1. C The easiest thing to do is to use a retained earnings t-account. If you use the retained earnings t-account, plug in the numbers that are given. So, the retained earnings for the year of $1 million will be the ending balance (which is a credit) and the earnings for last year of $2.1 million will be a credit also. This earnings figure would have come from an income statement. Now there needs to be a number on the debit side that makes the $2.1 million equal to $1 million. That debit is the dividends figure. It is important to remember that the net income figure (assuming that it is a positive net income figure like $2.1 million) gets put on the credit side of the t-account and the dividends get put on the debit side. The number on the debit side (the dividends figure) must be $1.1 million.

2. B The thing to remember for this question is that cash is a current asset. The hydraulic paper cutter is an asset, but it is not a current asset. When $15,000 worth of cash was used to buy the paper cutter, the current assets went down $15,000. The new balance is now $485,000.

3. D Revenues measure two important things. Revenues measure the inflows of assets from selling goods and providing services to customers. In other words, it measures the amount of money that the company will be making. Also, revenues measure the reduction of liabilities from selling goods and providing services to customers. An example of this can be seen in magazine companies. Normally, these companies collect magazine subscriptions in advance. The money taken in from these subscriptions gets put into a deferred revenue account. As the company starts providing the magazine service to the customers, deferred revenue (which is the liability) decreases. As the deferred revenue decreases, the actual revenue increases.

4. B Financial reporting does not provide any information on competitors’ performance. When you look at the financials of a company, you are not given any information about its competitors. All the objectives are on pages 17-18 of your text.

5. B The easiest way to determine whether something is an asset is to memorize these three rules: 1) An asset needs to be of value (which means it has to have benefits). 2) An asset needs to be controlled by the entity. 3) An asset needs to be preceded by an “event” (primarily a transaction).

Therefore, a good reputation for quality service is not an asset. There was no transaction that took place to obtain quality service. A fleet of cars acquired, a note receivable, and a patent purchased from a competitor were the result of a transaction. Also, all three of these events were of value and controlled by the entity.

6. B A decrease in the items on the left is not balanced by an increase in the items on the right. For a., an increase on the left and right will balance out. For c., a decrease on the left and right will balance out just like an increase and a decrease on the left for d.
7. C The best way to figure out this question is to do the journal entry involved in this particular transaction. What is being bought is a piece of equipment (which is an asset) on credit by the seller. The journal entry is:

   
   Equipment XXX  
   Equipment Payable XXX

The reason why equipment payable was used instead of cash is because the equipment was purchased on credit. The seller of the equipment received no cash yet. So, the purchaser of the equipment has taken on a liability which is why accounts payable is a credit (the liability has increased). Now if the purchaser instead wanted to pay for the equipment up front, then the credit would be cash (not accounts payable).

8. C One of the most important equations in accounting is:

   Assets = Liabilities + Equity

This equation is the foundation to the balance sheet. This equation can be rearranged to fit the format in question 8.

   Equity = Assets - Liabilities
   Equity = Current Assets - Current Liab. - Noncurrent Liab. + Noncurrent Assets

9. Period expenses are the cost of assets assigned to the period of their use or consumption. An example of this would be paper bought for the office. This paper expense will be recognized when the paper is actually being used. Now to say that expenses are always period costs is wrong because there are also product expenses. Product expenses are the cost of assets sold to customers in a given period. Product expenses are usually reported on the income statement as a single expense item called cost of goods sold.

10. C Expenses (product costs) are recognized when they match revenue, not when the expenses are actually paid. Also, expenses (period costs) are recognized in the period in which the service is consumed.

11. C Product expenses are the cost of assets sold to customers (in a given period). Another way of looking at it, is the cost of producing the good that is going to be sold to the customers. Administrative costs, advertising costs, and selling costs are not expenses that go into the production of the asset being sold to the customers. In other words, those costs are not part of the production of the asset.

12. C For this question, the first thing to remember is the balance sheet equation (which was used in question #8). The equation is: Assets = Liabilities + Equity From the information provided in the question, we know that at year end, total assets are $2,500,000, total liabilities are $900,000, and contributed capital is $1,400,000. It is important to remember that contributed capital falls under the equity section. Also, retained earnings falls under the equity section, BUT the retained earnings figure that we are given is for the beginning of the year, not the end of the year. We need the end of the year balance of retained earnings. The easiest way to find the ending balance is to
work backwards with the balance sheet equation. After plugging in the numbers we get:

\[ 2,500,000 = 900,000 + 1,400,000 + RE \]

** The equity section for this equation is $1,400,000 + RE. The reason why it is written this way is because we were given the capital (which is $1,400,000) and the only thing left under the equity section would be the ending balance to the retained earnings (RE).

\[ 2,500,000 = 2,300,000 + RE \]
\[ 200,000 = RE \]

So, the ending balance for retained earnings is $200,000. Now it is time to figure out the net income. The easiest way to do this is to work backwards on the retained earnings t-account (the same way as question #1). The ending balance is $200,000 and the beginning balance is $100,000. Both of these are credits on the t-account. We are told that the dividends for the year are $20,000. This will be a debit. All that needs to be done now is figuring out the plug number, which is going to be our net income figure. 

\[(200,000 + 20,000 - 100,000 = 120,000)\]

13. D The definition (or formula) for earnings per share is net income minus preferred dividends over the weighted shares of common stock outstanding. This earnings per share figure is one of the most important ratios used by investment analysts.

14. A

- LIFO = the method of allocating the cost of goods available for sale between ending inventory and cost of goods sold based on the assumption that the most recent purchases are sold first.
- FIFO = the method of allocating the cost of goods available for sale between ending inventory and cost of goods sold based on the assumption that the earliest purchases are sold first.
- Weighted Average Method = the method of allocating the cost of goods available for sale between ending inventory and cost of goods sold based on a single, weighted average cost per unit.
- Acquisition Cost = the method of allocating the cost of goods available for sale between ending inventory and cost of goods sold based on an identification of the actual units sold and in inventory.

