Financial Reporting Financial Statement Analysis and Valuation 9th edition Wahlen Test Bank

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Chapter 2—Asset and Liability Valuation and Income Recognition

MULTIPLE CHOICE

1. Which of the following assets appears on the balance sheet at Historical cost?
   a. Equipment
   b. Notes Payable
   c. Investments in Marketable Securities
   d. Accounts Payable

   ANS: A PTS: 1

2. Interest on Municipal Bonds represents what kind of tax difference?
   a. Permanent timing difference that results in that income item not being taxed.
   b. Temporary difference that will reversed in the future
   c. Tax rate on Municipal bonds are based on estimated tax rates.
   d. Not recognized in taxable income on the accrual basis of accounting.

   ANS: A PTS: 1

3. Shareholders' equity consists of what three components:
   a. Assets, liabilities, and contributed capital.
   b. Contributed capital, accumulated other comprehensive income, and retained earnings.
   c. Liabilities, contributed capital, and retained earnings.
   d. Liabilities, contributed capital, and accumulated other comprehensive income.

   ANS: B PTS: 1

4. Which of the following valuation methods reflects current values?
   a. acquisition cost
   b. present value of cash flows using historical interest rates
   c. net realizable value
   d. adjusted acquisition cost

   ANS: C PTS: 1

5. The use of acquisition cost as a valuation method is justified on the basis that acquisition cost is:
   a. timely
   b. relevant
   c. subjective
   d. objective

   ANS: D PTS: 1

6. Firms use acquisition cost valuations and adjusted acquisition cost valuations for which of the following types of assets?
   a. Assets that do not have fixed amounts of future cash flows.
   b. Assets that have fixed amounts of future cash flows.
   c. Assets with certain future economic benefits.
   d. monetary

   ANS: A PTS: 1

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7. The net amount a firm would receive if it sold an asset or the net amount it would pay to settle a liability is referred to as:
   a. current replacement cost
   b. net realizable value
   c. current cost
   d. acquisition cost

   ANS: B PTS: 1

8. Disregarding cash flows with owners, over sufficiently long periods of time, net income equals:
   a. revenues minus dividends and expenses
   b. assets minus liabilities
   c. stockholders' equity
   d. cash inflows minus cash outflows

   ANS: D PTS: 1

9. When income tax expense for a period is greater than income tax payable the difference will be reported how and on which financial statement?
   a. Deferred tax asset and Statement of Cash Flows
   b. Deferred tax asset and Balance Sheet
   c. Deferred tax liability and Statement of Cash Flows
   d. Deferred tax liability and Balance Sheet

   ANS: D PTS: 1

10. Permanent tax differences are revenues and expenses:
    a. that firms include in income tax returns, but do not appear in the income statement.
    b. that are included in both the tax return and income statement, but in different accounting periods.
    c. that firms include in the income statement, but do not appear in income tax returns.
    d. that are not included in either the tax return or the income statement.

    ANS: C PTS: 1

11. The traditional accounting model delays the recognition of value changes of assets and liabilities until what event occurs?
    a. A change in value.
    b. A market transaction.
    c. A balance sheet date.
    d. Cash is received or cash is paid.

    ANS: B PTS: 1

12. Fish Farm Corporation purchases a new tract of land on which it is going to build new growing and holding tanks in order to expand its business. Which of the following costs would **not** be part of the cost of the land?
    a. costs to run a title search
    b. costs of grading to level the land
    c. costs of tearing down an existing structure
    d. cost of the new holding tanks

    ANS: D PTS: 1

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13. Current replacement cost represents:
    a. the amount a firm would have to pay currently to acquire an asset it now holds
    b. the amount a firm would have to pay currently to acquire an asset it does not now hold
    c. the amount a firm would have to pay in the future to acquire an asset it now holds
    d. the amount a firm would have to pay to purchase a comparably depreciated version of the asset it now holds

    ANS: A PTS: 1

14. Which of the following is **not** one of methods used by GAAP for treating value changes?
    a. Recognize value changes on the balance sheet and income statement when they are realized in a market transaction
    b. Recognize value changes in the income statement when the value changes occur over time, but recognize them on the balance sheet when they are realized in a market transaction
    c. Recognize value changes on the balance sheet when the value changes occur over time, but recognize them in the income statement when they are realized in a market transaction
    d. Recognize value changes on the balance sheet and income statement when they occur over time, even though they are not realized in a market transaction

    ANS: B PTS: 1

15. Which of the following transactions is consistent with recognizing value changes on the balance sheet and income statement when they are realized in a market transaction?
    a. Selling land at a cost greater than its original purchase price.
    b. Recording an increase in the fair value of investments at year end.
    c. Translating foreign operations accounted for in Yen back to U.S. dollars in order to prepare consolidated financial statements.
    d. Writing down the value of an asset due to obsolescent.

    ANS: A PTS: 1

16. At origination which of the following temporary differences would create a deferred tax asset?
    a. Tax basis of an asset exceeds its financial reporting basis.
    b. Tax basis of a liability exceeds its financial reporting basis.
    c. Financial reporting basis of an asset is equal to its tax basis.
    d. Financial reporting basis of an asset exceeds its tax basis.

    ANS: A PTS: 1

17. Plaxo Corporation has a tax rate of 35% and uses the straight-line method of depreciation for its equipment, which has a useful life of four years. Tax legislation requires the company to depreciate its equipment using the following schedule: year 1- 50%, year 2 - 30%, year 3 - 15% and year 4 - 5%. In 2014 Plaxo purchases a piece of equipment with a four year life and an original cost of $100,000. What amount will Plaxo record as a deferred tax asset or liability in 2010?
    a. Deferred tax asset of $25,000.
    b. Deferred tax liability of $25,000.
    c. Deferred tax asset of $8,750.
    d. Deferred tax liability of $8,750.

