**Chapter 2**

**True-False**

1. The balance sheet is also called the statement of condition or statement of financial position.

2. The balance sheet is prepared for a period of time, generally a year.

3. A classified balance sheet means that the asset and liability sections are categorized into key areas.

4. Companies that use IFRS may switch the order of presentation of assets and liabilities, listing noncurrent items before current items.

5. As part of an integrated disclosure system required by the SEC, the information presented in annual reports includes three-year audited balance sheets.

6. A common-size balance sheet is useful to the analyst because it facilitates the structural analysis of the firm.

7. Working capital refers to the investment in property, plant and equipment.

8. The valuation of marketable securities on the balance sheet requires the separation of investment securities into three categories: held to maturity, trading securities, and securities available for sale.

9. Accounts receivable are recorded on the balance sheet at gross realizable value.

10. Retained earnings is the unused stash of cash that a firm has accumulated since inception.

**Fill in the Blank**

1. A expresses each item on the balance sheet as a percentage of total assets.

2. are those assets expected to be converted into cash within one year or operating cycle, whichever is longer.

3. are also referred to as short-term investments.

4. The net realizable value of accounts receivable is the actual amount of the account less an .

5. Additional information helpful to the analysis of accounts receivable and the allowance account is provided in the schedule of .

6. The three cost flow assumptions most frequently used in the U.S. are , , and .

7. arises when one company acquires another company for a price in excess of the fair market value of the net identifiable assets.

8. Companies that are paid in advance for services or products record a liability on the receipt of cash in an account titled or .

9. A lease affects both the balance sheet and the income statement.

10. Many companies list an account titled on the balance sheet even though no dollar amount will appear.

## **Multiple Choice**

1. The balancing equation is expressed as:

a. Assets + Liabilities = Stockholders' Equity.

b. Revenues – Expenses = Net Income.

c. Sales – Costs = Net Profit.

d. Assets = Liabilities + Stockholders' Equity.

2. Which of the following statements is false?

a. Common-size balance sheets allow for comparison of firms with different levels of total assets by introducing a common denominator.

b. The common-size balance sheet reveals the composition of assets within major categories.

c. Each item on a common-size balance sheet is expressed as a percentage of sales.

d. The common-size balance sheet reveals the capital and the debt structure of the firm.

3. Which of the following accounts would be classified as current assets on the balance sheet?

a. Accounts receivable, inventory, cash equivalents.

b. Marketable securities, accounts payable, property, plant and equipment.

c. Prepaid expenses, goodwill, long-term investments.

d. Property, plant and equipment, inventory, goodwill.

4. Which of the following items would not be classified as cash equivalents?

a. U.S. Treasury bills.

b. Trading securities.

c. Commercial paper.

d. Money market funds.

5. Which of the following marketable securities are reported at fair value?

a. Held to maturity and trading securities.

b. Trading securities and securities available for sale.

c. Held to maturity and securities available for sale.

d. Corporate bonds and convertible debt.

6. Which of the following items should alert the analyst to the potential for manipulation when analyzing accounts receivable and the allowance for doubtful accounts?

a. Sales, accounts receivable and the allowance for doubtful accounts are all growing at approximately the same rate.

b. A company lowers its credit standards and also increases the balance in the allowance for doubtful accounts.

c. Accounts receivable is growing at a large rate and the allowance for doubtful accounts is decreasing.

d. An analysis of the “Valuation and Qualifying Accounts” schedule required in the Form 10-K reveals that the amounts recorded for bad debt expense are close in amount to the actual amounts written off each year.

7. Which method of inventory assumes the last units purchased will remain in ending inventory on the balance sheet?

a. FIFO.

b. LIFO.

c. Average cost.

d. LIFO and FIFO.

8. Which type of firm would most likely carry the most finished goods inventory?

a. A manufacturing firm.

b. A retail firm.

c. A service firm.

d. A wholesale firm.

9. Which method of inventory would be least likely to be used by a European firm?

a. FIFO.

b. LIFO.

c. Average cost.

d. LIFO and FIFO.

