

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

Midterm Examination 2
November 9, 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 **show your work** for partial credit! †††

Question #	Max Marks	Obtained
1	10	
2	15	
3	10	
4	13	
5	12	
Total	<u>60</u>	

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

1. Conceptually, the value creation process occurs over long period of time, from the discovery of a new product to the expiration of warranties. However, accounting standards specify a much narrower range of alternatives for recognizing this value creation in revenue. Which of the following best explains the rationale for revenue recognition standards?
 - a) Revenue can be recognized when there is a sufficiently low amount of uncertainty in measuring the value created, resulting in sufficiently reliable numbers to evaluate managerial performance.
 - b) Revenue recognition is independent of the value creation process.
 - c) The revenue recognition standards need to be consistent with tax laws to reduce the cost of maintaining records for both financial reporting and tax purposes.
 - d) Given that many possible alternatives to reflect value creation, the standards must specify an arbitrary subset so that financial statements are comparable between companies.

2. In consignment arrangements, which of the following statements best describes how the consignor should record sales revenue?
 - a) Record revenue when the consignor delivers the goods.
 - b) Record revenue when the consignee takes possession of the goods.
 - c) Record revenue when the consignee has sells the goods.
 - d) Record revenue when the consignee returns the goods.

3. Which one of the following lists of financial assets would be normally considered to be equivalent to cash? Assume a year-end of December 31, 2011. Also assume that the Yen:CAD exchange rate is unstable, while the CAD:USD exchange rate is stable. (CAD = Canadian Dollar; USD = U.S. Dollar)
 - a) Term deposit due March 30, 2012; Japanese Yen.
 - b) Term deposit due April 15, 2012; U.S. Dollars.
 - c) Canadian Treasury bills maturing April 15, 2012.
 - d) U.S. Treasury bills maturing March 30, 2012.

4. In inventory accounting, which of the following lists best matches requirements under IFRS? (specific ID = specific identification; FIFO = first-in, first-out)
 - a) Absorption costing; specific ID, FIFO or weighted-average.
 - b) Absorption costing; specific ID, FIFO or weighted-average; perpetual system.
 - c) Variable costing; specific ID, FIFO or weighted-average; periodic system.
 - d) Absorption costing; FIFO; lower of cost and market.

5. Which of the following statements best reflects the accounting for strategic investments?
 - a) Consolidation and proportionate consolidation produce the same result, so enterprise can choose to apply either method for an investment.
 - b) To account for joint ventures, IFRS allows enterprises to choose between the proportionate consolidation method or the equity method because both methods produce the same outcome.
 - c) Consolidation, proportionate consolidation, and the equity method produce the same results on a gross basis (i.e., revenues, expenses, assets, liabilities).
 - d) Consolidation, proportionate consolidation, and the equity method produce the same results on a net basis (i.e., net assets, net income).

Place the letters for your answers in the appropriate box below:

Question:	1	2	3	4	5
Answer	A	C	D	A	D

Question 2: Revenue and expense recognition (15 marks; suggested time – 15 minutes)

South Olympia Systems (SOS) has a long-term project to install a complex information system for a client. The project has a contract price of \$40 million, and it was scheduled to be completed over four years from 2009 to 2012. SOS uses the percentage of completion method to account for long-term contracts using the cost-to-cost ratio. It is currently early 2012. The following table provides information relating to this project so far.

(Dollar amounts in millions)	2009	2010	2011	2012
Costs incurred in the year	\$ 4	\$ 20	\$10	Not avail
Additional costs to complete estimated at year-end	28	24	6	Not avail
Billings on construction-in-progress to-date	5	20	31	Not avail
Cash collected to-date	3	17	29	Not avail
Cumulative cost	4	24	34	--
Total estimated cost	32	48	40	--

Required:

- a. Compute the amount of revenue that SOS should recognize in each of 2009, 2010, and 2011. Show computations in good form for partial marks. [4 marks]

Revenue = %complete × total revenue – revenue previously recognized

$$2009 \text{ Rev} = (4 / 32) \times 40 = 12.5\% \times 40 = \$ 5\text{m}$$

$$2010 \text{ Rev} = (24 / 48) \times 40 - 5 = 50.0\% \times 40 - 5 = \$15\text{m}$$

$$2011 \text{ Rev} = (34 / 40) \times 40 - 20 = 85.0\% \times 40 - 20 = \$14\text{m}$$

