

# Sauder School of Business

## COMM 293 Midterm Examination

### Question Booklet

**Answer all questions in the other (answer) booklet, this booklet WILL NOT BE REVIEWED FOR GRADING PURPOSES**

**Time: 110 minutes**

**Total Marks: 100**

- No programmable calculators are permitted.
- Please show all calculations in an orderly and clear format for part marks.
- Time management is crucial. Be sure to attempt each question.
- **No questions will be permitted during this examination.** If you need to make an assumption, state it and continue. Read the questions carefully before making any assumptions.

**Question 1 (18 marks; suggested time 18 minutes) Revenue Recognition**

**Part A**

Brigante Construction Ltd. entered into a contract on October 1, 2002 with the province of British Columbia to construct a multi-unit residential complex in Whistler. The contract price is fixed at \$500 million and Brigante expects that the project will be complete by the end of 2005. Other information re: the contract is provided below. Brigante has a December 31<sup>st</sup> year-end.

In \$ millions	2002	2003	2004	2005
<b>Costs incurred (during the year)</b>	\$ 80	\$ 125	\$ 140	\$ 75
<b>Estimated costs to complete at the end of the year</b>	320	235	130	0

**Required:**

- (a) Determine the amount of revenue and gross profit that Brigante would record in each of the four years using the Completed Contract method. **(4 marks)**
- (b) Determine the amount of revenue and gross profit that Brigante would record in each of the four years using the Percentage of Completion method. Please round to the nearest million. **(10 marks)**

**Part B**

Costless Ltd. is a nationwide wholesaler who sells directly to consumers through its warehouse stores. While customers generally pay cash at the time of sale for most purchases, Costless sells some of its more expensive items (e.g., televisions) on “layaway”. Under a layaway arrangement, an individual contractually agrees to make a down payment equal to 20% of the purchase price. The customer then pays the remaining 80% two months later. Costless will deliver the item only when full payment has been received. During the two months, Costless

agrees not to sell the item to another party. If the customer decides not to take delivery of the good, or is unable to pay the balance owing, Costless is entitled to keep the down payment as compensation. Restated, the 20% is a non-refundable deposit. Once Costless releases the good to the customer, the company has no further obligations.

**Required:**

- (c) Based on your understanding of revenue recognition and accounting principles, how do you think the 20% down payment (non-refundable deposit) should be accounted for by Costless? Restated, should the revenue be recorded when the cash is received or delayed (deferred) until all the cash has been received? Give two reasons that support your position. **(4 marks)**

**Question 2 (18 marks; suggested time 18 minutes) Accounts Receivable**

Elway Ltd. is a publicly traded company who sells athletic gear to several professional sports leagues. All of the company's sales are made on credit and payment is required within 30 days after the sale. The following information is available for Elway's fiscal year ended December 31, 2005 (prior to any year end adjusting entries for bad debts):

Credit sales	\$ 5,580,000 CR
Accounts receivable (1/1/2005)	520,000 DR
Accounts receivable (12/31/2005)	641,200 DR
Allowance for doubtful accounts (1/1/2005)	31,000 CR
Bad debts expense (12/31/2005)	-0-
Writeoffs of accounts receivable	41,000
Recoveries of accounts previously written off	7,500

Elway's CFO estimates that bad debts expense is normally 1.5% of credit sales. However, the company is considering a switch to the aging method for the current period. Under the aging method, the company would apply the following percentages to accounts receivable on 12/31/2005:

Current	\$ 512,000	4%
1 – 30 days late	69,200	10%
31 – 60 days late	26,000	20%
61 – 90 days late	12,000	40%
91+ days late	22,000	80%
	<u>\$ 641,200</u>	

**Required:**

- (a) Determine the ending balances of Bad debts expense and Allowance for doubtful accounts for 2005 using the % of credit sales method. **(4 marks)**
- (b) Determine the ending balances of Bad debts expense and Allowance for doubtful accounts for 2005 using the aging method. **(5 marks)**
- (c) Calculate the A/R turnover ratio using your answers from part (b) [aging method] and briefly comment on Elway's management of accounts receivable. Are managers doing a good or bad job? Explain your conclusion. **(3 marks)**
- (d) Identify and discuss (in detail) two reasons why the direct write-off method for bad debts is not acceptable under GAAP. **(6 marks)**

