

Name: \_\_\_\_\_

Student #: \_\_\_\_\_

**Sauder School of Business**  
**University of British Columbia**  
**BUSI 293**  
**Practice Midterm Examination**

Time: 120 minutes

Marks: 90

This examination booklet contains 13 pages (including this page). Check to ensure that this paper is complete. No programmable calculators are permitted.

Please show all your calculations in an orderly format for part marks. No questions will be permitted during the examination. If you need to make an assumption, state it and continue. Read the questions carefully before making any assumptions.

**Inventory is NOT on the midterm; it will be examined on the final. Thus, IGNORE Question 5. Use it for final exam preparation.**

	<b>Marks</b>	
1. Adjustments/Corrections and Financial Statements	20	
2. Revenue Recognition	21	
3. Accounts Receivable	14	
4. Held-for-Trading Investments	14	
5. Inventory ( <b>not on midterm; examined on final</b> )	21	
<b>Total</b>	<b>90</b>	

**Question 1 (20 marks: suggested time 24 minutes)****Journal Entries and Financial Statements**

A friend of yours, Scott Crocker, is the president of Scott's Chocolates Inc. ("Scott's). Scott's sells organic chocolates and has just completed its first year of operations. The following is the Balance Sheet and other information provided by the bookkeeper (an inexperienced accountant):

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

	Debit	Credit
Cash in current account	\$ 3,000	
Cash in Washington State bank (Note 1)	15,000	
Accounts receivable (Note 2)	27,500	
Inventory (Note 3)	64,000	
Equipment (Note 4)	17,000	
Dividends paid (Note 5)	30,000	
Held-for-trading investments (Note 6)	15,600	
Accounts payable		\$ 15,133
Notes Payable (demand loan)		9,925
Common Shares (9,500 issued)		101,667
Net income for the first year		45,375
<b>Totals</b>	<b>\$172,100</b>	<b>\$172,100</b>

Additional information:

1. Scott's plans to expand into Washington State. The Food and Drug Branch of the United States Government has requested that \$15,000 be placed into a bank account in Seattle for a three-year period to cover any potential lawsuits against the company arising from the sale of its products in the USA.
2. Accounts receivable are comprised of the following:

The amounts owed by customers from credit sales	\$23,000
Deposits from customers	(10,500)
Amounts advanced (loaned) to majority shareholder (to be repaid by next year)	15,000
3. The inventory is comprised of the following:

Inventory at retail selling price	64,000
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The company earns a gross profit (sales – cost of goods sold) of 25% of sales on its products.
4. The equipment was purchased for \$16,000 on November 1, 2004. At the end of the year, the fair market value of the equipment was \$17,000. The equipment is expected to last for 6 years and be worthless at that time.

**Question 1 (20 marks: suggested time 24 minutes) continued**

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5. The Company paid \$30,000 to the majority shareholder for management services rendered. Since the payment was made to a shareholder the bookkeeper recorded it as dividends paid.
6. The excess cash received from the initial issue of the common shares was invested in shares of Canadian Oil Sands Inc., a public company whose shares trade on the Toronto Stock Exchange. The market value of the shares at October 31, 2005 was \$17,500.
7. The company signed an agreement with the local School Board on August 1, 2005 to provide the school district with chocolates for fund raising events equally over the next 10 months commencing September 1, 2005. On October 1, 2005, the Company received a cheque for \$20,000 representing payment for the total contract. The total amount was recorded as revenue.

**Required:**

- a) Calculate net income for the first year after adjusting for any errors based on the additional information provided above. Ignore income taxes. **(8 marks)**

**Question 1 (20 marks: suggested time 24 minutes) continued**

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- b) After making any adjustments and/or corrections in part a, prepare a classified Balance Sheet, in good format for Scott's Chocolates Inc at October 31, 2005. **(12 marks)**

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

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Revenue Recognition

Greek Construction Inc. has been selected as the general contractor for construction of the 2010 Olympic Speed Skating Oval in Richmond. The contract has a fixed price of \$5,000,000 and construction costs are anticipated at \$4,000,000. The controller of the company explained to the Board that they could adopt either the percentage of completion or the completed contract method in accounting for this contract. The Board decided to adopt the percentage of completion method.

Construction on the Oval commenced in April 2006 and the results of the four-year construction period were as follows:

Dec. 31, 2006	Total costs incurred to date	\$1,000,000
	Estimated additional costs to complete construction	\$3,000,000
Dec. 31, 2007	Total costs incurred to date (cumulative)	\$2,750,000
	Estimated additional costs to complete construction	\$2,000,000
Dec. 31, 2008	Total costs incurred to date (cumulative)	\$3,750,000
	Estimated additional costs to complete construction	\$1,500,000
Dec. 31, 2009	Total costs incurred to date	\$5,250,000
	Estimated additional costs to complete construction	none – construction completed

**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)**

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

- b) Does the adoption of percentage of completion method in accounting for long-term contracts help ensure the financial viability of the project? Discuss. **(2 marks)**
- c) The controller of Greek Construction wants to recognize revenue at the time of signing the contract. Would recognizing revenue at this point be in accordance with GAAP? **(2 marks)**

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

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Accounts Receivable

Video Electronics Inc. is the largest wholesaler of electronic games in Western Canada. Approximately 85% of the company's sales are made on credit and customers have twenty days from the date of sale to remit payment.

The following information is available for the year ended December 31, 2005:

Accounts receivable, gross (1/1/2005)	\$ 1,900,000
Allowance for doubtful accounts (1/1/2005)	75,000
Total sales in 2005	15,000,000
Payments on account received from customers	12,500,000
Write-offs of accounts receivable	125,000
Recoveries of bad debts during the 2005	15,000

Video accounts for bad debts using either of the following methods:

- (i) 1% of credit sales for the year, or
- (ii) 5% of current receivables (not yet due) and 25% of receivables which are overdue as at year-end.

As at December 31, 2005, 80% of gross accounts receivable are current.

**Required:**

- (a) Determine the December 31, 2005 balances in "Bad Debts Expense" and "Allowance for Doubtful Accounts" if the company uses the percentage of credit sales method. **(5 marks)**

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

(b) Determine the December 31, 2005 balance of “Allowance for Doubtful Accounts” if the company uses the aging method. **(5 marks)**

(c) Is the “Allowance for Doubtful Accounts” going to be adequate as at December 31, 2005 if the company uses the percentage of credit sales method? Fully explain your answer. **(4 marks)**

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

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HFTI/Temporary Investments/Short-term Investments/Marketable Securities

As at December 31, 2004, Kerrisdale Paints Inc. has the following temporary investments:

	<u># of shares</u>	<u>Cost/Share</u>	<u>Market Value/share</u>
Rose	500	\$43	\$ 34
Dogwood	200	\$20	24

During 2005, transactions relating to this portfolio were as follows:

- January 25 Received a dividend of \$1.10 per share on the shares of Dogwood
- April 1 Purchased 200 additional common shares in Rose for \$30 per share plus a brokerage fee of \$120
- October 31 Sold 300 common shares of Rose for \$33 per share less a brokerage fee of \$198.

On December 31, 2005, the shares of Rose and Dogwood were trading for \$34 and \$25 respectively. Assume Kerrisdale Paints **has always used the allowance method** when reporting its temporary investments at market.

**Required:**

- (a) Discuss whether the CICA's change to reporting marketable securities at market value is consistent with the accounting principles we have discussed in class. **(3 marks)**

- (b) Provide all of the necessary journal entries that would be required for 2005 with respect to temporary investments. **(11 marks)**

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

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

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Inventory

In January of 2005, Jacob Distributors (Jacob) signed an exclusive marketing agreement to sell a palm pilot. The purchasing and selling information for the year is presented below:

	<b>Units purchased</b>	<b>Price per unit</b>
<b>Purchases</b>		
February 20	1,500 units	\$190/unit
May 16	1,800 units	\$200/unit
October 11	3,300 units	\$220/unit
December 1	1,500 units	\$180/unit

<b>Sales</b>	<b>Units sold</b>	<b>Selling Price</b>
March 15	1,200 units	\$350/unit
June 15	2,000 units	\$375/unit
November 15	3,000 units	\$345/unit
December 15	1,500 units	\$325/unit

**Required:**

- (a) Calculate the gross profit margin and gross profit margin ratio for the year ended December 31, 2005 using the LIFO, FIFO and Weighted Average methods. Assume a periodic inventory system is used. **(10 marks)**

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

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

(b) Calculate the value of the inventory on December 31, 2005 using the FIFO cost-flow method? Why would a company use this cost-flow method? **(4 marks)**

(c) On December 15, 2005 your competitor introduced a product that appears to be comparable to the palm pilot. The competitor is selling its product for a retail price of only \$150. Discuss whether this will affect your financial statements for December 31, 2005. **(3 marks)**

(d) One of your closest friends has recently opened a new retail clothing store. He approaches you for advice. "You cannot believe how much of an investment I have in inventory. How should I be monitoring the inventory levels at my new store? I seem to have too little of products that are selling well and too much of products that aren't selling well." Briefly respond to her concern. **(4 marks)**