

Chapter 1 Financial Accounting and Its Economic Context

MULTIPLE CHOICE QUESTIONS

1. A bank that loans money to a company is called
- a supplier.
 - a creditor.
 - an equity investor.
 - a shareholder.

Ans: B LO 1 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

2. The auditors are charged with responsibility
- to detect financial fraud committed by employees during the course of their audit
 - to conduct a thorough and independent audit
 - to correct all errors in the financial statements
 - for the accuracy and completeness of the financial statements

Ans: B LO 1 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

3. Which of the following best describes the two perspectives of the financial reporting process that managers need to understand in investing decisions?
- Economic consequences and user orientation.
 - Corporate governance and user orientation.
 - User orientation and debt covenants.
 - Economic consequences and corporate governance.

Ans: A LO 1 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

4. Considering and understanding how business decisions affect the financial statements is
- the sole responsibility of the Securities and Exchange Commission.
 - provided in the auditor's report.
 - referred to as an economic consequence perspective.
 - interpreted strictly by the company's suppliers.

Ans: C LO 1,2,5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

5. A statement that “the financial statements were prepared in accordance with generally accepted accounting principles” is found in the
- collateral.
 - stock market.
 - footnotes to the balance sheet.
 - auditor’s report.

Ans: D LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

6. A statement that financial statement information “is the responsibility of the company” issuing the statements is found in the
- footnotes to the financial statements.
 - loan contract.
 - management letter.
 - board of directors’ report.

Ans: C LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

7. CPA is an abbreviation for
- Certified Public Accountant.
 - Certified Production Accountant.
 - Consumer Protection Agency.
 - Certified Permissible Accounting.

Ans: A LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

8. An explanation about the assumptions, estimates, and choices of alternative accounting methods used in the financial statements is found in the
- footnotes to the balance sheet.
 - auditor’s report.
 - statement of shareholders’ equity.
 - president’s letter to the shareholders.

Ans: A LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

9. Which of the following best describes assets paid to owners of a company as a return for their initial investment?
- payables
 - compensation contracts
 - dividends
 - interest

Ans: C LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

10. All of the following would likely be part of a loan contract except:
- maturity date
 - earning power
 - collateral
 - annual interest

Ans: B LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

11. A Certified Public Accountant
- reviews every transaction that a company conducts during any given year.
 - performs a company's audit.
 - is one of the investors of a company.
 - is responsible for the preparation and integrity of a company's financial statements.

Ans: B LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

12. An internal control system
- is maintained to ensure that transactions of a company are properly recorded and reported and the assets are safeguarded.
 - is included in the set of footnotes to the financial statements.
 - is an estimate of the profits a company expects to earn in the future.
 - measures how much control management has over its staff.

Ans: A LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

13. Footnotes to financial statements
- more fully explain certain items in the financial statements.
 - reflect financial notes personalized by the company's executive team.
 - show the detail of salaries of every employee.
 - justify fraudulent business practices.

Ans: A LO 2,3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

14. The balance sheet communicates
- proof to the investor that the company is profitable.
 - assets, liabilities, and shareholders' equity with all transactions reflected through the year.
 - assets, liabilities, and shareholders' equity as of a certain date.
 - operating, investing, and financing activities.

Ans: C LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 15.** The income statement communicates
- assets, liabilities, and shareholders' equity as of a certain date.
 - how much cash the owner received during the period.
 - information about dividends the company paid to its owners.
 - revenues less expenses during a period of time.

Ans: D LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 16.** Where would you find information on the amount of net income for the year?
- Factory production reports on units produced
 - Auditor's report
 - Income statement
 - Internal Revenue Service

Ans: C LO 3 BT: C Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 17.** The statement of cash flows communicates
- assets, liabilities, and owners' equity at a point of time.
 - operating, investing, and financing activities.
 - beginning balance plus income less dividends.
 - how much cash the company owes its employees.

Ans: B LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 18.** The retained earnings section of the statement of shareholders' equity communicates
- beginning balance plus income less dividends.
 - revenues less expenses during a period of time.
 - how much cash that management has paid for bonuses.
 - operating, investing, and financing activities.