    ANS: D PTS: 1

18. The income statement approach to measuring income tax expense:

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a. is required by FASB Statement No. 109.
b. compares revenues and expenses recognized for book and tax purposes, eliminates permanent differences, and computes income tax expense based on book income before taxes excluding permanent differences.
c. computes income tax expense as a difference between the tax basis of an asset or a liability and its reported amount in the [balance sheet] that will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled.
d. is required by IAS 12.

ANS: B PTS: 1

19. Future tax deductions:
a. result in deferred tax assets.
b. result in deferred tax liabilities.
c. occur where the tax basis of liabilities is more than the financial reporting basis.
d. occur where the tax basis of assets is less than financial reporting basis.

ANS: A PTS: 1

20. Future taxable income is characteristic of all of the following situations **except**:
a. where deferred tax assets result.
b. where deferred tax liabilities result.
c. where the tax basis of liabilities exceeds the financial reporting basis.
d. where the tax basis of assets is less than financial reporting basis.

ANS: A PTS: 1

21. When recognizing deferred tax assets and liabilities, the income statement approach and the balance sheet approach yield identical results:
a. when enacted tax rates applicable to future periods do not change.
b. when the firm recognizes no valuation allowance on deferred tax assets.
c. Both (a) and (b) are correct.
d. None of these answers is correct.

ANS: C PTS: 1

22. Firms may not include all income taxes for a period on the line for income tax expense in the income statement. Other places that income tax expenses may occur include all of the following **except**:
a. Discontinued Operations
b. Extraordinary Items
c. Other Comprehensive Income
d. Common Stock

ANS: D PTS: 1

23. U.S. GAAP, IFRS, and other major accounting standards are best characterized as:
a. historical accounting models.
b. current value accounting models.
c. acquisition cost accounting models.
d. mixed attribute accounting models.

ANS: D PTS: 1

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24. Which of the following would **not** represent an acquisition cost to be added to the purchase price of building:
    a. Sales Tax.
    b. Cost of grading the land.
    c. Capital repairs to get the building ready for occupancy.
    d. Renovations that would extend the life of the building.

    ANS: B PTS: 1

25. Valuation methods that reflect current values or a combination of historical and current values include all of the following **except**:
    a. fair value for assets and liabilities.
    b. current replacement cost for assets.
    c. net realizable value for assets.
    d. adjusted acquisition costs for assets.

    ANS: D PTS: 1

26. Historical costs include all of the following **except**:
    a. acquisition costs for assets
    b. net realizable values for assets.
    c. adjusted acquisition costs for assets.
    d. initial present value for assets and liabilities

    ANS: B PTS: 1

27. The existence of subjectivity in an asset valuation does not necessarily mean the valuation will not be reliable. All of the following are examples of this **except**:
    a. where historical cost is used for accounts receivable, fixed assets, and other assets with values that remain relatively stable.
    b. where market value is used for marketable equity securities, commodities, and financial assets are traded in liquid markets
    c. where historical cost is used for LIFO inventory layers where inventory has seen an inflationary increase in costs.
    d. where historical cost is used for internally generated intangible asset valuations.

    ANS: D PTS: 1

28. What level are inputs for estimating fair values are based on inputs that are readily available via prices for identical assets or liabilities in actively traded markets such as securities exchanges?
    a. Level 1.
    b. Level 2.
    c. Level 3.
    d. None of these.

    ANS: A PTS: 1

29. What level are inputs for estimating fair values are those inputs include quoted prices for similar assets or liabilities in active or inactive markets, other *observable* information such as yield curves and price indexes, and other *observable* data such as market-based correlation estimates?
    a. Level 1.
    b. Level 2.
    c. Level 3.

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d. None of these.

ANS: B PTS: 1

30. What level are inputs for estimating fair values based on a firm's own assumptions about the fair value of an asset or a liability, such as using various data to estimate present values?
a. Level 1.
b. Level 2.
c. Level 3.
d. None of these.

ANS: C PTS: 1

31. The accounting equation is represented by Assets= Liabilities + Stockholders' Equity which of the following would cause a change in the stockholders' equity accounts:
a. Sale of Land for cash and a note receivable for the balance
b. Collection of an account receivable
c. Purchased an asset for cash and 10,000 shares of preferred stock
d. Purchased inventory on account

ANS: C PTS: 1

32. Reporting financial assets and liabilities at fair values also is referred to as:
a. historical cost.
b. acquisition cost.
c. mark-to-market.
d. mortgage-backed cost

ANS: C PTS: 1

33. Present value methods are often used with receivables and liabilities:
a. With payment schedules in excess of one year.
b. With payment schedules of less than one year.
c. When fair values can be easily determined.
d. When asset are sold in the middle of the accounting cycle.

ANS: A PTS: 1

34. If a portfolio manager had to estimate the fair value of private equity funds invested in a young, privately-held start-up company, which of the following would he/she most likely identify as the level of inputs to determine this?
a. Level 1.
b. Level 2.
c. Level 3.
d. None of these.

ANS: C PTS: 1

35. If a portfolio manager had to estimate the fair value of illiquid mortgage-backed securities, which of the following would he/she most likely identify as the level of inputs to determine this?
a. Level 1.
b. Level 2.
c. Level 3.
d. None of these.

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ANS: C PTS: 1

36. If a portfolio manager had to estimate the fair value of investments in timber, which of the following would he/she most likely identify as the level of inputs to determine this?
a. Level 1.
b. Levels 1 and 2.
c. Levels 2 or 3.
d. All levels would be applicable.

