

ADM 2342
Intermediate Financial Accounting 1
MID TERM EXAM
Sections A and B
Fall 2014

Section A (Tuesday & Friday Days) Section B (Tuesday Evenings)

SOLUTIONS

Instructions:

1. This examination comprises 7 questions over 19 pages. Page 19 is a page for rough work. Answer all questions directly in this booklet. The booklet is not to be removed from the examination room. You may separate the pages but ensure that you put them back together, in the correct sequence and stapled, before handing in.
2. Limit your answer to the space provided. Blank sheets for rough work and supporting calculations are given at the end of each question. **You must show supporting calculations.**
3. This exam is out of 80 marks and is 2½ hours long. **You should budget your allotted time carefully at approximately 1.8 minutes per mark.**
4. Please do **not** ask the invigilator or the professor any questions, as they will not be answered. State reasonable assumptions, if you feel they are necessary.
5. Language dictionaries (non-electronic) are allowed if approved by the professor.
6. The use of electronic communication devices such as cell phones is strictly prohibited during the exam. Exam regulations prohibit you from having a cell phone or any recording or communication devices in your possession during the exam.
7. **You must sign the Statement of Academic integrity on page 2 of this exam.**

Question		Marks
1	Canadian Financial Reporting Environment	/8
2	Conceptual Framework	/6
3	The Accounting Information System	/10
4	Financial Position & Cash Flows	/16
5	Financial Position & Cash Flows	/10
6	Revenue Recognition	/16
7	Reporting Financial Performance	/14
	TOTAL	<u>/80</u>

Statement of Academic Integrity

The Telfer School of Management does not condone academic fraud, an act by a student that may result in a false academic evaluation of that student or of another student. Without limiting the generality of this definition, academic fraud occurs when a student commits any of the following offences: plagiarism or cheating of any kind, use of books, notes, mathematical tables, dictionaries or other study aid unless an explicit written note to the contrary appears on the exam, to have in his/her possession cameras, radios (radios with head sets), tape recorders, pagers, cell phones, or any other communication device which has not been previously authorized in writing.

Statement to be signed by the student:

I have read the text on academic integrity and I pledge not to have committed or attempted to commit academic fraud in this examination.

Signed: _____

Note: an examination copy or booklet without that signed statement will not be graded and will receive a final exam grade of zero.

Question No. 1 (8 marks)

A phenomenon called “*information asymmetry*” is common in financial reporting and can interfere with the objective of financial reporting.

Required:

- (a) Describe three types of information asymmetry found in the Canadian financial reporting environment and provide an example of each. (6 marks)
- (b) State the objective of financial reporting. (2 marks)

Answer:

- (a) *Three types of information asymmetry found in the Canadian financial reporting environment, with an example of each, are:*
 - (i) *Management may feel that disclosure of all information may hurt the company’s competitive advantage or position (Example: Management may want to limit the amount of information being disclosed in a lawsuit). (1 mark for type and 1 mark for example)*
 - (ii) *Managers may act in ways that will maximize their own well-being at the cost of other market participants. (Example: Management may only want to show positive information in order to maximize their bonus. (1 mark for type and 1 mark for example)*
 - (iii) *The TSX is not fully efficient. (Example: Not all information is reflected in the stock price of a company thereby detracting good companies from raising capital or causing stock prices to be discounted). (1 mark for type and 1 mark for example)*
- (b) *The objective of financial reporting is to provide financial information about a reporting entity that is useful to present and potential equity investors, lenders and other suppliers of capital in making decisions. (2 marks)*

Question No. 2 (6 marks)

This multiple choice question consists of 4 questions each worth 1½ marks. Circle the best answer for each question directly on your examination sheet. Only one answer will be accepted for each question. No account will be taken of any explanations provided. There is no penalty for guessing.

1. Which of the following does NOT relate to the concept of relevance?
 - a. The information must be capable of making a difference in a decision.
 - b. *Both material and immaterial information is important.*
 - c. The information has predictive value.
 - d. The information has feedback/confirmatory value.

