Financial Accounting Proficiency Sample Test Answers

1. ResellCo

Income statement for the year.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>1013</td>
</tr>
<tr>
<td>COGS</td>
<td>(390)</td>
</tr>
<tr>
<td>Bad debt expense</td>
<td>(32)</td>
</tr>
<tr>
<td>Advertising expense</td>
<td>(85)</td>
</tr>
<tr>
<td>Salary expense</td>
<td>(146)</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>(96)</td>
</tr>
<tr>
<td>Gain on sale of PP&amp;E</td>
<td>34</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(68)</td>
</tr>
<tr>
<td>Income before tax</td>
<td>=230</td>
</tr>
<tr>
<td>Tax expense</td>
<td>(55)</td>
</tr>
<tr>
<td>Net income</td>
<td>=175</td>
</tr>
</tbody>
</table>

Direct operating cash flows

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash receipts from customers</td>
<td>919</td>
</tr>
<tr>
<td>Cash paid to suppliers</td>
<td>(430)</td>
</tr>
<tr>
<td>Cash paid for advertising</td>
<td>(140)</td>
</tr>
<tr>
<td>Cash paid for salaries</td>
<td>(122)</td>
</tr>
<tr>
<td>Cash paid for interest</td>
<td>(59)</td>
</tr>
<tr>
<td>Cash paid for taxes</td>
<td>(47)</td>
</tr>
<tr>
<td>Operating cash flow</td>
<td>=121</td>
</tr>
</tbody>
</table>

Indirect cash-flow statement for the year.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>175</td>
</tr>
<tr>
<td>Adjustments for:</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>96</td>
</tr>
<tr>
<td>Receivables</td>
<td>(100)</td>
</tr>
<tr>
<td>Deferred revenues</td>
<td>20</td>
</tr>
<tr>
<td>Allowance for bad debt</td>
<td>18</td>
</tr>
<tr>
<td>Inventories</td>
<td>(59)</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>19</td>
</tr>
<tr>
<td>Prepaid advertising</td>
<td>(55)</td>
</tr>
<tr>
<td>Accrued Salaries</td>
<td>24</td>
</tr>
<tr>
<td>Interest payable</td>
<td>9</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>(34)</td>
</tr>
<tr>
<td>Tax refunds</td>
<td>(5)</td>
</tr>
<tr>
<td>Deferred tax liabilities</td>
<td>13</td>
</tr>
<tr>
<td>Operating cash flow</td>
<td>=121</td>
</tr>
</tbody>
</table>

| Capital expenditures             | (220)  |
| Proceeds from sale of PP&E       | 104    |
| Investing cash flow              | =116   |

| Debt issued                      | 145    |
| Stock buyback                    | (31)   |
| Dividends paid                   | (51)   |
| Financing cash flow              | =63    |

Net cash flow =68
1.1. Bad debt expense = Write-offs + change in allowance = 14 + 18 = **32**

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Write-off</td>
<td>Beginning balance: 60</td>
</tr>
<tr>
<td>14</td>
<td>Bad debt expense = <strong>32</strong></td>
</tr>
<tr>
<td></td>
<td>Ending balance: 78</td>
</tr>
</tbody>
</table>

1.2. (4 points) Cash received from customers = Sales net of bad debt expenses – change in receivables net of allowances and deferred revenues = 1013-32 – [(500-78-190)-(400-60-170)] = **919**

<table>
<thead>
<tr>
<th>Net receivables - advances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr</td>
</tr>
<tr>
<td>Beginning balance: 400-60-170</td>
</tr>
<tr>
<td>Total sales: 1013</td>
</tr>
<tr>
<td>Ending balance: 500-78-190</td>
</tr>
</tbody>
</table>

1.3. Cash paid to suppliers: **430**

   Beginning inventory + purchases – COGS = ending inventory
   => Purchases = COGS + Ending Inventory – Beginning Inventory
   => Purchases = COGS + Change in inventory

   Beginning payable + purchases – payments = ending payable
   => Payments = Purchases – [Ending payable – Beginning payable]
   => Payments = COGS + Change in Inventory – Change in payable
   => Payments = COGS + Change in inventory net of payables
   = 390 + [(411-131) - (352-112)] = **430**.