ANS: C PTS: 1

37. If a portfolio manager had to estimate the fair value of real estate, which of the following would he/she most likely identify as the level of inputs to determine this?
a. Level 1.
b. Level 2.
c. Level 3.
d. None of these.

ANS: B PTS: 1

38. If a portfolio manager had to estimate the fair value of privately placed bond issues, which of the following would he/she most likely identify as the level of inputs to determine this?
a. Level 1.
b. Level 2.
c. Level 3.
d. None of these.

ANS: B PTS: 1

39. All of the following can be used to describe reliability of accounting information **except**:
a. biased.
b. credible.
c. verifiable.
d. supported by source documents.

ANS: A PTS: 1

40. Relevant asset valuations refer to all of the following **except**:
a. they are timely.
b. they have the capacity to affect a user's decisions, based on the information.
c. they incorporate all available information.
d. they are always subjective.

ANS: D PTS: 1

COMPLETION

1. The amount initially paid to acquire an asset is called _____.

ANS: acquisition cost

PTS: 1

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2. Firms recognize the reduction in service potential of assets such as patents and trademarks using the process of _____.

   ANS: amortization

   PTS: 1

3. The amount that a company would have to pay today to acquire an asset it now holds is called _____.

   ANS: current replacement cost

   PTS: 1

4. The difference between income tax payable and income tax expense is reported on the balance sheet as either a(n) _____ or a(n) _____.

   ANS:
   deferred tax asset, deferred tax liability
   deferred tax liability, deferred tax asset

   PTS: 1

5. Items, such as interest revenue on municipal bond holdings, that do **not** affect taxable income or income taxes paid in any year are referred to as _____.

   ANS: permanent differences

   PTS: 1

6. Revenues and expenses that firms include in both net income to shareholders and in taxable income, but in different periods are referred to as _____.

   ANS: temporary differences

   PTS: 1

7. Stockholders' equity can be expanded into the following three accounts: Accumulated other comprehensive income, retained earnings and _____.

   ANS: contributed capital

   PTS: 1

   Balance Sheet Equation

Cash	+ Non-Cash Assets	= Liabilities	+ Contributed Capital	+ Accumulated Other Comprehensive Income	+ Retained Earnings

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8. Refer to the **Balance Sheet Equation**. If ORP Corporation sells $25,000 of its product on account, it will see an increase in non-cash assets and _____.

   ANS: retained earnings

   PTS: 1

9. Refer to the **Balance Sheet Equation**. To recognize the cost of goods sold ORP Corporation will reduce retained earnings and reduce _____.

   ANS:
   non-cash assets
   non cash assets
   PTS: 1

10. Refer to **Balance Sheet Equation.** ORP Corporation Purchases land for $9,000 cash and 1,000 shares of common stock values at 10 per share. This transaction results in ORP recording a decrease in cash of $9,000, an increase in non-cash assets of $ 19,000, and an increase in _____ of $10,000

    ANS: contributed capital

    PTS: 1

11. Refer to **Balance Sheet Equation.** JCP Company purchased marketable securities for $5,000 during the year, at the end of the year the company revalues the securities to $5,700. This revaluation would result in an increase to non-cash assets and _____.

    ANS: accumulated other comprehensive income

    PTS: 1

12. Refer to **Balance Sheet Equation.** The payment of a note payable by a firm reduces cash and _____.

    ANS: liabilities

    PTS: 1

13. Acquisition costs includes all costs necessary to get an asset ready for its _____.

    ANS: intended use

    PTS: 1

14. _____ assets and liabilities represent amounts of cash a firm can expect to receive or pay in the future.

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ANS: Monetary

PTS: 1

15. _____ is the net amount that a firm would receive if it sold an asset or the net amount it would have to pay to settle a liability.

ANS: Net realizable value

PTS: 1

16. A change in the _____ or _____ will **not** change a preset series of cash flows, however it will change the present value of those cash flows.

ANS:
interest rate, discount rate
discount rate, interest rate

PTS: 1

17. Net income equals revenues plus _____ minus expenses and _____.

ANS: gains, losses

PTS: 1

SHORT ANSWER

1. What valuation methods reflect historical cost? Discuss the advantages and disadvantages of valuing assets and liabilities using historical valuations.

ANS:
Valuation methods reflecting historical cost include:
1. acquisition cost
2. adjusted acquisition cost
3. present value of cash flows using historical interest rates

The main advantages of using historical valuations are simplicity, less subjectivity and reliability. The disadvantages include lack of relevance.

PTS: 1

2. What valuation methods reflect current values? Discuss the advantage(s) and disadvantage(s) of valuing assets and liabilities using current values.

ANS:
Valuation methods reflecting current values include:
1. current replacement cost
2. net realizable value

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3. present value of cash flows using current interest rates

The main advantage of using current values is increased relevance for financial statement users. The disadvantages include greater subjectivity.

PTS: 1

3. Discuss the three ways in which GAAP allows value changes to be treated in the financial statements. Provide an example of each value change treatment.

ANS:
1. Value changes recognized on the balance sheet and the income statement when realized in a market transaction. Examples include selling inventory or land.
2. Value changes recognized on the balance sheet when they occur, but recognized on the income statement when realized. Examples include marketable securities.
3. Value changes recognized on the balance sheet and the income statement when they occur. Examples include impairment losses.

PTS: 1

4. When income tax expense differs from income taxes currently payable on taxable income companies recognize deferred tax assets and deferred tax liabilities. What type of event would create a deferred tax asset and deferred tax liability?

