Reading 22: Financial Reporting Mechanics

Question #1 of 28

Question ID: 598951

An equipment manufacturer builds a machine and sells it to a firm that will use it for five years. For the manufacturer, this sale is classified as a(n):

- ✓ **A)** operating activity.
- ✗ **B)** financing activity.
- ✗ **C)** investing activity.

Explanation

This transaction is an operating activity for the manufacturer because it represents the manufacturer's day-to-day business function. For the buyer of the machine the purchase is an investing activity.

References

Question From: Session 6 > Reading 22 > LOS a

Related Material:

- Key Concepts by LOS

Question #2 of 28

Question ID: 414017

Washburn Motors signs a contract to sell a $100,000 luxury sedan to be delivered next month, and receives a $20,000 cash down payment from the buyer. How will the transaction *most likely* affect Washburn's assets and liabilities?

	Assets	Liabilities
✓ **A)**	Increase	Increase
✗ **B)**	Increase	Unchanged
✗ **C)**	Unchanged	Unchanged

Explanation

The down payment will increase cash (an asset) and unearned revenue (a liability). Revenues (and thus retained earnings and owner's equity) will not increase because the car has not been delivered.

References

Question From: Session 6 > Reading 22 > LOS d

Related Material:

- Key Concepts by LOS

Question #3 of 28

Question ID: 485770

A company collects cash from a customer to settle an account receivable. What effect does this transaction have on the company's total assets and total shareholders' equity?

	Assets	Equity
✓ **A)**	No effect	No effect
✗ **B)**	Increase	Increase
✗ **C)**	No effect	Increase

Explanation

Collecting amounts due from customers has no effect on the accounting equation because it increases one asset (cash) and decreases another asset (accounts receivable). Equity increases in the period when a company sells an item on credit and delivers it to a customer. Equity does not change when the firm later collects the cash.

References

Question From: Session 6 > Reading 22 > LOS f

Related Material:

- Key Concepts by LOS

Question #4 of 28

Question ID: 414019

Which of the following *least* accurately describes a correct use of double-entry accounting?

✗ **A)** A transaction may be recorded in more than two accounts.

✓ **B)** A decrease in a liability account may be balanced by a decrease in another liability account.

✗ **C)** An increase in an asset account may be balanced by an increase in an owner's equity account.

Explanation

Keeping the accounting equation in balance requires double-entry accounting, in which a transaction has to be recorded in at least two accounts. An increase in an asset account, for example, must be balanced by a decrease in another asset account or by an increase in a liability or owners' equity account. A decrease in a liability account may be balanced by an increase in another liability account, not a decrease. If two liabilities decrease without a balancing entry, the balance sheet will be out of balance.

References

Question From: Session 6 > Reading 22 > LOS d

Related Material:

- Key Concepts by LOS

Question #5 of 28

Question ID: 414018

The purchase of equipment for $25,000 cash is *most likely* to be recorded as:

- ✓ **A)** an increase in one asset account and a decrease in another asset account.
- ✗ **B)** an increase in an asset account and an increase in a liability account.
- ✗ **C)** an increase in two asset accounts.

Explanation

The purchase of equipment for cash is an increase in property, plant and equipment (an asset) and a decrease in cash (another asset).

References

Question From: Session 6 > Reading 22 > LOS d

Related Material:

- Key Concepts by LOS

Question #6 of 28

Question ID: 414021

Accruals are *best* described as requiring an accounting entry:

- ✗ **A)** when an expense has been incurred.
- ✗ **B)** only when a good or service has been provided.
- ✓ **C)** when the earliest event in a transaction occurs.

Explanation

Accruals require an accounting entry when the earliest event occurs (paying or receiving cash, providing a good or service, or incurring an expense) and one or more offsetting entries as the exchange is completed.

References

Question From: Session 6 > Reading 22 > LOS e

Related Material:

- Key Concepts by LOS

Question #7 of 28

Question ID: 414031

Reading the footnotes to a company's financial statements and the Management Discussion & Analysis is *least likely* to help an analyst determine:

- ✗ **A)** the various accruals, adjustments and assumptions that went into the financial statements.
- ✓ **B)** the detailed information that underlies the company's accounting system.
- ✗ **C)** how well the financial statements reflect the company's true performance.

