

# Analyzing financial ratios

[Business](#), [Accounting](#)



The Terry Project: Creating and Modifying the Financial Statements Acct 315  
Project Instructor: Dr. Jason Porter Introduction Most college courses in accounting focus on teaching the various components of the accounting system. While this is an effective way to learn and master each of the various components, it usually leaves students with only a vague notion of how those components work together. My goal is to bridge that gap using the Review Project and this Terry Project. The goal of the Review Project is to take you through the full accounting cycle, allowing you to practice each step and use it as you move on to the next step.

This project, on the other hand, will help you to consider a series of individual situations, how they should be accounted for and what each will do to the company's bottom line. Basically, this project has three goals: 1) to give you practice with at least one of the important topics we will cover in each chapter; 2) to encourage you to consider the consequences of business decisions on the financial statements; and 3) to provide you with an opportunity to work with a small group or partner to solve accounting problems.

To accomplish the first goal, I have provided you with some basic information about the financial accounts already prepared by Terry Co. For most of the chapters we cover, I will give you information about at least one transaction that Terry's accounting department has not yet recorded. It will be up to you to determine whether any adjustment needs to be made because of this new information. If so, then you will need to make the appropriate journal entries (including any tax effects). To accomplish the second goal, each assignment

will require to you create or adjust Terry's financial statements based on your adjusting entries.

In most cases, you will then have the opportunity to look at several commonly used financial ratios to determine what effect your changes will have on investors' opinion of Terry Co. To accomplish the third goal, you will work with a partner (or partners, depending on the class size) of your choice. Because of the way the system is set up for grading, once you have set up your Terry teams you will have to continue with that team for the rest of the semester. Your choice of partner is due at 5: 00pm on the due date given in the course schedule.

If necessary, you may use the Terry Groups discussion link in Blackboard to help you find a partner. You will have an opportunity to evaluate your partner at the end of the semester. These evaluations will be an important part of your grade on this assignment, so make sure that you are a team player. For those of you who are accounting majors, this project will provide you with some experience in the types of activities you will be doing throughout your professional careers: making journal entries, fixing financial statements, recognizing the effects of certain decisions of the financial statements, and discussing those effects with others.

For those of you who are majoring in other areas, this project will provide you with some perspective on how your business decisions will affect the way investors, creditors, and other outside stakeholders see your company. Remember that most investors see only the financial statements, so you must impress them with those numbers if you are to get the funding you need. Since GAAP is relatively strict on how information must be reported

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once the transaction has been performed, you will need to know the financial statement effects of your options before you make your decision.

This project will help you get a feel for how various decisions will affect the financial statements and the financial ratios. Finally, remember that accounting is not only important, it's also fun! And this project has been written to give you lots of opportunities for fun. Grading Each part of the project will be worth 25 points. The journal entries, if any are needed, will be worth 10 points, the corrections to the account balances and financial statements will be worth 9 points, and the interpretation of effects (including changes to the financial ratios) will be worth 6 points.

In some cases (see the instructions for Problems 1-3), this scale will be adjusted slightly due to the nature of the problem. Partial credit will be awarded on the work you show. I can't give partial credit if I only see a summary number or if I can't find or understand your work, so please take the time to show your work and label it clearly. Your files (see below) should be formatted so that they print out clearly and easily on standard portrait pages. Each part of the project should be turned in to the appropriate assignment drop box in Blackboard by 11: 00pm on the due date given in the course schedule.

Please note that because we will talk about this project in class, **NO LATE WORK WILL BE ACCEPTED** for this project after noon on the day following the due date. The assignments are cumulative, meaning that you will use the information from part #1 to answer part #2, and the information from part #2 to answer part #3. In order to help eliminate carry through error, I will post the solution to each part after the due date. It will be <https://assignbuster.com/analyzing-financial-ratios/>

your responsibility to correct your answers (and your Excel spreadsheet) before moving on to the next part.