ANS:
Deferred tax assets arise when taxable income exceeds book income. An example would be warranty expense. Deferred tax liabilities arise when book income exceeds taxable income. An example would be recognized more depreciation expense for tax purposes than for book purposes.

PTS: 1

5. Discuss the two principal reasons income before taxes for financial reporting differs from taxable income.

ANS:
1. Permanent Differences--Revenues and expenses that firms include in net income to shareholders, but which never appear in the income tax return.
2. Temporary Differences--Revenues and expenses that firms include in both net income to shareholders and in taxable income but in different periods.

PTS: 1

6. The analytical framework used to evaluate transactions is reproduced below:

Cash	+ Non-Cash Assets	= Liabilities	+ Contributed Capital	+ Accumulated Other Comprehensive Income	+ Retained Earnings

Using this analytical framework indicate the effect of each of the following transactions for TX Corporation:

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1. TX Corporation sold additional shares of common stock for $250,000 cash.
2. At the end of the period TX Corporation revalued the securities to $125,000.
3. During the next period TX Corporation sells equipment with a book value of $100,000 for $90,000.

ANS:

	Cash	+ Non-Cash Assets	= Liabilities	+ Contributed Capital	+ Accumulated Other Comprehensive Income	+ Retained Earnings
1.	+250,000			+250,000		
2.		-125,000			-125,000	
3.	+90,000	-100,000				-10,000

PTS: 1

7. The analytical framework used to evaluate transactions is reproduced below:

Cash	+ Non-Cash Assets	= Liabilities	+ Contributed Capital	+ Accumulated Other Comprehensive Income	+ Retained Earnings

Using this analytical framework indicate the effect of each of the following transactions for CX Corporation:

1. CX Corporation purchases land for $450,000 cash.
2. At the end of the period CX Corporation receives an appraisal that values the land at $540,000.
3. During the next period CX Corporation sells the land for $665,000.
4. CX pays taxes at a rate of 40%.

ANS:

	Cash	+ Non-Cash Assets	= Liabilities	+ Contributed Capital	+ Accumulated Other Comprehensive Income	+ Retained Earnings
1.	-450,000	+450,000				
2.	No Entry					
3.	+665,000	-450,000				+215,000
4.	-86,000					-86,000

PTS: 1

8a. Plaxo Corporation has a tax rate of 35% and uses the straight-line method of depreciation for its equipment, which has a useful life of four years. Tax legislation requires the company to depreciate this type of equipment using the following schedule: year 1 - 50%, year 2 - 30%, year 3 - 15% and year 4 - 5%. In 2011 Plaxo purchases a piece of equipment with a four-year life and an original cost of $100,000. Discuss how this transaction will affect Plaxo's income taxes in 2011.

ANS:
The difference in depreciation rates results in Plaxo recording a deferred tax liability in 2011 equal to the difference in the tax and financial depreciation expense multiplied by the firm's tax rate.

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Plaxo's tax depreciation expense in 2011 will be (50% *$100,000) $50,000, while its financial reporting depreciation expense will be (25% * $100,000) $25,000.

The $25,000 difference is multiplied by Plaxo's 35% tax rate to result in a deferred tax liability of $8,750.

PTS: 1

8b Assuming that Plaxo Corporation decides to use accelerated depreciation for both financial and tax reporting purposes for 2011, would there still be a deferred tax liability?
Ans: The depreciation amounts would be exactly the same, so there would be no deferred tax liability. A deferred tax liability only occurs when the accelerated depreciation method exceeds the straight line method of calculating depreciation expense.

9. For some transactions GAAP requires that value changes are recognized on the balance sheet and the income statement when they occur, even if not realized. Discuss what types of transactions get this type of treatment and the logic behind this accounting.

ANS:
The application of GAAP requires firms to write down assets whose fair values decrease below their book values. For example, GAAP requires that firms recognize a loss on equipment in which its fair value has decreased below its book value due to obsolescence or other permanent valuation effect.

GAAP does not allow firms to revalue upward the values of assets whose fair values have increased. Firms must await the validation of the value increase through a market transaction to justify this type of gain.

PTS: 1

10. Deferred tax assets and liabilities are created due to temporary differences between the tax and financial reporting basis of certain assets and liabilities. Discuss which scenarios result in a deferred tax asset and which result in deferred tax liabilities.

ANS:
Deferred tax assets result from the following two scenarios:
1. The tax basis of assets exceeds the financial reporting basis
2. The tax basis of liabilities is less than the financial reporting basis

Deferred tax liabilities result from the following two scenarios:
1. The tax basis of assets is less than the financial reporting basis
2. The tax basis of liabilities exceeds the financial reporting basis

PTS: 1

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11. H. Solo Company purchased a new piece of equipment with a list price of $175,000 and subject to a 5 percent discount if paid within 45 days. H. Solo paid within the discount period. The company also paid $1,500 to obtain title to the equipment and $600 as the license fee for the first year of operation. It paid $2,500 to level the area in which the equipment would be located and $12,500 to relocate other equipment that would have interfered with the proper operation of the new equipment. H. Solo paid $400 for property and liability insurance for the first year of operation. What is the acquisition cost of this equipment that H. Solo should record in its accounting records? Indicate the treatment of any amount not included in acquisition cost.

    ANS:
    H. Solo should record the equipment at the following cost:

Purchase price	=	$175,000 less 5% discount = $166,250
title	=	$1,500
leveling	=	$2,500
relocation	=	$12,500
TOTAL COST	=	$182,750

    The $600 license for the first year of operations is a period expense, $400 should be treated as insurance expense for the period.

