

## **Chapter 2--Financial Background: A Review of Accounting, Financial Statements, and Taxes**

*Student:* \_\_\_\_\_

1. The income statement is intended to inform the reader of:
  - A. the overall financial condition of the firm at a point in time.
  - B. how much the firm has earned during an accounting period.
  - C. how much income has been distributed to shareholders.
  - D. the cash flow generated by the firm over a period of time.
  
2. Which of the following does not cause accounting profit and cash flow to differ?
  - A. Depreciation
  - B. Sales made on credit
  - C. Payroll expense
  - D. Inventory purchased, but not yet sold
  
3. Differences between net income and cash flow come from:
  - A. accounts receivable.
  - B. depreciation.
  - C. short term securities.
  - D. a and b
  
4. Which of the following causes accounting profit and cash flow to differ?
  - A. Payroll expense
  - B. Cash sales
  - C. Depreciation
  - D. Inventory purchased and sold
  
5. The accounting matching principle dictates that we:
  - A. match expenses up with the employees that incur them.
  - B. prorate the cost of an asset over its expected economic life.
  - C. invoice the customer as soon as the merchandise is produced.
  - D. All of the above

6. Depreciation, from an accounting viewpoint, can best be thought of as:

- A. accounting for the physical deterioration of an asset.
- B. writing off assets like patents, trademarks, and copyrights.
- C. matching the carrying value of the asset with the estimated net realizable value of the asset.
- D. allocating the cost of the asset to the periods in which it gives service.

7. Which of the following causes net income to differ from cash flow?

- A. Depreciation
- B. The purchase of inventory on credit
- C. The sale of merchandise on credit
- D. All of the above

8. Managers whose bonuses are based on the income of the firm tend to overstate the value of accounts receivable and inventory with the following result:

- A. the firm's value is less than it is held out to be.
- B. profit is more than it is held out to be.
- C. the firm's value is more than it is held out to be.
- D. liabilities are less than they are held out to be.

9. The process of totaling all of the transactions for a recent period and bringing a company's records up to date is referred to as:

- A. closing the books.
- B. double entry.
- C. ending the period.
- D. starting over.

10. Which of the following does not appear on the income statement?

- A. Cost of Goods Sold
- B. Depreciation Expense
- C. Accumulated Depreciation
- D. Earnings Before Interest and Tax
- E. Gross Margin

11. Holding all other variables constant, an increase in net income can be caused by a decrease in:

- A. depreciation expense.
- B. the cost ratio.
- C. the tax rate.
- D. Both a and c
- E. a, b, and c are correct.

12. Holding all other variables constant, an increase in COGS will lead to:

- A. a decreased cost ratio.
- B. a higher gross margin.
- C. lower net income.
- D. paying more in taxes.

13. The income statement line item that shows the performance of operating activities without consideration of financing is:

- A. net income.
- B. EBIT.
- C. EBT.
- D. total assets.

14. EBIT is also called:

- A. net profit.
- B. operating profit.
- C. pretax profit.
- D. gross profit.

15. Which of the following equations is correct?

- A.  $\text{Dividends} = \text{Net income} - \text{Change in Retained Earnings}$
- B.  $\text{Dividends} = \text{Net income} + \text{Change in Retained Earnings}$
- C.  $\text{Dividends} = \text{Change in Retained earnings} - \text{Net income}$
- D. None of the above

16. Which of the following appears on the income statement?

- A. Accounts receivable
- B. Accumulated depreciation
- C. Depreciation expense
- D. Long-term debt

17. Which of the following is not included in the calculation of current assets?

- A. Accruals
- B. Accounts Receivable
- C. Allowance for Doubtful Accounts
- D. Cash
- E. Inventory

18. Which of the following does not appear on the right hand side of the balance sheet?

- A. Current Liabilities
- B. Accounts Receivable
- C. Retained Earnings
- D. Long Term Debt
- E. Total Equity

19. Net working capital can be referred to as:

- A. total assets minus current liabilities.
- B. current assets minus total liabilities.
- C. cash minus current liabilities.
- D. current assets minus current liabilities.

20. When an account is determined to be uncollectible, "writing off" the bad debt *usually* involves:

- A. reducing the receivables balance and the bad debt reserve by the amount of the account.
- B. writing a letter to the customer demanding payment.
- C. "expensing" the amount deemed uncollectible.
- D. All of the above

21. Inventory in a manufacturing firm differs from that in a retailing company because it includes:

- A. an additional category referred to as materials.
- B. finished goods inventory.
- C. "work in process" inventory.
- D. All of the above

22. The procedure for a payroll accrual requires identifying the portion of the payroll that falls after the payday but within the accounting period, and:

- A. paying employees that amount.
- B. recording the amount as an unusual cost.
- C. providing for both the expense and the liability for the unpaid payroll with an accrual entry when the books are closed.
- D. preparing a supporting note on the financial statement as to the amount of the unpaid payroll.

23. Accounting accruals are important in:

- A. accounting for depreciation.
- B. providing for unpaid payroll, rent, interest, and other expenses that relate to the current accounting period.
- C. drawing checks on the last day of the current accounting period to properly reflect expense in that period.
- D. providing for bad debts that may eventually be deemed uncollectible.

24. The net book value of an asset is:

- A. original cost less the current year's depreciation expense.
- B. original cost less accumulated depreciation.
- C. current market value of the asset less associated selling expense.
- D. current market value of the asset.

25. Which of the following will increase equity?

- A. An increase in dividends paid
- B. Issuance of new stock
- C. An increase in retained earnings from net income
- D. Both b & c
- E. All of the above

26. The two forms of equity infusion are:

- A. long term debt and common stock.
- B. direct investment in the company's stock and the retention of earnings.
- C. net working capital and accumulated depreciation.
- D. preferred stock and long-term debt.
- E. dividends and retained earnings.

27. Which of the following would cause a decrease in cash?

- A. Lengthening the time it takes to collect receivables from 15 to 30 days
- B. Selling fixed assets for more than book value
- C. An increase in accrued salaries expense
- D. Paying suppliers in 60 days versus 45 days

28. Which of the following is correct?

- A. Beginning equity + Net income – Dividends – Stock = Ending equity
- B. Beginning equity + Net income – Dividends + Stock = Ending equity
- C. Net income – Dividends – Stock = Ending equity
- D. Beginning equity – Net income – Dividends + Stock = Ending equity

29. When a receivable is written off as uncollectible, entries will usually be made into which accounts?

- A. Bad debt reserve
- B. Bad debt expenses
- C. Accounts receivable
- D. Both a and b
- E. Both a and c

30. Inventory reserve is conceptually similar to:

- A. bad debt expense.
- B. work in process.
- C. allowance for doubtful accounts.
- D. None of the above

31. The matching principle says:

- A. assets costs should be recorded in the period in which they are purchased.
- B. recognition of an asset's cost should match its service life.
- C. the customer should be invoiced as soon as merchandise is produced.
- D. only cash transactions should be recorded in the accounting records.

32. If their bonuses are based on net income, managers may:

- A. postpone writing off bad debts.
- B. increase depreciation.
- C. postpone dividend payments.
- D. hold more inventory.

33. Which of the following is a current asset?

- A. Accounts payable
- B. Accounts receivable
- C. Revenue
- D. Accumulated depreciation

34. Which of the following types of inventory will be held by a retail company?

- A. Supplies
- B. Finished goods
- C. Work in process
- D. Raw materials

35. During the last year Alpha Co had Net Income of \$150, paid \$20 in dividends, and sold new stock for \$40. Beginning equity for the year was \$700. Ending Equity was:

- A. \$830.
- B. \$840.
- C. \$850.
- D. \$870.

36. Uncollected receivables are normally:

- A. depreciated.
- B. expensed.
- C. not reported.
- D. written off.

37. Management is prone to overstate:

- A. accounts receivable and inventory.
- B. accounts receivable, but not inventory.
- C. inventory, but not accounts receivable.
- D. neither accounts receivable nor inventory.

38. Which of the following is a consumption tax?

- A. Ad valorem tax
- B. Real estate tax
- C. Excise tax
- D. Personal property tax

39. The tax schedule for married couples filing jointly:

- A. Results in less tax than would be paid by a single person if only one spouse works.
- B. Saves on taxes regardless of whether one or both spouses work.
- C. Results in most two income families paying more tax than if they were single.
- D. a and c

40. In order to compare the yields on municipal and corporate bonds the investor must restate the yield of either the taxable corporate bond to an after tax basis or the municipal bond to a pretax equivalent because:

- A. corporate bonds are tax free.
- B. municipal bonds are tax free and investors must compare rates on an equal basis.
- C. a municipal bond is typically safer than a taxable corporate bond.
- D. such restatements are not necessary for most taxpayers.

41. Taxable income is:

- A. total income excluding exempt items less deductions and exemptions.
- B. gross income less deductions.
- C. the sum of everything a person makes.
- D. gross income less state taxes, mortgage interest, and charitable contributions.

42. The marriage penalty refers to the fact that:

- A. married people have less freedom than their single friends.
- B. it generally costs more money to support a family than two single people.
- C. two-income married couples generally pay more taxes than they would if they were single and had the same two incomes.
- D. married people generally work harder than single people.

43. The relevant tax rate for investment decisions is the:

- A. average rate.
- B. lowest rate.
- C. marginal rate.
- D. effective rate.

