

UNIVERSITY OF TORONTO  
JOSEPH L. ROTMAN SCHOOL OF MANAGEMENT

MGT220F - FINANCIAL ACCOUNTING II  
TERM TEST  
TUESDAY, OCTOBER 26, 1999

Duration: 2 hours

Aid Allowed: Non-programmable calculator. Programmable calculators will be reset.

INSTRUCTIONS:

Part 1. Multiple choice questions. Answers to multiple choice questions are to be recorded on the mark sense sheet IN PENCIL.

Parts 2 and 3. Write your answers in the space provided on the test paper. This part of the test should be written in ink. Only papers written in ink, and not using white-out, will be considered for remarking. Papers must be submitted before leaving class on the day that they are returned to be considered for remarking. Papers will be remarked in total. The mark may go up, go down, or remain the same.

*Problem.* Show and label all calculations to obtain maximum marks.

*Mini-case.* Your recommendation(s) must be in keeping with GAAP.

TABLES ATTACHED

MARKS

1. \_\_\_\_\_

2. \_\_\_\_\_

3. \_\_\_\_\_

TOTAL \_\_\_\_\_

NAME \_\_\_\_\_

STUDENT NUMBER \_\_\_\_\_

**PART I. (24 marks)**

**Choose the BEST answer for each of the following independent questions.**

1. The two primary qualities that make accounting information useful for decision making are
  - a. comparability and consistency
  - b. materiality and timeliness
  - c. relevance and reliability
  - d. reliability and comparability
  - e. none of the above
2. Accounting information is considered to be relevant when it
  - a. can be depended on to represent the economic conditions and events that it is intended to represent
  - b. is capable of making a difference in a decision
  - c. is understandable by reasonably informed users of accounting information
  - d. is verifiable and neutral
  - e. none of the above
3. Information is neutral if it
  - a. provides benefits which are at least equal to the costs of its preparation
  - b. can be compared with similar information about an enterprise at other points in time
  - c. would have no impact on a decision maker
  - d. is free from bias that would lead users to make decisions influenced by the way it is measured or presented.
  - e. None of the above
4. Which of the following is an implication of the going concern assumption?
  - a. the historical cost principle is credible
  - b. Amortization policies are justifiable and appropriate
  - c. The current-noncurrent classification of assets and liabilities is justifiable and significant
  - d. All of the above
  - e. None of the above
5. Which of the following, in the most precise sense, means the process of converting noncash resources and rights into money?
  - a. recognition
  - b. measurement

- c. realization
  - d. allocation
  - e. none of the above
6. The process of recording an item in the journal of an entity is
- a. recognition
  - b. realization
  - c. allocation
  - d. matching
  - e. none of the above
7. Net income
- a. excludes certain gains and losses that result from incidental events
  - b. includes gains and losses from peripheral transactions
  - c. excludes extraordinary gains and losses
  - d. includes distributions of equity
  - e. none of the above
8. The occurrence which most likely would have no effect on 1999 net income (assuming that all amounts involved are material) is the
- a. sale in 1999 of an office building contributed by a shareholder in 1980
  - b. collection in 1999 of a receivable from a customer whose account was written off in 1996 by debiting the allowance account
  - c. correction of an error in 1999 of an undervaluation of inventory in 1998
  - d. worthlessness determined in 1999 of inventory purchased in 1997
  - e. none of the above
9. How should an unusual event not meeting the criteria for an extraordinary item be disclosed in the financial statements?
- a. shown as a separate item in operating revenues or expenses if material and supplemented by a note if deemed appropriate
  - b. shown in operating revenues or expenses if material but not shown as a separate item
  - c. shown net of income tax after ordinary net earnings but before extraordinary items
  - d. shown net of income tax after extraordinary items but before net earnings
  - e. none of the above
10. Which of the following is a required disclosure in the income statement when reporting a change in accounting policy?
- a. a per-share amount for the cumulative effect of the change

- b. the cumulative effect on prior years net of tax
  - c. the cumulative effect should be disclosed immediately after extraordinary items
  - d. none of the above
  - e. all of the above
11. Income taxes are allocated to
- a. cumulative effect of a change in accounting policy
  - b. extraordinary items
  - c. correction of errors
  - d. all of the above
  - e. none of the above
12. Marketable securities held to finance future construction of additional plants should be classified on a balance sheet as
- a. current assets
  - b. property, plant, and equipment (capital assets)
  - c. long-term liabilities
  - d. long-term investments
  - e. none of the above
13. Working capital is
- a. capital which has been reinvested in the business
  - b. unappropriated retained earnings
  - c. cash and receivables less current liabilities
  - d. all of the above
  - e. none of the above
14. When the current ratio is greater than 1:1, a payment of an account payable has what effect on working capital and the current ratio?
- |    | <u>Working Capital</u> | <u>Current Ratio</u> |
|----|------------------------|----------------------|
| a. | no effect              | increase             |
| b. | no effect              | no effect            |
| c. | increase               | decrease             |
| d. | decrease               | decrease             |
| e. | none of the above      |                      |
15. With respect to the computation of earnings per share, which of the following would be most indicative of a simple capital structure?
- a. common shares, preferred shares, and convertible bonds