Ans: A LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 19.** An investor wants to find the amount of cash and land that a company has. Where will the investor look?
- Statement of shareholders' equity
 - Income statement
 - Balance sheet
 - Statement of cash flows

Ans: C LO 3 BT: C Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 20.** Dividends declared and paid to the owners are found in the
- management letter.
 - income statement.
 - dividends statement.
 - statement of shareholders' equity.

Ans: D LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 21.** Cash received by a company from its regular operations during the year is found in its
- balance sheet.
 - statement of cash flows.
 - statement of shareholders' equity.
 - auditor's report.

Ans: B LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 22.** A company's profits during its most recent year are found in its
- balance sheet and income statement.
 - statement of cash flows only.
 - statement of shareholders' equity only.
 - income statement and statement of shareholders' equity.

Ans: D LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 23.** The cash paid during the year to satisfy a company's debt is found in its
- statement of cash flows.
 - income statement.
 - statement of shareholders' equity.
 - auditor's report.

Ans: A LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 24.** The amount which a company's customers owe the company for products delivered or services rendered is found in the
- footnotes only.
 - income statement.
 - balance sheet.
 - statement of cash flows.

Ans: C LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 25.** Solvency may be described as
- an amount owed that must be paid in the future.
 - amounts that can be distributed to owners only.
 - the amount invested in the firm by its owners.
 - the ability to generate enough cash to pay its debt as the amounts become due.

Ans: D LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 26.** Retained earnings may be described as
- the total past profits retained in the business.
 - a company's future growth.
 - the amount invested in the firm by its owners.
 - amounts retained for payments to vendors.

Ans: A LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 27.** All of the following might be found in the auditor's report except:
- A statement about conformity with GAAP.
 - A statement about the fair presentation of the financial conditions and operations of the audited company.
 - A statement about the effectiveness of the company's internal control system.
 - A statement about the function of the company's board of directors.

Ans: D LO 3 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 28.** Where would you most likely find a detailed explanation about estimates used in the financial statements of a company?
- management letter
 - financial footnotes
 - debt restrictions
 - debt contracts

Ans: B LO 3 BT: C Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 29.** To run a company effectively, which one of the following might be a source from which management might acquire capital?
- Customers
 - FASB
 - Debt and equity investors
 - Auditors

Ans: C LO 4 BT: C Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 30.** Liabilities may be described as
- amounts that will be used for future growth.
 - the amounts owed that must be paid in the future.
 - the total measured past growth of a firm less the amount distributed to the owners.
 - amounts the company paid during the past year.

Ans: B LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 31.** Public stock exchanges
- are operated by managers of a company.
 - are markets that sell annual reports.
 - provide a forum for buying and selling of equity interests in other companies.
 - are used to evaluate debt and equity investments.

Ans: C LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 32.** An equity investor is
- a person who provides money to a company with the expectation that it will be paid back with interest.
 - a creditor that has a regular trade relationship.
 - a person who provides money to a company as a gift with a stipulation that it will be used as agreed.
 - a person who provides money to a company, though the original money never has to be repaid, and who may be entitled to receive periodic cash payments.

Ans: D LO 4 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 33.** A debt investor is
- a person who provides money to a company with the expectation that it will be paid back with interest.
 - a person who provides money to a company and expects periodic cash payments in return, though the original money never has to be repaid.
 - a person who provides money to a company as a gift with a stipulation that it will be used as agreed.
 - often referred to as a stockholder.

Ans: A LO 4 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 34.** The board of directors
- provides money to a company with the expectation that it will be paid back with interest.
 - makes corporate decisions such as hiring and firing management and setting company policy.
 - is responsible for the future profits of a company.
 - is in charge of accounting and human resources on a daily basis.

Ans: B LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 35.** As a potential creditor, you are interested in a company's ability to pay loan interest and principal as they come due. Which of the following would be of the greatest interest to you in your analysis?
- statement of shareholders' equity.
 - income statement.
 - statement of cash flows.
 - Statement of Financial Accounting Standards.

Ans: C LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 36.** Which one of the following is an equity investor?
- A supplier of inventory waiting for payment
 - A person who purchases common stock of a corporation
 - A bank that loans money to a firm
 - A person who has a savings account in a bank

Ans: B LO 4 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 37.** Debt investments
- require payments to the shareholders for periodic dividends.
 - are found on a company's income statement.
 - may be secured with collateral.
 - return payments at the discretion of the board of directors.