<table>
<thead>
<tr>
<th>Inventory</th>
<th>Accounts payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr</td>
<td>Cr</td>
</tr>
<tr>
<td>Beginning balance: 352</td>
<td>Dr</td>
</tr>
<tr>
<td>Purchases : 449</td>
<td>Cr</td>
</tr>
<tr>
<td>Ending balance: 411</td>
<td>Payments = <strong>430</strong></td>
</tr>
<tr>
<td>COGS: 390</td>
<td>Purchases: 449</td>
</tr>
</tbody>
</table>

1.4. Cash paid = Advertising expense + Change in prepaid advertising
   = 85 + 147 – 92 = **140**

<table>
<thead>
<tr>
<th>Prepaid advertising</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr</td>
</tr>
<tr>
<td>Beginning balance: 92</td>
</tr>
<tr>
<td>Prepayments: 140</td>
</tr>
<tr>
<td>Ending balance: 147</td>
</tr>
</tbody>
</table>

1.5. Salaries paid = Salary expense – Increase in accrued salaries = 146 – (157-133) = **122**

<table>
<thead>
<tr>
<th>Accrued salaries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr</td>
</tr>
<tr>
<td>Beginning balance: 133</td>
</tr>
<tr>
<td>Salaries paid: <strong>122</strong></td>
</tr>
</tbody>
</table>

1.6. Cash paid for interest: **59**

   Interest paid = Interest expense – Increase in interest payable = 68 – (54-45) = **59**
Accrued interest

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning balance: 45</td>
<td></td>
</tr>
<tr>
<td>Interest expense: 68</td>
<td></td>
</tr>
<tr>
<td>Ending balance: 54</td>
<td></td>
</tr>
</tbody>
</table>

1.7. As an intermediate step compute current tax expense (You cannot assume a 40% tax rate.): 42

Tax expense = Current tax expense + Deferred tax expense = 55
Deferred tax expense = Increase in net deferred tax liabilities = (101-88)
Current tax expense = 55 - (101-88) = 42

Deferred tax liabilities

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning balance: 88</td>
<td></td>
</tr>
<tr>
<td>Deferred tax expense: 13</td>
<td></td>
</tr>
<tr>
<td>Ending balance: 101</td>
<td></td>
</tr>
</tbody>
</table>

1.8. Cash paid for taxes (You cannot assume a 40% tax rate.): 47
Taxes paid = Current tax expense + Increase in tax refunds receivable = 42 + (102-97) = 47

Tax refunds receivable

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning balance: 97</td>
<td></td>
</tr>
<tr>
<td>Taxes paid: 47</td>
<td></td>
</tr>
<tr>
<td>Current tax expense: 42</td>
<td></td>
</tr>
<tr>
<td>Ending balance: 102</td>
<td></td>
</tr>
</tbody>
</table>

1.9. Beginning gross PP&E + purchases – cost of PP&E sold = ending gross PP&E
800 + x – 135 = 885, x = 220

Gross PP&E

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Beginning balance 800</td>
<td></td>
</tr>
<tr>
<td>Purchases = 220</td>
<td></td>
</tr>
<tr>
<td>Cost of PP&amp;E sold 135</td>
<td></td>
</tr>
<tr>
<td>Ending balance 885</td>
<td></td>
</tr>
</tbody>
</table>

1.10. Title: Proceeds from sale
Amount: 104

1.11. Beginning acc. depreciation + Depreciation – Acc. depreciation of PP&E sold = ending balance:
160 + x – 65 = 191, x = 96

Accumulated depreciation

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation of PP&amp;E sold = 65</td>
<td></td>
</tr>
<tr>
<td>Beginning balance 160</td>
<td></td>
</tr>
<tr>
<td>Depreciation = 96</td>
<td></td>
</tr>
<tr>
<td>Ending balance 191</td>
<td></td>
</tr>
</tbody>
</table>

1.12. Title: Gain on sale
Amount: 34
Gain on sale = Proceeds from sale – (Cost of PP&E sold – Acc. depreciation of PP&E sold) = 104 – (135 – 65) = 34.

