Accounting: Practice Questions

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The following are some questions that popped into my head while studying/learning accounting concepts for the course Accounting for ECO. Note the course content may change from year to year.

Useful Formulae

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$
$$RE_{\text{END}} = RE_{\text{BEG}} + NI - DIV$$
$$A = L + PIC + RE$$
$$\text{Straight-line annual depreciation expense} = \frac{\text{Cost} - \text{Est. Salvage Value}}{\text{Est. Useful life}}$$
$$\text{Depreciation expense per unit produced} = \frac{\text{Cost} - \text{Est. Salvage Value}}{\text{Est. Total units to be made}}$$
$$\text{Double-Declining-Balance} = \text{Double the straight-line depr. rate} \times \text{Asset NBV at beg. year}$$
$$\text{Basic EPS} = \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Weighted Avg. Num. Shares Outstanding}}$$

1 Debits and Credits Basics

I find debits and credits to be rather confusing, for instinctively when I think of credit I think increase, and debit meaning decrease. But of course this is not the case, at least not by design. Fill in the table below with either “Increases” or “Decreases” for each account type.

Account Type	**Debit**	**Credit**
Assets		
Liabilities		
Equity (including revenue)		
Expenses		

2 Adjusting Entries

John pays foo inc. $1,000 in December for services to be provided in January. Write down the adjusting journal entry for December (year end) and the adjusting entry in January, once the services have been provided.

The above situation is best referred to as a(n)
a) Accrual
b) Reclassification
c) Balance sheet
d) None of the above

Suppose a company pays for six months of rent in advance, say at the start of December. Explain why the journal entry for December would list this prepaid expense as an asset and not an expense.

Company B seeks legal advice following the suspicion of money laundering. Company B receives the legal advice in December, but decides to not pay for it until January. Suppose the fiscal year ends in December. Write down the adjusting journal entry Company B must make in December.

(Credit to ChatGPT). On January 1, a company pays $24,000 for a 12-month office rent in advance. The payment covers rent for the entire year (January to December).
1. What is the journal entry the company should record on January 1 when it makes the payment?
2. What adjusting entry should the company make at the end of March, after three months of rent have passed, to recognize the rent expense for those three months?

3 Inventory Cost Flow Assumptions

Under inflationary times, which inventory cost flow assumption will result in lower net income: FIFO or LIFO?

Consider the case of Albert Heijn, a famous grocery store in The Netherlands. What inventory cost flow assumption makes most sense for them?

Phantom Profits: Suppose Cruiser's inc. sells a boat for $2000 and uses FIFO. The COGS (naturally, taken from the beginning inventory) is $1500. But the actual, current cost of replacing the boat has, because of inflation, risen to $1900. Suppose further the income tax rate is 30%. Calculate (i) the income tax Cruiser's inc. owes, (ii) net income, and (iii) the difference between this inflated net income and what it would be under current costs.

4 Noncurrent Assets

Explain why land is a non-depreciable asset.

Explain why a firm may decide not to capitalize things like office supplies, even though they provide many years of future economic benefits to the firm. Explain clearly which accounting concept is used in making this judgement.

In financial accounting, depreciation is an application of the ________ concept.
(a) matching
(b) conservatism
(c) objectivity
(d) none of the above

Why might an asset that is being disposed of have a positive net book value? List two reasons.

Suppose equipment that cost \$6000 when new was sold for \$1200, and that its estimated salvage value is \$900. Write the journal entry for what happens. How do the books balance?

Why might a firm acquire another for a price above and beyond the fair value of the net assets of that other firm (goodwill)?

Suppose Cruiser's inc. purchases a business. The business has the following information available: Inventory, \$250000; Land, \$150000; Buildings, \$400000; Notes payable, \$100000. Determine the fair value of net assets.

Suppose Cruiser's inc. purchases this business for \$1000000 in cash and assuming a note payable of \$100000. Write the journal entry for the transaction.

Now suppose that goodwill is tested for impairment, and it is found that the amount in goodwill paid actually exceeds the fair value by \$120000. Write the journal entry for the impairment loss adjustment.

Suppose it was an incorrect impairment adjustment, and really the fair value was determined to be \$200000. Describe the changes that must be made to account for this.

Why are advertising costs and research and development costs always treated as expenses?

Machine costs 1800000. Estimated useful life is 8 years. Estimated salvage value is 180000. Using the double-declining balance method, find the depreciation expense in the asset's third year.

5 Bonds

Write and explain two reasons why firms may choose to "call" bonds back from the bondholders before the scheduled maturity date.