- b. The gross profit (loss) for 2010 is (\$9 million). Compute the amount of gross profit for each of 2009 and 2011. [3 marks]

$$2009: \text{ GP} = (4 / 32) \times (40 - 32) = 12.5\% \times 8 = \$1.0\text{m}$$

$$2010: \text{ GP} = 100\% \times (40 - 48) - 1 = -8 - 1 = -\$9.0\text{m (given)}$$

$$2011: \text{ GP} = (34 / 40) \times (40 - 40) - -8 = 0 - -8 = \underline{\underline{\$8.0\text{m}}}$$

- c. Prepare all the journal entries required in **2011**. (Hint: four entries are required.) [8 marks]

Costs incurred	Dr. CIP	10	
	Cr. Cash, A/P		10
Billings	Dr. A/R (\$31 – \$20)	11	
	Cr. Billings on construction		11
Collections	Dr. Cash (\$29 – \$17)	12	
	Cr. A/R		12
Revenue and expense recognition	Dr. COGS	10	
	Dr. CIP	8	
	Cr. Revenue (see part a)		14
	Cr. Expected loss recovery on construct'n contract		4

Question 3: Receivables (10 marks; suggested time – 10 minutes)

Evans Shielding Products (ESP) uses the aging method for its accounts receivable. On January 1, 2011, the balance in the allowance for doubtful accounts was \$20,000. For the year ended December 31, 2011, ESP made \$1,942,000 of credit sales, wrote off \$75,000 of accounts as uncollectible, recovered \$8,000 on an account previously written off, and \$430,000 remained outstanding at year-end. The following table is the aging schedule for these receivables:

Days outstanding from invoice date	0-30 days	31-90	> 90 days	Total
Balance outstanding, Dec. 31, 2011	\$320,000	\$80,000	\$30,000	\$430,000
Estimated default rate	1%	2%	4%	--
Estimated amount of doubtful accounts	\$3,200	\$1,600	\$1,200	\$6,000

Required:

- a. Determine ESP's bad debts expense for 2011. [4 marks]

ADA	
	20,000
write-off 75,000	8,000 recovery
	53,000 BDE
	<u>6,000</u>

- b. During 2011, ESP factored \$200,000 of its receivables without recourse for net proceeds of \$186,000. Record the journal entry or entries relating the factoring transaction. [2 marks]

When A/R factored	Dr. Cash	186,000	
	Dr. Interest expense	14,000	
	Cr. Accounts receivable		200,000

- c. On January 1, 2011, ESP received a promissory note from a customer in exchange for a large purchase of goods from ESP. The note is pays interest at 7% annually, matures on December 31, 2013, and will pay ESP \$150,000 upon maturity. The market yield for this type of note is 10%. For 2011, how much interest income should ESP record for this note? [3 marks]

$$\begin{aligned}
 \text{PV of coupons} &= \$10,500 \times \text{PVFA}(10\%,3) = \$10,500 \times 2.4869 = \$ 26,112 \\
 \text{PV of principal} &= \$150,000 / 1.10^3 = \underline{112,697} \\
 \text{PV of note} &= \underline{\underline{\$138,809}}
 \end{aligned}$$

$$\text{Interest for 2011} = \$138,809 \times 10\% = \$13,881.$$

Question 4 Inventories and errors (12 marks; suggested time – 12 minutes)

Monster Bikes manufactures off-road bicycles. In 2011, the company's accountant recorded the following costs into the inventory account:

Variable costs (raw materials, labour, variable overhead)	\$10,680,000
Fixed manufacturing overhead	2,000,000
Salary of factory manager	100,000
Salary of company president	300,000
Advertising and promotion	500,000
Total	<u>\$13,580,000</u>

The company had no work-in-process at the end of both 2010 and 2011. Finished goods at the end of 2010 amounted to 6,000 bikes at \$250/bike. Production was 50,000 bikes and 4,000 bikes remained in the December 31, 2011 inventory. The company uses a periodic inventory system and the FIFO cost-flow assumption.