44. Investors pay federal income taxes on the interest earned on bonds issued by:

- A. cities.
- B. counties.
- C. states.
- D. the federal government.

45. In addition to raising money, the government uses the tax system to:

- A. promote a larger and more comprehensive government authority.
- B. incentivize desirable behavior on the part of taxpayers.
- C. support our position as the world's strongest nation.
- D. keep the nation growing as rapidly as possible.

46. Deductions are expenditures that can be subtracted in calculating taxable income. Which of the following is a deduction?

- A. Dependency exemption
- B. Credit card interest
- C. Interest on municipal bonds
- D. Donations to charities



47. The corporate tax schedule seems not to be progressive. Which statement is correct?

- A. The idea of progressive taxes refers only to individuals, the corporate schedule is intentionally not progressive.
- B. The corporate schedule is indeed not progressive because the rates do not increase steadily as income increases.
- C. Corporate Taxes are progressive because the more money a corporation makes, the more taxes it pays.
- D. Corporate taxes are conceptually progressive. The ups and downs in the schedule are designed to take away the benefit of low early rates for companies with large incomes.

48. Which of the following best describes how corporations are taxed on dividend income?

- A. Like individuals, corporations are taxed on all dividends received.
- B. Fifty percent of dividend income received by corporations is tax exempt.
- C. Varying amounts of dividend income received by corporations are tax exempt, depending on the percent of the paying corporation that the receiving corporation owns.
- D. In order to avoid triple taxation of earnings, dividend income received by one corporation from another in which it owns twenty percent stock is 100% tax exempt.

49. The federal tax system allows firms that have a tax loss in a year to apply the loss against past and future earnings. The process is referred to as loss carrybacks and carryforwards and permits the loss to be:

- A. carried forward for 20 years after having been carried back evenly over the past two years.
- B. carried back or forward for as many as 20 years.
- C. spread evenly over the last two years and evenly over the next 20 years.
- D. carried back two years and forward as many as 20 years.

50. If a firm that's doing very well pays the same return to equity and debt shareholders, and needs to raise more money, it may be wise to use debt because:

- A. interest is tax deductible resulting in a lower cost to the firm.
- B. Equity is the less desirable source of capital.
- C. borrowing is always less of an effort than raising additional equity capital.
- D. All of the above

51. Three years ago a piece of equipment was purchased for \$10,000. Assuming an eight-year life and straight-line depreciation, financial statements for the third year will show:

- A. depreciation expense of \$3,000 on the income statement, and accumulated depreciation of \$3,000 on the balance sheet.
- B. depreciation expense of \$1,250 on the income statement, and accumulated depreciation of \$3,000 on the balance sheet.
- C. depreciation expense of \$1,250 on the income statement, and accumulated depreciation of \$3,750 on the balance sheet.
- D. depreciation expense of \$1,250 on the income statement, and accumulated depreciation of \$1,250 on the balance sheet.

52. Selected accounts are listed below. How much is the firm's operating income?

Accrued payroll	\$ 2,000
Sales	45,000
Cost of goods sold	26,000
Interest expense	1,000
Expenses (other than interest)	8,000

- A. \$8,000
- B. \$10,000
- C. \$9,000
- D. \$11,000

53. Wessel Corp. plans to sell 1,000 units in 2005 at an average sale price of \$45 each. Cost of goods sold will be 40% of the sale price. Depreciation expense will be \$3,000, interest expense \$2,500, and other expenses will be \$4,000. Wessel's tax rate is 20%. What will Wessel Corp's net income be for 2005?

- A. \$ 3,500
- B. \$ 6,800
- C. \$14,000
- D. \$16,400
- E. \$28,400

54. Three years ago a machine was purchased for \$5,000. Assuming a ten-year life and straight line depreciation with a no salvage value, which of the following will appear on the income statement and balance sheet respectively after four years?

- A. Depreciation expense of \$2,000, accumulated depreciation of \$2,000.
- B. Depreciation expense of \$500, accumulated depreciation of \$2,000.
- C. Accumulated depreciation of \$2,000, depreciation expense of \$500.
- D. Accumulated depreciation of \$500, depreciation expense of \$2,000.
- E. Depreciation expense of \$1,500, accumulated depreciation of \$500.

55. Gowen, Inc. began the year with equity of \$1,000,000 and 100,000 shares of stock outstanding. During the year the firm paid a dividend of \$1.50 per share. Year-end equity was \$1,100,000. Assuming no other factors impacted equity, what was Gowen, Inc.'s net income for the year?

- A. \$100,000
- B. \$150,000
- C. \$200,000
- D. \$250,000
- E. \$300,000

56. Albert Corp. bought a machine for \$10,000 thirteen years ago. It has been depreciated on a straight line basis over a 20 year life with no salvage value. The firm just sold the machine for \$6,000. How much gain/loss should be reported on the sale?

- A. \$4,000 loss
- B. \$2,500 loss
- C. No gain or loss should be recorded.
- D. \$2,500 gain
- E. \$4,000 gain

57. The following items are components of a firm's balance sheet. How much is the firm's working capital (net working capital)?

Cash	\$ 2,000
Long-term debt	10,000
Inventory	12,000
Owners' equity	62,000
Accounts payable	8,000
Accruals	1,500
Accumulated depreciation	6,000
Accounts receivable	14,000

- A. \$14,500
- B. \$ 2,500
- C. \$18,500
- D. \$12,500

58. The following items are components of a traditional balance sheet. How much is the total equity of the firm?

Long-term debt	\$ 12,000
Common stock	15,000
Accounts payable	8,000
Paid in excess	6,000
Accrued interest payable	1,500
Plant and equipment	60,000
Retained earnings	28,000
Accounts receivable	22,000

- A. \$62,500
- B. \$49,000
- C. \$93,000
- D. \$97,000

59. The following items are components of a traditional balance sheet. How much are the total assets of the firm?

Plant and equipment	\$ 42,000
Common stock	15,000
Cash	8,000
Inventory	21,000
Bad debt reserve	6,000
Paid in excess	6,000
Accumulated depreciation	28,000
Accounts receivable	22,000

- A. \$87,000
- B. \$65,000
- C. \$59,000
- D. \$93,000

60. Belvedere, Inc. has an annual payroll of \$250,000. The firm pays employees every two weeks on Friday afternoon. Last month, the books were closed on the Thursday after payday. How much is the payroll accrual at the end of the month? (Round to nearest \$)

- A. \$2,852
- B. \$3,846
- C. \$4,780
- D. \$5,119

61. The Johnson Company bought a truck costing \$60,000 two years ago. The truck's estimated life was six years at the time of purchase. It was accounted for by using straight line depreciation with zero salvage value. If the truck was sold yesterday for \$65,000, what is the capital gain that must be reported on the sale of the truck?

- A. \$20,000
- B. \$25,000
- C. \$30,000
- D. \$35,000
- E. \$40,000

62. A firm had a piece of machinery that cost \$7,000 when new and has accumulated \$4,500 in depreciation. If the machine is sold for \$4,000, which of the following is true?

- A. The firm has a taxable gain of \$4,000 on the sale of the machine
- B. The firm has a taxable gain of \$1,500 on the sale of the machine
- C. The firm has a deductible loss of \$3,000 on the sale of the machine
- D. The firm has a taxable gain of \$7,000 on the sale of the machine

63. Grass Enterprises just closed a good year. It had Sales of \$10 million, EBIT of \$1 million and Net Income of \$500,000. The firm also paid dividends of \$150,000 during the year. If Grass started the year with equity of \$900,000, what will its year ending equity be?

- A. \$1,900,000
- B. \$1,400,000
- C. \$1,250,000
- D. \$850,000

64. Exxon Corp. bought an oil rig exactly 6 years ago for \$100,000,000. Exxon depreciates oil rigs straight line over 10 years assuming no salvage value. The rig was just sold to British Petroleum for \$30,000,000. What Capital Gain/Loss will Exxon report on this transaction?

- A. Gain of \$30,000,000
- B. Gain of \$10,000,000
- C. Loss of \$10,000,000
- D. Loss of \$30,000,000

65. Ben bought an ice cream machine 2 years ago for \$8,000. The depreciation life for ice cream machines is 4 years. Ben uses straight line depreciation and a convention of taking one-half year's depreciation in the first year. Ben just sold his machine to Jerry for \$6,000. What will be Ben's Capital Gain/(Loss) on this transaction?

- A. \$1,000
- B. \$2,000
- C. \$5,000
- D. (\$2,000)

66. Toys For U, Inc. just purchased a new asset costing \$500,000. The machine will be depreciated straight-line over a 10-year period using the convention of taking a half year's depreciation in the first year. Given the following information about old assets the firm already had, calculate net fixed assets at year end.

Gross Fixed Assets	\$2,000,000
Accumulated Depreciation	\$960,000
Continuing Annual Depreciation Expense	\$240,000

- A. \$765,000
- B. \$925,000
- C. \$1,275,000
- D. \$1,600,000

67. Selected financial statement accounts are as follows. How much is the firm's ending equity?

Income for the year	\$25,000
Dividends paid	6,000
Beginning equity for the year	56,000
Additional stock sold	22,000

- A. \$103,000
- B. \$97,000
- C. \$19,000
- D. \$85,000

68. The Tappan family has taxable income of \$50,000. Tax tables indicate that the first \$20,000 of income will be taxed at 24% and all income above \$20,000 will be taxed at 30%. What are the Tappan's marginal and average tax rates?