Since the final part of this project is due during finals week, it is not required. Instead, it will be worth 15 bonus points on the Terry Project. If you choose to complete the final part of the project, you must turn it in by 11:00pm on the due date in the course schedule to get the bonus points. Rounding All journal entries should be rounded to the nearest dollar throughout the Terry case. If you do not round appropriately, you will soon find that your balance sheet will not completely balance. You will be off by \$1 or \$2, especially in the later projects.

Rounding as you go will ensure that this does not become a problem. EPS should be rounded to the nearest penny (\$0.01) through the case and all other ratios should be rounded to three (3) decimal places (0.001). Background Information Terry Co. sells backpacks, laptop bags, briefcases, and other bags. The bags are purchased already made, then the Terry branding and finish is added. Because of several exclusive contracts and high quality products, the company has a strong following in its home state of Georgia and the surrounding area.

In addition to its own brand, the company also has contracts with many colleges, firms, and local organizations to sell bags with these other groups' logos. This practice has greatly increased Terry's sales, especially since the company is usually able to use lower quality inventory to fill these orders (this leads to lower costs for the other groups without damaging Terry's reputation). Because of its success during the past two (2) years, Terry was able to go public in January of last year. This has given the company

additional capital to grow, as well as allowing the original owners to diversify some of their risk.

Management's goal now is to begin marketing in the Northeast and Central regions of the country. If they are successful, they will continue on to the West Coast within a few years. Since much of their advertising is done through personal contacts and word of mouth, their growth will be slow. While that worries some of their new investors, recent economic trouble has left many investors pleased with the management team's more cautious growth. In their rush to go public, Terry's management has forgotten one small detail. They have not created a very strong accounting department.

While their auditors have been willing to help them clean up their books in the past, the managers are starting to realize that their lack of in-house accounting expertise is a problem. During the past year they engaged in several transactions and decisions that might have important repercussions on their financial statements, and they didn't know it. In an effort to start cleaning up their accounting system, they have finally hired you and your partner. Your first job will be to go through Terry's decisions for the year and clean up any mistakes that have been made, and to record any transactions that have been missed.

In the future, you will be expected to give management good advice about the accounting consequences of their actions before decisions are made. Based on recommendations from their auditor and SEC regulations, Terry uses an accrual accounting system based on U. S. GAAP. The company's fiscal year end is December 31st. Since Terry is a relatively small public company with an easy audit, the auditors don't usually arrive until about

January 15th. However, you are expected to have the financial statements ready to go by January 1st so that upper management can issue an earnings announcement to the stockholders.

Although an earnings announcement is known to be unaudited, investors are traditionally very harsh with companies that have a final earnings number below the initial earnings announcement. You will need to be as accurate as possible in order to avoid this type of market consequence. Terry Part #1: Chapter 3 Goal: To practice making necessary correcting and adjusting entries and using them to create an adjusted trial balance. (See Topic Guides AC 6, 11, 12, 14). Information: The table on the next page reports Terry's account balances on December 31st for the current and prior years.

The following entries have not yet been made for the current year: \* During the year the board declared and paid an \$250, 000 dividend. \* During the year the sales department wrote off \$500, 000 of accounts receivable (already included in the current account balances). They have now decided that 18% of their ending A/R balance is uncollectible. Terry uses the % of A/R method for recognizing bad debt expense. \* On June 1st, a year's lease on a new warehouse was prepaid for \$90, 000. The original payment was recorded appropriately, but no other entries have been made for this contract since that time. Terry's reported income tax expense (see below) includes an estimate for this year's taxes. Only the three adjustments mentioned above have not yet been included in this tax estimate. Because of this, you will need to record any tax effects from the transactions throughout this case (starting with the tax effects, if any, of these three entries). Since another tax payment will not be made until April, these adjustments should

be accounted for in Income Tax Expense and Income Tax Payable. Terry's tax rate is 30%. Assignment: \* 1.