Explanation

An analyst doesn't have access to the detailed information that flows through a company's accounting system, but only sees its end product, the financial statements. The analyst needs to understand the various accruals, adjustments, and management assumptions that went into the financial statements. Much of this is often explained in the footnotes to the statements and in Management's Discussion and Analysis, which is why it is crucial for an analyst to review these parts of the presentation. With this information, the analyst can better judge how well the financial statements reflect the company's true performance, and in what ways he needs to adjust the data for his own analysis.

References

Question From: Session 6 > Reading 22 > LOS h

Related Material:

- Key Concepts by LOS

Question #8 of 28

Question ID: 414013

In the expanded form of the accounting equation, assets equal liabilities plus contributed capital plus:

- ✗ **A)** ending retained earnings minus beginning retained earnings.
- ✓ **B)** ending retained earnings.
- ✗ **C)** beginning retained earnings plus revenue minus expenses.

Explanation

Equity equals contributed capital plus ending retained earnings. Ending retained earnings equal beginning retained earnings plus revenue minus expenses minus dividends paid.

References

Question From: Session 6 > Reading 22 > LOS c

Related Material:

- Key Concepts by LOS

Question #9 of 28

Question ID: 414026

The *best* description of the general ledger is that it:

- ✗ **A)** groups accounts into the categories that are presented in the financial statements.
- ✗ **B)** is where journal entries are first recorded.
- ✓ **C)** sorts the entries in the general journal by account.

Explanation

Information flows through an accounting system in four steps:

1. *Journal entries* record every transaction, showing which accounts are changed by what amounts. A listing of all the journal entries in order by date is called the "general journal."
2. The *general ledger* sorts the entries in the general journal by account.
3. At the end of the accounting period, an *initial trial balance* is prepared that shows the balances in each account. If any

adjusting entries are needed, they will be recorded and reflected in an *adjusted trial balance*.
4. The account balances from the adjusted trial balance are presented in the *financial statements*.

References

Question From: Session 6 > Reading 22 > LOS g

Related Material:

- Key Concepts by LOS

Question #10 of 28

Question ID: 414028

Which of the following is the *best* description of the flow of information in an accounting system?

✓ **A)** Journal entries, general ledger, trial balance, financial statements.

✗ **B)** General ledger, trial balance, general journal, financial statements.

✗ **C)** Trial balance, general ledger, general journal, financial statements.

Explanation

Information flows through an accounting system in four steps:
1. *Journal entries* record every transaction, showing which accounts are changed by what amounts. A listing of all the journal entries in order by date is called the "general journal."
2. The *general ledger* sorts the entries in the general journal by account.
3. At the end of the accounting period, an *initial trial balance* is prepared that shows the balances in each account. If any adjusting entries are needed, they will be recorded and reflected in an adjusted trial balance.
4. The account balances from the adjusted trial balance are presented in the *financial statements*.

References

Question From: Session 6 > Reading 22 > LOS g

Related Material:

- Key Concepts by LOS

Question #11 of 28

Question ID: 414016

A furniture store acquires a set of chairs for $750 cash and sells them for $1000 cash. These transactions are *most likely* to affect which accounts?

	Purchase	Sale
✓ **A)**	Assets only	Assets, revenue, expenses, owners' equity
✗ **B)**	Assets only	Assets and revenues only
✗ **C)**	Assets and expenses	Assets, revenue, expenses, owners' equity

Explanation

The purchase will be a decrease in cash and an increase in inventory, both asset accounts. The expense is not recorded until the chairs are sold. The sale will be a decrease in inventory and an increase in cash (assets), an increase in sales (revenues), an increase in cost of goods sold (expenses), and an increase in retained earnings (owners' equity) for the $250 profit.

References

Question From: Session 6 > Reading 22 > LOS d

Related Material:

- Key Concepts by LOS

Question #12 of 28

Question ID: 414020

An accounting entry that updates the historical cost of an asset to current market levels is *best* described as:

- ✗ **A)** a contra account.
- ✗ **B)** accumulated depreciation.
- ✓ **C)** a valuation adjustment.

Explanation

In some cases, accounting standards require balance sheet values of certain assets to reflect their current market values. Accounting entries that update these assets' values from their historical cost are called valuation adjustments. To keep the accounting equation in balance, changes in asset values are also changes in owners' equity, through gains or losses on the income statement or in "other comprehensive income."