**Question 3 (17 marks; suggested time 17 minutes) Temporary Investments**

On January 1, 2003, Drug Corporation Limited raised \$10 million in an initial public offering (IPO) to finance research and product testing for a drug to treat individuals addicted to harmful substances. These funds were expected to last three years. As only \$2.9 million was required

immediately, the balance of \$7.1 million was invested in temporary investments. Below are details of the stock portfolio from January 2003 until it was exhausted on October 27, 2005:

Date	Description of Transaction	Cash Inflow or (Outflow)
Jan 2, '03	<b>Bought:</b> 100,000 Silverados at \$20@ 200,000 Impalas at \$9@ 300,000 Edisels at \$11 @	(\$2,000,000) (1,800,000) <u>(3,300,000)</u> <b>(\$7,100,000)</b>
July 1, '03	<b>Sold:</b> 100,000 Impalas at \$12@	\$1,200,000
July 1, '04	<b>Sold:</b> 50,000 Silverados at \$17@	\$850,000
Oct 27, '05	<b>Sold:</b> 50,000 Silverados at \$12@ 100,000 Impalas at \$14@	\$ 600,000 <u>1,400,000</u> <b>\$2,000,000</b>

The market value of the total stock portfolio on December 31, 2003 was **\$5,000,000**. The market value of the total stock portfolio on December 31, 2004 was **\$7,850,000**. Finally, the market value of the portfolio on December 31, 2005 was **\$5,400,000**. **These valuations are based on the following year end values (please do not re-calculate).**

Name	Dec. 31, 2003	Dec. 31, 2004	Dec. 31, 2005
<b>Silverada</b>	\$22	\$21	N/A
<b>Impala</b>	\$10	\$11	N/A
<b>Edisel</b>	\$6	\$19	\$18

**Required:**

- Prepare journal entries for the transactions on July 1, 2003, July 1, 2004 and October 27, 2005. **(6 marks)**
- Prepare year end adjusting entries for December 31, 2003, December 31, 2004 and December 31, 2005. **(8 marks)**
- Traditionally GAAP used lower of cost and market method to value temporary investments but soon it will require the use of the market value method. Why is the market value method more appropriate than lower of cost and market to value temporary investments? **(3 marks)**

**Question 4 (18 marks; suggested time 18 minutes) Inventory**

Oil Wholesaler Limited owns a number of oil storage tanks. This year has been amazing for the firm because of the drastic increase in the price of a barrel of oil. The company is reporting record gross profits (up from \$50,000,000 last year) without a substantial change in the volume of production. Below is the purchase and sales data for the year ended September 30<sup>th</sup>, 2005:

Date	Description	Units (Barrels)	Cost	Proceeds
October 1, '04	Opening Balance	1,200,000 at \$25@	\$30,000,000	
November 1, '04	Purchase	900,000 at \$35@	31,500,000	
December 1, '04	Sold	(1,400,000) at \$41@		57,400,000
February 1, '05	Purchase	800,000 at \$45@	36,000,000	
May 1, '05	Sold	(1,300,000) at \$44@		57,200,000
July 1, '05	Purchase	1,800,000 at \$47@	84,600,000	
September 15, '05	Sold	(1,700,000) at \$72@		122,400,000
September 29, '05	Purchase	200,000 at \$67	13,400,000	
<b>Sept. 30, '05 Total or Balance</b>		<b>500,000 Barrels</b>	<b>\$195,500,000</b>	<b>\$237,000,000</b>

Oil Wholesaler uses a **periodic** inventory system.

**Required:**

- (a) Calculate the periodic value of ending inventory and gross profit using the LIFO/FISH method. **(3 marks)**
- (b) Calculate the periodic value of ending inventory and gross profit using the FIFO/LISH method. **(3 marks)**
- (c) Calculate the periodic value of ending inventory and gross profit using the weighted average method. **(3 marks)**
- (d) Calculate the inventory turnover ratio using the periodic LIFO and FIFO methods of inventory valuation. Also calculate the inventory turnover ratio using actual barrels of oil. Which (LIFO or FIFO) is the more representative of what really occurred? Explain your conclusion. **(5 marks)**
- (e) Which method of inventory valuation results in higher net income? Is it fair to assume that this method more fairly reflects managements' performance in this example? What extensively explains the record gross profits in the current year? **(4 marks)**

**Question 5 (29 marks; suggested time 29 minutes) Capital Assets**

**PART A**

Fraser River Freight (FRF) has been operating trucks and cranes in British Columbia for many years. In 2004, they identified a truck that had not been used for many years and was available for purchase. It was clear to FRF that the trucks' engine would require updating before it would be ready for use. The truck also comes equipped with a large crane that could be used as part of, or separate from, the truck.