2. Comparability allows any financial statement user to
 - a. make timely decisions.
 - b. understand all the information presented.
 - c. verify all the data provided.
 - d. *identify the real similarities and differences in economic phenomena.*

3. During a major renovation project of its head office, a worker was seriously injured. While the company believes that it was not at fault, it does include the incident in the notes to its financial statements. This is consistent with the
 - a. *full disclosure principle.*
 - b. periodicity assumption.
 - c. going concern assumption.
 - d. economic entity assumption.

4. Which of the following serves as the justification for the periodic recording of depreciation expense?
 - a. Association of efforts (expense) with accomplishments (revenue).
 - b. Minimization of income tax liability.
 - c. Immediate recognition of an expense
 - d. *Systematic and rational allocation of cost over the periods benefited.*

Question No. 3 (10 marks)

Sullivan Corporation adjusts and closes its accounts each August 31. The following 5 items may require adjustment at August 31, 2013, the corporation's accounting year-end:

1. Fuel supplies that cost \$6,575 were purchased during the accounting period from September 1, 2012 to August 31, 2013 and were debited to the fuel expense account. On August 31, 2013, the amount of fuel still on hand was \$3,180
2. The allowance for doubtful accounts has a credit balance of \$87,500 on August 31, 2013. Sullivan has estimated the amount of uncollectible customer accounts to be \$75,600.
3. Sullivan signed and paid for a maintenance contract for office cleaning covering a 30 month period starting on April 1, 2013 for \$120,000. The entire amount was set up as prepaid maintenance at the time of payment and no amount for the current year has been expensed.
4. Late in August, it was found that a posting error had been made. A deposit of \$3,360 from a customer that had been recorded as other income should have been recorded as unearned revenue.
5. On August 31, 2012, the prepaid insurance account showed a debit balance of \$6,400, which represented coverage for the next four months of September, October, November and December. On January 1, 2013, Sullivan also obtained another policy covering a 20-month period from that date. The twenty-month premium amounted to \$36,500 and was paid on January 1, 2013. At the time of payment, Sullivan debited prepaid insurance.

Required:

Prepare adjusting entries, where required, as at August 31, 2013 for the above 5 items. If no adjusting entry is required, state why. (Narrative explanations for journal entries are not required.)

Answer: (1 mark for each correct debit and credit - ½ mark for the correct account and ½ mark for the correct amount)

1.	Fuel inventory	3,180	
	Fuel expense.....		3,180
	<i>Must set up fuel inventory account at year end and reduce fuel expense by \$3,180</i>		
2.	Allowance for doubtful accounts.....	11,900	
	Bad debts expense		11,900
	<i>\$87,500 – \$75,600 = \$11,900</i>		
3.	Maintenance expense	20,000	
	Prepaid maintenance		20,000
	<i>(\$120,000 / 30 months) x 5 = \$20,000</i>		
4.	Other income.....	3,360	
	Unearned revenue.....		3,360
5.	Insurance expense	21,000	
	Prepaid insurance.....		21,000
	<i>Balance in the prepaid insurance account should be \$36,500 x 12/20 = \$21,900</i>		
	<i>Therefore: \$6,400 + \$36,500 – \$21,900 = \$21,000</i>		

Question No. 4 (16 marks)

The comparative Statement of Financial Position and the Statement of Income for Stafford Company are given below. Stafford Company is a private company that follows ASPE and uses a December 31 accounting year-end.

Stafford Company
Comparative Statement of Financial Position
As at December 31, 2013

	2013	2012
Debits		
Cash	\$44,900	\$40,000
Accounts receivable	52,500	60,000
Merchandise inventory	141,600	180,000
Prepaid interest	1,200	2,400
Investments (long term)	—	30,000
Land	38,400	10,000
Property, plant & equipment	259,000	250,000
Patent (net)	<u>1,400</u>	<u>1,600</u>
	<u>\$539,000</u>	<u>\$574,000</u>
Credits		
Accumulated depreciation	\$ 79,000	\$ 65,000
Accounts payable	49,700	50,000
Wages payable	1,500	2,000
Income taxes payable	13,400	9,000
Bonds payable	50,000	100,000
Common shares	329,000	320,000
Retained earnings	<u>16,400</u>	<u>28,000</u>
	<u>\$539,000</u>	<u>\$574,000</u>

