

# Module 2

## Introducing Financial Statements and Transaction Analysis

### Learning Objectives – coverage by question

	True/ False	Multiple Choice	Exercises	Problems	Essay Questions
<b>LO1</b> Describe information conveyed by the financial statements.	1-11	1-15	1-7	1-7	1-3
<b>LO2</b> Explain and illustrate linkages among the four financial statements.	12-14	16-24	8-9	8-10	4
<b>LO3</b> Illustrate use of the financial statement effects template to summarize accounting transactions.	15	25-30	10-15	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 2008, Southwest Airlines had net working capital of \$87 million and current assets of \$2,893 million. The firm's current liabilities are:
  - a. \$2,980 million
  - b. \$2,806 million
  - c. \$87 million
  - d. \$2,893 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 = \$2,893 - \$87 = \$2,806

Topic: Net working capital – Numerical calculations required

LO: 1

4. In 2008, Delphi Corporation had current assets of \$8,219 million and current liabilities of \$9,092 million. The firm's net working capital is:

- a. \$8,219 million
- b. \$873 million
- c. \$(873) million
- d. \$17,311 million
- e. None of the above

Answer: c

Rationale: Net working capital = current assets – current liabilities.  
 $\$8,219 - \$9,092 = \$(873)$  million. This is a negative working capital.

Topic: Net working capital – Numerical calculations required

LO: 1

5. In 2008, Kohl's Corporation had net working capital of \$1,952,441 thousand and current liabilities of \$1,771,448 thousand. The firm's current assets are:

- a. \$3,723,889 thousand
- b. \$180,993 thousand
- c. \$(180,993) thousand
- d. \$3,542,896
- e. None of the above.

Answer: a

Rationale: Net working capital = current assets – current liabilities.  
 $\$3,723,889 - \$1,771,448 = \$1,952,441$

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 required

LO: 1

10. During fiscal 2007, Mattel had sales of \$5,970,090, total expenses of \$5,370,097 and gross profit of \$2,777,300. What was Mattel's cost of sales for 2007? (\$ in thousands)

- a. \$599,993
- b. \$3,192,790
- c. \$2,592,797
- d. \$8,147,397
- e. There is not enough information to calculate the cost of sales.

Answer: b

Rationale: Sales – Cost of sales = Gross profit

\$5,970,090 – Cost of sales = \$2,777,300

Cost of sales = \$3,192,790



Topic: Net income – Numerical calculations required

LO: 1

11. During fiscal 2007, Kohl's had sales of \$16,473,734, Cost of merchandise sold of \$10,459,549 and gross profit of \$6,014,185. What was net income for 2007? (\$ in thousands)

- a. \$6,014,185 thousand
- b. \$7,682,249 thousand
- c. \$13,696,434 thousand
- d. \$22,487,919 thousand
- 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 required

LO: 1

12. During 2007, Skechers U.S.A., Inc. had Sales of \$1,394.2 million, Gross profit of \$600 million and Selling, general, and administrative expenses of \$491.2 million. What was Skechers' Cost of sales for 2007?

- a. \$794.2 million
- b. \$303 million
- c. \$903 million
- d. \$411.8 million
- e. There is not enough information to calculate the amount.

Answer: a

Rationale: Sales – Cost of sales = Gross profit  
\$1,394.2 – Cost of sales = \$600. Cost of sales = \$794.2

Topic: Components of financial statements – Numerical calculations required (More challenging, total assets not given)

LO: 1

13. In its December 31, 2008 financial statements, Harley-Davidson reported the following (in millions):

Long-term Assets	Current Liabilities	Long-term Liabilities	Total Liabilities	Equity
\$2,450.7	\$ 2,603.8	\$ 3,109.2	\$5,713.0	\$2,115.6

At December 31, 2008, current assets amount to:

- a. \$7,828.6 million
- b. \$153.1 million
- c. \$5,377.9 million
- d. \$6,681.9 million
- e. None of the above

Answer: c

Rationale: Total assets = Total liabilities + Equity and Total assets – long-term assets = current assets. Current assets = \$5,713 + \$2,115.6 - \$2,450.7. Current assets = \$5,377.9

Topic: Components of financial statements – Numerical calculations required

LO: 1

14. In 2007, Nordstrom, Inc. reported the following (in millions):

Current Assets	Current Liabilities	Long-term Liabilities	Equity
\$3,361	\$1,635	\$2,850	\$1,115

What amount did Nordstrom report as total assets?

- a. \$2,239 million
- b. \$4,485 million
- c. \$3,365 million
- d. \$8,961 million
- e. None of the above

Answer: e

Rationale: Total assets = Total liabilities + Equity

Total assets = \$1,635 + \$2,850 + \$1,115 = \$5,600. This amount is not given in the problem.