Management decided to purchase the truck and crane on June 1, and agreed upon a price of \$355,000 for the bundle. An appraisal of the truck and the crane resulted in market values of \$229,400 for the truck and \$140,600 for the crane. FRF will account for the items separately.

Immediately after the purchase was completed, FRF spent \$13,000 in order to make the truck's engine operational. On June 2, while driving the truck and crane back to the FRF offices, the driver hit a curb and damaged the air brake system requiring \$5,000 to repair the damage.

**Required:**

- (a) Prepare journal entry(ies) for the transactions that occurred in June of 2004. **(6 marks)**
- (b) FRF amortizes their trucks on a straight line bases over 20 years and their cranes using double declining balance based on an estimated 5 year useful life. The salvage value of the truck was estimated to be \$35,000, and \$18,000 for the crane. What would the amortization expense be for the new truck and the new crane for their fiscal years ending December 31, 2004 and 2005? **(8 marks)**
- (c) On January 1, 2006, FRF sold the crane to another company for \$95,000. Provide the necessary journal entry. **(6 marks)**
- (d) The president of FRF does not understand why they would use different methods to amortize their fixed assets. He asks you, since you have taken Commerce 293, "What is the objective of the amortization (depreciation) process?" He also asks "What is the main reason we would use an accelerated method of deriving amortization expense over a straight line method of amortization?" Respond to the president's two questions. **(4 marks)**

**PART B**

A business entity uses more than just physical and financial capital, as understood by Generally Accepted Accounting Principles (GAAP). These days, corporations are also making use of intangible assets such as Human and Intellectual capital.

**Required:**

Considering that GAAP is concerned with determining how assets are recorded and reported, choose one of the following examples and argue either for or against the item being recorded as an asset in the financial statements: **(5 marks)**

# Sauder School of Business

## COMM 293 Midterm Examination

### -SOLUTIONS-

**Question 1** (18 marks; suggested time 18 minutes) ; Revenue Recognition

**Required:**

- (a) Determine the amount of revenue and gross profit that Brigante would record in each of the four years using the Completed Contract method. (4 marks)

Estimated Total Gross Profit (in million \$'s)	2002	2003	2004	2005
Estimated total cost	\$80 + 320 = 400	\$80 + 125 + 235 = \$440	\$80+125 +140 + 130 = \$475	\$80 + 125 + 140+ 75 = 420
Estimated Total Gross Profit	<b>\$100</b>	<b>\$60</b>	<b>\$25</b>	<b>\$80</b>

	2002	2003	2004	2005
Revenues:	0	0	0	500
Gross profit:	0	0	0	80

Gross profit:  $\$500 - (80 + 125 + 140 + 75) = \mathbf{\$80 \text{ million}}$

- (b) Determine the amount of revenue and gross profit that Brigante would record in each of the four years using the Percentage of Completion method. Please round to the nearest million. (10 marks)

2002

Revenues:  $(80 / [80 + 320]) \times 500 - 0 = \mathbf{\$ 100 \text{ M}}$   
 Gross profit:  $\$ 100 - 80 = \mathbf{\$ 20 \text{ M}}$

2003

Revenues:  $([80 + 125] / [80 + 125 + 235]) \times 500 - 100 = \mathbf{\$ 133 \text{ M}}$   
 Gross profit:  $\$ 133 - 125 = \mathbf{\$ 8 \text{ M}}$

2004

Revenues:  $([80+125+140]/[80+125+140+130]) \times 500 - 100 - 133 = \mathbf{\$ 130 \text{ M}}$   
 Gross profit:  $\$ 130 - 140 = \mathbf{\$ (10)\text{M}}$

2005

Revenues:  $100\% \times 500 - 100 - 133 - 130 = \mathbf{\$ 137\text{M}}$   
 Gross profit:  $\$ 137 - 75 = \mathbf{\$ 62\text{M}}$

Part B

**Required:**

- (c) Based on your understanding of revenue recognition and accounting principles, how do you think the 20% down payment (non-refundable deposit) should be accounted for by Costless? Restated, should the revenue be recorded when the cash is received or delayed (deferred) until all the cash has been received? Give two reasons that support your position. (4 marks)

Record the 20% down payment as revenue immediately.

