Chapter 2 Solutions

Answers to Questions

1) There are several reasons why reported financial information is often not exactly correct or accurate. Much of the information that is presented has some degree of uncertainty tied to it. Those numbers can only be approximated because they will not be resolved until some future date. In addition, the sheer volume of transactions makes it impossible for gathered and reported data to always be exact. However, the information that is reported must still be fairly presented to allow users to make appropriate decisions. Information is viewed as presented fairly if it contains no material misstatements according to a recognized set of accounting standards such as U.S. GAAP or IFRS.

2) A misstatement is a balance that varies from the underlying reality of the event or transaction that it purports to report. In financial accounting, it is a mistake that was made by accident (an error) or on purpose (fraud).

3) Materiality describes the condition of a misstatement that is of a size or type that has an impact on a decision made by an investor, creditor, or some other decision maker. If a misstatement is immaterial, it poses no problem; no decision is impacted. However, if a decision maker makes a different decision because of the presence of a misstatement, it is viewed as material.

4) In determining whether a misstatement is material, the accountant considers the size of the problem in comparison to the size of the reporting entity. No single dollar amount can be used. In addition, fraud is considered worse than an error because of the intent to deceive. Therefore, a misstatement resulting from fraud is more likely to be material than an error of the same amount.

5) A misstatement is considered to be fraud when information is reported incorrectly on purpose. There is intent to deceive. In accounting, two types of fraud exist. One is a misstatement that occurs because of theft. Either the reported balances are wrong because assets have been removed or because numbers have been changed to cover up the theft. The other type of fraud occurs when reported balances are changed to make the business look different than it actually is. Often, numbers are physically changed so that operations look especially strong and financially healthy.

6) For virtually any business, many possible uncertainties exist. A few examples include:
    a. a pending lawsuit (what liability amount should be reported),
    b. a sale has been made but no cash has yet been collected (what asset amount should be reported),
    c. employees have been promised a bonus based on future stock price (what liability amount should be reported),
    d. products have been sold along with a warranty requiring that they be fixed if broken (what liability amount should be reported),

e. inventory has been acquired and is getting old but has not yet been sold (what asset amount should be reported).

7) Financial accounting can be compared to the painting of a portrait because the goal is to provide a likeness of a business or other organization that is presented fairly so that investors and creditors can make use of it to make financial decisions. Using numbers and words, the accountant hopes to provide information that will allow the user to see what the organization looks like, at least financially.

8) A language is simply a set of terminology and rules that allows one party to communicate with another. In financial accounting, the communication is financial information about an organization. Financial accounting has set rules (U. S. GAAP in the U. S. and IFRS in most of the rest of the world) along with a fairly set amount of terminology. If the appropriate members of the reporting entity (the accountants who produce the financial statements) understand these rules and terminology and the decision makers do as well, then the financial statements should successfully communicate information from one party to the other.

9) U. S. GAAP encompasses all of the official rules and pronouncements created or accepted by the Financial Accounting Standards Board (FASB). Those rules have now been brought together in the *Accounting Standards Codification*. Any financial statements or financial information that claims to be created in conformity with U.S. GAAP must follow these rules. Over the past several decades, FASB has issued hundreds of pronouncements that create new rules or modify existing ones. This evolution occurs because new transactions are created or problems are uncovered in connection with previous rules.

10) When companies release financial statements or other information that has been prepared according to U. S. GAAP, decision makers know that they are seeing information on which they can rely. It has been prepared using rules and terminology that they know. This allows for understanding and comparison. Thus, potential investors and creditors can assess their possible risks and rewards and make good investments. Without U. S. GAAP, individuals would have more difficulty evaluating their risks and would likely not make as many investments. Without that capital, significant economic growth is not possible.

11) Decision makers around the world want to compare businesses located in different countries. For example, how does Toyota's financial health compare with that of Ford? U. S. GAAP has long been required for financial reporting inside of the U.S. However, over the last 10-15 years, the use of country by country accounting rules outside of the U.S. has given way to a single set of standards known as IFRS. Global companies often have to spend the time and money necessary to produce financial statements under both sets of rules or decision makers face serious problems in making comparisons. Because of the sheer complexity of U.S. GAAP, no push exists to accept it outside of the U.S. Therefore, the only viable alternative for a single set of rules is acceptance of IFRS within the U.S. That idea has both proponents and opponents.