Suppose a firm calls back a bond with face value \$100,000 and book value of \$95,000 for a total payment of \$102,000. Write the journal entry effects of this early retirement of the bond.

6 Shareholder's Equity

Suppose Racers Inc. sold 40,000 additional shares of its \$2 par value common stock at a price of \$13 per share. Write the journal entry effects of this scenario.

Differentiate between *authorized*, *issued*, and *outstanding* shares.

Write the journal entry effects for a general transaction of the purchase of treasury stock with cash.

Preferred Stock Dividend Calculation:

6%, $100 par value cumulative preferred stock, 50,000 shares authorized, issued, and outstanding. Dividend payable semiannually, no dividends in arrears. Semiannual preferred dividend amount:

$4.50, $75 par value cumulative preferred stock, 50,000 shares authorized and issued, 40,000 shares outstanding (10,000 shares of treasury stock). Dividend payable quarterly, no dividends in arrears. Quarterly preferred dividend amount:

8%, $50 par value cumulative preferred stock, 100,000 shares authorized, 60,000 shares issued, 54,000 shares outstanding (6,000 shares of treasury stock). Dividend payable annually. Dividends were not paid in prior two years. Dividend in current year to pay dividends in arrears and current year's preferred dividend:

Explain why many financial managers prefer issuing bonds over preferred stock. Explain also why investors may prefer bonds to preferred stock dividends.

Write the journal entry for (i) the declaration date when the board of directors declares a cash dividend, and (ii) the payment date.

Fill in the blanks. Consider a stock dividend issuance. Common stock account must _______ by the number of shares issued multiplied by the ________ per share. Retained earnings ________ by the number of dividend shares issued multiplied by the ___________ per share. Any difference between market price and par value is recorded in the ________________________ account.

Suppose Company XYZ has Common Stock of value $1600000, 90000 shares issued at $20 per share, and 80000 shares outstanding. Net income for the year is 1 million.
(a) Calculate the amount of capital in excess of par.

(b) Calculate the amount of shares in treasury stock.

(c) Calculate earnings per share (EPS).

🌶🌶🌶 Based on all the above questions, I have asked ChatGPT to make a very difficult question. It is the following:
Company XYZ has issued $1,000,000 of 6% semiannual bonds with a 10-year maturity. The bonds were issued at 97% of face value. Midway through the bond term, after five years, interest rates drop, prompting the company to call the bonds back at a call price of 102%. Concurrently, the company decides to issue 50,000 shares of $5 par value common stock at $30 per share to finance new equipment worth $1,500,000 with an estimated useful life of 10 years, no salvage value, and depreciation calculated using the double-declining balance method. Additionally, the company declared and paid a semiannual cumulative preferred stock dividend of 8%, with 20,000 $100 par value preferred shares outstanding. There are no dividends in arrears.

1. Calculate the total cash paid to call back the bonds and the gain or loss from

calling the bonds

2. Write the journal entry for calling the bonds early, assuming the book value of the bonds at the time of the call is $960,000.

3. Write the journal entry for issuing common stock, including any effects on the additional paid-in capital account.

4. Calculate the depreciation expense for the third year of the new equipment using the double-declining balance method.

5. Determine the total preferred dividend that must be paid and journalize the declaration and payment of the preferred dividend.

6. Finally, after the transactions above, calculate the new earnings per share for Company XYZ, given that net income for the year is $2,000,000 and there are 200,000 shares of common stock outstanding before the new issuance. Assume no treasury stock.

7 Income and Cash Flow Statements

A store's cost for a carpet is \$12 and the owners desire a 20% gross profit ratio. Find what is the most likely selling price they will set.

Why might a discount store be satisfied with a relatively low gross profit ratio, while a boutique seeks a relatively high gross profit ratio to achieve profitability?

Explain why a weighted-average number of shares of common stock is used in calculating (basic) earnings per share.

On September 1, 2022, the beginning of her fiscal year, Cruisers, Inc. had 200,000 shares of common stock outstanding. On December 3, 2022, 40,000 additional shares were issued for cash. On June 28, 2023, 15,000 shares of common stock were acquired as treasury stock (and are no longer outstanding). Assume Cruisers Inc. had net income of \$1,527,000 for the year ended August 31, 2023, and had 80,000 shares of a 7%, \$50 par value preferred stock outstanding during the year. Calculate the basic earnings per share of common stock outstanding.

Consider the indirect method in listing cash flows from operating activities. Explain why depreciation and amortization expenses are added back to net income under this method; why gains/losses are deducted/added; why accounts receivable/accounts payable are subtracted/added.