Topic: Components of financial statements – Numerical calculations required

LO: 1

15. In 2007, Kenneth Cole Productions, Inc. reported the following (in thousands):

Current Assets	Long-term Assets	Current Liabilities	Total Liabilities
\$194,794	\$159,743	\$55,393	\$112,547

What amount did Kenneth Cole Productions report as equity in 2007?

- a. \$354,537 thousand
- b. \$287,142 thousand
- c. \$241,990 thousand
- d. \$186,597 thousand
- e. None of the above

Answer: c

Rationale: Total assets = Total liabilities + Equity

$\$194,794 + \$159,743 = \$112,547 + \text{Equity}$ . Equity = \$241,990.

Topic: Articulation of statement of retained earnings with income statement– Numerical calculations required

LO: 2

16. In 2007, Kohl's Corporation reports the following (in \$ millions): Net income 2007 of \$1,084, Retained earnings at the end of the year of \$6,563 and Retained earnings at the beginning of the year of \$5,479. Assume that there were no other Retained earnings transactions during fiscal 2007. What dividends did the firm pay in fiscal 2007?

- a. \$2,168 million
- b. \$100 million
- c. \$1,084 million
- d. \$0
- e. There is not enough information to calculate the amount.

Answer: d

Rationale: Retained earnings, 2007 = Retained earnings, 2006 + Net Income – Dividends.

Dividends = Retained earnings, 2006 + Net Income - Retained earnings, 2007

Dividends = \$5,479 + \$1,084 – \$6,563 = 0

Topic: Articulation of statement of retained earnings with balance sheet – Numerical calculations required

LO: 2

17. BJ Services, an oil and gas company, reports net income for fiscal 2008 of \$609.4 million, retained earnings at the end of the year of \$3,677.3 million, dividends during the year of \$58.7 million and other transactions that decreased retained earnings by \$57.3 million. What was the company's retained earnings balance at the start of fiscal 2008?

- a. \$3,183.9 million
- b. \$4,170.7 million
- c. \$3,069.3 million
- d. \$3,193.9 million
- e. There is not enough information to calculate the amount.

Answer: a

Rationale: Retained earnings, 2008 = Retained earnings, 2007 + Net Income – Dividends +/-

Other.  $3,677.3 = \text{Retained earnings, 2007} + 609.4 - 58.7 - 57.3$ . Retained earnings at the start of the year were \$3,183.9 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 2007 of \$8,144 million, Retained earnings at the start of the year of \$49,669 million and dividends of \$8,153 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. \$49,660 million
- b. \$49,700 million
- c. \$49,669 million
- d. \$65,997 million
- e. There is not enough information to calculate the amount.

Answer: a

Rationale: Retained earnings, 2007 = Retained earnings, 2006 + Net Income – Dividends.

Retained earnings, 2007 = \$49,669 + \$8,144 - \$8,153. Ending retained earnings = \$49,660.

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 2008 of \$26,537 million and Retained earnings at the end of fiscal 2007 of \$30,848 million. The company reported dividends of \$3,100 million and other transactions with shareholders that reduced retained earnings during the year by \$6,503 million. How much net income did the firm report in fiscal 2008?

- a. \$13,914 million net income
- b. \$13,914 million net loss
- c. \$5,292 million net income
- d. \$5,292 million net loss
- e. None of the above.

Answer: c

Rationale: Retained earnings, 2007 = Retained earnings, 2006 + Net Income – Dividends +/- Other transactions.

$\$26,537 = \$30,848 + \text{Net income} - \$3,100 - \$6,503$ . Net income = \$5,292 million income.

Topic: Articulation of statement of cash flows with balance sheet– Numerical calculations required

LO: 2

20. In its fiscal 2008 annual report, Nike, Inc. reported cash of \$2,133.9 million at year end. The statement of cash flows reports the following (in millions):

Net cash flow from operating activities	\$1,936.3
Net cash from investing activities	\$(413.8)
Net cash from financing activities	\$(1,245.3)

What was the balance in Nike's cash account at the start of fiscal 2008?

- a. \$2,133.9 million
- b. \$277.2 million
- c. \$1,856.7 million
- d. \$5,729.3 million
- e. None of the above.

Answer: c

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

$\$2,133.9 = \text{Cash at beginning of year} + \$1,936.3 - \$413.8 - \$1,245.3 = \$1,856.7$ .

Topic: Articulation of statement of cash flows with balance sheet– Numerical calculations required

LO: 2

21. In its fiscal 2007 Balance sheet, J. Crew, reported cash of \$131,510 thousand at year end. The statement of cash flows reports that cash increased by \$42,610 thousand during the year and that net cash flow from operating activities was \$168,230 thousand. What was the cash flow from investing activities during the year?