References

Question From: Session 6 > Reading 22 > LOS e

Related Material:

- Key Concepts by LOS

Question #13 of 28

Question ID: 414029

Prema Singh is the bookkeeper for Octabius Industries. Singh has been asked by the CFO of Octabius to review all purchases that occurred between February 1 and February 8 to investigate an error on the receiving dock. Singh will *most likely* look at the:

- ✗ **A)** initial trial balance.
- ✓ **B)** general journal.
- ✗ **C)** general ledger.

Explanation

Journal entries record every transaction, showing which accounts are changed by what amounts. A listing of all the journal entries in order by date is called the "general journal."

References

Question From: Session 6 > Reading 22 > LOS g

Related Material:

- Key Concepts by LOS

Question #14 of 28

Question ID: 598952

A firm buys a machine that it will use in its factory for five years. This purchase is *most appropriately* classified as a(n):

- ✗ **A)** operating activity.
- ✗ **B)** financing activity.
- ✓ **C)** investing activity.

Explanation

Purchases and sales of long-lived assets that are used in a firm's production process are classified as investing activities.

References

Question From: Session 6 > Reading 22 > LOS a

Related Material:

- Key Concepts by LOS

Question #15 of 28

Question ID: 414012

A company's chart of accounts is:

- ✗ **A)** the set of journal entries that makes up the components of owners' equity.
- ✗ **B)** used for entries that offset other accounts.
- ✓ **C)** a detailed list of the accounts that make up the five financial statement elements.

Explanation

A company's chart of accounts is a detailed list of the accounts that make up the five financial statement elements and the line items presented in the financial statements. Contra accounts are used for entries that offset other accounts. The categories that make up owners' equity are capital, additional paid-in capital, retained earnings and other comprehensive income.

References

Question From: Session 6 > Reading 22 > LOS b

Related Material:

- Key Concepts by LOS

Question #16 of 28

Question ID: 485771

Making a profitable sale on credit is *most likely* to have which of the following effects?

- ✓ **A)** Increase assets and increase equity.
- ✗ **B)** Increase assets and decrease liabilities.

✗ **C)** Decrease assets and increase equity.

Explanation

Making a profitable sale on credit will increase accounts receivable and decrease inventory. Given that the sale is profitable, the increase in accounts receivable will be greater than the decrease in inventory, resulting in a net increase in assets. Profit (due to sales being greater than cost of goods sold) will increase net income and retained earnings (equity).

References

Question From: Session 6 > Reading 22 > LOS f

Related Material:

- Key Concepts by LOS

Question #17 of 28

Question ID: 414024

Wichita Corporation reported the following balances as of December 31, 2007:

Cash	$?
Accounts payable	16,000
Accounts receivable	58,000
Additional paid-in capital	42,000
Common stock	19,600
Inventory	12,000
Plant and equipment	26,800
Notes payable	20,000
Retained earnings	32,000

Calculate Wichita's cash and total assets as of December 31, 2007 based only on these entries.

	Cash	Total assets
✓ **A)**	$32,800	$129,600
✗ **B)**	$16,000	$129,600
✗ **C)**	$32,800	$113,600

Explanation

Liabilities plus equity are equal to $129,600 ($16,000 accounts payable + $20,000 notes payable + $19,600 common stock + $42,000 additional paid-in capital + $32,000 retained earnings). Since assets must equal liabilities plus equity, cash must equal $32,800 ($129,600 total assets - $58,000 accounts receivable - $12,000 inventory - $26,800 plant and equipment).

References

Question From: Session 6 > Reading 22 > LOS f

Related Material:

- Key Concepts by LOS

Question #18 of 28

Question ID: 414027

A listing of all the firm's journal entries by date is called the:

- ✗ **A)** general ledger.
- ✗ **B)** adjusted trial balance.
- ✓ **C)** general journal.

Explanation

A listing of all the journal entries in order by date is called the "general journal." The *general ledger* sorts the entries in the general journal by account. At the end of the accounting period, an *initial trial balance* is prepared that shows the balances in each account. If any adjusting entries are needed, they will be recorded and reflected in an *adjusted trial balance*. The account balances from the adjusted trial balance are presented in the *financial statements*.

