FIN622 CURRENT SUBJECTIVE QUESTIONS

SOLVED BY TAHIR NAVEED

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Question # 1:

State and explain any five generally acceptable accounting principles. 5

I) Entity principle: specific business entity separate from personal affairs of the owner(s).
ii) Cost principle: valuation and recording of assets at cost.
iii) Going-concern assumption: connected with cost principle, assets acquired for use and not for resale.
IV) Objectivity principle: definite, factual basis for assets valuation; measuring transactions objectively.
v) Stable currency principle. The currency remains more or less stable and rate of inflation is almost zero.
vi) Adequate disclosure concept: facts necessary for proper interpretation of statements; Subsequent events", lawsuits against the business, assets pledged as securities/collaterals, contingent liabilities etc; reflected in Notes.

Question # 2:

What is the effect of financial leverage on the earnings of the firm? When leverage is advantageous? 3

Leverage: It means operating a business with borrowed money. It should be used to earn a return (on assets or equity) greater than cost of borrowing i.e. interest. Alternate term for this is "Gearing". This is opposite of Debt ratio. Low equity ratio indicates extensive use of leverage i.e. borrowings.
With leverage the financial risk is high and possibility that company may not pay back money borrowed and has entered bankruptcy. Advantage of it was that company can not pay dividends and fewer shares in the profit of company. Debt financing can be done to avoid giving up shares of ownership of the company. Unofficial financing known as trade

financing usually provides the major part of a company's working capital (day-to-day operational needs).

Question # 3:

If u buy an inventory for 20,000 what'll be effect on new working capital.

If company purchases inventory on cash current assets of company increase and on the other hand cash is decrease. So there is no effect in working capital.

Question # 4:

Why revenue a/c is credited & expense a/c debited? Give reason.

This is consistent with the rule that increases in owner's equity are recorded by credits and decreases are recorded by debits. So when company get revenue owner's equity is increased and has credit balance of revenue account and when company incur expenses owner's equity decreased and has debit balance of expense account.

Question # 5:

Find quick assets & total current assets

Current asset are all the assets in organization including inventory and prepaid expanses. Quick assets are those asses which were conveniently convertible into cash. Only cash, marketable securities and Receivables (called Quick Assets) are considered

Question # 6:

What is vertical & common size analysis? What is its usefulness? 3marks

Vertical Analysis

When using vertical analysis, the analyst calculates each item on a single financial statement as a percentage of a total. The term vertical analysis applies because each year's figures are listed vertically on a financial statement. The total used by the analyst on the income statement is net sales revenue, while on the balance sheet it is total assets.

Common Size:

A company financial statement that displays all items as percentages of a common base figure. This type of financial statement allows for easy analysis between companies or between time periods of a company.

Question # 7:

Differentiate between operating cycle & accounting cycle of a company. 3marks

Operating cycle:

The operating cycle for a company is the time period between the acquisition of goods and the final cash realization resulting from sales and subsequent collections. The shorter the operating cycle, the higher the quality of current assets and the greater the efficiency of management.

Operating Cycle=Inventory sale days (average) +Receivable Collection days (average).

Accounting cycle:

It mainly consists of Recording, Classifying and Summarizing financial transactions over an accounting period.

Accounting cycle may be summarized as follows

1. Journalize Transactions

2. Post to Ledger Accounts

3. Prepare A Trial Balance

4. End of Period Adjustments

5. Prepare an Adjusted Trial Balance

6. Prepare financial statements

7. Journalize and Post Closing Entries

8. Prepare an After Closing Trial Balance

Question # 8: (Marks: 5)

Following is the balance sheet of the ABC Company.

ABC Corporation Balance Sheet Mar. 31, 1991

Assets

Cash Rs. 12,500

Notes receivables 104,000

Accounts receivables (net) 68,500

Inventories at cost 50,000

Plan & equipment (net of depreciation) 646,000

Total assets Rs. 881,000

Liabilities & Stockholder's equity

Accounts payable Rs. 72,000

Notes payable 54,500

accrue liabilities 6,000

Common stock (60,000 shares, Rs.

10par)

600,000

Retained earnings 148,500

Total liabilities and owner's equity Rs. 881,000

Requirement: Find current Ratio and Quick Ratio?

SOLUTION:

Current Ratio = Current Assets / Current Liabilities

= 235,000 / 132,500

= 1.77

Quick Ratio = Current Assets - Inventories / Current Liabilities

= (235,000 – 50,000) / 132,500

= 185,000 / 132,500

= 1.39

Question # 9:

Using the following information, compute the price earning ratio to the nearest tenth.

Income Rs. 130,000

Beginning shares outstanding 250,000

Ending shares outstanding 270,000

Current price per share Rs. 7.50

Dividend per share Rs. 1.20

Price-earning ratio (P/E) = Market price/share

Earning/share

= 7.50/1.20

= 6.25

Question # 10:

Difference b/w Operating and Accounting Cycle.

Operating cycle:

The operating cycle for a company is the time period between the acquisition of goods and the final cash realization resulting from sales and subsequent collections. The shorter the operating cycle, the higher the quality of current assets and the greater the efficiency of management.

Operating Cycle=Inventory sale days (average) +Receivable Collection days (average).