Likely, over the next few years, some type of compromise will be worked out so that a single set of accounting rules will apply around the world.

12) An asset is a probable future economic benefit controlled or owned by a business or other organization. Numerous examples exist including cash, inventory, buildings, and equipment.

13) A liability is a probable future sacrifice of economic benefits arising from a present obligation. Examples include notes payable, accounts payable, salary payable, and income tax obligations.

14) The term "net assets" is a computed amount that is found by taking the assets reported by an organization and subtracting its liabilities. It is a measure of the amount of assets that a company has after all liabilities are removed.

15) A revenue is a measure of the increase in (or inflows of) an organization's net assets from sales of inventory or services.

16) An expense is an outflow or using up of net assets that was incurred by an organization to generate revenue.

Answers to True or False Questions

__F__ 1)

Only U.S. corporations are required to use U.S. GAAP. Most countries have adopted IFRS in some form or another for financial reporting purposes.

__T__ 2)

Companies face many unknowns when preparing financial statements, such as the results of lawsuits, collection of accounts receivables, or the length of time that a building will last.

__F__ 3)

It is highly unlikely that the equipment's cost was determined with such precise accuracy. For decision-making purposes, reported information must be presented fairly which means that it contains no material misstatements. Therefore, although the equipment probably did not cost exactly $122,756,255, the cost should not have been materially different than $122,756,255.

__F__ 4)

This is the definition of an asset, not a liability.

__F__ 5)

U.S. GAAP is established by the Financial Accounting Standards Board (FASB), a private organization. The Securities and Exchange Commission is the government body that has legal control over much of financial reporting but the SEC has allowed FASB to create U. S. GAAP.

__F__ 6)

IFRS has only gained wide scale acceptance in the last 10 years or so as the significance of the global economy has become more evident.

__F__ 7)

The information provided in financial statements is often not exact (because of uncertainties and the sheer volume of the numbers), but it still provides useful information to decision makers. Reported information needs to be presented fairly which means that it contains no material misstatements according to U.S. GAAP (or IFRS if those standards are applied).

__T__ 8)

The number that is reported is wrong and, therefore, misstated. Because the misstatement is only $93, it is unlikely to be material but it is still wrong.

__T__ 9)

Materiality is a relative concept that depends on size. For a small organization, virtually any misstatement might be material. For a large organization, misstatements of millions of dollars might not be material. The cause of the misstatement (whether it is from fraud or error) also impacts the decision about materiality.

__F__ 10)

It is not acceptable to have any material misstatements in a set of financial statements because a misstatement of that size or nature prevents the information from being fairly presented.

__F__ 11)

A misstatement can be caused by fraud (intentionally) or by error (unintentionally).

__F__ 12)

Accounting for a lawsuit or any other type of uncertainty can be extremely difficulty simply because there is no easy way to predict the future. The outcome of the lawsuit will not be known for months or maybe even years. Until then, the reporting can only be made based on estimations.

__F__ 13)

In judging materiality, fraud is considered a bigger problem than an error because of the intent to deceive. Thus, an error of $10,000 might not be judged material because it was the result of an accident. At the same time, fraud of $10,000 might be viewed as material because the intention makes it more likely that an investor or creditor's decision would be impacted.

__F__ 14)

In order for financial accounting to successfully communicate information, both the preparer of that information (the accountant) and the users of that information (investors and creditors) must understand the meaning of the terminology.

__F__15)

While employees certainly help generate revenues, the organization does not own them or have control over them so that they are not viewed as assets from an accounting perspective.

__T__16)

Revenue is the measure of the increase in net assets caused by the sale of inventory or a service. If a sale is made today but not collected, the seller's net assets have still increased. Cash does not go up but another asset (accounts receivable) increases to indicate the amount to be received later. Net assets increase as the result of a sale so that revenue is recognized.

