UNIVERSITY OF TORONTO
JOSEPH L. ROTMAN SCHOOL OF MANAGEMENT

MGT220F – FINANCIAL ACCOUNTING II
TERM TEST
TUESDAY, NOVEMBER 14, 2000

Duration: 1 ½ hours

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

ANSWERS

MARKS

TABLES ATTACHED

1. ______

2. ______

3. ______

TOTAL ______

NAME ________________________________

STUDENT NUMBER ____________________

PART I. **(20 marks)**

1. Which of the following is a recordable event?

   a. hiring a new company president
   b. a strike by employees
   c. placing an order for new computer equipment
   d. all of the above
   e. none of the above

2. Deposits held as compensating balances

   a. usually do not earn interest
   b. if legally restricted and held against short-term credit may be included as cash
   c. if legally restricted and held against long-term credit may be included among current assets
   d. **may be payment for bank services rendered to the company for which there is** no direct fee
   e. none of the above

3. A change in accounting estimate

   a. is a violation of generally accepted accounting principles
   b. is treated as a prior period adjustment if the change is a material amount
   c. is recorded retroactively
   d. always requires footnote disclosure
   e. none of the above

4. ABC Corporation had the following information for the year ended December 31 1999:

Average day's sales in inventories	160
Average day's sales in receivables	40

   The average number of days in the operating cycle for 1999 was

   a. 40
   b. 120
   c. 160
   d. 200
   e. none of the above

The following information relates to questions 5, 6, 7, and 8.

Reed Industries had 50,000 common shares outstanding and 8,000 preferred shares outstanding on January 1, 1999. One preferred share is convertible into 3 common shares. The company had 10,000, 5%, $100 bonds outstanding for the entire year. The bonds are each convertible into 3 common shares. During 1999 the company paid a total of $30,000 in dividends to common shareholders and $10,000 in dividends to preferred shareholders. On July 1, the company issued 10,000 common shares and on October 1 the company declared a 20% stock dividend. The corporate tax rate is 30% and the company's net income for 1999 was $200,000.

5. In the basic earnings per share calculation for this company, the weighted average number of common shares outstanding for the year is:

a. 58,000
b. 66,000
c. 67,000
d. 72,000
e. none of the above

6. Assume the weighted average common shares is 65,000. Basic earnings per share for 1999 is (rounded to the nearest penny):

a. $2.46
b. $2.62
c. $2.92
d. $3.08
e. none of the above

7. Assume the weighted average common shares (before conversions) is 70,000. Fully diluted earnings per share for 1999 is (rounded to the nearest penny):

a. $1.90
b. $2.02
c. $2.13
d. $2.35
e. none of the above

8. If each preferred share was convertible into 2 common shares (instead of 3), fully diluted earnings per share would be:

a. lower
b. higher
c. remain the same
d. cannot be determined from the information provided
e. none of the above

The following information relates to questions 9, 10 and 11.

ABC Company is in its fifth year of business and reports the following information on its December 31, 1999 financial statements:

Accounts Receivable	$ 100,000
Allowance for Doubtful Accounts	$ 3,500
Sales Revenue	$1,350,000
Bad Debts Expense	$ 5,000

9. ABC Company is using:

a. a balance sheet approach to value bad debts
b. an income statement approach to value bad debts
c. an aging of accounts receivable to value bad debts
d. two of the above statements are correct
e. **we cannot determine from the information provided which method is being** used to value bad debts

10. Assume that ABC has used the balance sheet method to value bad debts. The adjusting journal entry to record bad debts expense for the year:

a. included a $3,500 debit to the allowance for doubtful accounts
b. included a $3,500 credit to the allowance for doubtful accounts
c. included a $5,000 debit to the allowance for doubtful accounts
d. included a $5,000 credit to the allowance for doubtful accounts
e. included a $1,500 debit to bad debts expense

11. Assume that ABC has always used the income statement method to value bad debts. Last year's estimate of the allowance for doubtful accounts (i.e., the estimate made in December 1998) was:

a. smaller than the actual write-offs in 1999 by $1500
b. larger than the actual write-offs in 1999 by $1500
c. equal to the actual write-offs in 1999
d. smaller than the actual write-offs in 1999 by $3,500
e. larger than the actual write-offs in 1999 by $3,500

12. Adjusting entries are necessary:

a. to obtain a proper matching of revenue and expense
b. to adjust assets and liabilities to their current value
c. to achieve an accurate statement of assets and equities
d. two of the above are correct
e. a, b, and c are all correct