- b. earnings derived from one primary line of business
  - c. common shares
  - d. common shares, and preferred shares with rights attached
  - e. none of the above
16. In computations of weighted-average number of shares outstanding, when a stock dividend or stock split occurs, the additional shares are
- a. weighted by the number of days outstanding
  - b. weighted by the number of months outstanding
  - c. considered outstanding at the beginning of the year
  - d. are not included in the computation of weighted-average shares outstanding
  - e. none of the above
17. Convertible securities are not considered in computing fully dilutive earnings per share if the
- a. convertible securities were issued in the latter half of the year
  - b. convertible securities were issued at a premium
  - c. inclusion increases the loss per share
  - d. both b. and c. above
  - e. none of the above
18. Throughout 1999, King Corp. had 1,000 common shares outstanding. King's 1999 net income was \$4,000. King also had \$10,000, 8% bonds outstanding which were convertible into 1,000 shares of common stock. No bonds were converted during 1999. King's income tax rate is 30%.
- King's fully diluted earnings per share for 1999 would be (rounded to the nearest penny)
- a. \$2.00
  - b. \$2.28
  - c. \$2.40
  - d. \$4.56
  - e. none of the above
19. At December 31, 1998 Newman Enterprises had 500,000 common shares outstanding. On October 1, 1999, an additional 100,000 common shares were issued. In addition, Newman Enterprises had \$10 million of 8% convertible bonds outstanding at December 31, 1998 which are convertible into 225,000 common shares. No bonds were converted during 1999. The net income for the year ended December 31, 1999 was \$4 million. Assuming the income tax rate is 30%, the fully diluted earnings per share should be (rounded to the nearest penny)
- a. \$8.69

- b. \$6.40
- c. \$6.08
- d. \$5.33
- e. none of the above

**THE FOLLOWING INFORMATION RELATES TO QUESTIONS 20 AND 21.**

Chancellor Industries had 200,000 common shares, 20,000 convertible preferred shares, and \$1 million of 10% convertible bonds outstanding during 1999. The preferred shares are convertible into 40,000 common shares. During 1999, Chancellor Industries paid dividends of \$1.20 per share on the common shares and \$4.00 per share on the preferred shares. Each \$1,000 bond is convertible into 45 common shares. The net income for 1999 was \$800,000 and the income tax rate is 30%.

20. Basic earnings per share for 1999 is (rounded to the nearest penny)

- a. \$3.60
- b. \$3.67
- c. \$4.00
- d. \$4.40
- e. none of the above

21. Fully diluted earnings per share for 1999 is (rounded to the nearest penny)

- a. \$2.77
- b. \$2.81
- c. \$3.05
- d. \$3.33
- e. none of the above

22. Spectra Fashions had 300,000 common shares outstanding, and 200,000 preferred shares at December 31, 1998. During 1999 Spectra Fashions paid \$75,000 cash dividends on the common shares and \$60,000 on the preferred shares. Net income for the year was \$330,000. What should be Spectra Fashion's earnings per share (rounded to the nearest penny)?

