

***Introduction to Financial Accounting, 11e (Horngren)***  
**Chapter 2 Measuring Income to Assess Performance**

**Learning Objective 2.1 Questions**

- 1) The operating cycle begins with
- A) the acquisition of goods.
  - B) the receipt of cash from customers.
  - C) the payment for goods.
  - D) the initial investment by owners.
  - E) the sales to customers.

Answer: A

Diff: 1

Objective: L.O. 2-1

- 2) Net income is
- A) the difference between revenues and dividends
  - B) the difference between revenues and retained earnings.
  - C) the difference between cash and dividends.
  - D) the difference between revenues and total assets.
  - E) the difference between revenues and expenses.

Answer: E

Diff: 1

Objective: L.O. 2-1

- 3) Revenues are
- A) increases in liabilities resulting from delivering goods or services to customers.
  - B) decreases in net assets resulting from delivering goods or services to customers.
  - C) increases in net assets resulting from delivering goods or services to customers.
  - D) decreases in retained earnings resulting from delivering goods or services to customers.
  - E) another term for assets.

Answer: C

Diff: 2

Objective: L.O. 2-1

- 4) For which company would it seem sensible to use a fiscal year ending on June 30?
- A) A landscaping company
  - B) A retail store that sells lawn mowers and lawn equipment
  - C) A swimming pool retailer
  - D) A snowboard retailer
  - E) A hardware store

Answer: D

Diff: 2

Objective: L.O. 2-1

5) Kronic Enterprises sold inventory costing \$500 for \$900 on account. If Kronic Enterprises operates under the accrual basis, what net effect will this transaction have on the owners' equity side of the balance sheet?

- A) None, since the customer to whom the inventory was sold has not yet paid
- B) None, since sales and/or cost of goods sold are income statement accounts
- C) Decrease owners' equity by \$1,400
- D) Increase owners' equity by \$400
- E) Increase owners' equity by \$1,400

Answer: D

Diff: 3

Objective: L.O. 2-1

6) An accountant records a transaction when cash is paid or received under which basis of accounting?

- A) Cash
- B) Accrual
- C) Deferral
- D) Prepaid
- E) Cost recovery

Answer: A

Diff: 1

Objective: L.O. 2-1

7) Which of the following circumstances would result in a decrease in income under the accrual basis but would not result in a decrease in income under the cash basis?

- A) Purchase of inventory on account
- B) Payment of 2 months' rent in advance
- C) The expiration of prepaid rent
- D) The return of defective inventory purchased on account, where full credit was given
- E) The payment of the current period's utility bill

Answer: C

Diff: 3

Objective: L.O. 2-1

8) Hilac Plumbing records revenue as cash is received. Which method of income measurement is Hilac Plumbing using?

- A) The accrual basis
- B) The cash basis
- C) The recognition basis
- D) The revenue basis
- E) The realization basis

Answer: B

Diff: 2

Objective: L.O. 2-1

9) Which of the following circumstances would result in an increase in income under the cash basis and an increase in income under the accrual basis?

- A) The return of defective inventory purchased on account, where full credit was given
- B) Cash collection from a credit customer
- C) The cash sale of inventory at a sales price in excess of cost
- D) The expiration of prepaid rent
- E) The sale of inventory on account, at a sales price in excess of cost

Answer: C

Diff: 3

Objective: L.O. 2-1

10) Which of the following circumstances would result in a decrease in income under both the accrual and cash basis?

- A) The payment of last period's rent
- B) The payment of this period's rent
- C) The payment of next period's rent
- D) The cash purchase of land
- E) The purchase of equipment on account

Answer: B

Diff: 2

Objective: L.O. 2-1

11) An operating loss occurs when

- A) revenues exceed expenses.
- B) expenses exceed revenues.
- C) assets exceed liabilities.
- D) liabilities exceed assets.
- E) liabilities exceed owners equity.

Answer: B

Diff: 1

Objective: L.O. 2-1

12) Expenses are

- A) increases in net assets as a result of consuming resources in the process of providing services to a customer.
- B) decreases in net assets as a result of consuming resources in the process of providing services to a customer.
- C) increases in liabilities resulting from purchasing assets.
- D) increases in retained earnings resulting from operations.
- E) increases in equity resulting from operations.

Answer: B

Diff: 2

Objective: L.O. 2-1

13) The operating cycle is the time it takes for a company to buy goods.

Answer: FALSE

Diff: 1

Objective: L.O. 2-1

14) Because of the difficulty of measuring income, there is no reason to compare income levels between different companies.

Answer: FALSE

Diff: 1

Objective: L.O. 2-1

15) The additional owners' equity generated by net income or net profits is used to increase retained earnings.

Answer: TRUE

Diff: 1

Objective: L.O. 2-1

16) Because net income is the excess of revenues over liabilities, retained earnings increases by the amount of net income reported during the period less any dividends.

Answer: FALSE

Diff: 1

Objective: L.O. 2-1

17) According to accounting rules, fiscal years are required to be established over calendar years.

Answer: FALSE

Diff: 1

Objective: L.O. 2-1

18) An interim period is a time span that is less than a year and is established for accounting purposes.

Answer: TRUE

Diff: 1

Objective: L.O. 2-1

19) For revenue to be earned under the cash basis of accounting, the cash from the customer must be received.

Answer: TRUE

Diff: 1

Objective: L.O. 2-1

20) Cash for services performed in 20X8 is received in 20X9. Using the accrual basis of accounting, the revenue would appear on the 20X9 income statement.

Answer: FALSE

Diff: 2

Objective: L.O. 2-1

21) Revenue is recorded when accounts receivable are collected under the cash basis of accounting.

Answer: TRUE

Diff: 1

Objective: L.O. 2-1

22) Under the cash method, revenue is recorded when cash is collected.

Answer: TRUE

Diff: 1

Objective: L.O. 2-1

23) The accrual basis of accounting provides a better measure of economic performance than the cash basis.

Answer: TRUE

Diff: 1

Objective: L.O. 2-1

24) Analyze the following transactions in the accounting equation using the following worksheet.

1. Sales of inventory for \$20,000 on account; merchandise cost is \$13,000.
2. Rent payment made in advance for \$1,500.
3. Acquire additional inventory for \$8,000; paid \$2,000 cash with remainder on credit.
4. Received payment of \$4,000 from customer who purchased goods on credit last month.
5. Returned defective inventory in the amount of \$500. The inventory was purchased on account.

	Cash	Accounts Receivable	Inventory	Prepaid Rent	Accounts Payable	Retained Earnings
1						
1						
2						
3						
4						
5						

Answer:

	Cash	Accounts Receivable	Inventory	Prepaid Rent	Accounts Payable	Retained Earnings
1		+20,000				+20,000
1			-13,000			-13,000
2	-1,500			+1,500		
3	-2,000		+8,000		+6,000	
4	+4,000	-4,000				
5			-500		-500	

Diff: 3

Objective: L.O. 2-1

25) Why doesn't the cash basis of accounting require adjusting accounts with accruals?

