**Chapter 3**

**True-False**

1. The income statement presents cash revenues, cash expenses, net income, and earnings per share for an accounting period.

2. The statement of stockholders’ equity is an important link between the balance sheet and the income statement.

3. The income statement comes in two basic formats, the multiple-step and the single-step versions; however, for analysis purposes the single-step version should be used.

4. The common size income statement expresses each income statement item as a percentage of total assets.

5. Gross profit is the difference between sales and all operating expenses.

6. If the cost of goods sold percentage increases or decreases, this does not necessarily mean that costs have increased or decreased.

7. In volatile industries, such as high technology, gross profit margin may increase or decrease significantly each year.

8. Operating profit margin is impacted by sales and all operating expenses except cost of goods sold.

9. Users of financial statements need to distinguish between earnings increasing due to core operations versus items such as tax rate deductions.

10. Two special items, discontinued operations and extraordinary items, must be disclosed separately on the income statement.

**Fill in the Blank**

1. Two other terms used interchangeably with income are and .

2. income is the change in equity of a company during a period from transactions, other events, and circumstances relating to nonowner sources.

3. The method of inventory generally results in the matching of current costs with current revenues and therefore produces higher-quality earnings.

4. The gross profit margin and are complements of each other and the two percentages always add up to 100%.

5. costs are or should be a major expense in the budgets of companies for which marketing is an important element of success.

6. and represent the cost of assets other than land that will benefit a business enterprise for more than a year.

7. charges are the expenses recognized to record a decline in value of a long-term asset.

8. The method of accounting for investments should be used when the investor can exercise significant influence over the investee’s operating and financing policies.

9. Foreign currency translation effects, unrealized gains and losses, additional pension liabilities and cash flow hedges are items that may comprise a company’s other income.

10. Stock and stock result in the issuance of additional shares of stock to existing shareholders.

**Multiple Choice**

1. Which equation represents an income statement?

a. Assets = liabilities + stockholders’ equity.

b. Cash in – cash out = net income.

c. Revenues - expenses = net income.

d. Beginning retained earnings + revenues – expenses = ending retained earnings.

2. Which format of the income statement should be used for analysis purposes?

a. Multiple-step.

b. Cash basis.

c. Single-step.

d. Accrual basis.

3. Which of the following is an acceptable method to report total comprehensive income?

a. On the face of thebalance sheet.

b. Total comprehensive income does not have to be reported.

c. In the operating section of the cash flow statement.

d. In the statement of stockholders' equity.

4. How is a common-size income statement prepared?

a. Each income statement item is expressed as a percentage of total assets.

b. Each income statement item is expressed as a percentage of net sales.

c. Each income statement item is expressed as a percentage of net income.

d. Each income statement item is expressed as a percentage of cash flow.

5. How are sales reported on the income statement?

a. Sales are shown for three years net of returns and allowances.

b. Sales amounts are inflation-adjusted.

c. Sales are shown for two years and are reported in nominal terms.

d. Sales are shown at gross amounts, adjusted for inflation.

6. Which of the following statements is true?

a. In stable industries, such as retailers, the gross profit margin is generally volatile from year to year.

b. Gross profit margin and operating profit margin are complements of each other and the two percentages add up to 100%.

c. Fixed costs do not vary proportionately with volume changes but remain the same within a relevant range of activity.

d. In capital intensive industries sales volume changes result in a stable gross profit margin.

7. How should companies with more than one revenue source report revenue and cost of goods sold?

a. Each revenue source should be reported separately, but all cost of goods sold should be added together and reported as a single amount.

b. The revenues and cost of goods sold should be netted together and reported as a single line item.

c. All revenue sources should be added together and shown as one line item and all cost of goods sold should be added together and shown as one line item.

d. Each revenue line should be shown separately with a corresponding cost of goods sold line for each revenue source.

8. Selling and administrative expenses include which of the following income statement items?

a. Salaries, insurance, interest.

b. Salaries, rent, advertising.

c. Rent, interest, cost of goods.

d. Advertising, research & development, amortization.