References

Question From: Session 6 > Reading 22 > LOS g

Related Material:

- Key Concepts by LOS

Question #19 of 28

Question ID: 414030

Regarding the use of financial statements in security analysis and selection, it would be *most* accurate to say that:

- ✗ **A)** analysts can verify the accuracy of financial statements by using a firm's detailed accounting system information.
- ✓ **B)** analysts can use footnotes and Management's Discussion and Analysis to better understand assumptions used in the financial statements.
- ✗ **C)** further analysis of a firm's financial statements is typically not necessary if the firm has conformed to applicable accounting principles.

Explanation

Analysts must have a good understanding of a firm's accounting process and must read the footnotes to the financial statement as well as Management's Discussion and Analysis to better understand assumptions used in the financial statements. Even if the firm conforms to appropriate accounting principles, there is still room for management discretion. Because analysts do not have access to a firm's detailed accounting information, they must rely on what they can glean from the footnotes and Management's Discussion and Analysis.

References

Question From: Session 6 > Reading 22 > LOS h

Related Material:

- Key Concepts by LOS

Question #20 of 28

Question ID: 414022

Which of the following is the *least likely* to be considered an accrual for accounting purposes?

- ✗ **A)** Unearned revenue.
- ✗ **B)** Wages payable.
- ✓ **C)** Accumulated depreciation.

Explanation

Accruals fall into four categories:
1. Unearned revenue.
2. Accrued revenue.
3. Prepaid expenses.
4. Accrued expenses. Wages payable are a common example of an accrued expense.

Accumulated depreciation is considered a contra-asset account to property, plant and equipment, not an accrual.

References

Question From: Session 6 > Reading 22 > LOS e

Related Material:

- Key Concepts by LOS

Question #21 of 28

Question ID: 414023

Beta Company reported the following financial statement information:

December 31, 2006:

Assets	$58,000
Liabilities	28,000

December 31, 2007:

Assets	?
Liabilities	38,000

During 2007:

Stockholder investments	15,500
Net income	18,000
Dividends	7,750

Calculate Beta's total assets and stockholders' equity as of December 31, 2007.

	Total assets	Stockholders' equity
✓ **A)**	$93,750	$55,750
✗ **B)**	$79,250	$55,750

✗ **C)**	$93,750	$30,000

Explanation

Stockholders' equity, as of December 31, 2006, was $30,000 ($58,000 assets - $28,000 liabilities) and stockholders' equity, as of December 31, 2007, was $55,750 ($30,000 beginning equity + $15,500 stockholder investments + $18,000 net income - $7,750 dividends). Total assets, as of December 31, 2007, are $93,750 ($38,000 liabilities + $55,570 stockholders' equity).

References

Question From: Session 6 > Reading 22 > LOS f

Related Material:

- Key Concepts by LOS

Question #22 of 28

Question ID: 414025

Alpha Company reported the following financial statement information:

December 31, 2006:	
Assets	$70,000
Liabilities	45,000
December 31, 2007:	
Assets	82,000
Liabilities	55,000
During 2007:	
Stockholder investments	3,000
Net income	?
Dividends	6,000

Calculate Alpha's net income for the year ended December 31, 2007 and the *change* in stockholders' equity for the year ended December 31, 2007.

	Net income	Change in stockholders' equity
✓ **A)**	$5,000	$2,000 increase
✗ **B)**	($3,000)	$2,000 increase
✗ **C)**	$5,000	$2,000 decrease

Explanation

Stockholders' equity, as of December 31, 2006, was $25,000 ($70,000 assets - $45,000 liabilities) and stockholders' equity, as of December 31, 2007, was $27,000 ($82,000 assets - $55,000 liabilities). Stockholders' equity increased $2,000 during 2007. Net income for 2007 was $5,000 ($27,000 ending equity + $6,000 dividends - $3,000 stockholder investments - $25,000 beginning equity).

References

Question From: Session 6 > Reading 22 > LOS f

Related Material:

- Key Concepts by LOS

Question #23 of 28

Question ID: 414014

What is the fundamental balance sheet equation?

- ✗ **A)** Liabilities = Assets + Stockholders' Equity (L = A + E).
- ✓ **B)** Assets = Liabilities + Stockholders' Equity (A = L + E).
- ✗ **C)** Assets = Stockholders' Equity - Liabilities (A = E - L).

Explanation

The fundamental balance sheet equation is Assets = Liabilities + Stockholders' Equity (A = L + E). This is the fundamental accounting relationship that sets the basis for recording all financial transactions.