__F__17)

An expense is a measure of the outflow or reduction in net assets caused by a business's attempt to generate revenues. Buying a building increases one asset (the building) and reduces another (cash) so that there is no decrease in net assets. Thus, no expense is recorded.

Answers to Multiple Choice Questions

1) **Answer is C**

   There is virtually no uncertainty with a loan. Payment dates and amounts are specifically set by the terms of the loan contract. The amount that will be paid as interest will also be given. In contrast, collections of receivables as well as payments on warranties and lawsuits all involve unknown amounts of future cash (either to be collected or paid).

2) Answer is D

U.S. GAAP provides the standards and the terminology so that preparers will have a set method for conveying financial information. This standardization makes understanding by investors and creditors much more likely. However, U.S. GAAP is not used around the world and does not present exact information (because, for example, of uncertainty). In addition, U.S. GAAP has been developed over a number of decades although significant changes take place on a regular basis.

3) Answer is B

An asset must have probable future economic benefit and be owned or controlled by the reporting company. Inventory, receivables due from customers, and equipment and fixtures all meet this definition. However, the building here is rented by the company and is not owned by it. Therefore, the company does have ownership or control over the building so that it does not qualify as an asset.

4) Answer is A

The amount owed to the company is a receivable (an asset). Sales made to customers are reported as revenues. Cash collected from customers is an asset. The liability here is the loan that is owed to the bank. That qualifies as a debt.

5) Answer is B

The inflow or increase in net assets as a result of the sale of a good or service is known as revenue. No business is so small that a possible creditor or investor would not care about its financial information. Credit sales are viewed as revenue because receivables (the amount owed to the company by the customer) go up as a result of the sale. That increase in net assets is reported as a revenue. The intent of the company is not shown as an asset because it is not considered a probable future economic benefit.

6) Answer is A

When information is identified as presented fairly according to U.S. GAAP, the preparers are stating that no material misstatements exist within that information based on the rules and terminology specified by U.S. GAAP. Although U.S. GAAP predominates in the U.S., IFRS is much more common in the rest of the world.

7) Answer is C

IFRS rules are the dominant system outside of the U.S. (where U.S. GAAP continues to be mandated). IFRS rules are viewed as less complex than U.S. GAAP which makes them extremely popular with many people, especially those preparing financial statements. In its current format, IFRS rules have only become popular in the last 10 years or so whereas FASB has been producing U.S. GAAP since 1973 and other groups produced it prior to that date. Although the U.S. may eventually adopt IFRS rules, no date is currently specified.

8) Answer is D

Both the $2,000 and the $3,000 are reductions in the net assets of this business and both were incurred in hopes of generating revenues (both employees and a retail space are needed to earn revenues). In both cases, that meets the definition of an expense.

9) Answer is D

The company's cash (an asset) went up by $25,000 as did its liabilities (debt to the bank). Thus, no change occurs in the total of the net assets (which is the assets of the company less its liabilities).

Answers to Problems

1)

a) Cash – <u>Asset</u> because it has probable future economic benefit and it is either owned or controlled by the reporting company.
b) Building - <u>Asset</u> because it has probable future economic benefit and it is either owned or controlled by the reporting company.
c) Loan due to the bank – <u>Liability</u> because it is a debt of the business.
d) Inventory - <u>Asset</u> because it has probable future economic benefit and it is either owned or controlled by the reporting company.
e) Salary expense – <u>Expense</u> because it is a measure of the outflow or reduction in net assets caused by a business's attempt to generate revenue.
f) Rent expense – <u>Expense</u> because it is a measure of the outflow or reduction in net assets caused by a business's attempt to generate revenue.
g) Amounts owed to employees for work done - <u>Liability</u> because it is a debt of the business.
h) Equipment - <u>Asset</u> because it has probable future economic benefit and it is either owned or controlled by the reporting company.
i) Amounts owed to suppliers - <u>Liability</u> because it is a debt of the business.
j) Sales – <u>Revenue</u> because it is a measure of the inflow or increase in net assets generated by the sales made of either goods or services.

