MGT220HF – INTRODUCTION TO ACCOUNTING II

DECEMBER FINAL EXAMINATIONS

SOLUTIONS

PART A. **CHOOSE THE *BEST* ANSWER FOR EACH OF THE FOLLOWING INDEPENDENT QUESTIONS. (30 MARKS)**

1. The elements of financial statements include investments by owners. These are increases in an entity's net assets resulting from owners'

   a. transfers of assets to the entity
   b. rendering services to the entity
   c. satisfaction of liabilities to the entity
   d. all of the above
   e. none of the above

2. Preparation of consolidated financial statements when a parent-subsidiary relationship exists is an example of the

   a. economic entity assumption
   b. relevance characteristic
   c. comparability charastic
   d. neutrality characteristic
   e. none of the above

3. At December 31, 1998, Excellent Company had 450,000 common shares outstanding. On September 1, 1999, and additional 150,000 common shares were issued. In addition, Excellent had $10 million of 8% convertible bonds outstanding at December 31, 1998 which are convertible into 300,000 common shares. No bonds were converted into common shares in 1999. The net income for the year ended December 31, 1999 was $5 million. Assuming the income tax rate was 30%, what should be the fully diluted earnings per share for the year ended December 31, 1999, rounded to the nearest penny?

   a. $6.25
   b. $10.00
   c. $6.95
   d. $7.25
   e. none of the above

4. Which of the following relates to both relevance and reliability?

   a. Cost—benefit relationship
   b. Predictive value
   c. Verifiability
   d. Representational faithfulness
   e. None of the above

5. Trade-offs between the characteristics that make information useful may be necessary or beneficial. Issuance of interim financial statements is an example of a trade-off between

   a. relevance and reliability
   b. reliability and periodicity
   c. timeliness and materiality
   d. understandability and timeliness
   e. none of the above

6. Which of the following is not an internal event?

   a. Amortization
   b. Using raw materials in the production process
   c. Payment of dividends
   d. All of the above
   e. None of the above

7. Adjusting entries are necessary

   a. to obtain a proper matching of revenue and expense
   b. to achieve an accurate statement of assets and equities
   c. to adjust assets and liabilities to their fair market value
   d. both a. and b. above
   e. none of the above

8. If the inventory account at the end of the year is understated, the effect will be to

   a. overstate the gross profit
   b. overstate the cost of goods sold
   c. overstate the goods available for sale
   d. both a. and c. above
   e. none of the above

9. The Robert Company's account balances at the end of the third quarter for Accounts Receivable and the Allowance for Doubtful Accounts are $640,000 debit and $1,200 credit. Sales during the first nine months of the year were $1,800,000. It is estimated that 1.5% of sales will be uncollectible. The adjusting entry would include a credit to the allowance account for

   a. $28,200
   b. $27,000
   c. $25,800
   d. $9,600
   e. none of the above

10. Stately Corporation made a very large arithmetical error in the preparation of its year-end financial statements by improper placement of a decimal point in the calculation of amortization. The error caused the net income to be reported at almost double the proper amount. Correction of the error when discovered in the following year should be treated as

a. an increase in amortization expense for the year in which the error is discovered
b. a component of income for the year in which the error is discovered, but separately listed on the incomestatement and fully explained in a note to the financial statements
c. an extraordinary item for the year in which the error was made
d. any of the above
e. none of the above

11. A generally accepted method of valuation is

a. inventories at net realizable value
b. accounts receivable at estimated amount collectible
c. inventories at current cost
d. all of the above
e. none of the above

12. At the beginning of 1997, Evans Company received a three-year noninterest bearing $100,000 trade note. The market rate for equivalent notes was 8% at the time. Evans reported this note as a $100,000 trade note receivable on its 1997 year-end statement of financial position and $100,000 as sales revenue for 1997. What effect did this account for the note have on Evans' net earnings for 1997, 1998, 1999, and its retained earnings at the end of 1999, respectively?

a. overstate, overstate, understate, zero
b. overstate, understate, understate, understate
c. overstate, overstate, overstate, overstate
d. overstate, understate, understate, zero
e. none of the above

13. During the year, Kabuki Company made and entry to write off a $3,000 uncollectible acocunt. Before this entry was made, the balance in accounts receivable was $40,000 and the balance in the allowance account was $3,400. The net realizable value of accounts receivable after the write-off was

a. $40,000
b. $39,600
c. 33,600
d. 36,600
e. none of the above

14. During 1998, Dorsey Corporation transferred inventory to Gleem Corporation and agreed to repurchase the merchandise early in 1999. Gleem then used the inventory as collateral to borrow from Norwalk Bank, remitting the proceeds to Dorsey. In 1999 when Dorsey repurchased the inventory, Gleem used the proceeds to repay its bank loan.