Answer: The cash basis of accounting only records revenues and expenses when cash changes hands, while the accrual basis of accounting recognizes revenues when they are earned and expenses when they are incurred. Adjustments are necessary under the accrual basis of accounting since revenue can be earned even if cash is not received and expenses can be incurred even if cash is not paid.

Diff: 2

Objective: L.O. 2-1

26) Describe the advantages of the accrual basis of accounting and the cash basis of accounting.

Answer: The cash basis of accounting has the advantage of producing financial statements when cash is received and paid, giving users a clearer picture of the company's cash position. Proponents suggest that this is important since companies can appear to be doing well based on net income, yet go bankrupt for a lack of cash. The accrual basis of accounting has the advantage of producing a more complete summary of the entity's value-producing activities since it recognizes revenues when they are earned and expenses when they are incurred.

Diff: 2

Objective: L.O. 2-1

## Learning Objective 2.2 Questions

1) According to U.S. GAAP, revenue is recognized when it is

- A) realized or realizable only.
- B) earned only.
- C) received in a timely fashion.
- D) earned and realized or realizable.
- E) received in cash.

Answer: D

Diff: 2

Objective: L.O. 2-2

2) Which of the following is an example of revenue that may be realized but not yet earned?

- A) A customer paying in advance for services to be performed in the future.
- B) A credit sale made to a customer who has a strong credit history. The goods have been delivered.
- C) A credit sale made to a customer with a weak credit history such that the collection of the outstanding receivable is questionable. The goods have been delivered.
- D) The cash sale of a fixed asset, as opposed to the sale of inventory. The fixed asset has been delivered.
- E) It is impossible to have revenue that is realized but not earned.

Answer: A

Diff: 3

Objective: L.O. 2-2

3) Performing a service and receiving a promise to pay from the customer would

- A) increase revenue.
- B) decrease assets.
- C) increase liabilities.
- D) decrease expenses.
- E) decrease revenue.

Answer: A

Diff: 1

Objective: L.O. 2-2

4) Ace Office Equipment is an office equipment company specializing in sales of printers, scanners, and copiers. When should Ace Office Equipment recognize revenue from its sales?

- A) When the customer calls to accept delivery of a new copier
- B) When the customer signs a contract to buy a copier
- C) When the copier is delivered to the customer
- D) When the payment is received from the customer
- E) When the financial statements are prepared that includes this sale

Answer: C

Diff: 2

Objective: L.O. 2-2

5) Armingham Cable Company sells cable services and related accessories. Which of these situations demonstrate proper revenue recognition for Armingham Cable Company?

- A) Insurance is paid one month in advance of the due date because the Armingham Cable Company has extra cash.
- B) Cable services are sold to customers, and customers are billed in advance of receiving services. Revenue is recorded before rendering services.
- C) Cable boxes are purchased for sale to customers, but the accountant has not yet paid the bill.
- D) An interest bearing certificate of deposit is purchased. Interest will be received at the end of 60 days. Interest revenue will be recorded at the end of 60 days.
- E) Employees are paid for hours worked last month.

Answer: D

Diff: 2

Objective: L.O. 2-2

6) Revenue is recognized when a customer's promise to pay exists, even if the company is not relatively certain that they will receive payment.

Answer: FALSE

Diff: 1

Objective: L.O. 2-2

## Learning Objective 2.3 Questions

1) Mac's Computer Skills Training, purchased equipment for \$30,000 on January 1, 20X8, and believes the equipment has a useful life of 36 months. What will be the effect of the equipment's depreciation on the balance sheet equation?

- A) Decreases Equipment account and decreases Stockholders' Equity
- B) Decreases Equipment account and increases Stockholders' Equity
- C) Increases Equipment account and decreases Stockholders' Equity
- D) Increases Equipment account and increases Stockholders' Equity
- E) There is no effect on the balance sheet equation.

Answer: A

Diff: 2

Objective: L.O. 2-3

2) The recording of expenses in the same time period as the related revenues are recognized is known as

- A) cost recovery.
- B) realization.
- C) matching.
- D) recognition.
- E) period costs.

Answer: C

Diff: 2

Objective: L.O. 2-3

3) Which of the following costs are identified directly as expenses of the time period in which they are incurred?

- A) Product costs
- B) Period costs
- C) Both product and period costs
- D) Neither product nor period costs
- E) Period costs as long as the goods have not been sold

Answer: B

Diff: 2

Objective: L.O. 2-3

4) Which of the following costs are linked to the revenues earned during a period?

- A) Product costs
- B) Period costs
- C) Both product and period costs
- D) Neither product nor period costs
- E) Product costs as long as the goods remain in inventory

Answer: A

Diff: 2

Objective: L.O. 2-3



5) Rent is paid one year in advance. The payment is recorded as an asset, Prepaid Rent, and 1/12 of the amount each month is recorded as Rent Expense. This is an example of which of the following concepts?

- A) Recognition
- B) Neutrality
- C) Realization
- D) Matching
- E) Product costs

Answer: D

Diff: 2

Objective: L.O. 2-3

6) Which of the following accounts may be thought of as stored costs that are carried forward to future periods rather than immediately recorded as an expense?

- A) Prepaid insurance
- B) Utilities expense
- C) Salaries expense
- D) Depreciation expense
- E) Cost of goods sold

Answer: A

Diff: 1

Objective: L.O. 2-3

7) What is the effect on a company's balance sheet equation when depreciation expense is recognized?

- A) This transaction affects only the income statement, so no change on the balance sheet will occur.
- B) Total assets and total stockholders' equity will decrease by the same amount.
- C) There will be no change in the total assets, liabilities, and stockholders' equity account.
- D) Total liabilities will increase and total stockholders' equity will decrease by the same amount.
- E) Without knowing the exact dollar amount of depreciation, the effect on the balance sheet cannot be determined.

Answer: B

Diff: 3

Objective: L.O. 2-3

8) When a portion of prepaid rent expires, what will be the effect on the balance sheet equation?

- A) This transaction affects only the income statement, so there will be no effect on the balance sheet.
- B) There will be no overall effect on total assets, because two different asset accounts will change by the exact dollar amount, with one increasing and the other decreasing.
- C) Total assets and total liabilities will go down by the exact same dollar amount.
- D) Total assets and total stockholders' equity will go down by the exact same dollar amount.
- E) Without knowing the dollar amount of the transaction, the effect on the balance sheet equation cannot be determined.

Answer: D

Diff: 3

Objective: L.O. 2-3

9) Expenses that are naturally linked to revenues are product costs. Examples of product costs include \_\_\_\_\_ and \_\_\_\_\_.

- A) Advertising Expense; Utilities Expense
- B) Rent Expense; Depreciation Expense
- C) Interest Revenue; Interest Expense
- D) Cost of Goods Sold; Sales Commissions Expense
- E) Administrative Expense; Selling Expense

Answer: D

Diff: 2

Objective: L.O. 2-3

10) Floral Deliveries, Inc. paid \$6,000 for January, February, March and April's rent in advance on January 1, 20X9. The company recorded this transaction by increasing the balance in the Prepaid Rent account. The balance in the Prepaid Rent account as of March 1, 20X9, will be

- A) \$-0-.
- B) \$1,500.
- C) \$2,000.
- D) \$3,000.
- E) \$6,000.

