

Examination: (5071) Financial Accounting Summer semester 2003

Examiner: Prof. Alfred Luhmer

The following aids can be used: calculator

Hint: A total of 120 points can be achieved. The achievable points for a problem set are given in parentheses. You are advised to base your time allocation on these points.

Problem 1

(30 points)

Give short and precise answers!

1. What is the difference between financial accounting and management accounting?
2. What does it mean for a business to be treated as a separate legal entity?
3. What is the essence of the going-concern assumption and why is it needed?
4. Briefly explain the term "deferral" and give an example for each type of it.
5. What is a contra asset account and why is it used?
6. Indicate whether the normal balance of the following accounts is debit or credit:
 - a) service revenue
 - b) prepaid rent
 - c) rent expense
 - d) accumulated depreciation
 - e) unearned ticket revenue
 - f) owner's withdrawal
7. What is the difference between cash sales and credit sales and what effect does it have on period income?
8. Briefly describe revenue and profit recognition under the installment sales accounting method.
9. What is a callable bond?
10. What is "goodwill"?

Problem 2

(5 points)

What is the correct answer?

1. Which of the following does not result in dissolution of a partnership?
 - a) admission of a new partner
 - b) withdrawal of a partner
 - c) death of a partner
 - d) sale of partnership assets
 - e) bankruptcy of a partner

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2. The basic accounting equation can be expressed as
 - a) assets – liabilities = owner's equity
 - b) assets = equities
 - c) assets – liabilities = net assets
 - d) all of the above
3. Which of the following accounts is not closed at the end of an accounting period?
 - a) revenue from fees
 - b) gain on sale of equipment
 - c) owner's withdrawal
 - d) unearned revenue
4. Company SmartInvest holds a debt security categorized as held-to-maturity. The company will report an unrealized holding gain as part of net income if
 - a) the market rate of interest increases
 - b) the market rate of interest decreases
 - c) the issuer of the security goes bankrupt, or
 - d) the company never reports an unrealized holding gain
5. The revenue recognition principle provides that revenue is recognized when
 - a) it is realizable
 - b) it is realized or realizable and it is earned
 - c) it is realized
 - d) all of the above

Problem 3

(10 points)

What accounting term is defined or indicated by the phrase or sentence?

1. It adjusts income statement items from the accrual basis to the cash basis.
2. This adjusting entry increases both a balance sheet account and an income statement account.
3. Statement showing financial condition over a period of time.
4. Future economic benefit is its main characteristic.
5. Under that method bad debt expense is not based on estimates.
6. These methods always allocate higher depreciation charges to earlier periods of a plant asset's useful life.
7. This is the starting point of the adjustment process at the end of an accounting period.
8. These accounts are closed at the end of an accounting period.
9. "It merely increases business for stock exchanges" could be an argument against what reporting requirement for listed companies?
10. (Name one) form of business organization that is a separate accounting entity but not a separate legal entity.

Problem 4 – Preparation of Financial Statements

(30 points)

Frank Pitch and Don Sulphur have been close friends for years. They developed an extra-strong glue and started their partnership called "GotGlue?" on April 1, 2002. Nine months later, on December 31, 2002, they prepare the following trial balance before any adjusting entries have been made:

Trial balance: GotGlue?, December 31, 2002		
Cash	20.000	
Accounts Receivable	8.000	
Equipment	60.000	
Supplies	2.000	
Inventory (raw materials)	10.000	
Prepaid Insurance	4.000	
Accounts Payable		1000
Unearned Revenue		4.800
Frank's investment		34.000
Don's investment		28.000
Frank's withdrawal	4.500	
Don's withdrawal	4.500	
Revenues		60.200
Expenses	15.000	
	<u>128.000</u>	<u>128.000</u>

Frank and Don look through the source documents and disclose the following items:

- The insurance policy bought on April 1, 2002, provides protection for one year.
- A count of the supplies reveals that € 100 of supplies are still on hand.
- The equipment, purchased on April 1, 2002, has an estimated life of five years.

The partnership agreement states the following sharing rule for partnership income (**Hint:** This information is needed not before you prepare financial statements in #3):

- € 1.000 as monthly salary allowance for Frank
- € 700 as monthly salary allowance for Don
- the remainder of income is divided based on a ratio of 25% for Frank and 75% for Don

Required:

1. Prepare the journal entries for the adjustments.
2. Prepare the adjusted trial balance.
3. Prepare the Income Statement, the Statement of Owner's equity, and the Balance Sheet for GotGlue?.

Problem 5 – Accounting for Receivables**(10 points)**

Marianne Faithful recorded credit sales of € 210.000 in 2002. Since credit sales account for a major fraction of her overall sales she is always concerned whether she has made high enough allowances for uncollectible accounts. The current balance in that account is € 10.000 (credit). At the end of the year, on December 31, she prepared a schedule of receivables outstanding and, on the basis of past experience, estimated the percentage of receivables in each category that are uncollectible.

<u>Age</u>	<u>Amount</u>	<u>Percentage estimated to be uncollectible</u>
Less than 30 days old	€ 30.000	3%
31 – 60 days old	50.000	6%
61 – 90 days old	40.000	9%
91 – 120 days old	20.000	15%

1. What is the balance in the allowance account that should be reported in the balance sheet for the year ending December 31, 2002?
2. What amount should be charged to bad debt expense in 2002? Give the journal entry.
3. In early 2003, a specific account with an amount of € 500 must be written-off. What happens to the net realizable value of accounts receivable? Explain!

Problem 6 – Accounting for Long-Term Liabilities**(15 points)**

John Iceberg owns a ferry and offers express service from Greenland to Iceland. Since you never know what can happen to your ferry, John decides to buy a second ferry. To collect cash for that purpose he issues bonds on January 1, 2003. The face value of one bond is € 2.000, with term to maturity of 10 years and stated rate of interest of 8%. Interest is due on January 1, each year. The market rate of interest is 10%.

1. Explain whether the bond will be issued at a premium or at a discount and determine the exact amount of it.
2. Give the journal entry to record issuance of the bond.
3. Prepare the amortization schedule using the effective interest method for the years 2003 and 2004, respectively.
4. Give the journal entry to record accrued interest on December 31, 2003.

Hint - To determine the present value of the bond, you need the following information (calculation based on market rate of interest of 10%):

present value of € 1 due in 10 years $\rightarrow \text{€}1 \cdot \frac{1}{(1 + 10\%)^{10}} = 0,38554$

present value of an annuity of € 1 over 10 years $\rightarrow \text{€}1 \cdot \left(\frac{1 - \frac{1}{(1 + 10\%)^{10}}}{10\%} \right) = 6,14457$

Problem 7 – Inventory Valuation

(20 points)

Tom Lemon has his own retail store called “Tom’s Dusters” and for the period from July 1, 2002 to June 30, 2003 he recorded the following data:

	Number of dusters	Price	Month
Purchase	80	€ 2,50	January
	40	3,00	May
	40	4,00	June
Sale	20	5,00	April

1. Briefly explain the LIFO and FIFO method, respectively, of inventory valuation.
2. Determine the value of ending inventory and gross profit at June 30, 2003, under both the LIFO method and the FIFO method. Show calculations.
3. Assume Tom overstates the value of ending inventory at June 30, 2003. What will be the effect of this valuation error on next year’s profits? What will be the effect on total profits for the two years combined (assume that ending inventory at June 30, 2004, is correctly calculated)? Explain!

Good luck!