    On whose books should the cost of the inventory appear at the December 31, 1998 balance sheet date?

    a. Dorsey Corporation
    b. Gleem Corporation
    c. Norwalk Bank
    d. Gleem Corporation, with Dorsey making appropriate note disclosure
    e. None of the above

15. The use of a Discounts Lost account implies that the recorded cost of a purchased inventory item is its

    a. invoice price
    b. invoice price plus the purchase discount lost
    c. invoice price less the purchase discount taken
    d. invoice price less the purchase discount allowable
    e. none of the above

16. Dancer, Ltd. Is a calendar-year corporation. Its financial statements for the years 1998 and 1997 contained errors as follows:

	1998	1997
Ending inventory	$2,000 overstated	$6,000 overstated
Amortization expense	$1,600 understated	$4,000 overstated

    Assume that no correcting entries were made at December 31, 1997 or December 31, 1998 and that no additional errors occurred in 1999. Ignoring income taxes, by how much will working capital at December 31, 1999 be overstated or understated?

    a. $3,600 overstated
    b. $2,000 overstated
    c. $2,000 understated
    d. $3,600 understated
    e. none of the above

17. On April 15 of the current year, a fire destroyed the entire uninsured inventory of Wilcox Corp. The following data are available:

Sales, January 1 through April 15	\$360,000
Inventory, January 1	50,000
Purchases, January 1 through April 15	280,000
Markup on cost	25%

The amount of the inventory loss is estimated to be

a. \$42,000
b. \$40,000
c. \$45,000
d. \$50,000
e. none of the above

18. On May 1, 1999 Peacock began construction of a building. Expenditures of \$60,000 were incurred monthly for five months beginning on May 1. The building was completed and ready for occupancy on September 1, 1999. For the purpose of determining the amount of interest cost to be capitalized, the average accumulated expenditures on the building during 1999 were

a. \$50,000
b. \$75,000
c. \$240,000
d. \$300,000
e. none of the above

19. During 1998, Blitzen Corporation constructed a building costing \$500,000. The weighted-average accumulated expenditures on these assets during 1998 was \$225,000. To help pay for construction, \$150,000 was borrowed at 10% on January 1, 1998, and funds not needed for construction were temporarily invested in short-term securities, yielding \$4,500 in interest revenue. Other than the construction funds borrowed, the only other debt outstanding during the year was a \$250,000, 10-year, 9^ note payable dated January 1, 1992. What is the amount of interest that should be capitalized by Blitzen during 1998?

a. \$45,000
b. \$11,250
c. \$21,750
d. \$17,250
e. none of the above

20. On September 10, 1998, Wood Co. incurred the following costs for one of its printing presses:

Purchase of stapling attachment	$45,000
Installation of attachment	10,000
Replacement parts for renovation of press	30,000
Labour and overhead in connection with Renovation of press	14,000

Neither the attachment nor the renovation increased the estimated useful life of the press. However, the renovation resulted in significantly increased productivity. What amount of the costs should be capitalized?

a. $0
b. $44,000
c. $55,000
d. $99,000
e. none of the above

21. Stag Corporation purchased a machine on July 1, 1994 for $100,800. The machine was estimated to have a useful life of 10 years with an estimated residual value of $4,800. During 1997, it became apparent that the machine would become uneconomical after December 31, 2001, and that the machine would have no scrap value. Accumulated depreciation on this machine as of December 31, 1996, was $24,000. What should be the charge for amortization in 1997 under generally accepted accounting principles?

a. $14,400
b. $15,360
c. $19,200
d. $24,000
e. none of the above

22. Cummings Co. purchased machinery on January 2, 1992, for $360,000. The straight-line method is used and useful life is estimated to be 10 years, with a $40,000 residual value. At the beginning of 1998, Cummings spent $96,000 to overhaul the machinery. After the overhaul, Cummings estimated that the useful life would be extended 4 years (14 years total), and the residual value would be $30,000. The amortization expense for 1998 should be

a. $24,260
b. $29,250
c. $32,000
d. $33,000
e. none of the above

23. Mint Double, Inc. went to court this year and successfully defended the brand name of its product, “Sweet Gum,” from infringement by a competitor. The cost of this defense should be charged to

a. patents and amortized over the legal life of the patent
b. legal fees and amortized over 5 years or less
c. expenses of the period
d. trademarks and amortized over a period not to exceed 40 years
e. none of the above

24. Which of the following is a method of computing goodwill?

a. capitalize excess earnings
b. discount the excess earnings for a limited number of years
c. capitalize total average earnings and subtract the fair value of net assets
d. all of the above
e. none of the above

