

Commerce 353
Intermediate Financial Accounting I
2011 – Term 1 – Sections 101 and 102
Professor Kin Lo

Midterm Examination 1
October 11, 2011

Time: 80 minutes (7:00pm – 8:20pm)

Maximum Marks: 60

***** Please answer all questions in the space provided. *****

This is a closed book exam – only pens/pencils and calculators are permitted.
A dictionary is permissible with prior approval of the instructor.

For essay questions, clear and logical point form is acceptable.

††† Please **Think** before you write! †††

| Question # | Max Marks | Obtained |
|------------|-----------|----------|
| 1 | 10 | |
| 2 | 14 | |
| 3 | 12 | |
| 4 | 12 | |
| 5 | 12 | |
| Total | <u>60</u> | |

Question 1: Multiple choice (2 marks each; 10 marks total; suggested time – 10 minutes)

Select the letter of the best answer and write your answers in the boxes at the bottom of the page.

1. Reliable financial statements have several qualitative characteristics. Which of the following lists *best* identifies these characteristics?
 - a) Relevance, understandability, and comparability.
 - b) Faithful representation, usefulness, and objectivity.
 - c) Completeness, neutrality, and historical cost basis.
 - d) Faithful representation, substance over form, and neutrality.

2. Which of the following statements best describes a situation when a company would need to engage in costly signalling?
 - a) Management believes that the company’s shares are undervalued but cannot credibly communicate this belief to investors through other means.
 - b) Management believes that investors are not sophisticated enough to understand complex financial statements.
 - c) The cost of sending a signal is low.
 - d) A company signals when securities regulations requires it to issue such communication.

3. Applying the conceptual framework for financial reporting to employee training costs suggests that such costs should generally be expensed when incurred. Which of the following reasons best supports this treatment?
 - a) These costs meet the definition and recognition criteria for an expense.
 - b) Any benefits resulting from these expenditures are not under the control of the company.
 - c) The employee training costs do not generate probable future benefits for the company.
 - d) The employee training costs do not create an asset that can be sold.

4. Which of these statements most closely reflects the concept of adverse selection in companies?
 - a) Adverse selection reflects the fact that the owner of a firm and its manager possess different information about the cash flow potential of the firm.
 - b) Adverse selection reflects the fact that the owner of the firm cannot observe, without a cost, the effort applied by the manager.
 - c) Adverse selection reflects the assumption that managers are inherently risk averse.
 - d) Adverse selection can be eliminated if managers’ pay is based on the firm’s net income.

5. Which of these statements best explains why current accounting standards do not allow the recognition of gains on in-substance defeasance transactions?
 - a) The transactions do not meet the criteria for recognition and measurement because the resulting cash flows are too uncertain.
 - b) Conservatism requires the deferral of gains from such transactions.
 - c) The transactions destroy value.
 - d) The transactions have legal form but no economic substance.

Bonus question (2 marks): The assigned reading “Earnings management and earnings quality” by K. Lo, compares the detection of earnings management to solving a murder mystery or a crime scene investigation. In that article, how many elements of a crime scene investigation does the author discuss?

In the boxes below, place the letters for your answers (a number for the bonus):

| | | | | | | |
|-----------|---|---|---|---|---|-------|
| Question: | 1 | 2 | 3 | 4 | 5 | Bonus |
| Answer: | D | A | B | A | C | 7 |

Question 2: Financial accounting theory (14 marks; suggested time – 14 minutes)

On April 24, 2008, *The Economist* news magazine published an article entitled, “Gattaca!” in reference to a 1997 movie of this name, in which a genetically inferior man takes on the identity of a superior one in order to qualify for space travel. A portion of this article follows.

“GINA, the Genetic Information Non-Discrimination Act, has finally made it through Congress, and seems likely to become law in short order. The bill prohibits employers and insurers from “discriminating” in coverage or hiring on the basis of genetic test results. I [believe] this basically dooms private insurance. On the assumption that genetic testing will have significant (and growing) predictive value, I can’t see how you avoid either a scenario in which adverse selection problems quickly spiral out of control or, on the other hand, one in which [medical] conditions with a strong genetic components become effectively uninsurable (unless coverage is mandated), which is the result this legislation is presumably meant to prevent.”