1.13. (1 point) Income before tax: 1013-390-32-146-85+34-68=230
1.14. (1 point) Net income: 230 - 55 = 175

1.15. Debt issued: 145

Beginning balance of the principal portion of debt + Debt issued – Debt bought back = Ending balance
400 + x – 0 = 545, x = 145. You know the debt bought back is zero because no debt buybacks are listed on the financing section of the cash flow statement.

<table>
<thead>
<tr>
<th>Debt: Principal portion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dr</strong></td>
</tr>
<tr>
<td>Beginning balance: 400</td>
</tr>
<tr>
<td>Debt repurchased = 0</td>
</tr>
<tr>
<td>Ending balance: 545</td>
</tr>
</tbody>
</table>

1.16. Adjustment for depreciation: 96 b. [You should add back the depreciation expense. The most common mistake is to add back increase in accumulated depreciation. Accumulated depreciation can change due to non-operating reasons such as sale of PP&E. Only the operating changes due to depreciation should be added back.] Depreciation expense is a non-cash expense and is added back because it makes operating cash flow exceed net income.

1.17. Adjustment for receivables: 100 d. An increase in receivables reflects more credit sales than collections, which makes revenues exceed operating cash inflows. Some of you adjusted for $14 in write-offs. That is OK but was not expected for this problem.

Pick one of the statements below that best describes the reason for the adjustment.

1.18. Adjustment for deferred revenues: 20 a. An increase in deferred revenues reflects advance payments that exceeded deliveries, which makes operating cash inflows exceed revenues.

1.19. Adjustment for allowance for bad debt 18 b. An increase in allowance reflects bad debt expenses that exceeded write-offs, which makes expenses exceed cash outflows. Some of you adjusted for $14 in write-offs. That is OK but was not expected for this problem.

1.20. Adjustment for inventories 59. Adjustment for accounts payable 15 e. The combined effect is a negative adjustment of $40, which means that cash paid to suppliers exceeded cost of goods sold by $40, i.e., operating cash outflows exceeded expenses.

1.21. Adjustment for prepaid advertising 55 E. An increase in prepaid advertising reflects more pre-payments than expenses in the current period. Thus, operating cash outflows exceeded expenses.

1.22. Adjustment for accrued salaries 24 b. An increase in accrued salaries implies that salary expense exceeded salaries paid, i.e., expenses exceeded operating cash outflows.

1.23. Adjustment for interest payable 9 b. An increase in interest payable implies interest expense exceeded interest payments, i.e., expenses exceeded operating cash outflows. Interest payments are treated as operating because they affect net income on a recurring basis. Some of you may disagree with the classification but that is the way it is.

Pick one of the statements below that best describes the reason for the adjustment.

1.24. Missing adjustment on the indirect operating cash flow section

<table>
<thead>
<tr>
<th>Title</th>
<th>Gain on sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td>34</td>
</tr>
</tbody>
</table>

F. Gain on sale is backed out on the operating cash flow section because the entire pre-tax proceeds from sale are treated as investing cash flows. Since gain is included in net income, not backing it out on the operating cash flow section would mean that we are double counting the extra cash received from selling.

1.25. Adjustment for tax refunds receivable 5 A.


1.27. (1 point) Operating cash flow : 919-430-140-122-59-47= 121.
Investing cash flow = -220 + 104 = **(116)**.
Financing cash flow = 145 – 31 – 51 = **63**.

1.28. Net cash flow 63. Which account on the balance sheet should the net cash flow reconcile with? **Cash**. [The most common mistake was retained earnings.] Does it reconcile? Circle **YES** or **NO**.