Answer: D

Diff: 2

Objective: L.O. 2-3

11) Floral Deliveries, Inc. paid \$6,000 for January, February, March and April's rent in advance on January 1, 20X9. The company recorded this transaction by increasing the balance in the Prepaid Rent account. The balance in the Rent Expense account for the period, January 1, 20X9 through March 31, 20X9, as of March 31, 20X9, will be

- A) \$-0-.
- B) \$4,500.
- C) \$2,000.
- D) \$3,000.
- E) \$6,000.

Answer: B

Diff: 2

Objective: L.O. 2-3

12) On March 1, 20X9, Schmor Incorporated paid 6 months' insurance in advance, covering the period of March 1 to August 31, 20X9. The total payment was \$4,200. At the time of the payment, the entire amount was used to increase the balance in the Prepaid Insurance account. What will be the balance in the Prepaid Insurance account as of March 31, 20X9?

- A) \$-0-
- B) \$700
- C) \$2,800
- D) \$3,500
- E) \$4,200

Answer: D

Diff: 2

Objective: L.O. 2-3

13) Which situation violates the matching principle?

- A) Employees are paid for wages worked in a previous month. The wages expense was recorded in the previous month.
- B) Consulting fees incurred have been recorded as an expense even though a bill has not yet been received.
- C) Depreciation was recorded for equipment even though the equipment was purchased on a date other than January 1.
- D) A 1-year insurance policy was paid in full on January 1 and the total amount of the bill was recorded as an expense in January.
- E) Customers are billed for services even though the company knows a portion of the customers will never pay.

Answer: D

Diff: 2

Objective: L.O. 2-3

14) On January 1, 2015, equipment is purchased for \$100,000. The equipment will be used for ten years and has no salvage value. What is the depreciation expense for the year ending December 31, 2016?

- A) \$1,000
- B) \$2,000
- C) \$10,000
- D) \$20,000
- E) \$100,000

Answer: C

Diff: 2

Objective: L.O. 2-3

15) Accrual accounting uses the matching principle.

Answer: TRUE

Diff: 1

Objective: L.O. 2-3

16) The matching concept is closely related to the cash basis of accounting.

Answer: FALSE

Diff: 1

Objective: L.O. 2-3

17) Expenses, such as utilities, whose benefit is consumed by the passage of time rather than by the level of sales, are known as period costs.

Answer: TRUE

Diff: 2

Objective: L.O. 2-3

18) Costs that are linked with revenues and are charged as expenses when the related revenue is recognized are known as product costs.

Answer: TRUE

Diff: 2

Objective: L.O. 2-3

19) The process of allocating the cost of long-lived or fixed assets to expense is referred to as depreciation.

Answer: TRUE

Diff: 1

Objective: L.O. 2-3

20) Assets such as prepaid rent may be thought of as costs that are stored to be carried forward to future periods and recorded as expenses in the future.

Answer: TRUE

Diff: 2

Objective: L.O. 2-3

21) Under the accrual basis of accounting, prepaid assets become expenses when they expire.

Answer: TRUE

Diff: 1

Objective: L.O. 2-3

22) Use the following balance sheet equation format to show the effect of the following transactions. Write the account names that will be used for each transaction.

Account name	Total assets	Total liabilities	Paid-in capital	Retained Earnings
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1. The owners invest \$42,000 in the company.

2. The company purchases equipment costing \$6,000, paying \$2,000 with the remainder as a note payable.

3. The company acquires inventory costing \$2,500, paying \$1,500 with the remainder on account.

4. Depreciation on the equipment was \$200.

Answer:

Item	Account name	Total assets	Total liabilities	Paid-in capital	Retained Earnings
1.	Cash	+42,000			
	Paid-in capital			+42,000	
2.	Equipment	+6,000			
	Cash	(2,000)			
	Note payable		+4,000		
3.	Inventory	+2,500			
	Cash	(1,500)			
	Accounts Payable		+1,000		
4.	Depreciation expense				(200)
	Accumulated Depreciation-Equipment	(200)			

Diff: 2

Objective: L.O. 2-2 & 2-3

23) Describe how the matching concept is necessary to produce an income statement.

Answer: The matching concept is necessary to relate product and period costs to the revenues that are generated in a given time period. Expenses are matched with revenues whenever it is reasonable and practicable to do so. Thus, the recognition of expense on the income statement is tied to the recognition of revenues.

Diff: 2

Objective: L.O. 2-1 & 2-3

## Learning Objective 2.4 Questions

1) Net income is defined as

- A) revenues minus expenses.
- B) expenses minus revenues.
- C) assets minus revenues.
- D) assets plus revenues.
- E) owners' equity assets minus expenses.

Answer: A

Diff: 1

Objective: L.O. 2-4

2) Under accrual basis accounting, the recognition of salaries earned and the immediate payment of salaries to employees would

- A) increase assets.
- B) increase owners' equity.
- C) increase net income.
- D) decrease net income.
- E) increase revenue.

Answer: D

Diff: 1

Objective: L.O. 2-4

3) The following data pertains to Greenwold Manufacturing. Total assets at January 1, 20X9, were \$290,000; at December 31, 20X9, total assets were \$334,000. During 20X9, sales were \$995,000; cash dividends declared were \$10,000; and operating expenses (exclusive of cost of goods sold) were \$545,000. Total liabilities at December 31, 20X9, were \$128,000; at January 1, 20X9, total liabilities were \$105,000. There was no additional paid-in capital during 20X9. What was the amount of stockholders' equity as of January 1, 20X9?

- A) \$450,000
- B) \$440,000
- C) \$185,000
- D) \$635,000
- E) \$175,000

Answer: C

Diff: 1

Objective: L.O. 2-4

4) The following data pertains to Greenwold Manufacturing. Total assets at January 1, 20X9, were \$290,000; at December 31, 20X9, total assets were \$334,000. During 20X9, sales were \$995,000; cash dividends declared were \$10,000; and operating expenses (exclusive of cost of goods sold) were \$545,000. Total liabilities at December 31, 20X9, were \$128,000; at January 1, 20X9, total liabilities were \$105,000. There was no additional paid-in capital during 20X9. What was net income for 20X9?

- A) \$26,000
- B) \$31,000
- C) \$201,000
- D) \$440,000
- E) \$450,000

Answer: B

Diff: 3

Objective: L.O. 2-4

5) The following data pertains to Greenwold Manufacturing. Total assets at January 1, 20X9, were \$290,000; at December 31, 20X9, total assets were \$334,000. During 20X9, sales were \$995,000; cash dividends declared were \$10,000; and operating expenses (exclusive of cost of goods sold) were \$545,000. Total liabilities at December 31, 20X9, were \$128,000; at January 1, 20X9, total liabilities were \$105,000. There was no additional paid-in capital during 20X9. What was cost of goods sold for 20X9?