**Non-Refundable/Transfer of Risk**

- As the 20% is non-refundable, one can argue that there is **no residual risk** involved with the down payment. In other words, no matter what happens Costless gets to keep the amount.

**Amount is Measurable/Collectable**

- There is **no uncertainty** with respect to the measurement of the amount or to its collectability. As the amount is known and the cash has been received already, two of the three criteria for revenue recognition have been met.

Defer the recognition of the 20% down payment (i.e., do not record revenue right away).

**Not Earned**

- The critical event should not be the receipt of the deposit. The deposit is merely one part of a larger, broader agreement to deliver merchandise to the customer. In other words, Costless will **finish all significant acts (or transfer rewards)** only when the good is delivered. It is **upon delivery that Costless really earns** the revenue.

**Not Conservative**

- Costless may claim that the deposit is non-refundable. However, companies in practice will very often refund the deposit in order to maintain customer goodwill (especially when the item is not custom ordered). Therefore, recording the 20% as revenue immediately may be **misleading or overly aggressive** if the company offers a full refund in some cases.

**Question 2 (18 marks; suggested time 18 minutes), Accounts Receivable**

**Required:**

- (a) Determine the ending balances of Bad debts expense and Allowance for doubtful accounts for 2005 using the % of credit sales method. **(4 marks)**

$$\text{BDE} = 5,580,000 \times 1.5\% = \underline{\underline{83,700 \text{ DR}}}$$

A/R		AFDA		BDE	
520,000			31,000 (open)	-0- (open)	
5,580,000					
	41,000	41,000 (W/O)			
7,500	7,500		7,500 (recovery)		
	5,417,800		83,700	83,700 (plug)	
641,200			<u>81,200</u>	<u>83,700</u> (derived)	

- (b) Determine the ending balances of Bad debts expense and Allowance for doubtful accounts for 2005 using the aging method. **(5 marks)**

Current	\$ 512,000	x	4%	=	20,480
1 – 30 days late	69,200	x	10%	=	6,920
31 – 60 days late	26,000	x	20%	=	5,200
61 – 90 days late	12,000	x	40%	=	4,800
91+ days late	22,000	x	80%	=	17,600
	\$ 641,200				<u>55,000 CR</u>

A/R	AFDA	BDE
520,000	31,000 (open)	-0- (open)

5,580,000					
7,500	41,000 7,500	41,000 (W/O)	7,500 (recovery)		
	5,417,800		57,500 (plug)	57,500	
641,200			<b>55,000</b> (derived)	<b>57,500</b>	

(c) Calculate the A/R turnover ratio using your answers from part (b) [aging method] and briefly comment on Elway's management of accounts receivable. Are managers doing a good or bad job? Explain your conclusion. **(3 marks)**

$$\text{A/R turnover} = \frac{5,580,000}{[(520,000 - 31,000) + (641,200 - 55,000)] / 2} = \mathbf{10.4 \text{ times or } 35 \text{ days}}$$

Given that Elway's own credit terms are 30 days for full payment, the company has fallen behind on its collections and should take steps to speed up the time that it takes to receive payment from customers. In other words, management is doing a poor job.

(d) Identify and discuss (in detail) two reasons why the direct write-off method for bad debts is not acceptable under GAAP. **(6 marks)**

Reason #1

The direct write-off method results in **poor matching**. The period in which the write-off is recorded will quite often be different from the period in which the related sale (revenue) was generated. As the process of writing off is usually delayed until all other avenues of collection have been exhausted, there can be a **substantial delay** between bad debt expense recognition and the date of the sale. This contravenes the GAAP principle of matching which requires that the cost of generating revenues should be expensed in the same period as the revenue.

Reason #2

The direct write-off method results in **poor valuation on the balance sheet**. The **accounts receivable would be overstated** relative to its **net realizable value** (NRV) since included in the accounts receivable would be amounts which will likely go uncollected. The accounts receivable would therefore not be **conservatively or realistically valued**.

