

**UNIVERSITY OF WATERLOO**  
**School of Accounting and Finance**

**AFM 101**  
**Professor Shari Mann**  
**Professor Donna Psutka**  
**Professor Mindy Wolfe**

**Mid-Term Examination**  
**Fall 2010**

**Date and Time: October 21, 2010, 6:30 – 8:00pm**

**Pages: 17, including cover**

**Name: \_\_\_\_\_ SOLUTION \_\_\_\_\_**

**Student Number: \_\_\_\_\_**

**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	12	
2	19	
3	22	
4	8	
5	25	
Total	86	

**Question 1 (12 Marks)**

West Mountain Trading Company has been in business for a few years and has net assets of \$1,276,000 and net liabilities of \$1,112,000 at the end of 2009. The company's fiscal year end is December 31. Journalize the adjusting entry needed at December 31, 2009 for each of the following situations. You do not need to include explanations. Answers must appear in the space provided.

- a. The business received a loan for \$22,000 with a 9% interest rate on October 1. The principal and interest is due in 1 year. The original loan has been recorded but the interest has not.

Interest Expense	\$495	
Interest payable		\$495

$$\$22,000 * .09 * 3/12$$

- b. Interest revenue of \$4,200 has been earned but not yet received.

A/R	\$4,200	
Interest Revenue		\$4,200

- c. On July 1, the firm collected \$12,600 rent in advance, and debited Cash and credited Unearned Rent Revenue. The tenant was paying for two years rent starting July 1, 2009.

Unearned Rent Revenue	\$3,150	
Rent Revenue		\$3,150

$$\$12,600/2 \text{ years} = \$6,300/\text{year} * 6/12$$

- d. Wages expense is \$1,900 per day – Monday through Friday- and the business pays employees each Friday. This year, December 31 falls on a Wednesday.

Wages Expense	\$5,700
Wages Payable	\$5,700
(\$1,900 X 3 days)	

- e. The unadjusted balance of the inventory account is \$2,600. The total cost of inventory on hand is \$1,200.

COGS	\$1,400
Inventory	\$1,400
\$2,600-\$1,200	

- f. Equipment was purchased on April 1st at a cost of \$160,000. The equipment's useful life is seven years. The residual value is \$55,000.

Amortization Expense	\$11,250
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Accumulated Amortization	\$11,250
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$((\$160,000 - \$55,000) / 7 \text{ years}) = \$15,000 * 9/12 = \$11,250$

**Question 2** (19 marks)

Solomon Inc. sells ski equipment to retailers throughout North America. The firm's fiscal year end is December 31. The following provides all of the account balances from the unadjusted trial balance at the end of 2010.

	<b>Debit</b>	<b>Credit</b>
Cash.....	\$ 42,500	
Accounts Receivable.....	24,000	
Inventory .....	45,300	
Prepaid Insurance.....	18,000	
Machinery .....	210,000	
Accumulated Amortization Machinery		92,000
Accounts payable .....		48,000
Notes payable .....		80,000
Wages payable .....		18,000
Capital Stock. ....		70,000
Retained Earnings (as at 12/31/2009).		48,300
Sales Revenue .....		75,000
Cost of Goods Sold. ....	37,500	
Wages Expense .....	23,000	
Utility Expense.....	31,000	

**Required:**

The following events and/or circumstances have not yet been recorded by Solomon Inc. Provide the journal entry or adjusting journal entry, as appropriate, for each of the following events or circumstances. You do not need to include explanations. Answers must appear in the space provided.

- a. A one-year insurance policy on company assets was issued on July 1, 2010. Premiums are paid annually in advance.

Insurance Expense     \$9,000  
     Prepaid Insurance     \$9,000  
 (\$18,000 in PrePaid Insurance \* 6/12)

- b. The bill for December's utility costs of \$2,900 was paid on January 5, 2011.

Utility Expense         \$2,900  
     Utilities Payable     \$2,900

- c. The company issued 100,000 shares to new investors and received \$50,000 in cash and land valued at \$10,000.

Cash	\$50,000	
Land	\$10,000	
	Share Capital	\$60,000

- d. Sold merchandise costing \$13,000 for \$5,000 cash and \$21,000 on account to Feynman Co.