Many accountants claim that LIFO is the best measure of income because it closely approximates matching the current cost of goods sold against current revenues. After all, LIFO allocates the cost of the most recent purchases to cost of goods sold, whereas FIFO allocates the cost of the earliest purchases to cost of goods sold.

*** Something to think about: When prices are rising, the FIFO method produces the largest cost for ending inventory, the smallest cost of goods sold, and, therefore, the largest gross margin of the four methods. In contrast, the LIFO method produces the smallest cost for ending inventory, the largest cost of goods sold, and, therefore, the smallest gross margin of the four methods when prices are rising.
15. C The only time that FIFO and LIFO will result in the same cost of goods sold is when the prices of the goods do not change. The same reason that I gave in question #14 can be applied here. When prices are rising, the FIFO method produces the largest cost for ending inventory, the smallest cost of goods sold, and, therefore, the largest gross margin of the four methods. In contrast, the LIFO method produces the smallest cost for ending inventory, the largest cost of goods sold, and, therefore, the smallest gross margin of the four methods when prices are rising. Now, if the prices stay the same, it will not matter which method is used when determining cost of goods sold. Either way, you will get the same number.

16. a. If an entry were made on Nov. 1, it would be:
   
   Prepaid Rent 900  
   Cash 900

   (*Prepaid rent is an asset)

   At the end of Nov., the entry is:
   
   Rent Expense 300  
   Prepaid Rent 300

   So, the rent expense for Nov. is = $300

b. There is no entry. When the inventory is received in December is when an entry will be made. Accountants will only charge inventory when a transaction has occurred, meaning goods are delivered, or payment is made to employees or vendors.

c. If an entry were made on Nov. 1 when the insurance was bought, the entry would be:
   
   Prepaid Insurance 500  
   Cash 500

   At the end of November, the entry is:
   
   Insurance Expense 42  
   Prepaid Insurance 42

   So, the insurance expense for Nov. is = $42

d. This one can be done several ways. One way is to go ahead and match the utility expenses to the month of November. This would make sense because that is the month that the utility expenses were incurred. The only problem here is that an entry can’t be made at the end of the month since the bill does not come until December. So, if you are at the end of the month, a utility expense entry cannot be made yet unless you can see into the future and predict the bill. The entry would be made on December 3.

e. The key thing to remember here is that expenses are not recognized until they are incurred. For this problem, the expense for supplies is not going to be recognized until the supplies are used. So, if there are still $500 of supplies on hand, then $700 worth of supplies expense must be recognized (1200-500 = 700).
Fairfield Industries  
Income Statement  
For the Year Ended December 31, 19X2

<table>
<thead>
<tr>
<th></th>
<th>Delivery</th>
<th>Percentage</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>2,000,000</td>
<td>1,375,000</td>
<td>800,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>1,600,000</td>
<td>1,100,000</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Gross Margin</td>
<td>400,000</td>
<td>275,000</td>
<td>(300,000)</td>
</tr>
<tr>
<td>Expenses</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net Income</td>
<td>400,000</td>
<td>275,000</td>
<td>(300,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>200,000</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Receivable</td>
<td>1,200,000</td>
<td>575,000</td>
<td>0</td>
</tr>
<tr>
<td>Inventory</td>
<td>0</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>2,000,000</td>
<td>2,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>400,000</td>
<td>275,000</td>
<td>(300,000)</td>
</tr>
</tbody>
</table>

The company laid out $500,000 in its first year on this component and spent a further $1 million on equipment – hence the $2 million opening cash dropped to $500,000. It spent a further $1.1 million on the item in the second year and received $800,000 in cash receipts hence the closing cash balance of $200,000 at the end of the second year.

The delivery method shows the full revenue of $2 million and a receivable of $1.2 million. Cost of sales is the full cost of the inventory or $1.6 million. The cash method shows the $800,000 they received and the cash cost of $1.1 million they incurred in the second year. The “cash” cost of goods sold is $500,000 less than the available for sale which is the ending inventory, therefore. The middle column shows what a percentage completion method would reveal. In the first year, they incurred $500,000 of the total $1.6 million or 31.25 percent. In the second year, they incurred the other 68.75 percent of the total cost. Multiply this by the total revenue of $2 million to get $1,375,000. This creates a receivable of $575,000. (Not the easiest of problems!)

18. LIFO periodic means we want to know the ending inventory at the end of the period. There are 1,000 units left in inventory at the end. We can assume that all these were drawn from the opening inventory at $45. Ending inventory, therefore, should be valued at $45,000.

LIFO perpetual focuses on the sales as they occur. The first sales that took place were in March. So from the inventory out of the 3000 units in January. We are now left with 800 units in January. The next sale is during August for 2,400 units. These will come from the all the units in June (1,500) and clearing out the remaining 800 for January along with 100 units from the opening balance. In December there was another sale of 1,400 units. This will clear out all of November.
and only leave 100 units in October. So now we are left with: Opening balance 900 $45 40,500
November 100 $50 5,000
** So the ending inventory must be $40,500 + 5,000 = $45,500.

MfvB I typically work this using cost of goods sold at each point. The first sale was 2,200 units at $46 for a total of $101,200. The second sale was 1,500 at $48, 800 units at $46 and 100 at $45 for a total of $113,300. The third sale was 500 units at $51 and 900 units at $50 for a total of $70,500. The total cost of goods sold was $285,000. The inventory available for sale was $330,500. The ending inventory is the difference between the two or $45,500.