- A. Marginal = 29.8%; Average = 30.0%
- B. Marginal = 28.2%; Average = 27.6%
- C. Marginal = 30.0%; Average = 30.0%
- D. Marginal = 30.0%; Average = 27.6%
- E. Marginal = 24.0%; Average = 30.0%

69. The following is a listing of tax considerations for a family. How much is the family's taxable income?

3 exemptions	\$ 3,050	per exemption
Salary	45,000	
Real estate taxes	5,000	
Interest from savings account	1,500	
Interest from municipal bond	2,000	
Interest on mortgage	3,000	
Contributions to church	1,500	
Loss on sale of stock held for 3 years	6,000	

- A. \$25,800
- B. \$24,850
- C. \$30,800
- D. \$24,300

70. The following tax schedule applies to an individual. Her taxable income is \$40,000. How much is her total tax?

- 10% of the first \$10,000
- 15% of the next \$15,000
- 25% of the next \$10,000
- 35% of the next \$20,000

- A. \$8,500
- B. \$10,000
- C. \$7,500
- D. \$7,000

71. The following is a listing of tax considerations for a family. How much is the their taxable income?

2 exemptions	\$ 3,050	per exemption
Salary income of husband	40,000	
Real estate taxes	4,000	
Interest from savings account	800	
Interest on mortgage	2,800	
Contributions to church	600	

- A. \$36,800
- B. \$23,200
- C. \$27,300
- D. \$24,800

72. Assume a municipal bond is issued by the State of New York. Its yield is stated at 6%. A taxable corporate bond of equivalent quality is yielding 9%. You are in the 35% tax bracket and your son is in the 10% tax bracket. Which would be the correct investment strategy for both you and your son?

- A. You and your son should acquire the municipal bond.
- B. Your son should acquire the municipal bond, but you should acquire the corporate bond.
- C. You and your son should acquire the corporate bond.
- D. Your son should acquire the corporate bond, but you should acquire the municipal bond.

73. A corporate bond is yielding 9%. You are in the 35% tax bracket. What is the after tax yield on the bond?

- A. 5.85%
- B. 8.10%
- C. 3.90%
- D. 12.15%

74. Assume Corporation A owns 51% of Corporation B. If Corporation A received \$1,000,000 in dividends from Corporation B, how much would be taxable to Corporation A?
- A. \$510,000
  - B. \$800,000
  - C. \$200,000
  - D. \$0
75. Depreciation expense of \$2,000.00 will cause:
- A. accounts receivable to be reduced by \$2,000.00.
  - B. cash to be reduced by \$2,000.00.
  - C. accumulated Depreciation to increase by \$2,000.00.
  - D. accounts Payable to increase by \$2,000.00.
76. Which of the following is not part of working capital?
- A. Accumulated depreciation
  - B. Accounts Payable
  - C. Accounts Receivable
  - D. Inventory
77. An accrual is best defined as:
- A. a completed transaction that results in a liability.
  - B. an accumulation of a liability in regard to an incomplete transaction.
  - C. a completed transaction that results in an asset.
  - D. an expense paid in advance.
78. Which is equivalent to EBIT assuming the firm has no leverage?
- A. EBT
  - B. Net income
  - C. Net income + Depreciation
  - D. Gross Margin + Depreciation
79. Which of the following is a tax deductible expense?
- A. Repayment of the principle portion of a loan
  - B. Dividends
  - C. The purchase of inventory
  - D. Depreciation



80. When must a vendor be paid in full under the terms of 2/10, n. 30?

- A. 10 days from today
- B. On February 10th
- C. On the 30th of the current month
- D. 30 days from today

81. Retained earnings are:

- A. a liability.
- B. profits that have not been distributed to shareholders as dividends.
- C. the equivalent of stock.
- D. the same as cash.

82. Which of the following is not a common tax base?

- A. Income
- B. Wealth
- C. Marital status
- D. Consumption

83. If the state tax rate is 20% and the federal tax rate is 30%, what is the total effective tax rate?

- A. 34%
- B. 50%
- C. 44%
- D. 37%

84. Why would a corporation purchase the stock of another corporation?

- A. To prevent double taxation of its shareholders
- B. Because dividends received by a corporation are partially tax exempt
- C. It is equivalent to a tax carried forward
- D. It is equivalent to a tax carried back

85. The usefulness of financial statements in assessing the investment value of securities is *always* somewhat limited because:

- A. the information in financial statements more subjective rather than objective.
- B. companies are not always honest about their figures.
- C. past performance may not be indicative of future performance.
- D. the information is often confusing.

86. The biggest difference between the income statement and the balance sheet is:

- A. the income statement shows incoming deposits, while the balance sheet shows account balances from the bank.
- B. the income statement is submitted to the government, while the balance sheet is shown to investors.
- C. the income statement is always more accurate than the balance sheet.
- D. the balance sheet represents stocks of cash at a point in time, while the income statement reflects flows of cash over a time period.

87. The term “Cash” on a financial statement differs from the common definition of cash in that

- A. companies do not carry cash on hand and therefore do not use the term.
- B. cash refers to the currency a company has on hand and not to any other assets.
- C. cash is not considered an asset because of its highly liquid state.
- D. cash refers checking account balances as well as currency.

88. The accounts receivable balance can be misleading because:

- A. it may contain substantial amounts which will never be collected.
- B. the figures represent money that is incoming as opposed to tangible assets.
- C. costumers often delay payment which blows up the balance.
- D. it is not adjusted for the bad debt reserve.

89. The bad debt reserve represents:

- A. money that will be paid by the company.
- B. money that will be paid by customers.
- C. the fact that not all receivables are collected in the normal course of business.
- D. insurance against bad debts.

90. Overstated accounts include:

- A. items that will never be realized as cash.
- B. items that were recorded twice.
- C. transactions that are not recorded in both assets and liabilities.
- D. money that will be collected at year end.

91. If an inventory item has a base cost to the company of \$50, and requires three hours of labor at \$15/hr. to be turned into a salable item, the value of that piece of inventory is at least:

- A. \$65.
- B. \$165.
- C. \$95.
- D. \$45.

92. Depreciation matches the recognition of a long lived asset's cost with its service life. An example of this kind of asset would be:
- A. office supplies for a private school.
  - B. raw materials for a textile plant.
  - C. phone jacks for an electronics store.
  - D. machinery for a factory.
93. An asset still in use beyond its life estimate is said to be:
- A. a good investment.
  - B. fully depreciated.
  - C. fully functional.
  - D. in poor condition.
94. In most companies, the bulk of accounts payable arises from:
- A. buying inventory on credit.
  - B. selling inventory on credit.
  - C. buying airline tickets for traveling employees on credit.
  - D. customers paying off old bills.
95. Retained earnings represents:
- A. money paid to owners, stockholders, and executives.
  - B. funds a company can draw on in time of need.
  - C. profits that have been re-invested in the company.
  - D. income the government holds in trust for the company.
96. The most common term for a consumption tax is:
- A. wealth tax.
  - B. progressive tax.
  - C. sales tax.
  - D. income tax.
97. Which statement is true?
- A. Beginning equity + net income = ending equity
  - B. Beginning equity + net income – dividends = ending equity
  - C. Beginning equity + net income – dividends + new stock sold = ending equity
  - D. All of these statements are true.

98. \_\_\_\_\_ stock is an equity security that has some of the characteristics of debt.

- A. Common
- B. Equity
- C. Preferred
- D. Capital

99. The three most important financial statements are the balance sheet, income statement, and statement of retained earnings.

True False

100. A business's financial statements are numerical representations of what it is physically doing.

True False

101. To many people, income is their paycheck, but in accounting it is typically viewed as the excess of revenue received over costs and expenses.

True False

102. All entries in the accounting books must be made by the last day of the accounting period so that the firm may close their books.

True False

103. The double entry system of accounting breaks every entry into two parts each affecting a different account.

True False

104. The income statement reflects flows of money over a period of time. The balance sheet represents stocks of money at a point in time.

True False

105. EBIT is earnings before income taxes.

True False

106. Cost (of goods sold) includes only items that are closely related to production.

True False

107. In a manufacturing firm, there are two inventory accounts, called raw materials and finished goods.

True False

108. The traditional income statement is intended to measure profits by identifying cash flows in and out of the firm over an accounting period.

True False

109. EBIT (earnings before interest and taxes) is the earnings measure designed to provide information on operational performance.

True False

110. A decrease in financial leverage results in a larger tax liability because interest is tax deductible.

True False

111. The income statement measures the flow of funds in and out of the firm over a period of time.

True False

112. EBIT is a business's profit before consideration of financing charges.

True False

113. EBIT shows the profitability of operations after considering financing.

True False

114. Accounts payable is listed as a liability and therefore, by definition, requires the payment of interest by the borrower.

True False

115. Accounts receivable represents credit sales that have not yet been paid by customers.

True False

116. Generally, merchandise is sold on credit under terms such as 2/10, net 30, meaning the buyer may deduct 10% from the bill if he pays within 2 days or pay the full amount within thirty days.