Ans: C LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 38.** Annual reports of public companies
- are published once per year.
 - include financial statements adjusted for inflation.
 - are also known as Form 10-K.
 - are published by companies 4 times per year.

Ans: A LO 6 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 39.** Equity investments are bought and sold
- only on the first day of each year.
 - in stock exchanges such as the NASDAQ.
 - by a company's independent auditors.
 - from and to the SEC.

Ans: B LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 40.** Shareholders
- and employees are the owners of a company.
 - receive repayment of the cash they have invested in a business.
 - receive payment from a company regardless if the company is profitable or not.
 - may benefit from increases in the value of their investment of a company.

Ans: D LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 41.** Which of the following statements is true?
- Dividend payments are determined by management.
 - Dividend payments are specified by a contract.
 - Dividend payments are based on company collateral.
 - Dividend payments are paid at the board of director's discretion.

Ans: D LO 4 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 42.** Which of the following is a measure of past profits that have been retained in a business?
- liabilities
 - common stock.
 - retained earnings.
 - assets

Ans: C LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 43.** Ownership of an equity security entitles the holder to which basic right?
- The right to manage outstanding loans.
 - The right to pay dividends.
 - The right to vote for company directors at the annual shareholders' meeting.
 - The right to certify financial report reviews.

Ans: C LO 4 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 44.** Which of the following is a public exchange for equity and debt securities?
- The Federal Trade Commission.
 - The New York Stock Exchange.
 - The Securities and Exchange Commission.
 - The Financial Accounting Standards Board.

Ans: B LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 45.** Who prepares financial reports for a particular company?
- The Securities and Exchange Commission
 - The Board of Directors
 - The company's management
 - The company's auditors

Ans: C LO 5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 46.** As used in accounting, SEC is an abbreviation for
- Securities and Exchange Commission.
 - South Eccentric Commissioners.
 - Shareholders' Equity Commission.
 - Southeastern Conference.

Ans: A LO 5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 47.** The independence of the auditor is subject to question when the
- auditor is paid by the management of the company being audited.
 - auditor is independent.
 - audit firm is also responsible for preparing the tax return.
 - auditor is paid 1% of the company's profits for the audit services provided.

Ans: D LO 5 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 48.** Which of the following statements is true?
- Shopping for favorable audit opinions is permitted by the SEC.
 - No formal reporting of auditor switches is required by the SEC.
 - The SEC has enacted rules to help ensure financial literacy among audit committee members.
 - Since management constructs the financial statements, auditors have no legal liability to those who rely upon these reports.

Ans: C LO 5 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 49.** The advantage to the user of financial accounting statements that are audited by independent certified public accountants is assurance that the
- statements are produced in accordance with generally accepted accounting principles.
 - company will be solvent for at least one more year.
 - company cannot remain profitable for more than 2 to 3 years.
 - company pays its fair share of income taxes.

Ans: A LO 5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 50.** GAAP is an acronym for
- General Asset Accounting Procedures.
 - Government Agency Accounting Procedures.
 - Generally Accepted Accounting Principles.
 - Global Accounting Activity Principles.

Ans: C LO 5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 51.** Generally accepted accounting principles are determined by
- annual voting by all certified public accountants.
 - a privately financed body known as the FASB.
 - the SEC.
 - a congressional committee that passes laws governing accounting practice.

Ans: B LO 5 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 52.** When management goes beyond ethical boundaries in its attempt to make financial statements appear attractive, management
- should be commended for its creativity.
 - will not need an annual audit.
 - should pay its employees larger bonuses.
 - is perpetrating fraud or possible criminal activity.

Ans: D LO 5 BT: C Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 53.** Select the name that doesn't fit with the others on the list.
- PricewaterhouseCoopers
 - Sarbanes-Oxley
 - Deloitte & Touche
 - KPMG Peat Marwick

Ans: B LO 5 BT: C Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 54.** What encourages management to refrain from pressuring auditors too strongly?
- Possible legal liability
 - Outside investors and creditors
 - Prospects of higher net income
 - Economic incentives from outsiders

Ans: A LO 5 BT: C Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 55.** All of the following are functions of the board of directors except:
- Attending quarterly meetings.
 - Conducting performance review for management.
 - Declaring dividends.
 - Firing staff personnel.