- A) \$450,000
- B) \$435,000
- C) \$429,000
- D) \$419,000
- E) \$440,000

Answer: D

Diff: 3

Objective: L.O. 2-4

6) In an analysis of transactions using the balance sheet equation, revenues and expenses are adjustments to the \_\_\_\_\_ account.

- A) Accounts Receivable
- B) Accounts Payable
- C) Cash
- D) Capital Stock
- E) Retained Earnings

Answer: E

Diff: 1

Objective: L.O. 2-4

7) Which statement is the major link between two balance sheets?

- A) Statement of Retained Earnings
- B) Statement of Stockholders Equity
- C) Statement of Cash Flows
- D) Statement of Balancing Equity
- E) Income Statement

Answer: E

Diff: 1

Objective: L.O. 2-4

8) An account that may cause ethical conflict because of its need for judgment is

- A) utilities expense.
- B) accounts payable.
- C) accounts receivable.
- D) notes payable.
- E) depreciation expense.

Answer: E

Diff: 1

Objective: L.O. 2-4

9) If sales amount to \$150,000, rent expense is \$2,000, utilities expense is \$3,000, and net income is \$55,000, how much is Cost of Goods Sold?

- A) \$95,000
- B) \$145,000
- C) \$90,000
- D) \$50,000
- E) \$148,000

Answer: C

Diff: 2

Objective: L.O. 2-4

10) An income statement is a report of all revenues and expenses pertaining to a specific date.

Answer: FALSE

Diff: 1

Objective: L.O. 2-4

11) Net income appears on the income statement and balance sheet.

Answer: FALSE

Diff: 1

Objective: L.O. 2-4

12) The balance sheet provides a snapshot of an entity's financial position at an instant of time, while the income statement provides a moving picture of events over a span of time.

Answer: TRUE

Diff: 2

Objective: L.O. 2-4

13) The ending balance in retained earnings appears on the income statement.

Answer: FALSE

Diff: 1

Objective: L.O. 2-4

14) The Dyer Corporation began business operations on April 1, 20X9. The following transactions occurred during April 20X9:

1. The owner invested \$32,000 in the company.
2. Inventory costing \$13,000 was purchased. \$900 in cash was paid; the remainder was put on account.
3. Equipment costing \$23,000 was purchased, of which one-half was paid in cash. The remainder was paid with a note payable. Ignore interest expense. Depreciation for the month relating to the equipment was \$1,500.
4. The rent for April, May, and June 20X9 was paid. The rent payment was \$1,200.
5. Cash sales during the month totaled \$8,900. The cost of the inventory sold was \$5,100.
6. Credit sales during the month totaled \$11,000. The cost of the inventory sold was \$7,500.
7. The wages earned by the employees for the month were \$4,000, although only \$3,500 had been paid as of the end of the month.

Given the previous transactions, determine the net income or loss using the accrual basis for the Dyer Corporation for the month of April, 20X9.

Answer:

Sales revenue (\$8,900 + \$11,000)	\$19,900
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Expenses:

Cost of goods sold (\$5,100 + \$7,500)	12,600
Wage expense	4,000
Rent expense	400
Depreciation expense	<u>1,500</u>
Total expenses	<u>18,500</u>
Net income	<u>\$ 1,400</u>

Diff: 2

Objective: L.O. 2-4



15) Dynamic Enterprises had the following information during November 20X9:

Inventory purchases on account \$ 6,800. Inventory purchases for cash \$2,800.

Sales on account \$15,000. Cash sales \$3,500.

1. Cost of goods sold on cash and credit sales	\$9,200
2. Payment of 3 months' rent in advance (1 month's rent should be recognized in November)	2,100
3. Payment of inventory purchased on account	3,000
4. Collections from credit customers	9,900
5. Wages earned and paid during November	5,000
6. Wages earned but not paid during November	3,200
7. Credit purchases of supplies	1,200
8. Supplies used during November	200

Required:

Prepare an income statement for Dynamic Enterprises for the month of November, 20X9, under the accrual basis.

Answer:                      Dynamic Enterprises  
                                    Income Statement - Accrual Basis  
                                    For the Month Ended November 30, 20X9

Sales	\$18,500
Expenses:	
Cost of goods sold	9,200
Rent expense	700
Wage expense	8,200
Supply expense	<u>200</u>
Total expenses	<u>18,300</u>
Net income	<u>\$ 200</u>

Diff: 2

Objective: L.O. 2-4

16) Following is the balance sheet for Value Creation, Inc. as of January 31, 20X9:

Value Creation, Inc.  
Balance Sheet  
January 31, 20X9

Assets:		Liabilities:	
Cash	\$ 7,100	Accounts Payable	\$ 6,200
Accounts Receivable	4,000	Notes Payable	<u>8,300</u>
Merchandise Inventory	13,500	Total Liabilities	14,500
Prepaid Rent	3,300	Stockholders' Equity:	
Store Equipment	<u>15,600</u>	Paid-in Capital	\$17,600
		Retained Earnings	<u>11,400</u>
		Total Stockholders' equity	<u>29,000</u>
Total Assets	<u>\$43,500</u>	Total Liab. and Stockholders' Equity	<u>\$43,500</u>

The following transactions occurred during January:

1. The company paid \$2,100 of the accounts payable.
2. The company acquired \$3,500 of merchandise inventory, paying 40% in cash and the remainder on open account.
3. The utility bill of \$1,400 for the month of January was paid.
4. The company received \$2,200 from its credit customers.
5. Sales of merchandise inventory for the month of January totaled \$22,500, of which \$10,000 was paid in cash and the remaining amount was on open account. The cost of the merchandise sold was \$15,000.
6. The company paid \$1,600 of the note payable. Ignore interest expense.
7. Depreciation on the store equipment was \$900 for the month.
8. Additional store equipment of \$1,700 was acquired. Of this amount, \$700 was paid in cash and the remainder was added to the note payable balance.
9. The balance in the prepaid rent account represented 3 months' worth of rent paid in advance as of January 31, 20X9.

Required:

Prepare an income statement for the month ended January 31, 20X9.

Answer: Value Creation, Inc.