10. Which of the following statements is false?

a. Companies are allowed to use more than one inventory valuation method.

b. LIFO is an income tax concept.

c. Using FIFO for high-technology products makes sense if the firm is trying to reduce taxes because the technology industry is generally deflationary.

d. Companies using IFRS may not reverse entries for inventory write-downs if the market recovers.

Use the following information to answer questions 11 through 13:

ABC Companypurchases five products for sale in the order and at the costs shown:

Unit Cost per Unit

1 $10

2 $12

3 $15

4 $18

5 $13

11. Assume ABC sells two items and uses the FIFO method of inventory valuation. What amount would appear in ending inventory on the balance sheet?

a. $22

b. $46

c. $45

d. $31

12. Assume ABC sells two items and uses the LIFO method of inventory valuation. What amount would appear for cost of goods sold on the income statement?

a. $37

b. $41

c. $22

d. $31

13. Assume ABC uses the average cost method of inventory valuation. What unit cost would be used to determine the amount in ending inventory or cost of goods sold?

a. $12.67

b. $13.60

c. $15.00

d. $13.00

14. Which of the following statements is true?

a. The straight-line method of depreciation allocates a decreasing amount of depreciation expense each year.

b. Straight-line depreciation is the least used method for financial reporting purposes.

c. Fixed assets are reported at historical cost less accumulated depreciation on the balance sheet.

d. The total amount of depreciation over the asset’s life is larger when using an accelerated method of depreciation.

15. When will a firm regard goodwill on its books?

a. When one company acquires another company for a price in excess of the fair market value of the net identifiable assets acquired.

b. When the firm donates property to charities.

c. When it is determined that there has been a loss of value of long-term assets.

d. When fixed assets are impaired.

16. Which of the following accounts could be categorized as either a current or noncurrent liability depending on date the debt is due?

a. Notes payable and deferred taxes.

b. Accounts payable and current portion of long-term debt.

c. Deferred taxes and mortgages due in 30 years.

d. Long-term warranties and accounts payable.

17. Which items would be classified as long-term debt?

a. Accounts payable, unearned revenue, pension liabilities.

b. Common stock, retained earnings, bonds payable.

c. Mortgages, convertible debentures, bonds payable.

d. Deferred taxes, accrued expenses, treasury stock.

18. How are deferred taxes recorded on the balance sheet?

a. As current or noncurrent liabilities.

b. As stockholders’ equity.

c. As noncurrent assets or noncurrent liabilities.

d. As current or noncurrent assets or liabilities.

19. Which stockholders’ equity account represents the sum of every dollar a company has earned since its inception, less any payments made to shareholders in the form of dividends?

a. Treasury stock.

b. Accumulated other comprehensive income

c. Retained earnings.

d. Preferred stock.

20. Which item below would not be a quality of financial reporting issue related to the balance sheet?

a. Mismatching the type of debt (short or long-term) used to finance assets.

b. Discretionary expenses.

c. Overvaluation of assets.

d. Off-balance sheet financing.

## **Short Answer/Problem**

1. Explain the format and key components of a balance sheet prepared in the U.S. or overseas.

2. Define current assets and current liabilities and give two examples of each.

3. Why should the allowance for doubtful accounts and the valuation and qualifying accounts schedule be analyzed?

4. Write a short explanation of why you agree or disagree with the following statement:

“The LIFO method of inventory valuation cannot be used by grocery stores.”

5. Explain the impact of calculating depreciation using the straight-line method versus an accelerated method on the amounts shown on a balance sheet.

