

## SOLUTION

### Question 1 (20 marks: suggested time 24 minutes)

#### Required:

a) Start with net income as given	45,375
<u>Add/subtract adjustments:</u>	
Reduce inventory by the markup to selling price <b>[Inventory should be carried at its cost.</b> When the inventory was written up, the company would have DR. Inventory and CR. "Revenue" or "Gain"]	(16,000)
<u>"THOUGHT PROCESS":</u> When they purchased the chocolates, they would have DR. Inventory 48 and CR. Cash 48. <b>Assets ALWAYS equals L + SE.</b> Thus, if they DR. Inventory 16 (to increase it to 64) they must have CR. Revenue/Gain (since Liabilities would not be affected). If the asset is increased by 16, the shareholders equity must also be increased by 16 and, since the owners did not contribute any money re: this increase, it must flow through RE (via net income). Thus, to decrease the inventory back to 48 (from 64), you would DR. Revenue/Gain 16 and CR. Inventory 16. Thus, net income is reduced by 16. <u>NOTE:</u> The inventory has NOT been sold yet- the bookkeeper has just incorrectly adjusted it to show it at its selling price.	
Record amortization expense since there is no accumulated amortization indicated (\$16000÷6)	(2,667)
The amount paid to the majority shareholder should be an expense since it is for management services rendered. It is NOT a dividend.	(30,000)
Unrealized gain on investments (17,500-15,600)	+1900
Set up unearned revenue [Only 2/10 of the contract has been earned]	(16,000)
Equipment should be carried at cost not market [When the equipment was written up, the company would have DR. Equipment and CR. "Gain"]	<u>(1,000)</u>
<b>Revised net income (loss)</b>	<b>(18,392)</b>

b)

Scott's Chocolates Inc.,  
Balance Sheet  
October 31, 2005

ASSETS

Current assets

Cash		\$3,000
Held-for-trading investments (at market value)	17,500	
Accounts Receivable	23,000	
Due from shareholder	15,000	
Inventory	<u>48,000</u>	
Total current assets		<u>\$106,500</u>

Restricted cash### ` 15,000

Equipment	16,000	
Less: Accumulated amortization	<u>(2,667)</u>	<u>13,333</u>
Total Assets		<u>\$134,833</u>

LIABILITIES

Current Liabilities

Accounts payable	\$15,133
Notes payable@@	9,925
Unearned revenue^^^	<u>26,500</u>
Total current liabilities	51,558

SHAREHOLDERS' EQUITY

Common shares	101,667
Deficit***	<u>(18,392)</u>
Total shareholders' equity	<u>83,275</u>
Total Liabilities and Shareholders' Equity	<u>\$134,833</u>

### Since the cash is "restricted" (it cannot be used by the company), **it should NOT be shown as a current asset**. This is an example of a "**compensating balance**".

\*\*\* **When retained earnings has a debit balance is it called a "deficit"**. The debit balance is due to the net loss of 18,292 (from the revised income statement).

^^^ Deposits from customers are unearned revenue.  $26,500 = 16,000 + 10,500$ .

@@ Since the bank can demand the loan to be repaid at any time, it is considered a current liability.

**Question 2 (17 marks: suggested time 21 minutes)**

**Required:**

- a. Calculate the gross profit Peak Co. should recognize each year of the contract assuming it adopts the percentage of completion method for accounting for this contract. **(13 marks)**

**STEP-BY-STEP METHOD:**

**2006**

STEP 1:  $GP = 5,000,000 - (1,000,000 + 3,000,000) = 1,000,000$

STEP 2:  $1,000,000 \div (1,000,000 + 3,000,000) = 25\%$

STEP 3:  $25\% \times 1,000,000 = 250,000$

STEP 4: Same as Step 3 since this is the first year.

**2007**

STEP 1:  $GP = 5,000,000 - (2,750,000 + 2,000,000) = 250,000$

STEP 2:  $2,750,000 \div (2,750,000 + 2,000,000) = 57.89\%$

STEP 3:  $57.89\% \times 250,000 = 144,737$

STEP 4:  $144,737 - 250,000 = (105,263)$

**2008**

STEP 1:  $GP = 5,000,000 - (3,750,000 + 1,500,000) = (250,000)$

STEP 2: **Since there is an estimated loss on the entire contract, conservatism dictates that the full amount of the loss be recognized- i.e., 100% of the loss is recognized. Thus, calculation of the percentage of completion is NOT applicable.**

STEP 3:  $100\% \times (250,000) = (250,000)$

STEP 4:  $(250,000) - [250,000 + (105,263)] = (394,737)$

NOTE: Over the three years (2006, 2007 & 2008), the total income recognized is  $(250,000) = 250,000 + (105,263) + (394,737)$

**2009**

STEP 1:  $GP = 5,000,000 - (5,250,000) = (250,000)$

STEP 2: 100% since job is complete

STEP 3:  $100\% \times (250,000) = (250,000)$

STEP 4:  $(250,000) - (250,000) = 0$

Year	Gross Profit
2006	\$250,000
2007	(\$105,263)
2008	(\$394,737)
2009	\$0
<b>Cumulative</b>	<b>(250,000)</b>

- b) No, it simply recognizes income and costs over the construction period. It might be helpful to the creditors by providing more timely information but it doesn't make the project any more viable. It is simply a method of accounting and ignores the timing of cash flows.
- c) The company has not performed any of the work for the project. Accordingly, the criteria for revenue recognition (performance, measurement and collectability) have not all been met.