13. Which of the following relates to both relevance and reliability:

a. verifiability
b. representational faithfulness
c. cost-benefit relationship
d. predictive value
e. none of the above

14. Which of the following would have no effect on 1999 net income (assuming that all amounts involved are material):

a. the sale in 1999 of a new building contributed by a shareholder in 1990
b. a strike in 1999 which resulted in the complete shut-down of operations for 6 months
c. **collection in 1999 of a receivable from a customer whose account was** written off in 1997 by debiting the allowance account
d. dividends received on shares held as marketable securities
e. two or more of the above items would not affect 1999 net income

15. An empty warehouse which is not currently being used and which management does not intend to use or sell in the foreseeable future should most accurately be classified as part of:

a. Short-term investments
b. Long-term investments
c. Capital assets
d. Inventory
e. The warehouse should not be valued on the balance sheet, but its existence should be disclosed in a footnote

16. A company is said to have a complex capital structure if:

a. it has more than one class of shares
b. it has issued bonds
c. earnings are derived from more than one primary line of business
d. all of the above
e. none of the above

17. An extraordinary item is one which:

a. **occurs infrequently, is unusual by its nature, and is beyond the control of** management
b. has never happened before to a company and is unlikely to happen again
c. occurs infrequently or is unusual by its nature
d. always results in a reduction in net income
e. none of the above

18. You are the auditor of ABC Company's financial statements for the year ended December 31, 1999. While performing your audit tests in March 2000, you discover that $50,000 worth of inventory on the 1999 draft financial statements is obsolete and the company will not be able to sell it at any price. Which of the following statements is true?

a. the information you have discovered is an example of a loss contingency
b. the information you have discovered is an example of a subsequent event
c. you need to reduce the December 31, 2000 inventory value by $50,000
d. the information you have discovered does not require adjustment of the 1999 financial statements, however, it does require disclosure on the 1999 financial statements
e. the information you have discovered should be reported as an extraordinary item on the December 31, 2000 financial statements

19. Repayment of a demand loan with cash always results in:

- **a. a reduction in a company's debt/equity ratio**
- b. an increase in the current ratio
- c. a decrease in the current ratio
- d. a higher gross margin
- e. two of the above are correct

20. Which of the following is true about contingencies?

- **a. gain contingencies are never accrued, but sometimes disclosed**
- b. loss contingencies are never accrued, but sometimes disclosed
- c. gain contingencies can be accrued if the likelihood of occurance is very high
- d. loss contingencies must always be accrued
- e. gain contingencies and loss contingencies must always be accrued

PART 2. (10 MARKS)

Required: For each of the INDEPENDENT situations below:

1. Prepare the entry to record the transaction

2. Prepare a schedule showing interest revenue earned each year under the effective interest method.

On November 1, 2000, ABC Company accepted notes for the following independent transactions. ABC Company's year-end is October 31.

A. An employee requested a loan. The company accepted a three-year, noninterest-bearing note for $10,000 and gave the employee a cheque for $7,118.

Journal Entry:

Notes receivable	10,000		)
Discount		2,882	) 2 marks
Cash		7,118	)

Determining Interest Rate:
10,000/7118 = 1.404889

=12% 1 mark

OR

7118/10,000 = .7118

=12%

Year	Calculation (rate = their rate)	Interest	Bal. Discount	Bal. Note
0	(1) (1)		2,882	7,118
1	7,118 x rate	854	2,026	7,972
2	7,972 x rate	957	1069	8,929
3	9,043 x rate	1,071	0*	10,000*

*rounding

Total marks = 5

B. They accepted a three-year, $8,000, 6% note (interest payable annually) in exchange for a piece of land that had cost $2,000. The land's fair market value was not objectively determinable; the market rate of interest for notes of similar risk was 10%.

PV of note:

Principal	8,000 x (n=3; I=10%) .75132 =	6,010.56	1 mark
Interest	480 x (n=3; I=10%) 2.48685 =	1,193.69	1 mark
PV		7,204.25	
Discount (8,000 – 7,204.25)		795.75	

Journal entry:

Notes receivable	8,000		1 mark
Discount on N/R		796 (their no.)	1 mark
Land		2,000	1 mark
Gain on sale of land		5,204 (their no. – 2,000)	1 mark

	Interest Revenue	Cash	Discount	Book value of note
0	(10%) 1 mark	1 mark		1 mark 7,204
1	720	480	240	7,444
2	744	480	264	7,708
3	771	480	291	8,000

Total marks = 9

Total for part 2 = 14 MAX -= 10

PART 3. (10 MARKS)

You went to the office early today to try to catch up with some paper work. You overhead the following conversation between the President and Executive VP.