Stafford Company
Statement of Income
For the year ended December 31, 2013

Sales revenue	\$399,100
Cost of goods sold	(224,400)
Depreciation expense	(14,000)
Patent amortization	(200)
Salary expense	(80,000)
Interest expense	(4,400)
Other expenses	(44,000)
Investment revenue	900
Gain on sale of investments	10,000
Income tax expense	<u>(24,600)</u>
Net income	<u>\$ 18,400</u>

Additional information for 2013:

- (1) A piece of equipment valued at \$9,000 was acquired in exchange for 600 common shares.
- (2) A payment of \$50,000 was made at a maturity date to retire bonds payable.
- (3) Changes in the accounts payable account relate only to inventory transactions.
- (4) Long-term investments were sold for \$40,000.
- (5) A reassessment of prior years' income taxes resulted in \$6,000 being paid and added to the 2013 income tax expense.
- (6) Land was purchased for \$28,400 cash.

Question No. 4 (continued) (16 marks)

Required:

- (a) Prepare, with appropriate format and disclosure, the Statement of Cash Flows for Stafford Company for the year ending December 31, 2013 using the direct method. (11 marks)
- (b) Repeat part (a) above but prepare the operating activities section **only** using the indirect method. Omit any supplementary disclosures. (5 marks)

Note:

You may use any approach, such as T-accounts or a work sheet, to complete the requirements to this question but only the final statement will be marked. Use page 9 of the exam for rough work.

Answer:

(a)

*Stafford Company
Statement of Cash Flows
For the year ended December 31, 2013*

<i>Operating Activities</i>		
Cash from customers (\$399,100 + \$7,500)	\$406,600	(1 mark)
Cash paid to suppliers (\$224,400 - \$38,400 ¹ + \$300 ²)	(186,300)	(2 marks)
Cash paid for wages (\$80,000 + \$500)	(80,500)	(1 mark)
Cash paid for other expenses	(44,000)	(½ mark)
Cash paid for interest (\$4,400 - \$1,200)	(3,200)	(1 mark)
Cash paid for income tax (\$24,600 - \$4,400)	(20,200)	(1 mark)
Cash interest received	900	(½ mark)
Cash generated from operating activities		\$73,300
<i>Investing Activities:</i>		
Proceeds from sale of long-term investment	40,000	(½ mark)
Cash paid for purchase of land	(28,400)	(½ mark)
Cash generated from investing activities		11,600
<i>Financing Activities:</i>		
Dividends paid (\$28,000 + \$18,400 versus \$16,400)	(30,000)	(1 mark)
Bonds payable retired	(50,000)	(½ mark)
Cash used for financing activities		(80,000)
Net increase in cash during the year		4,900
Cash balance, beginning of the year		40,000 (½ mark)
Cash balance, end of the year		\$44,900

¹ \$180,000 - \$141,600 = \$38,400

² \$50,000 - \$49,700 = \$300

Disclosure Note:

Equipment costing \$9,000 was purchased in exchange for the issuance of 600 common shares. (1 mark)

Question No. 4 (continued) (16 marks)

(b)

Stafford Company
Statement of Cash Flows
For the year ended December 31, 2013

Operating Activities

<i>Net income</i>	\$18,400	(½ mark)
<i>Plus: Equipment depreciation expense</i>	14,000	(½ mark)
<i>Patent amortization expense</i>	200	(½ mark)
<i>Gain on sale of investment</i>	(10,000)	(½ mark)
<i>Decrease in accounts receivable</i>	7,500	(½ mark)
<i>Decrease in inventory</i>	38,400	(½ mark)
<i>Decrease in prepaid interest</i>	1,200	(½ mark)
<i>Decrease in accounts payable</i>	(300)	(½ mark)
<i>Decrease in wages payable</i>	(500)	(½ mark)
<i>Increase in income tax payable</i>	<u>4,400</u>	(½ mark)
<i>Cash generated from operating activities</i>	<u>\$73,300</u>	

Question No. 5 (10 marks)

The controller of Crayfish Technology Corporation, an international public company, has presented you with the following incomplete Statement of Financial Position as at June 30, 2014:

**Crayfish Technology Corporation.
Statement of Financial Position
As At June 30, 2014**

Assets

Current Assets			
Cash		\$ 10,195	
Marketable securities			a
Accounts receivable.....	\$153,682		
Less: allowance for doubtful accounts		<u> b</u>	147,421
Inventory			201,753
Prepaid expenses.....			<u> 8,902</u>
Total current assets			c
Noncurrent Assets			
Investments		\$ 14,873	
Property, plant & equipment			
Land			12,482
Building (net).....			d
Equipment and machinery	195,467		
Less: accumulated depreciation	<u>103,675</u>		91,792
Other assets			<u> 7,926</u>
Total non-current assets			283,855
Total Assets			\$ <u>661,774</u>

Liabilities and Shareholders' Equity

Current Liabilities			
Accounts payable.....		\$85,476	
Notes payable.....			e
Income taxes payable.....		6,421	
Current portion of long-term debt.....		4,893	
Accrued expenses		<u> 5,654</u>	
Total current liabilities.....			110,763
Long-Term Liabilities			
Long-Term debt		122,004	
Deferred income taxes			<u> f</u>
Total Liabilities			<u> g</u>

Shareholders' Equity

Contributed Capital			
Preferred shares, no par value, (authorized 10,000 shares; issued and outstanding 2,400 shares for \$14,281)			h
Common shares, no par value, authorized 400,000 shares; issued and outstanding 20,050 shares)			<u> i</u>
Total Contributed Capital			j
Retained earnings.....		206,471	
Accumulated other comprehensive income		<u> 35,136</u>	
Total Shareholders' Equity		<u>382,804</u>	
Total Liabilities and Shareholders' Equity		\$ <u> k</u>	

Question No. 5 (continued) (10 marks)

Required: (Show supporting calculations)

- (a) Calculate the amount that should be reported for each of the following:
- (i) deferred income taxes;
 - (ii) total contributed capital;
 - (iii) marketable securities. (6 marks)
- (b) Calculate the average issuance price for the common shares. (1 mark)
- (c) Identify three items that could be part of the balance showing in the accumulated other comprehensive income account. (3 marks)

Answer:

The amounts for each of the missing items are:

- a. \$9,648
- b. \$6,261
- c. \$377,919
- d. \$156,782
- e. \$8,319
- f. \$46,203
- g. \$278,970
- h. \$14,281
- i. \$126,916
- j. \$141,197
- k. \$661,774

- (a) Therefore:
- | | | | |
|------------------------------------|---|------------------|-----------|
| deferred income taxes (item f) | = | <u>\$46,203</u> | (2 marks) |
| total contributed capital (item j) | = | <u>\$141,197</u> | (2 marks) |
| marketable securities (item a) | = | <u>\$9,648</u> | (2 marks) |

(b) The average issuance price of the common shares is: $\$126,916 / 20,050 = \6.33 (1 mark)

(c) Three items that could be included in the balance of the AOCI account (page 164 of Kieso – Illustration A4-5) are: (1 mark each for any three items)

- (i) changes in revaluation surplus for PP&E items;
- (ii) gains or losses of re-measurement of defined benefit pension plans;
- (iii) gains and losses arising from translating the financial statements of certain foreign operations;
- (iv) gains and losses on hedging instruments for certain financial hedges; and
- (v) gains and losses on re-measuring FV-OCI investments.

Question No. 6 (16 marks)

The board of directors of Snowbird Construction Company is meeting to choose between the completed-contract method and the percentage-of-completion method of accounting for long-term contracts in the company's financial statements. Snowbird follows ASPE. You have been engaged to assist Snowbird's controller in the preparation of a presentation to be given at the board meeting. The controller provides you with the following information:

1. Snowbird commenced operations on January 1, 2014 and has a December 31 accounting year-end.
2. Construction activities for the year ended December 31, 2014 are as follows:

<u>Project</u>	<u>Total Contract Price</u>	<u>Billings Through 31/12/14</u>	<u>Cash Collections Through 31/12/14</u>
A	\$ 615,000	\$ 340,000	\$ 310,000
B	450,000	135,000	135,000
C	475,000	475,000	390,000
D	600,000	240,000	160,000
E	480,000	400,000	400,000
	<u>\$2,620,000</u>	<u>\$1,590,000</u>	<u>\$1,395,000</u>

<u>Project</u>	<u>Contract Costs Incurred Through 31/12/14</u>	<u>Estimated Additional Costs to Complete Contracts</u>
A	\$ 510,000	\$120,000
B	130,000	260,000
C	350,000	-0-
D	370,000	290,000
E	320,000	80,000
	<u>\$1,680,000</u>	<u>\$750,000</u>

3. Each contract is with a different customer.
4. Any work remaining to be done on any contract as at December 31, 2014 is expected to be completed in 2015.