**Question 3 (14 marks: suggested time 17 minutes)**

**Required:**

(a)

Credit sales = 15,000,000\*.85=12,750,000

The balance in the Allowance for Doubtful accounts	opening balance	CR	75,000
	Write offs	DR	125,000
	Recoveries	CR	15,000
	Bad debts exp.	CR	<u>127,500*</u>
	<b>Balance</b>	<b>CR</b>	<b>92,500</b>

\*12,750,000\*.01=127,500 = Balance in Bad Debts Expense Account

(b)

The balance in the Accounts Receivable account is: opening balance DR 1,900,000

Credit sales	DR	12,750,000
Collections	CR	12,500,000 ##
Write offs	CR	125,000
Recoveries	DR	<u>15,000</u>
<b>Balance</b>	<b>DR</b>	<b>2,040,000</b>

## Includes the \$15,000 of recoveries

Current portion 2,040,000\*.8\*.05= 81,600

Overdue portion 2,040,000\*.2\*.25= 102,000

**Balance in ADA should be \$183,600CR**

The present balance before any entry is a DR. balance of 35, 000 (opening balance of 75,000cr—writeoffs of 125,000dr + recoveries of 15,000cr)

Therefore the journal entry is:

Dr Bad Debt expense	\$218,600	[35,000 + 183,600]
Cr Allowance for D/A	\$218,600	

(c)

Since the aging method is more accurate, the % of net credit sales is insufficient because the % of net credit sales method results in an allowance of \$92,500 while the aging method indicates the balance should be \$183,600. Management should consider whether there were any significant unusual/unexpected writeoffs this year and/or whether economic conditions have changed.

**Question 4 (14 marks: suggested time 17 minutes)**

**Required:**

(a)

- the treatment is inconsistent with the cost method and the conservatism method (which prescribes the use of LCM)
- since it is based on market values, it is consistent with the need for relevant information and it is good for predicting future cash flows
- it is reliable as it is based on market values that are determined by the “stock market”.
- It is more understandable compared to LCM.

(b)

We need to establish the valuation allowance balance at 31/12/2004:

	<u>COST</u>	<u>MARKET</u>
Rose	\$21,500	\$17,000
Dogwood	<u>\$4,000</u>	<u>\$4,800</u>
	\$25,500	\$21,800

Thus, the Valuation Allowance would have had a CREDIT balance of \$3,700.

**During 2005**

25/1	Cash	220	
	Dividend Revenue		220
1/4	STI (Rose)	6,000	
	Brokerage fees expense	120	
	Cash		6,120
31/10	Weighted Average Cost = $\frac{(21,500 + 6,000)}{500 + 200} = \$39.29/\text{share}$		
	Cash	9,702 [(300x33-198)]	
	Brokerage fees expense	198	
	Realized loss	1,887	
	STI (Rose) [39.29 x 300]		11,787
31/12		<u>Cost</u>	<u>Market Value</u>
	Rose	\$15,716	\$13,600 (400 shares left x 34)
	Dogwood	<u>4,000</u>	<u>5,000</u> (200 x 25)
	Totals	\$19,716	\$18,600

**400 remaining shares cost 400\*39.29 = \$15,716**

The ending balance for the allowance account should be 1,116 CREDIT but the beginning balance of the allowance account is \$3,700 CREDIT. Therefore the allowance needs to be DEBITED by \$2,584

Fair value allowance	2,584	
Unrealized Gain		2,584

**Question 5 (21 marks: suggested time 25 minutes)**

**Required:**

(a)

Number of units purchased: 8,100 units for \$1,641,000

Beginning inventory for all methods: \$0

Number of units sold: 7,700 units for \$2,692,500

	<b>LIFO</b>	<b>FIFO</b>	<b>Weighted average</b>
Sales	\$2,692,500	\$2,692,500	\$2,692,500
COGS	1,565,000	1,569,000	1,559,943
Gross Profit	1,127,500	1,123,500	1,132,557
G.P.%	41.88%	41.73%	42.06%

**COGS (LIFO):**

$$\begin{aligned} &= (1,500 \times \$180) + (3,300 \times \$220) + (1,800 \times \$200) + (1,100 \times \$190) \\ &= 270,000 + 726,000 + 360,000 + 209,000 \\ &= 1,565,000 \end{aligned}$$

**COGS (FIFO):**

$$\begin{aligned} &= (1,500 \times \$190) + (1,800 \times \$200) + (3,300 \times \$220) + (1,100 \times \$180) \\ &= 285,000 + 360,000 + 726,000 + 198,000 \\ &= 1,569,000 \end{aligned}$$

**COGS (WAM):**

Weighted-Average cost

$$\begin{aligned} &= (\$0 + \$1,641,000) \div (0 + 8,100) = \$1,641,000 \div 8,100 \text{ units} = \$202.59 \text{ per unit} \\ \text{COGS} &= 7,700 \text{ units} \times \$202.59 = 1,559,943 \end{aligned}$$

(b) Ending inventory = COGAFS – COGS = 0 + 1,641,000 – 1,569,000 = \$72,000

Used when you want to show the most current cost of inventory on the Balance Sheet

(c)

Regardless of the method chosen, the cost of the inventory may be greater than the NRV of the inventory since the selling price will have to be lowered (significantly) to remain competitive.

If a loss is anticipated, it should be recognized in the current period (“LCM”).

(d)

- The use of the inventory turnover ratio would be helpful to see how many times a year the average inventory is being sold and whether this is reasonable.
- Use a perpetual inventory system to monitor inventory levels.
- Count inventory on a regular basis (monthly).
- Monitor sales of products by product line and use markdowns to “move” inventory that is not selling as well as expected.