Ans: D LO 5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 56.** Which of the following is least likely to be a by-product of ethical business practices?
- fewer lawsuits.
 - higher profits.
 - higher audit fees.
 - public trust.

Ans: C LO 5 BT: C Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 57.** Which of the following factors is least likely to encourage managers and auditors to act professionally?
- professional reputation.
 - tax structure
 - legal liability
 - ethics

Ans: B LO 5 BT: C Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 58.** Which of the following groups make up a company's audit committee?
- Auditors.
 - Outside directors from the Board.
 - Company officers.
 - All of the individuals in (a), (b), and (c) are included in the audit committee.

Ans: B LO 5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 59.** Which of the following groups enacted the Sarbanes Oxley Act?
- FASB
 - AICPA
 - U.S. Congress
 - PCAOB

Ans: C LO 5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 60.** Generally accepted accounting principles
- are laws created and enacted by Congress.
 - define the standards for internal management reporting.
 - increase the level of credibility in financial statements.
 - are created by the Securities and Exchange Commission.

Ans: C LO 5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 61.** Financial accounting practices and standards used in other countries
- are the same as practices used by United States companies.
 - have different systems of financial accounting.
 - are more progressive than those used by United States companies.
 - will often have common practices similar to U.S. GAAP.

Ans: D LO 6 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 62.** International Financial Reporting Standards (IFRS) are recognized as acceptable by major stock exchanges throughout the world except in
- England.
 - Japan.
 - The United States.
 - France.

Ans: C LO 6 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 63.** International Financial Reporting Standards (IFRS) are promulgated by
- the United Nations.
 - the World Bank.
 - the Big Four accounting firms.
 - the IASB.

Ans: D LO 6 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 64.** Which one of the following is true concerning the International Accounting Standards Board?
- a. It is the international accounting standards setting body that is attempting to bring greater uniformity to worldwide accounting practices.
 - b. It approves all financial statements before they are distributed to users.
 - c. It consistently disagrees with the FASB on its rulemaking.
 - d. It requires both national and international companies around the world apply the same accounting principles.

Ans: A LO 6 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 65.** All of the following are false regarding international accounting standards (IAS) except which of the following?
- a. The SEC requires all companies to use IAS.
 - b. There are no substantive differences between U.S. GAAP and IFRS.
 - c. The SEC prohibits U.S. stock exchanges from listing non-U.S. companies who follow IFRS.
 - d. All public companies in the European Union are required to report using IFRS and IAS.

Ans: D LO 6 BT: K Difficulty: Moderate TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 66.** Which one of the following statements is true?
- a. Financial accounting is the only accounting used in the United States.
 - b. Companies that have a profit objective use not-for-profit accounting.
 - c. Managerial accounting targets operating decisions.
 - d. Financial and tax accounting are virtually the same.

Ans: C LO 7 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

MATCHING QUESTIONS

1. Identify which of the users of financial statement information listed in A through E would most likely desire and/or benefit from the economic aspects listed in items 1 through 5 below. You may use each letter more than once or not at all.

Users

- A. bankers
- B. potential investors
- C. government agencies
- D. customers
- E. managers

- _____ 1. Want to choose a company to earn returns potentially higher than fixed income instruments
- _____ 2. Need to predict future cash flows necessary for repayment
- _____ 3. Want to determine how much tax a company must pay
- _____ 4. Want the best product possible for the money
- _____ 5. Want to maintain a level of compensation

Solution:

- 1. B
- 2. A
- 3. C
- 4. D
- 5. E

LO 1,2,4 BT: C Difficulty: Easy TOT: 2 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

2. For each description listed in items 1 through 4 below, select the letter of the accounting term (A through F) it best describes. You may use each letter more than once.

Accounting Terms

- A. Asset
- B. Liability
- C. Retained earnings
- D. Revenues
- E. Expenses
- F. Equity investment

- _____ 1. Total measured past growth less the amount distributed to owners
- _____ 2. A measure of assets generated from the products and services sold
- _____ 3. Owed and must be paid in the future
- _____ 4. Amount invested in the firm by its owners

Solution:

- 1. C
- 2. D
- 3. B
- 4. F

LO 3, 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

3. Identify which accounting document(s) listed in A through D would always provide the information indicated in items 1 through 5 below. You may use each letter more than once or not at all. Some items may require more than one answer.

