

UNIVERSITY OF WATERLOO
School of Accounting and Finance

AFM 101
Professor Duane Kennedy

Mid-Term Examination
Fall 2008

Date and Time: October 16, 2008, 7:15 – 8:45pm

Pages: 16, including cover

Name: _____

Student Number: _____

Tutorial Number and Time: _____

Instructions:

- 1) Cordless calculators may be used. The calculator must be standalone with no other communication or data storage features.
- 2) 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.
- 3) Show details of all calculations.
- 4) The final page of the examination contains a list of ratios. For your convenience, this page may be detached from the examination paper.
- 5) Please verify that this examination paper has the appropriate number of pages.

Question	Maximum Marks	Mark Awarded
1	20	
2	12	
3	12	
4	8	
6	28	
Total	80	

Question 1 (20 Marks)

The following information relates to activities for Freeland Limited for 2008.

- a) Net income for the year ended December 31, 2008, was \$45,000.
- b) An additional piece of land was purchased on November 30, 2008. The purchase price was paid in cash. Property taxes for 2008 were \$16,400. They were paid in cash and included in the calculation of net income.
- c) During the year, a piece of equipment was sold for \$15,000, received in cash. Any gain or loss on the sale was included in net income. A new piece of equipment costing \$40,000 was purchased in April. The seller of the equipment accepted a long-term note payable as full payment. Interest is payable annually on the note and the interest expense of \$2,000 for 2008 was included in net income.
- d) Dividends were paid in cash on December 1.
- e) Capital stock was issued on September 30.
- f) The company retired \$10,000 of bonds on March 15 when they matured. The company issued new bonds on October 1. The new bonds have a ten-year life. Both transactions occurred at the par (i.e., face or stated) value.

Selected account balances at December 31, 2007 and 2008 are shown in the following table. All account balances have the usual sign.

	<u>2007</u>	<u>2008</u>
Cash	\$48,000	\$69,700
Accounts receivable	37,000	28,000
Inventories	24,000	38,400
Prepaid expenses	5,000	2,500
Equipment	50,000	70,000
Accumulated amortization, equipment	23,000	31,000
Amortization expense, equipment	16,000	21,000
Land	200,000	275,000
Accounts payable	26,000	21,000
Interest payable	1,500	3,100
Long-term notes payable	31,000	71,000
Bonds payable	75,000	100,000
Capital stock	120,000	140,000
Retained earnings	87,500	117,500

Required:

Prepare the statement of cash flows for Freeland Limited for 2008 using the indirect method. *Please use the table on the following page to complete this question.* Be sure to prepare a schedule for any non-cash items for disclosure, if appropriate.

Question 2 (12 marks)

Webb Delivery Services provides local delivery 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.

Webb Delivery Services
Unadjusted Trial Balance
December 31, 2008

Accounts Payable	\$ 37,200
Accounts Receivable	26,800
Accumulated Amortization, Building	154,000
Advertising Expense	65,100
Building	440,000
Capital Stock	215,000
Cash	37,300
Delivery Equipment Rental Expense	132,000
Interest Expense	8,250
Land	215,000
Note Payable	110,000
Office Supplies Inventory	15,100
Operating Expenses	77,700
Prepaid Insurance	8,000
Retained Earnings (as at Dec 31, 2007)	189,750
Revenue	422,700
Salaries Expense	103,400

Required:

Provide the adjusting entries required at December 31, 2008. You do not need to include explanations. Answers must appear in the space provided.

- A) The company had \$2,300 of office supplies on hand on January 1, 2008. The company purchased \$12,800 of supplies during the year and debited the Office Supplies Inventory account. The office manager counted the office supplies inventory on December 31, 2008 and found that supplies costing \$1,800 remained on hand.

- B) Webb Delivery Services has a multi-year contract to rent delivery equipment from a local truck dealer. Webb pays equal monthly charges. Webb has not yet paid or recorded the rental charges for December but has paid all previous months.
- C) Webb Delivery Services has not recorded or sent invoices to clients for delivery services completed during the last two weeks of December. The invoices, for a total of \$13,200, will be sent on January 5, 2009.
- D) The building was purchased a number of years ago. It has an estimated life of 30 years with an expected salvage value of \$20,000. The company uses straight-line amortization.
- E) The prepaid insurance was purchased on September 1, 2008, and provides insurance coverage for twelve months.
- F) The note payable was borrowed on October 1, 2007 and must be repaid in three years. The note has a 10% interest rate and interest must be paid in equal amounts on April 1 and October 1.