Income Statement

For the Month Ended January 31, 20X9

Sales	\$22,500
Expenses:	
Cost of goods sold	15,000
Depreciation expense	900
Utility expense	1,400
Rent expense	<u>1,100</u>
Total expenses	<u>18,400</u>
Net income	<u>\$ 4,100</u>

Diff: 3

Objective: L.O. 2-4

17) Following is the balance sheet for the Pratley Corporation as of March 31, 20X9:

Assets		Liabilities	
Cash	\$ 7,100	Accounts Payable	\$ 6,200
Accounts Receivable	4,000	Notes Payable	<u>8,300</u>
Merchandise Inventory	13,500	Total Liab.	14,500
Prepaid Rent	3,300	Paid-in Capital	\$17,600
Store Equipment	<u>15,600</u>	Retained Earnings	<u>11,400</u>
		Total Stockholders' equity	<u>29,000</u>
Total Assets	<u>\$43,500</u>	Total Liab. and Stockholders' Equity	<u>\$43,500</u>

The following transactions occurred during April:

1. The company paid \$2,100 of the accounts payable.
2. The company acquired \$3,500 of merchandise inventory, paying 40% in cash and the remainder on open account.
3. The utility bill of \$600 for the month of April was paid.
4. The company received \$2,200 from its credit customers.
5. Sales of merchandise inventory for the month of April totaled \$12,900, of which \$5,400 was paid in cash and the remaining amount was on open account. The cost of the merchandise sold was \$8,100.
6. The company paid \$1,600 of the note payable.
7. Depreciation on the store equipment was \$600 for the month.
8. Additional store equipment of \$1,700 was acquired. Of this amount, \$700 was paid in cash and the remainder was added to the note payable balance.
9. The balance in the prepaid rent account represented 3 months' worth of rent paid in advance as of March 31, 20X9.
10. Net income for the month ended April, 20X9, was \$2,500.

Required:

Prepare an analysis of the above transactions using the balance sheet equation. Prepare a balance sheet dated April 30, 20X9.

Answer:

Trans- action	Cash	Accounts Receiv.	Merch. Inventory	Prepaid Rent	Store Equip.	Accounts Payable	Notes Payable	Paid-in Capital	Retained Earnings
	\$7,100	\$4,000	\$13,500	\$3,300	\$15,600	\$6,200	\$8,300	\$17,600	\$11,400
1	-2,100					-2,100			
2	-1,400		+3,500			+2,100			
3	-600								-600
4	+2,200	-2,200							
5	+5,400	+7,500							+12,900
			-8,100						-8,100
6	-1,600						-1,600		
7					-600				-600
8	-700				+1,700		+1,000		
9				-1,100					-1,100
	<u>\$8,300</u>	<u>\$9,300</u>	<u>\$8,900</u>	<u>\$2,200</u>	<u>\$16,700</u>	<u>\$6,200</u>	<u>\$7,700</u>	<u>\$17,600</u>	<u>\$13,900</u>

Pratley Corporation  
Balance Sheet  
April 30, 20X9

Assets:

Cash	\$ 8,300
Accounts Receivable	9,300
Merchandise Inventory	8,900
Prepaid Rent	2,200
Store Equipment	17,300
Accum. Deprec.	(600) <u>16,700</u>
Total Assets	<u>\$45,400</u>

Liabilities:

Accounts Payable	\$ 6,200
Notes Payable	<u>7,700</u>
Total Liabilities	13,900
<u>Stockholders' Equity:</u>	
Paid in Capital	17,600
Retained Earnings	<u>13,900</u>
Total Stockholders' equity	<u>31,500</u>
Total Liabilities and Stockholders' Equity	<u>\$45,400</u>

Diff: 3

Objective: L.O. 2-4

18) Specify whether each of the following terms belong on the Balance Sheet, Income Statement, or Statement of Stockholders' Equity and whether each is an asset, liability, revenue, expense, or neither.

1. accrual
2. sales
3. accounts receivable
4. account payable
5. cost of sales
6. prepaid rent
7. equipment
8. net earnings
9. dividends
10. predictive value

Answer:

<u>Financial statement</u>	<u>Account</u>
1. neither	neither
2. income statement	revenue
3. balance sheet	asset
4. balance sheet	liability
5. income statement	expense
6. balance sheet	asset
7. balance sheet	asset
8. income statement, statement of stockholders' equity	neither
9. statement of stockholders' equity	neither
10. neither	neither

Diff: 2

Objective: L.O. 2-4 & 2-5

## Learning Objective 2.5 Questions

1) The Goaling Company declared a \$3,500 cash dividend on March 1, 2012 payable on April 2, 2012. The effect of the March 1st transaction on the Goaling Company would be to

- A) decrease the balance in the cash account and decrease the balance in the retained earnings account by \$3,500.
- B) increase the balance in the dividend expense account and increase the balance in the dividend payable account by \$3,500.
- C) increase the balance in the dividend expense account and increase the balance in the retained earnings account by \$3,500.
- D) increase the balance in the dividend payable account and increase the balance in the prepaid dividend account by \$3,500.
- E) increase the balance in the dividend payable account and decrease the balance in the retained earnings account by \$3,500.

Answer: E

Diff: 2

Objective: L.O. 2-5

2) On May 1, 2011, Chickla Corporation's balance sheet had the following information available:

Total Assets	\$500,000
Total Liabilities	\$400,000
Total Stockholders' Equity	\$100,000

During the month of May, Chickla Corporation earned revenues of \$120,000 and incurred expenses of \$30,000. Dividends declared during May were \$20,000. The dividends will be paid in June. No other capital transactions occurred. What amount did Chickla Corporation's total stockholders' equity increase by in May?

- A) \$90,000
- B) \$120,000
- C) \$100,000
- D) \$70,000
- E) \$190,000

Answer: D

Diff: 2

Objective: L.O. 2-5

3) On September 12, 2012, Infinity Enterprises declared a \$7,000 cash dividend payable on October 1, 2012. The effect of the October 1, 2012, transaction on Infinity Enterprises would be to

A) increase the balance in the cash account and decrease the balance in the prepaid dividend account by \$7,000.

B) decrease the balance in the cash account and decrease the balance in the dividend payable account by \$7,000.

C) decrease the balance in the cash account and increase the balance in the dividend expense account by \$7,000.

D) decrease the balance in the cash account and increase the balance in the prepaid dividend account by \$7,000.

E) decrease the balance in the cash account and decrease the balance in the retained earnings account by \$7,000.

Answer: B

Diff: 2

Objective: L.O. 2-5

4) A liability for a cash dividend is recorded on the

A) stockholder appreciation date.

B) record date.

C) payment date.

D) declaration date.

E) dividends date.

Answer: D

Diff: 2

Objective: L.O. 2-5

5) Cash dividends

A) are distributions of cash to trade creditors.

B) are expenses like rent and depreciation.

C) should not be deducted from revenues on the income statement.

D) must be paid annually, regardless of the amount of cash in the bank.

E) cannot be paid if a net loss is incurred.

Answer: C

Diff: 2

Objective: L.O. 2-5

6) Solar Communications had the following balances in its stockholders' equity accounts as of December 31, 20X9:

Paid-in Capital	\$53,000
Retained Earnings	\$31,000

During the year ended December 31, 20X9, Solar Communications generated \$36,000 in net income, and declared and paid \$16,000 in dividends. The ending balance in the retained earnings account at December 31, 20X8, was

- A) \$11,000.
- B) \$26,000.
- C) \$13,000.
- D) \$67,000.
- E) \$40,000.

Answer: A

Diff: 2

Objective: L.O. 2-5

7) The Computing Company's balance sheet on September 30, 2012 follows:

Total Assets	\$75,000
Total liabilities	\$20,000
Paid-in-Capital	\$25,000
Retained Earnings	\$30,000

During the month of October, the Computing Company recognized revenues of \$52,000, cost of goods sold of \$39,000, depreciation expense of \$3,000, the payment of November and December's rent totaling \$2,000, and salary expense of \$6,000. The retained earnings balance at October 31, 2012, will be

- A) \$33,000.
- B) \$54,000.
- C) \$32,000.
- D) \$56,000.
- E) \$36,000.

