Chapter 7

Multiple Choice

1. On a balance sheet, what is the preferable presentation of notes or accounts receivable from officers, employees, or affiliated companies?
   a. As trade notes and accounts receivable if they otherwise qualify as current assets
   b. As assets but separately from other receivables
   c. As offsets to capital
   d. By means of notes or footnotes

Answer b

2. The basis for classifying assets as current or noncurrent is the period of time normally elapsed from the time the accounting entity expends cash to the time it converts
   a. Inventory back to cash or 12 months, whichever is shorter
   b. Receivable s back into cash or 12 months, whichever is longer
   c. Tangible fixed assets back into cash or 12 months, whichever is longer
   d. Inventory back to cash or 12 month, whichever is longer

Answer d

3. The valuation basis used in conventional financial statements is
   a. Replacement cost
   b. Market value
   c. Original cost
   d. A mixture of costs and values

Answer d

4. A transaction that would appear as an application of funds on a conventional funds statement using the all-financial-resources concept, but not on a statement using the traditional working capital concept would be the
   a. Acquisition of property, plant, and equipment for cash
   b. Reacquisition of bonds issued by the reporting entity
   c. Acquisition of property, plant, and equipment with an issue of common stock
   d. Declaration and payment of dividends

Answer c

5. There would probably be a major difference between a statement of source and application of working capital and a cash flow statement in the treatment of
   a. Dividends declared and paid
   b. Sales of noninventory assets for cash at a loss

c. Payment of long-term debt
d. A change during the period in the accounts payable balance

Answer d

6. A basic objective of the statement of cash flows is to
   a. Supplant the income statement and balance sheet
   b. Disclose changes during the period in all asset and all liability accounts
   c. Disclose the change in working capital during the period
   d. Provide essential information for financial statements users in making economic decisions

Answer d

7. A statement of cash flows should be issued by a profit-oriented business
   a. As an alternative to the statement of income and retained earnings
   b. Only if the business classifies its assets and liabilities as current and noncurrent
   c. Only when two-year comparative balance sheets are not issued
   d. Whenever a balance sheet and a statement of income and retained earnings are issued

Answer d

8. When preparing a statement of changes in financial position using the cash basis for defining funds, an increase in ending inventory over beginning inventory will result in an adjustment to reported net earnings because
   a. Funds were increased since inventory is a current asset
   b. The net increase in inventory reduced cost of goods sold but represents an assumed use of cash
   c. Inventory is an expense deducted in computing net earnings, but is not a use of funds
   d. All changes in noncash accounts must be disclosed under the all financial resources concept

Answer b

9. Which of the following should theoretically be presented in a statement of changes in financial position only because of the all-financial-resources concept?
   a. Conversion of preferred stock to common stock
   b. Purchase of treasury stock
   c. Sale of common stock
   d. Declaration of cash dividend

Answer a

10. When preparing a funds statement using the all financial resources concept, the retirement of long-term debt by the issuance of common stock should be presented in a statement of changes in financial position as a

	Source of Funds	*Use of Funds*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

Answer a

11. The working capital format is one possible format for presenting a statement of changes in financial position. Which of the following formats is (are) also theoretically acceptable?

	Cash	*Quick Assets*
a.	Acceptable	Not acceptable
b.	Not acceptable	Not acceptable
c.	Not acceptable	Acceptable
d.	Acceptable	Acceptable

Answer d

12. A gain on the sale of plant assets in the ordinary course of business should be presented in a statement of cash flows as a (an)
    a. Source and use of cash
    b. Use of cash
    c. Addition to income from continuing operations
    d. Deduction from income from continuing operations

Answer d

13. Which of the following should be presented in a statement of cash flows?

	Conversion of Long-term debt to common stock	*Conversion of preferred stock to common stock*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

Answer c

14. The balance sheet discloses
    a. Stocks
    b. Flows
    c. Both stocks and f lows
    d. Neither stocks nor flows

Answer a

15. Which of the following is not a balance sheet element?
    a. Assets
    b. Liabilities
    c. Gains
    d. Equities

Answer c

16. Which of the following is not a component of equity?
    a. Common stock
    b. Treasury stock
    c. Retained earnings
    d. Unearned revenue

Answer d

17. Which of the following is not an important aspects of *SFAS No. 157*(FASB ASC 820)?
    a. A new definition of fair value.
    b. A requirement that all assets and liabilities are to be measured at their fair value.
    c. A fair value hierarchy used to classify the source of information used in fair value measurements (for example, market based or nonmarket based).
    d. New disclosures of assets and liabilities measured at fair value based on their level in the hierarchy.