1.29. Explain changes in Treasury stock account by showing the causes of increases and decreases. 

\[
\text{B/B + Repurchased} - \text{Retired or reissued} = \text{E/B}
\]

\[
200 + 31 - 35 = 196
\]

1.30. Explain changes in retained earnings by showing the causes of increases and decreases. 

\[
\text{B/B + Net income} - \text{Dividends declared} - \text{Effects of retirements} = \text{E/B}
\]

\[
773 + 175 - 51 - (35 - 22) = 884
\]

2. **Minority Interest** (3 points) Consolidated income statement (You may not need all rows.)

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>100</td>
</tr>
<tr>
<td>Salary expense</td>
<td>(80)</td>
</tr>
<tr>
<td>Subsidiary income</td>
<td>=20</td>
</tr>
<tr>
<td>Minority interest</td>
<td>(2)</td>
</tr>
<tr>
<td>Consolidated net income</td>
<td>=18</td>
</tr>
</tbody>
</table>

2.1. (4 points) Consolidated indirect-cash flow statement with the operating, investing, and financing sections. You may not need all rows.

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated net income</td>
<td>18</td>
</tr>
<tr>
<td>Adjustment for increase in receivables</td>
<td>(4)</td>
</tr>
<tr>
<td>Adjustment for increase in salary payable</td>
<td>3</td>
</tr>
<tr>
<td>Minority interest</td>
<td>2</td>
</tr>
<tr>
<td>Operating cash flow</td>
<td>=19</td>
</tr>
<tr>
<td>Purchase of PP&amp;E</td>
<td>(7)</td>
</tr>
<tr>
<td>Investing cash flow</td>
<td>=(7)</td>
</tr>
<tr>
<td>Dividends paid to minority shareholders</td>
<td>(1)</td>
</tr>
<tr>
<td>Financing cash flow</td>
<td>=(1)</td>
</tr>
<tr>
<td>Net cash flow</td>
<td>=11</td>
</tr>
</tbody>
</table>

2.2. (3 points) Ending balance of minority interest on the consolidated balance sheet = **101**

\[
\text{Beginning balance} + \text{Minority income} - \text{Minority dividends} = \text{Ending balance}
\]

\[
100 + 2 - 1 = 101
\]

3. **DealCo**

3.1. (3 points) Income statement for year 1. Show numbers to be subtracted in parentheses.

<table>
<thead>
<tr>
<th>Account</th>
<th>Y1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>100</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>(60)</td>
</tr>
<tr>
<td>Warranty expense</td>
<td>(30)</td>
</tr>
<tr>
<td>Income before taxes</td>
<td>=10</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(4)</td>
</tr>
<tr>
<td>Net income</td>
<td>=6</td>
</tr>
</tbody>
</table>

3.2. (3 points) Balance sheet at the end of year 1
3.3. (3 points) Direct operating cash-flow statement for year 1.

<table>
<thead>
<tr>
<th>Y1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from customers 100</td>
</tr>
<tr>
<td>Cash paid for the car (60)</td>
</tr>
<tr>
<td>Cash paid for warranties (10)</td>
</tr>
<tr>
<td>Cash paid for taxes (12)</td>
</tr>
<tr>
<td>Operating cash flow= =18</td>
</tr>
</tbody>
</table>

3.4. (3 points) Indirect operating cash-flow statement for year 1

<table>
<thead>
<tr>
<th>Y1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income 6</td>
</tr>
<tr>
<td>Increase in accrued expenses 20</td>
</tr>
<tr>
<td>Increase in deferred taxes (8)</td>
</tr>
<tr>
<td>Operating cash flow= =18</td>
</tr>
</tbody>
</table>

Journal entries for year 1
Purchase car

<table>
<thead>
<tr>
<th>A</th>
<th>+dr</th>
<th>-cr</th>
<th>L</th>
<th>-dr</th>
<th>+cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>78</td>
<td></td>
<td>Deferred tax assets</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>OE on B/S</td>
<td></td>
<td></td>
<td>Contributed capital 60</td>
<td></td>
<td></td>
</tr>
<tr>
<td>OE on B/S</td>
<td></td>
<td></td>
<td>Retained earnings 6</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sell car

