CHAPTER 2—INTRODUCTION TO FINANCIAL STATEMENTS AND OTHER FINANCIAL REPORTING TOPICS

MULTIPLE CHOICE

1. At the end of the fiscal year, an adjusting entry is made that increases both interest expense and interest payable. This entry is an application for which accounting principle?
   a. full disclosure
   b. materiality
   c. matching
   d. going concern
   e. realization

   ANS: C

2. Who is responsible for the preparation and integrity of financial statements?
   a. a cost accountant
   b. management
   c. an auditor
   d. a bookkeeper
   e. the FASB

   ANS: B

3. Which of the following is <u>not</u> an objective of the SEC's integrated disclosure system?
   a. to coordinate the Form 10-K requirements with those of the annual report
   b. to lessen the impact of the FASB
   c. to expand the management discussion of liquidity, capital resources, and results of operations
   d. to improve the quality of disclosure
   e. to standardize information requirements

   ANS: B

4. Which of the following is <u>not</u> a type of audit opinion?
   a. unqualified opinion
   b. qualified opinion
   c. adverse opinion
   d. clean opinion
   e. disclaimer of opinion

   ANS: D

5. Which of the following statements is not true?
   a. A qualified opinion or an adverse opinion may bring into question the reliability of the financial statements.
   b. A disclaimer of opinion indicates that one should not look to the auditor's report as an indication of the reliability of the statements.
   c. In some cases, outside accountants are associated with financial statements when they have performed less than an audit.
   d. A review is substantially less in scope than an examination in accordance with generally accepted auditing statements.
   e. The accountant's report expresses an opinion on reviewed financial statements.

   ANS: E

6. In addition to the balance sheet, the income statement, and the statement of cash flows, a complete set of financial statements must include:
   a. an auditor's opinion
   b. a ten-year summary of operations
   c. a note disclosure of such items as accounting policies
   d. historical common-size (percentage) summaries
   e. a list of corporate officers

   ANS: C

7. Which of the following statements is not correct concerning summary annual reports?
   a. A summary annual report omits much of the financial information included in an annual report.
   b. When a company issues a summary annual report, the proxy materials it sends to shareholders must include a set of fully audited statements and other required financial disclosures.
   c. A summary annual report generally has more nonfinancial pages than financial pages.
   d. A summary annual report is adequate for reasonable analysis.
   e. The concept of a summary annual report was approved by the Securities and Exchange Commission.

   ANS: D

8. Which of the following would not be considered a subsequent event?
   a. A major customer declares bankruptcy subsequent to the balance sheet date but prior to issuing the statements. This event was not considered on the balance sheet date.
   b. A major purchase of a subsidiary subsequent to the balance sheet date but prior to issuing the statements.
   c. Substantial debt incurred subsequent to the balance sheet date but prior to issuing the statements.
   d. Substantial stock issued subsequent to the balance sheet date but prior to issuing the statements.
   e. Hiring of employees for a new store, subsequent to the balance sheet date but prior to issuing the statements.

   ANS: E

9. Which of these statements is <u>not</u> true?
   a. Transactions must be recorded in a journal.
   b. All transactions could be recorded in the general journal.
   c. Companies use a number of special journals to record most transactions.
   d. Special journals are designed to improve record- keeping efficiency.
   e. The form of the journals are the same from industry to industry.

   ANS: E

10. Which of these statements is <u>not</u> true?
   a. Asset, liability, and stockholders' equity accounts are referred to as permanent accounts.
   b. Revenue, expense, and dividend accounts are described as temporary accounts.
   c. Temporary accounts are closed at the end of the period to retained earnings.
   d. The balance sheet will not balance until the temporary accounts are closed to retained earnings.
   e. With double-entry, each transaction is recorded twice.

   ANS: E

11. Which of the following is a type of audit opinion that a firm would usually prefer?
   a. unqualified opinion
   b. qualified opinion
   c. adverse opinion
   d. clear opinion
   e. none of the answers are correct

   ANS: A

12. Which of the following is a permanent account?
   a. dividends
   b. advertising expense
   c. building
   d. selling expense
   e. insurance expense

   ANS: C

13. Which of the following is a temporary account?
   a. advertising expense
   b. land
   c. building
   d. accounts payable
   e. bonds payable