    PTS: 1

12. Accord Inc. income tax return shows taxes currently payable for 2011 of $85,000. The company reported deferred tax assets of $35,000 at the end of 2010 and $24,000 at the end of 2011. Accord reported deferred tax liabilities of $48,000 at the end of 2011 and $54,000 at the end of 2011.

    Determine the amount of income tax expense reported by Accord for 2011.

    ANS:
    Accord's income tax expense for 2011 can be determined by this journal entry:

Income tax expense	$102,000	
Deferred Tax Asset		$11,000
Deferred Tax Liability		$6,000
Income taxes payable		$85,000

    PTS: 1

PROBLEM

1. There are three valuation methods that reflect historical values: acquisition cost, adjusted acquisition cost, and present value of cash flows using historical interest rates. For each of three methods discuss what the valuation represents and provide an example of a balance sheet item that is valued using the method. In addition, for each of the three methods valuation methods explain its advantages and disadvantages.

    ANS:
    1. Acquisition cost is the amount paid initially to acquire the asset, examples include prepayments, land, and intangibles with indefinite lives. The advantage is simplicity and reliability, the disadvantage is lack of relevance.
    2. Adjusted acquisition cost is the amount paid initially to acquire an asset less accumulated

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depreciation and amortization, examples include equipment and intangible assets with limited lives. The advantage is simplicity and reliability, the disadvantage is lack of relevance and subjectivity due to not being able to observe the actual consumption of the asset.

3. Present value of cash flows using historical interest rates is an item in which cash receipts or cash payments will occur over time, these future cash flows are then discounted at the interest rate in effect at the time of the initial transaction. Balance sheet examples include notes receivable and notes payable. The advantage is simplicity and reliability, the disadvantage is subjectivity due to not updating the interest rate as time elapses.

PTS: 1

2. The analytical framework used to evaluate transactions is reproduced below:

Cash	+ Non-Cash Assets	= Liabilities	+ Contributed Capital	+ Accumulated Other Comprehensive Income	+ Retained Earnings

Using this analytical framework indicate the effect of each of the following transactions for Wisco Corporation:

1. Wisco sold merchandise for $225,000 on account which cost $170,000 to manufacture.
2. Wisco purchased for cash $110,000 of raw material inventory.
3. The company paid $25,000 in advance for an advertising campaign that would be aired next year.
4. Wisco paid its employees $15,000 for the month.
5. The company purchased $7,000 of supplies on account.
6. Wisco issued $25,000 of long-term debt.
7. The company used $10,000 of excess cash to purchase marketable securities.
8. Wisco purchased a machine for $22,000 in cash.
9. At the end of the year Wisco paid dividends of $5,000.
10. At the end of the year the marketable securities that Wisco purchased in transaction 7 were now worth $11,500.
11. Depreciation for the period was $1,500.

ANS:

Cash	+ Non-Cash Assets	= Liabilities	+ Contributed Capital	+ Accumulated Other Comprehensive Income	+ Retained Earnings

1. Wisco sold for merchandise for $225,000 on account which cost $170,000 to manufacture.

Cash	+ Non-Cash Assets	= Liabilities	+ Contributed Capital	+ Accumulated Other Comprehensive Income	+ Retained Earnings
	+ 225,000				+ 225,000
	- 170,000				- 170,000

2. Wisco purchased for cash $110,000 of raw material inventory.

Cash	+ Non-Cash Assets	= Liabilities	+ Contributed Capital	+ Accumulated Other Comprehensive	+ Retained Earnings

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							Income		
-	110,000	+	110,000						

3. The company paid $25,000 in advance for an advertising campaign that would be aired next year.

	Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
-	25,000	+	25,000								

4. Wisco paid its employees $15,000 for the month.

	Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
-	15,000									-	15,000

5. The company purchased $7,000 of supplies on account.

	Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
		+	7,000	+	7,000						

6. Wisco issued $25,000 of long-term debt.

	Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
+	25,000			+	25,000						

7. The company used $10,000 of excess cash to purchase marketable securities.

	Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
-	10,000	+	10,000								

8. Wisco purchased a machine for $22,000 in cash.

	Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
-	22,000	+	22,000								

9. At the end of the year Wisco paid dividends of $5,000.

	Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings

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- 5,000								- 5,000	

10. At the end of the year the marketable securities that Wisco purchased in transaction 7 were now worth $11,500.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
	+	1,500					+	1,500		

11. Depreciation for the period was $1,500.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
	-	1,500							-	1,500

PTS: 1

3. The analytical framework used to evaluate transactions is reproduced below:

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings

Using this analytical framework, indicate the effect of each of the following transactions for Staples Corporation:

1. Staples recorded cash sales of $25,000. The merchandise had cost $19,000 to manufacture.
2. Staples purchased $8,500 of raw material inventory on account.
3. The company paid $2,500 for property insurance for the next 12 months.
4. Staples paid its employees $5,000 for the month.
5. The company purchased $1,000 of supplies on account.
6. Staples issued $25,000 of long-term debt.
7. The company used $10,000 of excess cash to purchase marketable securities.
8. Staples purchased a machine for $16,000 using $8,000 cash with the balance on account.
9. Staples paid $2,500 for interest expense on the long-term debt.
10. At the end of the year the marketable securities that Staples purchased in transaction 7 were now worth $14,500.
11. Depreciation for the period was $1,500.
12. Staples examined the equipment and determined that its fair value was $10,000.

