This means that companies can sometimes report income even though no cash is received and expenses even though no cash is paid. For example, the income statement included depreciation of \$51.2 million, which was not a cash expense. Thus, to determine how much cash was generated, net income is too low by the depreciation amount of \$51.2 million.

Topic: Book Value vs. Market Value**LO: 1**

3. Book value of stockholders' equity usually differs from company market value. Explain some reasons why a company's book value of stockholders' equity can differ from a company's market value.

Answer:

1. GAAP generally reports assets and liabilities at historical costs; whereas the market attempts to estimate fair values for assets.
2. GAAP excludes resources that cannot be reliably measured such as talented management, employee morale, recent innovations and successful marketing; whereas the market attempts to value these with some recognition of uncertainty.
3. GAAP does not consider market differences in which companies operate such as competitive conditions and expected changes; where as the market attempts to factor in these differences in determining value.
4. GAAP does not usually report expected future performance; whereas the market does attempt to predict future performance.

Topic: Articulation of the Financial Statements**LO: 2**

4. Explain the concept of articulation among the four financial statements.

Answer:

Articulation refers to the fact that the four financial statements are linked to each other and that changes in one statement affect the other three. For example, net income reported on the income statement is linked to the statement of retained earnings, which in turn is linked to the balance sheet. Also, the statement of cash flows explains how the cash reported on the balance sheet changes from one period to the next. Understanding how the financial statements articulate, helps us to analyze transactions and events and to understand how events affect each financial statement separately and all four together.