Required: [note that both parts were graded together, so there is no specific mark allocation to each part]

- a. *Focusing on medical insurance (instead of employment), explain how adverse selection problems will “quickly spiral out of control” when GINA is enacted*

- b. *Explain why the author concludes that, under GINA, many medical conditions with a strong genetic component will become uninsurable.*
 - Without genetic tests, individuals and insurance providers have the same (lack of) information.
 - Insurers are willing to provide coverage to individuals because they can spread the risk over many individuals. They only need to right on average for the insurance premiums they collect to be sufficient to cover the medical costs when they arise.
 - This is a case of adverse selection (not moral hazard) because genetics cannot be changed; it is just a matter of individuals having an information advantage over the insurance companies.
 - With the advance in genetic testing, individuals will have a better understanding of which medical conditions they are more likely to experience.
 - Under GINA, insurance providers will suspect that individuals will have genetic tests results that are not accessible to the insurance company.
 - Individuals who know that they have a genetic pre-disposition to certain ailments will seek insurance for those conditions, and the insurance company cannot prevent them from doing so under GINA.
 - Other people who do not have these genetic pre-dispositions will find less benefit to obtaining this insurance.
 - Thus, the expected cost of insurance will increase.
 - To cover that increased cost, insurance companies will need to raise insurance premiums.
 - The increased premiums will further reduce the pool of people who will find the insurance beneficial. Hence, the reference to adverse selection spiralling out of control.
 - These premiums will possibly be too high for anyone to afford; people may be better off paying for the cost of treatment when needed.
 - Ultimately, insurance companies will need to be rationally sceptical of people seeking insurance, and assume the worse (i.e., assume that they are “lemons”).
 - Now, because insurance companies are not able to pool high and low risk individuals, they could find it unprofitable to insure some medical conditions (i.e., those that are hereditary/genetic) because such a high fraction of the insured will need expensive medical treatment.
 - Given a choice of providing insurance that is unprofitable or not providing that insurance, these companies will ultimately decide not to insure certain medical condition. This is what is meant by these conditions being “uninsurable”—people might want to get the insurance but can’t.

Question 3: Financial accounting theory and frameworks for financial reporting
(12 marks; suggested time – 12 minutes)

The September 17, 2011 issue of *The Economist* news magazine contained a short articles called “The R-word index: Up means down.” This article follows.

“It has been a thoroughly wretched summer in the rich world: weak growth, dismal jobs numbers, and plunges in stock markets. Now there is yet another cause for concern.

“*The Economist*’s informal R-word index tracks the number of newspaper articles that use the word “recession” in a quarter. The index has the advantage of being timely: data for the articles are available immediately, whereas first estimates of GDP [Gross Domestic Product] are typically released four weeks after the end of the quarter. If not foolproof, it boasts a decent record: previous incarnations of the index pinpointed the start of the American recessions in 1990 and 2007.

“The latest iteration counts articles published in the *Financial Times* and the *Wall Street Journal*. It shows the index declining steadily from a peak in early 2009, with just a brief pause during the summer of 2010. September [of 2011], however, has brought a change in the weather. Measured at a quarterly rate, the index has visibly turned up since the start of this month. The chances that a slowdown will become a recession still hang in the balance.”



Required:

Discuss the merits of the R-word index by applying concepts from financial accounting theory and the framework for financial reporting. Basic concepts from macroeconomics may also be useful in your answer.

- This index provides more relevant information because it is available earlier—it is more timely than official GDP figures.
- The R-word index aggregates information from only two sources (*Financial Times* and *Wall Street Journal*), so it is incomplete--the index may not reflect broader sentiments about the economy.
- On the other hand, there are many different writers who contribute to these newspapers, so the index is actually aggregating information from many different sources.
- In general, information that is aggregated over many different people/sources is more accurate, as shown in the Beaver (1981) paper on forecasting football games.
- Aggregation helps because it pools common beliefs while minimizing the effect of idiosyncrasies.
- Counting “recession” can be a problem in terms of representational faithfulness: both affirmative and negative used of the term (“we are going into a recession” or “we will not go into a recession”) are counted the same.
- Likewise, an article may discuss historical instances of recession, or recession in a foreign country, both of which can have little bearing on recession in the U.S. (the focus of the article and the R-word index).
- In terms of macroeconomics, the immediate availability of the index on a continuous basis has a significant drawback: publication and use of the index may lead to a self-fulfilling prophecy.
- If some writers become pessimistic about the economy and so use “recession” more frequently, the R-word index will increase immediately, and people who see an increase in this index will become more worried about the economy and spend less, causing a decrease in economic activity, which then affects other people writing about the economy.
- It may only take a few writers to start this vicious cycle.
- To avoid this cycle, it may be better to not have this index continuously calculated, but released only periodically.

Question 4: Accrual accounting – subsequent events**(12 marks; suggested time – 12 minutes)**

You and your team of auditors are examining the financial statements of Capilano Water Company (CWC) for the fiscal year ended June 30, 2011. It is October 11, 2011. During the audit, you identified the following issues. (Assume all amounts are material.)