Make the appropriate journal entries, if any, to account for the adjustments mentioned above (including any necessary changes to income tax expense).

2. Create Terry's Year 2 adjusted trial balance. Hint: Trial balances need to be in a specific order and they are only for the current year! Terry Co. |

Account Balances	As of 12/31/Year 2	Year 2	Year 1
A/R	\$2, 250, 000		
Accounts Payable	\$2, 125, 000	\$1, 177, 263	\$1, 500, 000
Accumulated Depreciation	\$3, 000, 000	\$2, 500, 000	
Additional Paid-In Capital	\$750, 000	\$750, 000	
Advertising Expense	\$468, 750	\$150, 000	
Allowance for Bad Debts	\$125, 000	\$625, 000	

Building	\$2, 000, 000	\$2, 000, 000	Cash	\$1, 500, 000	\$1, 250, 000
Common Stock	\$1, 000, 000	\$1, 000, 000	(\$1 par, 2, 000, 000 authorized, 1, 000, 000 outstanding)		
Cost of Goods Sold	\$13, 683, 969	\$4, 400, 000	Current Portion of Loan Payable	\$125, 000	\$125, 000
Depreciation Expense	\$500, 000	\$180, 000	Equipment	\$7, 000, 000	\$3, 250, 000
Executive Salaries Expense	\$1, 093, 750	\$500, 000	Expansion Fund	\$750, 000	\$750, 000
Income Tax Expense	\$1, 316, 887	\$450, 000	Income Tax Payable	\$437, 500	\$250, 000
Insurance Expense	\$37, 500	\$45, 000	Interest Expense	\$159, 375	\$50, 000
Inventory	\$3, 000, 000	\$3, 500, 000			

Land	\$2, 750, 000	\$1, 750, 000	Loan Payable	\$625, 000	\$750, 000
Loans to other businesses	\$1, 000, 000	\$1, 000, 000	Miscellaneous Admin. Expenses	\$12, 344	\$8, 000
Miscellaneous Selling Expenses	\$121, 875	\$40, 000	Notes Payable	\$3, 500, 000	\$2, 000, 000
Office Supplies					



Expense| \$96, 875| \$75, 000| Patents| \$375, 000| \$375, 000| Prepaid Insurance| \$187, 500| \$375, 000| Prepaid Rent| \$312, 500| \$250, 000| Rent Expense| \$90, 625| \$15, 000| Rent Revenue| \$78, 125| \$19, 000| Retained Earnings| ??? | \$6, 437, 500| Sales Discounts| \$250, 000| \$50, 000| Sales Force Salaries Expense| \$343, 750| \$155, 000|

Sales Returns| \$2, 187, 500| \$500, 000| Sales Revenue| \$25, 000, 000| \$8, 000, 000| Selling Commissions Expense| \$1, 250, 000| \$40, 000| Shipping Expense| \$204, 688| \$100, 000| Unearned Revenue| \$625, 000| \$375, 000| Utilities Expense| \$187, 500| \$80, 000| Wages Payable| \$250, 000| \$312, 500|

Terry Part #2: Chapter 4 Goal: \* To practice creating a multi-step income statement in good form. (See Topic Guides AC 15, 16, 17, 25).

Information: \* Now that all of the necessary adjusting entries have been made and an adjusted trial balance prepared, management would like you to create Terry's financial statements. In addition to creating the financial statements, Terry's management has asked you to calculate the following financial ratios: \* \* Profit Margin (NI / Net Sales) \* Times Interest Earned (Income before Interest and Taxes / Interest Expense) \* EPS (NI / Common Stock Shares Outstanding) Assignment: \* 1. Create a multi-step income statement in good form for Terry Co. for Year 2. Although Terry uses a perpetual inventory system, the purchasing department has kept track of the following inventory information (for use in creating the multi-step income statement): Purchases| \$13, 470, 313 |

Purchase Discounts| \$202, 031 | Purchase Returns| \$112, 438 | Purchase Allowances| \$175, 000 | Shipping Charges (i. e. Freight In)| \$203, 125 | \* \*

The following information can be used to break down Terry's operating

activities: \* \* Reported depreciation expense is for administrative, not selling, equipment. \* Shipping expense refers to shipping out sales orders. \* Insurance, rent, and utilities costs are treated as administrative expenses. \* If you have other questions about how the operating activities should be broken down, please ask the instructor!