References

Question From: Session 6 > Reading 22 > LOS c

Related Material:

- Key Concepts by LOS

Question #24 of 28

Question ID: 414015

The following amounts were drawn from the records of JME Company: total assets = $1,200; total liabilities = $750; contributed capital = $600. Based on this information alone, retained earnings must be equal to:

- ✗ **A)** $150.
- ✓ **B)** −$150.
- ✗ **C)** $450.

Explanation

(1,200 − 750 − 600) = −150

References

Question From: Session 6 > Reading 22 > LOS c

Related Material:

- Key Concepts by LOS

Question #25 of 28

Question ID: 414032

Sergey Martinenko is an investment analyst with Profis, Martinenko and Verona. He is explaining to his new assistant, John Stevenson, why it is crucial for an investment analyst to read the footnotes to a firm's financial statement and the Management Discussion and Analysis (MD&A) before making an investment decision. Which rationale is Martinenko *least likely* to provide to Stevenson regarding the importance of analyzing the footnotes and MD&A?

- ✗ **A)** Accruals, adjustments and assumptions are often explained in the footnotes and MD&A.
- ✓ **B)** The footnotes disclose whether or not the company is adhering to GAAP.
- ✗ **C)** Evaluating the footnotes helps the analyst assess whether management is manipulating earnings.

Explanation

Various accruals, adjustments, and management assumptions that went into the financial statements are often explained in the footnotes to the statements and in Management's Discussion and Analysis. Because adjustments and assumptions within the financial statements are to some extent at the discretion of management, the possibility exists that management can try to manipulate or misrepresent the company's financial performance. With this information, the analyst can better judge how well the financial statements reflect the company's true performance, and in what ways he needs to adjust the data for his own analysis. Whether or not the company is adhering to GAAP is addressed in the auditor's opinion, not the footnotes.

References

Question From: Session 6 > Reading 22 > LOS h

Related Material:

- Key Concepts by LOS

Question #26 of 28

Question ID: 414033

Jack Rivers is an investment analyst for the equity fund of a family office. The head of the family, Charlotte Blackmon, is concerned that management may be manipulating the earnings of some of the companies that the fund invests in. Rivers explains to Blackmon, "Even though we don't have access to the detailed transactions that underlie the financial statements, we can be sure that management is not manipulating earnings because I read the footnotes to the financial statements of every company we invest in. The footnotes would disclose any deviation from appropriate accounting parameters." Rivers is:

- ✓ **A)** incorrect because even within appropriate accounting parameters, management can manipulate earnings through the assumptions that rely on their discretion.
- ✗ **B)** correct.
- ✗ **C)** incorrect because deviation from appropriate accounting parameters is addressed in the auditor's report, so a qualified opinion in the auditor's report ensures that management is not manipulating earnings.

Explanation

Because adjustments and assumptions within the financial statements are to some extent at the discretion of management, the possibility exists that management can try to manipulate or misrepresent the company's financial performance. A clean auditor's report does not ensure that management is unable to manipulate earnings, and a qualified opinion expresses reservations about the appropriateness of accounting policies. An analyst doesn't have access to the detailed information that flows through a company's accounting system, but only sees its end product, the financial statements.

References

Question From: Session 6 > Reading 22 > LOS h

Related Material:

- Key Concepts by LOS

Question #27 of 28

Question ID: 414010

Allowance for bad debts and investment in affiliates are *most likely* to be shown as what types of accounts?

	Allowance for bad debts	Investment in affiliates
✓ **A)**	Contra-asset	Asset
✗ **B)**	Contra-asset	Liabilities
✗ **C)**	Liabilities	Asset

Explanation

Allowance for bad debts is a contra-asset account to accounts receivable. Investments in affiliates are considered assets.

References

Question From: Session 6 > Reading 22 > LOS b

Related Material:

- Key Concepts by LOS

Question #28 of 28

Question ID: 414011

Accumulated depreciation and treasury stock are *most likely* to be shown as what types of accounts?

	Accumulated depreciation	Treasury stock
✗ **A)**	Liability	Equity
✓ **B)**	Contra-asset	Contra-equity
✗ **C)**	Contra-asset	Equity

Explanation

Accumulated depreciation is a contra-asset account to the asset account property, plant & equipment. Treasury stock is a contra-equity account to common stock or additional paid-in capital.

References

Question From: Session 6 > Reading 22 > LOS b

Related Material: