

Examination:

(5071) Financial Accounting

Winter semester: 2003/04

Examiner:

Prof. Alfred Luhmer

The following aids can be used:

calculator

Hint: A total of 120 points can be achieved. There are 7 problem sets. The achievable points for a problem set are given in parentheses. You are advised to base your time allocation on these points.

Examination questions:

Problem set 1 (15 points)

Give short and precise answers!

1. A change in depreciation rates will lead to a change in reported cash flows from operating activities. Is this statement true? Why?
2. What are three main characteristics of intangible assets?
3. When is accounting information *useful*?
4. Briefly describe the two different approaches to interim reporting.
5. What is a normal balance of an account? Indicate whether the following accounts' normal balances are debit or credit.
 - a. insurance expense
 - b. property and equipment
 - c. revenues from sales
 - d. discount on bonds payable

Problem set 2 (10 points)

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

1. A contingency which is not recorded.
2. The adjusting entry for this type of deferral involves a revenue and a liability account.
3. In a partnership, this results when the new partner's capital credit on the date of admittance is greater than his or her investment in the firm.
4. This type of bond can be retired before maturity at the issuer's option.
5. Statement showing financial condition at a point in time.
6. These methods always allocate higher depreciation charges to earlier periods of the plant asset's useful life.
7. It is a sale for which you cannot record revenues.
8. Under this accounting method for long-term contracts, you do not record a current period loss if the overall profitability is still given.
9. "It merely increases business for stock exchanges" could be an argument against what reporting requirement for listed companies?
10. It adjusts income statement items from the accrual basis to the cash basis.

Problem 3 (15 points)

1. Describe the cost flow assumptions used in average cost, FIFO, and LIFO methods of inventory valuation.
2. Assume prices are increasing, what method would you chose if it is your objective to report a high accounting income? Explain!
3. Assume that ending inventory in a given year is overstated by an amount X. What effect does it have on profits in that given year, on next year's profits, and on overall profits? Explain!
4. What is meant by LIFO-liquidation?

Problem set 4 (20 points)

Mike Dreamer intends to build a new stadium somewhere near Magdeburg. To collect cash for that purpose he issued bonds on January 1, 2004. The face value of one bond is € 4.000, 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 2004 and 2005, respectively.
4. Give the journal entry to record accrued interest on December 31, 2004.
5. What is the difference between the straight-line method of amortization and the effective interest method of amortization. Why is the latter method the preferred one?

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

PV of € 1 due in 10 years

$$\rightarrow \text{€}1 \cdot \frac{1}{(1 + 10\%)^{10}} = 0,38554$$

PV 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 set 5 (15 points)

Recently, the following short dialogue was notelessly audiotaped in Country U:

- Manager: "Mr. Trustworthy, did you read my proposal how to report the latest transaction with our affiliate Greedy Inc.?"
- Accountant: "Yes I did, but I do not recommend your approach because it would not properly communicate the nature of the transaction."
- Manager: "You didn't get my point. I asked you where is it written that my approach is prohibited?"

1. The accounting system in Country U can be described by either "accounting based on principles" or "accounting based on rules". What do you think is more likely, and why?
2. What are advantages or disadvantages, respectively, of accounting based on principles and accounting based on rules? (Hint: You could think of advantages and disadvantages with respect to new financial instruments or auditing.)

Problem set 6 (30 points)

Francis Baldhead and his sister Meg started their own business called HairRepair on April 1, 2003. Nine months later, on December 31, 2003, the accounts show the following balances before any adjusting entries have been made:

Cash	€ 21.000	Prepaid Insurance	4.800
Supplies	1.000	Accounts Payable	2.800
Equipment	10.000	Note Payable	30.000
Unearned Revenue	3.200	Owner's Capital	12.000
Accounts Receivable	15.000	Owner's Withdrawal	7.800
Expenses	8.400	Revenues Earned	20.000

Francis and Meg look through the source documents and discloses the following items:

- b) The insurance policy bought on July 1, 2003, provides protection for two years.
- c) A count of the supplies reveals that € 200 of supplies are still on hand.
- d) The note was issued on July 1, 2003, with a face value of € 30.000 and a 5% semiannual interest rate. The first interest payment is due on January 1, 2004.
- e) The equipment, purchased on October 1, 2003, has an estimated life of five years.

Required:

1. Prepare an unadjusted trial balance to check whether the debits equal the credits for the account balances given above.
2. Prepare the journal entries for the adjustments.
3. Prepare the adjusted trial balance.
4. Prepare the Income Statement, the Statement of Owner's equity, and the Balance Sheet for HairRepair.

Problem set 7 (15 points)

A machine is purchased at a price of € 80.000. This machine has a useful life of 4 years and possesses a salvage value of € 20.000.

1. Give the depreciation schedule using the sum-of-the-year-digits method in the following format:

Year	Depreciation base	Depreciation fraction	Depreciation charge	Book value at year end
1				
2				
3				
4				

2. What is the underlying assumption used to justify this allocation method?
3. What other allocation methods do you know? Explain the underlying assumptions!

Good luck!