2. Calculate the three (3) ratios listed above. Please round your ratios to three decimal places on all parts of the Terry Project!

3. If appropriate, include the ratios in the income statement.

Terry Part #3: Chapter 5 Goal: \* To practice creating a balance sheet in good form. (See Topic Guides AC 17, 22, 25). Information: \* Now that all of the necessary adjusting entries have been made, an adjusted trial balance prepared, and an Income Statement finished, you are ready to create Terry's last two financial statements: the balance sheet and the statement of cash flows. After you have created the balance sheet, Terry's management has asked you to calculate the following financial ratios: \* \* Current Ratio (Current Assets / Current Liabilities) \* ROA (Net Income / Average Total Assets) \* ROE ([Net Income - Preferred Stock Dividends] / Average Total Equity)

Assignment: \* 1. Create a balance sheet in good form for Terry Co. for Year 2 (HINT: Follow the U. S. GAAP format we discussed in class). 2. Calculate the three (3) ratios listed. Extra Credit: \* Although it is an important skill, I am not requiring you to create Terry's Statement of Cash Flows.

However, if you would like the extra practice in creating this important financial statement, you can earn up to 10 bonus points by giving it a try. The grading for the extra credit will be similar to the grading on the rest of the project. Whether you attempt the bonus or not, the solution to this

portion of the project will include the statement of cash flows for use in future assignments. Terry Part #4: Chapter 7 Goal: \* To practice factoring accounts receivable, and to observe the effects of factoring on the three main financial statements. (See Topic Guides A 10, 35, 36).

Information: \* During December, Terry's management decided to factor part of its accounts receivable in order to get some additional cash and to eliminate the time and effort involved in collecting their delinquent accounts. \* After some negotiations, Terry's CFO made a deal with the First National Collections Bank. First National will buy 70% of Terry's accounts receivable, with recourse. The bank will only charge a 2% financing charge for the transaction but will hold 8% of the A/R being sold to cover any returns and discounts that may occur after the sale.

Upon reviewing the accounts being sold, Terry's collections officers believe that only 11% of these accounts might default. The deal was completed on December 31st, but has not yet been included in the financial statements. \* Terry's management would like to know the effect of the sale on the following ratios: \* \* Quick Ratio ( $[\text{Cash} + \text{Cash Equivalents} + \text{net A/R}] / \text{Current Liabilities}$ ) \* Accounts Receivable Turnover Ratio ( $\text{Net Sales} / \text{Average net A/R}$ ) \* Current Ratio \* ROA Assignment: \* 1. Calculate each of the four (4) ratios before you make any adjustments. . Make the appropriate journal entries, if any, to account for the factoring of A/R (including any necessary changes to income tax expense). 3. Make any necessary changes to the financial statements. 4. Calculate the four (4) ratios after you make any adjustments. 5. What do you think the investors' reaction will be to management's decision to factor A/R? In other words, based on your changes

to the financial statements and the changes in the ratios, do you think investors will be happy with the decision? Why or why not? Hints: \* 1. Don't try to change Bad Debt Expense.