Required:

- (a) (10 marks) Compute the amount of gross profit (loss) to be reported by Snowbird Construction Company for the year ended December 31, 2014, assuming Snowbird uses:
 - (i) The completed-contract method.
 - (ii) The percentage-of-completion method.
- (b) For Project B, assuming the percentage of completion method is used, prepare the year-end journal entry to recognize revenue and gross profit for 2014. (3 marks)
- (c) For Project D, assuming the percentage of completion method is used, indicate the relevant account balances that would appear on Snowbird's Statement of Financial Position as at December 31, 2014. (3 marks)

Question No. 6 (continued) (16 marks)

Answer:

(a) (1) and (2)

Projects	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
Contract price	<u>\$615,000</u>	<u>\$450,000</u>	<u>\$475,000</u>	<u>\$600,000</u>	<u>\$480,000</u>
Contract costs incurred	510,000	130,000	350,000	370,000	320,000
Estimated additional costs to complete	<u>120,000</u>	<u>260,000</u>	<u>-0-</u>	<u>290,000</u>	<u>80,000</u>
Total estimated cost	630,000	390,000	350,000	660,000	400,000
Total estimated gross profit or (loss)	<u>\$ (15,000)</u>	<u>\$ 60,000</u>	<u>\$125,000</u>	<u>\$ (60,000)</u>	<u>\$ 80,000</u>

The amount reported as income (loss) under the **completed-contract method** for 2014 is:

Project A	\$(15,000)	(1 mark)
B	-0-	(1 mark)
C	125,000	(1 mark)
D	(60,000)	(1 mark)
E	<u>-0-</u>	(1 mark)
	<u>\$ 50,000</u>	

The amount reported as income (loss) under **the percentage-of-completion method** for 2014 is:

Project A	\$(15,000)	(1 mark)
B	20,000	$\$60,000 \times (\$130,000 \div \$390,000)$ (1½ mark)
C	125,000	(1 mark)
D	(60,000)	(1 mark)
E	<u>64,000</u>	$\$80,000 \times (\$320,000 \div \$400,000)$ (1½ mark)
	<u>\$134,000</u>	

(b) Construction in Process.....	20,000	(1 mark)
Construction Expenses.....	130,000	(1 mark)
Revenue from Long-term Contracts.....	150,000	(1 mark)

(c) (1) Accounts Receivable:

Billings	\$240,000	
Less: Cash collections	<u>160,000</u>	
Balance	<u>\$ 80,000</u>	(1 mark)

(2) Construction in Process

Costs (\$370,000 – \$60,000)	\$310,000	
Less: Billings on Contract	<u>(240,000)</u>	
Balance	<u>\$ 70,000</u>	(1 mark)

Question No. 7 (14 marks)

Monterrey Tanning Company (MTC), a private company which follows ASPE, is located in Picton, Ontario. The company's bookkeeper has provided you with an unaudited, combined single-step Income Statement and Statement of Retained Earnings for the calendar year ended December 31, 2013, shown below:

**Monterrey Tanning Company
Combined Statement of Income and Retained Earnings
For the year ended December 31, 2013**

Net sales revenue	\$ 640,000
Operating expenses	
Cost of goods sold	400,000
Selling, general, and administrative expenses.....	166,000
Other, net	<u>17,000</u>
	<u>583,000</u>
Income before income tax.....	57,000
Income tax.....	<u>17,100</u>
Net income	39,900
Retained earnings, January 1, 2013 as reported.....	\$150,000
Gain on sale of land (net of tax expense of \$4,500)	<u>10,500</u>
Retained earnings, January 1, 2013 as restated	160,500
Dividends on common shares	12,000
Dividends on preferred shares	<u>10,400</u>
Retained earnings, December 31, 2013	<u>\$ 178,000</u>

Additional facts concerning the above statement are as follows:

1. The selling, general and administrative expenses for 2013 included the results of an identified segment of the business that management had determined would be eliminated from the ongoing operations of the company and would be subsequently discontinued. The segment was disposed of on August 31, 2013 for \$45,000 net of \$3,000 in disposal costs. The carrying value of the assets of the discontinued segment on the disposal date was \$41,000. Up to the date of disposal, the segment had generated revenues and incurred expenses of \$57,000 and \$66,000, respectively.
2. Included in "other, net" was a loss resulting from the write-down of certain tanning products held in inventory in the amount of \$5,000. Management has considered this loss to be material.
3. The sale of the land sold for the gain took place on June 16, 2013.
4. MTC has a 30% tax rate.