6. Using the following information analyze the accounts receivable and the allowance for doubtful accounts for this company:

2015 2014

Sales $11,230 $10,340

Accounts receivable, net 1,510 1,860

Allowance for doubtful accounts 43 32

7. Using the following excerpts from the most recent annual report of WooHoo, a high technology firm, analyze the accounts receivable and allowance for doubtful accounts. Be sure to show all calculations and write a thorough interpretation of those calculations.

|  |  |  |
| --- | --- | --- |
| *(dollars in millions)* | *2015* | *2014* |
| Net sales | $7,200 | $6,400 |
| Accounts receivable - less allowance for doubtful accounts of $22 at April 30, 2015 and $40April 30, 2014 | $1,000 | $1,030 |

**WooHoo**

**Valuation And Qualifying Accounts**

**For the Years Ended April 30, 2015, 2014 and 2013**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Balance at beginning of period | Charged to expenses | Deductions | Balance at end of period |
| Allowance for doubtful accounts |  |  |  |  |
| 2015 | $40 | $5 | ($23) | $22 |
| 2014 | $51 | $4 | ($15) | $40 |
| 2013 | $46 | $25 | ($20) | $51 |

8. Why is the inventory accounting method chosen by a company important to the user of financial statement information?

9. Using the following information calculate the ending inventory balance and the cost of goods sold expense that would be reported at the end of the year if the following inventory valuation methods are used:

a. Average cost

b. FIFO

c. LIFO

Units Purchase Price

Beginning inventory 100 $25

Purchase #1 80 $26

Purchase #2 160 $23

Purchase #3 90 $24

Sales 260

10. Using the following information calculate the ending inventory balance and the cost of goods sold expense that would be reported at the end of the year if the following inventory valuation methods are used:

a. Average cost

b. FIFO

c. LIFO

Units Purchase Price

Beginning inventory 8 $8

Purchase #1 15 $9

Purchase #2 24 $11

Purchase #3 12 $13

Sales 40

11.The Breakfast Company purchases equipment for $100,000. Management estimates that the equipment will have a useful life of eight years and no salvage value.

a. Calculate depreciation expense and the book value of the equipment at the end of the first year using the straight-line method of depreciation.

b. Calculate depreciation expense and the book value at the end of the first year using the double-declining balance method of depreciation.

12. Redtop Co. purchased a piece of equipment last year for $300,000. Management estimates that the equipment will have a useful life of five years and no salvage value. The depreciation expense recorded for tax purposes will be $72,000 this year (Year 2). The company uses the straight-line method of depreciation for reporting purposes.

a. Calculate the amount of depreciation expense for reporting purposes this year (Year 2).

b. What will be the net book value of the equipment reported on the balance sheet at the end of this year (Year 2)?

c. Will a deferred tax asset or liability be created as a result of the depreciation recorded for tax and financial reporting purposes?

d. What amount will be added to the deferred tax account as a result of the depreciation timing difference?

13. Explain the differences between accounts payable, short-term debt, current maturities of long-term debt, accrued liabilities and unearned revenue.

14. Explain the differences between long-term notes payable, mortgages, debentures, bonds payable, and convertible debt.

15. Using the following balance sheet, prepare a common size balance sheet:

Assets Liabilities and stockholders' equity

Current assets Current liabilities

Cash 4 Accounts payable 28

Short-term investments 9 Current portion of

Accounts receivable 32 long-term debt 12 Inventory 41 Total current liabilities 40

Prepaid expenses 2 Long-term liabilities

Deferred taxes, current 7 Long-term debt 48

Total current assets 95 Total liabilities 88

Long-term assets Stockholders' equity

Property & equipment 53 Common stock and PIC 51 Goodwill 12 Retained earnings 30

Long-term investments 8

Other assets 1 Total stockholders' equity 81

Total assets 169 Total liabilities and equity 169

16. Analyze the following common size balance sheet:

2015 2014

Current assets:

Cash 1% 16%

Accounts receivable 24 18

Inventory 35 30

Total current assets 60% 64%

Property, plant and equipment 37 26

Other assets 3 10

Total assets 100% 100%

Current liabilities:

Accounts payable 29% 27%

Short-term debt 23 33

Total current liabilities 52% 60%

Long-term debt 22 17

Total liabilities 74% 77%

Common stock and paid in capital 9 10

Retained earnings 17 13

Total stockholders' equity 26% 23%

Total liabilities and stockholders' equity 100% 100%