

LECTURE GUIDE EXAMPLES – CHAPTER 1
Introduction to Financial Statements

Example 1 – The Accounting Equation

Indicate the effect of the following transactions on the accounting equation.

- a. Stock is issued for \$50,000 in cash.
- b. A building is purchased for \$100,000, a 20% down payment is made, a note is signed for the remainder
- c. Office supplies are purchased on account for \$3,500
- d. A customer makes a \$2,000 payment on account
- e. Paid for the office supplies purchased on account

SOLUTION

- a. Asset = I, liabilities = NE, owners' equity = I.
- b. Asset = I, liabilities = I, owners' equity = NE.
- c. Asset = I, liabilities = I, owners' equity = NE.
- d. Asset = NE, liabilities = NE, owners' equity = NE.
- e. Asset = D, liabilities = D, owners' equity = NE.

Example 2 – The Cost Principle

Assume you just bought a delivery van for your business. The van had a sticker price of \$18,000. A neighbor purchased an identical van last week for \$16,500. You paid \$15,000 for the van. At which price should the van be recorded? Why?

SOLUTION

The van should be recorded at \$15,000, which is its cost to the business. This figure is easily verifiable. At the time of purchase, it represents the fair market value of the van, but the FMV will seldom be reflected in the balance sheet again.

Example 3 – Ethical Dilemma

Martin is engaged in the audit of Permatrex Corporation, a pharmaceutical firm. Permatrex is a large firm with thousands of employees, and is hoping to issue a large amount of 10-year bonds. Martin has just learned that Permatrex is a defendant in numerous lawsuits alleging that it sold a drug in the 1960s that caused birth defects. The lawsuits probably won't be resolved for at least 15 or 20 years, and losing the suits could cause Permatrex to go out of business. Key officers in Permatrex have requested that Martin not disclose the lawsuits, reasoning that: (1) Permatrex is innocent; (2) the company can't issue the bonds if the lawsuits are disclosed, thereby causing great disruption in the business (including the loss of many jobs); and (3) the bonds will be fully paid off before the lawsuits are resolved. What should Martin do?

SOLUTION The lawsuits are loss contingencies and must be disclosed. A CPA cannot knowingly misrepresent facts and may not subordinate his/her judgment to others. Martin cannot justify the omission by saying that it will do more harm than good. Also, discuss the stakeholders and the consequences to each.

LECTURE GUIDE EXAMPLES - CHAPTER 2
A Further Look at Financial Statements

Example 1 – Profitability Measures

For 2001, calculate the return on assets and profit margin ratio for Procter & Gamble. How can we interpret these calculations?

SOLUTION

$$\text{Return on assets} = \frac{\text{net income}}{\text{ave. total assets}} = \frac{2,922}{(34387+34366)/2 = 34,376} = 8.5$$

$$\text{Profit margin ratio} = \frac{\text{net income}}{\text{net sales}} = \frac{2,922}{39,244} = 7.4$$

Interpret: To interpret these measures, we might (1) understand what they measure, (2) compare to last year, (3) compare to other companies in the same industry, and/or (4) compare to rules of thumb.

- (1) ROA: for every \$1 of assets invested by the company, they generate \$.085 of profit.
 PM: for every \$1 in sales, P&G generates \$.074 of profit.
- (2) Last year: ROA = 10.6; PM = 8.9. Both measures were better last year.
- (3) Industry/S&P data: ROA: 10.48/7.86 (5-year average); PM = 8.66/10.6. P&G is below the industry average for both measures and well below the S&P for profit margin. P&G is better than the S&P for return on assets.

Example 2 – Liquidity Measures

For 2001, calculate the working capital, current ratio, and quick ratio, and working capital for Procter & Gamble. How can we interpret these calculations?