- a. \$125,620 cash outflow
- b. \$125,620 cash inflow
- c. \$88,900 cash outflow
- d. \$210,840 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 2007 Balance Sheet, CarMax reported Cash and cash equivalents at the start of the year of \$19,455 thousand. By the end of the year, the Cash and cash equivalents had decreased to \$12,965 thousand. The company's Statement of Cash Flows reported Cash from operating activities of \$79,520 thousand, Cash from financing activities of \$171,007 thousand. What amount did the company report for Cash from investing activities?

- a. \$257,017 thousand cash inflow
- b. \$257,017 thousand cash outflow
- c. \$244,038 thousand cash inflow
- d. \$244,038 thousand cash outflow
- e. None of the above.

Answer: b

Rationale: Cash at end of year = Cash at start of year + Cash from operations + Cash from investing + Cash from financing.  $\$12,965 = \$19,455 + \$79,520 + \text{Cash from investing} + \$171,007$ . Cash from investing is an outflow of \$257,017.

Topic: Articulation of statement of cash flows with balance sheet– Numerical calculations required

LO: 2

23. In its fiscal 2007 balance sheet, Dell, Inc. reported cash of \$9,546 million at the beginning of the year. The statement of cash flows reports the following (in millions):

Net cash flow from operating activities	\$3,949
Net cash from investing activities	\$(1,763)
Change in cash during the year	\$1,782

What did Dell report for "Net cash for financing activities" during fiscal 2007?

- a. \$404 million cash inflow
- b. \$404 million cash outflow
- c. \$3,968 million cash inflow
- d. \$3,968 million cash outflow
- e. None of the above.

Answer: d

Rationale: Change in cash during the year = Cash from operations + Cash from investing + Cash from financing.  $\$1,782 = \$3,949 - \$1,763 - \text{Cash from financing}$ . Cash from financing is an outflow.

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 \$100 of inventory on credit affect the balance sheet if the cost of the inventory sold was \$40?

- a. It would increase non-cash assets by \$100 and increase equity by \$100
- b. It would decrease non-cash assets by \$40 and decrease equity by \$40
- c. It would increase cash by \$100 and increase equity by \$100
- d. Both a. and b., above.
- e. None of the above

Answer: d

Rationale: The sale on credit is an account receivable, a non-cash asset that increases revenue and therefore increases equity (answer a). The sale also involves reducing inventory by \$40, a non-cash asset, which is an expense and therefore a decrease to equity of \$40 (answer b). Therefore both a and b are correct and the answer is c.

Topic: Transaction effects on the financial statements (More challenging)

LO: 3

28. How would a purchase of \$100 of inventory on credit affect the income statement?

- a. It would increase liabilities by \$100
- b. It would decrease retained earnings by \$100
- c. It would increase assets by \$100
- d. Both a. and c., above.
- e. None of the above

Answer: e

Rationale: The purchase on credit is an account payable. 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.

Balance Sheet						Income Statement								
Transaction	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Rev-enues	-	Expen-ses	=	Net Income
??	-50		50	=							-		=	

- a. Repay accounts payable of \$50 with cash.
- b. Collect cash for accounts receivable of \$50.
- c. Purchase inventory of \$50 on account.
- d. Purchase inventory of \$50 for cash.
- e. None of the above

Answer: d

Rationale: The purchase of inventory for cash decreases cash by \$50 and increases inventory, a noncash asset, by \$50.

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.

Balance Sheet						Income Statement								
Transaction	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Rev-enues	-	Expen-ses	=	Net Income
??	-30		150	=	120						-		=	

- a. Repay accounts payable of \$30, net.
- b. Record accounts receivable of \$150 and cash collected of \$30.
- c. Purchase inventory of \$150 partly on account.
- d. Purchase \$150 of equipment on account.
- e. None of the above

Answer: c

Rationale: The purchase of \$150 inventory partly on account implies that the rest is purchased for cash. Cash decreases by \$30 and accounts payable (a liability) increase for the balance of \$120.