True False

117. The balance sheet can be thought of as a listing of all of sources and uses of cash over a specific period of time.

True False

118. Leverage is the use of equity financing.

True False

119. Net book value is equal to market value less accumulated depreciation.

True False

120. Vendors extend trade credit when they deliver product without demanding immediate payment.

True False

121. If machinery that cost \$8,000 when new, has accumulated depreciation of \$4,500, and is sold for \$4,000, the gain recognized on the sale would be \$4,000.

True False

122. Although depreciation is a noncash expense, the government still allows the deduction on the firm's tax return.

True False

123. Leverage means using borrowed money to enhance the return on an equity investment.

True False

124. The tax system taxes capital gains more aggressively than ordinary income.

True False

125. Preferred stock is referred to as a cross between debt and common equity because it has some characteristics of each.

True False

126. Wealth Taxes are levied by cities and counties on the value of real estate. They are also called *ad valorem* taxes.

True False

127. The government uses the tax system to collect revenue and to incentivize people to act in ways it deems beneficial.

True False

128. A progressive tax system taxes incremental income at progressively higher rates.

True False

129. Congress intended preferential tax treatment on capital gains, recognizing that offering an incentive to capital investments is healthy for the economy.

True False

130. A taxpayer's average rate is the rate that will be paid on the next dollar of income.

True False

131. Municipal bonds are debt obligations of the states, municipalities and political subdivisions. They are exempt from federal taxation

True False

132. The taxation of proprietorships is about the same as that of corporations.

True False

133. A company has a loss of \$15,000 this year, a profit of \$3,000 last year, a profit of \$8,000 two years ago, and another profit of \$2,000 three years ago. It makes sense to file amended returns for the last three years.  
True False

134. The corporate tax table seems dissimilar to individual tax tables in that corporate rates are not always increased as income increases.  
True False

135. The corporate tax system takes away the benefit of low rates on early income as income increases.  
True False

136. In the corporate tax system, higher-income taxpayers pay targeted rates on their whole incomes.  
True False

137. One of the most significant exemptions for most people is interest on a home mortgage.  
True False

138. *Match the following:*

1. Retained earnings	The accumulated earnings of a company that have not been distributed to shareholders as dividends.	_____
2. Dividends	Earnings distributed to a firm's owners	_____
3. Paid in excess	The amount paid for stock above its par value	_____
4. Common stock	The par value of outstanding stock	_____

139. If it makes tax sense to finance businesses with debt, why do firms typically borrow less than half of their capital, i.e., what are the negatives of debt financing?



140. The corporate tax system appears not to be progressive, but in fact it's more progressive than the personal system. Explain.

141. The tax treatment of capital gains is a big political issue. Republicans generally favor lower rates on capital gains while Democrats do not. Why is the issue so politically sensitive?

142. During the past year, Albert Corporation had  
sales of \$5 million,  
cost of goods sold of \$2.7 million,  
operating expense of \$1.3 million, and  
interest expense of \$0.5 million.

During the year Albert  
paid a preferred stock dividend of \$100,000  
paid a common stock dividend of \$150,000 and  
paid off debt of \$2.3 million.

What was Albert's taxable income?

143. The following question(s) refer to the year-end account balances for UBUS, Inc. The accounts are listed in alphabetical order, NOT in the order they appear on the financial statements. The applicable tax rate is 40%.

### UBUS Income Statement

Cost of Goods Sold	330
Depreciation Expense	35
Interest Expense	20
Operating Expense (excluding depreciation)	115
Sales	600
Tax	???

### UBUS Balance Sheet

Accounts Payable	35
Accounts Receivable	65
Accruals	30
Accumulated Depreciation	(175)
Cash	35
Common Stock	120
Fixed Assets (gross)	390
Inventory	135
Long Term Debt	200
Retained Earnings	65

a) What was UBUS Inc.'s earnings before interest and taxes (EBIT)?

- a. \$155
- b. \$120
- c. \$100
- d. \$215
- e. \$200

b) What is UBUS Inc.'s tax liability?

- a. \$48
- b. \$60
- c. \$55
- d. \$40
- e. \$35

c) What was UBUS Inc.'s Net Income?

- a. \$72
- b. \$45
- c. \$60
- d. (\$20)
- e. \$100

d) What is UBUS Inc.'s Total Assets?

- a. \$420
- b. \$570
- c. \$625
- d. \$450
- e. \$490

e) What is UBUS Inc.'s Total Equity?

- a. \$115
- b. \$120
- c. \$185
- d. \$205
- e. \$240

f) What is UBUS Inc.'s Net Working Capital?

- a. \$35
- b. \$70
- c. \$100
- d. \$130
- e. \$170

144. The following is a listing of tax considerations for John and Jane Alexander, who file jointly and have two children.

John's salary	\$45,000
Jane's salary	50,000
Real estate taxes	4,000
Interest from savings account	1,500
Interest from Arizona bonds	2,000
Interest on home mortgage	3,000
Contributions to charities	1,500
Gain on sale of stock held for 5 years	6,000

Assume the following hypothetical tax table:

0 - \$10,000	10%
\$10,000 - \$35,000	15%
\$35,000 - \$65,000	25%
over \$65,000	30%

The personal exemption rate is \$3,050

The long-term capital gains rate for this family is 18%.

- a. How much is the Alexanders' taxable income?
- b. What is the tax on their ordinary income?
- c. What is their capital gains tax?
- d. What is their overall average tax rate including the tax on capital gains?
- e. What is their marginal tax rate on ordinary income?

145. XYZ Inc. has taxable income of \$14,000,000 in 20xx.

- a. What is their tax liability using the corporate income tax schedule?
- b. How would it change if they had losses of \$4,000,000 two years ago and no income last year?

146. The Smith family has the following income

Salaries	\$88,000
Dividends	4,000
Interest on General Motors Bonds	9,000
Interest on Boston Bonds	8,000
Interest on savings accounts	2,000

During the tax year they sold a vacation home for \$65,000 that they had acquired several years ago for \$58,000. They also sold some of their GM stock, receiving \$22,000 after brokerage commissions. The shares had originally been purchased for \$30,000. They paid \$19,000 interest on their home mortgage and \$3,000 interest on credit card debt. They paid state income tax of \$7,000 and real estate tax of \$3,000. They donated \$2,000 to their church. They also paid \$1,400 toward the support of an elderly parent. The Smith's have two small children. The personal exemption rate is \$3,050. What is the Smith's taxable income? Show all calculations clearly.

147. A family has taxable income of \$150,000. What is their tax liability if the relevant tax table is as follows:

0 - \$ 12,000	10%
\$12,000 - \$ 40,000	15%
\$40,000 - \$ 90,000	27%
\$90,000 - \$160,000	30%

148. What is the corporate tax paid by a firm with taxable income of \$300,000, given the following tax tables.

\$0 - \$50,000	15%
\$50,000 - \$75,000	25%
\$75,000 - \$100,000	34%
\$100,000- \$335,000	39%

149. Red and Blue have EBIT of \$20.0M and pay tax at a flat rate of 30%. Red is equity financed and pays \$1.2M in dividends while Blue is debt financed and pays 1.2M in interest. How much will each company add to its retained earnings for the year. Explain the difference.

## Chapter 2--Financial Background: A Review of Accounting, Financial Statements, and Taxes **Key**

1. The income statement is intended to inform the reader of:
  - A. the overall financial condition of the firm at a point in time.
  - B.** how much the firm has earned during an accounting period.
  - C. how much income has been distributed to shareholders.
  - D. the cash flow generated by the firm over a period of time.
  
2. Which of the following does not cause accounting profit and cash flow to differ?
  - A. Depreciation
  - B. Sales made on credit
  - C.** Payroll expense
  - D. Inventory purchased, but not yet sold
  
3. Differences between net income and cash flow come from:
  - A. accounts receivable.
  - B. depreciation.
  - C. short term securities.
  - D.** a and b
  
4. Which of the following causes accounting profit and cash flow to differ?
  - A. Payroll expense
  - B. Cash sales
  - C.** Depreciation
  - D. Inventory purchased and sold
  
5. The accounting matching principle dictates that we:
  - A. match expenses up with the employees that incur them.
  - B.** prorate the cost of an asset over its expected economic life.
  - C. invoice the customer as soon as the merchandise is produced.
  - D. All of the above

6. Depreciation, from an accounting viewpoint, can best be thought of as:

- A. accounting for the physical deterioration of an asset.
- B. writing off assets like patents, trademarks, and copyrights.
- C. matching the carrying value of the asset with the estimated net realizable value of the asset.
- D.** allocating the cost of the asset to the periods in which it gives service.

7. Which of the following causes net income to differ from cash flow?

- A. Depreciation
- B. The purchase of inventory on credit
- C. The sale of merchandise on credit
- D.** All of the above

8. Managers whose bonuses are based on the income of the firm tend to overstate the value of accounts receivable and inventory with the following result:

- A.** the firm's value is less than it is held out to be.
- B. profit is more than it is held out to be.
- C. the firm's value is more than it is held out to be.
- D. liabilities are less than they are held out to be.

9. The process of totaling all of the transactions for a recent period and bringing a company's records up to date is referred to as:

- A.** closing the books.
- B. double entry.
- C. ending the period.
- D. starting over.