COGS	\$13,000	
	Inventory	\$13,000
Cash	\$ 5,000	
A/R	\$21,000	
	Revenue	\$26,000

- e. On December 31st purchased a building for \$25,000 cash and a \$125,000 mortgage with a 4% interest rate. Payments of interest and principal are to be made quarterly.

Building	\$150,000	
	Cash	\$ 25,000
	Mortgage Payable	\$125,000

- f. Sold a piece of machinery for \$25,000 in cash. The original cost of the machine was \$80,000 and the accumulated amortization was \$45,000.

Cash	\$25,000	
Accum. Amortization	\$45,000	
Loss on Sale of Machinery	\$10,000	
Machine		\$80,000

**Question 3** (22 marks)

The following information relates to activities for Bell Limited for 2009.

The company sold equipment for \$15,000 cash and replaced it with new equipment that it paid for with cash.

Land was also purchased for cash, and no land was sold.

Bell Limited made a payment on the principal of Notes Payable using cash.

Dividends were paid in cash and Share Capital was issued for cash.

Selected (final) account balances at December 31, 2008 and 2009 are shown in the following table. All account balances have the usual sign.

	<u>2009</u>	<u>2008</u>
<b>Current Assets:</b>		
Cash	\$ 25,300	\$ 40,600
Accounts Receivable	47,100	44,000
Inventories	94,300	114,900
Prepaid Expenses	1,700	2,200
<b>Plant Assets:</b>		
Land	35,100	10,000
Equipment, net	80,900	93,700
<b>Total Assets</b>	<u>\$ 284,400</u>	<u>\$ 305,400</u>
<b>Current Liabilities:</b>		
Accounts payable	\$ 22,700	\$ 24,600
Salaries payable	2,100	1,400
Other accrued liabilities	24,400	22,500
<b>Long Term liabilities:</b>		
Notes Payable	55,000	65,000
<b>Shareholders' equity</b>		
Share Capital	131,100	122,300
Retained Earnings	49,100	69,600
<b>Total Liabilities and Shareholder's equity</b>	<u>\$ 284,400</u>	<u>\$ 305,400</u>
<b>Revenues</b>		
Sales revenue		\$ 338,000
Interest revenue		11,700
Total Revenues		<u>\$ 349,700</u>
Cost of goods sold	185,200	
Amortization expense, equipment	15,300	
Other operating expenses	140,700	
Loss from sale of equipment	5,000	
Income Tax expense	16,900	
Total Expenses		363,100
Net Income/ (loss)		\$ ( 13,400)

**Required:**

Prepare the statement of cash flows for Bell Limited for 2009 using the indirect method.

Bell Limited  
Statement of Cash Flows  
For the year ended December 31, 2009

Operating Activities:		
Net Loss	(\$13,400)	
Items not affecting Cash		
Amortization Expense	15,300	
Loss from Sale of Equipment	5,000	
A/R Increase	(3,100)	
Inventory Decrease	20,600	
Prepaid Expense Decrease	500	
A/P Decrease	(1,900)	
Salaries Payable	700	
Accrued Liabilities	1,900	
<hr/>		
Net cash flow from operating activities		<u>25,600</u>
Investing Activities:		
Purchase of Land	(25,100)	
Equipment Sold	15,000	
Equipment Purchased	(22,500)	
<hr/>		
Net cash flow from investing activities		<u>(32,600)</u>
Financing Activities		
Dividends paid	(7,100)	
Share Capital issued	8,800	
Notes Payable	(10,000)	
<hr/>		
Net cash flow from financing activities		(8,300)
Net Decrease in Cash		(15,300)
Cash Balance at beginning of year		40,600
Cash Balance at end of year		<u>25,300</u>

#### Question 4 (8 Marks)

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

- A. List one cost and one benefit to Canadian companies as they switch to International Financial Reporting Standards.

**Benefits -“speak the same language” as other countries**  
**-don’t have to reconcile to US GAAP (reduce costs)**  
**- reduce cost of capital by increasing access to capital markets**

**Costs – training and education**

- B. What does a high Return on Assets (ROA) ratio tell us about a company?

**-how much the firm earned for each dollar of investment**  
**or**  
**-managements effectiveness in creating profit from investments**

- C. The article “Hide and Seek” discusses red flags investors should look for to ensure that earnings statements reflect the company’s bottom line. Explain briefly 2 of the red flags discussed in the article.

