AFM 391 Sample (Old) Final Exam

DIRECTIONS: The sample exam is a revised version of an old AFM 391 exam. The final exam will have similar format and the length. Note that the course evolves over time; for example, the order chapters are discussed changes.

- All solutions shall be prepared based on IFRS unless it is stated otherwise.
- Questions on examination are **not** permitted during the exam. If you believe an exam question requires clarifying, please include your assumptions as part of your answer.
- The fiscal year end of all the companies mentioned in the exam is December 31 unless stated otherwise.
- Please round your answers **to the nearest dollar** unless stated otherwise.
- If a question requires a journal entry, and you are uncertain about a specific account name, please indicate in your account title whether it is an asset, liability, stockholders' equity, revenue, expense, gain, or loss.
- Show your work as partial credit may be awarded.

Additional Materials Allowed: Students are allowed to use a financial calculator.

MULTIPLE CHOICES:

Please choose **the best answer** and transfer all answers to the table below by blackening the letter of the correct answer. A multiple choice problem will **not** be graded if no answer is transferred to the table.

1	(a)	(b)	(c)	(d)	14	(a)	(b)	(c)	(d)
2	(a)	(b)	(c)	(d)	15	(a)	(b)	(c)	(d)
3	(a)	(b)	(c)	(d)	16	(a)	(b)	(c)	(d)
4	(a)	(b)	(c)	(d)	17	(a)	(b)	(c)	(d)
5	(a)	(b)	(c)	(d)	18	(a)	(b)	(c)	(d)
6	(a)	(b)	(c)	(d)	19	(a)	(b)	(c)	(d)
7	(a)	(b)	(c)	(d)	20	(a)	(b)	(c)	(d)
8	(a)	(b)	(c)	(d)	21	(a)	(b)	(c)	(d)
9	(a)	(b)	(c)	(d)	22	(a)	(b)	(c)	(d)
10	(a)	(b)	(c)	(d)	23	(a)	(b)	(c)	(d)
11	(a)	(b)	(c)	(d)	24	(a)	(b)	(c)	(d)
12	(a)	(b)	(c)	(d)	25	(a)	(b)	(c)	(d)
13	(a)	(b)	(c)	(d)					

Multiple Choices:

1. Which of the following statements about liabilities is *true*?
    a. Conceptually, liabilities should be valued at the present value of all cash to be paid in the future.
    b. All liabilities must have a definite amount owed and must not be contingent on a future event.
    c. A noninterest-bearing note sometimes is called a discounted note because the cash received is more than the face amount of the note.
    d. The market rate of interest is the interest rate used to determine the amount of cash interest that will be paid on the principal.

2. A firm's future payments for holiday and vacation pay are earned as employees provide service, accumulate but do not vest, most likely will be paid and are estimable. However, unused vacation credit can be carried over two years at most. This firm is so much fun to work for that a material and estimable percentage of personnel let some vacation benefits lapse. Therefore:
    a. this firm should accrue all earned vacation pay except for vacation salary benefits not expected to be paid.
    b. this firm should accrue all earned vacation pay.
    c. this firm need not accrue vacation pay .
    d. this firm would accrue all earned vacation pay only if the benefits vest.

3. On January 1, 2006, ST purchased a machine and gave a $30,000 three year, 8% note payable to the seller. The market interest rate was 12%. The annual interest payments are to be paid on each December 31. On January 1, 2006, ST should record the net liability amount determined as follows:
    a. compute the present value of its face amount and the three $2,400 interest amounts by using a discount rate of 8%.
    b. compute the present value of its face amount and the three $2,400 interest amounts by using a discount rate of 12%.
    c. use its face amount, $30,000 plus the $7,200 interest.
    d. use its face amount, $30,000 minus $7,200 interest.

4. The result of an effective interest rate that is higher than the stated rate on a debt security is the:
    a. carrying value of the debt will decrease each interest period.
    b. security will sell at a premium.
    c. cash interest paid on each interest date will be changed.
    d. dollar amount of interest expense reported on the income statement, assuming the interest method is used, will increase each interest period.

5. A company reacquires shares of its own stock during the fiscal year and reports the transaction in the theoretically correct manner. What effect will this transaction have on stockholders' equity and earnings per share, respectively?
    a. increase and decrease
    b. decrease and decrease
    c. decrease and increase
    d. increase and no effect

6. On December 31, 2005, TTX reported owners' equity of $150,000. During 2006, TTX declared and paid cash dividends of $30,000; reported net income of $15,000; issued additional common shares for $70,000; and distributed stock dividends of $15,000. Therefore, the 2006 ending amount of stockholders' equity was:
    a. $190,000.
    b. $205,000.
    c. $135,000.
    d. None of the above.

7. The cost of a compensatory stock option plan should be expensed:
    a. during the accounting periods in which the related services are rendered.
    b. never is expensed.
    c. in full when the stock option is granted to the employee.
    d. in full when the stock option is exercised by the employee.

8. Intrinsic value of an option is the
    a. difference between the price of the underlying security and the strike price.
    b. value due to expectations that the price of the underlying security will rise above the strike price.
    c. minimum value of the option.
    d. option premium value.

9. Pat Co. has $3,000,000 of 8% convertible bonds outstanding. Each $1,000 bond is convertible into 30 no par value common shares. The bonds pay interest on January 31 and July 31. On July 31, 2006, the holders of $900,000 bonds exercised the conversion privilege after the interest has been paid. On that date the market price of the bonds was 105, the market price of the common shares was $36, the carrying value of the common shares was $18 and the total Contributed Surplus—Bond Conversion was $450,000. The total unamortized bond premium at the date of conversion was $210,000. Using the book value method, Pat should record as a result of this conversion
    a. a loss of $9,000.
    b. no gain or loss.
    c. a debit of $210,000 to Premium on Bonds Payable.
    d. a credit of $135,000 to Contributed Surplus—Bond Conversion.

10. In computing EPS, the preferred stock dividends are subtracted from (and not added back to) the numerator of
    a. Basic EPS whenever the preferred stock is non-convertible.
    b. Diluted EPS whenever the preferred stock is convertible.
    c. Basic EPS whenever the preferred stock is cumulative.
    d. Diluted EPS whenever the preferred stock is cumulative.

11. For purposes of computing the weighted average number of shares outstanding during the year, a midyear event that must be treated as occurring at the beginning of the year is the:
    a. Sale of additional common stock.
    b. Issuance of stock warrants.
    c. Reacquisition of common shares.
    d. Declaration and issuance of stock dividend.

Use the following information for questions 12 and 13.

Edwards Co. had 200,000 common shares, 30,000 convertible preferred shares, and $1,500,000 of 10% convertible bonds outstanding during 2006. The bonds would have been issued at par if no conversion rights were attached. The preferred shares are convertible into 40,000 common shares. During 2006, Edwards paid dividends of $1.20 per share on the common shares and $3.00 per share on the preferred shares. Each $1,000 bond is convertible into 45 common shares. The net income for 2006 was $900,000 and the income tax rate was 30%.

12. Basic earnings per share for 2006 is (rounded to the nearest penny)
    a. $3.75.
    b. $4.05.
    c. $4.29.
    d. $4.50.

13. Diluted earnings per share for 2006 is (rounded to the nearest penny)
    a. $2.98.
    b. $3.38.
    c. $3.27.
    d. $3.41.

14. When a company adopts a pension plan, the prior service costs should be charged to
    a. operations of current and future periods.
    b. operations of prior periods.
    c. operations of the current period.
    d. retained earnings.

Use the following information for questions 15 and 16.

On January 1, 2011, Ning Inc. has the following balances:

Accrued benefit obligation, accounting basis	$1,400,000
Fair value of plan assets	1,250,000

The interest rate for the obligation and the plan assets is 10%. Other data related to the pension plan for 2010 are:

Service cost	$80,000
Amortization of unrecognized prior service costs	18,000
Contributions	90,000
Benefits paid	75,000
Actual return on plan assets	88,000
Amortization of unrecognized net gain	6,000

15. The balance of the projected benefit obligation at December 31, 2010 is
    a. $1,524,000.
    b. $1,530,000.
    c. $1,543,000.
    d. $1,545,000.

16. The fair value of plan assets at December 31, 2010 is
    a. $1,177,000.
    b. $1,263,000.
    c. $1,353,000.
    d. $1,428,000.

17. Presented below is information related to Marley Ltd. pension data for 2010:

Service cost	$900,000
Actual return on plan assets	210,000
Interest on projected benefit obligation	390,000
Amortization of experience loss	90,000
Amortization of unrecognized prior service cost	165,000
Expected return on plan assets	180,000

    What amount should be reported for pension expense in 2010?
    a. $1,365,000.
    b. $1,335,000.
    c. $1,515,000.
    d. $1,155,000.

18. Oil Products purchased an oil tanker depot on January 1, 2005 at a cost of $5 million. Oil Products expects to use the tank for 10 years, at which time it is leagally required to dismantle the depot and remove the underground storage tanks. It is estimated that it will cost $500,000 to retire the depot at the end of depot's useful life. The present value of the retiring cost is $279,197 based on an effective interest rate of 6%. Oil Products prepare financial statements annually at the end of December. How should Oil Products report the cost for retiring the depot?
   a. record an expense of $500,000 by December 31, 2014.
   b. record a liability of $500,000 by December 31, 2005.
   c. record a liability of $279,197 by December 31, 2005.
   d. record a liability of $295,949 by December 31, 2005.

19. Interest cost included in the net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan represents the
   a. shortage between the expected and actual returns on plan assets.
   b. increase in the projected benefit obligation due to the passage of time.
   c. increase in the fair value of plan assets due to the passage of time.
   d. amortization of the discount on unrecognized prior service cost.

Use the following information for questions 20 through 21.

Marat Company's December 31 year-end financial statements contained the following errors:

	Dec. 31, 2006	**Dec. 31, 2007**
Ending inventory	$1,500 understated	$2,200 overstated
Amortization expense	$400 understated	no error

An insurance premium of $3,600 was prepaid in 2006 covering the years 2006, 2007, and 2008. The prepayment was recorded with a debit to insurance expense of $3,600 in 2006. In addition, on December 31, 2007, fully amortized machinery was sold for $1,900 cash, but the sale transaction was not recorded until 2008. There were no other errors during 2007 or 2008 and no corrections have been made for any of the errors. Ignore income tax considerations.

20. What is the total net effect of the errors on Marat's **2007** net income?
   a. Net income understated by $2,900.
   b. Net income overstated by $1,500.
   c. Net income overstated by $2,600.
   d. Net income overstated by $3,000.

21. What is the total effect of the errors on the balance of Marat's retained earnings at **December 31, 2007**?
    a. Retained earnings understated by $2,000.
    b. Retained earnings understated by $900.
    c. Retained earnings understated by $500.
    d. Retained earnings overstated by $700.

Use the following information for questions 22 and 23.

Egoyan Company purchased a machine on January 1, 2004, for $600,000. At the date of acquisition, the machine had an estimated useful life of six years with no residual value. The machine is being amortized on a straight-line basis. On January 1, 2007, Egoyan determined, as a result of additional new information, that the machine had an estimated useful life of eight years from the date of acquisition with no residual value. An accounting change was made in 2007 to reflect this additional information.

22. Assuming that the direct effects of this change are limited to the effect on amortization and the related tax provision, and that the income tax rate was 30% in 2004, 2005, 2006, and 2007, what should be reported in Egoyan's income statement for the year ended December 31, 2007, as the cumulative effect on prior years of changing the estimated useful life of the machine?
    a. $0.
    b. $40,000.
    c. $60,000.
    d. $210,000.
23. What is the amount of amortization expense on this machine that should be charged in Egoyan's income statement for the year ended December 31, 2007?
    a. $60,000.
    b. $75,000.
    c. $120,000.
    d. $150,000.

24. A segment of a business enterprise is to be reported separately when the revenues of the segment exceed 10 percent of the
    a. total combined revenues of all segments reporting profits.
    b. total revenues of all the enterprise's operating segments.
    c. total export and foreign sales.
    d. combined net income of all segments reporting profits.

25. Which of the following subsequent events (post-balance sheet events) would require adjustment of the accounts before issuance of the financial statements?
    a. Loss of plant as a result of fire
    b. Changes in the quoted market prices of securities held as an investment
    c. Loss on an uncollectible account receivable resulting from a customer's major flood loss
    d. Loss on a lawsuit, the outcome of which was deemed uncertain at year end.

Problem 1 Income Tax

Lee Ltd. started its business on January 1, 2004. Lee incurred a taxable loss of $50,000 in 2004, which was the same as its pretax accounting loss of 2004. Lee believed that it is more likely than not to have taxable income in years following 2004. In 2005, Lee's pretax accounting income was a profit of $80,000.

The following three items caused differences between Lee's pretax accounting income and taxable income in 2005:

1. Excess of tax amortization over book amortization for a piece of equipment, $18,000. This $18,000 difference will reverse in equal amounts in 2006 and 2007.
2. Deferral, for book purposes, of $4,000 rent received in advance. The rent will be earned in 2006, but is taxable in 2005.
3. Premium paid for life insurance carried by the company on key officers is $2,000 in 2005. This is not deductible for tax purposes, but is expensed for accounting purposes.

The existing tax rate is a 30% flat rate for all the years.

Instructions:

(a) Prepare journal entry (entries) to record income taxes for 2004.

(b) Prepare journal entry (entries) to record income taxes for 2005.

Problem 2 Lease

The following information relates to a lease contract:

Lease inception	Jan. 1, 2004
The cost (to lessor) of leased equipment at Jan. 1, 2004	$10,000
The fair value of leased equipment at Jan. 1, 2004	$12,000
Interest rate for lease accounting (both lessee and lessor)	10%
Lease payments due	Dec. 31, 2004, 2005, 2006
End of lease term	Jan. 1, 2007
Expected residual value at Jan. 1, 2007	$1,000
Expected residual value at Jan. 1, 2010 (end of useful life)	$100

The lease allows the lessee to purchase the asset for $200 on Jan. 1, 2007.

There are no uncertainties with respect to collectibility of lease payments, or performance by lessor. Assume no taxation.

Present value of 1 for 3 periods at 10%	.75132
Present value of 1 for 6 periods at 10%	.56447
Present value of an ordinary annuity of 1 for 3 periods at 10%	2.48685
Present value of an ordinary annuity of 1 for 6 periods at 10%	4.35526

Instructions:

(a) Determine the amount of the annual lease payment required by the lessor.

(b) Prepare all necessary 2004 entries for lessor.

(c) Prepare all necessary 2004 entries for lessee.

Problem 3 Cash Flow

The balance sheet data of Lima Company at the end of 2006 and 2005 are as follows:

	2006	2005
Cash	$ 75,000	$105,000
Accounts receivable	190,000	155,000
Allowance for doubtful accounts	(10,000)	(20,000)
Merchandise inventory	210,000	135,000
Prepaid expenses	30,000	75,000
Land	370,000	120,000
Equipment	270,000	225,000
Accumulated amortization—equipment	(54,000)	(24,000)
Totals	$1,081,000	$771,000
Accounts payable	$204,000	$165,000
Accrued expenses	36,000	54,000
Notes payable—bank, long-term		120,000
Mortgage payable	90,000	
Common shares, no par	727,000	477,000
Retained earnings (deficit)	24,000	(45,000)
	$1,081,000	$771,000

At 2006 year end, the following additional information is available:

Land was acquired for $150,000 in exchange for common shares valued at $150,000 during the year. Equipment costing $15,000 was sold for $6,000; book value of the equipment was $12,000. All investment in long-term assets was in cash if not mentioned otherwise. No sale of land. Cash dividends of $30,000 were charged to retained earnings and paid during the year; the transfer of net income to retained earnings was the only other entry in the Retained Earnings account. Common shares of $100,000 were issued for cash.

Instructions:

(a) Prepare the operating activities section of the statement of cash flow for year 2006 using the indirect method.

(b) Prepare the investing activities section of the statement of cash flows for year 2006.

(c) The 2006 income statement of Lima reported $800,000 sales revenue, and $525,000 cost of goods sold. Calculate (1) the operating cash inflow received from customers; (2) the operating cash outflow paid to merchandise suppliers.

Multiple Choices

1. a	2. a	3. b	4. d	5. c	6. b	7. a	8. a	9. b	10. c
11. d	12. b	13. c	14. a	15. d	16. c	17. a	18. d	19. b	20. d
21. c	22. a	23. a	24. b	25. d					

Problem 1 Income Tax

(a) Prepare journal entry (entries) to record income taxes for 2004.

Dr. Future Income Tax Asset	15,000*	
Cr. Future Income Tax Benefit		15,000

$50,000*30%=$15,000

(b) Prepare journal entry (entries) to record income taxes for 2005.

Dr. Current Income Tax Expense	5,400*	
Cr. Income Tax Payable		5,400

*$18,000*30%=$5,400

Dr. Future Income Tax Expense	19,200	
Cr. Future Income Tax Liability		4,200*
Cr. Future Income Tax Asset		15,000

*($18,000-$4,000)*30%=$4,200

Calculate taxable income for 2005.

Accounting Income	$80,000
Add: Non-deductible life insurance	2,000
Less: Excess of tax amortization	(18,000)
Add: Taxable rent	4,000
Less: Carryforward loss from 2004	(50,000)
Taxable income	$18,000

Problem 2 Lease

Solutions:
(a)

Fair market value of leased asset to lessor	$12,000
Less: Present value of Bargain Purchase Option	
$200 X .75132	
(Present value of 1 at 10% for 3 periods)	(150)
Amount to be recovered through lease payments	$11,850
Three annual lease payments	
$11,850 ÷ 2.48685*	$4,765

*Present value of an ordinary annuity of 1 for 3 periods at 10%

(b)

Date	Account	Debit	Credit
1/1/04	Lease Payments Receivable*	14,495	
	Cost of Goods Sold	10,000	
	Sales Revenue		12,000
	Equipment purchased for lease		10,000
	Unearned Interest Revenue— Leases		2,495
	* ($4,765X 3) +$200=$14,495		
12/31/04	Unearned Interest Revenue— Leases	1,200	
	Interest Revenue		1,200
	($12,000 X 10%=$1,200)		
	Cash	4,765	
	Lease Receivable		4,765

(c)

Date	Account	Debit	Credit
1/1/04	Equipment under Capital Lease	12,000	
	Obligation under Capital Lease		12,000
12/31/04	Interest Expense (10% X $12,000)	1,200	
	Obligation under Capital Lease	3,565	
	Cash		4,765
	Depreciation Expense – Capital Lease	1,983	
	Accumulated Depreciation – Capital Lease		1,983
	($12,000 – 100) / 6 years = $1,983		

Problem 3 Cash Flows

(a)

Net Income ($24,000+$45,000+$30,000)	$99,000
Adjustments:	
Increase in net A/R	(45,000)
Increase in Inventory	(75,000)
Decrease in Prepaid Expense	45,000
Increase in A/P	39,000
Decrease in Accrued Expense	(18,000)
Amortization Expense ($54,000+$3,000-$24,000)	33,000
Loss on Selling Equipment	6,000
Net Operating Cash Flow	$84,000

(b)

Cash receipts from selling equipment	$6,000
Cash payments on purchasing equipment	(60,000)
Cash payments on purchasing land	(100,000)
Net Investing Cash Flow	$(154,000)

(c)

(1) $800,000-$45,000=$755,000
(2) $600,000*-$39,000=$561,000
*$525,000+$210,000-$135,000=$525,000+$75,000=$600,000