10. Which of the following does not appear on the income statement?

- A. Cost of Goods Sold
- B. Depreciation Expense
- C.** Accumulated Depreciation
- D. Earnings Before Interest and Tax
- E. Gross Margin

11. Holding all other variables constant, an increase in net income can be caused by a decrease in:

- A. depreciation expense.
- B. the cost ratio.
- C. the tax rate.
- D. Both a and c
- E.** a, b, and c are correct.

12. Holding all other variables constant, an increase in COGS will lead to:

- A. a decreased cost ratio.
- B. a higher gross margin.
- C.** lower net income.
- D. paying more in taxes.

13. The income statement line item that shows the performance of operating activities without consideration of financing is:

- A. net income.
- B.** EBIT.
- C. EBT.
- D. total assets.

14. EBIT is also called:

- A. net profit.
- B.** operating profit.
- C. pretax profit.
- D. gross profit.

15. Which of the following equations is correct?

- A.** Dividends = Net income - Change in Retained Earnings
- B. Dividends = Net income + Change in Retained Earnings
- C. Dividends = Change in Retained earnings - Net income
- D. None of the above

16. Which of the following appears on the income statement?

- A. Accounts receivable
- B. Accumulated depreciation
- C.** Depreciation expense
- D. Long-term debt

17. Which of the following is not included in the calculation of current assets?

- A.** Accruals
- B. Accounts Receivable
- C. Allowance for Doubtful Accounts
- D. Cash
- E. Inventory



18. Which of the following does not appear on the right hand side of the balance sheet?

- A. Current Liabilities
- B. Accounts Receivable**
- C. Retained Earnings
- D. Long Term Debt
- E. Total Equity

19. Net working capital can be referred to as:

- A. total assets minus current liabilities.
- B. current assets minus total liabilities.
- C. cash minus current liabilities.
- D. current assets minus current liabilities.**

20. When an account is determined to be uncollectible, "writing off" the bad debt *usually* involves:

- A. reducing the receivables balance and the bad debt reserve by the amount of the account.**
- B. writing a letter to the customer demanding payment.
- C. "expensing" the amount deemed uncollectible.
- D. All of the above

21. Inventory in a manufacturing firm differs from that in a retailing company because it includes:

- A. an additional category referred to as materials.
- B. finished goods inventory.
- C. "work in process" inventory.**
- D. All of the above

22. The procedure for a payroll accrual requires identifying the portion of the payroll that falls after the payday but within the accounting period, and:

- A. paying employees that amount.
- B. recording the amount as an unusual cost.
- C. providing for both the expense and the liability for the unpaid payroll with an accrual entry when the books are closed.**
- D. preparing a supporting note on the financial statement as to the amount of the unpaid payroll.

23. Accounting accruals are important in:

- A. accounting for depreciation.
- B. providing for unpaid payroll, rent, interest, and other expenses that relate to the current accounting period.**
- C. drawing checks on the last day of the current accounting period to properly reflect expense in that period.
- D. providing for bad debts that may eventually be deemed uncollectible.

24. The net book value of an asset is:

- A. original cost less the current year's depreciation expense.
- B.** original cost less accumulated depreciation.
- C. current market value of the asset less associated selling expense.
- D. current market value of the asset.

25. Which of the following will increase equity?

- A. An increase in dividends paid
- B. Issuance of new stock
- C. An increase in retained earnings from net income
- D.** Both b & c
- E. All of the above

26. The two forms of equity infusion are:

- A. long term debt and common stock.
- B.** direct investment in the company's stock and the retention of earnings.
- C. net working capital and accumulated depreciation.
- D. preferred stock and long-term debt.
- E. dividends and retained earnings.

27. Which of the following would cause a decrease in cash?

- A.** Lengthening the time it takes to collect receivables from 15 to 30 days
- B. Selling fixed assets for more than book value
- C. An increase in accrued salaries expense
- D. Paying suppliers in 60 days versus 45 days

28. Which of the following is correct?

- A. Beginning equity + Net income – Dividends – Stock = Ending equity
- B.** Beginning equity + Net income – Dividends + Stock = Ending equity
- C. Net income – Dividends – Stock = Ending equity
- D. Beginning equity – Net income – Dividends + Stock = Ending equity

29. When a receivable is written off as uncollectible, entries will usually be made into which accounts?

- A. Bad debt reserve
- B. Bad debt expenses
- C. Accounts receivable
- D. Both a and b
- E.** Both a and c

30. Inventory reserve is conceptually similar to:

- A. bad debt expense.
- B. work in process.
- C.** allowance for doubtful accounts.
- D. None of the above

31. The matching principle says:

- A. assets costs should be recorded in the period in which they are purchased.
- B.** recognition of an asset's cost should match its service life.
- C. the customer should be invoiced as soon as merchandise is produced.
- D. only cash transactions should be recorded in the accounting records.

32. If their bonuses are based on net income, managers may:

- A.** postpone writing off bad debts.
- B. increase depreciation.
- C. postpone dividend payments.
- D. hold more inventory.

33. Which of the following is a current asset?

- A. Accounts payable
- B.** Accounts receivable
- C. Revenue
- D. Accumulated depreciation

34. Which of the following types of inventory will be held by a retail company?

- A. Supplies
- B.** Finished goods
- C. Work in process
- D. Raw materials

35. During the last year Alpha Co had Net Income of \$150, paid \$20 in dividends, and sold new stock for \$40. Beginning equity for the year was \$700. Ending Equity was:

- A. \$830.
- B. \$840.
- C. \$850.
- D.** \$870.

36. Uncollected receivables are normally:

- A. depreciated.
- B. expensed.
- C. not reported.
- D.** written off.

37. Management is prone to overstate:

- A.** accounts receivable and inventory.
- B. accounts receivable, but not inventory.
- C. inventory, but not accounts receivable.
- D. neither accounts receivable nor inventory.

38. Which of the following is a consumption tax?

- A. Ad valorem tax
- B. Real estate tax
- C.** Excise tax
- D. Personal property tax

39. The tax schedule for married couples filing jointly:

- A. Results in less tax than would be paid by a single person if only one spouse works.
- B. Saves on taxes regardless of whether one or both spouses work.
- C. Results in most two income families paying more tax than if they were single.
- D.** a and c

40. In order to compare the yields on municipal and corporate bonds the investor must restate the yield of either the taxable corporate bond to an after tax basis or the municipal bond to a pretax equivalent because:

- A. corporate bonds are tax free.
- B.** municipal bonds are tax free and investors must compare rates on an equal basis.
- C. a municipal bond is typically safer than a taxable corporate bond.
- D. such restatements are not necessary for most taxpayers.

41. Taxable income is:

- A.** total income excluding exempt items less deductions and exemptions.
- B. gross income less deductions.
- C. the sum of everything a person makes.
- D. gross income less state taxes, mortgage interest, and charitable contributions.

42. The marriage penalty refers to the fact that:

- A. married people have less freedom than their single friends.
- B. it generally costs more money to support a family than two single people.
- C.** two-income married couples generally pay more taxes than they would if they were single and had the same two incomes.
- D. married people generally work harder than single people.

43. The relevant tax rate for investment decisions is the:

- A. average rate.
- B. lowest rate.
- C.** marginal rate.
- D. effective rate.

44. Investors pay federal income taxes on the interest earned on bonds issued by:

- A. cities.
- B. counties.
- C. states.
- D.** the federal government.

45. In addition to raising money, the government uses the tax system to:

- A. promote a larger and more comprehensive government authority.
- B.** incentivize desirable behavior on the part of taxpayers.
- C. support our position as the world's strongest nation.
- D. keep the nation growing as rapidly as possible.

46. Deductions are expenditures that can be subtracted in calculating taxable income. Which of the following is a deduction?

- A. Dependency exemption
- B. Credit card interest
- C. Interest on municipal bonds
- D.** Donations to charities

47. The corporate tax schedule seems not to be progressive. Which statement is correct?

- A. The idea of progressive taxes refers only to individuals, the corporate schedule is intentionally not progressive.
- B. The corporate schedule is indeed not progressive because the rates do not increase steadily as income increases.
- C. Corporate Taxes are progressive because the more money a corporation makes, the more taxes it pays.
- D.** Corporate taxes are conceptually progressive. The ups and downs in the schedule are designed to take away the benefit of low early rates for companies with large incomes.

48. Which of the following best describes how corporations are taxed on dividend income?

- A. Like individuals, corporations are taxed on all dividends received.
- B. Fifty percent of dividend income received by corporations is tax exempt.
- C.** Varying amounts of dividend income received by corporations are tax exempt, depending on the percent of the paying corporation that the receiving corporation owns.
- D. In order to avoid triple taxation of earnings, dividend income received by one corporation from another in which it owns twenty percent stock is 100% tax exempt.

49. The federal tax system allows firms that have a tax loss in a year to apply the loss against past and future earnings. The process is referred to as loss carrybacks and carryforwards and permits the loss to be:

- A. carried forward for 20 years after having been carried back evenly over the past two years.
- B. carried back or forward for as many as 20 years.
- C. spread evenly over the last two years and evenly over the next 20 years.
- D.** carried back two years and forward as many as 20 years.