**-Big Bath-take 1 big hit, write offs all in one period**  
**-Pro Forma reporting**  
**-Move debt off the B/S to SPE**  
**-Manipulation of pension plan assumptions**  
**-Record expenses as assets**  
**-Using tax credits or other nonoperating income to boost earnings**  
**-Diluting Shares through employee stock options**  
**-Channel Stuffing-selling merchandise that will be returned or selling at a deep discount**  
**-Changing accounting standards (US GAAP vs Canadian GAAP)**  
**-Words that are red flags “going concern”, CEO CFO leaving to pursue other interests**

- D. The article “The consequences of earnings management for the non-financial manager?” discusses consequences of manipulating earnings. Briefly describe two consequences of manipulating earnings.

**-Reversal of fortune-increasing current period income is done at the expense of future period income which will be lower.**  
**-Loss of credibility**  
**– Managements credibility of providing accurate estimates**  
**- If all managers manipulate earnings the loss of credibility of accounting information in general.**



### Question 5 (25 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. What is the purpose of an audit?
  - A) to prove the accuracy of an entity's financial statements.
  - B) to lend credibility to an entity's financial statements.
  - C) to endorse the quality of leadership that managers provide for a corporation.
  - D) to establish that a corporation's shares are a sound investment.
  
2. Why can't a business's balance sheet created under Canadian GAAP be used to accurately predict what the business might be sold for?
  - A) it identifies all the revenues and expenses of the business.
  - B) assets are generally listed on the balance sheet at their historical cost, not their current value.
  - C) it gives the results of operations for the current period.
  - D) some of the assets and liabilities on the balance sheet may actually be those of another entity.
  
3. Why would Parker Bank, in deciding whether to make a loan to Davis Company, be interested in the amount of liabilities Davis has on its balance sheet?
  - A) The liabilities represent resources that could be used to repay the loan.
  - B) If Davis already has many other obligations, it might not be able to repay the loan.
  - C) Existing liabilities give an indication of how profitable Davis has been in the past.
  - D) Parker would be interested in the amount of Davis's assets but not the amount of liabilities.
  
4. Woofers Corporation reported the following for 2007; total assets, \$260,000; total liabilities, \$105,000; share capital, \$120,000. Therefore, retained earnings was
  - A) \$155,000.
  - B) \$245,000.
  - C) \$140,000.
  - D) \$35,000.
  - E) None of the above is correct.

5. If Bender Corporation recently purchased goods from you on account, which of Bender's financial statements would you look at to determine whether Bender has sufficient resources to be able to pay for the goods when payment is due in 30 days?
- income statement.
  - balance sheet.
  - statement of retained earnings.
  - cash flow statement.
6. Assume a company's January 1, 2006, financial position was: Assets, \$156,000 and Liabilities, \$65,000. During January 2006, the company completed the following transactions: (a) paid on a note payable \$10,000 (no interest was paid); (b) collected an accounts receivable, \$9,500; (c) paid an accounts payable, \$6,000; and (d) purchased a truck, \$9,000 cash, and a took out a loan for \$20,000 (note payable). The company's January 31, 2006 financial position is
- |    | Assets    | Liabilities | Stockholders' Equity |
|----|-----------|-------------|----------------------|
| A) | \$100,000 | \$69,000    | \$31,000             |
| B) | \$160,000 | \$69,000    | \$91,000             |
| C) | \$169,000 | \$45,000    | \$124,000            |
| D) | \$174,500 | \$49,000    | \$125,500            |
7. When a company buys equipment for \$60,000 and pays for one third in cash and the other two thirds is financed by a note payable, which of the following are the effects on the accounting equation?
- cash decreases by \$60,000
  - equipment increases by \$20,000
  - liabilities increase by \$40,000
  - total assets increase by \$60,000
8. During 2009, its second year in operation, Banner Company delivered goods to customers for which customers paid or promised to pay \$5,850,000. The amount of cash collected from customers was \$5,960,000. The amount of accounts receivable at the beginning of 2009 was \$1,200,000. What is the amount of sales revenue that Banner should report on its income statement for 2009?
- \$4,650,000.
  - \$4,760,000.
  - \$5,850,000.
  - \$5,960,000.