However, you will need to close part of the Allowance for Bad Debts (the same percentage as you are selling! ). 2. If you are using my solutions as your template (available in Module 2), any changes that need to be made to Income Tax Expense will be made automatically, as will many of the changes to the Statement of Cash Flows. 3. The sale of A/R will not affect the cash flow from customers, so you will need to manually readjust the Change in A/R in your statement of cash flows to be the same as it was before the adjustments. 4. Your statement of cash flows will not need to include any new balance sheet accounts you have created, but you will need to add two (2) line items somewhere in the Statement. 5. It is usually up to the individual analyst to decide whether or not to include the ' Due from' account as part of A/R when calculating the financial ratios. In this case, however, the company has decided that you should include ' Due from' as part of accounts receivable. Terry Part #5: Chapter 8 Goal: \* To practice correcting the financial statements for an inventory calculation error. (See Topic Guides A 13, 14, 35, 36). Information: \* Terry's management is afraid that an error was made when calculating COGS.

Most of the calculations have already been checked by the auditors, but management still thinks that one inventory item has not been correctly recorded. They would like you to go back through the inventory calculations for that item to correct any possible mistakes. Currently they show that 1,000 units of item TC178, purchased for \$22 each, were on hand at the

beginning of the year. During the year \$630, 000 worth of TC178 was purchased, discounts of \$6, 000 were earned by making early payments on these purchases, and \$3, 000 worth of returns were made during the year.

The records show that all units of TC178 had been sold by the end of the year. \* Terry uses the perpetual LIFO system for calculating inventory. Their inventory transactions for item TC178 for the period are as follows: (NOTE that the vendor provides free shipping on all units of TC178) \* \* At the beginning of the period, 1, 000 units of TC178, purchased for \$22 each, were on hand. \* On Jan 15, an additional 5, 000 units were purchased for \$27 each \* On February 28, 4, 500 units were sold. \* On March 14, an additional 8, 000 units were purchased for \$32 each. On March 20, a 3% cash discount was earned by paying for the March 14 purchase early. \* On March 30, 5, 000 units were sold. \* On July 30, 3, 200 units were sold. \* On August 20, an additional 7, 000 units were purchased for \$33 each. \* On September 2, 4, 000 units were sold. \* On December 1, 2, 700 units were sold. \* Terry's management would like to know the effect of any necessary correction on the following ratios: \* \* Inventory Turnover (COGS / average total inventory) \* Current Ratio \* ROA Assignment: \* 1.

Calculate each of the three (3) ratios before you make any adjustments. 2. Make the appropriate journal entries, if any, to correct the reported values of item TC178 (including any necessary changes to income tax expense). 3. Make any necessary changes to the financial statements. 4. Calculate the three (3) ratios after you make any adjustments. 5. What do you think the investors' reaction will be to the adjustment of inventory? In other words,

based on your changes to the financial statements and the change in the ratios, do you think investors will be happy with the restatement?

Why or why not? Hints: \* 1. Start out by calculating Terry's COGS on TC178. You might want to do this by setting up a formal COGS equation for TC178. The formal equation for one product would look just like the COGS section of the income statement, but it would only include the values for the one product. In this case, you want to use the numbers currently being reported for TC178 (see above). 2. Use the perpetual inventory method to find out what purchases, purchase discounts, and COGS should be for TC178. Set up a new COGS equation for TC178 using the new information. . Compare the new COGS equation to the old equation. The differences between the two equations are the changes that you need to record. 4. Keep in mind that Terry has a perpetual inventory system. This means the company won't have a ' purchase returns' or a ' purchase discount' account. Instead, everything will be done using the inventory account. Your final entry, then, should change only three accounts: COGS, Inventory, and A/P. You can get the changes to COGS and Inventory from the differences in your COGS equations (old vs. new). Use A/P as the plug figure. Terry Part #6: Chapter 10 Goal: \* To practice recording an exchange of PPE and to determine the effects of the exchange on the financial statements. (See Topic Guides A 19, 35, 36). Information: \* On December 15th, Terry's management decided to trade in one of their machines for a newer model. After long discussions with their auditors, Terry's management has decided that the increased capacity of the new machine makes this an exchange without substance. The old machine

originally cost \$450, 000 and had been fully depreciated to its \$70, 000 salvage value.