50. If a firm that's doing very well pays the same return to equity and debt shareholders, and needs to raise more money, it may be wise to use debt because:

- A.** interest is tax deductible resulting in a lower cost to the firm.
- B. Equity is the less desirable source of capital.
- C. borrowing is always less of an effort than raising additional equity capital.
- D. All of the above

51. Three years ago a piece of equipment was purchased for \$10,000. Assuming an eight-year life and straight-line depreciation, financial statements for the third year will show:

- A. depreciation expense of \$3,000 on the income statement, and accumulated depreciation of \$3,000 on the balance sheet.
- B. depreciation expense of \$1,250 on the income statement, and accumulated depreciation of \$3,000 on the balance sheet.
- C.** depreciation expense of \$1,250 on the income statement, and accumulated depreciation of \$3,750 on the balance sheet.
- D. depreciation expense of \$1,250 on the income statement, and accumulated depreciation of \$1,250 on the balance sheet.

52. Selected accounts are listed below. How much is the firm's operating income?

Accrued payroll	\$ 2,000
Sales	45,000
Cost of goods sold	26,000
Interest expense	1,000
Expenses (other than interest)	8,000

- A. \$8,000
- B. \$10,000
- C. \$9,000
- D.** \$11,000

53. Wessel Corp. plans to sell 1,000 units in 2005 at an average sale price of \$45 each. Cost of goods sold will be 40% of the sale price. Depreciation expense will be \$3,000, interest expense \$2,500, and other expenses will be \$4,000. Wessel's tax rate is 20%. What will Wessel Corp's net income be for 2005?

- A. \$ 3,500
- B. \$ 6,800
- C.** \$14,000
- D. \$16,400
- E. \$28,400

54. Three years ago a machine was purchased for \$5,000. Assuming a ten-year life and straight line depreciation with a no salvage value, which of the following will appear on the income statement and balance sheet respectively after four years?

- A. Depreciation expense of \$2,000, accumulated depreciation of \$2,000.
- B.** Depreciation expense of \$500, accumulated depreciation of \$2,000.
- C. Accumulated depreciation of \$2,000, depreciation expense of \$500.
- D. Accumulated depreciation of \$500, depreciation expense of \$2,000.
- E. Depreciation expense of \$1,500, accumulated depreciation of \$500.

55. Gowen, Inc. began the year with equity of \$1,000,000 and 100,000 shares of stock outstanding. During the year the firm paid a dividend of \$1.50 per share. Year-end equity was \$1,100,000. Assuming no other factors impacted equity, what was Gowen, Inc.'s net income for the year?

- A. \$100,000
- B. \$150,000
- C. \$200,000
- D.** \$250,000
- E. \$300,000

56. Albert Corp. bought a machine for \$10,000 thirteen years ago. It has been depreciated on a straight line basis over a 20 year life with no salvage value. The firm just sold the machine for \$6,000. How much gain/loss should be reported on the sale?

- A. \$4,000 loss
- B. \$2,500 loss
- C. No gain or loss should be recorded.
- D.** \$2,500 gain
- E. \$4,000 gain

57. The following items are components of a firm's balance sheet. How much is the firm's working capital (net working capital)?

Cash	\$ 2,000
Long-term debt	10,000
Inventory	12,000
Owners' equity	62,000
Accounts payable	8,000
Accruals	1,500
Accumulated depreciation	6,000
Accounts receivable	14,000

- A. \$14,500
- B. \$ 2,500
- C.** \$18,500
- D. \$12,500

58. The following items are components of a traditional balance sheet. How much is the total equity of the firm?

Long-term debt	\$ 12,000
Common stock	15,000
Accounts payable	8,000
Paid in excess	6,000
Accrued interest payable	1,500
Plant and equipment	60,000
Retained earnings	28,000
Accounts receivable	22,000

- A. \$62,500
- B.** \$49,000
- C. \$93,000
- D. \$97,000



59. The following items are components of a traditional balance sheet. How much are the total assets of the firm?

Plant and equipment	\$ 42,000
Common stock	15,000
Cash	8,000
Inventory	21,000
Bad debt reserve	6,000
Paid in excess	6,000
Accumulated depreciation	28,000
Accounts receivable	22,000

- A. \$87,000
- B. \$65,000
- C. \$59,000**
- D. \$93,000

60. Belvedere, Inc. has an annual payroll of \$250,000. The firm pays employees every two weeks on Friday afternoon. Last month, the books were closed on the Thursday after payday. How much is the payroll accrual at the end of the month? (Round to nearest \$)

- A. \$2,852
- B. \$3,846**
- C. \$4,780
- D. \$5,119

61. The Johnson Company bought a truck costing \$60,000 two years ago. The truck's estimated life was six years at the time of purchase. It was accounted for by using straight line depreciation with zero salvage value. If the truck was sold yesterday for \$65,000, what is the capital gain that must be reported on the sale of the truck?

- A. \$20,000
- B. \$25,000**
- C. \$30,000
- D. \$35,000
- E. \$40,000

62. A firm had a piece of machinery that cost \$7,000 when new and has accumulated \$4,500 in depreciation. If the machine is sold for \$4,000, which of the following is true?

- A. The firm has a taxable gain of \$4,000 on the sale of the machine
- B. The firm has a taxable gain of \$1,500 on the sale of the machine**
- C. The firm has a deductible loss of \$3,000 on the sale of the machine
- D. The firm has a taxable gain of \$7,000 on the sale of the machine

63. Grass Enterprises just closed a good year. It had Sales of \$10 million, EBIT of \$1 million and Net Income of \$500,000. The firm also paid dividends of \$150,000 during the year. If Grass started the year with equity of \$900,000, what will its year ending equity be?

- A. \$1,900,000
- B. \$1,400,000
- C. \$1,250,000
- D. \$850,000

64. Exxon Corp. bought an oil rig exactly 6 years ago for \$100,000,000. Exxon depreciates oil rigs straight line over 10 years assuming no salvage value. The rig was just sold to British Petroleum for \$30,000,000. What Capital Gain/Loss will Exxon report on this transaction?

- A. Gain of \$30,000,000
- B. Gain of \$10,000,000
- C. Loss of \$10,000,000
- D. Loss of \$30,000,000

65. Ben bought an ice cream machine 2 years ago for \$8,000. The depreciation life for ice cream machines is 4 years. Ben uses straight line depreciation and a convention of taking one-half year's depreciation in the first year. Ben just sold his machine to Jerry for \$6,000. What will be Ben's Capital Gain/(Loss) on this transaction?

- A. \$1,000
- B. \$2,000
- C. \$5,000
- D. (\$2,000)

66. Toys For U, Inc. just purchased a new asset costing \$500,000. The machine will be depreciated straight-line over a 10-year period using the convention of taking a half year's depreciation in the first year. Given the following information about old assets the firm already had, calculate net fixed assets at year end.

Gross Fixed Assets	\$2,000,000
Accumulated Depreciation	\$960,000
Continuing Annual Depreciation Expense	\$240,000

- A. \$765,000
- B. \$925,000
- C. \$1,275,000
- D. \$1,600,000

67. Selected financial statement accounts are as follows. How much is the firm's ending equity?

Income for the year	\$25,000
Dividends paid	6,000
Beginning equity for the year	56,000
Additional stock sold	22,000

- A. \$103,000
- B.** \$97,000
- C. \$19,000
- D. \$85,000

68. The Tappan family has taxable income of \$50,000. Tax tables indicate that the first \$20,000 of income will be taxed at 24% and all income above \$20,000 will be taxed at 30%. What are the Tappan's marginal and average tax rates?

- A. Marginal = 29.8%; Average = 30.0%
- B. Marginal = 28.2%; Average = 27.6%
- C. Marginal = 30.0%; Average = 30.0%
- D.** Marginal = 30.0%; Average = 27.6%
- E. Marginal = 24.0%; Average = 30.0%

69. The following is a listing of tax considerations for a family. How much is the family's taxable income?

3 exemptions	\$ 3,050	per exemption
Salary	45,000	
Real estate taxes	5,000	
Interest from savings account	1,500	
Interest from municipal bond	2,000	
Interest on mortgage	3,000	
Contributions to church	1,500	
Loss on sale of stock held for 3 years	6,000	

- A. \$25,800
- B.** \$24,850
- C. \$30,800
- D. \$24,300

70. The following tax schedule applies to an individual. Her taxable income is \$40,000. How much is her total tax?

- 10% of the first \$10,000
- 15% of the next \$15,000
- 25% of the next \$10,000
- 35% of the next \$20,000

- A. \$8,500
- B. \$10,000
- C.** \$7,500
- D. \$7,000

71. The following is a listing of tax considerations for a family. How much is the their taxable income?

2 exemptions	\$ 3,050	per exemption
Salary income of husband	40,000	
Real estate taxes	4,000	
Interest from savings account	800	
Interest on mortgage	2,800	
Contributions to church	600	

- A. \$36,800
- B. \$23,200
- C.** \$27,300
- D. \$24,800

72. Assume a municipal bond is issued by the State of New York. Its yield is stated at 6%. A taxable corporate bond of equivalent quality is yielding 9%. You are in the 35% tax bracket and your son is in the 10% tax bracket. Which would be the correct investment strategy for both you and your son?

- A. You and your son should acquire the municipal bond.
- B. Your son should acquire the municipal bond, but you should acquire the corporate bond.
- C. You and your son should acquire the corporate bond.
- D.** Your son should acquire the corporate bond, but you should acquire the municipal bond.