**Question 3 (17 marks; suggested time 17 minutes) Temporary Investments**

Cash		Temp. Inv.		Allowance		Unrealized		Realized	
		0			0				
1,200	7,100	7,100	900		1,200	1,200			300
		6,200			1,200	<u>1,200</u>			<u>300</u>
850			1,000	3,850			3,850	150	
		5,200		2,650			<u>3,850</u>	<u>150</u>	
2,000			1,900		550	550			100
		3,300		2,100		<u>550</u>			<u>100</u>

**Required:**

(a) Prepare journal entries for the transactions on July 1, 2003, July 1, 2004 and October 27, 2005. **(6 marks)**

	Debit	Credit
<b>July 1, 2003:</b> Cash Temporary Investments (Relized) Gain  100,000 x \$9 = \$900,000 (Impalas)	1,200,000	900,000 300,000
<b>July 1, 2004:</b> Cash Temporary Investments (Relized) Loss  50,000 x \$20 = \$1,000,000 (Silverados)	850,000  150,000	1,000,000
<b>October 27, 2005:</b> Cash Temporary Investments (Relized) Gain  50,000 x \$20 = \$1,000,000 (Silverados) 100,000 x \$9 = <u>900,000</u> (Impalas) <u>\$1,900,000</u>	2,000,000	1,900,000 100,000

(b) Prepare year end adjusting entries for December 31, 2003, December 31, 2004 and December 31, 2005. **(8 marks)**

	Debit	Credit
<b>December 31, 2003:</b> (Unrealized) Loss on Temporary Investments Allowance on Temporary Investments  <b>At Market:</b> Silverada: 100,000 x \$22 = \$2,200,000 Impala: 100,000 x \$10 = 1,000,000 Edisel: 300,000 x \$6 = <u>1,800,000</u> <u>\$5,000,000</u>  <b>At Cost:</b> \$7,100,000 – 900,000 = \$6,200,000  \$6,200,000 – 5,000,000 = 1,200,000	1,200,000	1,200,000
<b>December 31, 2004:</b> (Unrealized) Gain on Temporary Investments Allowance on Temporary Investments <b>At Market:</b> Silverada: 50,000 x \$21 = \$ 1,050,000 Impala: 100,000 x \$11 = 1,100,000 Edisel: 300,000 x \$19= <u>5,700,000</u> <u>\$7,850,000</u>  <b>At Cost:</b> \$6,200,000 – 1,000,000 = \$5,200,000  1,200,000 + (7,850,000 – 5,200,000) = 3,850,000	3,850,000	3,850,000

<b>December 31, 2005:</b> (Unrealized) Loss on Temporary Investments Allowance on Temporary Investments	550,000	550,000
<b>At Market:</b> Edisel: 300,000 x \$18= <u>\$5,400,000</u>		
<b>At Cost:</b> 300,000 x \$11 = \$3,300,000 2,650,000 – (5,400,000 – 3,300,000) = 550,000		

- (c) Traditionally GAAP used lower of cost and market method to value temporary investments but soon it will require the use of the market value method. Why is the market value method more appropriate than lower of cost and market to value temporary investments? **(3 marks)**

Using the market value method to value temporary investments is **both reliable and relevant** as the market values can be objectively and inexpensively verified. Further, as the objective of investing in temporary investments is to speculate, using the lower of cost or market value method does not allow for the recording of unrealized gains above cost. This is inconsistent with the economics and business intent of the management of the temporary investments; the market value corrects for this omission. In summary, lower of cost and market is conservative and unnecessarily biased whereas market value is neutral (tells it like it is) and unbiased.

**Question 4 (18 marks; suggested time 18 minutes) Inventory**

**Required:**

- (a) Calculate the periodic value of ending inventory and gross profit using the LIFO/FISH method. **(3 marks)**

**FISH Periodic Ending inventory:** 500,000 x \$25 = **\$12,500,000**

**LIFO Cost of goods sold:**

Goods available less ending inventory: 195,500,000 – 12,500,000 = \$183,000,000

**Gross profit:** Sales – Cost of Goods Sold: \$237,000,000 – 183,000,000 = **\$54,000,000**

- (b) Calculate the periodic value of ending inventory and gross profit using the FIFO/LISH method. **(3 marks)**

