

AFM 101
Fall 2011

Solution

Instructions:

- 1) Answers for the multiple-choice questions must be recorded on the UW answer card. All other questions must be answered in the space provided on the examination paper. Answers written outside of the provided space will not be graded. You must submit both this examination paper and the UW answer card.
- 2) Show details of all calculations.
- 3) The final page of the examination contains a list of ratios. For your convenience, this page may be detached from the examination paper.

Additional Materials Allowed:

- 1) Cordless calculators may be used. The calculator must be standalone with no other communication or data storage features

Marking Scheme:

Question	Maximum Marks	Score
1	12	
2	18	
3	16	
4	8	
5	26	
Total	80	

Question 1 (12 marks)

Malet Computing Services provides computer consulting services and related computing services for small businesses. The following alphabetical listing shows all of the account balances taken from the unadjusted trial balance at the end of the fiscal year. All account balances have the usual sign.

Malet Computing Services
Unadjusted Trial Balance
December 31, 2011

Accumulated Depreciation, Equipment	\$ 60,750
Advertising Expense	21,900
Cash	14,500
Equipment	248,000
Interest Expense	1,200
Note Payable	30,000
Office Supplies Inventory	8,500
Operating Expenses	24,200
Prepaid Advertising	2,100
Retained Earnings (as at Dec 31, 2010)	76,700
Revenue	588,300
Salaries Expense	487,700
Share Capital	50,000
Trade Payables	3,800
Trade Receivables	12,250
Unearned Revenue	10,800

Required:

Provide the adjusting entries required at December 31, 2011. You do not need to include explanations. Answers must appear in the space provided.

- A) The unearned revenue results from a contract to provide computing services for the Freeland Corporation for the period from November 1, 2011, to April 30, 2012.

Unearned Revenue	\$3,600	
Revenue		\$3,600
(\$10,800 / 6 months) * 2 months		

- B) Consulting work performed but not recorded at the end of the year totaled \$8,500.

Trade Receivables	\$8,500	
Revenue		\$8,500

- C) The company had \$1,650 of office supplies on hand on January 1, 2011. The company purchased \$6,850 of supplies during the year and debited the Office Supplies Inventory account. The office manager counted the office supplies inventory on December 31, 2011 and found that supplies costing \$1,200 remained on hand.

Supplies Expense	\$7,300	
Office Supplies Inventory		\$7,300
\$1,650 + 6,850 – 1,200		

- D) The prepaid advertising was purchased on December 1, 2011, and will appear in local magazines for 3 months.

Advertising Expense	\$700	
Prepaid Advertising		\$700

- E) The equipment was purchased a number of years ago. It has an estimated life of 6 years with an expected salvage value of \$5,000. The company uses straight-line Depreciation.

Depreciation Expense	\$40,500	
Accumulated Depreciation, Equipment		\$40,500
(\$248,000 – 5,000) / 6 years		

- F) The note payable was borrowed on September 1, 2009 and must be repaid in three years. The note has a 6% annual interest rate and interest must be paid in equal amounts on March 1 and September 1.

Interest Expense	\$600	
Interest Payable		\$600
\$30,000 * 6% * 4/12		

Question 2 (18 marks)

The following information relates to activities for Markle Company for 2011.

- a) The company paid cash to the bondholders for the bonds that matured on September 1.
- b) Dividends were paid in cash on August 1.
- c) The company paid cash for the purchase of the land.
- d) A piece of equipment was sold for \$25,000, received in cash. Any gain or loss on the sale was included in net income. A new piece of equipment costing \$80,000 was purchased in October. Markle paid for the equipment by giving the seller a long-term note for the full amount.
- e) Markle Company issued bonds on March 1 for \$50,000 received in cash.
- f) Net income for the year ended December 31, 2011, was \$75,000.
- g) Common shares were issued on April 30.

Selected (final) account balances at December 31, 2010 and 2011 are shown in the following table. All account balances have the usual sign.

	<u>2010</u>	<u>2011</u>
Cash	\$ 34,000	\$71,200
Trade receivables	45,200	38,600
Inventories	86,600	95,800
Equipment	215,000	230,000
Accumulated depreciation, equipment	105,000	93,000
Depreciation expense, equipment	27,000	31,000
Land	370,000	448,000
Trade payables	62,500	73,600
Interest payable	3,300	2,400
Long-term notes payable	64,500	144,500
Bonds payable	180,000	150,000
Common shares	255,000	315,000
Retained earnings	378,000	402,600

Required:

Prepare the statement of cash flows for the Markle Company for 2011 using the indirect method.
Please use the following table to complete this question.