Pres	"As you know, there's some talk on the street that we may not meet the analysts' expectations. Our share price is down this morning. When will you have the preliminary financial statements?"
VP	"That's what I came to see you about. I have the preliminaries and I'm afraid the news is not good. EPS is $1.27, 3 cents short of expectations. I have reviewed all accounting estimates and methods and have some suggestions. "One of our customers is several months behind with his payments. I called the President and told him he has to sign a note for the entire amount. He agreed. I also asked him for some collateral so that if they default on the note we have some claim to their assets. His receivables and inventories are assigned to the bank, but he has some equipment which is fully paid for. "This means we can reduce our bad debts expense by $150,000 which would increase our EPS to $1.29."
Pres	"Is his equipment worth that much? And how does this affect our receivables?
VP	"No. The equipment is pretty old. We'll be lucky if it's worth $75,000. "As far as our receivables are concerned, once he signs the note the amount is taken out of trade receivables and set up as a note receivable."
Pres	"What else have you got?"
VP	"Our policy has been to depreciate all assets using straight-line. If we change to double declining balance for our computer systems, we will reduce this year's expense by $20,000. This actually is more representative of the usefulness of computer systems. "Have you had any news about the litigation against us? We have accrued a $200,000 loss. Is there any way we can win this case?"
Pres	"Call the lawyer. When I spoke with him last week he was going to call the claimant to discuss settling out of court."
VP	"I wonder if they would accept less. If we could get them down to $145,000, we would have the magic number."

Pres	"I'll call Joe Clements. I just may be able to make this happen."
	"Joe, its me. I want to get this litigation settled. I'm willing to offer $130,000 payable immediately.
	"Well, just tell your board of directors that this could drag on for a few years. And of course, there's no guarantee that you would win. Even if you did win, you wouldn't get the full $200,000.
	"Joe, Joe, Joe, stop with the arguments. I'm serious about this. I know all about the methods you use to manipulate your share price. You don't want the Ontario Securities Commission nosing around, do you?
	"I wouldn't call it blackmail, Joe. I didn't make any threat.
	"So, you don't think you can get away with only $130,000. How much do you think it will take to get past the board? By the way, does your board know how you manage your share price?
	"Hmmm. Too much. We can't go with more than $140,000.
	"Okay. We'll have our lawyer draw up the papers. He'll arrange to meet with you by the end of the week. Have a good day, Joe."
VP	"What's Joe been up to? And why haven't you reported it?
Pres	"Revise the financials and get back to me this afternoon. I want to make certain we have it right. The auditors are coming next week."
Required:	**You are the internal auditor. Analyse the case using proper case format. Consider all legal and ethical issues as well.**

OVERVIEW

Company:)
Public Company)
Rumours that they may not meet analysts' expectations)
) 2 marks
Role:)
Internal Auditor (professional, employee))

Users: (1 mark max. for 2 or more)
Management (aggressive)
Shareholders (conservative, aggressive)
Creditors (conservative)

Constraints:
GAAP – public company (1 mark)

FRO:
Conservative (1 mark)

Issues:

1. Reduced Bad Debts Expense (1 mark)

   (A/R transferred to N/R)
   Collateral – only half the value of the note at best (1 mark)

   GAAP
   - N/R must be reported at fair value (1 mark)
   - Reliability of F/S – fair reporting (1 mark)

   Alternatives
   - do not reduce bad debts expense
   - reduce bad debts expense by $75,000 (because of collateral)
   - reduce bad debts by more than 75,000

   (1 mark each for any two)

   Recommendation: (In keeping with analysis) (1 mark)

2. Change in Policy – Depreciation method (1 mark)

SLN to DDB (1 mark)

GAAP

- method of depreciation should be representative of usefulness of asset
- should not be contradictory to usefulness
  (1 mark)
- change in policy requires retroactive treatment
- restate all comparatives and opening retained earnings
  (1 mark)
- change in policy requires note disclosure
  (1 mark)

Recommendation: In keeping with analysis (1 mark)

3. Contingent Liability (1 mark)

GAAP

- If you are reasonably sure of the amount and reasonably sure you will lose the case, you must accrue
- If you are not reasonably sure of the amount OR that of the outcome, note disclosure is required

(1 mark)

You know the amount, and you reasonably certain they will pay
(1 mark)

Recommendation: Record $140,000 loss/liability
(1 mark)

Legal/Ethical Issue:

Blackmail (1 mark)

EACH MARK = ½ MARK