Answer b

18. The definition of fair value in SFAS No 157(FASB ASC 820) is
    a. Entry price based
    b. Exit price based
    c. Replacement cost based
    d. Historical cost based

Answer b

19. The SFAS No 157 (FASB ASC 820) fair value hierarchy contains
    a. Two level
    b. Three levels
    c. Four levels
    d. Five levels

Answer b

20. Which of the following s the lowest level of the SFAS 157 (FASB ASC 820) fair value hierarchy?
    a. Unobservable inputs (that are corroborated by observable market data)
    b. Unobservable inputs (that are not corroborated by observable market data)
    c. Observable market-based inputs (or unobservable inputs that are corroborated by market data)
    d. Quoted market prices for *identical* assets or liabilities in *active* markets

Answer b

21. The calculation net income/sales is the formula for which of the following ratios
    a. Return on assets
    b. Profit margin
    c. Asset turnover
    d. Asset usage

Answer b

22. The calculation sales/average total assets is the formula for which of the following ratios
    a. Return on assets
    b. Profit margin
    c. Asset turnover
    d. Asset usage

Answer c

23. The calculation net income/average total assets is the formula for which of the following ratios
    a. Return on assets
    b. Profit margin
    c. Asset turnover
    d. Asset usage

Answer a

24. The firm's ability to use its financial resources to adapt to change is the definition of
    a. Liquidity
    b. Solvency
    c. Financial flexibility
    d. Working capital

Answer c

25. A firm's ability to obtain cash for business operations change is the definition of
    a. Liquidity
    b. Solvency
    c. Financial flexibility
    d. Working capital

Answer b

26. The firm's ability to convert an asset to cash or to pay a current liability change is the definition of
    a. Liquidity
    b. Solvency
    c. Financial flexibility
    d. Working capital

Answer a

27. Net cash provided (used) by operating activities − net cash used in acquiring property, plant is the calculation for
    a. Free cash flow
    b. Cash flow from investing activities
    c. Working capital
    d. Current ratio

Answer a

28. Which of the following is a difference between IAS No. 7 and SFAS No. 95 (FASB ASC 230)?
    a. IAS No. 7 requires the use of the direct method
    b. IAS No. 7 required the use of the indirect method
    c. IAS No 7 requires the use of the all financial resources concept of funds
    d. IAS No. 7 requires extraordinary items be disclosed separately as operating, investing, or financing activities

Answer d

29. Investments in equity securities are disclosed as current assets on a company's balance sheet if
    a. Management intends to sell them within a year and they have a ready market exists.
    b. The fair market value cannot be determined.
    c. Management intends to convert them into common stock within one year.
    d. Management owns less than 50% of the outstanding stock.

Answer a

30. What is reported on the statement of cash flows?
    a. Operating, investing, and financing activities of an entity for a period of time
    b. All revenues and expense listed by operating, financing, and operating actitivity
    c. Operating, investing, and financing activities of an entity at the balance sheet date
    d. A detail of all incoming and outgoing cash flows of a business

Answer a

Essay

1. Discuss the following balance sheet elements as defined by SFAC No. 6:
    a. Assets

       Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (1) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows; (2) a particular enterprise can obtain the benefit and control others' access to it; and (3) the transaction or other event giving rise to the enterprise's right to or control of the benefit has already occurred.

    b. Liabilities

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. A liability has three essential characteristics: (1) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand; (2) the duty or responsibility obligates a particular enterprise, leaving it little or no discretion to avoid the future sacrifice; and (3) the transaction or other event obligating the enterprise has already happened.

c. Equity

Equity is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest. Equity in a business enterprise stems from ownership rights (or the equivalent). It involves a relation between an enterprise and its owners as owners rather than as employees, suppliers, customers, lenders, or in some other nonowner role.

2. List three valuation techniques currently used on the balance sheet and discuss how each are used (What accounts?).

Asset	**Measurement Basis**
Cash	Current value
Accounts receivable	Expected future value
Marketable securities	Fair value or amortized cost
Inventory	Current or past value
Investments	Fair value, amortized cost, or the result of applying the equity method
Property, plant, and equipment	Past value adjusted for depreciation

3. Define the following terms:

a. Current assets

Current assets are those assets that may *reasonably be expected* to be realized in cash, sold or consumed during the normal operating cycle of the business or one year, whichever is longer

b. Investments

Investments may be divided into three categories:

1. Securities acquired for specific purposes, such as using idle funds for long periods or exercising influence on the operations of another company.
2. Assets not currently in use by the business organization, such as land held for a future building site.
3. Special funds to be used for special purposes in the future, such as sinking funds.

c. Property, plant and equipment

Property, plant and equipment consists of the tangible assets owned by a company and used in the production and or sale of a company's product.

d. Current liabilities

Obligations whose liquidation is reasonably expected to require the use of existing resources properly classified as current assets or the creation of other current liabilities.

e. Treasury stock

Previously issued stock that has been reacquired by the company.

