Hong Kong Community College

Study Guide for CC2101
Financial Accounting

Contributed by:
- Aggie CHEI
- Pauline HO
- Sherry LEUNG
- Barbara NGAI (Coordinator)
- Helen WONG
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1. Syllabus

**CC2101 Financial Accounting**

<table>
<thead>
<tr>
<th>Level</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credits</td>
<td>3</td>
</tr>
<tr>
<td>Nature</td>
<td>Non-Science</td>
</tr>
<tr>
<td>Medium of Instruction</td>
<td>English</td>
</tr>
<tr>
<td>Teaching Pattern</td>
<td>28 hours of Lecture</td>
</tr>
<tr>
<td></td>
<td>14 hours of Tutorial</td>
</tr>
<tr>
<td>Prerequisites</td>
<td>Nil</td>
</tr>
<tr>
<td>Assessment</td>
<td>40% Coursework</td>
</tr>
<tr>
<td></td>
<td>60% Examination</td>
</tr>
</tbody>
</table>

**Aims**

This subject introduces the basic concepts of financial accounting. It enables students to apply fundamental financial theories, analyze financial statements and reports, and prepare basic financial statements.

**Learning Outcomes**

On successfully completing this subject, students will be able to:

- understand the assumptions, principles and conventions underlying financial accounting process
- appreciate the role and importance of accounting information in assisting decision-making in a business context
- undertake the work involved in the recording, processing, summarizing and reporting phases of an accounting cycle
- apply relevant accounting concepts and principles in the preparation of financial statements
- apply fundamental analytical tools for the interpretation of financial statements

**Indicative Contents**

- **Role and Principles of Financial Accounting and Reporting**
  Nature, principles and scope of financial accounting, management accounting, financial management and auditing; Users of financial accounts and statements; Accounting Standards; Ethical consideration in Financial Reporting; Application of information technology in processing financial and related information.

- **Financial Accounting Framework**
  Double-entry bookkeeping and accounting systems; Methods of classifying expenditure between capital and revenue; Accounting treatment of fixed assets, current assets, liabilities, provisions and reserves, and capital; Control accounts, bank reconciliation, suspense accounts,
and correction of errors; Preparation of journal, ledger accounts, trial balance and basic financial statements.

- **Additional Issues on Earnings**
  Extraordinary items, accounting changes, earnings per share, cash and stock dividends.

- **Preparation of Financial Statements**
  Preparation of Financial Statements for sole-traders, clubs or societies, partnerships, and limited companies.

- **Analysis and Interpretation of Financial Statements**
  Need for analysis and interpretation of financial statements; Interpretation techniques including ratio analysis and cash flow statement; Calculation and interpretation of basic financial ratios.

**Teaching/Learning Approach**

Lectures focus on the introduction and explanation of key concepts and applications of the accounting principles.

Tutorials provide students with the opportunity to deepen their understanding of the concepts taught in lectures and to apply the theories to the analysis of problem sets and case studies.

**Assessment Approach**

A variety of assessment tools will be used, including individual assignments, in-class exercises, tests and an examination designed to develop and assess students’ analytical and quantitative skills in solving accounting problems.

**Indicative Readings**

**Recommended Textbook**

**References**


HKICPA. *Hong Kong Financial Reporting Standards*. 

~ P.4 ~
2. Teaching Plan

Hong Kong Community College
CC2101 Financial Accounting
Tentative Teaching Plan
Semester Two 2009/2010

Subject Leader

Ms Barbara Ngai  (Office: S1308, Tel: 3746 0219, email: ccbngai@hkcc-polyu.edu.hk)

Subject Lecturers

Mr Ben C B Wong (Office: S1426, Tel: 3746 0428, email: ccbenw@hkcc-polyu.edu.hk)
Mr Ben K F Wong (Office: S1224f, Tel: 3746 0439, email: ccbwong@hkcc-polyu.edu.hk)
Ms Helen Wong  (Office: S1427, Tel: 3746 0228, email: cchelen@hkcc-polyu.edu.hk)
Ms Arison Woo  (Office: S1337, Tel: 3746 0618, email: ccarison@hkcc-polyu.edu.hk)

Objectives

This subject introduces the basic concepts of financial accounting. It enables students to apply fundamental financial theories, analyze financial statements and reports, and prepare basic financial statements.

Learning Outcomes

On successfully completing this subject, students will be able to:

- Understand the assumptions, principles and conventions underlying financial accounting process.
- Appreciate the role and importance of accounting information in assisting decision-making in a business context.
- Undertake the work involved in the recording, processing, summarizing and reporting phases of an accounting cycle.
- Apply relevant accounting concepts and principles in the preparation of financial statements.
- Apply fundamental analytical tools for the interpretation of financial statements.

Text and References

Textbook:

**Reference:**  

## Tentative Teaching Schedule

<table>
<thead>
<tr>
<th>Week No.</th>
<th>Lecture</th>
<th>Tutorial</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Financial Statements and Business Decisions</td>
<td>No tutorial class.</td>
<td>Chapter 1</td>
</tr>
<tr>
<td>2</td>
<td>Investing and Financing Decisions and the Balance Sheet</td>
<td>Ch.1: E1-4, 1-7, 1-10; P1-1; AP1-2</td>
<td>Chapter 2</td>
</tr>
<tr>
<td>3</td>
<td>Operating Decisions and the Income Statement</td>
<td>Ch.2: E2-3, 2-5, 2-11, 2-12; P2-2; CP1-5</td>
<td>Chapter 3</td>
</tr>
<tr>
<td>4</td>
<td>Adjustments, Financial Statements and the Quality of Earnings (Part 1)</td>
<td>Ch.3: E3-4, 3-7, 3-8, 3-13; P3-2</td>
<td>Chapter 4</td>
</tr>
<tr>
<td>5</td>
<td>Adjustments, Financial Statements and the Quality of Earnings (Part 2)</td>
<td>Ch.4: E4-6, 4-10, 4-14, 4-18; P4-1</td>
<td>Chapter 4</td>
</tr>
<tr>
<td>6</td>
<td>Reporting and Interpreting Sales Revenue, Receivables and Cash (Part 1)</td>
<td>Ch.4: E4-6, 4-10, 4-14, 4-18; P4-1</td>
<td>Chapter 6</td>
</tr>
<tr>
<td>7</td>
<td>Reporting and Interpreting Sales Revenue, Receivables and Cash (Part 2)</td>
<td>Ch.6: E6-3, 6-11, 6-13; P6-2; P6-7; P6-8; CP6-6</td>
<td>Chapter 6</td>
</tr>
<tr>
<td>8</td>
<td>Reporting and Interpreting Cost of Goods Sold and Inventory (Part 1)</td>
<td>Ch.6: E6-3, 6-11, 6-13; P6-2; P6-7; P6-8</td>
<td>Chapter 7</td>
</tr>
<tr>
<td>9</td>
<td>Reporting and Interpreting Cost of Goods Sold and Inventory (Part 2)</td>
<td>Ch.7: E7-10, 7-12, 7-19, 7-22; P7-2</td>
<td>Chapter 7</td>
</tr>
<tr>
<td>10</td>
<td>Reporting and Interpreting Property, Plant, and Equipment; Natural Resources and</td>
<td>Ch.7: E7-10, 7-12, 7-19, 7-22; P7-2</td>
<td>Chapter 8</td>
</tr>
<tr>
<td>Chapter</td>
<td>Intangibles (Part 1)</td>
<td>Reporting and Interpreting Property, Plant, and Equipment; Natural Resources and Intangibles (Part 2)</td>
<td>Reporting and Interpreting Liabilities (up to P.473 only)</td>
</tr>
<tr>
<td>---------</td>
<td>---------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>11</td>
<td></td>
<td>Ch.8: E8-4, 8-11, 8-13; P8-2</td>
<td>Ch.8: E8-4, 8-11, 8-13; P8-2</td>
</tr>
</tbody>
</table>

**Assessment Weighting**

- Coursework: 40%
- Examination: 60%

100% (Note that students must pass both coursework and final exam to qualify for a pass in this course.)

**Assessment Methods for Coursework**

- Mid-term Test 50%
- Assignment 1 20% (Individual)
- Assignment 2 20% (Individual)
- Participation * 10%

100%

* Participation is based on the involvement of students in lecture classes, tutorial classes and related activities. It will also take into account of the question being raised by students in class.

**Attendance and other rules / regulations**

The attendance requirement and all other rules and regulations in the HKCC Student Handbook and in the respective Programme Definitive Document apply. Please refer to these documents for details.
Lectures

- Class lectures throughout the semester will be presented using white-board or PowerPoint slides where appropriate. Notes or handouts will be posted on MOODLE from which you can download. To make learning more effective, it is suggested that you should read the chapter(s) or notes to be covered in advance.
- You are expected to bring the printed notes yourself for two chapters during each lecture class.
- Depending on progress, it is expected that on average around 3 weeks are required to finish every 2 chapters. The extent and pace of coverage are subject to modifications, if necessary, taking into account of students’ progress.
- Basic concepts concerning the effect upon receipt and pay out of cash and basic understanding of Statement of Cash Flow are required.
- You can see the lecturer or tutor during the consultation hours listed out by the lecturer or otherwise make an appointment with the lecturer prior to seeing him/her.
- Students are expected to answer questions in accordance with the US accounting system.
- If there are calendar holidays, additional lecture(s) may be held depending on the progress of the course.