73. A corporate bond is yielding 9%. You are in the 35% tax bracket. What is the after tax yield on the bond?

- A.** 5.85%
- B. 8.10%
- C. 3.90%
- D. 12.15%

74. Assume Corporation A owns 51% of Corporation B. If Corporation A received \$1,000,000 in dividends from Corporation B, how much would be taxable to Corporation A?
- A. \$510,000
  - B. \$800,000
  - C.** \$200,000
  - D. \$0
75. Depreciation expense of \$2,000.00 will cause:
- A. accounts receivable to be reduced by \$2,000.00.
  - B. cash to be reduced by \$2,000.00.
  - C.** accumulated Depreciation to increase by \$2,000.00.
  - D. accounts Payable to increase by \$2,000.00.
76. Which of the following is not part of working capital?
- A.** Accumulated depreciation
  - B. Accounts Payable
  - C. Accounts Receivable
  - D. Inventory
77. An accrual is best defined as:
- A. a completed transaction that results in a liability.
  - B.** an accumulation of a liability in regard to an incomplete transaction.
  - C. a completed transaction that results in an asset.
  - D. an expense paid in advance.
78. Which is equivalent to EBIT assuming the firm has no leverage?
- A.** EBT
  - B. Net income
  - C. Net income + Depreciation
  - D. Gross Margin + Depreciation
79. Which of the following is a tax deductible expense?
- A. Repayment of the principle portion of a loan
  - B. Dividends
  - C. The purchase of inventory
  - D.** Depreciation

80. When must a vendor be paid in full under the terms of 2/10, n. 30?

- A. 10 days from today
- B. On February 10th
- C. On the 30th of the current month
- D.** 30 days from today

81. Retained earnings are:

- A. a liability.
- B.** profits that have not been distributed to shareholders as dividends.
- C. the equivalent of stock.
- D. the same as cash.

82. Which of the following is not a common tax base?

- A. Income
- B. Wealth
- C.** Marital status
- D. Consumption

83. If the state tax rate is 20% and the federal tax rate is 30%, what is the total effective tax rate?

- A. 34%
- B. 50%
- C.** 44%
- D. 37%

84. Why would a corporation purchase the stock of another corporation?

- A. To prevent double taxation of its shareholders
- B.** Because dividends received by a corporation are partially tax exempt
- C. It is equivalent to a tax carried forward
- D. It is equivalent to a tax carried back

85. The usefulness of financial statements in assessing the investment value of securities is *always* somewhat limited because:

- A. the information in financial statements more subjective rather than objective.
- B. companies are not always honest about their figures.
- C.** past performance may not be indicative of future performance.
- D. the information is often confusing.

86. The biggest difference between the income statement and the balance sheet is:

- A. the income statement shows incoming deposits, while the balance sheet shows account balances from the bank.
- B. the income statement is submitted to the government, while the balance sheet is shown to investors.
- C. the income statement is always more accurate than the balance sheet.
- D.** the balance sheet represents stocks of cash at a point in time, while the income statement reflects flows of cash over a time period.

87. The term “Cash” on a financial statement differs from the common definition of cash in that

- A. companies do not carry cash on hand and therefore do not use the term.
- B. cash refers to the currency a company has on hand and not to any other assets.
- C. cash is not considered an asset because of its highly liquid state.
- D.** cash refers checking account balances as well as currency.

88. The accounts receivable balance can be misleading because:

- A.** it may contain substantial amounts which will never be collected.
- B. the figures represent money that is incoming as opposed to tangible assets.
- C. costumers often delay payment which blows up the balance.
- D. it is not adjusted for the bad debt reserve.

89. The bad debt reserve represents:

- A. money that will be paid by the company.
- B. money that will be paid by customers.
- C.** the fact that not all receivables are collected in the normal course of business.
- D. insurance against bad debts.

90. Overstated accounts include:

- A.** items that will never be realized as cash.
- B. items that were recorded twice.
- C. transactions that are not recorded in both assets and liabilities.
- D. money that will be collected at year end.

91. If an inventory item has a base cost to the company of \$50, and requires three hours of labor at \$15/hr. to be turned into a salable item, the value of that piece of inventory is at least:

- A. \$65.
- B. \$165.
- C.** \$95.
- D. \$45.

92. Depreciation matches the recognition of a long lived asset's cost with its service life. An example of this kind of asset would be:
- A. office supplies for a private school.
  - B. raw materials for a textile plant.
  - C. phone jacks for an electronics store.
  - D.** machinery for a factory.
93. An asset still in use beyond its life estimate is said to be:
- A. a good investment.
  - B.** fully depreciated.
  - C. fully functional.
  - D. in poor condition.
94. In most companies, the bulk of accounts payable arises from:
- A.** buying inventory on credit.
  - B. selling inventory on credit.
  - C. buying airline tickets for traveling employees on credit.
  - D. customers paying off old bills.
95. Retained earnings represents:
- A. money paid to owners, stockholders, and executives.
  - B. funds a company can draw on in time of need.
  - C.** profits that have been re-invested in the company.
  - D. income the government holds in trust for the company.
96. The most common term for a consumption tax is:
- A. wealth tax.
  - B. progressive tax.
  - C.** sales tax.
  - D. income tax.
97. Which statement is true?
- A. Beginning equity + net income = ending equity
  - B. Beginning equity + net income – dividends = ending equity
  - C. Beginning equity + net income – dividends + new stock sold = ending equity
  - D.** All of these statements are true.



98. \_\_\_\_\_ stock is an equity security that has some of the characteristics of debt.

- A. Common
- B. Equity
- C. Preferred**
- D. Capital

99. The three most important financial statements are the balance sheet, income statement, and statement of retained earnings.

**FALSE**

100. A business's financial statements are numerical representations of what it is physically doing.

**TRUE**

101. To many people, income is their paycheck, but in accounting it is typically viewed as the excess of revenue received over costs and expenses.

**TRUE**

102. All entries in the accounting books must be made by the last day of the accounting period so that the firm may close their books.

**FALSE**

103. The double entry system of accounting breaks every entry into two parts each affecting a different account.

**TRUE**

104. The income statement reflects flows of money over a period of time. The balance sheet represents stocks of money at a point in time.

**TRUE**

105. EBIT is earnings before income taxes.

**FALSE**

106. Cost (of goods sold) includes only items that are closely related to production.

**TRUE**

107. In a manufacturing firm, there are two inventory accounts, called raw materials and finished goods.

**FALSE**

108. The traditional income statement is intended to measure profits by identifying cash flows in and out of the firm over an accounting period.

**FALSE**

109. EBIT (earnings before interest and taxes) is the earnings measure designed to provide information on operational performance.

**TRUE**

110. A decrease in financial leverage results in a larger tax liability because interest is tax deductible.

**TRUE**

111. The income statement measures the flow of funds in and out of the firm over a period of time.

**FALSE**

112. EBIT is a business's profit before consideration of financing charges.

**TRUE**

113. EBIT shows the profitability of operations after considering financing.

**FALSE**

114. Accounts payable is listed as a liability and therefore, by definition, requires the payment of interest by the borrower.

**FALSE**

115. Accounts receivable represents credit sales that have not yet been paid by customers.

**TRUE**

116. Generally, merchandise is sold on credit under terms such as 2/10, net 30, meaning the buyer may deduct 10% from the bill if he pays within 2 days or pay the full amount within thirty days.

**FALSE**

117. The balance sheet can be thought of as a listing of all of sources and uses of cash over a specific period of time.

**FALSE**

118. Leverage is the use of equity financing.

**FALSE**

119. Net book value is equal to market value less accumulated depreciation.

**FALSE**

120. Vendors extend trade credit when they deliver product without demanding immediate payment.

**TRUE**

121. If machinery that cost \$8,000 when new, has accumulated depreciation of \$4,500, and is sold for \$4,000, the gain recognized on the sale would be \$4,000.

**FALSE**

122. Although depreciation is a noncash expense, the government still allows the deduction on the firm's tax return.

**TRUE**

123. Leverage means using borrowed money to enhance the return on an equity investment.

**TRUE**

124. The tax system taxes capital gains more aggressively than ordinary income.

**FALSE**

125. Preferred stock is referred to as a cross between debt and common equity because it has some characteristics of each.

**TRUE**

126. Wealth Taxes are levied by cities and counties on the value of real estate. They are also called *ad valorem* taxes.

**TRUE**

127. The government uses the tax system to collect revenue and to incentivize people to act in ways it deems beneficial.

**TRUE**

128. A progressive tax system taxes incremental income at progressively higher rates.

**TRUE**

129. Congress intended preferential tax treatment on capital gains, recognizing that offering an incentive to capital investments is healthy for the economy.

**TRUE**

130. A taxpayer's average rate is the rate that will be paid on the next dollar of income.

**FALSE**

131. Municipal bonds are debt obligations of the states, municipalities and political subdivisions. They are exempt from federal taxation

**TRUE**

132. The taxation of proprietorships is about the same as that of corporations.

**FALSE**

133. A company has a loss of \$15,000 this year, a profit of \$3,000 last year, a profit of \$8,000 two years ago, and another profit of \$2,000 three years ago. It makes sense to file amended returns for the last three years.

**FALSE**

134. The corporate tax table seems *dissimilar* to individual tax tables in that corporate rates are *not always* increased as income increases.