Accounting Documents

- A. Auditor’s report
- B. Management letter
- C. Financial statements
- D. Footnotes

- _____ 1. Represents that the financial statements are stated fairly, in all material respects
- _____ 2. Indicates that financial statements were prepared in conformity with GAAP
- _____ 3. Contains assets, liabilities, and equity, as well as income from operations
- _____ 4. Explains certain items on the balance sheet
- _____ 5. An acceptance of responsibility of financial information provided

Solution:

- 1. A
- 2. A, B, D
- 3. C

- 4. D
- 5. B

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

4. For each financial statement listed in 1 through 4 below, place the letter (A through D) of the best description in the space provided. You may use each letter more than once or not at all.

Descriptions

- | |
|---|
| A. Assets, liabilities, and shareholders' equity |
| B. Increased by net income and decreased by dividends |
| C. Operating, investing, and financing activities |
| D. Revenues less expenses |

- _____ 1. Balance sheet
_____ 2. Income statement
_____ 3. The retained earnings section of the statement of shareholders' equity
_____ 4. Statement of cash flows

Solution:

- 1. A
- 2. D
- 3. B
- 4. C

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

SHORT ANSWER QUESTIONS

1. What independent party attests that the balance sheet and income statement present fairly the financial position of the company?

Solution: auditor

LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

2. Who assesses whether the financial statements fairly represent the financial position and results of operations?

Solution: independent auditor

LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

3. Where would you most likely find statements revealing the assumptions, estimates, and choices of alternative accounting methods used in the balance sheet?

Solution: footnotes to the financial statements

LO 2 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

4. Which financial statement would you review to determine the amount of cash a company received from an issue of capital stock during the year?

Solution: statement of cash flows

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

5. Which financial statement would you review to determine a company's interest expense?

Solution: income statement

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 6.** Identify the financial statement in which revenues less expenses are reported.

Solution: income statement

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 7.** What financial statement communicates profits retained and distributions to shareholders?

Solution: statement of shareholders' equity

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 8.** What financial statement communicates cash flows from operating activities?

Solution: statement of cash flows

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 9.** What financial statement lists and measures assets, liabilities, and shareholders' equity at a certain date?

Solution: balance sheet

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 10.** What financial statement shows where the money came from and where it went?

Solution: statement of cash flows

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 11.** Identify which financial statement you would review to determine the amount of cash a company paid to retire its debt.

Solution: statement of cash flows

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 12.** Which source would you review to determine that the financial statements are fairly stated in accordance with GAAP?

Solution: auditor's report

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 13.** Which financial statement would you review to determine if a company's operating cash flow is sufficient to pay day-to-day obligations?

Solution: statement of cash flows

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 14.** Which financial statement would best help you understand the increases and decreases in cash over a period of time?

Solution: statement of cash flows

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 15.** What financial statement would you review to determine if a company's payroll expense exceeds \$1,000,000?

Solution: income statement

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 16.** What financial statement would you review to determine the profitability ratio?

Solution: income statement

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 17.** What financial statement would you review to determine whether or not dividends were distributed during the year?

Solution: statement of shareholders' equity and the statement of cash flow

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 18.** On which financial statement would you find the amount invested by a company's owners? What is the name of this amount?

Solution: balance sheet and also the statement of shareholders' equity; common stock

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 19.** On which financial statement(s) would you find the accumulation of total profits and losses less distributions to owners since the company began operations? What is the name of this amount?

Solution: balance sheet and statement of shareholders' equity; retained earnings

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 20.** List the names of the financial statements that appear in an annual report.

Solution: balance sheet, income statement, statement of cash flows, statement of shareholders' equity

LO 3 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 21.** What accounting name is given to one who provides money to a company with the expectation that it will be paid back with interest?

Solution: debt investor or creditor or lender

LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

- 22.** What is the name of a person who provides money to a company who never has to be paid back but expects periodic cash payments?