Equipment: Beginning balance + purchase – cost of equipment sold = ending balance

$$\mathbf{\$215,000 + 80,000 - \text{cost of equipment sold} = \$230,000}$$

$$\mathbf{\text{Cost of equipment sold} = \$65,000}$$

Accumulated Depreciation:

Beginning balance + expense – acc. dep'n on equipment sold = ending balance

$$\mathbf{\$105,000 + 31,000 - \text{accumulated depreciation on equipment sold} = \$93,000}$$

$$\mathbf{\text{Accumulated depreciation on equipment sold} = \$43,000}$$

$$\mathbf{\text{Net Book Value} = \text{Cost} - \text{Accumulated Depreciation} = \$65,000 - 43,000 = \$22,000}$$

$$\mathbf{\text{Gain on Sale of Equipment} = \text{Selling price} - \text{Net book value} = \$25,000 - 22,000 = \$3,000}$$

Markle Company
Statement of Cash Flows

For the Year Ended December 31, 2011

Operating Activities:

<u>Net Income</u>	<u>\$ 75,000</u>	
<u>Add (deduct) items not affecting cash</u>		
<u>Depreciation expense</u>	<u>31,000</u>	
<u>Gain on sale of equipment</u>	<u>(3,000)</u>	
<u>Decrease in trade receivables</u>	<u>6,600</u>	
<u>Decrease in inventory</u>	<u>(9,200)</u>	
<u>Increase in trade payables</u>	<u>11,100</u>	
<u>Decrease in interest payable</u>	<u>(900)</u>	
Net cash flow from operating activities		<u>\$ 110,600</u>

Investing Activities:

<u>Purchase of land</u>	<u>(\$ 78,000)</u>	
<u>Sale of equipment</u>	<u>25,000</u>	
Net cash flow from investing activities		<u>(53,000)</u>

Financing Activities

<u>Redeem maturing bonds</u>	<u>(\$ 80,000)</u>	
<u>Pay dividends</u>	<u>(50,400)</u>	
<u>Issue bonds</u>	<u>50,000</u>	
<u>Issue common shares</u>	<u>60,000</u>	
Net cash flow from financing activities		<u>(20,400)</u>
<u>Net increase in cash</u>		<u>\$ 37,200</u>
<u>Cash balance, January 1, 2011</u>		<u>34,000</u>
Cash balance on December 31, 2011		<u>\$ 71,200</u>

Non-cash Investing and Financing Activities

Purchase of equipment financed with long-term note for \$80,000

Question 3 (16 marks)

The Barnett Bicycle Shop specializes in high quality touring bicycles and related items. It operates a small store. At the start of 2011, the income statement accounts have zero balances and its statement of financial position account balances are as follows:

Cash	\$5,200	Trade Payables	\$12,800
Trade Receivables	3,900	Unearned Revenues (deposits)	7,150
Inventory	92,750	Note Payable (due in 3 years)	35,000
Delivery Truck	28,000	Common Shares	30,000
Accumulated Depreciation - Truck	(21,000)	Retained Earnings	36,200
Furniture, Fixtures & Equipment	12,300		

Required:

Provide the journal entries required to record the following transactions that occurred in January 2011. You do not need to include explanations. Answers must appear in the space provided.

A) The shop sold the delivery truck for \$8,500 in cash.

Cash	\$8,500	
Accumulated Depreciation – Truck	21,000	
 Delivery Truck		\$28,000
 Gain on Sale of Delivery Truck		1,500

B) Salaries of \$14,100 for January were paid.

Salaries Expense	\$14,100	
 Cash		\$14,100

C) The shop paid \$2,000 in dividends to the owner.

Retained Earnings	\$2,000	
 Cash		\$2,000

D) The shop delivered three bicycles which were ordered in 2010. The customers had placed deposits totaling \$3,000 when the bicycles were ordered. The selling price for all three bicycles was \$9,600. The customers paid the remainder of the price in cash. The cost of the bicycles was \$4,200.

Cash	\$6,600	
Unearned Revenues (deposits)	3,000	
Sales		\$9,600
Cost of Goods Sold	\$4,200	
Inventory		\$4,200

E) The shop paid half of the trade payables during January.