Required:

- a. Provide the journal entry to correct the error in the inventory account. [2 marks]

Dr. Salary and wage expense	300,000	
Dr. Advertising and promotion expense	500,000	
Cr. Inventories		800,000

- b. Compute the ending value of inventory and the cost of goods sold for 2011. [4 marks]

Beginning inventory = 6,000 bikes × \$250/bike = \$1,500,000

COGAS = BI + P = \$1,500,000 + \$12,780,000 = \$14,280,000

Cost per unit produced = \$12,780,000 / 50,000 bikes = \$255.60/bike

Ending inventory = 4,000 bikes × \$255.60/bike = \$1,022,400

COGS = BI + P – EI = COGAS – EI = \$14,280,000 – \$1,022,400 = \$13,257,600

or COGS = 6,000 bikes × \$250/bike + 46,000 bikes × \$255.60/bike
= \$1,500,000 + \$11,757,600 = \$13,257,600

Ending finished goods inventory = \$1,022,400 COGS = \$13,257,600

- c. If the error in inventory costing had not be corrected as per part (a), by how much would inventory be overstated at the end of 2011? [3 marks]

Uncorrected cost per unit produced = \$13,580,000 / 50,000 bikes = \$271.60 / bike

Uncorrected ending inventory = 4,000 bikes × \$271.60 / bike = \$1,086,400

Inventory overstated by \$1,086,400 – \$1,022,400 = \$64,000

or \$800,000 / 50,000 units × 4,000 units = \$64,000

- d. If the company uses the weighted-average cost method, how much would be the ending value of inventory and cost of goods sold for 2011. [4 marks]

WA cost per unit = **COGAS / unit available** = \$14,280,000 / 56,000 bikes = \$255 / bike

Ending inventory = 4,000 bikes × \$255/bike = \$1,020,000

COGS = COGAS – EI = \$14,280,000 – \$1,020,000 = \$13,260,000

Ending finished goods inventory = \$1,020,000 COGS = \$13,260,000

Question 5: Financial assets (12 marks; suggested time – 12 minutes)

Magneto Ore Company (MOC) has a December 31 fiscal year-end. The company has three financial investments.

Investment A: 200 shares of Apple Inc.

MOC purchased these shares on June 17, 2011, when Apple's share price was \$320 per share. Apple paid no dividends and. At the close of December 31, 2011, the price of Apple shares had increased to \$405. MOC has classified this investment as held for trading.

Investment B: 800 shares of BCE Inc.

MOC purchased these shares on March 11, 2011 at \$35/share. Between March 11 and the year-end, MOC received BCE dividends totalling \$1.035 per share. At the close of December 31, 2011, the price of BCE shares had increased to \$41/share. MOC has classified this investment as available-for-sale.

Investment C: Loblaw's corporate bonds with face value of \$100,000.

These bonds were purchased on January 1, 2011 at a cost of \$108,425. The bonds pay annual interest at 8%, and mature on January 1, 2016. The yield on the date of purchase was 6%. On December 31, 2011, these bonds had a market value of \$104,000. MOC intends to hold these bonds for 5 years.

Required:

- a. Record all journal entries for Investment A for the year 2011. [3 marks]

Jun 17	Dr. HFT investment (200 sh × \$320/sh)	64,000	
	Cr. Cash		64,000
Dec 31	Dr. HFT investment (200 sh × (\$405-\$320)/sh)	17,000	
	Cr. Unrealized gain on HFT investment		17,000

- b. Record all journal entries for Investment B for the year 2011. [4 marks]

Jun 17	Dr. AFS investment (800 sh × \$35/sh)	28,000	
	Cr. Cash		28,000
Jul/Oct	Dr. Cash (800 sh × \$1.035)	828	
	Cr. Dividend income		828
Dec 31	Dr. AFS investment (800 sh × (\$41-\$35)/sh)	4,800	
	Cr. OCI on AFS investment		4,800

- c. Determine the amounts that MOC should report on its balance sheet as at end of 2011 and 2012 for Investment C. [3 marks]

Year	Jan 1 amort. cost	+ Interest income 6%	- Coupon payment	Amortization	Dec 31 amort. cost
2011	108,425	6,505	8,000	1,495	106,930
2012	106,930	6,416	8,000	1,584	105,346
2013	105,346	6,321	8,000	1,679	103,667
2014	103,667	6,220	8,000	1,780	101,887
2015	101,887	6,113	8,000	1,887	100,000

Solution

Solution

- d. Suppose that at the time of purchasing Investment C, MOC had instead classified it as available for sale. Record the journal entry to recognize any unrealized gains or losses in year 2011. [2 marks]

Dec 31	Dr. OCI on AFS investment	2,930	
	Cr. AFS investment (\$104,000 - \$106,930)		2,930