Required:

- (a) Prepare a corrected combined Income Statement and Statement of Retained Earnings for Monterey Tanning Company for the year ended December 31, 2013. (11 marks)
- (b) Assume Monterey had elected to follow IFRS and had prepared a Statement of Comprehensive Income. If there were 30,000 weighted average common shares outstanding throughout the year, show the required EPS presentation based upon the figures contained in your answer to part (a) above. (3 marks)

Question No. 7 (continued) (14 marks)

Answer:

*Monterey Tanning Company
Combined Statement of Income and Retained Earnings
For the Year Ended December 31, 2013*

<i>(a)</i>		
<i>Revenues and Gains:</i>		
<i>Net sales revenue</i> ¹		\$ 583,000
<i>Gain on sale of land</i>		<u>15,000</u>
<i>Total revenues and gains</i>		598,000
 <i>Expenses and Losses:</i>		
<i>Cost of goods sold</i>		400,000
<i>Selling, general and administrative expenses</i> ²		104,000
<i>Loss due to write-down of inventory</i>		5,000
<i>Other, net</i> ³		<u>12,000</u>
<i>Total expenses and losses</i>		521,000
 <i>Income before income tax and discontinued operations</i>		
		77,000
<i>Income tax (30%)</i>		<u>23,100</u>
<i>Income before discontinued operations</i>		53,900
<i>Discontinued operations</i>		
<i>Loss from operations of discontinued operations (net of tax saving of \$2,700)</i> ⁴	6,300	
<i>Gain on disposal of discontinued operations (net of tax expense of \$1,200)</i> ⁵	<u>2,800</u>	<u>3,500</u>
<i>Net income</i>		50,400
<i>Retained earnings, January 1, 2013</i>		<u>150,000</u>
		200,400
<i>Less: Dividends on preferred shares</i>		10,400
<i>Less: Dividends on common shares</i>		<u>12,000</u>
<i>Retained earnings, December 31, 2013</i>		<u>\$178,000</u>

*(b) (Assuming IFRS standards had been followed)*⁶

<i>EPS – Income before discontinued operations</i>	$\$53,900 - \$10,400 / 30,000$	\$ 1.4500
<i>EPS – Discontinued operations</i>	$3,500 / 30,000$	<u>(0.1167)</u>
<i>EPS – Net Income</i>	$\$50,400 - \$10,400 / 30,000$	<u>\$ 1.3333</u>

¹ \$640,000 – \$57,000 = \$583,000 (remove discontinued operations revenues).

² \$166,000 – \$66,000 + (\$45,000 – \$41,000) = \$104,000 (remove discontinued operations expenses and add back gain on disposal of discontinued operations).

³ \$17,000 – \$5,000 = \$12,000

⁴ Pre-tax loss from operations of discontinued operations is \$57,000 – \$66,000 = (\$9,000). Tax saving is 30% x (\$9,000) = (\$2,700).

⁵ Pre-tax gain from disposal of discontinued operations is \$45,000 – \$41,000 = \$4,000. Tax expense is 30% x \$4,000 = \$1,200.

⁶ If IFRS standards had been followed, a Statement of Comprehensive Income would have had to have been prepared by Monterey. However, under current IFRS, EPS is always based upon net income and not comprehensive income (which includes both net income and other comprehensive income). Therefore, in the solution, EPS is based upon net income (i.e. \$50,400) irrespective whether there exists other comprehensive income. Because discontinued operations are also present in this question, the EPS presentation must be expanded into three lines. For this question EPS starts with “income before discontinued operations” (\$53,900), the effect on EPS by the net loss on discontinued operations (-\$3,500) and EPS on “net income” (\$50,400). ASPE has no standards pertaining to EPS.