25. The owners of Bates Shoe Store are contemplating selling the business to new interests. The cumulative earnings for the past 5 years amounted to $750,000 including extraordinary gains of $25,000. The annual earnings based on an average rate of return on investment for this industry wold have been $115,000. If excess earnings are to be capitalized at 15%, the implied goodwill should be

a. $175,000
b. $233.334
c. $200,000
d. $725,000
e. none of the above

26. In computing earnings per share for a simple capital structure, if the preferred shares are cumulative, the amount that should be deducted as an adjustment to the numerator (net income) is the

a. preferred dividends in arrears
b. preferred dividends in arrears times (one minus the tax rate)
c. annual preferred dividend times (one minus the tax rate)
d. preferred dividends in arrears plus current preferred dividends
e. none of the above

27. When computing basic earnings per share, dilutive securities are

a. ignored
b. recognized whether they are dilutive or anti-dilutive
c. recognized only if they are anti-dilutive
d. recognized only if they are dilutive
e. none of the above

28. Sask Corp. had 600,000 common shares outstanding on January 1, and 1,500,000 common shares outstanding on July 1, and had income applicable to common shares of $1,575,000 for the year ending December 31, 1998. Earnings per share for 1998 would be

a. $2.63
b. $1.25
c. $1.50
d. $1.75
e. none of the above

29. In determining fully diluted earnings per share, dividends on nonconvertible cumulative preferred shares should be

a. disregarded
b. added back to net income whether declared or not
c. deducted from net income if declared
d. deducted from net income if paid
e. none of the above

30. The market price of a $100,000, 10-year, 12% (pays interest annually) bond issue sold to yield an effective rate of 10% is

a. $112,289
b. $112,462
c. $113,327
d. $187,236
e. none of the above

BONUS QUESTIONS

31. The primary quality of information that gives assurance that it is reasonably free of bias is

a. relevance
b. reliability
c. verifiability
d. neutrality
e. none of the above

32. The characteristic that is demonstrated when a high degree of consensus can e secured among independent measurers using the same measurement method is

a. neutrality
a. relevance
b. reliability
c. verifiability
e. none of the above

<u>PART B</u>. ***SHOW AND LABEL ALL COMPUTATIONS*** **(10 MARKS)**

Pagnioli Company exchanged machinery with an appraised value of $1,950,000, a recorded cost of $2,700,000 and accumulated amortization of $1,350,000 with Paris Corporation for machinery Paris owns. Paris' machinery had an appraised value of $1,850,000, a recorded cost of $3,240,000, and accumulated amortization of $1,782,000. Paris also gave Pagnoli $100,000 in the exchange. Assume amortization has already been updated.

Required:

(a) Prepare the entries on both companies' books assuming that it is considered an exchange of dissimilar assets.

<u>Pagnoli</u>

Cost	$2,700,000
AA	1,350,000
NBV	1,350,000
FMV	1,950,000
Gain	$ 600,000

Machinery	1,850,000	
Cash	100,000	
Accumulated Amortization	1,350,000	
Gain on exchange		600,000
Machinery		2,700,000

<u>Paris</u>

Cost	$3,240,000
AA	1,782,000
NBV	1,458,000
FMV	1,850,000
Gain	$ 392,000

Machinery	1,782,000	
Accumulated amortization	1,950,000	
Gain on exchange		392,000
Machinery		3,240,000
Cash		100,000

(b) Prepare the entries on both companies' books assuming that it is considered an exchange of similar assets.

Pagnoli

Machinery	1,250,000	
Cash	100,000	
Accumulated amortization	1,350,000	
Machinery		2,700,000

Paris

Machinery	1,558,000	
Accumulated amortization	1,782,000	
Machinery		3,240,000
Cash		100,000

(b) PART C. (10 MARKS)

Veryshrewd Corporation commenced business two years ago. Analysts predict that EPS for the year-end will be $1.35, up from $1.17 last year. Veryshrewd plans to issue 1,000,000 new common shares early next year.

The executive officers of Veryshrewd Corporation have been given a new performance-based compensation plan for this year. The performance criteria of this plan is linked to growth in earnings per share. If growth is 15%, the bonus rate is 15% of their salaries. If growth is below 15% no bonus payments will be made.

The executive officers agreed to meet in the office on Saturday morning to review the preliminary year-end financial statements.

You were hired at to help out with the year-end workload, and wanted to put your best foot forward. You had come to work on this Saturday morning to finish up some analysis you had been assigned. Your office was beside the coffee station. You inadvertently overhead the following conversation when the officers came out to get their coffee.

Exec A. "We are so close to earning the bonus. We could reduce the estimate of bad debts expense. I mean, who really knows how much we will or won't collect? There must be a range, you know, a high estimate and a low estimate, we can look at."

Exec B. "There is a range. And our current estimate is the lowest figure we can consider."

Exec. C. "What if we increase our collection efforts. We could then adjust the low-high range down, and decrease the estimated expense."

Exec B. "What about the property we acquired at the beginning of this year? You know the land is not depreciable. Could we allocate more of the purchase price to the land? This will have a double-barrel effect – we could reduce amortization expense and income tax expense if the depreciable asset has a lower cost."