   ANS: A

14. In terms of debits and credits, which of the following accounts have the same normal balances?
   a. accounts payable, accounts receivable, notes payable
   b. dividends, accounts receivable, notes payable
   c. advertising expense, selling expense, accounts receivable
   d. land, building, accounts payable
   e. common stock, notes payable, land

   ANS: C

15. If liabilities total $70,000 and stockholders' equity totals $50,000, then total assets must be:
    a. $20,000
    b. $80,000
    c. $120,000
    d. $30,000
    e. $30,000

    ANS: C

16. Tiffin Company had retained earnings of $50,000 at the end of last year. For the current year, income was $20,000 and dividends $15,000. What is the balance in retained earnings at the end of the current year?
    a. $85,000
    b. $45,000
    c. $55,000
    d. $60,000
    e. none of the answers are correct

    ANS: C

17. Smith Company had retained earnings of $60,000 at the end of the current year. For the current year, income was $30,000 and dividends $10,000. What was the balance in retained earnings at the end of the prior year?
    a. $30,000
    b. $40,000
    c. $60,000
    d. $30,000
    e. $70,000

    ANS: B

18. Which of the following is <u>not</u> a true statement relating to the Treadway Commission?
    a. The Treadway Commission is the popular name for the National Commission on Fraudulent Reporting.
    b. The Treadway Commission has released reports detailing internal control systems.
    c. Management's Report on Internal Control over Financial Reporting and the independent public accounting firm report to the shareholders and board of directors often refer to criteria established on internal control by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).
    d. The Treadway Commission has issued a number of recommendations for the prevention of fraud on financial reports, ethics, and effective internal controls.
    e. The Treadway Commission is a voluntary private-sector organization formed to support the Sarbanes-Oxley Act.

    ANS: E

TRUE/FALSE

1. Subsequent events are those that occur after the balance sheet date but before the statements are issued.

   ANS: T

2. A disclaimer of opinion is necessary when the exceptions to fair presentation are so material that a qualified opinion is not justified.

   ANS: F

3. The responsibility for the preparation and integrity of financial statements rests with management.

   ANS: T

4. The assets for the balance sheet must equal the liabilities and stockholders' equity.

   ANS: T

5. The retained earnings account is the link between the balance sheet and the statement of cash flows.

   ANS: F

6. A summary annual report is a condensed annual report that omits much of the financial information included in a typical annual report.

   ANS: T

7. A sole proprietorship is a legal entity separate from its owner.

   ANS: F

8. A partnership is a business owned by two or more individuals. Each owner is personally responsible for the debts of the partnership.

   ANS: T

9. A corporation is considered to be a legal entity separate and distinct from the stockholders.

   ANS: T

10. The principal financial statements of a corporation are the balance sheet, income statement, and statement of cash flows.

    ANS: T

11. A balance sheet shows the financial condition of an accounting entity for a particular period of time.

    ANS: F

12. At any point in time, assets must equal the contribution of the creditors only.

    ANS: F

13. The income statement is a summary of revenues and expenses and gains and losses, ending with net income, for a particular period of time.

    ANS: T

14. Retained earnings always shows a positive balance.

    ANS: F

15. The statement of retained earnings reconciles the beginning retained earnings balance to the retained earnings balance at the end of the current period.

    ANS: T

16. The statement of cash flows consists of two sections: cash flows from operating activities and cash flows from financing activities.

    ANS: F

17. Contingent liabilities are recorded as a liability only if the loss is considered substantial and the amount is reasonably determinable.

    ANS: F

18. The sequence of accounting procedures completed during each accounting period is called the accounting cycle.

    ANS: T

19. Transactions must be external to the company.

    ANS: F

20. Accounts store the monetary information from the recording of transactions.

    ANS: T

21. T-accounts have a left, or credit, side and a right, or debit, side.

    ANS: F

22. Several accounts could be involved in a single transaction, but the debits and credits must still be equal.

    ANS: T

23. After posting, the general ledger accounts contain the same information as in the journals, but the information has been summarized by account.

    ANS: T

24. The point of cash receipt for revenue and cash disbursement for expenses is important under the accrual basis when determining income.

    ANS: F

25. The accrual basis needs numerous adjustments at the end of the accounting period.

ANS: T

26. An adverse opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.

ANS: F

27. From the point of view of analysis, the unqualified opinion without an explanatory paragraph or explanatory language carries the highest degree of reliability.

ANS: T

28. One is unlikely to regard a qualified opinion or an adverse opinion as casting serious doubts on the reliability of the financial statements.