SOLUTION

$$\text{Working capital} = \text{current assets} - \text{current liabilities} = 10,889 - 9,846 = \$1,043$$

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}} = \frac{10,889}{9,846} = 1.11$$

$$\text{Quick ratio} = \frac{\text{quick assets}}{\text{current liabilities}} = \frac{2,306 + 212 + 2,931}{9,846} = \frac{5,449}{9,846} = .55$$

Interpret: To interpret these measures, we might (1) understand what they measure, (2) compare to last year, (3) compare to other companies in the same industry, and/or (4) compare to rules of thumb.

- (1) P&G has \$1,043 more in current assets than it has in current liabilities. For every \$1 of current liabilities, it has \$1.11 in current assets and \$.55 in quick assets.
- (2) Last year's numbers were: working capital = \$5; current ratio = 1.00; quick ratio = .44. All measures have improved since last year.

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A Further Look at Financial Statements

- (3) Industry/S&P data: working capital = can't be compared; current ratio = 1.07/1.62; quick ratio = .57/1.11. P&G is very close to the industry averages, but is definitely lower than the companies in the S&P 500 (a broad measure of the market).
- (4) Rules of thumb: working capital = none; current ratio = 2.00; quick ratio = 1.00. P&G is significantly below these levels.

Example 3 – Solvency Ratios

For 2001, calculate the debt to total assets ratio and the debt to equity ratio for Procter & Gamble. How can we interpret these calculations?

SOLUTION

$$\text{Debt to total assets} = \frac{\text{total debt (liab.)}}{\text{total assets}} = \frac{22,377}{34,387} = .651$$

$$\text{Debt to equity} = \frac{\text{total debt}}{\text{stockholder's eq.}} = \frac{23,377}{12,010} = 1.86$$

Interpret: To interpret these measures, we might (1) understand what they measure, (2) compare to last year, (3) compare to other companies in the same industry, and/or (4) compare to rules of thumb.

- (1) Debt to total assets: for every \$1 invested in assets, \$.651 has been provided by creditors. Debt to equity: P&G has almost twice (1.86 times) as much debt as it has equity.
- (2) Last year's numbers were: debt to total assets = 64.2%; debt to equity = 1.80. Both measures were slightly better last year.
- (3) Industry/S&P data: debt to total assets = couldn't find; debt to equity = 2.06/1.06. P&G seems to be in a bit better shape than the industry, but it has a higher (worse) debt to equity ratio than the companies in the S&P 500 (a broad measure of the market).
- (4) Rules of thumb: debt to total assets = 60%; debt to equity = 1.86. P&G is worse than both rules of the thumb, but not by a large amount.

Example 4 – More Liquidity and Solvency Measures

For 2001, calculate the current cash debt coverage ratio and the cash debt coverage ratio for Procter & Gamble. How can we interpret these calculations?

SOLUTION

$$\text{Current cash debt coverage} = \frac{\text{cash from oper.}}{\text{ave. current liab.}} = \frac{5,804}{(9,846+10,141)/2 = 9,993} = .58$$

$$\text{Cash debt coverage} = \frac{\text{cash from oper.}}{\text{ave. total liab.}} = \frac{5,804}{(22,377+22,079)/2 = 22,228} = .26$$

Interpret: To interpret these measures, we might (1) understand what they measure, (2) compare to last year, (3) compare to other companies in the same industry, and/or (4) compare to rules of thumb.

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- (1) Current cash debt coverage (liquidity): for every \$1 of current liabilities, \$.58 in cash is generated from current operations.
Cash debt coverage (solvency): for every \$1 of liabilities, \$.26 in cash is generated from current operations.
- (2) Last year's numbers were: current cash debt coverage = .44; cash debt coverage = .22.
Both measures have improved since last year, especially the current cash debt coverage (cash from operations went up and current liabilities went down).
- (3) Industry/S&P data: unable to find.
- (4) Rules of thumb: current cash debt coverage = .4; cash debt coverage = .2. P&G is well above the minimum for current cash debt coverage, but only slightly above the minimum for cash debt coverage. Liquidity seems to be in good shape and solvency appears adequate.