9. What is amortization?

a. The process used to allocate the cost of natural resources.

b. The process used to allocate the cost of tangible fixed assets.

c. The process used to allocate the cost of capital leases, leasehold improvements and intangible assets.

d. The process used to allocate the cost of oil, gas, minerals and standing timber.

10. Which item would not be classified as an operating expense?

a. Interest expense.

b. Rent expense.

c. Depreciation.

d. Repairs and maintenance.

11. Which of the following statements is true?

a. It is unnecessary to analyze operating expenses over which management exercises discretion.

b. Impairment charges do not need to be analyzed since they are generally a non-recurring expense.

c. A good way to improve operating profit is to cut repairs and maintenance costs as much as possible.

d. Operating expenses can be easily analyzed by preparing a common-size income statement.

12. Why is it important to assess operating profit?

a. Operating profit represents the firm’s profits after consideration of all revenues, expenses and comprehensive income.

b. The figure for operating profit provides a basis for assessing the success of the firm apart from its financing and investing activities and separate from tax considerations.

c. Operating profit represents the firm’s profits after consideration of all revenues and expenses.

d. Operating profit represents the firm’s profits after consideration of all revenues and expenses, except for taxes.

13. Which of the items below would be included under “Other income and expense”?

a. Salaries, interest expense, equity losses.

b. Equity earnings, gains from sale of assets, interest income.

c. Research and development, dividend income, interest expense.

d. Advertising, cost of goods sold, selling and administrative expenses.

14. How does the equity method distort earnings?

a. Income is recognized even though cash may never be received.

b. Equity earnings are recorded even if the investor cannot exercise influence over the investee’s policies.

c. Equity earnings are only recorded on a cash basis of accounting.

d. Equity earnings are recorded when investment ownership is 100%.

15. How is it possible for a U.S. firm to have increasing earnings but a lower effective tax rate?

a.The firm has expenses that are not deductible for tax purposes.

b. Tax rates in foreign countries where the firm operates are higher.

c. Tax rates in foreign countries where the firm operates are lower.

d. It is not possible for a firm to have an effective tax rate different from the U.S. federal statutory tax rate.

16. Which item is not a special item that must be disclosed separately on the income statement?

a. Extraordinary gain.

b. Extraordinary loss.

c. Foreign currency translation adjustments.

d. Discontinued operations.

17. How is earnings per common share calculated?

a. Operating profit divided by the average number of common stock shares outstanding.

b. Net profit divided by the average number of common and preferred stock shares outstanding.

c. Operating profit divided by the average number of repurchased common stock shares.

d. Net profit divided by the average number of common stock shares outstanding.

18. Which of the following items could be found on a statement of shareholders' equity?

a.Reasons for retained earnings increases or decreases.

b. A reconciliation of beginning to ending cash.

c. The market value of the firm’s common stock.

d. Assets = Liabilities + Stockholders’ Equity.

Use the following information for Jett Co. to answer questions 19 and 20.

2015 2014

Sales 1,200 1,000

COGS 850 700

Operating expenses 200 200

Income taxes 30 35

19. Jett Co.'s gross profit, operating profit and net profit margins for 2015 are:

a. 50.0%, 32.5%, 22.5% respectively.

b. 29.2%, 12.5%, 10.0%, respectively.

c. 27.0%, 11.0%, 10.5%, respectively.

d. 21.5%, 17.5%, 12.0%, respectively.

20. Jett Co.'s average tax rates for 2015 and 2014 are:

a. 15.5% and 10.0%

b. 20.0% and 35.0%

c. 25.8% and 35.4%.

d. 31.4% and 36.8%.

**Short Answer/Problem**

1. Explain why the multiple-step format of the income statement is best for analysis?

2. What questions should the analyst try to answer when analyzing the trend of a firm's sales number?

3. The gross profit margin is increasing for a firm. Give three reasons that could explain the increase.

4. Discuss the following statement: “Gross profit margin should be stable for all firms.”

5. Why might it be unfavorable for a firm to reduce repairs and maintenance, advertising, and research and development expenses?