# 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

I - Income Statement

SE - Statement of Stockholders' Equity

CF - Statement of Cash Flows

Financial Statement Item	Financial Statement
a. Office building	
b. Trademarks	
c. Dividends	
d. Proceeds of sale of investments	
e. Repayments of bank loan	
f. Treasury stock	

Answer:

Financial Statement Item	Financial Statement
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

I - Income Statement

SE - Statement of Stockholders' Equity

CF - Statement of Cash Flows

Financial Statement Item	Financial Statement
a. Land	
b. Proceeds from sale of land	
c. Prepaid insurance expense	
d. Insurance expense	
e. Revenue	
f. Unearned revenue	

Answer:

Financial Statement Item	Financial Statement
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 2007 and 2008, in the table below:

<b>(\$ millions)</b>	<b>2008</b>	<b>2007</b>
Total assets		\$10,688.3
Contributed capital	\$ 2,500.9	\$ 1,963.1
Earned capital	\$ 5,324.7	
Total Liabilities	\$ 4,617.1	\$ 3,662.6
Liabilities and equity		\$10,688.3

Answer:

(\$ millions)	2008	2007
Total assets	\$12,442.7	\$10,688.3
Contributed capital	\$ 2,500.9	\$ 1,963.1
Earned capital	\$ 5,324.7	\$ 5,062.6
Total Liabilities	\$ 4,617.1	\$ 3,662.6
Liabilities and equity	\$12,442.7	\$10,688.3

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	_____ A
b. Unearned revenue	_____ L
c. Notes payable	_____ L
d. Retained earnings	_____ E
e. Trademark	_____ A
f. Common stock	_____ E
g. Accounts payable	_____ L

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

Financial statement item	Balance sheet classification
Interest payable	
Treasury stock	
Insurance expense	
Goodwill	
Note payable, due in 2015	
Prepaid insurance expense	

Answer:

Financial statement item	Balance sheet classification
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 2015	d. Long term liability
Prepaid insurance expense	a. Current asset

Topic: Accounting concepts and articulation of financial statements

LO: 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) b. 3) c. 1) d. 4)

Topic: Articulation of retained earnings account

LO:2

9. Caterpillar Inc's Statement of stockholders' equity for 2007 and 2006, shows the following amounts. Fill in the missing items to show how retained earnings articulate across the years.

(\$ millions)	2007	2006
Retained earnings, beginning of year		\$ 9,937
Net income for the year	3,537	
Dividends		(645)
Other	0	(338)
Retained earnings, end of year	\$14,593	\$11,808

Answer:

(\$ millions)	2007	2006
Retained earnings, beginning of year	\$11,808	\$ 9,937
Net income for the year	3,537	2,854
Dividends	(752)	(645)
Other	0	(338)
Retained earnings, end of year	\$14,593	\$11,808

Topic: Preparation of financial statements and income statement / balance sheet articulation  
(More challenging – requires preparation of two financial statements)

LO:2

10. Smart Set Clothing begins operations in May. During the month the company receives \$9,000 from a shareholder for common stock and gets a \$1,000 loan from a bank. The company buys \$8,000 of inventory for cash and sells half of the inventory for \$7,000 on credit. The company had no other transactions in May. Fill in the missing amounts below.

Income Statement  
For the month of May

Sales	_____
Cost of sales	_____
Net income	_____

Balance Sheet  
At the end of May

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 May

Sales	\$7,000
Cost of sales	4,000
Net income	\$3,000

Balance Sheet  
At the end of May

Cash	\$ 2,000
Accounts receivable	7,000
Inventory	4,000
Total assets	\$13,000
Accounts payable	\$ 0
Bank loan	1,000
Total liabilities	1,000
Contributed capital	9,000
Retained earnings	3,000
Total equity	12,000
Total liabilities and equity	\$13,000

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.

Balance Sheet						Income Statement								
Transaction	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	-	Expenses	=	Net Income
#1	50			=					50	50	-		=	50
#2			50	=					50	50	-		=	50
#3	50		-50	=							-		=	

- a. Services of \$50 were performed on credit.
- b. Services of \$50 were performed for cash.
- c. Inventory of \$50 was purchased for cash.
- d. Accounts receivable of \$50 were collected from customers.

Transaction	Description (a, b, c, or d)
#1	b
#2	a
#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.

Balance Sheet						Income Statement								
Transaction	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	-	Expenses	=	Net Income
#1	-50		50	=							-		=	
#2	-50			=					-50		-	50	=	-50
#3				=	50				-50		-	50	=	-50

- a. Wages of \$50 were paid in cash.
- b. Services of \$50 were performed for cash.
- c. Inventory of \$50 was purchased for cash.
- d. Wages of \$50 were accrued at the end of the period.

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

Answer:

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

Topic: Effects of transactions on balance sheet accounts

LO: 3

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

a. Borrow \$100 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, Raphael has \$250 in his pocket	5) Inventory
f. Mr. Wisner, a potential customer had no cash with him. Raphael agrees to let Mr. Wisner pay \$1 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 (with a line) to the financial statement effects listed on the right.