Trade Payables	\$6,400	
Cash		\$6,400

F) The shop purchased a new delivery truck for \$33,200. The shop made a down payment of \$4,000 cash and financed the remainder of the cost with a bank loan.

Delivery Truck	\$33,200	
Cash		\$4,000
Bank Loan		29,200

G) A customer ordered a unique bicycle with a selling price of \$4,800. The customer paid a deposit equal to one-quarter of the price of the bicycle.

Cash	\$1,200	
Unearned Revenues (deposits)		\$1,200

Question 4 (8 marks)

The answers to the following questions must appear in the space provided.

A. Discuss the role of financial analysts in the financial reporting process for a publicly traded company.

- **Gather information about the company from many sources**
- **Prepare analysis about company that assists investors in making investment decisions**
- **Make recommendations to buy, hold or sell shares based on forecasts of future performance**

B. The article “Playing by the Rules” discusses earnings management. Discuss the consequences of earnings management for a firm.

- **Managed earnings will reverse in the future**
- **Reduce the credibility of the managers when the earnings management is discovered**

C. The articles “Accrual Accounting Can Be Costly” and “Cash Doesn’t Lie” discuss the relationship between large accruals and stock returns. Explain the term “large positive accrual.”

- **Accruals are non-cash earnings**
 - **Large positive accruals will be income increasing leading to positive stock return**
- **Large accruals occur when net income is significantly different than cash from operations**
 - **When the accrual is positive, net income is greater than cash from operations leading to positive stock return**

D. The Conceptual Framework for Financial Reporting identifies relevance as a fundamental qualitative characteristic of accounting information. Discuss factors that make accounting information relevant.

- **Accounting information is relevant if it has**
 - **Predictive value: helps users predict future cash flows**
 - **Confirmatory value: confirms or changes prior expectations based on previous evaluations**

Question 5 (26 marks)

Choose the correct response from the answers provided. There is no mark penalty for incorrect responses. Mark the correct responses by completing the University of Waterloo answer card, using a black lead HB pencil only. Write your name and student number on the answer card and **mark your student number in the appropriate ovals**. You **do not** need to complete the section number and card number. **Answers recorded on the following pages will not be marked.**

1. On April 1, 2011, Allen Company signed a \$12,000, one-year, 10 percent note payable. At due date, April 1, 2012, the principal and interest will be paid. Interest expense should be reported on the income statement (for the year ended December 31, 2011) as which of the following?
 - A. \$ 700.
 - B. \$ 800.
 - C. \$ 900.
 - D. \$ 1,200.

2. On December 31, 2011, Ted Corporation paid \$2,000 for next year's insurance coverage. How should this transaction be recorded by Ted Corporation?

A. Insurance Expense	\$2,000	
Insurance Payable		\$2,000
B. Prepaid Insurance	\$2,000	
Insurance Payable		\$2,000
C. Cash	\$2,000	
Retained Earnings		\$2,000
D. Prepaid Insurance	\$2,000	
Cash		\$2,000

3. A company receives a \$25,000 cash deposit from a customer on March 15 but will not deliver the goods until April 20. Which of the following statements is false?
 - A. Cash will be reported on the statement of cash flows for the month of March
 - B. Revenue will be recorded and reported on the income statement for April
 - C. A liability will be reported on the statement of financial position at the end of March
 - D. Revenue will be recorded and reported on the income statement for March

4. Expresso Company purchased a machine that cost \$48,000 and had an estimated useful life of 8 years (no residual value) on January 1, 2009. The company uses the straight-line method of depreciation. The net book value at the end of 2012, would be which of the following?
 - A. \$18,000.
 - B. \$24,000.
 - C. \$30,000.
 - D. \$36,000.