- a. \$1.10
- b. \$0.90
- c. \$0.85
- d. \$0.65
- e. none of the above

23. Which set of ratios best helps a company to evaluate its ability to meet its current debts?

- a. current ratio, earnings per share, and quick (acid-test) ratio

- b. current ratio, and quick (acid-test) ratio
  - c. receivables turnover and inventory
  - d. return on investment, earnings per share and receivables turnover
  - e. none of the above
24. Jabot Cosmetics has a current ratio of 3:1. The ratio will decrease if the company
- a. borrows cash on a three-month note
  - b. pays off an accounts payable which was classified as a current liability
  - c. sells merchandise held for sale at more than its cost
  - d. all of the above
  - e. none of the above
25. The ratio of total cash, trade receivables, and marketable securities to current liabilities is
- a. the current ratio
  - b. the quick (acid-test) ratio
  - c. significant only if the result is 2:1 or better
  - d. a measure of efficiency
  - e. none of the above
26. The average number of days to collect accounts receivable can be calculated by
- a. dividing 365 days by the receivables turnover
  - b. dividing 365 days by average receivables (net)
  - c. dividing average receivables (net) by credit sales
  - d. multiplying 365 days times the receivable turnover
  - e. none of the above
27. Which of the following is an appropriate computation for return on investment (ROI)?
- a. total assets divided by net income
  - b. sales divided by total assets
  - c. revenues divided by capital assets
  - d. net income divided by shareholders' equity
  - e. none of the above
28. Which of the following measures long-term solvency?
- a. Inventory turnover
  - b. Age of receivables
  - c. Long-term debt to equity
  - d. Current ratio
  - e. None of the above

29. Common-size

- a. Analysis is a percentage, or vertical, analysis
- b. Statements may be used to compare statements from different years to detect trends
- c. Statements may be useful in identifying problem areas
- d. All of the above
- e. None of the above

30. Information from DeLuxe Spa's balance sheet is as follows:

Current assets:

|                       |                  |
|-----------------------|------------------|
| Cash                  | \$15,000         |
| Marketable securities | 15,000           |
| Accounts receivable   | 40,000           |
| Inventories           | 47,000           |
| Prepaid expenses      | <u>3,000</u>     |
| Total current assets  | <u>\$120,000</u> |

Current liabilities:

|                                   |                 |
|-----------------------------------|-----------------|
| Notes payable                     | \$ 2,000        |
| Accounts payable                  | 18,000          |
| Accrued expenses payable          | 10,000          |
| Income taxes payable              | 4,000           |
| Current portion of long-term debt | <u>6,000</u>    |
| Total current liabilities         | <u>\$40,000</u> |

What is the quick (acid-test) ratio?

- a. 0.75:1
- b. 1.75:1
- c. 2.96:1
- d. 3.00:1
- e. none of the above



**PART B. (10 marks)**

Forrester Creations has decided to surface and maintain for ten years a vacant lot next to one of its retail outlets to serve as a parking lot for customers. Management is considering the following bids involving two different qualities of surfacing for a parking area of 12,000 square metres:

**Bid A.** A surface that costs \$8.25 per square metre. This surface will have to be replaced at the end of five years. The annual maintenance cost on this surface is estimated at 15 cents per square metre for each year except the last of its service. The replacement surface will be the same as the initial surface.

**Bid B.** A surface that costs \$12.50 per square metre. This surface has a probable useful life of 10 years and will require annual maintenance in each year except the last year, at an estimated cost of 5 cents per square metre.

**Required:** Prepare computations showing which bid should be accepted by Forrester Creations. Assume an interest rate of 9%. Annual maintenance expenditures are incurred at the end of each year. Prices are not expected to change during the next 10 years.





**PART C. (10 marks)**

While you and your friend were having lunch at Gina's, you overheard the following conversation between Jack Abbot and Grace Turner of Jabot Cosmetics:

Jack: "My instructions were to amortize the plant building over 35 years. I don't care if the board of directors' survey indicates that 20 years is more realistic! You'd think they didn't know that the bank had requested a set of audited financial statements for our first six months. If they [bank] don't like what they see, they won't grant the loan we applied for.

"Speaking of the board of directors – some of those jokers want to declare a 5% stock dividend. We're only half way through the year, and I don't think it's going to be a very profitable one."

Grace: "Calm down Jack. This is how I see it. This is your first year in business. As you said, you don't think there will be a very large profit this year. Is this so unusual in a company's first year? – I don't think so. In fact I think you should take advantage of this. No one expects this to be a banner year, so get all the big stuff out of the way now. For example, if I were you I would agree to the 20 year amortization period for the plant. And, I would also recommend an accelerated method such as double-declining balance. That gives you an opportunity to 'create' a trend, so to speak. You have to be more strategic in your policy decisions!"

Jack: "I like the way you think Grace."

Grace: "Well, didn't I tell you that you wouldn't regret hiring me!"

The next Monday, your firm sent you to audit Jabot Cosmetics.

During discussions with Jabot's lawyer you discovered that Brash & Sassy Limited is suing Jabot for patent infringement. Counsel for Jabot estimates that the amount of the loss will be \$2,200,000; furthermore, she claims that Jabot probably will lose this case.

The lawyer also told you that the employees' union is going to renegotiate its contract. Due to the general increase in labour disputes and strikes both inside and outside the industry, the possibility that a costly strike will occur is becoming increasingly more likely.

**Required: Assume the role of auditor and address the issues in the case.**



END OF TEST