ANS:

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings

1. Staples recorded cash sales of $25,000. The merchandise had cost $19,000 to manufacture.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive	+	Retained Earnings

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							Income		
+	25,000							+	25,000
		-	19,000					-	19,000

2. Staples purchased $8,500 of raw material inventory on account.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
	+	8,500	=	8,500						

3. The company paid $2,500 for property insurance for the next 12 months.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
-	2,500	+	2,500							

4. Staples paid its employees $5,000 for the month.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
-	5,000								-	5,000

5. The company purchased $1,000 of supplies on account.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
	+	1,000	=	1,000						

6. Staples issued $25,000 of long-term debt.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
+	25,000		=	25,000						

7. The company used $10,000 of excess cash to purchase marketable securities.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
-	10,000	+	10,000							

8. Staples purchased a machine for $16,000 using $8,000 cash with the balance on account.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings

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-	8,000	+	16,000	+	8,000			

9. Staples paid $2,500 for interest expense on the long-term debt.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
- 2,500										- 2,500

10. At the end of the year the marketable securities that Staples purchased in transaction 7 were now worth $14,500.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
		+ 4,500						+ 4,500		

11. Depreciation for the period was $1,500.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
		- 1,500								- 1,500

12. Staples examined the equipment and determined that its fair value was $10,000.

Cash	+	Non-Cash Assets	=	Liabilities	+	Contributed Capital	+	Accumulated Other Comprehensive Income	+	Retained Earnings
		- 4,500								- 4,500

PTS: 1

4. The following problem requires present value information:

Biotech sold a patent on a new blood analyzer to Pharma. The sales agreement which was signed on January 1, 2009 requires Pharma to pay Biotech $1 million immediately. In addition, Pharma is required to pay $700,000 each December 31 for 20 years starting with December 31, 2009. Pharma and Biotech judge that a 10 percent is an appropriate interest rate for this arrangement.

a. Compute the present value of the receivable on Biotech's books on January 1, 2009 immediately after receiving the $1 million down payment.
b. Compute the present value of the receivable on Biotech's books on December 31, 2009.
c. Compute the present value of the receivable on Biotech's books on December 31, 2010.

ANS:
Jan. 1 2009:
The present value of an ordinary annuity of $700,000 for 20 periods, at 10% equals ($700,000 * 8.5136) $5,959,520.

Dec. 31, 2009:
After receiving the first payment the present value of $600,000 for 19 periods, at 10% equals ($700,000 * 8.3649) $5.

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Dec. 31, 2010:
After receiving the second payment the present value of 700,000 for 18 periods, at 10% equals ($700,000 * 8.2014) $5,740,980

PTS: 1

5. Jurgen Company's income tax return shows income taxes for 2010 of $75,000 (that is, $75,000 is owed for 2010). For financial reporting, the firm reports deferred tax assets of $67,900 at the beginning of 2010 and $63,600 at the end of 2010. It reports deferred tax liabilities of $53,600 at the beginning of 2010 and $59,400 at the end of 2010.

Required:
a. Compute the amount of income tax expense for 2010.
b. Assume for this part that the firm's deferred tax assets are as stated above for 2010 but that its deferred tax liabilities were $83,500 at the beginning of 2010 and $72,100 at the end of 2010. Compute the amount of income tax expense for 2010.
c. Explain contextually why income tax expense is higher than taxes owed in Part a and lower than taxes owed in Part b.

ANS:

a.

Taxes Currently Payable	$ 75,000
Plus Decrease in Deferred Tax Assets: $67,900 – $63,600	4,300
Plus Increase in Deferred Tax Liabilities: $59,400 – $53,600	5,800
Income Tax Expense	$ 85,100

b.

Taxes Currently Payable	$75,000
Plus Decrease in Deferred Tax Assets: $67,900 – $63,600	4,300
Less Decrease in Deferred Tax Liability: $83,500 – $72,100	(11,400)
Income Tax Expense	$ 67,900

c. In both Part a. and Part b., the value of the deferred tax asset decreased, which means that the company utilized deferred tax assets to decrease taxes owed relative to the amount expensed. However, the difference lies in the change in the deferred tax liability. In Part a., the deferred tax liability increased, which occurs when the firm has larger deductions (lower income) on its tax return relative to amounts expensed (amounts recognized in income). The advantageous treatment of these amounts leads to lower current cash outflows for taxes than amounts recognized as income tax expense. For Part b., the situation is reversed. In Part b., the decrease in the deferred tax liability means that previous timing differences likely reversed, leading to higher cash payments required for current income tax payments relative to amounts recognized as income tax expense.

PTS: 1

6. Fellsmere Company's income tax return shows income taxes for 2010 of $35,000. The firm reports deferred tax assets before any valuation allowance of $32,600 at the beginning of 2010 and $35,200 at the end of 2010. It reports deferred tax liabilities of $26,900 at the beginning of 2010 and $24,300 at the end of 2010.

Required:

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a. Assume for this part that the valuation allowance on the deferred tax assets totaled $14,400 at the beginning of 2010 and $15,100 at the end of 2010. Compute the amount of income tax expense for 2010.
b. Assume for this part that the valuation allowance on the deferred tax assets totaled $14,400 at the beginning of 2010 and $12,700 at the end of 2010. Compute the amount of income tax expense for 2010.