<u>Transaction</u>	<u>Financial statement effect</u>
Sell common stock for cash	Decrease assets and decrease equity
Pay accounts payable	Decrease liabilities and decrease assets
Repurchase common stock	Increase assets and decrease assets
Purchase inventory for cash	Increase assets and increase equity

Answer:

<u>Transaction</u>	<u>Financial statement effect</u>
Sell common stock for cash	Decrease assets and decrease equity
Pay accounts payable	Decrease liabilities and decrease assets
Repurchase common stock	Increase assets and decrease assets
Purchase inventory for cash	Increase assets and increase equity

Topic: Financial statement effects

LO:3

15. Consider the transactions listed on the left. Match them (with a line) to the financial statement effects listed on the right.

<u>Transaction</u>	<u>Financial statement effect</u>
Pay wages with cash	Increase assets and increase liabilities
Repay bank loan	Decrease liabilities and decrease assets
Prepay insurance expense	Decrease assets and decrease equity
Receive prepayment from customer	Decrease assets and increase assets

Answer:

<u>Transaction</u>	<u>Financial statement effect</u>
Pay wages with cash	Increase assets and increase liabilities
Repay bank loan	Decrease liabilities and decrease assets
Prepay insurance expense	Decrease assets and decrease equity
Receive prepayment from customer	Decrease assets and increase assets

# Problems

Topic: Analyzing Balance Sheet Accounts

LO: 1

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
2004	3,683.2	1,800.1		1,172.7			3,218.5
2005		2,110.0	5,255.2	873.1	1,298.5	2,171.6	
2006	3,550.6		5,532.2		1,179.8	2,775.5	2,756.7
2007	3,467.3	2,189.3		1,905.1	1,376.0	3,281.1	
2008		2,450.7	7,828.6	2,603.8	3,109.2		2,115.6

Answer:

(\$ millions)	Current Assets	Long-term Assets	Total Assets	Current Liabilities	Long-term Liabilities	Total Liabilities	Equity
2004	3,683.2	1,800.1	5,483.3	1,172.7	1,092.1	2,264.8	3,218.5
2005	3,145.2	2,110.0	5,255.2	873.1	1,298.5	2,171.6	3,083.6
2006	3,550.6	1,981.6	5,532.2	1,595.7	1,179.8	2,775.5	2,756.7
2007	3,467.3	2,189.3	5,656.6	1,905.1	1,376.0	3,281.1	2,375.5
2008	5,377.9	2,450.7	7,828.6	2,603.8	3,109.2	5,713.0	2,115.6

Topic: Analyzing Balance Sheet Accounts

LO: 1

2. 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
2004		2,033		1,341	1,475	2,816	1,789
2005	2,874	2,047			1,205	2,828	
2006	2,742		4,822	1,433		2,653	2,169
2007	3,361	2,239		1,635	2,850		1,115

Answer:

(\$ millions)	Current Assets	Long-term Assets	Total Assets	Current Liabilities	Long-term Liabilities	Total Liabilities	Equity
2004	2,572	2,033	4,605	1,341	1,475	2,816	1,789
2005	2,874	2,047	4,921	1,623	1,205	2,828	2,093
2006	2,742	2,080	4,822	1,433	1,220	2,653	2,169
2007	3,361	2,239	5,600	1,635	2,850	4,485	1,115



Topic: Preparing a balance sheet from a list of accounts

LO: 1

3. Use the accounts below for Black and Decker to prepare a balance sheet at December 31, 2008. (\$ millions)

Contributed capital	44.3
Cash	277.8
Long-term debt	1,444.7
Accounts receivable	924.6
Other current assets	377.0
Other long-term assets	2,051.8
Current liabilities	1,483.9
Inventory	1,024.2
Other long-term liabilities	1,129.9
Property plant and equipment	527.9
Retained earnings	1,536.8
Other equity	(456.3)

Answer:

Black and Decker  
Balance Sheet  
At December 31, 2008

Cash	\$ 277.8
Accounts receivable	924.6
Inventory	1,024.2
Other current assets	377.0
Current assets	<u>2,603.6</u>
Property plant and equipment	527.9
Other long-term assets	2,051.8
Total assets	<u>\$ 5,183.3</u>
Current liabilities	\$ 1,483.9
Long-term debt	1,444.7
Other long-term liabilities	1,129.9
Total liabilities	<u>4,058.5</u>
Contributed capital	44.3
Retained earnings	1,536.8
Other equity	(456.3)
Total equity	<u>1,124.8</u>
Total liabilities and equity	<u>\$ 5,183.3</u>

Topic: Preparing an income statement from a list of accounts

LO: 1

4. Use the accounts below for Black and Decker to prepare an income statement for the year ended December 31, 2008. (\$ millions)

Cost of goods sold	4,087.7
Sales	6,086.1
Other operating expenses	54.7
Selling, general and administrative expenses	1,521.6
Income tax expense	71.1
Interest and other nonoperating expenses	57.4

Answer:

Black and Decker	
Income Statement	
For the year ended December 31, 2008	
Sales	6,086.1
Cost of goods sold	<u>4,087.7</u>
Gross profit	1,998.4
Selling, general and administrative expenses	1,521.6
Other operating expenses	<u>54.7</u>
Operating income	422.1
Interest and other nonoperating expenses	<u>57.4</u>
Earnings before income taxes	364.7
Income taxes	<u>71.1</u>
Net earnings	<u><u>293.6</u></u>

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, 2007 to prepare an income statement and a balance sheet. (\$ millions)

Answer:

Delphi Corporation Income Statement For the year ended December 31, 2007	
Sales to General Motors	\$ 8,301
Sales to other customers	13,982
Total sales	<u>22,283</u>
Cost of sales	<u>21,066</u>
Gross profit	1,217
Other operating expenses	<u>3,162</u>
Operating income (loss)	(1,945)
Other nonoperating expenses	<u>1,642</u>
Loss before taxes	(3,587)
Tax expense (benefit)	<u>(522)</u>
Net income (loss)	<u>\$ (3,065)</u>

Delphi Corporation Balance Sheet At December 31, 2007	
Cash	\$ 1,036
Accounts receivable	3,894
Inventory	1,808
Other current assets	<u>1,481</u>
Current assets	8,219
Property, net	3,863
Other long-term assets	<u>1,585</u>
Total assets	<u>\$13,667</u>
Accounts payable	\$ 2,904
Other current liabilities	<u>6,188</u>
Current liabilities	9,092
Long-term liabilities	<u>17,884</u>
Total liabilities	26,976
Contributed capital	2,900
Retained earnings	(14,976)
Other equity	<u>(1,233)</u>
Total equity	<u>(13,309)</u>
Total liabilities and equity	<u>\$13,667</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)

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

Company	Assets	Liabilities	Number of shares outstanding (in millions)	End of year stock price (per share)
Nike, Inc.	12,442.7	4617.4	394.3	\$67.56
Skechers, USA, Inc.	828.0	201.3	33.0	\$19.51
Kenneth Cole Productions, Inc.	354.5	112.5	11.4	\$16.98

Answer:

a. and b.

Company	Book Value of Equity (Assets – Liabilities)	Market Capitalization (Shares outstanding × stock price)	Market to book ratio
Nike, Inc.	7,825.3	26,638.9	3.40
Skechers, USA, Inc.	626.7	643.8	1.03
Kenneth Cole Productions, Inc.	242.0	193.6	0.80

c.

Nike has a market to book ratio of 3.4, the highest among the three companies. This means that Nike's economic value exceeds its GAAP book value by a factor of more than three. 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, Kenneth Cole has a book value of equity that exceeds its market value. The market undervalues this company, relative to GAAP, perhaps because the company's earning power is low. Skechers has a market to book just above 1.0 which means that the company's brand name, while still valuable, is not significant enough to boost its stock price.

Topic: Using the Financial Statement Effects Template (Same transactions as in Problem 15 but without financial statement effects template).

LO: 1

7. Whammy Company begins the month of May with \$1,000 in cash and \$1,000 in contributed capital. During the month, the company has seven transactions. Analyze the transactions and prepare an income statement and balance sheet for May.

The owner invests an additional \$5,000 cash in the business.

The company purchases inventory for \$2,000 on credit.

The company sells all the inventory for \$3,000 on account.

The company collects \$500 of the accounts receivable.

The company pays \$500 on the account payable.

Employees earn \$300, to be paid next month.

The company pays dividends of \$400.

Answer:

Whammy Company  
Income Statement  
For the month of May

Sales	3,000	
Cost of sales	2,00	
Gross profit	1,000	
Wages expense	300	
Net income	700	

Whammy Company  
Balance Sheet  
At end of May

Cash	5,600	
Accounts receivable	2,500	
Total assets	8,100	
Accounts payable	1,500	
Wages payable	300	
Total liabilities	1,800	
Contributed capital	6,000	
Retained earnings	300	
Total equity	6,300	
Total liabilities and equity	8,100	

Topic: Reconciling statement of cash flows – articulation of accounts over time

LO: 2

8. Following is cash flow information for Harley Davidson Inc. for three recent years. Prepare the statements of cash flow for 2006 through 2008.

