

6.5: End of Chapter Exercises

Questions

1. What is liquidity as applied to financial information?
2. Why would a company share part of their revenue with a bank when a customer pays with a credit card?
3. How are credit card sales and credit sales different?
4. Who loans money to the customer when they pay with a credit card?
5. What do companies do to reduce the risk that customers will not pay them for purchases made on credit?
6. What is an allowance for uncollectible accounts?
7. Current assets are compared to what in the current ratio?
8. What is the difference between the current ratio and the quick ratio?
9. How would an increase in quick assets that does not affect current liabilities change the quick ratio?
10. How would you determine the change in current ratio if a transaction decreases current assets and current liabilities by the same amount?
11. What label is used on accounts receivable turnover?
12. What number is divided by accounts receivable turnover to get days sales in receivable?
13. What is the formula to calculate inventory turnover?
14. How is the average inventory calculated?
15. What is the difference between gross profit and net profit?
16. Net profit margin compares net income before taxes with what other financial statement element?
17. Improving return on investment/assets can be done by increasing net profit before taxes or reducing what?
18. Is there such thing as too high a net profit margin?

True/False

1. ____ Cash is the most important and most valuable asset for a company.
2. ____ A company with accounts receivable has a risk that they will not get paid.
3. ____ The estimate of how much accounts receivable will not get paid affects retained earnings.
4. ____ A reconciliation should be completed by the same person who originally recorded the transactions being reconciled.
5. ____ Borrowing more cash is a long term solution for a company needing cash to pay employees.
6. ____ The term Accounts Receivable, Net means that the allowance for uncollectible accounts has been subtracted.
7. ____ A purchase of prepaid insurance policy with cash will have no effect on the quick ratio.
8. ____ The sale of inventory to a customer for more than the cost will increase the current ratio.
9. ____ A company can never be too liquid.
10. ____ The quick ratio is always higher than the current ratio.
11. ____ To calculate average accounts receivable for 2023, the Accounts Receivable amounts for 2022 and for 2023 are used.
12. ____ When inventory turnover goes up, days sales in inventory goes down.
13. ____ The longer it takes to sell inventory the better for a company.
14. ____ One number used for calculating the net profit margin is the same as for calculating return on investment/assets.
15. ____ Gross profit will always be higher than net profit before taxes.
16. ____ Cost of goods sold is not used in the calculation of any of the profitability ratios.
17. ____ Profitability ratios are never shown as percentages.

Multiple Choice

1. Cash is essential for a business to meet its obligations but it is not very valuable to the business because of the following:
 - A. Cash is extremely liquid and easily transferred to others.
 - B. Cash does not generate very good returns for shareholders.
 - C. Cash is not liquid and thus could generate losses when it is used in exchange.
 - D. Cash is mostly electronic in form and thus is never where you need it.
2. What internal controls might a company put in place to help speed up the collection of accounts receivable?

- A. Check prices and shipping information to make sure that customers are billed only for what they received at the agreed upon price.
- B. Check the credit history of new customers to see what their track record is for paying their bills.
- C. Send reminders to customers about the due dates of their accounts receivable.
- D. All of the above could be effective internal controls to help speed up collections.

3. The RST Company reports on their balance sheet Accounts Receivable of \$466 million net of an allowance of \$23 million. What percentage of the total amount owed by customers does RST estimate they will not collect?

- A. 4.9%
- B. 4.7%
- C. 4.3%
- D. 5.2%

4. The RST Company reports on their balance sheet Accounts Receivable of \$466 million net of an allowance of \$23 million. If an analysis of the entire list of customers included in accounts receivable showed that the allowance for uncollectible accounts should be 7% of the total owed by customers, the RST would need to do which of the following on the accounting equation?

- A. Decrease revenues.
- B. Increase current liabilities
- C. Increase expenses
- D. Increase current assets

5. Which of the following would not be included when calculating the quick ratio but would be when calculating the current ratio?

- A. Cash
- B. Current Liabilities
- C. Marketable Securities
- D. Inventory

6. Which of the following transactions would always result in a decrease in the current ratio?

- A. Borrowing money from the bank to be paid off in 10 years and using that money to pay accounts payable this month.
- B. Selling inventory for \$100 that cost the company \$70.
- C. Recording a utility bill for costs this accounting period that will be paid next accounting period.
- D. Collection of cash from customers that had owed us accounts receivable from sales last accounting period.

7. Which of the following could be a good reason why inventory turnover could be too high?

- A. Inventory that is too low could indicate shortages and the inability to satisfy customers.
- B. Companies do not want to move around the inventory in their warehouses too many times.
- C. Inventory that sits too long may need to be sold at a discount to customers.
- D. Obsolete inventory can take place when inventory is held in warehouses for too long.

8. The average days in receivables for ABC, Inc. went from 64 in 2022 to 59 in 2023. Which of the following would be a valid explanation for this change?

- A. Inventory is selling more quickly for ABC.
- B. Accounts receivable turnover increased between 2022 and 2023.
- C. ABC, Inc. became less liquid in 2023 than they were in 2022.