The new machine sold for \$600, 000, but the vendor offered Terry a \$95, 000 trade-in on the old machine if the balance is paid in cash. Terry's management was excited about the deal, since they would have been able to sell the old machine for only \$90, 000 if they had tried to dispose of it on the open market. \* Although the deal was completed on December 29th, no journal entries have yet been recorded. \* Terry's management would like to know the effect of the exchange on the following ratios: \* \* Asset Turnover (Net Sales / average total assets) \* Current Ratio ROA Assignment: \* 1. Calculate each of the three (3) ratios before you make any adjustments. 2. Make the appropriate journal entries, if any, to account for the trade-in (including any necessary changes to income tax expense). 3. Make any necessary changes to the financial statements. 4. Calculate the three (3) ratios after you make any adjustments. 5. What do you think investors' reaction will be to the exchange? In other words, based on your changes to the financial statements and the change in the ratios, do you think investors will be happy with the exchange? Why or why not? Terry Part #7: Chapter 11

Goal: \* To practice accounting for partial-year depreciation, and to determine the effect of switching to partial-year depreciation on the financial statements. (See Topic Guides A 21, 35, 36). Information: \* Terry purchased \$1, 200, 000 of new equipment during the year (not including the exchange in Part #6). Most of this equipment was purchased during January; however the last purchase (Machine X7S4) occurred on September 1st for use in the

sales department. Machine X7S4 cost the company \$300, 000. \* Originally, Terry recorded depreciation on all of its new equipment for the entire year.

Now, however, the CFO is worried that the auditor will insist that they use partial-year depreciation on Machine X7S4. In order to avoid problems with the auditor, he has decided to go ahead and switch to partial-year depreciation now. At the time of the purchase, the sales manager estimated that Machine X7S4 would last six (6) years and would have a \$23, 000 salvage value. Terry uses the sum-of-the-years digits method of calculating depreciation. \* Terry's management would like to know the effect of the change to partial-year depreciation on the following ratios: \* Asset Turnover (Net Sales / average total assets) \* Current Ratio \* ROA Assignment: \* 1. Calculate each of the three (3) ratios before you make any adjustments. 2. Make the appropriate journal entries, if any, to account for the switch to partial-year depreciation (including any necessary changes to income tax expense) on Machine X7S4 only (the rest of the depreciation has been appropriately recorded). 3. Make any necessary changes to the financial statements. 4. Calculate the three (3) ratios after you make any adjustments. 5. What do you think investors' reaction will be to the decision to use partial-year depreciation?

In other words, based on your changes to the financial statements and the change in the ratios, do you think investors will be happy with the CFO's decision to use partial-year depreciation instead of full-year depreciation? Why or why not? Hints: 1. The easiest way to do this problem is to make both entries: full-year depreciation and partial-year depreciation. 2. Once you have both entries, determine what you need to debit and credit to adjust



your books from the first entry (full-year depreciation) that was actually made to the second entry (partial-year depreciation) that should have been made. 3.

Remember, if you change an income statement account, there WILL be a tax effect! Terry Part #8: Chapter 17 Goal: \* To practice accounting for changes in the market value of available for sale securities, and making the corrections to the financial statements. (See Topic Guides A 27, 35, 36). Information: \* Terry's Expansion Fund is made up of available for sale (AfS) securities. The securities were purchased on January 1st of last year (Year 1). At the end of year 1, the CFO made the correct entry to account for the change in value, but the changes were reported as part of Retained Earnings in the balance sheet.

No adjustment has yet been made for changes in value in the current year (Year 2). The table below gives the information about the securities that are part of the expansion fund. Terry's upper management has elected to report the combined value of the AfS Investment account and the market adjustment account as the 'Expansion Fund' in the balance sheet.