Exec A. "No, we got three estimates from outsiders before we allocated the cost between land and building. We used the estimate that minimized the cost allocated to the building."

Exec C. "Get another estimate – and choose the estimator carefully."

Exec A. "We still have to review the repair and maintenance account. Some items may qualify as improvements."

Exec B. “There must be some repair items that we could capitalize. Let’s do that now. Then, on Monday, we can get the new accounting student to make the entries. It may be better to not involve the regular accounting staff.”

Exec A. “But what about the auditors?”

Exec B. “We’ll work on justifying the changes – there’s always a way. You know that, don’t you?”

Exec A. “I think the first step is to determine exactly how much we need to increase net income to get, say, 16% growth. If we can manage it without getting a new estimate for the land and building, it would be to our advantage. You know we would have to pay a handsome fee to the estimator. And, the auditors would really investigate any significant adjustment between these two accounts. They would review all the estimates and you know how conservative accountants are! I think our best route is to review the repair and maintenance account. It seems to me that we had some rather large repair bills this year.”

Exec C. “Let’s get to work. I recommend we don’t go home until we get that magic 16% increase. A 1% cushion is important. The auditors always find something!”

On Monday morning there was a note on your desk to make the following journal entries. The explanations you were to note on the entries were provided.

1. Reduce bad debts expense and allowance for doubtful accounts by $10,000. Explanation: accounts previously considered to be uncollectible had been collected during the last few weeks: Lake Company $4,000; Sanderson Group $6,000.

2. Transfer $18,000 from the repair and maintenance account to the office decoration account. If there is no such account, add the account to the general ledger. Explanation: the office had been refurbished during the year.

3. Transfer $2,000 from repair and maintenance to the accumulated amortization - motor vehicles account. Explanation: replacement tires on the delivery truck which will extend the useful life of the truck.

4. Transfer 90% of the balance in the advertising expense account to prepaid advertising. Explanation: one of the advertisements won’t be aired until next year. The other 9 ads appeared so close to the end of the year it is felt that most of the benefit won’t be realized until next year.

5. Recalculate and adjust amortization for the year on the building account. Explanation: change in estimated useful life of the building from 20 to 25 years.

You reviewed the aging of accounts receivable and discovered the Lake balance had been in the 90 day column and the Sanderson Group balance had been in the 60 day column. Both accounts had been paid during the last two weeks.

You reviewed the repair and maintenance account and were able to verify that $18,000 had been spent to refurbish the office during the year and that they had paid $2,000 for new tires.

Required: Assume the role of the accounting student. You have been given instructions from the top executive of Veryshrewd. However, you report to the Chief Accountant. Analyse the issues and include your analysis in a memo to the Chief Accountant.

A solution:

Memo the Chief Accountant: Use memo format

Overview

Role: Accounting student – temporary – fair reporting

Users: Shareholders – aggressive/conservative
Officers/Management – aggressive – bonus depends on EPS
Creditors – conservative

Company: Analysts predictions EPS = $1.35. Important to achieve estimate as they are issuing 1,000,000 common shares early in the year
New compensation plan for this year only – based on EPS – all or nothing
Public company

Constraint: GAAP – public company, preparing for 'auditors'

FRO: Accountant (conservative)
Management (aggressive)

Issues and Analysis:

Marks: 1 for recognition
1 for GAAP
1 for reasonable recommendation

1. Bad Debts expense: -- Already at low – lower expense = higher NI.
Also, collection of accounts has no impact on bad debts expense.

2. Property valuation – allocation of cost to land and building – allocation needs to be reliable (fair presentation required by GAAP). They have already selected the most aggressive of three choices. Should not get any further estimates – especially the type they are looking for.

3. R&M vs capital investments: $18,000 to office decoration – legitimate entry if the decorations will last for more than one year. This would be a capital vs revenue expenditure. The amount should be amortized over its useful life using a method that reflects the usefulness of the redecoration. They may choose to not recognize any amortization this year – based on a policy of $0 amort during the first year and a whole year's amortization during the last year.

$2,000 tires = a repair. Relacement of tires is a normal repair. This is not considered an extension of useful life, but maintenance to achieve normal life.

4. Advertisements – Advertisement is expensed as used; it is difficult to determine when benefit happens. However, the one ad which has not yet aired should be deferred as prepaid advertising. 90% should be expensed.

5. Change in estimate – is this realistic? Accounting information must be reliable. They may change the estimate only if it is a better estimate – if new information came to light since they purchased the building that leads them to believe that their original estimate no longer is reasonable. However, it seems to be an earnings management decision; one not based on any new information re the life of the building. Change in estimate does not require retroactive treatment; no restatement or reissuing of financials is required.

6. Ethics – Recognition = 1
Discission = 1