ANS: F

29. A review has substantially less scope than an examination in accordance with generally accepted auditing standards.

ANS: T

30. The accountant's report expresses an opinion on reviewed financial statements.

ANS: F

31. Sometimes financial statements are presented without an accompanying accountant's report.

ANS: T

32. The responsibility for the preparation and integrity of financial statements rests with the auditors.

ANS: F

33. The proxy is the solicitation sent to stockholders for the election of directors and for the approval of other corporation actions.

ANS: T

34. In practice, some of the required information in the 10-K is incorporated by reference.

ANS: T

35. A summary annual report generally has more nonfinancial pages than financial pages.

ANS: T

36. Accepted accounting principles leave ample room for arriving at different results in the short run.

ANS: T

37. Ethics can be a particular problem with financial reports.

ANS: T

38. With the expansion of international business and global capital markets, the business community and governments have shown a decreased interest in the harmonization of international accounting standards.

ANS: F

39. The IASC does not have authority to enforce its standards, but these standards have been adopted in whole or in part by many countries.

ANS: T

40. Domestic accounting standards have developed to meet the needs of international environments.

ANS: F

41. It is generally recognized that the market is more efficient when dealing with small firms that are not trading on large organized stock markets.

ANS: F

42. The market will not be efficient if it does not have access to relevant information or if fraudulent information is provided.

ANS: T

43. For consolidated statements, all transactions between entities being consolidated (i.e., intercompany transactions) must be eliminated.

ANS: T

44. The financial statements of the parent and the subsidiary are consolidated for all subsidiaries unless control is temporary or does not rest with the majority.

ANS: F

45. When a subsidiary is not consolidated, it is accounted for as an investment on the parent's balance sheet.

ANS: T

46. There are three methods of accounting for a business combination.

ANS: F

47. Accounting for a business combination must be accounted for using the purchase method.

ANS: T

48. For a business combination, the purchase method views the business combination as the acquisition of one entity by another. The firm doing the acquiring records the identifiable assets and liabilities at fair value at the date of acquisition.

ANS: T

49. The efficient market hypothesis (EMH) relates to the ability of capital markets to generate prices for securities that reflect worth.

ANS: T

50. The auditor will issue a qualified opinion when he/she has not performed an audit sufficient in scope to form an opinion.

ANS: F

51. The audit opinion of a public company is similar to an opinion for a private company except for the public company comments will be added as to the effectiveness of internal control over financial reporting.

ANS: T

52. For public companies reporting under Sarbanes-Oxley, the auditor reports on the firm's internal controls in addition to the audit report.

ANS: T

53. For public companies reporting to the SEC, the 10-K, 10-Q, 8-K, and proxy can be found at http://www.sec.gov.

ANS: T

54. Most companies consolidate the parent's and subsidiary's accounts summed.

ANS: T

55. A company must have majority voting shares of the other company in order to consolidate.

ANS: F

56. For consolidating, the FASB recognizes risks, rewards, decision-making ability and the primary beneficiary.

ANS: T

57. In 2007, the Securities and Exchange Commission announced that it would accept financial statements from foreign private issues without reconciliation to U.S. GAAP if they are prepared using IFRS as issued by the International Accounting Standards Board.
ANS: T

58. Financial statements of legally separate entities may be issued to show financial position, income, and cash flow as they would appear if the companies were a single entity.
ANS: T

PROBLEMS

1. The following are selected accounts and account balances of Gorr Company on December 31:

	Permanent (P) or Temporary (T)	Normal Balance Dr. (Cr.)
Inventory	_____	_____
Land	_____	_____
Wages Payable	_____	_____
Capital Stock	_____	_____
Retained Earnings	_____	_____
Revenues	_____	_____
Dividends	_____	_____
Advertising Expense	_____	_____

Required:
a. Indicate whether the account is a permanent (P) or temporary (T) account.
b. Indicate the normal balance in terms of debit (Dr.) or credit (Cr.).

ANS:

	Permanent (P) or Temporary (T)	Normal Balance Dr. (Cr.)
Inventory	P	Dr.
Land	P	Dr.
Wages Payable	P	Cr.
Capital Stock	P	Cr.
Retained Earnings	P	Cr.
Revenues	T	Cr.
Dividends	T	Dr.
Advertising Expense	T	Dr.