9. Golden Company had these transactions during the accounting period.

Sold merchandise for \$600; its cost was \$400.

Collected \$400 from an account receivable. The account was established in the previous year.

Used office supplies of \$50.

Golden's net income for the period would be which of the following?

- A) \$ 50.
- B) \$150.
- C) \$600.
- D) \$900.

10. On January 1, 2009, Grover Inc., started the year with a \$22,000 credit balance in its retained earnings account. During 2009, the company earned net income of \$40,000 and declared and paid dividends of \$10,000. Also, the company received cash of \$15,000 as an additional investment by its owners. Therefore, the balance in retained earnings on December 31, 2009, would be which of the following?

- A) \$42,000.
- B) \$52,000.
- C) \$57,000.
- D) \$67,000.

11. On December 31, 2009, BTW Corporation paid \$9,500 for next year's insurance policy. This transaction should be recorded as follows by BTW:

- |                      |         |         |
|----------------------|---------|---------|
| A) Cash              | \$9,500 |         |
| Insurance Payable    |         | \$9,500 |
| B) Prepaid Insurance | \$9,500 |         |
| Insurance Payable    |         | \$9,500 |
| C) Prepaid Insurance | \$9,500 |         |
| Cash                 |         | \$9,500 |
| D) Insurance Expense | \$9,500 |         |
| Cash                 |         | \$9,500 |

12. On January 1, 2009, Antonio Company purchased a delivery truck that cost \$44,000. Cash of \$20,000 was paid, and the balance of \$24,000 is payable on January 31, 2010. The truck has an estimated useful life of four years and no residual value. Considering only these facts, depreciation expense (on the truck) for 2009, would be
- \$11,000.
  - \$6,000.
  - \$5,000.
  - \$44,000.
  - None of the above is correct.
13. At the end of 2009, the following data were taken from the accounts of Stars Company:

Share Capital	\$ 555,000
Retained earnings, beginning balance January 1, 2009	350,000
Total revenue earned during 2009	930,000
Total expenses incurred during 2009	810,000
Total cash collected during 2009	880,000

- The 2009 closing entries would include a
- \$930,000 net credit to Retained earnings.
  - \$930,000 net debit to Retained earnings.
  - \$120,000 debit to Retained earnings.
  - \$120,000 credit to Retained earnings.
  - none of the above.
14. ABC Company reported total sales revenue of \$80,000 and total expenses of \$72,000 (i.e., net income \$8,000) for the year ended December 31, 2009. During 2009, accounts receivable increased by \$3,000, merchandise inventory decreased by \$2,000, accounts payable increased by \$1,000, and \$5,000 in amortization expense was recorded. Assuming no other adjustments to net income are needed, what was the net cash inflow from operating activities?
- \$10,000.
  - \$11,000.
  - \$13,000.
  - \$19,000.
15. Which one of the following statements about cash flows from operating activities, in a cash flow statement prepared under the indirect method, is correct?
- An increase in accounts receivable would be subtracted from net income.
  - An increase in salaries payable would be subtracted from net income.
  - An increase in inventory would be added to net income.
  - Depreciation expense would be subtracted from net income.

16. Sean Company reported income tax expense of \$240,000. Beginning income taxes payable was \$30,000 while ending income taxes payable was \$25,000. What cash was paid for taxes?
- A) \$240,000
  - B) \$245,000
  - C) \$235,000
  - D) It cannot be computed with the given information.
17. Which of the following is not true of the direct method of preparing a cash flow statement?
- A) it gives the user a sense of the magnitude of gross dollars flowing in and out of the company.
  - B) it has the same cash flows from investing and financing activities as the indirect method.
  - C) it has a different net cash inflow (outflow) from operating activities than the indirect method.
  - D) it reports the same net increase or decrease in cash as the indirect method.
18. During 2009, its second year in operation, Banner Company delivered goods to customers for which customers paid or promised to pay \$5,850,000. Assume all sales were on account and the amount of cash collected from customers was \$5,960,000. The amount of accounts receivable at the beginning of 2009 was \$1,200,000. Based on this information, what is the amount of accounts receivable that Banner would report at the end of 2009?
- A) \$ 110,000.
  - B) \$1,090,000.
  - C) \$1,310,000.
  - D) \$5,850,000.