6. If an investor wants to understand how well a firm is performing in their core industry, which profit number (gross, operating or net) would be the best to analyze? Explain why.

7. RBO Company purchased 25% of the voting common stock of YJD Company on January 1 and paid $800,000 for the investment. YJD Company reported $50,000 of earnings for the year and paid $10,000 in cash dividends. Calculate investment income and the balance sheet investment account balance for RBO Company using the following methods:

a. Cost method.

b. Equity method.

8. Using the single-step income statement for ABC Company prepare a multiple-step income statement.

ABC Company

Income Statement

Income

Net sales $1,750

Interest income 90

1,840

Costs and expenses

Cost of goods sold 1,000

Interest expense 70

Depreciation expense 220

Income tax expense 70

Advertising expense 110

General and administrative expenses 180

Net earnings $ 190

9. Prepare an income statement using the following information:

Gross profit margin 40%

Gross profit $7,500

Tax rate 35%

Operating profit $400

10. Using the following information prepare a common size income statement:

Net sales $9,500

Cost of goods sold 5,900

Gross profit $3,600

General and administrative expenses 1,250

Selling expenses 920

Operating profit $1,430

Income tax expense 460

Net profit $ 970

11. The following information is available for Escalante Computer Company. Analyze the gross profit margin making any calculations deemed necessary.

2015 2014 2013

Product sales $2,700 $2,400 $1,960

Service revenues 380 50 40

Total sales $3,080 $2,450 $2,000

Cost of products $2,100 $1,750 $1,450

Cost of services 260 35 30

Total cost of sales $2,360 $1,785 $1,480

Gross profit $ 720 $ 665 $ 520

12. Explain the possible causes of the trends in the following data:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Year 1 | Year 2 | Year 3 |
| Gross profit margin | 35% | 31% | 28% |
| Operating profit margin | 9% | 11% | 13% |
| Net profit margin | 4% | 10% | 7% |

13. Use the following information to analyze BobKat Equipment Sales. Calculate any profit measures deemed necessary in order to discuss the profitability of the company.

BobKat Equipment Sales

Income Statement

For the Years Ended Dec. 31, 2015 and 2014

2015 2014

Net sales $124,000 $138,000

COGS 90,000 95,000

Gross profit $ 34,000 $ 43,000

General and administrative expenses 31,000 36,000

Operating profit $ 3,000 $ 7,000

Interest expense (1,000) (1,000)

Earnings before taxes $ 2,000 $ 6,000

Income taxes 800 1,800

Net income $ 1,200 $ 4,200

14.Analyze the common size income statements below for Coast Company:

|  |  |  |
| --- | --- | --- |
| (in percent) | 2015 | 2014 |
| Net sales | 100 | 100 |
| COGS | 62 | 65 |
| Gross margin | 38 | 35 |
| Research and development | 9 | 5 |
| Selling, general and administrative | 11 | 17 |
| Restructuring, asset impairments and other charges | 1 | 8 |
| Income/(loss) from operations | 17 | 5 |
| Interest expense | (3) | (1) |
| Income/(loss) before taxes | 14 | 4 |
| Provision for/(benefit from) income taxes | 4 | 1 |
| Net income/(loss) | 10 | 3 |

15. Analyze the common size income statements below for 3T Company:

|  |  |  |
| --- | --- | --- |
|  | 2015 | 2014 |
| Net sales | 100% | 100% |
| COGS | 89 | 87 |
| Gross margin | 11% | 13% |
| Selling, general and administrative | 7 | 9 |
| Restructuring, asset impairments and other charges | 0 | 9 |
| Income/(loss) from operations | 4% | (5)% |
| Interest expense | (1) | (2) |
| Income/(loss) before taxes | 3% | (7%) |
| Provision for/(benefit from) income taxes | 1 | 0 |
| Income/(loss) after taxes | 2% | (7)% |
| Discontinued operations, net | 6 | 1 |
| Net income (loss) | 8% | (6)% |