LECTURE GUIDE EXAMPLES - CHAPTER 3
The Accounting Information System

Example 1 – Transaction Analysis

Peoples, Inc. began in business on July 1. Indicate how each of the transactions below affects the accounting equation. Place your answers in the chart on *page x*. Note that the type of transaction should be indicated for any event that affects stockholders' equity.

- a. On July 1, cash of \$95,000 was invested in the business in exchange for common stock.
- b. Peoples acquired land by paying \$60,000 cash to Nashtown, Inc.
- c. Peoples purchased an estimated three month supply of office supplies on account for \$600. The company will pay for these supplies later.
- d. Peoples received \$800 for services performed.
- e. Peoples performed services for \$2,000. The company will be paid later in the month.
- f. Peoples received confirmation that a major corporation has selected their corporation to perform major consulting work. The work will start January 1 of next year.
- g. Peoples purchased office equipment for \$6,000. The company signed a 2-year note with ACME Office Equipment Company.
- h. Peoples paid \$1,800 for a 1-year license to operate as a business. The license expires June 30th of next year.
- i. Peoples collected \$800 of the money owed from e.
- j. Peoples paid \$400 of the amount it owed from c.
- k. An employee has worked and earned \$600 which was paid during the month.
- l. Peoples received a \$5,000 retainer to handle a tax audit that the company will start next month.
- m. Peoples paid \$500 for rent during the month.
- n. Dividends of \$700 were paid during the month.

SOLUTION

See chart attached.

Example 2 – Journal Entries

Record the transactions from Example 1 in general journal entry form.

a.	<u>Stock is issued</u>		
	Cash	95,000	
	Common stock		95,000
b.	<u>Land is purchased</u>		
	Land	60,000	
	Cash		60,000
c.	<u>Office supplies are purchased on account</u>		
	Office supplies	600	
	Accounts payable		600
d.	<u>Services were performed in exchange for cash</u>		
	Cash	800	
	Service revenue		800
e.	<u>Services were performed on account</u>		
	Accounts receivable	2,000	
	Service revenue		2,000
f.	<u>Received confirmation of a new customer</u>		
	No entry		

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g.	<u>Purchased office equipment with a note payable</u>		
	Office equipment	6,000	
	Notes payable		6,000
h.	<u>Purchased a license for cash</u>		
	License	1,800	
	Cash		1,800
i.	<u>Collected part of the money on account from e.</u>		
	Cash	800	
	Accounts receivable		800
j.	<u>Paid part of the money owed from c.</u>		
	Accounts payable	400	
	Cash		400
k.	<u>An employee worked and was paid</u>		
	Salaries expense	600	
	Cash		600
l.	<u>Received a retainer for future work</u>		
	Cash	5,000	
	Unearned service revenue		5,000
m.	<u>Paid monthly rent</u>		
	Rent expense	500	
	Cash		500
n.	<u>Paid dividends</u>		
	Dividends	700	
	Cash		700

Example 3 – Posting to the Ledger

Record the transactions affecting cash from Example 1 to the Cash general ledger account.

Cash		Account No.				
Date		Explanation	Ref	Debit	Credit	Balance
a.		Issued stock		95,000		95,000
b.		Bought land			60,000	35,000
d.		Performed services		800		35,800
h.		Purchased license			1,800	34,000
i.		Collected A/R		800		34,800
j.		Paid A/P			400	34,400
k.		Paid salaries			600	33,800
l.		Received retainer		5,000		38,800
m.		Paid rent			500	38,300
n.		Paid dividends			700	37,600

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The Accounting Information System