Tutorials

- You are required to work out all questions as listed for the tutorials. Try to answer the MC and other questions at the end of each chapter as this will help you grasp the main concepts of each topic.
- Bring your textbook or relevant tutorial questions to each tutorial class.
- Answers to assigned tutorial questions will be posted on MOODLE at times by lecturers. Additional assignments and tutorials may be given whenever necessary.
- If you wish to obtain answers to other questions that you have done in the textbook, you are to check against the solutions of each chapter posted on MOODLE.
- Tutorial(s) may be used for lecture purpose if necessary.

Assignments

- Individual Assignment 1: To be distributed. Submission deadline: Week 7; answers will be given in Week 8.
- Individual Assignment 2: To be distributed. Submission deadline: Week 11; answers will be given in Week 12.
  Changes will be announced during lecture hours.
- Assignments must be hand-written on A4 or proper papers. Computer printout will not be accepted.
- If make-up assignment is permitted by lecturer, marks will be deducted by 40% for each day of late submission.
- Students who are found copying from others will be given zero mark. This will apply as well to those giving his/her assignment for others to copy.
Mid-term Test

- Mid-term test will cover Chapters 1, 2, 3, 4 and 6 to be held in Week 9.
- Mid-term test will be scheduled to be a common exam for all sections. For your provisional reference, it will consist of 1 LONG QUESTION and 30 MC questions (tentatively) covering materials from both the tutorials and lectures. Changes may be made at the discretion of lecturers.
- Make-up test will not be arranged unless under very exceptional circumstances.
- Printed dictionary or electronic one is not allowed.
3. Learning Outcome Matrix

<table>
<thead>
<tr>
<th>Learning Outcome/Chapter</th>
<th>Ch1</th>
<th>Ch2</th>
<th>Ch3</th>
<th>Ch4</th>
<th>Ch6</th>
<th>Ch7</th>
<th>Ch8</th>
<th>Ch9</th>
<th>Ch11</th>
<th>Ch14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Understand the assumptions, principles and conventions underlying financial accounting process.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Appreciate the role and importance of accounting information in assisting decision-making in a business context.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Undertake the work involved in the recording, processing, summarizing and reporting phases of the accounting cycle.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Apply relevant accounting concepts and principles in the preparation of financial statements.</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apply fundamental analytical tools for the interpretation of financial statements.</td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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4. Study Guide by Chapter

4.1 Chapter 1 - Financial Statement and Business Decision

4.1.1 Chapter Learning Outcomes

✓ Describe the process that businesses use to communicate financial information to investors and creditors.
✓ Recognize the information conveyed in each of the four basic financial statements.
✓ Introduce the basic accounting equation (also called the balance sheet equation).

4.1.2 Chapter Highlights

➤ Four Basic Financial Statements

The four basic financial statements are used to communicate financial information to decision makers. This chapter provides an overview of each of the four basic financial statements.

- The balance sheet is a statement of financial position that reports dollar amounts for the assets, liabilities, and stockholders’ equity at a specific point in time.
- The income statement is a statement of operation that reports revenues, expenses, and net income for a stated period of time.
- The statement of retained earnings explains changes to the retained earnings balance that occurred during the reporting periods.
- The statement of cash flows reports inflows and outflows of cash for a specific period of time.

➤ Basic Accounting Equation

\[
\begin{align*}
\text{Assets} & = \text{Liabilities} + \text{Stockholders’ Equity} \\
\text{Economic resources} & \quad \text{Sources of financing for the economic resources} \\
\text{(e.g. cash, inventory)} & \quad \text{(Liability: From creditors} \\
\text{} & \quad \text{Stockholders’ Equity: From stockholders}
\end{align*}
\]

➤ Management Responsibilities and the Demand for Auditing
4.1.3 Self-test Questions and Exercises

True-False Questions

1. When accounting and reporting for a business entity, the accounting and reporting for the business must be kept separate from other economic affairs of its owners.

2. A balance sheet should be dated for a period (such as “For the year ended December 31, 2006”), whereas an income statement should be dated at a point in time (such as “December 31, 2006”).

3. Companies prepare financial statements at the end of each year and more often as needed.

4. Generally accepted accounting principles (GAAP) are essentially identical in most developed countries.

5. An audit guarantees that the financial statements are free of all misstatements.

Multiple Choice Questions

1. The primary purpose of the balance sheet is to
   A) measure the net income of a business up to a particular point in time.
   B) report the difference between cash inflows and cash outflows for the period.
   C) report the financial position of the reporting entity at a particular point in time.
   D) None of the above is correct.

2. On January 1, 2006, two individuals invested $500,000 each to form Jordan Corporation. Jordan had total revenues of $200,000 during 2006 and $250,000 during 2007. Total expenses for the same periods were $120,000 and $140,000 respectively. Cash dividends paid out to stockholders totaled $20,000 in 2006 and $25,000 in 2007. What was Jordan’s total stockholders’ equity at the end of 2006 and 2007?
   A) $1,000,000 and $1,065,000 respectively.
   B) $1,060,000 and $1,145,000 respectively.
   C) $1,100,000 and $1,170,000 respectively.
   D) $1,210,000 and $1,410,000 respectively.
3. Atlantic Corporation reported the following amounts at the end of the first year of operation, December 31, 2006: contributed capital $100,000; sales revenue $400,000; total assets $300,000; $20,000 dividends; and total liabilities $160,000. Retained earnings and total expenses would be

A) retained earnings $40,000 and expenses $340,000.
B) retained earnings $60,000 and expenses $320,000.
C) retained earnings $140,000 and expenses $240,000.
D) retained earnings $160,000 and expenses $220,000.
E) None of the above is correct.

4. The purpose of an audit is to

A) prove the accuracy of an entity's financial statements.
B) lend credibility to an entity's financial statements.
C) endorse the quality of leadership that managers provide for a corporation.
D) establish that a corporation's stock is a sound investment.

5. Financial accounting

A) provides information primarily for external decision makers.
B) is required for corporations but probably would not be done by other business entities.
C) provides information primarily for the use of managers of the company.
D) has been practiced in this country for approximately the past 15 years.

**Exercises**

Using the income statement model and the balance sheet model, fill in the missing amounts for each independent case below. Assume the amounts given are at the end of the company's first year of operation.

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Total Revenue</th>
<th>Total Assets</th>
<th>Total Expenses</th>
<th>Total Liabilities</th>
<th>Net Income (Loss)</th>
<th>Stockholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Randolph</td>
<td>$600,000</td>
<td>$350,000</td>
<td>$450,000</td>
<td>$130,000</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Newman</td>
<td>$125,000</td>
<td>?</td>
<td>?</td>
<td>$90,000</td>
<td>$20,000</td>
<td>$55,000</td>
</tr>
<tr>
<td>Wiseman</td>
<td>?</td>
<td>$160,000</td>
<td>?</td>
<td>?</td>
<td>($20,000)</td>
<td>$110,000</td>
</tr>
<tr>
<td>Martin</td>
<td>$150,000</td>
<td>$275,000</td>
<td>$125,000</td>
<td>$50,000</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>VanTassel</td>
<td>?</td>
<td>?</td>
<td>$80,000</td>
<td>$55,000</td>
<td>$13,000</td>
<td>$73,000</td>
</tr>
</tbody>
</table>
4.1.4 Solution to Self-test Questions and Exercises

True-False Questions

1. T
2. F (It should be vice versa. The balance sheet should be dated at a point in time and the income statement should be dated for a period of time.)
3. T
4. F (Different sets of GAAP have been developed within countries. Differences in political, cultural, and economic histories have produced many cross-national differences in the world.)
5. F (An audit provides assurance that the statements are free from material misstatement based on audit tests.)

Multiple Choice Questions

1. C
2. B
3. A
4. B
5. A

Exercises

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Total Revenue</th>
<th>Total Assets</th>
<th>Total Expenses</th>
<th>Total Liabilities</th>
<th>Net Income (Loss)</th>
<th>Stockholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Randolph</td>
<td></td>
<td>$220,000</td>
<td></td>
<td></td>
<td>$150,000</td>
<td>$220,000</td>
</tr>
<tr>
<td>Newman</td>
<td>$145,000</td>
<td></td>
<td>$105,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wiseman</td>
<td>$70,000</td>
<td></td>
<td></td>
<td>$50,000</td>
<td></td>
<td>$225,000</td>
</tr>
<tr>
<td>Martin</td>
<td>$25,000</td>
<td></td>
<td></td>
<td></td>
<td>$25,000</td>
<td>$225,000</td>
</tr>
<tr>
<td>VanTassel</td>
<td>$93,000</td>
<td>$128,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
4.2 Chapter 2 - Investing and Financing Decisions and the Balance Sheet

4.2.1 Chapter Learning Outcomes

☑ Define the objective of financial reporting, the elements of the balance sheet, and the related key accounting assumptions and principles.
☑ Identify what constitutes a business transaction and recognize common balance sheet account titles used in business.
☑ Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders’ Equity.
☑ Determine the impact of business transactions on the balance sheet using two basic tools: Journal entries and T-accounts.
☑ Prepare a simple classified balance sheet and analyze the company using the financial leverage ratio.
☑ Identify investing and financing transactions.

4.2.2 Chapter Highlights

➢ Elements of the Balance Sheet

Balance sheet elements present the basic accounting equation (A = L + SE).
- **Assets**: Economic resources with probable future benefits owned by the entity as a result of past transactions. Listed on the balance sheet in the order of liquidity.
- **Liabilities**: Are probable debts or obligations of the entity that result from past transactions, which will be paid with assets or services. Listed on balance sheet in the order of maturity dates.
- **Stockholders equity (Owners Equity)**: The owners’ residual interest in net assets (assets minus liabilities). Two categories:
  i) **Contributed capital**: The investments of the owners.
  ii) **Retained earnings**: The cumulative earnings that are not distributed to the owners and are reinvested in the business.

➢ Key Steps in Transaction Analysis

i) **Analyze**: Identify which accounts increase and decrease.
ii) **Journalize**: Debit means the left side of an account; Credit means the right side of an account. By referencing the accounting equation, debits increase asset accounts and credits increase liability and stockholders’ equity accounts.
iii) **Posting**: An act of transferring journal entry amounts to the appropriate accounts in the ledger (T-account).

➢ Transaction Analysis Model

\[
\begin{array}{lll}
\text{Assets (A)} & = & \text{Liabilities (L)} = \text{Stockholders’ Equity (SE)} \\
\text{Increase} & \text{Decrease} & \text{Decrease} & \text{Increase} & \text{Decrease} & \text{Increase} \\
\text{Debit} & \text{Credit} & \text{Debit} & \text{Credit} & \text{Debit} & \text{Credit}
\end{array}
\]
- **T-Account Format**

<table>
<thead>
<tr>
<th>Assets (A)</th>
<th>Liabilities (L)</th>
<th>Stockholders’ Equity (SE)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase</td>
<td>Decrease</td>
<td>Decrease</td>
</tr>
<tr>
<td>Debit</td>
<td>Credit</td>
<td>Debit</td>
</tr>
</tbody>
</table>

- **The Related Key Accounting Assumptions and Principles**

  - **Separate-entity assumption** – “Business” transactions are separate from “owner” transactions.
  - **Unit-of-measure assumption** – Accounting information will be measured and reported in the national monetary unit of that company.
  - **Continuity (going-concern) assumption** – A business is expected to continue operation in the foreseeable future without forced liquidation.
  - **Historical cost principle**: Requires assets to be recorded at historical cost that, on the date of the transaction, is cash paid plus the current dollar value of all non-cash consideration given in exchange.

### 4.2.3 Self-test Questions and Exercises

**True-False Questions**

1. An "account" is a standardized format used to accumulate the effects of transactions on each financial statement item.

2. Under the separate entity assumption, it is assumed that a business will continue to operate in the foreseeable future.

3. If a company has liabilities of $100,000 and their stockholders’ equity is $70,000, then total assets must be $30,000.

4. The balance sheet shows a company's financial position at a particular point in time.

5. Debits always increase and credits always decrease the accounts.
Multiple Choice Questions

1. Hong Kong companies prepare their financial reports in terms of Hong Kong dollars, whereas Japanese companies report results in yen. This practice is an example of the:
   
   A) Historical cost principle.  
   B) Materiality constraint.  
   C) Full disclosure principle.  
   D) Unit-of-Measure Assumption.

2. A company purchased a car, office furniture, and office supplies by issuing a check for $5,000 and a note payable for $19,500. The market value of the items was $28,500. The total recorded value of the items is
   
   A) $28,500.  
   B) $19,500.  
   C) $24,500.  
   D) $31,300.

3. On a balance sheet, assets are listed in the order of
   
   A) dollar amount (largest first).  
   B) date of acquisition (earliest first).  
   C) ease of conversion to cash.  
   D) importance to the operation of the business.

4. MJ company declares a cash dividend to be paid to its stockholders next month. The effect of the transaction is to:
   
   A) decrease assets and liabilities.  
   B) increase assets and stockholders' equity.  
   C) decrease assets and stockholders' equity.  
   D) increase liabilities and decrease stockholders' equity.

5. "Accounts Payable" refers to
   
   A) an amount owed to a business.  
   B) an amount a business owes to a third party.  
   C) the bottom line on the income statement.  
   D) the total cash paid by a business during the year.
Exercises

Show how each transaction affects the accounting equation: Assets = Liabilities + Stockholders’ Equity.

1. Individuals invest $50,000 to start a business.
2. The company borrows $75,000 and signs a note agreeing to pay back the money.
3. Purchased $15,000 worth of supplies on credit.
4. Land is purchased for $25,000 cash.

4.2.4 Solution to Self-test Questions and Exercises

True-False Questions

1. T
2. F (Under the continuity assumption, it is assumed that a business will continue to operate in the foreseeable future. The separate-entity assumption requires business transactions to be separate from the transactions of its owners.)
3. F (Assets = Liabilities + Stockholders’ Equity. Therefore, Assets = $100,000 + 70,000. Assets = $170,000.)
4. T
5. F (Debits are always on the left and credits are always on the right. Debits always increase asset accounts and credits always decrease assets. The opposite rule is true for liability and stockholders' equity accounts.)

Multiple Choice Questions

1. D
2. C
3. C
4. D
5. B
Exercises

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Stockholders Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Supplies</td>
<td>Land</td>
</tr>
<tr>
<td></td>
<td>Notes</td>
<td>Accts</td>
</tr>
<tr>
<td></td>
<td>Payable</td>
<td>Payable</td>
</tr>
<tr>
<td></td>
<td>Contributed</td>
<td>Capital</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.50,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.75,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>4.-25,000</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td>100,000</td>
<td>15,000</td>
<td>25,000</td>
</tr>
<tr>
<td>140,000</td>
<td>15,000</td>
<td>25,000</td>
</tr>
<tr>
<td>140,000</td>
<td>15,000</td>
<td>25,000</td>
</tr>
</tbody>
</table>

4.3 Chapter 3 – Operating Decisions and the Income Statement

4.3.1 Chapter Learning Outcomes

✓ Describe a typical business operating cycle and explain the necessity for the time period assumption.
✓ Explain how business activities affect the elements of the income statement.
✓ Explain the accrual basis of accounting and apply the revenue and matching principles to measure income.
✓ Apply transaction analysis to examine and record the effects of operating activities on the financial statements.
✓ Prepare financial statements.
✓ Compute and interpret the total asset turnover ratio.

4.3.2 Chapter Highlights

➢ Income Statement

Revenues – Expenses = Net Income (Net Loss)

Income statement reports the profitability of a company over a given period.
- Operating Revenues – Results from the sale of goods or services.
- Operating Expenses – Costs incurred for the normal operations.
- Other Revenues (Gains), Other Expenses (Losses)
- Income Tax Expense – The last expense listed on the income statement for profit-making corporations.
- Earnings per Share – Required disclosure on corporate income statements.

➢ Statement of Retained Earnings

Beginning RE + Net Income (or – Net Loss) – Dividends Declared = Ending RE

Net income or net loss comes from the income statement, so the income statement must be prepared first and the statement of Retained Earnings next. The ending retained earnings will be put on the balance sheet as the value of retained earnings.

➢ Cash Basis vs. Accrual Accounting:

- Cash basis accounting: Records revenue when cash is received and expenses when cash is paid.
- Accrual basis accounting: Requires the reporting of revenues when earned and expenses when incurred, regardless of timing of cash receipts and cash payments. Is in agreement with GAAP for the preparation of financial statements.
The Related Key Accounting Assumptions and Principles

- **Revenue Principle**: Revenue is normally recognized when earned (at the point of the sale) regardless of when cash is actually received. Revenue is earned when title, risk, and rewards of ownership are transferred to the customer.

- **Matching Principle**: Requires that costs incurred to generate revenues must be recognized in the same period.

- **The Time Period Assumption**: The company’s life can be broken down into artificial periods.

**Expanded Transaction Analysis Model**

\[
\text{Assets (A)} = \text{Liabilities (L)} = \text{Stockholders’ Equity (SE)}
\]

\[
\begin{array}{ccc|cc|ccc}
& \text{Increase} & \text{Decrease} & \text{Debit} & \text{Credit} & \text{Decrease} & \text{Increase} & \text{Debit} & \text{Credit} \\
\text{Expenses and Losses} & \text{Increase} & \text{Decrease} & \text{Debit} & \text{Credit} & \text{Decrease} & \text{Increase} & \text{Debit} & \text{Credit} \\
\text{Revenues and Gains} & \text{Decrease} & \text{Increase} & \text{Debit} & \text{Credit} & \text{Increase} & \text{Decrease} & \text{Debit} & \text{Credit}
\end{array}
\]

4.3.3 Self-test Questions and Exercises

**True-False Questions**

1. The operating cycle is the time it takes for a company to purchase goods, pay for the goods, sell them to customers, and collect the cash from the customers.

2. The income statement provides investors with information about a company's investment activities.

3. Accrual basis accounting recognizes revenues when cash is received from the customer.

4. Every transaction which affects either revenue or an expense account also affects retained earnings on the balance sheet.

5. Revenue accounts normally have debit balances because they represent assets received while expense accounts normally have credit balances because they represent assets used.
Multiple Choice Questions

1. LUX Company sold hardware for $12,000 cash and $18,000 of hardware to credit customers. Which of the following is the correct journal entry to record this transaction?

   A) Cash, debit, $12,000; Accounts Receivable, credit, $18,000; Unearned Revenues, credit, $30,000
   B) Cash, debit, $12,000; Accounts Receivable, debit, $18,000, Hardware Revenues, credit, $30,000
   C) Cash, debit, $12,000; Unearned Revenues, debit, $18,000; Hardware Revenues, $30,000
   D) Cash, debit, $30,000; Hardware Revenues, credit, $30,000

2. Which of the following is the correct order for preparing the financial statements?

   A) Statement of retained earnings, balance sheet, income statement, and statement of cash flows.
   B) Statement of cash flows, balance sheet, statement of retained earnings, and income statement.
   C) Balance sheet, statement of retained earnings, income statement, and statement of cash flows.

3. When delivery of goods and services for $25,000 results in a cash receipt of $15,000 and the balance of $10,000 on account, the reported revenues for the time period are

   A) $15,000.
   B) $25,000.
   C) $10,000.
   D) $35,000.

4. Which of the following would cause retained earnings to decrease?

   A) Sale of service on credit.
   B) Gains on disposal of equipment.
   C) Dividend declared by the board of directors.
   D) All of the above make retained earnings decrease.
5. Which of the following is a peripheral transaction?

   A) Income tax expense
   B) Interest expense
   C) General and administrative expenses
   D) Depreciation expense

**Exercises**

On December 1, 2009, Lucky SK Company, was started with $100,000 invested by the owners as contributed capital. On December 31, the accounting records contained the following amounts:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$100</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>3,900</td>
</tr>
<tr>
<td>Cash</td>
<td>25,000</td>
</tr>
<tr>
<td>Contributed capital</td>
<td>50,000</td>
</tr>
<tr>
<td>Consulting fees earned</td>
<td>10,500</td>
</tr>
<tr>
<td>Dividends declared</td>
<td>2,100</td>
</tr>
<tr>
<td>Office equipment</td>
<td>24,100</td>
</tr>
<tr>
<td>Office supplies</td>
<td>$500</td>
</tr>
<tr>
<td>Rent expense</td>
<td>1,500</td>
</tr>
<tr>
<td>Salaries expense</td>
<td>2,000</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>100</td>
</tr>
<tr>
<td>Telephone expense</td>
<td>200</td>
</tr>
</tbody>
</table>

Prepare an income statement in good form for December 31, 2009 which is the first month of operation. Ignore taxes.
4.3.4 Solution to Self-test Questions and Exercises

**True-False Questions**

1. T
2. F (The income statement provides investors with information about operating activities.)
3. F (Accrual accounting recognizes revenue earned regardless of whether cash has come in or not.)
4. T
5. F (Revenue accounts normally have credit balances because they represent earnings which increase stockholders' equity. Expense accounts usually have debit balances because they reduce stockholders’ equity. Neither revenues nor expenses represent assets.)

**Multiple Choice Questions**

1. B
2. D
3. B
4. C
5. B

**Exercises**

Lucky SK Company
Income Statement
For the Month Ended December 31, 2009
(In U.S. dollars)

<table>
<thead>
<tr>
<th>Revenues:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Consulting fees earned</td>
<td>$10,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent expense</td>
<td>$1,500</td>
</tr>
<tr>
<td>Salaries expense</td>
<td>2,000</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>100</td>
</tr>
<tr>
<td>Telephone</td>
<td>200</td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td>3,800</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$6,700</td>
</tr>
</tbody>
</table>
4.4 Chapter 4 - Adjustments, Financial Statements, and the Quality of Earnings

4.4.1 Chapter Learning Outcomes

✓ Explain the purpose of adjustments and analyze the adjustments necessary at the end of the period to update balance sheet and income statement accounts.
✓ Explain the purpose of a trial balance.
✓ Present an income statement with earnings per share, statement of stockholders’ equity and balance sheet.
✓ Explain the closing process.

4.4.2 Chapter Highlights

➢ Adjusting Entries

- Adjusting entries are prepared due to timing differences.
- Timing differences occur when cash is received before or after revenues are earned and expenses are incurred.
- There are two types of adjusting entries: accruals and deferrals.
  i) Accruals are for those events where revenues have been earned or expenses incurred but they have not been recorded in the journal.
  ii) Deferrals represent the receipt of assets or the payment of cash in advance of the revenue being earned or the expense being recognized.

4.4.3 Self-test Questions and Exercises

True-False Questions

1. When an adjustment decreases prepaid insurance and increases insurance expense for the portion expired, that is an example of a prepaid expense adjusting entry.

2. The earnings per share ratio are disclosed at the bottom of the statement of cash flows.

3. Revenue and expense accounts are often called permanent (real) accounts because their balances are closed at the end of the accounting year.

4. Depreciation expense is an estimated allocation of the cost of long-lived assets and is recorded in a contra asset, accumulated depreciation because it is only an estimated amount and not known with certainty.
5. Unearned rent revenue is an example of a liability account that will usually not be satisfied by payment of cash but rather by allowing the tenant to occupy the premises for which they have prepaid.

Multiple Choice Questions

1. Which of the following is TRUE about every adjusting entry?
   A) They affect only income statement accounts.
   B) They affect a balance sheet account and an income statement account.
   C) They affect only balance sheet accounts.
   D) The affect only accounts with normal debit balances.

2. If the accountant forgets to adjust the Prepaid Expenses account, there will be:
   A) an understatement of net income.
   B) an overstatement of net income.
   C) an overstatement of expense.
   D) no under- or overstatement of net income.

3. An accrued revenue would be shown on the balance sheet as:
   A) a receivable.
   B) a payable.
   C) a prepaid revenue.
   D) unearned revenue.

4. A deferred expense would be shown on the balance sheet as:
   A) a receivable.
   B) a payable.
   C) a prepaid revenue.
   D) unearned revenue.

5. Employees are paid $2,400 every Friday for a five-day workweek. The accounting period ends on Wednesday, December 31. Adjusting the salary and benefit expense for the last three days of the accounting period would:
   A) increase a deferred expense.
   B) increase an accrued expense.
   C) decrease a deferred expense.
   D) decrease an accrued expense.
Exercises

Center Company is completing the information processing cycle at the end of the annual accounting period, December 31, 2009. Four adjusting entries must be made on this date to update the accounts. The following accounts, selected from Center Company's chart of accounts, are to be used for this purpose. They are coded on the left for easy reference.

A. Cash 
B. Notes payable 
C. Interest receivable 
D. Equipment 
E. Accumulated depreciation 
F. Notes payable 
G. Interest payable 
H. Wages payable 
I. Unearned rent 
J. Rent expense 
K. Wage expense 
L. Depreciation expense 
M. Interest expense 
N. Interest revenue 
O. Rent revenue 
P. Some other account not listed

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. On December 1, 2009, the company collected $9,000 rent revenue in advance for some warehouse space temporarily rented to a customer (credited in full to unearned rent). The rent was collected for December, January, and February.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Office supplies purchased during 2009 amounted to $5,000, which was debited in full to office supplies during the year. The year-end inventory count of office supplies showed $600 of supplies on hand. The beginning inventory of office supplies was $800.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. On November 1, 2009, the company signed a $50,000 interest-bearing note payable. It was for one year and specified 12 percent annual interest payable at the maturity date of the note.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4.4.4 Solution to Self-test Questions and Exercises

True-False Questions

1. T
2. F (Earnings per share (EPS) are reported on the income statement.)
3. F (Revenue and expense accounts are often called temporary (nominal) accounts because their balances are closed at the end of the accounting year.)
Multiple Choice Questions

1. B
2. B
3. A
4. C
5. B

The adjusting entry is:

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary and Benefit Expense (the accrued expense)</td>
<td>$1,440</td>
</tr>
<tr>
<td>Accrued Expenses Payable (the accrued liability)</td>
<td>$1,440</td>
</tr>
</tbody>
</table>

Exercises

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Code</td>
<td>Amount</td>
</tr>
<tr>
<td>A.</td>
<td>I</td>
<td>$3,000</td>
</tr>
<tr>
<td>B.</td>
<td>P</td>
<td>$5,200</td>
</tr>
<tr>
<td>C.</td>
<td>M</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

A. ($9,000 \times \frac{1}{3}) = $3,000.
B. ($800 + 5,000 − 600) = $5,200.
C. ($50,000 \times 12\% \times \frac{2}{12}) = $1,000.
4.5 Chapter 6 –Reporting and Interpreting Sales Revenue, Receivables, and Cash

4.5.1 Chapter Learning Outcomes

✓ Apply the revenue principle to determine the accepted time to record sales revenue for typical retailers, wholesalers, manufacturers, and service companies.
✓ Analyze the impact of credit card sales, sales discounts, and sales returns on the amounts reported as net sales.
✓ Analyze and interpret the gross profit percentage.
✓ Estimate, report, and evaluate the effects of uncollectible accounts receivable (bad debts) on financial statements.
✓ Report, control, and safeguard cash.

4.5.2 Chapter Highlights

➢ Accounting for Bad Debts
- Bad debt expense is reported as an adjusting entry at the end of the accounting period:

  Bad Debt Expense xxx
  Allowance for Doubtful Accounts xxx

- When it is determined that a specific account is uncollectible, that account should be written off against the allowance.

  Allowance for Doubtful Accounts xxx
  Accounts Receivable (name of customer) xxx

➢ Reconciliation of the Cash Accounts and the Bank Statements
The reconciliation is the process of comparing and updating the ending cash balance in the company’s records and the ending cash balance reported by the bank on the monthly bank statement.

<table>
<thead>
<tr>
<th>Ending cash balance per books</th>
<th>Ending cash balance per bank statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add:</td>
<td>Add:</td>
</tr>
<tr>
<td>Notes collected by bank</td>
<td>Deposits in transit</td>
</tr>
<tr>
<td>Interest received or paid by bank</td>
<td></td>
</tr>
<tr>
<td>Deduct:</td>
<td>Deduct:</td>
</tr>
<tr>
<td>NSF checks</td>
<td>Outstanding checks</td>
</tr>
<tr>
<td>Bills and Interest paid by the bank</td>
<td>+/- Bank errors</td>
</tr>
<tr>
<td>Bank charges</td>
<td></td>
</tr>
<tr>
<td>+/- Company errors</td>
<td></td>
</tr>
<tr>
<td>Adjusted balance per books</td>
<td>Adjusted balance per bank</td>
</tr>
</tbody>
</table>
Internal control of cash
- Separation of duties, and
- Prescribed policies and procedures.

4.5.3 Self-test Questions and Exercises

True-False Questions

1. When a particular account receivable is determined to be uncollectible, the entry to write off the account requires a debit to the allowance for doubtful accounts.

2. Credit terms “2/10, n/30” mean that if payment is made in two days, a 10% discount will be given; if not paid within two days, the full invoice price will be due in thirty days.

3. Sales returns and allowances should be included as a selling expense.

4. The allowance for doubtful accounts normally has a debit balance after the year-end adjustment.

5. When completing a bank reconciliation, bank service charges should be deducted from the company's cash balance.

Multiple Choice Questions

1. A customer used a credit card to pay for $400 of services. The credit card company charged 2.5% for its services. How much did the company record as a deposit to its checking account as a result of the sales transaction?
   A) $400.00
   B) $410.00
   C) $390.00
   D) $388.00

2. The unadjusted credit balance of the Allowance for Doubtful Accounts account is $650. Uncollectible accounts are estimated to be $15,600, based on an analysis of a schedule of aging of accounts receivable. After recording the appropriate journal entry for the bad debts expense, what will be the adjusted balance of the Allowance for Doubtful Accounts?
   A) $650
   B) $16,250
   C) $14,950
   D) $15,600
3. The unadjusted debit balance of the Allowance for Doubtful Accounts account is $350. Uncollectible accounts are estimated to be $15,800, based on an analysis of a schedule of aging of accounts receivable. After recording the appropriate journal entry for the bad debts expense, what will be the balance of the Bad Debt Expense account?

A) $15,800  
B) $15,450  
C) $16,150  
D) $350

4. The proper treatment on the bank reconciliation of outstanding checks is to

A) add them to the book balance of cash.  
B) add them to the bank balance of cash.  
C) deduct them from the book balance of cash.  
D) deduct them from the bank balance of cash.

5. Which of the following demonstrates a poor internal control procedure?

A) The bookkeeper makes cash deposits and records journal entries related to cash, while the treasurer prepares the bank reconciliation.  
B) The president, who does no bookkeeping, prepares the bank reconciliation each month.  
C) The treasurer signs all checks after the bookkeeper prepares the supporting documents.  
D) One bookkeeper prepares cash deposits and the other bookkeeper enters the collections in the journal and ledger.

Exercises

Where, if at all, do items A to G (listed below) belong to in the following bank reconciliation?

1. Balance per bank statement, June 30 $XXX  
   PLUS (1) _____  
   MINUS (2) _____  
   Correct cash balance, June 30 $XXX

2. Balance per company books, June 30 $XXX  
   PLUS (3) _____  
   MINUS (4) _____  
   Correct cash balance, June 30 $XXX
Items:

A. Checks written during June that had not cleared by June 30.
B. Bank service charges for June which were not known until the June 30 bank statement arrived.
C. Deposit made on June 30 that did not reach the bank until July 1.
D. Upon reviewing the company's cash receipts book after June 30, it was discovered that the accounting clerk had neglected to post one receipt to the cash account.
E. The bank statement reported a “NSF check” during June.
F. The bank incorrectly deducted the check of another company to the bank account during June.
G. The company was paid interest on its account by the bank.

4.5.4 Solution to Self-test Questions and Exercise

True-False Questions

1.T
2.F (If payment is made in two days, a 10% discount will be given; if not the full invoice price will be due in thirty days.)
3.F (The sales returns and allowances account should be reported as a deduction from sales revenue because it is a contra-revenue account.)
4.F (Should be credit balance)
5.T

Multiple Choice Questions

1.C
2.D
3.C
4.D
5.A

Exercises

(1.) C, F;
(2.) A;
(3.) D, G;
(4.) B, E.
4.6 Chapter 7 - Reporting and Interpreting Cost of Goods Sold and Inventory

4.6.1 Chapter Learning Outcomes

✓ Apply the cost principle to identify the amounts that should be included in inventory and the matching principle to determine cost of goods sold.
✓ Report inventory and cost of goods sold using the four inventory costing methods.
✓ Recognize the Financial Statement Effects of the inventory costing methods.
✓ Report inventory at the lower of cost or market (LCM).
✓ Understand and compare Perpetual and Periodic Inventory Systems.
✓ Analyze the effects of inventory errors on financial statements.

4.6.2 Chapter Highlights

➢ Nature of Cost of Goods Sold

\[
\text{Beginning inventory} + \text{Cost of purchases of merchandise during the period} = \text{Goods available for sale} \\
\text{Goods available for sale} - \text{Ending inventory} = \text{Cost of goods sold}
\]

➢ The Four Inventory Costing Methods

- **Specific Identification**
  When units are sold, the specific cost of the unit sold is added to cost of goods sold.

- **First-In, First-Out Method (FIFO)**
  a. Assumes the first costs in are the first costs out.
  b. The oldest costs are included in cost of goods sold.
  c. The newest costs are included in ending inventory.

- **Last-In, First-Out Method (LIFO)**
  a. Assumes the last costs in are the first costs out.
  b. The newest costs are included in cost of goods sold.
  c. The oldest costs are included in ending inventory.

- **Average Cost Method**
  a. Uses the weighted average unit cost of the goods available for sale for both cost of goods sold and ending inventory.
Average cost per unit = \( \frac{\text{Cost of goods available for sale (dollars)}}{\text{Quantity available for sale (units)}} \)

b. This method uses a weighted-average rather than a simple average.
c. Produces results between the FIFO and LIFO methods.

Financial Statement Effects of Inventory Costing Methods

In times of changing prices, each method will produce differences in net income, stockholders' equity, and asset valuation amounts.

Lower of Cost or Market (LCM)

Ending inventory is reported at the lower of cost or market (LCM). It is a more conservative approach.
- If replacement cost is lower than actual cost, LCM must be used for balance sheet reporting.
- Holding losses (write-downs) are recognized in the current period, but holding gains (write-ups) are not recognized.

Perpetual and Periodic Inventory Systems

i) Perpetual
a. Up-to-date records are kept for inventory and cost of goods sold.
b. The cost of goods acquired during the period is a direct increase in the inventory account. The Purchases account is not used.
c. The cost of goods sold during the period is a direct decrease in the inventory account. In addition, a cost of goods sold account is increased for a like amount.

ii) Periodic
a. No up-to-date record exists for inventory.
b. Inventory is updated once in a while (periodically).
c. Physical count of inventory at year-end is required to derive the ending inventory amount.
d. Goods acquired during the period are accumulated in the Purchases account.
e. Cost of goods sold cannot be calculated until a physical count of the inventory is performed and an ending inventory value is determined.
4.6.3 **Self-test Questions and Exercises**

**True-False Questions**

1. When the weighted average inventory method is used, ending inventory and cost of goods sold are valued at a different cost per unit.

2. LIFO can be used for income tax purposes and FIFO can be used for financial reporting purposes for a company in a given year.

3. The beginning inventory of one accounting period becomes the beginning inventory amount of the next accounting period.

4. An understatement error in the ending inventory causes an overstatement of both net income and current assets in that year.

5. Under the periodic inventory system, the balance in the inventory account changes each time a purchase or sale of inventory is recorded.

**Multiple Choice Questions**

1. Consider the following:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$80,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning merchandise inventory</td>
<td>$10,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>$45,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

Determine the value of the ending merchandise inventory.

A) $10,000  
B) $15,000  
C) $5,000   
D) $25,000

2. Which of the following is true during periods of rising prices?

A) The use of FIFO will result in smaller net income than LIFO.  
B) The use of FIFO will result in a larger cost of goods sold than LIFO.  
C) The use of LIFO will result in a smaller cost of goods sold than FIFO.  
D) The use of FIFO will result in a higher net income and higher ending inventory than LIFO.
3. Consider the following:

<table>
<thead>
<tr>
<th>Item</th>
<th>Units on hand</th>
<th>Cost/Unit</th>
<th>Market/Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>2,000</td>
<td>$5.00</td>
<td>$5.50</td>
</tr>
<tr>
<td>B</td>
<td>3,000</td>
<td>$4.50</td>
<td>$3.00</td>
</tr>
</tbody>
</table>

Use Lower of Cost or Market and determine the amount of the write-down that the company will record.

A) $3,500  
B) $2,500  
C) $4,500  
D) $2,000

4. Inventory at the end of the current period was understated because one bin of inventory was not counted or included in the ending inventory totals. Because of this error,

A) net income for the period was overstated.  
B) net income for the following period will be overstated.  
C) the cost of goods sold for the current period was understated.  
D) total equity for the current year is overstated.

5. A company recorded net purchases on credit of $15.7 million for 2010. In 2009, ending accounts payable was $1.4 million and in 2010, it was $1.9 million. How much cash was paid to suppliers in 2010?

A) $14.8 million  
B) $15.0 million  
C) $15.2 million  
D) $15.7 million
Exercises

Compute the missing amounts in the income statement under three different inventory costing methods: (Round your answers to the nearest dollar).

<table>
<thead>
<tr>
<th></th>
<th>FIFO</th>
<th>LIFO</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue (4,000 units)</td>
<td>$80,000</td>
<td>$80,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Cost of goods sold:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning inventory (1,000 units @ $10 per unit)</td>
<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Purchases (5,000 units @ $12 per unit)</td>
<td>60,000</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Goods available for sale</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Ending inventory (2,000 units)</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Gross margin</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Expenses</td>
<td>20,000</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Net income (pretax)</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

4.6.4 Solution to Self-test Questions and Exercises

True-False Questions

1. F (Goods available for sale in dollars is divided by goods available for sale in units to determine the weighted average cost per unit. This unit cost is applied to both ending inventory and cost of goods sold.)

2. F (If LIFO is used for tax purposes, it must also be used for financial statement purposes. This requirement is known as the LIFO conformity rule.)

3. F (The ending inventory of one accounting period becomes the beginning inventory amount of the next accounting period.)

4. F (If ending inventory is understated, cost of goods sold is overstated and gross margin is understated. Therefore, net income would be understated on the income statement while current assets would be understated on the balance sheet.)

5. F (Cost of goods sold is computed as goods available for sale minus ending inventory.)
Multiple Choice Questions

1. C
2. D
3. C
4. B
5. C

Exercises

<table>
<thead>
<tr>
<th></th>
<th>FIFO</th>
<th>LIFO</th>
<th>Weighted Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue (4,000 units)</td>
<td>$80,000</td>
<td>$80,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Cost of goods sold:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning inventory (1,000)</td>
<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Purchases (5,000 units)</td>
<td>60,000</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Goods available for sale</td>
<td>70,000</td>
<td>70,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>24,000 (A)</td>
<td>22,000 (B)</td>
<td>23,333 (C)</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>46,000</td>
<td>48,000</td>
<td>46,667</td>
</tr>
<tr>
<td>Gross margin</td>
<td>34,000</td>
<td>32,000</td>
<td>33,333</td>
</tr>
<tr>
<td>Expenses</td>
<td>20,000</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Net income (pretax)</td>
<td>14,000</td>
<td>12,000</td>
<td>13,333</td>
</tr>
</tbody>
</table>

Computations:
A. $2,000 \text{ units} \times \$12 = \$24,000$
B. $(1,000 \text{ units} \times \$10) + (1,000 \text{ units} \times \$12) = \$22,000$
C. $(\$70,000 \div 6,000) \text{ units} \times 2,000 \text{ units} = \$23,333$
OR $\$70,000 \div 6,000 \text{ units} = \$11.67$ (rounded)
    \$11.67 \times 2,000 \text{ units} = \$23,340$
4.7 Chapter 8 - Reporting and Interpreting Property, Plant and Equipment; Natural Resources; and Intangibles

4.7.1 Chapter Learning Outcomes

✓ Define, classify, and explain the nature of long-lived productive assets.
✓ Apply the cost principle to measure the acquisition and maintenance of property, plant, and equipment.
✓ Apply various cost allocation methods (depreciation methods) as assets are held and used over time.
✓ Recognize the disposal of property, plant, and equipment.
✓ Apply measurement and reporting concepts for natural resources and intangible assets.

4.7.2 Chapter Highlights

➢ Classification of Long-Lived Assets

- Long-Lived Assets are resources that determine a company’s productive capacity.

  i) Tangible assets have physical substance. They are usually classified as property, plant, and equipment (fixed assets).

  ii) Intangible assets have no physical substance. These assets confer rights on the owner. They are evidenced by legal documents. Examples include patents, copyrights, franchises, licenses, and trademarks.

➢ Acquisition Costs

Acquisition costs are the net cash equivalent paid or to be paid for long-lived assets. Examples:

- Costs to buy the asset include the invoice price (less early payment discounts), sales taxes, legal fees, and transportation costs.
- Setup costs, including special wiring, platforms (such as concrete foundations), and other installation costs.
- Costs to place the asset in service (to be ready it for use) include expenditures for testing, adjusting, renovating, and complying with safety requirements.
- Generally, financing charges associated with the asset are treated as interest expense (not capitalized). Exception: self-constructed assets.
➢ Repairs, Maintenance, and Additions

Depending on the nature of the cost, these expenditures must be recorded either to expense accounts or to asset accounts.

- **Revenue expenditures**: recorded as expenses in the current period since they provide benefits only during the current accounting period.

- **Capital expenditures**: recorded as increases in asset accounts since they provide benefits for one or more accounting periods beyond the current period.

➢ Depreciation Concepts

i) The journal entry is:

<table>
<thead>
<tr>
<th>Depreciation Expense</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated Depreciation</td>
<td>xxx</td>
</tr>
</tbody>
</table>

ii) The cost of the asset shown on the balance sheet as:

\[
\text{Asset Cost} - \text{Accumulated Depreciation} = \text{Net Book Value of Asset}
\]

➢ Depreciation Methods

i) **Straight-line depreciation**

\[
\text{Depreciation expense} = (\text{Cost} - \text{Residual Value}) \times \frac{1}{\text{Useful life}}
\]

ii) **Units-of-production depreciation**

\[
\text{Depreciation rate per unit} = \frac{\text{Cost} - \text{Residual value}}{\text{Estimated total production}}
\]

\[
\text{Depreciation expense} = \text{Depreciation rate per unit} \times \text{Actual production (Units used)}
\]
iii) **Declining-balance depreciation**

\[
\text{Annual Depreciation} = \frac{\text{Net Book Value}}{\text{Useful Life in Years}} \times 2
\]

**Double-declining-balance (DDB) rate** = Straight Line Rate \( \times 2 = 2 \)

- **Recording Disposals**
  1. If Cash > Book Value, record a gain (credit).
  2. If Cash < Book Value, record a loss (debit).
  3. If Cash = Book Value, no gain or loss.

The journal entry is:

<table>
<thead>
<tr>
<th>Cash</th>
<th>XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated Depreciation</td>
<td>XXX</td>
</tr>
<tr>
<td>Asset</td>
<td>XXX</td>
</tr>
<tr>
<td>Gain / Loss on Disposal</td>
<td>(Loss)XXX (Gain)XXX</td>
</tr>
</tbody>
</table>

**4.7.3 Self-test Questions and Exercises**

**True-False Questions**

1. The cash-equivalent cost of an asset received is measured as any cash given plus the current market value of the non-cash consideration given up. If this value is not determinable, the current market value of what is received should be used instead.

2. If a second-hand machine is purchased for productive use in a business, all renovation and repair costs on the used machine incurred by the purchaser prior to its productive use should be excluded from the cost of the asset.

3. The first step in recording the disposal of a long-lived asset is to recognize depreciation expense for the period of time since the last depreciation adjustment was made.

4. The systematic and rational allocation of the acquisition cost of natural resources to those periods in which the resources contribute to revenue is called depletion.

5. Depreciation expense, as computed for financial reporting, has a direct effect on a corporation's cash flow.
Multiple Choice Questions

1. A company purchased for a cash machine with a list price of $120,000, upon which a 25% trade discount was applied. The machine was shipped FOB shipping point at a cost of $5,000. Installation and test runs of the machine cost $3,000. The recorded acquisition cost of the machine is:
   A) $98,000
   B) $128,000
   C) $90,000
   D) $93,000

2. A special repair on a machine will extend the life of the machine an additional four years beyond the original estimated life of 6 years. The $50,000 cost of this repair is:
   A) a revenue expenditure.
   B) a capital expenditure.
   C) an ordinary repair and maintenance expenditure.
   D) either (A) or (B).

3. Which of the following is the GAAP that requires the recording of depreciation?
   A) materiality constraint
   B) matching principle
   C) cost principle
   D) time period assumption

4. Which of the following assets are not depreciated?
   A) buildings
   B) office equipment
   C) land
   D) delivery vans

5. Production equipment with an acquisition cost of $250,000 and updated accumulated depreciation of $200,000 is sold for $60,000 cash. The journal entry to record the disposal (sale) will include:
   A) a credit to Gain on Sale of Asset of $10,000.
   B) a debit to Cash for $60,000 and a debit of Accumulated Depreciation of $200,000.
   C) a credit to Equipment for $250,000.
   D) all of the above.
Exercises

Hubbard Company purchased a truck on January 1, 2009, at a cost of $34,000. The company estimated that the truck would have a useful life of 4 years and a residual value of $4,000.

Required:
Calculate depreciation expense under straight line and double declining balance for 2009-2012.

4.7.4 Solution to Self-test Questions and Exercises

True-False Questions
1. T
2. F (Generally renovation and repair costs paid by the purchaser prior to a machine's use should be included in the cost of the machine. These costs are usually capitalized unless they are not material accounts.)
3. T
4. T
5. F (Depreciation itself requires no outflow of cash. The cash flow took place when the asset was paid for. However, depreciation has an indirect effect on cash since it affects the amount of income taxes to be paid.)

Multiple Choice Questions
1. A
2. B
3. B
4. C
5. D

Exercises

<table>
<thead>
<tr>
<th>Year</th>
<th>Depreciation Straight-line method</th>
<th>Depreciation Declining balance method 200% acceleration rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$7,500</td>
<td>$17,000</td>
</tr>
<tr>
<td>2010</td>
<td>$7,500</td>
<td>$ 8,500</td>
</tr>
<tr>
<td>2011</td>
<td>$7,500</td>
<td>$ 4,250</td>
</tr>
<tr>
<td>2012</td>
<td>$7,500</td>
<td>$  250</td>
</tr>
</tbody>
</table>

Computations:
Straight-line: ($34,000 - 4,000)/4 years = $7,500
Declining-balance:
2009 \( \frac{1}{4} \times 200\% \times 34,000 = 17,000 \)
2010 \( \frac{1}{4} \times 200\% \times (34,000 - 17,000) = 8,500 \)
2011 \( \frac{1}{4} \times 200\% \times (34,000 - 25,500) = 4,250 \)
2012 Book value $4,250 - $4,000 target book value = $250
4.8 Chapter 9 – Reporting and Interpreting Liabilities

4.8.1 Chapter Learning Outcomes

✓ Define, measure, and report current liabilities.
✓ Report contingent liabilities.
✓ Report long-term liabilities.

4.8.2 Chapter Highlights

➢ Current Liabilities

- Current liabilities are short-term obligations that will be paid within the current operating cycle or one year, whichever is longer.
- Specific operating activities of companies are usually financed, at least in part, by related current liabilities.
- Current liability accounts that appear on most balance sheets:
  i) Accounts Payable (A/P or Trade Payable)
  ii) Accrued Liabilities
  iii) Current Portion of Long-Term Debt
  iv) Deferred Revenue

➢ Contingent Liabilities

- They are estimated Liabilities on the balance Sheet. Whether a situation produces a contingent liability depends on two factors:
  i) The liability must be probable, and
  ii) The liability must be reasonably estimated.

- The conditions that can exist and how they should be handled are:

<table>
<thead>
<tr>
<th>Condition</th>
<th>Probable</th>
<th>Reasonably Possible</th>
<th>Remote</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subject to estimation</td>
<td>Record as liability</td>
<td>Disclose in note</td>
<td>Disclosure not required</td>
</tr>
<tr>
<td>Not subject to estimate</td>
<td>Disclose in note</td>
<td>Disclose in note</td>
<td>Disclosure not required</td>
</tr>
</tbody>
</table>

➢ Long Term Liabilities

- Non-current liabilities; i.e., all liabilities not properly classified as current liabilities.
- Often incurred to finance the acquisition of operational (long-lived) assets.
- Long-term liabilities include long-term notes payable, bonds payable, and mortgages payable. The borrowing agreement specifies the amount borrowed, the interest rate imposed, and the repayment schedule.
- Long-term liabilities are presented on the balance sheet immediately following current liabilities.

4.8.3 Self-test Questions

True-False Questions

1. Fundamentally, liabilities are measured at their cash equivalent amount.
2. When a liability is recorded, it includes the principle and interest to be paid.
3. Current liabilities are short-term and usually will be paid or satisfied within three months.
4. Liabilities must be fully reported in conformity with the full-disclosure principle.
5. A liability, to be reported on the balance sheet, must have a fixed, known amount to be paid in the future.

Multiple Choice Questions

1. A current liability is a short-term obligation that
   A) will be paid within the current operating cycle.
   B) will be paid within one year of the balance sheet date.
   C) will be paid in the longer of periods (A) and (B).
   D) does not affect liquidity.

2. Current assets are $400,000 of the total assets of $1,000,000. Current liabilities are $200,000 of the total liabilities of $700,000. What is the current ratio?

   A) 2.00
   B) 2.50
   C) 1.43
   D) 1.75
3. Your company borrowed $50,000 on September 30 by issuing a 6-month short-term note payable that bears simple interest of 12%. On December 31, the end of the accounting period, the required adjusting entry related to the note will include a debit to Interest Expense and a credit to Interest Payable for the accrued amount of:

A) $1,500.
B) $6,000.
C) $3,000.
D) $2,000.

4. Deferred revenues of $24,000 were received and properly recorded and entered in the ledger of the company. At the end of the accounting period, one-fourth of the deferred revenue had been earned, but unrecorded. The adjusting entry will require:

A) a debit to Unearned Revenues and a credit to Revenues for $6,000.
B) a debit to Unearned Revenues and a credit to Cash for $6,000.
C) a debit to Unearned Revenues and a credit to Accounts Payable for $6,000.
D) a debit to Cash and a credit to Revenues for $6,000.

5. Which of the following rules about contingent liabilities is NOT true?

A) A contingent liability that can be estimated and is probable should be recorded.
B) A contingent liability that cannot be estimated and is probable should be recorded.
C) A contingent liability that cannot be estimated and is remote should not be recorded or disclosed.
D) A contingent liability that can be estimated and is only reasonably possible should be disclosed but not recorded.

4.8.4 Solution to Self-test Questions

True-False Questions

1. T
2. F (A liability is recorded at the principle only and the interest is recognized as it is incurred with the passage of time.)
3. F (Current liabilities are short-term and usually will be paid or satisfied within one year or the operating cycle whichever is longer.)
4. T
5. F (Fixed and known amounts to be paid are not required for liabilities to be reported on the balance sheet. Warranty liabilities, for example, are based on estimates.)
Multiple Choice Questions

1. C
2. A
3. A
4. A
5. B
4.9 Chapter 11 – Reporting and Interpreting Owners’ Equity

4.9.1 Chapter Learning Outcomes

✓ Explain the role of stock in the capital structure of a corporation.
✓ Describe the characteristics of common stock and analyze transactions affecting common stock.
✓ Discuss dividends and analyze transactions.
✓ Describe the characteristics of preferred stock and analyze transactions affecting preferred stock.

4.9.2 Chapter Highlights

➢ Understanding the Business

Advantages of the corporate form of business:

- **Ease of Transfer**: Stock ownership can be transferred (sold) easily through established markets (stock exchanges).
- **Limited liability** for owners: The maximum a stockholder stands to lose is the investment in the stock.
- Since a corporation is a separate legal entity, it enjoys **continuity of life** (separate from its owners).
- Corporations have the ability to raise substantial amounts of capital through debt and equity issues.
- Corporations offer the ability for owners to earn high returns on their investments. However, this is not without risk and can result in losses to owners.

➢ Role of Stock

- **Authorized** number of shares is the *maximum* number of shares that can be issued by a corporation as specified in its charter. This should be a larger number than a corporation plans to issue initially to provide for the option of selling stock in the future.
- **Issued** number of shares is the total *cumulative* number of authorized shares that have been *sold to date* by the corporation. Unissued number of shares is the number of authorized shares that have not yet been sold to date.
- **Outstanding** number of shares is the number of shares currently owned by stockholders ("out" there).

“Outstanding shares = Issued shares - Treasury stock shares”
- **Treasury stock** is the number of shares that has been sold to investors and then reacquired by the corporation. If there is no treasury stock, the number of issued shares will equal the number of outstanding shares.

➢ **Common Stock**

- Common stock is the residual equity (the "leftovers") of a corporation.
  i) It ranks after preferred stock for dividends and liquidation distributions.
  ii) Common stockholders are the "risk takers" and, therefore, they are voting owners of a corporation.

- Common stockholders receive **dividends** after the preferred stockholders receive their dividends. The board of directors, usually based on the company’s profitability for common stockholders, determines dividend rates.

- A corporation may issue two types of common shares: **par value** and **no-par value**.

➢ **Initial Sale of Stock**

- When a corporation sells stock to the public, the transaction must be recorded in the accounts of the corporation. When stock sales are made for cash, **Cash** is debited and **Common Stock** is credited for par value.

  \[
  \begin{align*}
  \text{Cash} & \quad xxx \\
  \text{Common Stock} & \quad xxx
  \end{align*}
  \]

- Any additional amount in excess of par is credited to **Capital in Excess of Par Value**.

  \[
  \begin{align*}
  \text{Cash} & \quad xxx \\
  \text{Common Stock} & \quad xxx \\
  \text{Capital in Excess of Par Value} & \quad xxx
  \end{align*}
  \]

- In the case of **no-par common stock** that has no **stated value**, the total proceeds received at the issue are debited to **Cash** and credited to **No-Par Common Stock**. The capital in excess of par value account is not used under these circumstances.

➢ **Repurchase of Stock**

- **Treasury stock** is previously issued stock that is reacquired by the issuing corporation. The **cost method** records treasury stock at its cost:

  \[
  \begin{align*}
  \text{Treasury Stock} & \quad xxx \\
  \text{Cash} & \quad xxx
  \end{align*}
  \]
- **Resale** of Treasury Stock

  I. When treasury stock shares are resold, cash is debited and treasury stock is credited (reduced by the **cost** of the proportional number of shares resold).

  II. If treasury stock is acquired and resold for the same amount, that is the extent of the journal entry.

  III. If the acquisition and resale amounts differ, additional elements appear in the journal entry.

  i) Treasury stock is resold for **more** than its cost (an economic gain):

     a. **Capital in Excess of Par** is credited for the difference.

     b. A gain results in an overall **increase** in stockholders' equity.

  ii) Treasury stock is resold for **less** than its cost (an economic loss):

     a. **Capital in Excess of Par** is debited for the difference.

     b. If that account balance is not adequate to absorb this difference, **Retained Earnings** are reduced to the extent needed.

     c. A loss results in an overall **decrease** in stockholders' equity.

  ➢ **Preferred Stock**

  - Combines some of the features of bonds and common stock.

    i) Typically lacks the control feature of common stock in that it usually does not have voting rights.

    ii) Often used to raise corporate capital without diluting common stockholders' control.

  - Generally, preferred stock is less risky than common stock because of its preference to receive dividends and asset distributions (upon liquidation) before common stockholders.

  - Most preferred stock has a fixed dividend rate such as a specified percent of par or a specified amount per share.

  - **Dividends on Preferred Stock**

    i) Investors in preferred stock give up some (voting) rights compared to those in common stock.

    ii) Preferred Stock enjoys a **preference** in dividends.

    iii) Dividends must be allocated between **preferred shareholders** and **common shareholders**.

    iv) Two dividend preferences are Current Dividend Preference and Cumulative Dividend Preference.
4.9.3 Self-test Questions and Exercises

True-False Questions

1. A major advantage that a corporation has over a proprietorship or partnership is that it allows individuals to participate in ownership by purchasing small amounts of stock.