Answer: A

Diff: 3

Objective: L.O. 2-5

8) Carpenter and Sons' balance sheet on January 1, 2012, had total assets of \$73,000, total liabilities of \$20,000, paid-in capital of \$30,000, and retained earnings of \$23,000. During the month of January, Carpenter and Sons' recognized revenues of \$73,000, cost of goods sold of \$47,000, depreciation expense of \$12,000, the payment of February and March's rent totaling \$2,500, and salary expense of \$8,000. The retained earnings balance at January 31, 2012, will be

- A) \$29,000.
- B) \$27,750.
- C) \$31,000.
- D) \$41,000.
- E) \$26,500.

Answer: A

Diff: 3

Objective: L.O. 2-5



9) Cash dividends are an expense, and therefore they appear on the income statement.

Answer: FALSE

Diff: 1

Objective: L.O. 2-5

10) The date the board of directors declares a dividend is known as the record date.

Answer: FALSE

Diff: 2

Objective: L.O. 2-5

11) Frequently, the statement of retained earnings is added to the bottom of the balance sheet.

Answer: FALSE

Diff: 1

Objective: L.O. 2-5

12) Determine the missing values.

Revenues	\$250
Expenses	200
Dividends Declared	20
Additional investments by owners	A
Net income	B
Retained Earnings, Beginning	C
Retained Earnings, Ending	110
Paid-in Capital, Beginning	60
Paid-in Capital, Ending	60
Total Assets, Beginning	D
Total Assets, Ending	250
Total Liabilities, Beginning	95
Total Liabilities, Ending	E

Answer:

$A = 0$  Beginning Paid-in Capital + Additional Investments by Owners = Ending Paid-in Capital;

$60 + \text{Additional Investments by Owners} = 60$ ;  $A = \text{Additional Investments by Owners} = 0$

$B = 50$  Net income = Revenues - Expenses;  $B = 250 - 200$

$C = 80$  Retained Earnings, Beg + Net income - Dividends = Retained Earnings, End;  $C + 50 - 20 = 110$

$D = 235$  Assets, Beg = Liabilities, Beg + (Retained Earnings, Beg + Paid-in Capital, Beg)  $D = 95 + (80 + 60)$

$E = 80$  Assets, End = Liabilities, End + (Retained Earnings, End + Paid-in Capital, End)  $250 = E + (110 + 60)$ ;

$E = 80$

Diff: 2

Objective: L.O. 2-4 & 2-5

13) The Lone Maple Corporation had net income during 2012 of \$46,000. During the year, dividends of \$14,000 were declared, of which \$10,000 had been paid as of year end. As of the beginning of 2012, the Paid-in Capital account had a balance of \$38,000 and the Retained Earnings account had a balance of \$54,000. Prepare the Retained Earnings column for the Statement of Stockholders' Equity for the Lone Maple Corporation for the year ended December 31, 2012.

Answer:

Retained Earnings, Beginning Balance	\$ 54,000
Add: Net Income	46,000
Less: Dividends Declared	<u>(14,000)</u>
Retained Earnings, Ending Balance	<u>\$ 86,000</u>

Diff: 2

Objective: L.O. 2-5

## Learning Objective 2.6 Questions

1) Which financial ratio is required to be reported on the face of the income statement of publicly-held corporations?

- A) Earnings per share
- B) Price-earnings ratio
- C) Dividend-yield ratio
- D) Dividend payout ratio
- E) Inventory turnover ratio

Answer: A

Diff: 2

Objective: L.O. 2-6

2) Which financial ratio measures how much the investing public is willing to pay for a chance to share the company's potential earnings?

- A) Earnings per share
- B) Price-earnings ratio
- C) Dividend-yield ratio
- D) Dividend payout ratio
- E) Profit margin ratio

Answer: B

Diff: 2

Objective: L.O. 2-6

3) Mason Manufacturing had 2012 earnings of \$850,000. Cash dividends per share were \$1.25. The company had an average of 350,000 shares of common stock outstanding. The market price of the stock at the end of the year was \$30 per share. What are the earnings per share for 2012?

- A) \$ 1.50.
- B) \$24.00.
- C) \$ 2.43.
- D) \$ 21.50.
- E) This cannot be determined from the information given.

Answer: C

Diff: 2

Objective: L.O. 2-6

4) Mason Manufacturing had 2012 earnings of \$850,000. Cash dividends per share were \$1.25. The company had an average of 350,000 shares of common stock outstanding. The market price of the stock at the end of the year was \$30 per share. What was the price-earnings ratio for Mason Manufacturing?

- A) 24.0
- B) 18.4
- C) 9.36
- D) 12.35
- E) Cannot be determined from the information provided

Answer: D

Diff: 2

Objective: L.O. 2-6

5) Mason Manufacturing had 2012 earnings of \$850,000. Cash dividends per share were \$1.25. The company had an average of 350,000 shares of common stock outstanding. The market price of the stock at the end of the year was \$30 per share. What was the dividend-yield for Mason Manufacturing?

- A) 4.17%
- B) 1.25%
- C) 4.80%
- D) 15.0%
- E) Cannot be determined from the information provided

Answer: A

Diff: 2

Objective: L.O. 2-6

6) Stone, Inc. had 2012 earnings of \$1,500,000. Cash dividends per share were \$0.50. The company had an average of 1,225,000 shares of common stock outstanding. The market price of the stock at the end of the year was \$6.00 per share. What was the earnings per share for 2012?

- A) \$0.60
- B) \$0.75
- C) \$1.22
- D) \$1.25
- E) \$5.50

Answer: C

Diff: 2

Objective: L.O. 2-6

7) Stone, Inc. had 2012 earnings of \$1,500,000. Cash dividends per share were \$0.50. The company had an average of 1,225,000 shares of common stock outstanding. The market price of the stock at the end of the year was \$6.00 per share. What was the price-earnings ratio for Stone, Inc.?

- A) 6.5
- B) 4.92
- C) 3.00
- D) 12
- E) 5.20

Answer: B

Diff: 2

Objective: L.O. 2-6

8) Stone, Inc. had 2012 earnings of \$1,500,000. Cash dividends per share were \$0.50. The company had an average of 1,225,000 shares of common stock outstanding. The market price of the stock at the end of the year was \$6.00 per share. What was the dividend-yield for Stone, Inc.?

- A) 12.00%
- B) 10.00%
- C) 20.33%
- D) 8.33%
- E) Cannot be determined from the information provided

Answer: D

Diff: 2

Objective: L.O. 2-6

9) Which financial ratio measures the return on an investment in common stock by dividing the cash dividends per share by the market price per share?

- A) Earnings per share
- B) Price-earnings ratio
- C) Dividend-yield ratio
- D) Dividend payout ratio
- E) Accounts receivable turnover ratio

Answer: C

Diff: 2

Objective: L.O. 2-6

10) The dividend-yield ratio must appear on the face of the balance sheet.