**TRUE**

135. The corporate tax system takes away the benefit of low rates on early income as income increases.

**TRUE**

136. In the corporate tax system, higher-income taxpayers pay targeted rates on their whole incomes.

**TRUE**

137. One of the most significant exemptions for most people is interest on a home mortgage.

**FALSE**

138. *Match the following:*

- |                      |  |
|----------------------|--|
| 1. Retained earnings | The accumulated earnings of a company that have not been distributed to shareholders as dividends. <b><u>1</u></b> |
| 2. Dividends         | Earnings distributed to a firm's owners <b><u>2</u></b>  |
| 3. Paid in excess    | The amount paid for stock above its par value <b><u>3</u></b>  |
| 4. Common stock      | The par value of outstanding stock <b><u>4</u></b>   |

139. If it makes tax sense to finance businesses with debt, why do firms typically borrow less than half of their capital, i.e., what are the negatives of debt financing?

Debt increases a firm's risk because it may fail if earnings aren't sufficient to pay the interest. As debt increases, so does the risk of failure, and lenders eventually refuse to lend more money. Hence the risk associated with debt limits the amount any firm can borrow.

140. The corporate tax system appears not to be progressive, but in fact it's more progressive than the personal system. Explain.

The corporate system recovers the benefit of lower rates on the first money earned as income increases substantially, the personal system does not do that directly.

141. The tax treatment of capital gains is a big political issue. Republicans generally favor lower rates on capital gains while Democrats do not. Why is the issue so politically sensitive?

Wealthier people tend to invest in stocks and other assets that are likely to produce long term capital gains. Hence favorable treatment of capital gains is seen as a tax break for the rich at the expense of the middle and lower classes.

142. During the past year, Albert Corporation had  
sales of \$5 million,  
cost of goods sold of \$2.7 million,  
operating expense of \$1.3 million, and  
interest expense of \$0.5 million.

During the year Albert  
paid a preferred stock dividend of \$100,000  
paid a common stock dividend of \$150,000 and  
paid off debt of \$2.3 million.

What was Albert's taxable income?

Sales	\$5,000,000
Cost of goods sold	<u>\$2,700,000</u>
Gross profit margin	\$2,300,000
Operating expenses	<u>\$1,300,000</u>
Earnings before interest and taxes	\$1,000,000
Interest expense	<u>\$ 500,000</u>
Earnings before tax (taxable income)	\$ 500,000

143. The following question(s) refer to the year-end account balances for UBUS, Inc. The accounts are listed in alphabetical order, NOT in the order they appear on the financial statements. The applicable tax rate is 40%.

### **UBUS Income Statement**

Cost of Goods Sold	330
Depreciation Expense	35
Interest Expense	20
Operating Expense (excluding depreciation)	115
Sales	600
Tax	???

### UBUS Balance Sheet

Accounts Payable	35
Accounts Receivable	65
Accruals	30
Accumulated Depreciation	(175)
Cash	35
Common Stock	120
Fixed Assets (gross)	390
Inventory	135
Long Term Debt	200
Retained Earnings	65

a) What was UBUS Inc.'s earnings before interest and taxes (EBIT)?

- a. \$155
- b. \$120
- c. \$100
- d. \$215
- e. \$200

b) What is UBUS Inc.'s tax liability?

- a. \$48
- b. \$60
- c. \$55
- d. \$40
- e. \$35

c) What was UBUS Inc.'s Net Income?

- a. \$72
- b. \$45
- c. \$60
- d. (\$20)
- e. \$100

d) What is UBUS Inc.'s Total Assets?

- a. \$420
- b. \$570
- c. \$625
- d. \$450
- e. \$490

e) What is UBUS Inc.'s Total Equity?

- a. \$115
- b. \$120
- c. \$185
- d. \$205
- e. \$240

f) What is UBUS Inc.'s Net Working Capital?

- a. \$35
- b. \$70
- c. \$100
- d. \$130
- e. \$170

a) b

$$\$600 - \$330 - \$115 - \$35 = \$120$$

b) d

$$\text{EBT} = \$120 - \$20 = \$100$$

$$\text{Tax} = \$100 \times .4 = \$40$$

c) c

$$\$100 - \$40 = \$60$$

d) d

$$\$35 + \$65 + \$135 + \$390 - \$175 = \$450$$

e) c

$$\$120 + \$65 = \$185$$

f) e

$$\$35 + \$65 + \$135 - \$35 - \$30 = \$170$$

144. The following is a listing of tax considerations for John and Jane Alexander, who file jointly and have two children.

John's salary	\$45,000
Jane's salary	50,000
Real estate taxes	4,000
Interest from savings account	1,500
Interest from Arizona bonds	2,000
Interest on home mortgage	3,000
Contributions to charities	1,500
Gain on sale of stock held for 5 years	6,000

Assume the following hypothetical tax table:

0 - \$10,000	10%
\$10,000 - \$35,000	15%
\$35,000 - \$65,000	25%
over \$65,000	30%

The personal exemption rate is \$3,050

The long-term capital gains rate for this family is 18%.

- How much is the Alexanders' taxable income?
- What is the tax on their ordinary income?
- What is their capital gains tax?
- What is their overall average tax rate including the tax on capital gains?
- What is their marginal tax rate on ordinary income?



- a. Taxable income  
Salaries + interest + capital gain - re tax - mortgage - charity - exemptions  
 $\$95,000 + \$1,500 + 6,000 - \$4,000 - \$3,000 - \$1,500 - \$12,200 = \$81,800$
- b. Ordinary taxable income:  $\$81,800 - \$6,000 = \$75,800$   
 $\$10,000(.1) + \$25,000(.15) + \$30,000(.25) + \$10,800(.30) = \$15,490$
- c. Capital gains tax:  
 $\$6,000(.18) = \$1,080$
- d. Average tax rate:  
 $(\$15,490 + \$1,080) / \$81,800 = 20.3\%$
- e. Marginal tax rate on ordinary income: 30%

145. XYZ Inc. has taxable income of \$14,000,000 in 20xx.

- a. What is their tax liability using the corporate income tax schedule?
- b. How would it change if they had losses of \$4,000,000 two years ago and no income last year?

- a. First \$10M is taxed at 34% the remainder at 35%:  
 $\$10,000,000 (.34) + \$4,000,000 (.35) = \$4,800,000$
- b.  $\$10,000,000 (.34) = \$3,400,000$

146. The Smith family has the following income

Salaries	\$88,000
Dividends	4,000
Interest on General Motors Bonds	9,000
Interest on Boston Bonds	8,000
Interest on savings accounts	2,000

During the tax year they sold a vacation home for \$65,000 that they had acquired several years ago for \$58,000. They also sold some of their GM stock, receiving \$22,000 after brokerage commissions. The shares had originally been purchased for \$30,000. They paid \$19,000 interest on their home mortgage and \$3,000 interest on credit card debt. They paid state income tax of \$7,000 and real estate tax of \$3,000. They donated \$2,000 to their church. They also paid \$1,400 toward the support of an elderly parent. The Smith's have two small children. The personal exemption rate is \$3,050. What is the Smith's taxable income? Show all calculations clearly.

Ordinary Income:  $\$88,000 + \$4,000 + \$9,000 + \$2,000 = \$103,000$

Capital Gain/(Loss):	Vacation Home: \$65,000
	- \$58,000 = \$7,000
	GM stock $\$22,000 - \$30,000 = \underline{(\$8,000)}$
	(\$1,000)

Deductions:	Mortgage interest:	\$19,000	
	Local taxes	10,000	
	Charity	<u>2,000</u>	
		\$31,000	
			Exemptions: $\$3,050 \times 4 = \$12,200$

Taxable income:  $\$103,000 - \$1,000 - \$31,000 - \$12,200 = \$58,800$

Note: Ignore exempt income, credit card interest, and support of elderly parent.

147. A family has taxable income of \$150,000. What is their tax liability if the relevant tax table is as follows:

0 - \$ 12,000	10%
\$12,000 - \$ 40,000	15%
\$40,000 - \$ 90,000	27%
\$90,000 - \$160,000	30%

\$12000 $\times$ .10 =	\$ 1,200
\$28000 $\times$ .15 =	\$ 4,200
\$50000 $\times$ .27 =	\$13,500
\$60000 $\times$ .30 =	<u>\$18,000</u>
	\$36,900

148. What is the corporate tax paid by a firm with taxable income of \$300,000, given the following tax tables.

\$0 - \$50,000	15%
\$50,000 - \$75,000	25%
\$75,000 - \$100,000	34%
\$100,000- \$335,000	39%

$$(\$50,000 \times 0.15) + (\$25,000 \times 0.25) + (\$25,000 \times 0.34) + (\$200,000 \times 0.39) =$$

$$\$7,500 + \$6,250 + \$8,500 + \$78,000 = \$100,250$$

149. Red and Blue have EBIT of \$20.0M and pay tax at a flat rate of 30%. Red is equity financed and pays \$1.2M in dividends while Blue is debt financed and pays 1.2M in interest. How much will each company add to its retained earnings for the year. Explain the difference.

	Companies	
	Red	Blue
	Equity Financed	Debt Financed
	(\$ in millions)	
EBIT	\$20.00	\$20.00
Interest	0.00	1.20
EBT	20.00	18.80
Tax @ 30%	6.00	5.64
Net Income	14.00	13.16
Dividends	1.20	0.00
Net Retained Earnings	\$12.80	\$13.16

Blue is able to retain more because its interest payment to debt investors is tax deductible while Red's dividend payment to equity investors is not.