(in thousands)	2008/12/31	2007/12/31	2006/12/31
Cash from operations		798,146	761,780
Cash from investing	(393,247)	391,205	(35,259)
Cash from financing	1,268,600	(1,024,894)	(629,099)
Cash at end of year	593,558		238,397

Answer:

Harley Davidson Inc.  
Statement of Cash Flows  
For year ending December 31

(in thousands)	2008	2007	2006
Cash from operations	(684,649)	798,146	761,780
Cash from investing	(393,247)	391,205	(35,259)
Cash from financing	1,268,600	(1,024,894)	(629,099)
Increase in cash during the year	190,704	164,457	97,422
Cash at beginning of year	402,854	238,397	140,975
Cash at end of year	593,558	402,854	238,397

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, 2008	1,463.7
Net income, 2006	100.1
Net income, 2007	181.2
Net income, 2008	236.7
Dividends, 2006	63.6
Dividends, 2007	64.8
Dividends, 2008	69.7

Answer:

Snap-On Incorporated  
Statement of Retained Earnings  
For year ending December 31

(in millions)	2008	2007	2006
Retained earnings, beginning of year	\$1,296.7	\$1,180.3	\$1,143.8
Net income (loss) for the year	236.7	181.2	100.1
Dividends declared	(69.7)	(64.8)	(63.6)
Retained earnings, end of year	<u>\$1,463.7</u>	<u>\$1,296.7</u>	<u>\$1,180.3</u>

Topic: Articulation of Retained Earnings (More Challenging – involves losses in two out of three years.)

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. The company paid no dividends during this period.

(in millions)

Retained earnings, December 31, 2005	1,298
Net income (loss), 2006	(330)
Net income (loss), 2007	602
Net income (loss), 2008	(77)
Other retained earnings transaction, 2007	32

Answer:

**Goodyear Tire & Rubber Company  
Statement of Retained Earnings  
For year ending December 31**

(in millions)	2008	2007	2006
Retained earnings, beginning of year	1,602	968	1,298
Net income (loss) for the year	(77)	602	(330)
Other transactions	0	32	0
Retained earnings, end of year	<u>1,525</u>	<u>1,602</u>	<u>968</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 statements 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.

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

Answer:

Balance Sheet						Income Statement			
Transaction	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.

Balance Sheet						Income Statement								
Transaction	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	-	Expenses	=	Net Income
Purchase \$2,000 of inventory on credit				=							-		=	
Pay \$1,000 cash for rent expense				=							-		=	
Collect \$12,000 cash for accounts receivable				=							-		=	
Pay \$9,000 cash toward accounts payable				=							-		=	

Answer:

Balance Sheet						Income Statement								
Transaction	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 \$1,000 cash for rent expense	-1000			=					-1000 (Retained earnings)		+1000 (Rent exp.)		=	-1000
Collect \$12,000 cash for accounts receivable	+12000		-12000 (AR)	=							-		=	
Pay \$9,000 cash toward accounts payable	-9000			=	-9000 (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 \$2,000 on credit				=							-		=	
Collect \$2,000 cash from customers				=							-		=	
Purchase \$5,000 of equipment				=							-		=	
Pay \$10,000 on a note payable that came due				=							-		=	
Pay \$1,000 cash interest on borrowings				=							-		=	
Record depreciation of \$1,000				=							-		=	
Record \$800 of employee wages earned but unpaid				=							-		=	
Pay \$200 dividend				=							-		=	

Answer:

Balance Sheet							Income Statement							
Transaction	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 inventory for \$2,000 on credit			+2,000 (AR) -1,000 (Inventory)	=				+1,000 (Retained earnings)		+2,000 (Rev.)	-	+1,000 (COGS)	=	+1,000
Collect \$2,000 cash from customers	+2,000		-2,000 (AR)	=							-		=	
Purchase \$5,000 of equipment	-5,000		+5,000 (Equipment)	=							-		=	
Pay \$10,000 on a note payable that came due	-10,000			=	-10,000 (Note Payable)						-		=	
Pay \$1,000 cash interest on borrowings	-1,000			=				-1,000 (Retained earnings)			-	+1,000 (Interest exp.)	=	-1,000
Record depreciation of \$1,000			-1,000 (Equipment)	=				-1,000 (Retained earnings)			-	+1,000 (Depn exp.)	=	-1,000
Record \$800 of employee wages earned but unpaid				=	+800 (Wages Payable)			-800 (Retained earnings)			-	+800 (Wage exp.)	=	-800
Pay \$200 dividend	-200			=				-200 (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 \$3,700 for rent			=				-	=
Performed services for \$5,000 cash			=				-	=
Performed services for \$14,000 on account			=				-	=
Paid \$3,500 cash wages			=				-	=
Received \$12,000 cash on account			=				-	=
Paid \$1,100 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 \$3,700 for rent	-3,700		=		-3,700 (Retained earnings)		+3,700 (Rent exp.)	= -3,700
Performed services for \$5,000 cash	+5,000		=		+5,000 (Retained earnings)	+5,000 (Rev.)	-	= +5,000
Performed services for \$14,000 on account		+14,000 (AR)	=		+14,000 (Retained earnings)	+14,000 (Rev.)	-	= +14,000
Paid \$3,500 cash wages	-3,500		=		-3,500 (Retained earnings)		+3,500 (Wage exp.)	= -3,500
Received \$12,000 cash on account	+12,000	-12,000 (AR)	=				-	=
Paid \$1,100 dividends	-1,100		=		-1,100 (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. Record the following transactions for the month of May, in the financial statement effects template below, for Whammy Company. Then, total the accounts and prepare an income statement and balance sheet for May.