8 Extra Review

Penn company uses a periodic inventory system. At the end of the annual accounting period, the accounting records provided the following information for product 1:

	Units	Unit Cost
Inventory, prior year	2,000	\$5
For the current year:		
Purchase, March 21	5,000	\$7
Purchase, August 1	3,000	\$8
Inventory, current year	4,000	

Compute ending inventory and cost of goods sold for the current year under FIFO, LIFO, and average cost inventory costing methods. (**Hint:** Set up adjacent columns for each case.)

A company issued \$500,000 of 10-year, 6% bonds payable on January 1, 2020. The bonds pay interest annually. The market rate for bonds of similar risk and maturity is 8%. The bonds were issued at a discount of \$45,000. What is the bond carrying amount at the end of 2021, assuming the company uses the effective interest method?

9 Past Exam Questions

The following information is available for MAASPRODUCTION B.V., a Dutch company that builds pre-fabricated houses. The order in which the accounts are placed is random.

Balance Sheet 1/1/2020	
Total current assets	250,000
Total liabilities	???
Total non-current assets	1,000,000
Income statement 2020	
Net income	100,000
Dividends	50,000
Balance Sheet 1/1/2021	
Total shareholder's equity	1,000,000
Total liabilities	1,000,000

Use the relationships you learned between the financial statements. What should be the number reported under total liabilities at 1/1/2020?

A. 250,000
B. 300,000
C. 900,000
D. None of the above.

Use the same table as in the previous question to answer the following: What was the return on investment of the average total assets of MAASPRODUCTION B.V.? Round to one decimal.

A. 3.1%
B. 6.2%
C. 10.0%
D. None of the above.

Mr. Maes has a 12 year-old Lexus with straight-line depreciation expenses of 800 per year. When buying a new car, the Lexus will be traded in for its book value of 8,000. The new company car has a cost of 60,000 and an economic life of 15 years. The residual (salvage) value at the end of the economic life is 15,000.
What is the effect on net income in the first year after the purchase?

A. The net income will be lower by 2,200
B. The net income will be lower by 3,000
C. The net income will be lower by 52,000
D. None of the above.

On January 1 2021, the board of directors of ROYAL DUTCH CRAB NV declared a dividend payout ratio of 50%. The earnings per share were 1.00. The dividends will be paid two months later. In total, the company has 500,000 shares that are authorized. The amount of shares issued is 200,000, and 20,000 shares are in treasury stock.

Use the following ratio:

$$\text{Dividend payout ratio} = \text{Dividend per share} \,/\, \text{earnings per share.}$$

What is the total amount of dividends payable that is recorded in the liability section of the balance sheet on January 1, 2021?

A. 250,000
B. 100,000
C. 0
D. None of the above.

On November 1, a company borrowed 4.8 million in cash from a bank and signed an interest-bearing note due in six months. The interest rate was 8% per year, payable at maturity. The accounting period ends December 31.

What is the correct adjusting entry on December 31?

A. Dr. Interest Expense		192,000	
	Cr. Cash		192,000
B. Dr. Interest Payable		64,000	
	Cr. Cash		64,000
C. Dr. Interest Expense		64,000	
	Cr. Interest Payable		64,000

The following information is available for a company for 2020:

- Total Shareholder's equity, beginning balance \$100,000 (31/12/2019)
- Net income \$40,000 (31/12/2020)
- Ending balance common stock 2019 \$18,000 (31/12/2019)
- Ending balance common stock 2020 \$15,000 (31/12/2020)
- Dividends declared in 2020: \$6,000

The total shareholder's equity ending balance for 2020 will be:

A. \$ 49,000
B. \$131,000
C. \$149,000
D. \$182,000

Part II:

Managerial Accounting

This is going to be drilled into your head a million times if it hasn't been already. What are the major differences between managerial and financial accounting?

Give an example of how fixed costs may not always necessarily be fixed; and provide the name of the assumption used to deal with this.

Explain why variable costs may not be linear beyond the relevant range.

Traditional vs. Contribution margin income statement format: Suppose that Jimmy Corp. somehow had revenues of \$100,000 and operating income of \$10,000. But Jimmy's luck ran out, and revenues dropped by 20%. Jimmy (incorrectly) thinks that this must been his operating income has also dropped by 20%. You have the following information (before the drop in revenues): Variable expenses were \$60,000 and fixed expenses were \$30,000. Fixed expenses do not change, and we stay within the relevant range following the drop in revenues. Explain to Jimmy, using the contribution margin income statement format, why the actual reduction in operating income will be much more severe (provide the exact value).