Accounting cycle:

It mainly consists of Recording, Classifying and Summarizing financial transactions over an accounting period.

Accounting cycle may be summarized as follows

1. Journalize Transactions
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8. Prepare an After Closing Trial Balance

Question # 11:

Financial Challenge in the Managing a company operating cycle.

The operating cycle for a company is the time period between the acquisition of goods and the final cash realization resulting from sales and subsequent collections. In order to in increase the performance company should have short operating cycle. The common characteristic of receivables is that the company expects to receive cash some time in the future. This causes two valuation problems. First, a period of time must pass before the receivable can be collected, so the entity incurs costs for the use of these funds. Second collection may not be made.

Question # 12:

Why P/E Ration generally higher during low inflation.

The P/E gives you an idea of what the market is willing to pay for the company's earnings. The higher the P/E the more the market is willing to pay for the company's earnings. Some investors read a high P/E as an overpriced stock and that may be the case, however it can also indicate the market has high hopes for this stock's future and has bid up the price.

Question # 13:

Short Term liquidity of Companies.

It is a measure that indicates that company has as much cash or cash equivalents that company can fulfill current liabilities.

Question # 14:

Find out Cash Flow from Operating Activities using Indirect Method.

Cash flow from operating activities is generally derived from the principal revenue producing activities of the business. Cash Flow from Operating Activities is the indicator of success or failure of a business's operations. If the cash flow from operations is continuously negative, this means that the business revenue is not enough to recover the costs that are incurred to earn it. Therefore, in the long run Cash flow from operations must be positive.

Examples of cash flows from operating activities are:

• Cash receipt from sale of goods and rendering of services.

• Cash receipts from fees, commission and other revenues.

• Cash payments to suppliers for goods and services.

• Cash payments to and on behalf of the employees.

• Cash payments or refunds of income taxes.

Question # 15:
Explain these ratios?
1. Cash ratio
2. Quick ratio
3. Current ratio 5

Cash ratio indicates the immediate liquidity of the firm. A high cash ratio indicates that the firm is not using its cash to its best advantages; cash should be put to work in the operations of the company.
Cash Ratio = Cash + Cash Equivalents + Marketable Securities/ Current Liabilities

Quick ratio measures "immediate liquidity" Only cash, marketable securities and Receivables (called Quick Assets) are considered. Inventories and pre-paid expenses are excluded from current assets.

Current ratio measures "general liquidity". Higher the current Ratio, the greater the ability of the firm to pay its bills; however, the ratio must be regarded as a crude measure because it does not take into account the liquidity of the individual components of the current assets composed principally of cash and non-overdue receivables is generally regarded as more liquid than a firm whose current assets consist primarily of inventories.
Current Ratio = (Current Assets) / (Current Liabilities).

Question# 16: (5marks)

	Year 1	Year2
Avg account receivable	400000	416000
Credit sales	260000	310000

Net 30 days

Inventory receivable turnover ratio =????

SOLUTION:

Year 1:

Inventory receivable turnover ratio = Net Credit sales/ Avg account receivable

= 260000/400000 = 0.65

Year 2:

Inventory receivable turnover ratio = Net Credit sales/ Avg account receivable

= 310000/416000 = 0.75

Question # 17:

Debt is not always a bad thing. Explain 3

Debt is not always a bad thing because when company is growing and at the road of progress then owners does not want to enter new share holder to divide their profit and they prefer to borrow than equity.

Question # 18:

How horizontal analysis minimizes the problems of vertical analysis? 3

Horizontal analysis is used to evaluate the trend in the accounts over the years, while vertical analysis, also called a Common Size Financial Statement discloses the internal structure of the firm. It indicates the existing relationship between sales and each income statement account. When an analyst compares financial information for two or more years for a single company, the process is referred to as horizontal analysis, since the analyst is reading across the page to compare any single line item, such as sales revenues.

Question # 19:

List down the component of stockholders equity 3

Capital

Retain earning

Preferred Stock

Common Stock

Question # 20:

What is earning per share?

Earning per share = Net profit available for equity shareholders/Number of equity shares

Question # 21:

Using the following information, compute the dividend yield to the nearest tenth.

Income Rs. 130,000

Beginning shares outstanding 250,000

Ending shares outstanding 270,000

Current price per share Rs. 7.50

Dividend per share Rs. 1.20

Dividend yield = dividend per share / market price per share

= 1.20 / 7.50

= 0.16

Question # 22:

In one subjective question 3 different scenarios was given. Teacher asked to comment on the scenarios according to GAAP.

These are ‘Ground rules’ i.e. Principles for preparing financial statements. These are constantly evolving. These embody accounting concepts, measurement techniques and standards of presentation of financial statements. These Accounting Principles enable comparability between various enterprises and of the operational performance of the same enterprise over many years. These give reliability to Financial Statements.

Following are some of the Generally Accepted Accounting Principles:

i) Entity principle: specific business entity separate from personal affairs of the owner(s).

ii) Cost principle: valuation and recording of assets at cost.

iii) Going-concern assumption: connected with cost principle, assets acquired for use and not for resale.

IV) Objectivity principle: definite, factual basis for assets valuation; measuring transactions objectively.

v) Stable currency principle. The currency remains more or less stable and rate of inflation is almost zero.

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