CHAPTER 1

FINANCIAL STATEMENT ANALYSIS: AN INTRODUCTION

SOLUTIONS

1. B is correct. This is the role of financial reporting. The role of financial statement analysis is to evaluate the financial reports.
2. A is correct. The balance sheet portrays the current financial position. The income statement and statement of cash flows present different aspects of performance.
3. B is correct. Profitability is the performance aspect measured by the income statement. The balance sheet portrays the current financial position. The statement of cash flows presents a different aspect of performance.
4. C is correct. The notes disclose choices in accounting policies, methods, and estimates.
5. A is correct. Information about management and director compensation is not found in the auditor's report. Disclosure of management compensation is required in the proxy statement, and some aspects of management compensation are disclosed in the notes to the financial statements.
6. B is correct. These are components of management commentary.
7. C is correct. An unqualified opinion is a "clean" opinion and indicates that the financial statements present the company's performance and financial position fairly in accordance with a specified set of accounting standards.
8. C is correct. Ratios are an output of the process data step but are an input into the analyze/interpret data step.

CHAPTER 2

FINANCIAL REPORTING MECHANICS

SOLUTIONS

1. C is correct. Sales of products, a primary business activity, are classified as an operating activity. Issuance of debt would be a financing activity. Acquisition of a competitor and the sale of surplus equipment would both be classified as investing activities.
2. A is correct. Issuance of debt would be classified as a financing activity. B is incorrect because payment of income taxes would be classified as an operating activity. C is incorrect because investments in common stock would be generally classified as investing activities.
3. A is correct. An asset is an economic resource of an entity that will either be converted into cash or consumed.
4. C is correct. Owners' equity is a residual claim on the resources of a business.
5. A is correct. Assets must equal liabilities plus owners' equity and, therefore, €2,000 = €1,200 + Owners' equity. Owners' equity must be €800.
6. B is correct.

Beginning retained earnings	$1,400
+ Net income	200
– Distributions to owners	(100)
= Ending retained earnings	$1,500

7. C is correct.

   Assets = Liabilities + Contributed capital + Beginning retained earnings − Distributions to owners + Revenues − Expenses

Liabilities	$1,000
+ Contributed capital	500
+ Beginning retained earnings	600
− Distributions to owners	(0)
+ Revenues	5,000
− Expenses	(4,300)
= Assets	$2,800

8. C is correct. This is a contribution of capital by the owners. Assets would increase by $500,000 and contributed capital would increase by $500,000, maintaining the balance of the accounting equation.
9. A is correct. The payment of January rent represents prepaid rent (an asset), which will be adjusted at the end of January to record rent expense. Cash (an asset) decreases by $12,000. Deposits (an asset) increase by $4,000. Prepaid rent (an asset) increases by $8,000. There is no net change in assets.
10. B is correct. The sale of products without receipt of cash results in an increase in accounts receivable (an asset) of €10,000. The balance in inventory (an asset) decreases by €8,000. The net increase in assets is €2,000. This would be balanced by an increase in revenue of €10,000 and an increase in expenses (costs of goods sold) of €8,000.
11. C is correct. The receipt of cash in advance of delivering goods or services results in unearned revenue, which is a liability. The company has an obligation to deliver $30,000 in goods in the future. This balances the increase in cash (an asset) of $30,000.
12. B is correct. Depreciation is an expense and increases accumulated depreciation. Accumulated depreciation is a contra account which reduces property, plant, and equipment (an asset) by €250,000. Assets decrease by €250,000, and expenses increase by €250,000.
13. A is correct. The balance sheet shows the financial position of a company at a particular point in time. The balance sheet is also known as a "statement of financial position."
14. B is correct. The three sections of the statement of cash flows are operating, investing, and financing activities.
15. C is correct. Cash received prior to revenue recognition increases cash and deferred or unearned revenue. This is a liability until the company provides the promised goods or services.
16. A is correct. When cash is to be received after revenue has been recognized but no billing has actually occurred, an unbilled (accrued) revenue is recorded. Such accruals would usually occur when an accounting period ends prior to a company billing its customer. This type of accrual can be contrasted with a simple credit sale, which is reflected as an increase in revenue and an increase in accounts receivable. No accrual is necessary.

17. B is correct. Payment of expenses in advance is called a prepaid expense which is classified as an asset.
18. C is correct. When an expense is incurred and no cash has been paid, expenses are increased and a liability ("accrued expense") is established for the same amount.
19. B is correct. The general ledger is the collection of all business transactions sorted by account in an accounting system. The general journal is the collection of all business activities sorted by date.
20. C is correct. In order to balance the accounting equation, the company would either need to increase assets or decrease liabilities. Creating a fictitious asset would be one way of attempting to cover up the fraud.