2. Treasury shares are no longer outstanding but they are still issued.

3. If a corporation issued 1,000 shares of its $1 par value stock for $50 per share, the common stock account would increase by $50,000.

4. One of the common stockholders’ rights is to receive a fixed dividend rate when the board of directors declares a dividend.

5. A liability is created on the date that a cash dividend is declared.

Multiple Choice Questions

1. A corporation reacquired 1,000 shares of its $0.01 par value common stock outstanding, paying $14 per share. Three months later, the 500 shares of the treasury stock was reissued for $16 per share. The journal entry to record the sale of the treasury stock will include:
   A) a credit to Treasury Stock for $8,000.
   B) a credit to Treasury Stock for $7,000.
   C) a debit to Cash for $7,000.
   D) a credit to Capital from Treasury Stock Transaction of $7,000.

2. On the date of declaration, which account is debited for the amount of the declared cash dividend?
   A) Retained Earnings.
   B) Cash Dividend Expense.
   C) Common Stock.
   D) Contributed Capital.

3. Which of the following is TRUE about treasury stock?
   A) It is an asset.
   B) It receives cash dividends.
   C) It retains voting rights.
   D) It is a contra-equity account.
4. A corporation's charter permits the corporation to issue 100,000 shares of $0.01 par value common stock. The corporation sold 50,000 shares and, later, reacquired 1,000 shares to hold as treasury stock. What is the number of shares outstanding?

A) 100,000.
B) 50,000.
C) 51,000.
D) 49,000.

5. Which of the following is a benefit of the corporate form of business?

A) Raising large amounts of capital is easier.
B) Ownership interests are easily transferred.
C) Limited liability of the owners (stockholders).
D) All of the above.

Exercises

1. Yasmeen's Yard Art issued 50,000 shares of $2 par value and common stock for $10 per share.

Required:
Record the journal entry.

2. Amethyst Inc. has the following account balances:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock ($1 par, 100,000 shares</td>
<td>100,000</td>
</tr>
<tr>
<td>outstanding, 96,000 shares outstanding)</td>
<td></td>
</tr>
<tr>
<td>Capital in Excess of Par</td>
<td>400,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>200,000</td>
</tr>
<tr>
<td>Treasury Stock (at cost)</td>
<td>32,000</td>
</tr>
</tbody>
</table>

Required:
What is the total stockholders’ equity?
How many shares of treasury stock does Amethyst have?
4.9.4 Solution to Self-test Questions and Exercises

True-False Questions

1. T
2. T
3. F (The common stock account would increase by $1,000 or only the par value of the shares issued.)
4. F (Common stockholders are not guaranteed a fixed dividend rate. Instead dividends are determined by the level of earnings, sufficiency of cash, and the need to retain earnings to grow the company.
5. T

Multiple Choice Questions

1. B
2. A
3. D
4. D
5. D

Exercises

1.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>500,000</td>
</tr>
<tr>
<td>Common Stock</td>
<td>100,000</td>
</tr>
<tr>
<td>Capital in Excess of Par</td>
<td>400,000</td>
</tr>
</tbody>
</table>

2. Total stockholder’ equity = $668,000 ($100,000 + 400,000 + 200,000 – 32,000)
Amethyst has 4,000 shares of treasury stock (100,000 shares issued – 96,000 shares outstanding).
4.10 Chapter 14 – Analysis Financial Statement

4.10.1 Chapter Learning Outcomes

✓ Compute and interpret component percentages.
✓ Compute and interpret profitability ratios.
✓ Compute and interpret liquidity ratios.
✓ Compute and interpret solvency ratios.
✓ Compute and interpret market test ratios.

4.10.2 Chapter Highlights

➢ Component Percentages

- Component percentages are used to express each item on a particular financial statement as a percentage of a single base amount.
  i) The base amount on the income statement is net sales and the base amount on the balance sheet is total assets.
  ii) The component percentage is derived by dividing each statement item by the base amount from that statement.
  iii) The amount is then multiplied by 100 to convert it to a percent.

➢ Profitability Ratios

1. Return on Equity (ROE)

   \[
   \text{Return on Equity} = \frac{\text{Net Income}}{\text{Average Owners' Equity}}
   \]

2. Return on Assets (ROA)

   \[
   \text{Return on Equity} = \frac{\text{Net Income} + \text{Interest Expense (net of tax)}^*}{\text{Average Total Assets}}
   \]

   * Interest expense (net of tax) is added to income since it is a return to creditors but it was previously deducted to arrive at income.
3. Earnings per Share (EPS)

\[
\text{Earnings per Share} = \frac{\text{Net Income*}}{\text{Average Number of Shares Outstanding for the Period}}
\]

*If there are preferred dividends, the amount is subtracted from net income.

4. Profit Margin

\[
\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales Revenue}}
\]

5. Fixed Asset Turnover

\[
\text{Fixed Asset Turnover Ratio} = \frac{\text{Net Sales Revenue}}{\text{Average Net Fixed Assets}}
\]

➢ Liquidity Ratios

1. Cash Ratio

\[
\text{Cash Ratio} = \frac{\text{Cash + Cash Equivalents}}{\text{Current Liabilities}}
\]

2. Current Ratio

\[
\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}
\]

3. Quick Ratio (Acid Test)

\[
\text{Quick Ratio} = \frac{\text{Cash + Short - term Investment + Accounts Receivable}}{\text{Current Liabilities}}
\]
Solvency Ratios

1. Times Interest Earned Ratio

\[
\text{Times Interest Earned Ratio} = \frac{\text{Net Income} + \text{Interest Expense} + \text{Income Tax Expense}}{\text{Interest Expense}}
\]

2. Debt-To-Equity

\[
\text{Debt-to-Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Owners' Equity}}
\]

Market Test Ratios

1. Price/Earnings (P/E) Ratio

\[
\text{Price/Earnings Ratio} = \frac{\text{Current Market Price per Share}}{\text{Earnings per Share}}
\]

Self-test Questions and Exercises

True-False Questions

1. Ratio analysis only involves relationships within a single accounting period.
2. The fixed asset turnover ratio measures management's ability to generate sales with the use of fixed assets. It is especially valuable for capital intensive companies.
3. Liquidity refers to the ability of a company to meet its currently maturing obligations, and solvency refers to the ability of a company to meet its long-term obligations on a continuing basis.
4. The higher the debt to equity ratio, the higher the financial risk of the company.
5. A company with a high price earnings ratio presents lower risk to investors.
Multiple Choice Questions

1. Which of the following is usually included in the measurement of tests of profitability?

   A) Owners' equity
   B) Average total assets
   C) Income
   D) Cash flows from operating activities

2. Consider the following information:

   | Net sales revenue | $1,850,000 |
   | Income           | $180,000   |
   | Interest expense | $12,000    |
   | Income tax expense | $30,000  |
   | Beginning common shares outstanding | 450,000 |
   | Ending common shares outstanding | 470,000 |
   | Income before extraordinary items | $340,000 |

   Compute the earnings per share to the nearest cent.
   A) $0.48.
   B) $0.39.
   C) $0.25.
   D) $0.74.

3. Consider the following information:

   | Cash                        | $45,000 |
   | Cash equivalents            | $60,000 |
   | Cash flows from operating activities | $970,000 |
Current assets $480,000  
Current liabilities $230,000  
Net credit sales $890,000  
Average net receivables $62,000

Compute the **cash ratio** to the nearest hundredth.

A) 0.46 to 1.  
B) 0.19 to 1.  
C) 2.08 to 1.  
D) 1.73 to 1.

4. Consider the following information:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total current liabilities</td>
<td>$120,000</td>
</tr>
<tr>
<td>Total long-term liabilities</td>
<td>$890,000</td>
</tr>
<tr>
<td>Ending balance of owners’ equity</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Ending balance of retained earnings</td>
<td>$420,000</td>
</tr>
<tr>
<td>Ending balance of fixed assets</td>
<td>$1,560,000</td>
</tr>
</tbody>
</table>

Compute the **debt-to-equity ratio** to the nearest hundredth.

A) 0.53.  
B) 0.57.  
C) 0.46.  
D) 0.67.

5. Which of the following ratios is computed by the equation of Cash + Cash Equivalents/Current Liabilities?

A) Quick (or acid test) ratio.  
B) Cash ratio.  
C) Current ratio.  
D) Quality of income.
Exercises

The records of Washington Company showed the following:

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average total assets</td>
<td>$230,000</td>
<td>Revenues</td>
<td>$100,000</td>
</tr>
<tr>
<td>Average total liabilities</td>
<td>130,000</td>
<td>Expenses**</td>
<td>(81,000)</td>
</tr>
<tr>
<td>Average stockholders’ equity*</td>
<td>100,000</td>
<td>Interest expense</td>
<td>(2,000)</td>
</tr>
</tbody>
</table>

Net income $  17,000

*10,000 average number of shares outstanding; current market price, $30
**Including income tax; income tax rate, 30%

Compute the following:
A. Return on assets
B. Return on equity

4.10.4 Solution to Self-test Questions and Exercises

True-False Questions

1. F (It is important for ratio analysis to consider several accounting periods to establish trends for a company. Considering ratios for only a single period can mask continuity issues.)
2. T
3. T
4. T
5. F (The company with a higher price earnings ratio presents higher risk because failure to meet future expected earnings performance will cause their price to drop sharply.)

Multiple Choice Questions

1.C
2.B
3.A
4.D
5.B

Exercises

A. ($17,000 + $2,000 x .70) ÷ $230,000 = 8%
B. $17,000 ÷ $100,000 = 17%
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