1. Answer: A – When Martinez borrows the money, it will record an increase in cash (assets) and an increase in notes payable (liabilities) for the $5,000 borrowed. Borrowing cash is an inflow for financing activities.

2. Answer: C – At the end of 2015, Martinez will accrue 10 months of interest: $5,000 x 6% x 10/12 = $250. Martinez will record an increase in interest payable (liabilities) and interest expense, which will decrease equity. There is no impact on the statement of cash flows until the interest is paid in 2016.

3. Answer: B – Fullerton will record 7 months of interest expense in 2015: $10,000 x 9% x 7/12 = $525. Fullerton will record 11 months of interest expense on the eighteen-month note in 2016: $10,000 x 9% x 11/12 = $825. All of the interest is paid in 2016.

4. Answer: A – Paying the principle balance on a note payable decreases assets (cash) and liabilities (notes payable), and is reported as a cash outflow for financing activities on the statement of cash flows. Payment of interest is a cash outflow for operating, not financing, activities.

5. Answer: C – Washington Company will pay all of the interest due on the note when the note matures in 2016. The interest paid is $720 ($12,000 x 6%), and is reported as a cash outflow for operating activities on the statement of cash flows.

6. Answer: D – At the time of the sale, Yetzer would record revenue of $1,000, accounts receivable of $1,050 (because the customer owes the entire amount, including sales tax), and a liability of $50 (sales tax payable).

7. Answer: C – When a company pays sales tax due, liabilities (sales tax payable) decrease and assets (cash) decrease.

8. Answer: D – If a contingent liability is considered probable, and the amount of the liability can be reasonably estimated, it must record a liability on the balance sheet and report an expense related to the liability on the income statement. Contingent liabilities that are considered possible, but not probable and/or cannot be reasonably estimated are disclosed in the footnotes.

9. Answer: B – Susceptibility to natural disaster, such as flood, is not a basis for any type of contingent liability. Instead, contingent liabilities must be connected to some actual past event, such as a lawsuit.

10. Answer: A – Warranty expense for 2015 is equal to 2% of 2015 sales ($250,000 x 2% = $5,000). The $2,800 payment for warranty claims in 2015 would be recorded as a reduction to the warranties payable liability and a reduction to cash. The ending balance in warranties payable would be $6,200 ($4,000 beginning balance - $2,800 paid claims + $5,000 additional warranty expense).