19. The financial statements for Ozzie Company show the following:

Cost of Goods Sold	\$123,000	
		Ending
	Beginning Balance	Balance
Merchandise Inventory	\$ 25,000	\$ 26,000
Accounts Receivable	35,000	33,000
Accounts Payable	18,000	21,000

How much cash was paid for merchandise?

- A) \$117,000.
  - B) \$119,000.
  - C) \$121,000.
  - D) \$124,000.
20. A company purchases \$15,000 of inventory in April 2008 and will pay for it in May 2008. Which one of the following statements is false?
- A) The company will report an accounts payable of \$15,000 in April 2008.
  - B) The statement of cash flows will report an operating cash outflow of \$15,000 in May 2008.
  - C) The income statement will report the \$15,000 as cost of goods sold in April 2008 when they are purchased.
  - D) None of the above is false.
  - E) All of the above are false.
21. Taco Bravo's asset turnover ratio in 2009 was 3.24, in 2008 it was 3.10 and in 2007 it was 2.88. Which of the following is true about Taco Bravo's asset turnover ratio?
- A) The ratio has improved over the last three years.
  - B) The improvement from 2008 to 2009 was most likely caused by a decrease in net sales or an increase in total assets.
  - C) In 2009, Taco Bravo was able to generate \$3.24 of revenue for every dollar invested in average total assets.
  - D) Both A and C are true.
  - E) All of the above are true.
22. A machine that cost \$40,000 was purchased at the beginning of the current year. Its estimated useful life is 8 years and its estimated residual value is \$8,000. The adjusting entry at the end of the first year would include a
- A) \$4,000 credit to accumulated depreciation and a debit to depreciation expense.
  - B) \$5,000 debit to depreciation expense and a credit to accumulated depreciation.
  - C) \$32,000 debit to depreciation expense and a credit to accumulated depreciation.
  - D) \$4,000 debit to repair expense and a credit to accumulated depreciation.

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

	<u>2009</u>		<u>2008</u>		<u>2007</u>
Sales Revenue	\$ 42,905		\$ 37,491		\$ 24,578
Cost of Goods Sold	<u>25,683</u>		<u>24,294</u>		<u>1,646</u>
Gross Profit	17,222		13,197		22,932
Amortization Expense	3,831		2,828		1,511
Other Expenses	326		620		599
Net Income	<u>\$ 13,065</u>		<u>\$ 9,749</u>		<u>\$ 20,822</u>
Current Assets	\$ 31,555		\$ 30,006		
Total Assets	\$ 47,501		\$ 36,171		
Current Liabilities	\$ 11,506		\$ 11,361		
Total Liabilities	\$ 15,861		\$ 13,874		
Total Shareholder's Equity	\$ 31,640		\$ 22,297		
Shares Outstanding	899		888		
Cash Flow from Operating Activities	\$ 14,510		\$ 8,556		

23. What was the Quality of Income Ratio in 2009?

- A) .84
- B) .86
- C) .90
- D) 1.11

24. What was the Debt to Equity Ratio in 2009?

- A) .36
- B) .50
- C) .62
- D) 1.99

25. What was the asset turnover ratio in 2009?

- A) .90
- B) 1.03
- C) 1.11
- D) 1.90





## Ratios

Price- Earnings Ratio

$$\frac{\text{Market Price}}{\text{Net Income}}$$

**OR**

$$\frac{\text{Market Price per Share}}{\text{Earnings per Share}}$$

Debt to Equity Ratio

$$\frac{\text{Total Liabilities}}{\text{Owners' Equity}}$$

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

$$\frac{\text{Net Income Available to Common Shareholders}}{\text{Weighted-Average Number of Common Shares Outstanding}}$$

Net Profit Margin

$$\frac{\text{Net Income}}{\text{Net Sales}}$$

Quality of Income Ratio

$$\frac{\text{Cash Flow from Operating Activities}}{\text{Net Income}}$$

Capital Acquisition Ratio

$$\frac{\text{Cash Flow from Operating Activities}}{\text{Cash Paid for Property, Plant, and Equipment}}$$

Return on Equity

$$\frac{\text{Net Income}}{\text{Average Shareholders' Equity}}$$

## Answers to Multiple Choice

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