Answer: FALSE

Diff: 1

Objective: L.O. 2-6

11) Another name for the P-E ratio is the earnings multiple.

Answer: TRUE

Diff: 2

Objective: L.O. 2-6

12) The price-earnings ratio is earnings per share of common stock divided by the market price per share of common stock.

Answer: FALSE

Diff: 2

Objective: L.O. 2-6

13) The dividend-yield ratio is computed as the current market price of the stock divided by the current dividend per share.

Answer: FALSE

Diff: 2

Objective: L.O. 2-6

14) Companies with exceptional growth (growth stocks) tend to pay a higher percentage of their earnings in dividends.

Answer: FALSE

Diff: 1

Objective: L.O. 2-6

15) The dividend-payout ratio is computed as common dividends per share divided by earnings per share.

Answer: TRUE

Diff: 2

Objective: L.O. 2-6

16) Following is a list of selected financial data for a series of companies:

	Per-share Data			Ratios and Percentages		
Company	Price	Earnings	Dividends	P-E	Dividend-yield	Dividend-payout
Jacobs	\$50	\$1.75	A	B	C	30%
Simons	\$35	D	\$2.25	E	F	40%
Russell	G	\$5.25	\$1.75	12.0	I	J

1. Compute the missing figures and identify the company with

- the highest dividend-yield.
- the highest dividend-payout percentage.
- the lowest market price relative to earnings.

2. Assume that you know nothing about any of these companies other than the data given and the computations you have made from the data. If you were interested in receiving dividend income, which company would you choose as

- the most attractive investment? Why?
- the least attractive investment? Why?

Answer:

- $A = .53$  Dividend-payout = dividends/earnings;  $.30 = A/1.75$   
 $B = 28.6$  P-E = Price/earnings;  $B = 50/1.75$ ;  
 $C = .0106$  Dividend-yield = Dividends/Price;  $C = .53/50$ ;  $C = 1.06\%$   
 $D = 5.63$  Dividend-payout = dividends/earnings;  $.40 = 2.25/D$ ;  $D = 5.63$   
 $E = 6.22$  P-E = Price/earnings;  $E = 35/5.63$ ;  $E = 6.22$   
 $F = .0643$  Dividend-yield = Dividends/Price;  $F = 2.25/35$ ;  $F = 6.43\%$   
 $G = 63$  P-E = Price/earnings;  $12.0 = G/5.25$ ;  $G = 63$   
 $I = .0278$  Dividend-yield = Dividends/Price;  $I = 1.75/63 = 2.78\%$   
 $J = 33\%$  Dividend Payout = dividends/earnings;  $J = 1.75/5.25 = .33$

- Simons
- Simons
- Simons

2. a. Simons

Simons has the highest dividend-yield and has the highest dividend-payout. It also has the highest dividends per share.

b. Jacobs

Jacobs has the lowest dividend-yield ratio and the lowest dividend-payout ratio.

Diff: 3

Objective: L.O. 2-6

## Learning Objective 2.7 Questions

1) The cost-effectiveness constraint requires that standard setting bodies choose rules that

- A) have decision-making benefits that exceed the costs of providing the information.
- B) have revenue generating ability.
- C) have revenue generating ability that exceeds the cost of providing the information.
- D) have costs known to the SEC.
- E) are not costly to implement.

Answer: A

Diff: 2

Objective: L.O. 2-7

2) R&D costs are expensed in the period that they occur,

- A) which is a violation of the matching principle.
- B) because FASB determined that the benefits of R&D are often harder to pinpoint than the costs.
- C) because it was the only way FASB could get verifiability.
- D) because IASB lobbied FASB to do so.
- E) because the U.S. Congress passed a law on it.

Answer: B

Diff: 2

Objective: L.O. 2-7

3) The primary objective of financial reporting focuses on

- A) consistency.
- B) representational faithfulness.
- C) validity.
- D) decision usefulness in making investment, credit and resource allocation decisions.
- E) the matching concept.

Answer: D

Diff: 2

Objective: L.O. 2-7

4) The two main qualities that make accounting information useful for decision making are \_\_\_\_\_ and \_\_\_\_\_.

- A) relevance and reliability
- B) relevance and faithful representation
- C) understandability and verifiability
- D) comparability and consistency
- E) timeliness and reliability

Answer: B

Diff: 2

Objective: L.O. 2-7

5) Standards issued by the Financial Accounting Standards Board are

- A) products of logic and philosophical discussions with Congress.
- B) issued by the FASB without the input of interested parties such as corporate accountants, financial analysts and lobbyists.
- C) often the result of compromises among the interested parties.
- D) never influenced by the SEC.
- E) None of the above statements is true.

Answer: C

Diff: 2

Objective: L.O. 2-7

6) The two attributes that make financial information relevant are \_\_\_\_\_ and \_\_\_\_\_.

- A) reliability; faithful representation
- B) reliability; verifiability
- C) comparability; consistency
- D) understandability; timeliness
- E) predictive value; confirmatory value

Answer: E

Diff: 2

Objective: L.O. 2-7

7) \_\_\_\_\_ is the capability of information to make a difference to the decision maker.

- A) Verifiability
- B) Reliability
- C) Relevance
- D) Validity
- E) Neutrality

Answer: C

Diff: 2

Objective: L.O. 2-7

8) Relevance is defined as

- A) choosing accounting policies without attempting to achieve purposes other than measuring economic impact.
- B) the capability of information to make a difference to the decision maker.
- C) the quality of information that allows users to depend on it to represent the conditions or events that it purports to represent.
- D) a correspondence between the accounting numbers and the resources or events those numbers purport to represent.
- E) a quality of information such that there would be a high extent of consensus among independent measurers of an item.

Answer: B

Diff: 2

Objective: L.O. 2-7

9) \_\_\_\_\_ is a quality of information that helps users form their expectations about the future.

- A) Timeliness
- B) Faithful representation
- C) Verifiability
- D) Predictive value
- E) Confirmatory value

Answer: D

Diff: 2

Objective: L.O. 2-7

10) Verifiability is defined as

- A) the quality of information that allows users to depend on it to represent the conditions or events that it purports to represent.
- B) the capability of information to make a difference to the decision maker.
- C) choosing accounting policies without attempting to achieve purposes other than measuring economic impact.
- D) a correspondence between the accounting numbers and the resources or events those numbers purport to represent.
- E) a quality of information such that it can be checked to ensure it is correct.

Answer: E

Diff: 2

Objective: L.O. 2-7

11) Neutrality is defined as

- A) information which is free from bias and not slanted to influence the behavior of decision makers.
- B) the capability of information to make a difference to the decision maker.
- C) the quality of information that allows users to depend on it to represent the conditions or events that it purports to represent.
- D) a correspondence between the accounting numbers and the resources or events those numbers purport to represent.
- E) a quality of information such that there would be a high extent of consensus among independent measures of an item.