ANS:

(a)

Taxes Currently Payable		$35,000
Less Increase in Deferred Tax Assets:		
Beginning of Year: $32,600 – $14,400 =	$18,200	
End of Year: $35,200 – $15,100 =	20,100	(1,900)
Less Decrease in Deferred Tax Liabilities:	$26,900 – $24,300	(2,600)
Income Tax Expense		$30,500

(b)

Taxes Currently Payable		$35,000
Less Increase in Deferred Tax Assets:		
Beginning of Year: $32,600 – $14,400 =	$18,200	
End of Year: $35,200 – $12,700 =	22,500	(4,300)
Less Decrease in Deferred Tax Liabilities:	$26,900 – $24,300	(2,600)
Income Tax Expense		$28,100

PTS: 1

7. The financial statement disclosures for Able Company, a retail chain, revealed the following information regarding the firm's income taxes:

For the Year Ended January 31:	**2011**	**2010**
Income before Income Taxes:		
United States	$3,042	$2,614
Income Tax Expense		
Current:		
Federal	$ 919	$ 680
State and Local	155	118
Total Current	$1,074	$ 798
Deferred:		
Federal	$94	$ 195
State and Local	22	35
Total Deferred	$ 116	$ 230
Total	$1,190	$1,028

January 31	**2011**	**2010**	**2009**
Components of Deferred Tax Assets and Liabilities			

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Deferred Tax Assets:			
Self-Insured Benefits	$190	$154	$199
Deferred Compensation	333	298	185
Inventory	48	45	57
Postretirement Health Care Obligation	39	43	42
Uncollectible Accounts	148	134	114
Other	129	54	167
Total Deferred Tax Assets	$887	$728	$764
Deferred Tax Liabilities:			
Depreciation	$(1,137)	$ (946)	$ (827)
Pensions	(269)	(219)	(191)
Other	(97)	(85)	(60)
Total Deferred Tax Liabilities	$(1,503)	$(1,250)	$(1,078)
Net Deferred Tax Liability	$ (616)	$ (522)	$ (314)

Required:

a. Assuming that Able had no significant permanent differences between book income and taxable income, did income before taxes for financial reporting exceed or fall short of taxable income for 2010? Explain.

b. Did income before taxes for financial reporting exceed or fall short of taxable income for 2011? Explain.

c. Will the adjustment to net income for deferred taxes to compute cash flow from operations in the statement of cash flows result in an addition or a subtraction for 2010? For 2011?

d. Able does not contract with an insurance agency for property and liability insurance; instead, it self-insures. Able recognizes an expense and a liability each year for financial reporting to reflect its average expected long-term property and liability losses. When it experiences an actual loss, it charges that loss against the liability. The income tax law permits self-insured firms to deduct such losses only in the year sustained. Why are deferred taxes related to self-insurance disclosed as a deferred tax asset instead of a deferred tax liability? Suggest reasons for the direction of the change in amounts for this deferred tax asset between 2009 and 2011.

e. Able treats certain storage and other inventory costs as expenses in the year incurred for financial reporting but must include these in inventory for tax reporting. Why are deferred taxes related to inventory disclosed as a deferred tax asset? Suggest reasons for the direction of the change in amounts for this deferred tax asset between 2009 and 2011.

f. Firms must recognize expenses related to postretirement health care and pension obligations as employees provide services, but claim an income tax deduction only when they make cash payments under the benefit plan. Why are deferred taxes related to health care obligation disclosed as a deferred tax asset? Why are deferred taxes related to pensions disclosed as a deferred tax liability? Suggest reasons for the direction of the change in amounts for these deferred tax items between 2009 and 2011.

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g. Firms must recognize expenses related to uncollectible accounts when they recognize sales revenues, but claim an income tax deduction when they deem a particular customer's accounts uncollectible. Why are deferred taxes related to this item disclosed as a deferred tax asset? Suggest reasons for the direction of the change in amounts for this deferred tax asset between 2009 and 2011.

h. Able uses the straight-line depreciation method for financial reporting and accelerated depreciation methods for income tax purposes. Why are deferred taxes related to depreciation disclosed as a deferred tax liability? Suggest reasons for the direction of the change in amounts for this deferred tax liability between 2009 and 2011.

ANS:

a. Able's income before income taxes for financial reporting exceeded taxable income because the net deferred tax liability increased between the end of 2010 and the end of 2011. Also note that total income tax expense exceeds income taxes currently payable, so Able deferred some tax payments to later years.

b. Income before income taxes for financial reporting exceeded taxable income because the net deferred tax liability increased between the end of 2010 and the end of 2011. In addition, total income tax expense exceeded income taxes currently payable.

c. The deferral of tax payments in 2010 and 2011 results in an addition to net income of $230 million and $116 million, respectively, when cash flow from operations is computed. Able did not pay as much income taxes as the subtraction for income tax expense in the income statement would suggest.

d. Able recognizes insurance expense earlier for financial reporting than for tax reporting, giving rise to a deferred tax asset for the future savings in income taxes when actual losses materialize. The decline in the deferred tax asset for self-insured benefits between the end of 2009 and the end of 2010 indicates that Able paid out more in actual claims during 2010 than it recognized as an expense. The increase in the deferred tax asset for self-insured benefits between the end of 2010 and the end of 2011 indicates that Able recognized more expense than it paid in actual claims during 2011.

e. Able recognizes these costs as expenses earlier for financial reporting than for tax reporting, giving rise to a deferred tax asset for the future income taxes savings when it sells the inventory items. The decline in the deferred tax assets for inventory between the end of 2009 and the end of 2010 suggests that inventories declined during 2009, resulting in a larger expense for tax reporting than for financial reporting. The increase in the deferred tax assets for inventory between the end of 2010 and the end of 2011 suggests that inventories increased during 2010.