4. How is fair value defined in SFAS No. 157 (FASB ASC 820)?

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

5. Describe the fair value hierarchy as defined in SFAS No.157.

Level 1:	Quoted market prices for Company A common stock traded and quoted identical assets or liabilities in active markets on the New York Stock Exchange
Level 2: Observable market-based inputs, other than Level 1 quoted prices (or unobservable inputs corroborated by market data)	Company B common stock traded and quoted only on an inactive market in an emerging country A privately placed bond of Z whose value is derived from a similar Z bond that is publicly traded An over-the-counter interest rate swap, valued based on a model whose inputs are observable, such as LIBOR (London Interbank Offered Rate)forward interest rate curves.
Level 3: Unobservable inputs (not corroborated by observable market data)	A long-dated commodity swap whose forward price curve, used in a valuation model, is not directly observable or correlated with observable market data Shares of a privately held company whose value is based on projected cash fl ows

6. Obtain a company's financial statements and ask the students to compute the following:
   a. Return on investment
   b. Adjusted return on investment
   c. Profit margin ratio
   d. Asset turnover ratio

e. Free cash flow

These answers are dependent on the company selected.

7. What questions does the statement of cash flows enable financial statement users to answer?

   The statement of changes in financial position was designed to enable financial statement users to answer such questions as:

   1. Where did the profits go?
   2. Why weren't dividends larger?
   3. How was it possible to distribute dividends in the presence of a loss?
   4. Why are current assets down when there was a profit?
   5. Why is extra financing required?
   6. How was the expansion financed?
   7. Where did the funds from the sale of securities go?
   8. How was the debt retirement accomplished?
   9. How was the increase in working capital financed?

8. Define the following terms:

a. Liquidity

Liquidity is the firm's ability to convert an asset to cash or to pay a current liability. It is referred to as the "nearness to cash" of an entity's economic resources and obligations.

b. Solvency

Solvency refers to a firm's ability to obtain cash for business operations. Specifically, it refers to a firm's ability to pay its debts as they become due.

c. Financial flexibility

Financial flexibility is the firm's ability to use its financial resources to adapt to change. It is the firm's ability to take advantage of new investment opportunities or to react quickly to a "crisis" situation. Financial flexibility comes in part from quick access to the company's liquid assets. However, liquidity is only one part of financial flexibility. Financial flexibility also stems from a firm's ability to generate cash from its operations, contributed capital, or sale of economic resources without disrupting continuing operations.

9. Discuss the direct vs. indirect methods of preparing the statement of cash flows.

   The direct and indirect methods relate to the presentation of cash flows from operating activities. Reporting gross cash receipts and payments is termed the *direct method,* and includes reporting the following classes of operating cash receipts and payments:

   1. Cash collected from customers
   2. Interest and dividends received

3. Other operating cash receipts
4. Cash paid to employees and other suppliers of goods and services
5. Interest paid
6. Income taxes paid
7. Other operating cash payments

The FASB has stated a preference for the use of the direct method but A company that chooses not to use the direct method for reporting operating cash flow information must report the same amount of operating cash flow by adjusting net income to reconcile it with operating cash flow. This method of reporting is termed the *indirect method*. The required adjustments include the effect of past deferrals of operating cash receipts and payments; accruals of expected operating cash receipts and payments; and the effect of items related to investing and financing activities such as depreciation, amortization of goodwill, and gains or losses on the sale of property, plant, and equipment.

10. Define and discuss the three major sections of the statement of cash flows.

The three sections of the statement of cash flows are 1. Cash flows from operating activities, 2. Cash flows from investing activities and 3. Cash flows from financing activities. Cash flows from operating activities are generally the cash effect from transactions that enter into the determination of net income exclusive of financing and investing activities. Investing activities include making and collecting loans; acquiring and disposing of debt or equity securities of other companies; and acquiring and disposing of property, plant, and equipment, and other productive resources. Financing activities result from obtaining resources from owners, providing owners with a return of and a return on their investment, borrowing money and repaying the amount borrowed, and obtaining and paying for other resources from long-term creditors.