Solution: equity investor or owner

LO 4 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic

AICPA BB: Critical Thinking AICPA FN: Reporting

23. Identify the responsibilities of the board of directors.

Solution: Sets company policies; declares dividends; sets management compensation; hires and fires management; appoints the audit committee

LO 4 BT: K Difficulty: Easy TOT: 2 min. AACSB: Analytic

AICPA BB: Critical Thinking AICPA FN: Reporting

SHORT PROBLEMS

1. Bricklin Company has \$700 in its checking account. A customer owes Bricklin \$1,100. The company has store equipment that cost \$1,600 and a truck that cost \$5,200. Bricklin Company owes the bank \$3,600 on the truck loan of which one payment of \$900 is due in one week, and owes \$4,200 to creditors for its monthly operating expenses, including rent, all of which is due in the next 30 days.
- A. List Bricklin Company's assets and the dollar amount of each.
 - B. List Bricklin Company's liabilities and the dollar amount of each.
 - C. Is Bricklin Company solvent? Explain.

Solution:

A.

ASSETS

Cash	\$ 700
Accounts receivable	1,100
Truck	5,200
Store equipment	<u>1,600</u>
Total	<u><u>\$8,600</u></u>

B.

LIABILITIES

Note payable (truck loan)	\$3,600
Accounts payable	<u>4,200</u>
Total	<u><u>\$7,800</u></u>

- C. Solvency is the ability of a company to generate cash in order to meet its debts as they come due. While Bricklin Company's assets exceed its liabilities by \$800, the company is not solvent. A truck payment of \$900 is due in one week, but only \$700 of cash is available. Bricklin cannot be sure when the customer will pay the \$1,100 amount owed. Bricklin Company appears to have a cash flow problem.

LO 3 BT: AN Difficulty: Moderate TOT: 7 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

2. Sonnan Company showed profits for the last two years totaling \$120,000 and \$260,000, respectively. Sonnan Company paid a total of \$90,000 to its owners over the two-year period.
- A. How much remains in Sonnan Company as retained earnings at the end of the second year of business?
- B. Briefly explain the concept of 'earning power' as it pertains to Sonnan Company.

Solution:

A. Total profits (\$120,000 + \$260,000)	\$380,000
Distributions to owners	<u>(90,000)</u>
	<u>\$290,000</u>

- B. Earning power is the ability to grow and provide a substantial return to its owners. Sonnan Company demonstrates earning power given by the fact that it paid a portion of its earnings to its owners, yet retained a sizable portion to finance the business for future income production.

LO 3 BT: AN Difficulty: Moderate TOT: 3 min. AACSB: Analytic
 AICPA BB: Critical Thinking AICPA FN: Reporting

3. Matura, Inc. reported the following activities for the year:
- Borrowed \$350,000 from the bank to be repaid in 5 years
 - Issued stock to investors for \$40,000 cash
 - Paid dividends to shareholders totaling \$10,000
 - Purchased equipment by promising to pay \$150,000 to a creditor over the next 3 years
- A. Identify which activities are debt investments.
- B. Identify which activities are equity investments.

Solution:

- A. Debt investments: Borrowed \$350,000 from the bank to be repaid in 5 years
 Promising to pay \$150,000 to a creditor over the next 3 years
- B. Equity investments: Issued stock to investors for \$40,000 cash

LO 4 BT: AN Difficulty: Moderate TOT: 3 min. AACSB: Analytic
 AICPA BB: Critical Thinking AICPA FN: Reporting

SHORT ESSAY QUESTIONS

1. Veronica Ingram is the CEO of a small corporation whose stock is traded on public stock exchange. She has been concerned with the high cost of producing and distributing annual financial statements. She has proposed that the corporation stop producing these financial reports which would save the company \$240,000 annually. Briefly explain to Ms. Ingram why her proposal cannot be adopted.

Solution:

Although the \$240,000 savings is significant, failure to comply with the Securities Exchange Act of 1934 is a violation of regulatory practices for publicly held companies. This Act requires companies with equity securities that are listed on public security markets to (1) annually file a Form 10-K (audited financial reports), (2) quarterly 10-Qs (unaudited quarterly financial statements) and (3) annually provide audited financial reports to the shareholders. Violations lead to being barred from public trading.

LO 1 BT: AP Difficulty: Moderate TOT: 3 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

2. Why must managers understand financial reporting?

Solution:

Managers often use financial statements to assess the financial condition and performance of their own company, its competitors, and other companies of which investments in stocks and bonds of other companies might be undertaken. Managers must understand how business decisions affect the financial statements and how capital providers and other outsiders use financial statements to evaluate and control their actions.