Example 1 – Analysis of Transactions

	Assets						=	Liabilities			S/H Equity		
	Cash	Acct. Rec.	Supplies	License	Equip.	Land	=	AP	NP	Unearned Rent	Common Stock	Retained Earnings	Type of Transaction
a.	+95,000										+95,000		
b.	(60,000)					60,000							
c.			600					600					
d.	800											800	Service revenue
e.		2,000										2,000	Service revenue
f.													
g.					6,000				6,000				
h.	(1,800)			1,800									
i.	800	(800)											
j.	(400)							(400)					
k.	(600)											(600)	Salaries expense
l.	5,000									5,000			
m.	(500)											(500)	Rent expense
n.	(700)											(700)	Dividends
Total	37,600	1,200	600	1,800	6,000	60,000	=	200	6,000	5,000	95,000	1,000	

107,200

107,200

LECTURE GUIDE EXAMPLES - CHAPTER 4
Accrual Accounting Concepts

Example 1 – Prepaid Expenses (Supplies)

On October 5, the company paid \$2,500 for advertising supplies. An inventory on October 31 reveals that \$1,000 of the supplies remain on hand. Record the entry made on October 5 to record the purchase and prepare the October 31 adjusting entry to record the use of the supplies.

SOLUTION

October 5

Supplies	2,500	
Cash		2,500

October 31

Supplies expense	1,500	
Supplies		1,500

Example 2 – Prepaid Expenses (Insurance)

On October 4, the company paid \$600 for a 1-year insurance policy. Coverage began October 1. Record the entry made on October 4 to record the payment and prepare the October 31 adjusting entry to record the use of the insurance.

SOLUTION

October 4

Prepaid insurance	600	
Cash		600

October 31

Insurance expense	50	
Prepaid insurance		50

Example 3 – Depreciation

On October 1, the company purchased office equipment for \$4,800. Record the purchase and depreciation for the month of October. The equipment has an estimated life of 10 years.

SOLUTION

October 1

Office equipment	4,800	
Cash		4,800

October 31

Depreciation expense ($\$4,800 \div 10 \div 12$)	40	
Accumulated depreciation: office equipment		40

Example 4 – Unearned Revenue

On October 2, the company received \$1,200 for advertising services expected to be completed by December 31. Record the receipt of cash and the adjusting entry needed on October 31.

SOLUTION

October 2

Cash	1,200	
Unearned service revenue		1,200

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<u>October 31</u>		
Unearned service revenue	400	
Service revenue		400

Example 5 – Accrued Revenue

During October, the company earned \$2,000 for advertising services, but did not send the bills until October 31. December 31. Record the adjusting entry needed on October 31.

SOLUTION

<u>October 31</u>		
Accounts receivable	2,000	
Service revenue		2,000

Example 6 – Accrued Interest

On October 1, the company borrowed \$10,000 from Third National Bank. The bank is charging 6% interest. Record the loan and the adjusting entry needed on October 31.

SOLUTION

<u>October 1</u>		
Cash	10,000	
Notes payable		10,000
 <u>October 31</u>		
Interest expense ($10,000 \times 6\% \times 1/12$)	50	
Interest payable		50

Example 7 – Accrued Salaries

As of October 31, the company's employees had worked three days for which they had not yet been paid. Salaries amount to \$500 per day. Record the adjusting entry needed on October 31.

SOLUTION

<u>October 31</u>		
Salaries expense	1,500	
Salaries payable		1,500

Example 8 – Closing Entries

The balances in the temporary accounts for the Flanders Company are shown below. Prepare the necessary closing entries.

	Dr.	Cr.
Consulting revenue		10,000
Interest revenue		500
Salary expense	6,000	
Advertising expense	750	
Utility expense	1,000	
Depreciation expense	400	
Dividends	800	

LECTURE GUIDE EXAMPLES - CHAPTER 4
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SOLUTION

(1) Closing revenue accounts.

Consulting revenue	10,000	
Interest revenue	500	
Income summary		10,500

(2) Closing expense accounts.

Income summary	8,150	
Salary expense		6,000
Advertising expense		750
Utility expense		1,000
Depreciation expense: equipment		400

(3) Closing the income summary account.

Income summary	2,350	
Retained earnings		2,350

(4) Closing the dividends account.

Retained earnings	800	
Dividends		800