2. Listed below are several accounts or statement categories.

Account or Statement Category	Balance Sheet (BS) Income Statement (IS) Statement of Cash Flows (SCF)
Accounts Receivable	
Inventory	
Prepaid Insurance	
Sales	
Cost of Goods Sold	
Cash Flow from Investing Activities	
Notes Payable	
Interest Expense	
Tax Expense	
Taxes Payable	
Administrative Expense	
Current Assets	
Advertising Expense	
Cash Flow from Financing Activities	

Required:
In the space provided, indicate the financial statement as balance sheet (BS), income statement (IS), or statement of cash flows (SCF).

ANS:

Account or Statement Category	Balance Sheet (BS) Income Statement (IS) Statement of Cash Flows (SCF)
Accounts Receivable	BS
Inventory	BS
Prepaid Insurance	BS
Sales	IS
Cost of Goods Sold	IS
Cash Flow from Investing Activities	SCF
Notes Payable	BS
Interest Expense	IS
Tax Expense	IS
Taxes Payable	BS
Administrative Expense	IS
Current Assets	BS
Advertising Expense	IS
Cash Flow from Financing Activities	SCF

3. Below is a list of auditor's reports as well as a list of phrases describing the reports.

a. adverse
b. unqualified
c. qualified
d. reviewed
e. disclaimer
f. compiled

_____ 1. Presentation of financial information as presented by management
_____ 2. This opinion states that except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of entity in conformity with generally accepted accounting principles.
_____ 3. This opinion states that the financial statements do not present fairly the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.
_____ 4. Consists principally of inquiries made to company personnel and analytical procedures applied to financial data.
_____ 5. The auditor does not express an opinion on the financial statements.
_____ 6. This opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.

Required:
In the space provided, place the appropriate letter identifying each type of auditor's report.

ANS:

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

4. Listed below is information related to several adjusting entry situations. Assume that the accounting year ends on December 31.

   1. $3,000 paid for insurance on October 1 for a one-year period (October 1 - September 30). This transaction was recorded as a debit to prepaid insurance ($3,000) and a credit to cash ($3,000).
   2. Interest on bonds payable in the amount of $500 has not been recorded at December 31.
   3. Rent expense in the amount of $1,200 was paid on November 1. This transaction was recorded as a debit to rent expense ($1,200) and a credit to cash ($1,200). This rent payment was for the period November 1 to January 31.

   Required:
   Record the original entries and the adjusting entries using T-accounts.

   ANS:

Prepaid Insurance

10-1	3,000	12-31	750

Cash

		10-1	3,000
		11-1	1,200

Insurance Expense

12-31	750		

Interest Expense

12-31	500		

Interest Payable

		12-31	500

Prepaid Rent

12-31	400		

Rent Expense

11-1	1,200	12-31	400

5. Listed below is information related to several entry situations. Assume that the accounting year ends on December 31.

   1. The company acquired land for $100,000 issuing a note payable.
   2. Equipment is acquired for $30,000 cash.
   3. Memberships were sold for $20,000, accepting accounts receivables.
   4. Salaries of $15,000 were paid in cash.
   5. Utilities were paid in cash in the amount of $5,000.

   Required:
   Record these entries using T-accounts. Use the number of the transaction in lieu of a date for identification purposes.

   ANS:

Land	
(1) 100,000	

Notes Payable	
	(1) 100,000

Equipment	
(2) 30,000	

Cash	
	(2) 30,000
	(4) 15,000
	(5) 5,000

Membership Revenue	
	(3) 20,000

Accounts Receivable	
(3) 20,000	

Salaries	
(4) 15,000	

Utilities Expense	
(5) 5,000	

6. Monroe Company recorded these transactions during the year. Monroe Company has an accounting year-end of December 31.

   1. An insurance policy was recorded on July 1 in the amount of $5,000, recorded as prepaid insurance. The policy provides liability protection for a one-year period.
   2. Monroe Company rents property for $1,000 per month. Rent revenue has not been received for December.
   3. Income taxes of $8,000 need to be recorded for December.
   4. A promissory note payable of $10,000 was recorded on October 1. At December 31, interest payable of $200 was owed.
   5. At December 31, salary expense of $800 was payable.

   Required:
   Record the adjusting entries at December 31 using T accounts. Use the number of the transaction in lieu of a date for identification purposes.