<table>
<thead>
<tr>
<th>A</th>
<th>+dr</th>
<th>-cr</th>
<th>L</th>
<th>-dr</th>
<th>+cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100</td>
<td></td>
<td>Accrued warranty cost 30</td>
<td></td>
<td>30</td>
</tr>
<tr>
<td>OE via I/S</td>
<td>60</td>
<td></td>
<td>Sales revenue 100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>COGS</td>
<td></td>
<td></td>
<td>Warranty expense 30</td>
<td>60</td>
<td>100</td>
</tr>
</tbody>
</table>

Pay for warranty repairs in year 1

<table>
<thead>
<tr>
<th>A</th>
<th>+dr</th>
<th>-cr</th>
<th>L</th>
<th>-dr</th>
<th>+cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10</td>
<td></td>
<td>Accrued warranty costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>OE via I/S</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Tax expense in year 1: Reporting income is $10 but the taxable income is $30 because the tax authorities do not allow the estimated warranty costs for year 2 to be booked as an expense in year 1. Alternatively, the book basis of accrued warranty costs is -$20 (minus sign is because
they are a liability), while their tax basis is $0. The deferred tax liability = (-20-0)*0.4 = -8, or a deferred tax asset of $8. Since the taxable income is $30, the current taxes payable are $12.

<table>
<thead>
<tr>
<th>A</th>
<th>Deferred tax assets</th>
<th>+dr 8</th>
<th>-cr</th>
<th>L Taxes payable OE via I/S Tax expense</th>
<th>-dr 4</th>
<th>+cr 12</th>
</tr>
</thead>
</table>

Taxes paid in year 1:

<table>
<thead>
<tr>
<th>A</th>
<th>Cash</th>
<th>+dr 12</th>
<th>-cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>L</td>
<td>Taxes payable OE via I/S</td>
<td>-dr 12</td>
<td>+cr</td>
</tr>
</tbody>
</table>

3.5. (2 points) Income statement for year 2. Show numbers to be subtracted in parentheses.

<table>
<thead>
<tr>
<th>Y2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales 100</td>
</tr>
<tr>
<td>Cost of goods sold (60)</td>
</tr>
<tr>
<td>Warranty expense (30)</td>
</tr>
<tr>
<td>Income before taxes =10</td>
</tr>
<tr>
<td>Income tax expense (4)</td>
</tr>
<tr>
<td>Net income =6</td>
</tr>
</tbody>
</table>

3.6. (2 points) Balance sheet at the end of year 2

<table>
<thead>
<tr>
<th>A</th>
<th>Cash</th>
<th>+dr 84 8</th>
<th>-cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>L</td>
<td>Accrued warranty expense</td>
<td>-dr 20</td>
<td></td>
</tr>
<tr>
<td>OE on B/S</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital 60</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings 12</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3.7. (1 points) Direct operating cash-flow statement for year 2. Show numbers to be subtracted in parentheses.

<table>
<thead>
<tr>
<th>Y2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from customers 100</td>
</tr>
<tr>
<td>Cash paid for the car (60)</td>
</tr>
<tr>
<td>Cash paid for warranties (30)</td>
</tr>
<tr>
<td>Cash paid for taxes (4)</td>
</tr>
<tr>
<td>Operating cash flow= =6</td>
</tr>
</tbody>
</table>

3.8. (1 points) Indirect operating cash-flow statement for year 2

<table>
<thead>
<tr>
<th>Y2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income 6</td>
</tr>
<tr>
<td>Operating cash flow= 6</td>
</tr>
</tbody>
</table>

Journal entries for year 2
Purchase car
Sell car

<table>
<thead>
<tr>
<th>A</th>
<th>+dr</th>
<th>-cr</th>
<th>L</th>
<th>-dr</th>
<th>+cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>60</td>
<td></td>
<td>OE via B/S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td>60</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

OE via B/S

Pay for warranty repairs for the car sold in year 1

<table>
<thead>
<tr>
<th>A</th>
<th>+dr</th>
<th>-cr</th>
<th>L</th>
<th>-dr</th>
<th>+cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100</td>
<td></td>
<td>OE via I/S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued warranty cost</td>
<td>60</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