Security	Purchase Price	End Year 1 Price	End Year 2 Price
10, 500 of XYZ Inc.	\$5.00	\$7.00	\$7.50
8, 000 of Sampson's Inc.	\$5.25	\$6.75	\$8.00
2, 000 of Friday's Foods Inc.	\$7.00	\$8.75	\$6.00
55, 000 of Arborium Inc.	\$9.00	\$11.00	\$9.00

\* Terry's management would like to know the effects of the changes in value of the following ratios: \* Current Ratio \* ROA

Assignment: \* 1. Calculate each of the two (2) ratios before you make any adjustments. 2. Make the appropriate journal entries, if any, to account for the change in value of the expansion fund securities (including any

necessary changes to income tax expense). 3. Make any necessary changes to the financial statements (see Hint #5 below). 4. Calculate the two (2) ratios after you make any adjustments. 5. What do you think investors' reaction will be to management's investment decisions?

In other words, based on your changes to the financial statements and the change in the ratios, do you think investors will be pleased with the portfolio? Why or why not? \* \* Hints: 1. Make a table showing the total value of the securities at each of the important dates (purchase, end of Year 1, and end of Year 2). 2. Create t-accounts for the Expansion Fund and the Market Adjustment - AfS. What do you need as the ending balance of the Market Adjustment - AfS account for the net amount of the two accounts to equal the ending value of the portfolio?

You will need to do this twice (once for year 1 and once for year 2) in order to get all of the numbers you need. 3. The difference between the ending value in the Market Adjustment - AfS account for year 1 and 0 will be the amount of the adjustment that they made last year. The difference between the ending value needed in the Market Adjustment - AfS account at the end of year 2 and the amount already in the account from year 1 will be the adjustment that you need this year. 4. Make the necessary adjustment to the Financial Statements.

Keep in mind that the change in value for AfS securities should be recorded in Unrealized Increase/Decrease in AfS Securities, which should be recorded as part of the Other Comprehensive Income line below RE on the Balance Sheet. 5. Since Other Comprehensive Income has not been reported before, you'll need to add that line to the balance sheet. When you do, you will need

to add a balance for year 1, not just report it as a '0' as we've done when with other lines added to the balance sheet. You don't need to make a journal entry for Year 1, because you were told that Terry's CFO made the correct adjustment.

However, Terry's Year 1 balance sheet reported the Unrealized Increase/Decrease as part of Retained Earnings instead of reporting it in an Other Comprehensive Income line. Since you are now adding an Other Comprehensive Income line to the balance sheet, you'll want to make sure that you move last year's Unrealized Increase/Decrease out of Retained Earnings and include it in the new line item (for both years).

Terry Part #9: Chapter 13 Goal: \* To practice recording contingent liabilities and reporting them in the financial statements. (See Topic Guides LE 2, 6, 16). Information: At the beginning of November, Year 2, Terry issued 500, 000, \$5 off coupons. The coupons will expire at the end of February, Year 3. During November and December, 40, 000 of the coupons were used. Terry's advertising experts estimate that next year approximately 22, 500 coupons will be used in January and another 10, 750 in February. \* The accounting department has appropriately accounted for the coupons that have already been honored as part of advertising expense. \* Terry's management would like to know the effects of the adjustment on the following ratios: \* Current Ratio \* ROA

Assignment: 1. Calculate each of the two (2) ratios before you make any adjustments. 2. Make the appropriate journal entries, if any, to account for the coupon liability (including any necessary changes to income tax expense). 3. Make any necessary changes to the financial statements. 4. Calculate the two (2) ratios after you make any adjustments. 5. What do you

think investors' reaction will be to the decision to issue a coupon? In other words, based on your changes to the financial statements and the change in the ratios, do you think investors will be happy with this advertising strategy?