2)

Following are some of the typical uncertainties associated with each of these assets or liabilities.

a. Inventory – whether the item can be sold, how much the sales price might be, how long the company will have to wait before a sale can be made.
b. Receivable from a customer – how much of the balance will be collected, when the collection of cash will be made.
c. Equipment – how long the asset will last, what the asset will be worth when the company decides to dispose of it, how much maintenance will cost to keep the asset operating efficiently.
d. Income taxes payable – because the taxing authority can audit income tax returns, the major uncertainty is whether additional amounts will be demanded at some point in the future.
e. Liability from lawsuit – how much (if any) will have to be paid on the lawsuit, when that payment date might occur.

3)

The reported balance for inventory at a jewelry store is misstated. The problem could either have occurred because of an error or because of fraud. Here are a number of possibilities.

<u>Error:</u>
--Jewelry was bought but the amount that was paid was written down incorrectly.
--Jewelry was bought and accidentally damaged so that it was worthless. However, no one noticed the damage that was done.
--Jewelry was sold at the very end of the year but no record of the sale was made because of the lack of time.

<u>Fraud:</u>
--Jewelry was stolen. The records were then reduced so that no difference would appear between the amount of jewelry on hand and the reported balance.
--Officials wanted the company to look especially prosperous so the inventory balance was reported at a higher amount than was appropriate for the jewelry that was on hand.

4)

a. The company owes $1,000 for some purchases made last month and pays that amount now. <u>Answer:</u> The liability for this previous purchase is reduced by $1,000 and cash (an asset) is reduced by $1,000. If both assets and liabilities are reduced by $1,000, no change in net assets takes place.

b. The company borrows $220,000 from a bank on a loan. <u>Answer:</u> Cash (an asset) goes up by $220,000 and the liability that is now owed to the bank also goes up by $220,000. If both assets and liabilities are increased by $220,000, no change in net assets takes place.

c. The company sells a service to a customer for $30,000 with payment made immediately. Answer: Cash (an asset) goes up by $30,000. There is no change in liabilities so net assets increase by $30,000.

d. The company sells a service to a customer for $40,000 but payment will not be made for several months. Answer: A receivable from the customer (an asset) goes up by $40,000. There is no change in liabilities so net assets increase by $40,000.

e. The company pays $8,000 in cash for several pieces of equipment. Answer: Equipment (an asset) goes up by $8,000 and cash (also an asset) goes down by $8,000. If one asset increases while the other decreases, no change in net assets takes place.

f. The company rented a large truck for one day for $500 which it paid at the end of the work day. Answer: Cash (an asset) goes down by $500. There is no change in any other asset or in a liability. As the only change in an asset or a liability, net assets decrease by $500.

Answers to Research Assignments

1)

a. The largest revenue was “Sales by Company-operated restaurants” and the amount was $16,233.3 million. The largest expense was “Food and paper” and the amount was $5,300.1 million.

b. The largest asset was “Property and equipment, at cost” and the amount was $34,482.4 million. The largest liability was “Long-term debt” and the amount was $11,497.0 million. That liability category encompasses all notes and bonds payable that are not due within the next year.

2)

Assets – already covered

--Companies own things, called assets.

--Typical examples of assets include buildings, trucks, inventory, equipment, and cash

Assets – not yet covered

--Assets includes intangible items such as trademarks and patents

--Assets are separated into current and noncurrent categories

--Property, plant, and equipment is also known as fixed assets

--Manufacturing businesses usually have more fixed assets than service businesses

Liabilities – already covered

--Liabilities are the debts of the business

--Common examples include money owed to banks and taxes owed to governments

Liabilities – not yet covered

--Liabilities are either current (payable within one year) or long-term (not payable within one year)

--Failure to pay liabilities can push a company into bankruptcy

3)

a. As of January 2, 2011, Johnson & Johnson reports $102,908 million in assets.

b. As of January 2, 2011, Johnson & Johnson reports $46,329 million in liabilities.

c. As of January 2, 2011, Johnson & Johnson holds net assets of $56,579 million ($102,908 less $46,329).