Transaction	Balance Sheet					Income Statement								
	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Rev-enues	-	Expenses	=	Net Income
Balance, May 1				=							-		=	
Invest \$5,000 cash in the business				=							-		=	
Purchase inventory for \$2,000 on credit				=							-		=	
Sell all of the inventory for \$3,000 on account				=							-		=	
Collect \$500 of the account receivable				=							-		=	
Pay \$500 on the account payable				=							-		=	
Employees earn \$300, to be paid next month				=							-		=	
Pay dividends of \$400				=							-		=	

Answer:

Balance Sheet							Income Statement		
Transaction	Cash Asset	+ Noncash Assets	=	Liabilities	+ Contrib. Capital	+ Earned Capital	Revenues	- Expenses	= Net Income
Balance May 1	1,000		=		1,000		-		=
Invest \$5,000 cash in the business	+5,000		=		+5,000 (Common Stock)		-		=
Purchase inventory for \$2,000 on credit		+2,000 (Inventory)	=	+2,000 (AP)			-		=
Sell all of the inventory for \$3,000 on account		+3,000 (AR) -2,000 (Inventory)	=			+1,000 (Retained earnings)	+3,000 (Rev.)	- +2,000 (COGS)	= +1,000
Collect \$500 of the account receivable	+500	-500 (AR)	=				-		=
Pay \$500 on the account payable	-500		=	-500 (AP)			-		=
Employees earn \$300, to be paid next month			=	+300 (Wages Payable)		-300 (Retained earnings)	-	+300 (Wages exp.)	= -300
Pay dividends of \$400	-400		=			-400 (Dividend)	-		=
Bal. May 31	5,600	2,500	=	1,800	6,000	300	3,000	- 2,300	= 700

Whammy Company  
Income Statement  
For the month of May

Sales	3,000
Cost of sales	2,00
Gross profit	1,000
Wages expense	300
Net income	700



Whammy Company  
Balance Sheet  
At end of May

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Cash	5,600
Accounts receivable	2,500
Total assets	<u>8,100</u>
Accounts payable	1,500
Wages payable	300
Total liabilities	<u>1,800</u>
Contributed capital	6,000
Retained earnings	300
Total equity	<u>6,300</u>
Total liabilities and equity	<u>8,100</u>



## 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 January 2, 2009, (which is the company's 2008 fiscal year) includes the following items (excerpts only):

(in \$ millions)	2008	2007
Cash flows from operating activities:		
Net earnings	236.7	181.2
Depreciation	47.9	53.5
Change in accounts receivable	29.1	(2.6)
Change in accounts payable	(43.7)	(15.3)
Net cash provided by operating activities	215.0	231.1

- 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 2008, this item is a cash inflow of \$29.1 million and in 2006 this item is a cash outflow of \$2.6 million. Explain why this item is on the statement. Why is it a cash inflow one year and a cash outflow the other year?
- Did Snap-On accounts payable increase or decrease during 2008? How do you know?

Answer:

- Snap-On adds back depreciation to undo the effect it had on the income statement. In 2008, Snap-On deducted \$47.9 million depreciation in computing net income. Depreciation is a non-cash expense so Snap-On did not actually use \$47.9 million cash to pay depreciation expense. Thus, to determine how much cash was generated, net income is too low by the depreciation amount of \$47.9 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 (as in 2008). 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 2007).
- Accounts payable decreased during 2008 because the line item for accounts payable shows a cash outflow. Paying off accounts payable uses cash, which is shown as a cash outflow.

Topic: Statement of cash flows

LO: 1

2. The statement of cash flows for Snap-On Incorporated for the year ended January 2, 2009, (which is the company's 2008 fiscal year) includes the following items (excerpts only). Explain why the company's Net earnings are smaller than its Net cash provided by operating activities.

(in \$ millions)	2008	2007
Cash flows from operating activities:		
Net earnings	236.7	181.2
Depreciation	47.9	53.5
Change in accounts receivable	29.1	(2.6)
Change in accounts payable	(43.7)	(15.3)
Net cash provided by operating activities	215.0	231.1

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. For example, the income statement included depreciation of \$47.9 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 \$47.9 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; whereas 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. 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.