**LISH Periodic Ending inventory:** (200,000 x 67) + (300,000 x 47) = **\$27,500,000**

**FIFO Cost of goods sold:**

Goods available less ending inventory: 195,500,000 – 27,500,000 = \$168,000,000

**Gross profit:** Sales – Cost of Goods Sold: \$237,000,000 – 168,000,000 = **\$69,000,000**

- (c) Calculate the periodic value of ending inventory and gross profit using the weighted average method. **(3 marks)**

**Average cost per barrel:**

195,500,000 / (1,200,000 + 900,000 + 800,000 + 1,800,000 + 200,000) =

195,500,000 / 4,900,000 = \$39.90 @

**Periodic Ending inventory:** 500,000 x \$39.90 = **\$19,950,000**

**Cost of goods sold:**

Goods available less ending inventory:

195,500,000 – 19,950,000 = **\$175,550,000** (or 4,400,000 x \$39.90, rounding)

**Gross profit:** Sales – Cost of Goods Sold: \$237,000,000 – 175,550,000 = **\$61,450,000**

- (d) Calculate the inventory turnover ratio using the periodic LIFO and FIFO methods of inventory valuation. Also calculate the inventory turnover ratio using actual barrels of oil. Which (LIFO or FIFO) is the more representative of what really occurred? Explain your conclusion. **(5 marks)**

$$\text{LIFO turnover ratio: } \frac{\$183,000,000}{(30,000,000 + 12,500,000)/2} = \underline{\underline{8.61 \text{ times}}}$$

$$\text{FIFO turnover ratio: } \frac{\$168,000,000}{(30,000,000 + 27,500,000)/2} = \underline{\underline{5.84 \text{ times}}}$$

$$\text{Using barrels turnover ratio: } \frac{4,400,000}{(1,200,000 + 500,000)/2} = \underline{\underline{5.18 \text{ times}}}$$

Of the two valuation methods, **FIFO is the more representative** as it is closer to the “actual” which would avoid valuation methods and look exclusively at actual barrels. LIFO is less representative as it uses **very old/low unit costs for ending inventory** and uses higher “replacement” unit cost for deriving cost of goods sold. FIFO avoids this problem as both the **numerator and denominator more internally consistent as to the valuation** of these amounts.

- (e) Which method of inventory valuation results in higher net income? Is it fair to assume that this method more fairly reflects managements’ performance in this example? What extensively explains the record gross profits in the current year? **(4 marks)**

**FIFO** results in the higher net income. The higher gross profit is a function of the fact that the **cost of a barrel of oil increase from \$25 to \$67 during the year**. This **increase is not a result of management effort, but rather a function of macro economic supply/demand events and storms** (i.e., hurricane Katrina). The record profits, especially as derived by the FIFO valuation system is a function of Oil Wholesaler having **record holding gains**, the replacement cost of oil increased significantly. This is particularly evident by the change in replacement cost between July 1 (\$47 per barrel) and September 29 (\$67 per barrel). These holding gains can be approximated as the difference between FIFO and LIFO gross profit of \$15,000,000 (\$69,000,000 - \$54,000,000).

**Question 5 (29 marks; suggested time 29 minutes) Capital Assets**

**PART A**

**Required:**

(a) Prepare journal entry(ies) for the transactions that occurred in June of 2004. **(6 marks)**

	<b>Debit</b>		<b>Credit</b>
<b>June 1, 2004:</b>			
Truck	220,100		
Crane	134,900		
Cash			355,000
	<u>Truck</u>	<u>Crane</u>	<u>Total</u>
Market	\$229,400	\$140,600	370,000
Pro-ration	62%	38%	100%
Cost	\$220,100	134,900	\$355,000
<b>June 1, 2004:</b>			
Truck	13,000		
Cash			13,000
The cost to make the newly purchased truck usable is capitalized to the cost of the truck.			
<b>June 2, 2004:</b>			
Repairs Expense	\$5,000		
Cash			5,000
This is a general maintenance cost , not capitalized			

(b) FRF amortizes their trucks on a straight line basis over 20 years and their cranes using double declining balance based on an estimated 5 year useful life. The salvage value of the truck was estimated to be \$35,000, and \$18,000 for the crane. What would the amortization expense be for the new truck and the new crane for their fiscal years ending December 31, 2004 and 2005. **(8 marks)**

**Truck**

(S.L. – 20 years)

