

Extra Credit Questions for Exam I

1. (15 Points) The following accounts are taken from the adjusted trial balance of the Knox Company at December 31, 20x8:

Sales	\$240,000
Sales returns	1,000
Sales salaries expense	14,000
General and administrative expenses	15,000
Selling expenses	8,000
Purchases	160,000
Purchases returns and allowances	2,000
Freight-In	10,000
Inventory—01/01/x8	80,000
Retained earnings—01/01/x8	50,000

In addition, the following information is available:

1. In December, an accountant for the company discovered that depreciation in the amount of \$5,000 (pretax) on a major piece of equipment had not been recorded in 20x7. The amount is considered material.
2. The inventory on December 31, 20x8 was \$75,000.
3. Ten thousand shares of common stock were outstanding during the entire year. Knox paid dividends of \$0.65 per share.
4. On October 1, Knox decided to discontinue its unprofitable restaurant segment. This segment comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the company. The disposition process was completed on November 2, 20x8. From January 1, 20x8 to Nov. 2, 20x8, the segment had incurred an operating loss (pre tax) of \$14,000. The segment was sold for \$500,000 and the book value of this segment was \$400,000.
5. In November, a material loss of \$3,000 occurred resulting from an earthquake, which is an infrequent event for the geographic location in which the business operates.
6. The restructuring costs in connection with plan closing and employee relocation amounted to \$10,000. These restructuring costs were not related to the disposition of the restaurant segment.
7. During the year, Knox changed the inventory costing method from FIFO to average method. This change resulted in a cumulative effect of \$10,000 (pre-tax) (increasing the cost of goods sold). The company adopted the **retrospective** approach for this change.
8. The applicable tax rate is 40%.

**Required:** Prepare an income statement for the year ended 12/31/20x8 for Knox Company using a multiple-step format for the continuing operation section.

2. (5 points) Define earnings quality and the merits of reporting earnings information in different sections of the income statement.
  
3. (5 points) List two popular earnings management devices and provide two examples of companies which used these devices to manage earnings.