LO 1 BT: C Difficulty: Moderate TOT: 2 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

3. What are the two fundamental economic reasons why investors and creditors demand financial accounting information?

Solution:

Creditors need financial information to monitor and enforce the debt and compensation contracts written with management, and investors need financial information to help decide where to invest their funds.

LO 1 BT: K Difficulty: Moderate TOT: 2 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

4. What information is provided in a management letter? Who signs it?

Solution:

The CEO and CFO provide a management letter that acknowledges responsibility for the financial information provided in the financial statements and notes.

LO 2 BT: K Difficulty: Moderate TOT: 2 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

5. Describe the two components of the income statement.

Solution:

The two components of the income statement are revenues and expenses, the difference of which represents net income or loss for a period of time. Revenues are a measure of the assets generated from the products sold and services provided. Expenses are a measure of the asset outflows or costs associated with selling the products and providing the services.

LO 3 BT: K Difficulty: Easy TOT: 2 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

6. Describe the three components of the statement of cash flows.

Solution:

The three components of the statement of cash flows are operating, investing, and financing activities. Operating activities are associated with the actual products and services provided by a company. Investing activities include the purchase and sale of assets, such as equipment and land. Financing activities refer to the collections and payments related to a company's capital resources, such as cash borrowings, loan payments, cash from owners, and payment of dividends to owners.

LO 3 BT: K Difficulty: Easy TOT: 4 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

7. What is the role of the Securities and Exchange Commission?

Solution:

The Securities and Exchange Commission is an agency of the federal government that was commissioned to implement and enforce the Securities Act of 1933 and the Securities Exchange Act of 1934.

LO 5 BT: K Difficulty: Easy TOT: 1 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

8. Why might corporate management want to lobby the FASB?

Solution:

Corporate management and other interested parties wish to influence generally accepted accounting principles (GAAP). Because financial statements are prepared by management using GAAP, management is very concerned that accounting principles used provide benefits to investors, creditors, and the others associated with financial reporting.

LO 5 BT: AP Difficulty: Moderate TOT: 2 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

9. The Sarbanes-Oxley Act was passed in response to a series of financial and accounting scandals. The purpose of the Act was to bolster corporate governance and restore confidence in the financial reporting system. Describe one of the new things that the management of a U.S. public corporation is required to do under this act.

Solution:

- certification that the financial statements have been reviewed by the CEO and CFO, or
- file an annual report on internal controls over financial reporting, or
- additional responsibilities to ensure that adequate internal controls are in place, or
- provide reasonable assurance that financial records are complete and accurate.

LO 5 BT: K Difficulty: Moderate TOT: 4 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

10. Frank Smithson, chief operating officer for Star Master Corporation, has discovered that two separate and distinct sets of financial statements are being provided—one to the Internal Revenue Service and the other to its shareholders. He objected to this policy and is insisting that one set of financial statements be provided to all interested parties. Provide examples of the needs of the two parties.

Solution:

Although one might initially react favorably to Frank's proposal of one set of financial statements for all users, it would be impossible. Various rules for determining income and financial position are specified by each user. These rules reflect different uses of accounting information. The IRS raises money to support government operations and has codified rules designed to accomplish this task. The public information provided to shareholders and other outside parties is governed by generally accepted accounting principles that are designed to provide the general users with information required for investment decisions.

LO 5 BT: AP Difficulty: Moderate TOT: 4 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

11. What powers does the Securities and Exchange Commission have?

Solution:

The Securities and Exchange Commission has the power to prescribe the accounting practices and standards to be employed by companies within its jurisdiction—public companies. However, the SEC has chosen to delegate the responsibility for establishing accounting practices and standards to the Financial Accounting Standards Board (FASB). The SEC also is responsible for ensuring that listed companies prepare and file registration statements before they issue new securities, and file periodic quarterly and annual reports.

LO 5 BT: K Difficulty: Moderate TOT: 3 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting

12. What methods of controlling the ethical decisions by managers are common? Why are these methods necessary?

Solution:

The methods of controlling the quality of management decisions are financial statements, debt and compensation contracts, the board of directors, auditors, and the audit committee. These methods are necessary in order to protect the investments of shareholders and creditors.

LO 5 BT: C Difficulty: Moderate TOT: 3 min. AACSB: Analytic
AICPA BB: Critical Thinking AICPA FN: Reporting