Why or why not? Hint: \* 1. In some of the earlier parts of the project, we did not include new balance sheet accounts in the Cash Flow from Operations section of Terry's Statement of Cash Flows. Each of those cases, however, included a definite cash effect that was reported as a specific line item in the Cash Flow from Investing section (such as the sale of A/R in Part #4). In this case, however, there is no definite cash effect, so any new balance sheet accounts will have to be added to the statement of cash flows. Terry Part #10: Chapter 14 Goal: To practice recording long-term liabilities and reporting them in the financial statements. (See Topic Guides LE 8, 10, 16). Information: \* On December 1, Terry issued a \$1, 500, 000, semi-annual, 6 year, 9% bond. The market rate for similar bonds on that day was 8%. Terry uses the effective interest method to record the amortization or premiums and discounts. Terry's management has decided to report net bonds on the balance sheet, instead of reporting the bond and its premium or discount separately. No entries have yet been made for the bond. Terry's management would like to know the effects of the new bond on the following ratios: \* Debt to Equity Ratio (Total Liabilities / Total Equity) \* Current Ratio \* ROA Assignment: \* 1. Calculate each of the three (3) ratios before you make any adjustments. 2. Make the appropriate journal entries, if any, to account for the new bond and any accrued interest (including any necessary changes to income tax expense). 3. Make any necessary changes to the financial

statements. 4. Calculate the three (3) ratios after you make any adjustments. . What do you think investors' reaction will be to management's decision to issue a new bond? In other words, based on your changes to the financial statements and the change in the ratios, do you think investors will be happy with the decision to issue the new debt? Why or why not? Hints: 1. Start out by making the journal entry to record the issuance of the bond at its present value. 2. Next calculate the interest expense to be reported and any premium or discount to be amortized at the time of the first interest payment. . Multiply your interest expense and amortization numbers for the first payment by the number of months the bond has been outstanding divided by 6 (for the 6 months in each semi-annual payment period). This will give you two of the three line items you need for the interest entry on the bond this year. 4. You will need to add three line items to your Statement of Cash Flows to make it balance after recognizing the issuance of the bond and the accrued interest. One line item is the cash from the bond issue.

One of the others is one of the four non-cash (4) accruals that have to be reversed in your Cash Flows from Operations section. Terry Part #11: Chapter 15 Goal: \* To practice accounting for the payment of dividends and the purchase of treasury stock. (See Topic Guides LE 20, 23, 26). Information: \* Using the money from their recent bond issue, Terry's management has decided to declare an additional \$715, 000 dividend (see Part #1 for information on the first dividend of the year). The date of declaration is December 30, Year 2. The date of record will be January 15, Year 3, and the date of payment will be January 30, Year 3. As an additional

signal to the market, Terry's management repurchased 60,000 shares of Terry's common stock on December 31st for \$24 a share. Terry's management would like to know the effects of the extra dividend and share repurchase on the following ratios: \* Current Ratio \* ROA Assignment: \* 1. Calculate each of the two (2) ratios before you make any adjustments. 2. Make the appropriate journal entries, if any, to account for Terry's extra dividend and stock repurchase (including any necessary changes to income tax expense). 3. Make any necessary changes to the financial statements. . Calculate the two (2) ratios after you make any adjustments. 5. What do you think investors' reaction will be to management's decision to issue a second dividend and to repurchase shares? In other words, based on your changes to the financial statements and the change in the ratios, do you think investors will be happy with the decision to pay out so much cash to investors? Why or why not? Hints: \* 1. These transactions will affect EPS, but they will not affect Net Income. 2. As you think about investor reactions, keep in mind that stockholders are not the only investors in a firm!

----- [ 1 ]. 1To understand why we use A/P for the plug figure, we have to go back to what the journal entry would look like for a purchase. We would debit inventory (since this is a perpetual inventory firm) and credit A/P. Mis-recording the inventory effects of sales would cause errors in our inventory and COGS accounts. Mis-recording the inventory effects of purchases would cause errors in our inventory and A/P accounts. So, in order to correct for all of Terry's mistakes, we need to adjust inventory, COGS, and A/P.