   ANS:

Prepaid Insurance	
	(1) 2,500

Insurance Expense	
(1) 2,500	

Rent Receivable	
(2) 1,000	

Rent Revenue	
	(2) 1,000

Income Taxes Payable	
	(3) 8,000

Income Tax Expense	
(3) 8,000	

Interest Payable	
	(4) 200

Interest Expense	
(4) 200	

Salary Payable	
	(5) 800

Salary Expense	
(5) 800	

7. Danner Company reported the following amounts in its 2006 annual report.

Net income for 2006	$ 8,450
Dividends declared and paid in 2006	?
Retained earnings, December 31, 2005	82,000
Retained earnings, December 31, 2006	90,000

Required:
Solve for dividends declared and paid in 2006 and prepare a statement of retained earnings for Danner Company for the year ended December 31, 2006. (Include the proper heading.)

ANS:

Danner Company
Statement of Retained Earnings
For the Year Ended December 31, 2006

Retained earnings, December 31, 2005	$82,000
Net income for 2006	8,450
Less dividends declared and paid in 2006	450
Retained earnings, December 31, 2006	$90,000

8. Users of financial reports rely on those reports to aid them in making decisions.

Required:
Determine the financial statement where the user would most likely find the answer to the question. Select between the income statement, balance sheet, and statement of stockholders' equity.

a. User: Management
   Question: How did selling expense compare to that of last year?
b. User: Supplier of inventory
   Question: How much does the company currently owe in accounts payable?
c. User: Banker
   Question: How much debt does the company have on its books?
d. User: Stockholder
   Question: How much did the company pay in dividends this past year?

ANS:

a. income statement
b. balance sheet
c. balance sheet
d. statement of stockholders' equity

9. Dorset Company began the year with total assets of $400,000 and total liabilities of $300,000.

Required:
Using this information and the accounting equation, answer each of the following independent questions.

a. What was Dorset's stockholders' equity at the beginning of the year?
b. Assuming Dorset Company's assets increased by $50,000 and its total liabilities increased by $30,000 during the year, what would be the amount of stockholders' equity at the end of the year?
c. Assuming Dorset's total assets increased to $500,000 and its stockholders' equity increased to $150,000, what would be the amount of total liabilities at the end of the year?

ANS:
a. $100,000
b. $120,000
c. $350,000

10. Listed below is information related to the accounts of Jasper Company.

	Case 1	Case 2	Case 3
Total assets, end of period	$60,000	$_____	$90,000
Total liabilities, end of period	_____	20,000	30,000
Common stock, end of period	20,000	25,000	25,000
Retained earnings, beginning of period	25,000	20,000	30,000
Net income for the period	10,000	5,000	_____
Dividends for the period	3,000	5,000	4,000

Required:
Fill in the blank with the appropriate dollar amount.

ANS:

Case 1	Total liabilities, end of period	$ 8,000
Case 2	Total assets, end of period	$65,000
Case 3	Net income for the period	$ 9,000

11. Listed below are several terms related to financial statements.

a. income statements
b. notes
c. balance sheet
d. statement of cash flows
e. statement of retained earnings (reconciliation of retained earnings)

Required:
Match the letter that goes with each term.

_____ 1. Shows the financial condition of an accounting entity as of a particular date.
_____ 2. Details the inflows and outflows of cash during a specified period of time.
_____ 3. Summarizes the results of operations for a particular period of time.
_____ 4. Links the balance sheet to the income statement.
_____ 5. Used to present additional information on items included in the financial statements and to present additional financial information.

ANS:
1. c
2. d
3. a
4. e
5. b

12. Consider the rules for increasing and decreasing the various types of accounts, as listed below.

Type of Account	Debit	Credit
Asset	_____	_____
Liability	_____	_____
Owner's equity	_____	_____
Revenue	_____	_____
Expense	_____	_____
Dividends	_____	_____

Required:
Indicate increase or decrease following the debit and credit rules for the type of account.

ANS:

Type of Account	Debit	Credit
Asset	Increase	Decrease
Liability	Decrease	Increase
Owner's equity	Decrease	Increase
Revenue	Decrease	Increase
Expense	Increase	Decrease
Dividends	Increase	Decrease

13. Indicate in days, the Form 10-K deadline for each category of filers.

Case 1: Large accelerated filer ($700 million or more market value)

Case 2: Accelerated filer ($75 million or more and less than $700 million market value)

Case 3: Non-accelerated filer (less than $75 million market value)

Case 1: _____

Case 2: _____

Case 3: _____

ANS:

Case 1: ___60____

Case 2: ___75____

Case 3: ___90____