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f. The deferred tax asset related to the health care obligation indicates that Able has recognized more expenses cumulatively for financial reporting than for payments made to the health care plan. The slight increase in the deferred tax assets for postretirement health care between the end of 2009 and the end of 2010 indicates that Able grew the number of employees, improved health care benefits, or experienced increased health care costs during 2010. The decrease in the deferred tax assets for postretirement health care between the end of 2010 and the end of 2011 suggests a decline in the number of employees, lower health care benefits, or lower health care costs. The deferred tax liability related to pension indicates that Able has contributed larger amounts cumulatively to its pension fund than it has recognized as expenses for financial reporting. The growing amounts over time suggest that Able has consistently grown the number of its employees or their retirement benefits each year.

g. The deferred tax asset related to uncollectible accounts indicates that Able recognizes losses for uncollectibles earlier for financial reporting than for tax reporting. The deferred tax asset indicates the future savings in income taxes the firm will realize when it writes off actual uncollectible accounts. The increasing amount for this deferred tax asset is consistent with growth in sales.

h. The deferred tax liability indicates that Able recognizes depreciation earlier for tax reporting than for financial reporting. The increasing amounts for this deferred tax liability suggest that Able increased its capital expenditures each year and therefore had more depreciable assets in the early years of their lives, when accelerated depreciation exceeds straight-line depreciation, than it has depreciable assets in the later years of their lives, when straight-line depreciation exceeds accelerated depreciation.

PTS: 1

8. For each of the items below, determine whether the items are temporary differences or permanent differences.

For each temporary difference, determine whether a deferred tax asset or deferred tax liability is created by the temporary difference described. Assume that each of the temporary differences described is an originating difference.

1. Accrued bad debt expense
2. The dividends received deduction
3. Installment sales revenue
4. Insurance payments for executives for which the company is the beneficiary
5. Fines paid for law violations
6. Municipal bond interest
7. Accrued warranty expense
8. Revenues received in advance
9. Expenses paid for in advance (prepaid insurance)
10. Tax depreciation expense exceeds GAAP (book) depreciation expense

ANS:
1. Temporary difference, deferred tax asset
2. Permanent difference
3. Temporary difference, deferred tax liability
4. Permanent difference
5. Permanent difference

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6. Permanent difference
7. Temporary difference, deferred tax asset
8. Temporary difference, deferred tax asset
9. Temporary difference, deferred tax liability
10. Temporary difference, deferred tax liability

PTS: 1

9. On January 1, 2010, Starlight Company's balance sheet reported a deferred tax liability of $185,000 and a deferred tax asset of $99,900. The future taxable amounts that existed as of January 1, 2010 will reverse equally over the next four years beginning in 2010, while the future deductible amounts that existed as of January 1, 2010 will reverse equally over the next three years beginning in 2010. The enacted income tax rate for all tax years as of January 1, 2010 was 37%. On February 1, 2010, the tax laws were amended resulting in income tax rates of 38% for 2010 and 2011; the income tax rate will be 40% for tax years 2012 and later.

***Required*:**
Prepare the journal entry on February 1, 2010 to record the impact of the amended income tax rates.

ANS:

February 1, 2010	Income Tax Expense	5,500	
	Deferred Tax Asset	4,500*	
	Deferred Tax Liability		10,000**

* The $99,900 deferred tax asset balance was calculated by multiplying the income tax rate by the dollar amount of the future deductible amounts (X); therefore, $.37X = $99,900, and X equals $270,000. The $270,000 future deductible amount will reverse equally ($90,000) over the next three years, including 2010, creating a deferred tax asset of $104,400 [($90,000 × .38) + ($90,000 × .38) + ($90,000 ×.40)] given the new income tax rates. The debit to the deferred tax asset account is necessary to increase it from $99,900 to $104,400.

** The $185,000 deferred tax liability balance was calculated by multiplying the income tax rate by the dollar amount of the future taxable amounts (X); therefore, $.37X = $185,000, and X equals $500,000. The $500,000 future taxable amount will reverse equally ($125,000) over the next four years, including 2010, creating a deferred tax liability of $195,000 [($125,000 × .38) + ($125,000 ×.38) + ($125,000 ×.40) + ($125,000 × .40)] given the new income tax rates. The credit to the deferred tax liability account is necessary to increase it from $185,000 to $195,000.

PTS: 1

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10. On December 31, 2009, Loran Corporation reported a deferred tax liability totaling $12,000, resulting from depreciation timing differences pertaining to a depreciable asset purchased during 2009. Loran uses straight-line depreciation over four years for GAAP (book) purposes; for tax purposes, the depreciation deduction is 40% of cost during 2009, 30% of cost during 2010, 20% of cost during 2011, and 10% of cost during 2012. During 2010, Loran expensed $80,000of warranty costs that will be deducted for tax purposes in future years. Loran also accrued revenue totaling $135,000 which is taxable in 2011. Loran's GAAP (book) income before taxes during 2010 totaled $380,000The marginal income tax rate is 40% for all years.

Required:

(1) What is the taxable income?
(2) Prepare the journal entry to record income tax expense for the year ended December 31, 2010.

ANS:

(1)

GAAP (book) income before Taxes	$380,000
- Excess Tax Depreciation	-10,000
+ Accrued Warranty Expense	80,000
- Accrued Revenue	-135,000
Taxable Income	$315,000

(2)

Dec. 31, 2010	Income Tax Expense	142,000	
	Deferred Tax Asset	32,000*	
	Deferred Tax Liability		48,000
	Income Taxes Payable ($315,000 × .40)		126,000

* Warranty expense timing difference ($80,000× .40)

The $12,000 deferred tax liability at the end of 2009 is calculated by multiplying the difference between GAAP (book) depreciation and tax depreciation; therefore, the difference between the two depreciation calculations was $30,000 ($12,000/.40).
There was a 15% (40% - 25%) difference in depreciation rates during 2009, resulting in a depreciation difference of $30,000. The asset's depreciable basis (original cost) was $200,000 ($30,000/.15). The GAAP depreciation expense in 2010 was $50,000 ($200,000/4) and tax depreciation during 2010 was $60,000 ($200,000 × .30).

PTS: 1

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