5. Asset turnover measures
- how often a company replaces its assets.
 - how efficiently a company uses its assets to generate sales.
 - the portion of the assets that have been financed by creditors.
 - the overall rate of return on assets.
6. Randy, Inc., issued \$50,000 of bonds, earned income of \$28,000, sold long-term investments for \$12,000, repaid a \$8,000 note payable at maturity, repurchased shares of the company for \$15,000, and purchased new equipment for \$19,000. What is the net cash flow from financing activities?
- \$20,000.
 - \$27,000.
 - \$48,000.
 - \$67,000.
7. A company acquired some land (independently appraised at \$12,000) and paid for it by issuing 1,000 shares of its common shares (par \$10 per share; no market price was quoted). How should this be reported on the cash flow statement?
- Report \$12,000 as inflow and outflow of cash.
 - Report \$12,000 as an inflow of cash.
 - Should not be reported on the cash flow statement.
 - Report on a schedule of significant noncash transactions if it is material.
8. Hill's Copy Service performed photocopy services during December, 2011, but had not collected any cash (or other assets) from its customers by the end of the accounting period, December 31, 2011. What effect did performing these services have on the fundamental accounting model?
- Increased assets and increased liabilities.
 - Increased assets and increased shareholders' equity.
 - Increased assets and decreased shareholders' equity.
 - Decreased liabilities and decreased shareholders' equity.
9. Failure to make an adjusting entry to recognize service revenue receivable would cause which of the following?
- an overstatement of assets, net income, and shareholders' equity.
 - an overstatement of assets and shareholders' equity and an understatement of net income.
 - no effect on assets, liabilities, net income, nor shareholders' equity.
 - an understatement of assets, net income, and shareholders' equity.
10. Which of the following statements about the capital acquisitions ratio is true?
- A high ratio indicates less need for outside financing of property, plant and equipment.
 - The ratio is computed by dividing cash flow from operations by the average property, plant and equipment, net from the statement of financial position.
 - A low ratio may indicate a failure to update property, plant and equipment which can limit a company's ability to compete in the future.
 - A high ratio indicates a greater need for outside financing of property, plant and equipment

11. At the end of its accounting period, December 31, 2011, May Corporation owed \$1,000 for property taxes which had not been recorded nor paid. Therefore, the 2011 adjusting entry should be which of the following?
- A. \$1,000 credited to an expense account and debited to a liability account.
 - B. \$1,000 debited to an expense account and credited to an asset account.
 - C. \$1,000 credited to a liability account and debited to an expense account.
 - D. \$1,000 debited to a liability account and credited to an asset account.
12. The cash flow statement and the statement of financial position are interrelated because
- A. the ending amount of cash on the cash flow statement must agree with the amount on the statement of earnings.
 - B. the ending amount of cash on the cash flow statement must agree with the amount in the statement of retained earnings.
 - C. both disclose the corporation's net earnings.
 - D. the ending amount of cash on the cash flow statement must agree with the amount in the statement of financial position.
13. If a company fails to adjust a Prepaid Rent account for rent that has expired, what effect will this have on that month's financial statements?
- A. Failure to make an adjustment does not affect the financial statements.
 - B. Assets will be overstated and net earnings and shareholders' equity will be understated.
 - C. Assets will be overstated and net earnings and shareholders' equity will be overstated.
 - D. Expenses will be overstated and net earnings and shareholders' equity will be understated.
14. If a loss of \$20,000 is incurred in selling (for cash) office equipment that cost \$90,000 and had accumulated depreciation of \$22,500, the total amount reported in the investing activities section of the cash flow statement is
- A. \$70,000.
 - B. \$67,500.
 - C. \$47,500.
 - D. \$87,500.
15. The cash flow statement (indirect method) reports depreciation expense as an addition to net income because Depreciation does which of the following?
- A. causes an inflow of funds for the replacement of assets.
 - B. reduces reported net income of the period but does not involve an outflow of cash for that period.
 - C. is a direct use of cash.
 - D. reduces reported net income and causes an inflow of cash.

16. What are discontinued operations?
- A. the amount reflected on the income statement for adjustments made to statement of financial position accounts when applying different accounting principles.
 - B. the result of the disposal of a major segment of the business.
 - C. a gain or loss that is both unusual in nature and infrequent in occurrence.
 - D. a prediction of earnings for future accounting periods.
17. Assume the 2011 income statement reported total sales revenue of \$160,000. The 2010-2011, comparative statements of financial position showed that trade receivables increased by \$10,000. What was the "cash inflow from customers" for 2011?
- A. \$140,000.
 - B. \$150,000.
 - C. \$160,000.
 - D. \$170,000.
18. On January 1, 2011, the ledger of Global Corporation correctly showed supplies inventory of \$500. During 2011, supplies purchases amounted to \$700. A count (inventory) of supplies on hand at December 31, 2011, showed \$400. The 2011 income statement should report supplies expense amounting to which of the following?
- A. \$ 700.
 - B. \$ 800.
 - C. \$ 1,100.
 - D. \$ 1,200.
19. Cash receipts from customers are greater than sales revenues when there is a(n)
- A. increase in cost of goods sold
 - B. decrease in cost of goods sold
 - C. increase in trade receivables
 - D. decrease in trade receivables
20. With respect to shareholders' equity, indicate which one of the following statements is correct.
- A. Revenues are recorded as credits to the revenue accounts and expenses are recorded as debits to the expense accounts.
 - B. Revenues are recorded as debits to the revenue accounts and expenses are recorded as credits to the expense accounts.
 - C. Contributions (investments) by owners are recorded as debits to the share capital accounts.
 - D. Withdrawals by owners are recorded as credits to the share capital accounts.