OE via I/S

Pay for warranty repairs for the car sold in year 2

<table>
<thead>
<tr>
<th>A</th>
<th>+dr</th>
<th>-cr</th>
<th>L</th>
<th>-dr</th>
<th>+cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100</td>
<td></td>
<td>OE via I/S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accrued warranty costs</td>
<td>60</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

OE via I/S

Tax expense in year 2: Reporting income is $10 and the taxable income is also $10 because the tax authorities allow the warranty repairs for the car sold in year 1 to be an expense in year 2. Alternatively, the book basis of accrued warranty costs is -$20 (minus sign is because they are a liability), while their tax basis is $0. The deferred tax liability = (-20-0)*0.4 = -8, or a deferred tax asset of $8. Thus, there is no change in deferred tax assets from prior year. Note that the journal entries show changes in balances.

<table>
<thead>
<tr>
<th>A</th>
<th>+dr</th>
<th>-cr</th>
<th>L</th>
<th>-dr</th>
<th>+cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes payable</td>
<td></td>
<td></td>
<td>OE via I/S</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Tax expense</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Taxes paid in year 2:

<table>
<thead>
<tr>
<th>A</th>
<th>+dr</th>
<th>-cr</th>
<th>L</th>
<th>-dr</th>
<th>+cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>4</td>
<td></td>
<td>OE via I/S</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Taxes payable</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

4. StepUp:
4.1. (4 points) Fill in the balance sheet at the end of the year.
### 4.2. (3 points) Prepare an income statement for the year

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realized gain</td>
<td>25</td>
</tr>
<tr>
<td>Tax expense</td>
<td>(10)</td>
</tr>
<tr>
<td>Net income</td>
<td>= 15</td>
</tr>
</tbody>
</table>

### 4.3. (3 points) Prepare an indirect cash flow statement for the year. You may not need all rows.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>15</td>
</tr>
<tr>
<td>Adjustments if any: Gain on sale of PP&amp;E</td>
<td>(25)</td>
</tr>
<tr>
<td>Operating cash flow</td>
<td>= (10)</td>
</tr>
<tr>
<td>Proceeds from sale of AFSS</td>
<td>55</td>
</tr>
<tr>
<td>Investing cash flow</td>
<td>= 55</td>
</tr>
<tr>
<td>Financing cash flow</td>
<td>= 0</td>
</tr>
<tr>
<td>Net cash flow</td>
<td>= 45</td>
</tr>
</tbody>
</table>

### 4.4. (2 points) Do the changes in the deferred tax account on the balance sheet reconcile with adjustments on the cash flow statement? Circle YES or NO.

**Journal entries for clarity**

**Reverse the fair value adjustment for securities sold**

<table>
<thead>
<tr>
<th>A Securities fair value adjustment</th>
<th>+dr 9</th>
<th>L Deferred tax liabilities</th>
<th>-dr 3.60</th>
<th>+cr 5.40</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>OE via B/S</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>AOCI</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Book the realized gain and tax**

<table>
<thead>
<tr>
<th>A AFSS: Cost</th>
<th>+dr 55</th>
<th>-cr 30</th>
<th>L</th>
<th>-dr</th>
<th>+cr 25</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Circle YES or NO.
Mark the remaining securities to their new fair value: The new balance of securities fair value adjustment should be $35 because the cost is $70 and the market value is $105. The current balance of the fair value adjustment is 30-9=21. Thus, we need to increase the fair value adjustment by $14.

<table>
<thead>
<tr>
<th>A</th>
<th>+dr</th>
<th>-cr</th>
<th>L</th>
<th>+dr</th>
<th>-cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities fair value adjustment</td>
<td>14</td>
<td></td>
<td>Deferred tax liabilities</td>
<td></td>
<td>5.60</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>OE via B/S</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>AOCI</td>
<td></td>
<td>8.40</td>
</tr>
</tbody>
</table>

The balance sheets show a net change in deferred tax liabilities of $2, yet we see no adjustment on the cash-flow statement because this increase is not due to operating reasons and did not affect the current tax assessed or the tax expense.