Answer: A

Diff: 2

Objective: L.O. 2-7

12) Faithful representation requires information to be \_\_\_\_\_, \_\_\_\_\_ and free from material errors.

- A) timely; comparable
- B) relevant; reliable
- C) consistent; verifiable
- D) confirmatory; predictive
- E) complete, neutral

Answer: E

Diff: 2

Objective: L.O. 2-7



13) \_\_\_\_\_ requires all companies in an industry to follow similar accounting principles and methods. For example, most companies in the department store industry use the same inventory method.

- A) Validity
- B) Verifiability
- C) Faithful representation
- D) Consistency
- E) Comparability

Answer: E

Diff: 2

Objective: L.O. 2-7

14) \_\_\_\_\_ requires accountants to present information clearly and concisely.

- A) Verifiability
- B) Validity
- C) Understandability
- D) Relevance
- E) Reliability

Answer: C

Diff: 1

Objective: L.O. 2-7

15) The characteristics that enhance relevance and faithful representation are

- A) predictive value; confirmatory value.
- B) validity; verifiability.
- C) understandability; timeliness; predictive value.
- D) comparability; verifiability; timeliness; understandability.
- E) consistency; understandability; confirmatory value.

Answer: D

Diff: 1

Objective: L.O. 2-7

16) Using LIFO to value inventory one year and using FIFO the next is a violation of which accounting principle?

- A) Conservatism
- B) Recognition
- C) Neutrality
- D) Matching
- E) Consistency

Answer: E

Diff: 2

Objective: L.O. 2-7

17) The cost-effectiveness constraint asserts that an item should be included in a financial statement if its omission or misstatement would tend to mislead the reader.

Answer: FALSE

Diff: 1

Objective: L.O. 2-7

18) Relevance means that the information can be counted on to represent faithfully the condition of the company, given the rules in use.

Answer: FALSE

Diff: 2

Objective: L.O. 2-7

19) With verifiability, knowledgeable and independent observers would agree that the information presented has been appropriately measured.

Answer: TRUE

Diff: 2

Objective: L.O. 2-7

20) U.S. financial reporting follows the IASB framework for decision usefulness.

Answer: FALSE

Diff: 2

Objective: L.O. 2-7

21) Relevance and validity are the two main qualities that make accounting information useful for decision making.

Answer: FALSE

Diff: 1

Objective: L.O. 2-7

22) One of the components of relevance is neutrality.

Answer: FALSE

Diff: 2

Objective: L.O. 2-7

23) Define the following terms:

a. Neutrality

b. Relevance

c. Consistency

d. Verifiability

Answer:

a. Neutrality: free from bias; the information is not slanted to influence behavior in a particular direction

b. Relevance: the capability of information to make a difference to the decision-maker

c. Consistency: using the same accounting policies and procedures from period to period

d. Verifiability: A quality of information such that it can be checked to ensure it is correct

Diff: 2

Objective: L.O. 2-7

## Learning Objective 2.8 Questions

1) Reliability is defined as

- A) the quality of information that allows it to help users form their expectations about the future.
- B) the capability of information to make a difference to the decision maker.
- C) the quality of information that allows decision makers to depend on it to represent the conditions or events that it purports to represent.
- D) choosing accounting policies without attempting to achieve purposes other than measuring economic impact.
- E) a quality of information such that there would be a high extent of consensus among independent measurers of an item.

Answer: C

Diff: 2

Objective: L.O. 2-8

2) What is the concept that differentiates a corporation from its management?

- A) Entity
- B) Going concern
- C) Reliability
- D) Cost-benefit criterion
- E) Materiality

Answer: A

Diff: 1

Objective: L.O. 2-8

3) The reason that companies use historical costs to value long-term assets is the

- A) entity concept.
- B) materiality convention.
- C) going concern convention.
- D) periodicity convention.
- E) neutrality principle.

Answer: C

Diff: 2

Objective: L.O. 2-8

4) Which item would most likely be expensed even though it is an asset?

- A) desk
- B) computer
- C) filing cabinets
- D) printer
- E) trash can

Answer: E

Diff: 2

Objective: L.O. 2-8

5) The convention that gives financial statement users more timely information is the

- A) stable monetary unit
- B) materiality convention
- C) going concern convention
- D) periodicity convention
- E) entity concept

Answer: D

Diff: 1

Objective: L.O. 2-8

6) Reliability is the assumption that, ordinarily, an entity persists indefinitely.

Answer: FALSE

Diff: 1

Objective: L.O. 2-8

7) The stable monetary unit concept is based on a principle of low inflation.

Answer: TRUE

Diff: 2

Objective: L.O. 2-8

8) Reliability refers to whether the information makes a difference to the decision maker.

Answer: FALSE

Diff: 2

Objective: L.O. 2-8

9) The assumption that in all ordinary situations an entity persists indefinitely is known as the reliability assumption.

Answer: FALSE

Diff: 1

Objective: L.O. 2-8

10) Which of the following concepts applies to situations 1-6 below.

Entity	Periodicity
Reliability	Stable monetary unit
Going Concern	Cost-effectiveness constraint
Materiality	

1. Rhodes, Inc. acquired equipment with a fair market value of \$22,000 and only paid \$1,000 for the equipment at an auction. Following company policy which expenses assets with a cost of \$1,000 or less, Rhodes, Inc. recorded an expense of \$1,000.

2. McElwain, Inc. has divisions in several countries. Before publishing financial statements, McElwain, Inc. translates its divisional financial information to U.S. dollars.

3. Smith Enterprises, is experiencing financial difficulties due to poor economic conditions. The organization has been in existence for 50 years and has experienced these conditions in the past with little financial impact to the organization. Although Smith Enterprises may be impacted, there is no reason to believe that it will go bankrupt.

4. Komar Cable Company, owned by Katherine Hoots and Kate Coleman, each deposited \$50,000 into the business's bank account. Both Katherine and Kate have access to the bank account and periodically transfer money from their personal accounts to the business account, but they never access the business account for personal use.

5. Mower Technology prepares monthly financial statements even though it is costly to do so.

6. Water Waste Systems only records accounting transactions when there is convincing evidence that can be verified by independent auditors.

Answer:

1. Materiality
2. Stable monetary unit
3. Going concern
4. Entity
5. Periodicity
6. Reliability

Diff: 2

Objective: L.O. 2-8

- 11) For each example, write the qualitative characteristic(s) or accounting term that best corresponds.
- a. A company that uses a different inventory method every year is not following this characteristic of financial information.
  - b. An error of \$100 of revenue for Sherry's Dairy King versus \$100 of revenue for McDonald's.
  - c. Record revenue when it is earned and record expenses when incurred regardless of when cash changes hands.
  - d. A parent corporation, a subsidiary, and a retail store are examples of this concept.
  - e. The SEC requires companies with publicly traded securities to file financial reports with the SEC quarterly.
  - f. Three auditors count the same amount of cash.

Answer:

- a. consistency
- b. materiality
- c. accrual accounting
- d. entity
- e. periodicity
- f. verifiability

Diff: 2

Objective: L.O. 2-7 & 2-8