21. Ramstetter, Inc., purchased a piece of land with a new building on January 1, 2011. The land was valued at \$40,000 and the building was valued at \$120,000 with a 40 year life and a zero salvage (residual) value. How would the land and building appear in the plant, property and equipment section of the December 31, 2011, statement of financial position?
- Land at 30,000; Building at 120,000.
 - Land at 40,000; Building at 120,000.
 - Land at 40,000; Building at 120,000 less accumulated depreciation of 3,000.
 - Land at 40,000 less accumulated depreciation of 1,000; Building at 120,000 less accumulated depreciation of 3,000.
22. On March 1, 2011, the premium on a two-year insurance policy on equipment was paid amounting to \$1,800. At the end of 2011 (end of the accounting period), the financial statements for 2011, would report which of the following?
- Insurance expense, \$0; Prepaid insurance \$1,800.
 - Insurance expense, \$750; Prepaid insurance \$1,050.
 - Insurance expense, \$900; Prepaid insurance \$900.
 - Insurance expense, \$1,800; Prepaid insurance \$0.
23. What happens when the actual earnings reported exceed the expected earnings for a company?
- there is no share price reaction because forecasts of earnings almost never reflect actual results
 - it causes an increase in the share price
 - it causes a decrease in the share price
 - it can have any of these effects since it is impossible to understand the changes in market price of share
24. Time Corporation reported the following for 2011:
- | | |
|---------------|--------------------------|
| Share Capital | 5,000 shares outstanding |
| Revenues | \$100,000 |
| Expenses | \$95,000 |
- What was the amount of earnings per share?
- \$ 1.00.
 - \$ 2.00.
 - \$19.00.
 - \$20.00.
25. Russell Company sold a piece of equipment for cash. It originally cost \$20,000. The accumulated depreciation at the date of disposal was \$15,000. A gain on the disposal of \$2,000 was reported. What was the cash inflow from this transaction?
- \$3,000
 - \$4,000
 - \$5,000
 - \$7,000

26. On January 1, 2011, Hampton Corporation had the following balances in its shareholders' equity accounts: Common shares - \$100,000 (10,000 shares) and Retained earnings - \$30,000. During 2011, the company issued 1,000 additional shares of common shares for \$10 per share, reported net income of \$40,000, and paid cash dividends of \$20,000. What amount of total shareholders' equity would the company report in its December 31, 2011, statement of financial position?
- A. \$120,000
 - B. \$140,000
 - C. \$160,000
 - D. \$180,000

Answer Key

1. C
2. D
3. D
4. B
5. B
6. B
7. D
8. B
9. D
10. A
11. C
12. D
13. C
14. C
15. B
16. B
17. B
18. B
19. D
20. A
21. C
22. B
23. B
24. A
25. D
26. C

Ratios

Price-Earnings Ratio	$\frac{\text{Market Price per Share}}{\text{Earnings per Share}}$
Debt to Equity Ratio	$\frac{\text{Total Liabilities}}{\text{Total Shareholders' Equity}}$
Total Asset Turnover Ratio	$\frac{\text{Sales}}{\text{Average Total Assets}}$
Return on Assets	$\frac{\text{Profit} + \text{Interest Expense (net of tax)}}{\text{Average Total Assets}}$
Earnings per Share	$\frac{\text{Profit Available to Common Shareholders}}{\text{Average Number of Common Shares Outstanding}}$
Net Profit Margin	$\frac{\text{Profit}}{\text{Net Sales}}$
Return on Equity	$\frac{\text{Profit}}{\text{Average Shareholders' Equity}}$
Quality of Income Ratio	$\frac{\text{Cash Flow from Operating Activities}}{\text{Profit}}$
Capital Acquisition Ratio	$\frac{\text{Cash Flow from Operating Activities}}{\text{Cash Paid for Property, Plant, and Equipment}}$