- CWC's draft financial statements show \$100,000 of inventory of bottled water as of June 30, 2011. On August 17, 2011, it was discovered that the spring from which the company sources its water had been contaminated. Samples from the year-end inventory show that a quarter of it had been contaminated and not suitable for sale.
- On September 7, 2011, one of CWC's water delivery trucks was destroyed in an accident. This truck had a value of \$80,000 on the books of CWC as of June 30, 2011.
- In February 2011, CWC purchased 1,000 shares of Royal Bank Corporation (RBC) at \$60 per share. These shares are widely traded on the Toronto Stock Exchange and share prices are available on a daily basis. The share price on June 30, 2011 was \$55 and as of October 11, 2011, the share price has further declined to \$48.
- You noted that the cash balance on September 30, 2011 was \$3,000, much lower than the \$67,000 shown on the draft financial statements that you are auditing.

Required:

Using the table below, identify the accounting treatment that would be most appropriate for each of the four issues described above, and explain why that is the appropriate treatment.

| | Item | June 30, 2011 balance sheet amount after adjustment (if any) | Explanation |
|----|---------------------------------|--------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| a. | Inventory – bottled water | \$75,000 (↓\$25,000) | Information obtained in the subsequent events period relates to a contamination event prior to year-end, so the decline in inventory value should be recognized. |
| b. | Equipment – truck | \$80,000 (no change) | Accident occurred after the year-end, so decline in value should not be reflected in the financial statements for June 30, 2011. |
| c. | Investment – RBC shares | \$55,000 (no change) | In an efficient market, the change in value after the year-end reflects information and events occurring after the year-end. The decline in value after June 30, 2011 is not relevant. |
| d. | Cash | \$67,000 (no change) | A variety of different reasons could explain the change in cash balance after the year-end. The \$3,000 is not an indication that the cash balance is overstated at year-end. |

Question 5: Accrual accounting and the accounting cycle**(12 marks; suggested time – 12 minutes)**

The following presents Foxtrot Hotel's *draft* financial statements for December 2010, with comparative figures for 2009. Amounts in \$000's.

| Balance sheets as at Dec. 31 | | | | | |
|------------------------------------|---------|---------|-----------------------------------|---------|---------|
| | 2010 | 2009 | | 2010 | 2009 |
| Cash | \$ 180 | \$ 250 | Accounts payable | \$1,200 | \$1,400 |
| Accounts receivable (gross) | 2,500 | 2,000 | Current portion of long-term debt | 300 | 300 |
| Less: allowance for doubtful accts | (40) | (100) | Current liabilities | 1,500 | 1,700 |
| Inventories | 2,140 | 1,810 | Long-term debt | 900 | 1,200 |
| Current assets | 4,780 | 3,960 | Total liabilities | 2,400 | 2,900 |
| Land | 500 | 500 | Preferred shares | 800 | 800 |
| Plant and equipment (net) | 3,500 | 3,820 | Common shares | 2,000 | 2,000 |
| Goodwill | 820 | 820 | Retained earnings | 4,400 | 3,400 |
| Non-current assets | 4,820 | 5,140 | Total equity | 7,200 | 6,200 |
| Total assets | \$9,600 | \$9,100 | Total liabilities and equity | \$9,600 | \$9,100 |

| Cash flow statements for years ended Dec. 31 | | | Income statements for years ended Dec. 31 | | |
|----------------------------------------------|-------|-------|-------------------------------------------|---------|---------|
| | 2010 | 2009 | | 2010 | 2009 |
| Cash flow from operating activities | 250 | 700 | Revenue | \$7,500 | \$7,000 |
| Cash flow from investing activities | 100 | (400) | Operating expenses | 5,500 | 4,800 |
| Cash flow from financing activities | (420) | (350) | Interest expense | 400 | 400 |
| Net change in cash | (70) | (50) | Earnings before tax | 1,600 | 1,800 |
| Cash, Jan. 1 | 250 | 300 | Income taxes | 480 | 540 |
| Cash, Dec. 31 | 180 | 250 | Net income | \$1,120 | \$1,260 |

Required:

a. For 2010, the company had not yet recorded the bad debts expense for the year. Suppose that the analysis of accounts receivable shows that the allowance for doubtful accounts should be 8% of gross accounts receivable at the end of the year. Show the necessary adjusting entry. (3 marks)

- Dr. Bad debts expense (8% × \$2,500k – \$40k) 160k
- Cr. Allowance for doubtful accounts 160k

b. Suppose that the allowance for doubtful accounts should have been 8% of gross accounts receivable for both 2009 and 2010. That is, there is an error in the \$100k amount shown in the 2009 balance sheet shown above. Ignoring your answer to part (a), record the journal entries required to reflect this adjustment. Ignore the effect of income taxes. (6 marks)

- Dr. Opening retained earnings (8% × \$2,000k – \$100k) 60k
- Cr. Allowance for doubtful accounts 60k
- Dr. Bad debts expense (8% × \$2,500k – \$40k – \$60k) 100k
- Cr. Allowance for doubtful accounts 100k

c. Using the draft financial statements presented above, determine the amount of dividends declared in 2010. (3 marks)

- Opening R/E + NI – Div = Closing R/E → Div = 3,400 + 1,120 – 4,400 = \$120k