Cost = original cost + initial repair = \$220,100 + \$13,000 = \$233,100

Salvage value = 35,000

$$\frac{233,100 - 35,000}{20} = \frac{198,100}{20} = \$9,905$$

2004 \$9,905 x 7/12 = \$ 5,778

2005 \$9,905

**Crane**

(DDB based on 5 years) 5 years of amortization = 20% per year (1/5 yrs)

DDB = 2 X 20% = 40%

2004 \$134,900 x .4 x 7/12 = \$31,476.67 \* (rounded to \$31,477)

\* no salvage value is taken into account with accelerated methods

2005 (\$134,900 - \$31,477) x .4 = \$ 41,369.20

- (c) On January 1, 2006, FRF sold the crane to another company for \$95,000. Provide the necessary journal entry. **(6 marks)**

<b>January 1, 2006:</b>		
Cash	95,000	
Accumulated Amortization (31,477 + 41,369) crane	72,846	134,900
Gain on sale of crane (plug)		32,946

- (d) The president of FRF does not understand why they would use different methods to amortize their fixed assets. He asks you, since you have taken Commerce 293, "What is the objective of the amortization process?" He also asks "what is the main reason we would use an accelerated method of deriving amortization expense over a straight line method of amortization?" Respond to the president's two questions. **(4 marks)**

**"What is the objective of the amortization (depreciation) process?"**

Amortization is a rational and systematic process of allocating the cost of an asset to expense due to time, use or technological obsolescence. Restate, the objective of amortization is to match the realization of the future benefit of the asset with the period when the corporation receive this benefit either by way of revenue, cost reduction or expense avoidance. Amortization is not a process of valuation of the asset to approximate fair market value, but rather an attempt to allocate the cost of the asset to expense and the future benefit of the asset is realized. Note, suggesting that cost less accumulated amortization provides a useful clue as to the asset replacement decision is true, but not relevant to this requirement.

**"What is the main reason we would use an accelerated method of deriving amortization expense over a straight line method of amortization?"**

Straight line amortization assumes that the benefits are earned equally over the life of the asset. An accelerated method assumes that the revenue generation does not occur evenly over the life of the asset but is of more benefit earlier on in its life. Restated, accelerate amortization method (like double declining balance) are used when the asset provides the firm with more of its beneficial advantages in the earlier years of its useful life, and in the later years it is less advantageous or competitive. More of the future benefit is realized in the earlier years, so more of it future benefit (cost) should be expensed in the early years. Also, in latter years, when amortization is lower, it is expected that the asset will require more maintenance costs such that over its entire useful life its usage costs (amortization and repair and maintenance) is relatively constant.

**PART B**

**Required:**

GAAP is concerned with determining how expenditures are recorded and reported. Choose **one** of the following two examples of an expenditure (of \$100,000) and argue either for or against the item being recorded as an asset in the financial statements. Restated, should this \$100,000 expenditure be classified as an asset or as an expense: **(5 marks)**

- (i) Training costs expenditures or (ii) Advertising expenditures

**Note: Please circle your choice**

**Training**

Training costs: the costs of training employees in a specialized process will bring economic value to the company in the future

Why is it an asset?

- 1) It has future benefit because of the future earning potential of the employee base has increased and the ability to remain competitive is enhanced.
- 2) The company has invested in the employees and has created the environment where these assets can be put to use for the company. The potential for wealth exists where it previously did not. If they were to lose the employees, they would have to spend the same amount in the future to re-train.
- 3) The human capital may not be recorded until the course is complete and the benefits have been absorbed by the employees.

#### Challenges to recording of an asset

1. The probable future value is not certain. The cost of the courses may not be a fair representation of the real potential of the employees.
2. Does the company own the right to the future potential. What if the employee no longer works there, or chooses not to use what was learned.
3. The recording of the cost of generating the capital may not be a reasonable value of the potential earnings.

#### **Advertising**

Why is it an asset? You are intent on creating a customer base that can be argued to be an asset

You could argue that the future economic value is the benefit of creating a base of customers that will engage in trade/business in the future. You have built the brand loyalty over the years.

The company could argue that it owns the right to that asset demonstrated through the recognition of that loyalty,

The event that created that ownership already occurred in that they money was spent and the brand recognition was formed with the advertising campaign.

#### Challenges to recording of an asset

- How will the company know that the advertising is the root cause of the increase in activity?
- How do we measure the "asset"
- What are the time periods that the asset generated income for and how do we know?