Question 3 (12 marks)

Straus Construction Limited is a small company which specializes in the renovation of homes and cottages. On September 30, 2008, the end of the fiscal year, the company had \$475,000 of net assets and \$387,000 of liabilities. All appropriate adjusting entries were made at the end of September.

Required:

Provide the journal entries required to record the following transactions that occurred in October 2008. You do not need to include explanations. Answers must appear in the space provided.

A) The company sold an old truck which had an original cost of \$45,000. The accumulated amortization on the truck was \$38,500 at the end of September. Straus Construction received \$2,000 in cash and a note receivable for \$8,000. The note will be paid by the purchaser in six months along with interest at annual rate of 8 percent.

B) Salaries of \$7,500 for the last half of September were paid.

C) The company received and paid the electricity bill for \$300.

D) Straus Construction purchased a new fork-lift tractor for use in the business. The cost was \$22,400. In addition, there were sales taxes of 10% based on the purchase price. The company paid \$10,000 in cash and signed a short-term note, with a 6 percent annual interest rate, for the remainder.

E) Paid \$3,300 on account for construction supplies which were received in September.

F) Completed a renovation project for D. Good. The invoice price was \$11,300. The customer had paid an initial deposit of \$2,000 in July and a second deposit of \$1,500 in September. An invoice was sent to D. Good for the remaining amount and the customer is expected to pay in November.

Question 5 (28 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 January 1, 2008, the ledger of Global Corporation correctly showed supplies inventory of \$500. During 2008, supplies purchases amounted to \$700. A count (inventory) of supplies on hand at December 31, 2008, showed \$400. The 2008 income statement should report supplies expense amounting to which of the following?
 - A) \$ 700.
 - B) \$ 800.
 - C) \$ 1,100.
 - D) \$ 1,200.
 - E) none of the above

2. The financial statements of Juliet Company show the following:

Sales: \$154,000

	<u>Beginning Balance</u>	<u>Ending Balance</u>
Accounts Receivable	\$38,000	\$32,000
Accounts Payable	31,000	35,000
Inventory	34,000	37,000

How much cash was collected from customers?

- A) \$148,000.
- B) \$150,000.
- C) \$154,000.
- D) \$160,000.
- E) none of the above

3. Assume Minor Company recorded the following adjusting entry at year-end:

Dr Insurance expense.....\$800
Cr Prepaid insurance.....\$800

If the beginning balance in prepaid insurance was \$700 and \$1,500 was paid for an insurance premium during the year, the ending balance in the prepaid insurance account (after the above adjusting entry) would be which of the following?

- A) \$100 debit.
 - B) \$1,400 debit.
 - C) \$1,500 debit.
 - D) \$2,200 debit.
 - E) none of the above
4. On January 1, 2008, Milburn Corporation had the following balances in its shareholders' equity accounts: Common shares - \$100,000 (10,000 shares) and Retained earnings - \$30,000. During 2008, 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, 2008, balance sheet?
- A) \$120,000.
 - B) \$140,000.
 - C) \$160,000.
 - D) \$180,000.
 - E) none of the above
5. The qualitative characteristic that says accounting information can influence users' decisions is which of the following?
- A) comparability.
 - B) materiality.
 - C) relevance.
 - D) reliability.
6. 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?
- A) Report \$12,000 as inflow and outflow of cash.
 - B) Report \$12,000 as an inflow of cash.
 - C) Should not be reported on the cash flow statement.
 - D) Report on a schedule of significant noncash transactions if it is material.

7. On July 1, 2007, Bill Company signed a two-year \$8,000 note payable with 9 percent interest. At due date, July 1, 2009, the principal and interest will be paid in full. Interest expense should be reported on the income statement for the year ended December 31, 2007, in the amount of which of the following?
- A) \$ 360.
 - B) \$ 420.
 - C) \$ 720.
 - D) \$ 1,440.
 - E) none of the above
8. What happens when the actual earnings reported exceed the expected earnings for a company?
- A) there is no share price reaction because forecasts of earnings almost never reflect actual results
 - B) it causes an increase in the share price
 - C) it causes a decrease in the share price
 - D) it can have any of these effects since it is impossible to understand the changes in market price of share
9. Which of the following is a cash flow from operating activities?
- A) Purchase of merchandise for resale.
 - B) Sale of a piece of land no longer used in operations.
 - C) Sale of long-term investments in common shares.
 - D) Payment of a note payable.
10. Espresso Company purchased a machine that cost \$28,000 and had an estimated useful life of 7 years (no residual value) on January 1, 2007. The company uses the straight-line method of amortization. The net book value at the end of 2008, would be which of the following?
- A) \$16,000.
 - B) \$20,000.
 - C) \$24,000.
 - D) \$28,000.
 - E) none of the above
11. If Papa John's reports an asset turnover ratio of 2.34 for 1998 and their competitor Pizza Hut reports 3.79 for their 1998 ratio, it means which of the following?
- A) Papa John's is better able to pay their current obligations with their current assets
 - B) Papa John's has been more effective in managing the use and level of its assets
 - C) Papa John's has been less effective in managing the use and level of its assets
 - D) Papa John's is less able to pay off their current obligations with their current assets

12. Which of the following errors would most likely lead to an overstatement of income?
- A) Recording revenue next period when the cash is collected although it is earned in the current year
 - B) Recording an expense incurred this year when the cash is paid next year
 - C) Failure to adjust deferred rent revenue account for the portion of rent earned this year
 - D) Failure to adjust prepaid expenses account for the portion of insurance expired this year
13. The operating cycle of a business is best defined as which of the following?
- A) the period of time for which we prepare our financial statements
 - B) the length of time over which our plant and equipment assets are expected to be used by the company in generating revenues
 - C) the time it takes for a company to purchase and pay for goods or services from suppliers, sell those goods or services to customers and collect cash from the customers
 - D) one year
14. The owner of an office building should report rent collected in advance as a debit to cash and a credit to which of the following?
- A) a revenue.
 - B) an asset other than cash.
 - C) a liability.
 - D) an expense.
15. The debt-to-equity ratio does which of the following?
- A) assesses solvency or the relative proportion of the company financed by debt as opposed to equity financing
 - B) assesses the liquidity or ability to pay current obligations as they come due
 - C) assesses the profitable operations of the company
 - D) All of these are correct
16. The asset turnover ratio is used to assess which of the following?
- A) whether the company can pay their bills currently due with their existing cash and receivables
 - B) whether the company can borrow money from the bank
 - C) whether the company is using its assets effectively in generating sales revenue
 - D) whether the company is collecting cash from credit customers in a timely manner

17. Lori Company sold an operational asset, a machine, for cash. It originally cost \$20,000. The accumulated amortization 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?
- A) \$3,000.
 - B) \$4,000.
 - C) \$5,000.
 - D) \$7,000.
 - E) none of the above
18. On March 1, 2007, the premium on a two-year insurance policy on equipment was paid amounting to \$1,800. At the end of 2007 (end of the accounting period), the financial statements for 2007, would report which of the following?
- A) Insurance expense, \$0; Prepaid insurance \$1,800.
 - B) Insurance expense, \$750; Prepaid insurance \$1,050.
 - C) Insurance expense, \$900; Prepaid insurance \$900.
 - D) Insurance expense, \$1,800; Prepaid insurance \$0.
 - E) none of the above
19. Failure to make an adjusting entry to recognize accrued salaries payable would cause which of the following?
- A) an understatement of expenses and liabilities and an overstatement of shareholders' equity.
 - B) an overstatement of expenses and liabilities.
 - C) an understatement of expenses, liabilities and shareholders' equity.
 - D) an understatement of assets and shareholders' equity.
 - E) none of the above
20. In applying the revenue principle to a given transaction, the most important moment or period in time is when which of the following happens?
- A) related cash inflows occur.
 - B) related expenses are incurred.
 - C) sales transaction is completed (i.e., ownership passes) or services are rendered.
 - D) the service contract is signed regarding service to be performed.
21. Failure to make an adjusting entry to recognize service revenue receivable would cause which of the following?
- A) an overstatement of assets, net income, and shareholders' equity.
 - B) an overstatement of assets and shareholders' equity and an understatement of net income.
 - C) no effect on assets, liabilities, net income, nor shareholders' equity.
 - D) an understatement of assets, net income, and shareholders' equity.

22. Why is the cash basis of accounting not appropriate for use by publicly traded corporations?
- A) the OSC (Ontario Securities Commission) does not allow its use
 - B) no assets or liabilities other than cash would ever appear on the balance sheet, giving a distorted picture of financial position
 - C) the income reported could not be distorted if a large customer paid for goods in advance or we postponed paying for goods or services until the next accounting period
 - D) the cash basis is not permitted for tax purposes
23. During 2008, Blue Corporation incurred operating expenses amounting to \$100,000, of which \$75,000 were paid in cash; the balance will be paid in January 2009. Transaction analysis of operating expenses for 2008, should reflect which of the following?
- A) decrease shareholders' equity, \$75,000; decrease assets, \$75,000.
 - B) decrease assets, \$100,000; decrease shareholders' equity, \$100,000.
 - C) decrease assets, \$100,000; increase liabilities, \$25,000; decrease shareholders' equity, \$100,000.
 - D) decrease shareholders' equity, \$100,000; decrease assets, \$75,000; increase liabilities, \$25,000.
 - E) none of the above

Brown Company reported the following December 31 amounts in its financial statements (in millions):

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Sales revenue	\$626.0	\$598.8	\$565.5
Cost of goods sold	352.6	322.2	301.1
Gross profit	273.4	276.6	264.4
Amortization expense	93.2	87.7	82.9
Other expenses	106.2	105.5	99.1
Net income	74.0	83.4	82.4
Current assets	53.4	47.7	44.9
Total assets	402.3	374.4	344.4
Current liabilities	77.3	62.2	55.2
Total liabilities	222.8	198.2	179.2
Shares outstanding	45.0	40.0	40.0

24. What is the Debt to Equity Ratio for the Brown Company for 2008?
- A) 0.55
 - B) 4.95
 - C) 1.24
 - D) 0.81
 - E) none of the above

25. What is the Net Profit Margin for the Brown Company for 2008?
- A) 0.118
 - B) 0.437
 - C) 0.271
 - D) 0.184
 - E) none of the above
26. What is the Return on Assets ratio for the Brown Company for 2008?
- A) 0.184
 - B) 0.191
 - C) 0.203
 - D) 0.095
 - E) none of the above
27. What is the Return on Equity ratio for the Brown Company for 2008?
- A) 1.061
 - B) 0.208
 - C) 0.412
 - D) 0.416
 - E) none of the above
28. What is the Total Asset Turnover Ratio for the Brown Company for 2008?
- A) 1.612
 - B) 1.556
 - C) 0.704
 - D) 0.806
 - E) none of the above

Ratios

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

UNIVERSITY OF WATERLOO
School of Accounting and Finance

AFM 101
Professor Duane Kennedy

Mid-Term Examination
Fall 2008

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Pages: 16, including cover

Name: ***Solution***

Student Number: _____

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Instructions:

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Question	Maximum Marks	Mark Awarded
1	20	
2	12	
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4	8	
6	28	
Total	80	

Question 1 (20 Marks)

The following information relates to activities for Freeland Limited for 2008.

- a) Net income for the year ended December 31, 2008, was \$45,000.
- b) An additional piece of land was purchased on November 30, 2008. The purchase price was paid in cash. Property taxes for 2008 were \$16,400. They were paid in cash and included in the calculation of net income.
- c) During the year, a piece of equipment was sold for \$15,000, received in cash. Any gain or loss on the sale was included in net income. A new piece of equipment costing \$40,000 was purchased in April. The seller of the equipment accepted a long-term note payable as full payment. Interest is payable annually on the note and the interest expense of \$2,000 for 2008 was included in net income.
- d) Dividends were paid in cash on December 1.
- e) Capital stock was issued on September 30.
- f) The company retired \$10,000 of bonds on March 15 when they matured. The company issued new bonds on October 1. The new bonds have a ten-year life. Both transactions occurred at the par (i.e., face or stated) value.

Selected account balances at December 31, 2007 and 2008 are shown in the following table. All account balances have the usual sign.

	<u>2007</u>	<u>2008</u>
Cash	\$48,000	\$69,700
Accounts receivable	37,000	28,000
Inventories	24,000	38,400
Prepaid expenses	5,000	2,500
Equipment	50,000	70,000
Accumulated amortization, equipment	23,000	31,000
Amortization expense, equipment	16,000	21,000
Land	200,000	275,000
Accounts payable	26,000	21,000
Interest payable	1,500	3,100
Long-term notes payable	31,000	71,000
Bonds payable	75,000	100,000
Capital stock	120,000	140,000
Retained earnings	87,500	117,500

Required:

Prepare the statement of cash flows for Freeland Limited for 2008 using the indirect method. *Please use the table on the following page to complete this question.* Be sure to prepare a schedule for any non-cash items for disclosure, if appropriate.

Freeland Limited
Statement of Cash Flows
for the year ended December 31, 2008

Operating Activities:

<u>Net Income</u>	<u>\$45,000</u>	
<u>Add (deduct) items not affecting cash</u>		
<u>Amortization expense</u>	<u>21,000</u>	
<u>Gain on sale of equipment</u>	<u>(8,000)</u>	
<u>Decrease in accounts receivable</u>	<u>9,000</u>	
<u>Increase in inventories</u>	<u>(14,400)</u>	
<u>Decrease in prepaid expenses</u>	<u>2,500</u>	
<u>Decrease in accounts payable</u>	<u>(5,000)</u>	
<u>Increase in interest payable</u>	<u>1,600</u>	
Net cash flow from operating activities		<u>\$51,700</u>

Investing Activities:

<u>Purchase of land</u>	<u>(\$75,000)</u>	
<u>Sale of equipment</u>	<u>15,000</u>	
Net cash flow from investing activities		<u>(60,000)</u>

Financing Activities

<u>Issue of capital stock</u>	<u>\$20,000</u>	
<u>Retirement of bonds</u>	<u>(10,000)</u>	
<u>Issue of bonds</u>	<u>35,000</u>	
<u>Payment of dividends</u>	<u>(15,000)</u>	
Net cash flow from financing activities		<u>30,000</u>
<u>Net increase in cash</u>		<u>21,700</u>
<u>Cash, beginning of year</u>		<u>48,000</u>
<u>Cash, end of year</u>		<u>69,700</u>

Non-cash Investing and Financing Activities

Purchase of equipment costing \$40,000 financed with a long-term note payable

Question 2 (12 marks)

Webb Delivery Services provides local delivery 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.

Webb Delivery Services
Unadjusted Trial Balance
December 31, 2008

Accounts Payable	\$ 37,200
Accounts Receivable	26,800
Accumulated Amortization, Building	154,000
Advertising Expense	65,100
Building	440,000
Capital Stock	215,000
Cash	37,300
Delivery Equipment Rental Expense	132,000
Interest Expense	8,250
Land	215,000
Note Payable	110,000
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Revenue	422,700
Salaries Expense	103,400

Required:

Provide the adjusting entries required at December 31, 2008. You do not need to include explanations. Answers must appear in the space provided.

- A) The company had \$2,300 of office supplies on hand on January 1, 2008. The company purchased \$12,800 of supplies during the year and debited the Office Supplies Inventory account. The office manager counted the office supplies inventory on December 31, 2008 and found that supplies costing \$1,800 remained on hand.

Office Supplies Expense	13,300	
Office Supplies Inventory		13,300
\$15,100 – 1,800		

B) Webb Delivery Services has a multi-year contract to rent delivery equipment from a local truck dealer. Webb pays equal monthly charges. Webb has not yet paid or recorded the rental charges for December but has paid all previous months.

Delivery Equipment Rental Expense	\$12,000	
Accounts Payable or		
Equipment Rent Payable		\$12,000
\$132,000 / 11 months		

C) Webb Delivery Services has not recorded or sent invoices to clients for delivery services completed during the last two weeks of December. The invoices, for a total of \$13,200, will be sent on January 5, 2009.

Accounts Receivable	\$13,200	
Revenue		\$13,200

D) The building was purchased a number of years ago. It has an estimated life of 30 years with an expected salvage value of \$20,000. The company uses straight-line amortization.

Amortization Expense	\$14,000	
Accumulated Amortization, Building		\$14,000
<u>(\$440,000 – 20,000)</u>		
30 years		

E) The prepaid insurance was purchased on September 1, 2008, and provides insurance coverage for twelve months.

Insurance Expense	\$2,667	
Prepaid Insurance		\$2,667
\$8,000 * (4/12)		

F) The note payable was borrowed on October 1, 2007 and must be repaid in three years. The note has a 10% interest rate and interest must be paid in equal amounts on April 1 and October 1.

Interest Expense	\$2,750	
Interest Payable		\$2,750
\$110,000 * 10% * 3/12		

Question 3 (12 marks)

Straus Construction Limited is a small company which specializes in the renovation of homes and cottages. On September 30, 2008, the end of the fiscal year, the company had \$475,000 of net assets and \$387,000 of liabilities. All appropriate adjusting entries were made at the end of September.

Required:

Provide the journal entries required to record the following transactions that occurred in October 2008. You do not need to include explanations. Answers must appear in the space provided.

- A) The company sold an old truck which had an original cost of \$45,000. The accumulated amortization on the truck was \$38,500 at the end of September. Straus Construction received \$2,000 in cash and a note receivable for \$8,000. The note will be paid by the purchaser in six months along with interest at annual rate of 8 percent.

Cash	\$2,000	
Note receivable	8,000	
Accumulated amortization	38,500	
Truck		\$45,000
Gain on sale of truck		3,500

- B) Salaries of \$7,500 for the last half of September were paid.

Salaries payable	\$7,500	
Cash		\$7,500

- C) The company received and paid the electricity bill for \$300.

Utilities (or Electricity) expense	\$300	
Cash		\$300

D) Straus Construction purchased a new fork-lift tractor for use in the business. The cost was \$22,400. In addition, there were sales taxes of 10% based on the purchase price. The company paid \$10,000 in cash and signed a short-term note, with a 6 percent annual interest rate, for the remainder.

Equipment	\$24,640	
Cash		\$10,000
Short-term note payable		14,640
\$22,400 + 22,400 * 10%		

E) Paid \$3,300 on account for construction supplies which were received in September.

Accounts payable	\$3,300	
Cash		\$3,00

F) Completed a renovation project for D. Good. The invoice price was \$11,300. The customer had paid an initial deposit of \$2,000 in July and a second deposit of \$1,500 in September. An invoice was sent to D. Good for the remaining amount and the customer is expected to pay in November.

Accounts receivable	\$7,800	
Unearned revenue or customer deposits	3,500	
Revenue		\$11,300

Question 4 (8 Marks)

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

- a) The article “Time for Common Accounting Standards” talks about the shift from Canadian GAAP to International Financial Reporting Standards. Briefly discuss reasons for the shift.
- Canadian capital markets are too small to use distinct Canadian accounting standards that are neither IFRS nor US GAAP
 - IFRS are used in more than 100 countries and the SEC is accepting IFRS for foreign private issuers
 - After transition is complete, it is expected to reduce cost of capital, increase access to international capital markets and reduce cost of preparing financial statements
- b) The article “Informative or Misleading” discusses pro forma reporting. Briefly discuss reasons for investors to be concerned about pro forma reporting.
- Pro forma reporting may be used to mislead investors about company performance
 - May be used to manage investor expectations
 - May be used to exceed analyst earnings forecasts
 - May be used to guide investor attention away from disappointing performance under GAAP towards positive performance based on pro forma earnings
- c) The article “Cash Flow Reigns Once Again” discusses the importance of cash. Briefly discuss the importance of examining cash flows when making investment decisions.
- It is easier to use flexibility in accounting standards to manipulate income to obtain positive results than it is to manipulate cash flows
 - A company generating positive cash flows from operations can avoid external financing
 - Review of investing activities can show whether a company is making adequate investments to keep capital assets current
- d) Briefly discuss the impact on a company’s financial statements of “aggressive accounting.”
- Aggressive accounting will result in recognizing additional revenues and profits in the current year than may be appropriate or recognizing revenues and profits in earlier years than may be appropriate

Question 5 (28 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 January 1, 2008, the ledger of Global Corporation correctly showed supplies inventory of \$500. During 2008, supplies purchases amounted to \$700. A count (inventory) of supplies on hand at December 31, 2008, showed \$400. The 2008 income statement should report supplies expense amounting to which of the following?
 - A) \$ 700.
 - B) \$ 800.
 - C) \$ 1,100.
 - D) \$ 1,200.
 - E) none of the above

2. The financial statements of Juliet Company show the following:

Sales: \$154,000

	<u>Beginning Balance</u>	<u>Ending Balance</u>
Accounts Receivable	\$38,000	\$32,000
Accounts Payable	31,000	35,000
Inventory	34,000	37,000

How much cash was collected from customers?

- A) \$148,000.
- B) \$150,000.
- C) \$154,000.
- D) \$160,000.
- E) none of the above

3. Assume Minor Company recorded the following adjusting entry at year-end:

Dr Insurance expense.....\$800
Cr Prepaid insurance.....\$800

If the beginning balance in prepaid insurance was \$700 and \$1,500 was paid for an insurance premium during the year, the ending balance in the prepaid insurance account (after the above adjusting entry) would be which of the following?

- A) \$100 debit.
- B) \$1,400 debit.
- C) \$1,500 debit.
- D) \$2,200 debit.
- E) none of the above

4. On January 1, 2008, Milburn Corporation had the following balances in its shareholders' equity accounts: Common shares - \$100,000 (10,000 shares) and Retained earnings - \$30,000. During 2008, 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, 2008, balance sheet?

- A) \$120,000.
- B) \$140,000.
- C) \$160,000.
- D) \$180,000.
- E) none of the above

5. The qualitative characteristic that says accounting information can influence users' decisions is which of the following?

- A) comparability.
- B) materiality.
- C) relevance.
- D) reliability.

6. 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?

- A) Report \$12,000 as inflow and outflow of cash.
- B) Report \$12,000 as an inflow of cash.
- C) Should not be reported on the cash flow statement.
- D) Report on a schedule of significant noncash transactions if it is material.

7. On July 1, 2007, Bill Company signed a two-year \$8,000 note payable with 9 percent interest. At due date, July 1, 2009, the principal and interest will be paid in full. Interest expense should be reported on the income statement for the year ended December 31, 2007, in the amount of which of the following?
- A) \$ 360.
 - B) \$ 420.
 - C) \$ 720.
 - D) \$ 1,440.
 - E) none of the above
8. What happens when the actual earnings reported exceed the expected earnings for a company?
- A) there is no share price reaction because forecasts of earnings almost never reflect actual results
 - B) it causes an increase in the share price
 - C) it causes a decrease in the share price
 - D) it can have any of these effects since it is impossible to understand the changes in market price of share
9. Which of the following is a cash flow from operating activities?
- A) Purchase of merchandise for resale.
 - B) Sale of a piece of land no longer used in operations.
 - C) Sale of long-term investments in common shares.
 - D) Payment of a note payable.
10. Espresso Company purchased a machine that cost \$28,000 and had an estimated useful life of 7 years (no residual value) on January 1, 2007. The company uses the straight-line method of amortization. The net book value at the end of 2008, would be which of the following?
- A) \$16,000.
 - B) \$20,000.
 - C) \$24,000.
 - D) \$28,000.
 - E) none of the above
11. If Papa John's reports an asset turnover ratio of 2.34 for 1998 and their competitor Pizza Hut reports 3.79 for their 1998 ratio, it means which of the following?
- A) Papa John's is better able to pay their current obligations with their current assets
 - B) Papa John's has been more effective in managing the use and level of its assets
 - C) Papa John's has been less effective in managing the use and level of its assets
 - D) Papa John's is less able to pay off their current obligations with their current assets

12. Which of the following errors would most likely lead to an overstatement of income?
- A) Recording revenue next period when the cash is collected although it is earned in the current year
 - B) Recording an expense incurred this year when the cash is paid next year
 - C) Failure to adjust deferred rent revenue account for the portion of rent earned this year
 - D) Failure to adjust prepaid expenses account for the portion of insurance expired this year
13. The operating cycle of a business is best defined as which of the following?
- A) the period of time for which we prepare our financial statements
 - B) the length of time over which our plant and equipment assets are expected to be used by the company in generating revenues
 - C) the time it takes for a company to purchase and pay for goods or services from suppliers, sell those goods or services to customers and collect cash from the customers
 - D) one year
14. The owner of an office building should report rent collected in advance as a debit to cash and a credit to which of the following?
- A) a revenue.
 - B) an asset other than cash.
 - C) a liability.
 - D) an expense.
15. The debt-to-equity ratio does which of the following?
- A) assesses solvency or the relative proportion of the company financed by debt as opposed to equity financing
 - B) assesses the liquidity or ability to pay current obligations as they come due
 - C) assesses the profitable operations of the company
 - D) All of these are correct
16. The asset turnover ratio is used to assess which of the following?
- A) whether the company can pay their bills currently due with their existing cash and receivables
 - B) whether the company can borrow money from the bank
 - C) whether the company is using its assets effectively in generating sales revenue
 - D) whether the company is collecting cash from credit customers in a timely manner

17. Lori Company sold an operational asset, a machine, for cash. It originally cost \$20,000. The accumulated amortization 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?
- A) \$3,000.
 - B) \$4,000.
 - C) \$5,000.
 - D) \$7,000.
 - E) none of the above
18. On March 1, 2007, the premium on a two-year insurance policy on equipment was paid amounting to \$1,800. At the end of 2007 (end of the accounting period), the financial statements for 2007, would report which of the following?
- A) Insurance expense, \$0; Prepaid insurance \$1,800.
 - B) Insurance expense, \$750; Prepaid insurance \$1,050.
 - C) Insurance expense, \$900; Prepaid insurance \$900.
 - D) Insurance expense, \$1,800; Prepaid insurance \$0.
 - E) none of the above
19. Failure to make an adjusting entry to recognize accrued salaries payable would cause which of the following?
- A) an understatement of expenses and liabilities and an overstatement of shareholders' equity.
 - B) an overstatement of expenses and liabilities.
 - C) an understatement of expenses, liabilities and shareholders' equity.
 - D) an understatement of assets and shareholders' equity.
 - E) none of the above
20. In applying the revenue principle to a given transaction, the most important moment or period in time is when which of the following happens?
- A) related cash inflows occur.
 - B) related expenses are incurred.
 - C) sales transaction is completed (i.e., ownership passes) or services are rendered.
 - D) the service contract is signed regarding service to be performed.
21. Failure to make an adjusting entry to recognize service revenue receivable would cause which of the following?
- A) an overstatement of assets, net income, and shareholders' equity.
 - B) an overstatement of assets and shareholders' equity and an understatement of net income.
 - C) no effect on assets, liabilities, net income, nor shareholders' equity.
 - D) an understatement of assets, net income, and shareholders' equity.

22. Why is the cash basis of accounting not appropriate for use by publicly traded corporations?
- A) the OSC (Ontario Securities Commission) does not allow its use
 - B) no assets or liabilities other than cash would ever appear on the balance sheet, giving a distorted picture of financial position
 - C) the income reported could not be distorted if a large customer paid for goods in advance or we postponed paying for goods or services until the next accounting period
 - D) the cash basis is not permitted for tax purposes
23. During 2008, Blue Corporation incurred operating expenses amounting to \$100,000, of which \$75,000 were paid in cash; the balance will be paid in January 2009. Transaction analysis of operating expenses for 2008, should reflect which of the following?
- A) decrease shareholders' equity, \$75,000; decrease assets, \$75,000.
 - B) decrease assets, \$100,000; decrease shareholders' equity, \$100,000.
 - C) decrease assets, \$100,000; increase liabilities, \$25,000; decrease shareholders' equity, \$100,000.
 - D) decrease shareholders' equity, \$100,000; decrease assets, \$75,000; increase liabilities, \$25,000.
 - E) none of the above

Brown Company reported the following December 31 amounts in its financial statements (in millions):

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Sales revenue	\$626.0	\$598.8	\$565.5
Cost of goods sold	352.6	322.2	301.1
Gross profit	273.4	276.6	264.4
Amortization expense	93.2	87.7	82.9
Other expenses	106.2	105.5	99.1
Net income	74.0	83.4	82.4
Current assets	53.4	47.7	44.9
Total assets	402.3	374.4	344.4
Current liabilities	77.3	62.2	55.2
Total liabilities	222.8	198.2	179.2
Shares outstanding	45.0	40.0	40.0

24. What is the Debt to Equity Ratio for the Brown Company for 2008?
- A) 0.55
 - B) 4.95
 - C) 1.24
 - D) 0.81
 - E) none of the above

25. What is the Net Profit Margin for the Brown Company for 2008?
- A) 0.118
 - B) 0.437
 - C) 0.271
 - D) 0.184
 - E) none of the above
26. What is the Return on Assets ratio for the Brown Company for 2008?
- A) 0.184
 - B) 0.191
 - C) 0.203
 - D) 0.095
 - E) none of the above
27. What is the Return on Equity ratio for the Brown Company for 2008?
- A) 1.061
 - B) 0.208
 - C) 0.412
 - D) 0.416
 - E) none of the above
28. What is the Total Asset Turnover Ratio for the Brown Company for 2008?
- A) 1.612
 - B) 1.556
 - C) 0.704
 - D) 0.806
 - E) none of the above

Answer Key

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