D. ABC should look at how to be more efficient in their collections of A/R so they can turn this around in 2024.

9. When considering how efficient a company is at using their assets to generate revenues and profits, the best measure is:

- A. Gross profit margin ratio
- B. Quick ratio
- C. Return on investment/assets
- D. Net profit margin ratio

10. Gross profit margin and net profit margin both use amounts reported only on which financial statement?

- A. Income statement
- B. Balance sheet
- C. Statement of equity
- D. Cash flows statement

Problems

1. If Puddle Incorporated had total Accounts Receivable at the end of 2022 of \$603 million and an allowance for uncollectible accounts of \$18 million **show the effect of the following in the accounting equation worksheet** for 2023:

- Sales on credit of \$4,323 million during the year
- Collection of accounts receivable of \$4,160 million during the year
- Write off of uncollectible accounts of \$14 million during the year
- An increase in the allowance for uncollectible accounts to 3% of total accounts receivable from customers

Required:

- a. Calculate how much customers actually owe to Puddle at the end of 2023.
 - b. Calculate how much is estimated will not be collected by Puddle at the end of 2023.
 - c. State how much expenses increased due to the estimate of uncollectible accounts.
 - d. How much would Puddle show as the amount they actually plan to collect (Accounts Receivable, Net)
2. If ZZBest Corp. has current assets of \$24 million and current liabilities of \$14 million what is the impact on the current ratio of the following transactions? Each situation is independent.
- a. Purchase of inventory costing \$3 million on credit.
 - b. Sell inventory costing \$2.5 million for a sales price of \$4.5 million on credit.
 - c. Borrowing \$11 million in cash from bank that will be repaid in 5 years.
 - d. Pay cash for a prepaid insurance policy costing \$1 million and covering one year.
 - e. Pay cash for rent expense of \$3 million.

Required: For each transaction indicate whether the current ratio went up or down or stayed the same and why (i.e. change in current assets, liabilities, etc.)

3. The following information was reported for Pepsi for 2022 – Sales \$86.3 billion and Accounts Receivable of \$10.2 billion – for 2021 Accounts Receivable was \$8.7 billion. For Coca Cola for 2022 – Sales \$43 billion and Accounts Receivable of \$3.5 billion – for 2021 Accounts Receivable was \$3.5 billion. With this information calculate the accounts receivable turnover and days sales in receivables for 2022 for both of these competitors.

Required:

- a. Based on your calculations, which company is doing a more efficient job of collecting from customers. Explain.
- b. Based on your answers which company is the most liquid? Why?
- c. How much would Pepsi have to increase sales while keeping accounts receivable the same to get days sales in receivable to be 30 days?

4. For Coca Cola, 2022 COGS was \$18 billion and 2021 COGS was \$15.4 billion. Their inventory at the end of 2022 was \$4.2 billion and at the end of 2021 it was \$3.4 billion and at the end of 2020 it was \$3.1 billion. With this information calculate the inventory turnover and days in inventory for 2022 and 2021.

Required:

- Based on your calculations, in which year did Coca Cola do a more efficient job of selling inventory? Explain.
 - Based on your answers did liquidity for Coca Cola get higher or lower? Explain.
 - How much would Coca Cola have had to reduce their inventory at the end of 2022 to increase the number for inventory turnover to 5 times a year?
5. During 2020, Twitter, Inc. (NYSE: [TWTR](#)) will be issuing (approximately) \$600 million of unsecured notes that will be due in 2027. Assume that on the day immediately before the note issuance, Twitter has current assets of \$4,500 million and current liabilities of \$2,370 million.

Required:

- Will the notes be classified as assets or liabilities on Twitter's balance sheet? Will these notes be Notes Receivable or Notes Payable?
 - When Twitter issues these notes in 2020, will the notes be classified as current or long-term??
 - On the day that these notes are issued, will Twitter's current ratio be impacted? If so, will it increase or decrease?
 - Assuming no change in net income before taxes, what would the impact be on return on investment/assets? Would it increase or decrease?
6. For fiscal year ending September, 2021, Apple, Inc. had a gross profit margin ratio of 39.3%, a net profit margin ratio of 27.4% and return on investment/assets of 20.7% and the total assets as of the end of the year was \$ 351 billion. For the year ending September 2022, Apple reported the following amounts:

Sales \$394 billion

Cost of Sales \$224 billion

Expenses not including taxes \$51 billion

Total Assets at the end of the year \$353 billion

Required:

- Calculate the three profitability ratios for Apple for year ending September 2022.
- Using those ratios describe the change in profitability for Apple between 2021 and 2022.
- Indicate how each of the profitability ratios calculated in 2 will be affected by the following independent transactions/changes if they happened during fiscal 2022:

Independent transaction or change in 2022		Gross Profit Margin Ratio	Net Profit Margin Ratio	Return on Investment/Assets
Apple pays \$10 billion in cash for an enormous new manufacturing facility in the United States to avoid tariffs on imported phones	Indicate in the box to the right whether the ratio increases or decreases or stays the same because of the change or transaction			
Costs for Apple's phones stays the same as in 2021 but Apple is forced to reduce the selling price of phones by 10% in 2022 because of competition				
Apple cuts its research and development expense by 20% but that does not change its sales or any of their other costs to make their products.				

Research/Discussion

Group Research

Identify the financial statements for a publicly traded company. The group will probably need the most recent year and the previous year annual report. Each member of the group choose one of the following ratios and calculate them for the most recent year and the year previous. Write a paragraph that indicates what the comparison shows about the liquidity, efficiency or profitability of company:

Current ratio and quick ratio

Accounts Receivable Turnover and Days Sales in Receivables

Inventory Turnover and Days in Inventory

Gross Profit Margin Percent, Net Profit Ratio and Return on Investment/Assets

Bankruptcy Research

Since J. Crew has filed for bankruptcy in May, 2020, find their financial statements at [J Crew Quarterly Financial Statements](#)

Using this last quarterly financial statement filing calculate the following:

Quick Ratio and Current Ratio as of November 2, 2019

Gross Profit Margin Ratio and Net Profit Margin ratio for 13 weeks ending November 2, 2019

Do these calculations indicate that J. Crew was having problems prior to the pandemic that forced them to close stores across the country in early 2020? Why would you think J. Crew would want to go to court to get protection from their creditors in 2020? What do you think needs to happen if J. Crew is going to continue to operate?

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