**York University**
**Faculty of Liberal Arts and Professional Studies**
**School of Administrative Studies**

**ADMS 4510**
**Accounting Theory and**
**Contemporary Issues in Accounting**

**Course Director:**
**Section A (Thu 7:00 pm – 10:00 pm) – Shaweta Roopra, CA**
**Section B (Tue – 4:00 pm – 7:00 pm) – Harpreet Roopra, CA**

**Midterm Examination**

# DATE: October 22, 2011

**Both valid sectional student card and photo identification are required.**

## Please complete the following information:

| Student Name | Student Number |
|---|---|
| | |

# INSTRUCTIONS:

- You are required to both sign in and sign out with your Photo ID and student card for this examination. In case you do not have your photo ID with you, please bring to the next class - your grade and midterm will not be released until we see a copy.

- Please write all of your answers in the examination booklets provided.

**Allocate your time carefully.**

**Note: This paper must be handed back with your exam booklet.**

**Question # 1 (10 marks)**

Duca Ltd operates under ideal conditions. It has just bought an asset worth $6,200, which will generate $2,410 cash flow at the end of one year and $4,000 at the end of second year. At that time, the asset will be useless in operations and Duca Ltd. plans to go out of business. The asset will have known salvage value of $840 at the end of second year. The interest rate is 10% per annum.
Duca Ltd. finances the asset by issuing $1,205 par value of 12% coupon bonds to yield 10%. Interest is payable at the end of first and second years, at which time the bonds mature. The balance of the cost of the asset is financed by the issuance of common shares.

**Required:**

A. Prepare a present-value based balanced sheet as at end of first year and an income statement for the year. Duca Ltd plan to pay no dividends in this year. (5 marks)
B. Give two conditions why ideal conditions are unlikely to hold. (2 marks)
C. If ideal conditions do not hold, but present value-based financial statements are prepared anyway, is net income likely to be the same as you calculated in part a? Explain why or why not. (3 marks)

**Question # 2 (7 marks)**

"It is possible to reduce risk in a portfolio of diversification."
Required:

A. Do you agree with this statement? Explain why or why not? (2 marks)
B. Can the risk of portfolio be reduced to zero by diversification? Explain. (3 marks)
C. Why is beta the most relevant measure of risk in a diversified portfolio? (2 marks)

**Question # 3 (10 marks)**

John plans to invest \$25,000 in the shares of the company A (act $a_1$) or the same amount in the company Z (act $a_2$) for 1 year. John is a rational risk-averse investor, identifies two states of nature:
State H: the company expects high future cash flows.
State L: The company expects low future cash flows.

On the basis of his information to date about each firm, Bill assess the following subjective prior state probabilities (i.e., the same probabilities for each company):
State H: 0.8
State L: 0.2

The following is the payoff table for these two investments. Payoffs are net of the original investment.

| | | State | |
|---|---|---|---|
| | | **H** | **L** |
| **Act** | $a_1$ | 2,500 | 1,000 |
| | $a_2$ | 2,625 | 500 |

**Required:**

A. On the basis of his prior probabilities, which act should John take? Show calculations. (3 marks)

B. John decides to review the Management Discussion and Analysis (MD&A) to review the discussion of risk and uncertainties. He knows that careful evaluation of the quality of these discussions will provide inside evidence of the company's future cash flow expectations. That is, companies with high expectations will tend to provide better disclosure. John knows, however, the MD&A is not a perfect predictor. Some firms that expect high future performance may disguise their optimism by poor disclosure, to reduce the likelihood that new competitors will be attracted to the industry. Conversely, some firms that expect low future performance may provide excellent disclosure. They do this to reduce concerns about estimation is, thereby reducing the "hit" to their share price when poor performance prospects become known.

   John has summarized by the following information system:

| | | Current MD&A Evidence | |
|---|---|---|---|
| | | **Good Disclosure** | **Poor Disclosure** |
| **State** | H | 0.8 | 0.2 |
| | L | 0.3 | 0.7 |

   Upon reading the MD&A, John finds that Company A has good disclosure and Company Z has poor disclosure. Which act $a_1$ or $a_2$ should John take now? Show calculations? (5 marks)

C. John tells you about his decision. You respond by suggesting that he should perhaps have bought some of both Company A and Company Z shares. Explain why you make this suggestion. (2 marks)

**<u>Question # 4 (6 marks)</u>**

On January 21, 1993, The Wall Street Journal reported that XYZ's fourth quarter earnings rose 6.2% to \$1.34 billion or \$1.57 a share, setting a new record and bringing the earnings for 1992 to \$4.73 billion or \$5.51 a share. After adjusting for low-persistence items, 1992 earnings from continuing operations were up about 10% from the previous year.

The journal also reported that forecasts made by analysts averaged \$1.61 per share for the fourth quarter of 1992, and from \$5.50 to \$5.60 per share for the whole year. One analyst was quoted as saying that 1992 "wasn't a bad year for XYZ" despite the downtuen in the stock market on the day of earnings announcement.

Yet, on the same day the fourth quarter earnings were announced, XYZ stock price fell \$1.50 to \$82.63 on the New York Stock Exchange.

Required:

A. Give three reasons to explain why this could happen. (4 marks)
B. Use the CAPM model to explain how the new information caused the current price slip. Calculations are not required. (2 marks)

**<u>Question # 5 (5 marks)</u>**

Desginer Ltd. is a listed public company. It is in a volatile industry. The marker price of its shares is highly sensitive to its earnings. The company's annual meeting is to be held soon, and the president is concerned, expecting to be attacked strongly by a dissident group of shareholders.

One issue the dissidents are expected to focus on is the company's amortization policy. They will claim that the annual declining-balance amortization changes are excessive – that the company's conservative amortization policy seriously understates annual earnings per share, saying the shares' market price to be artificially low. Threats have even been made of suing management and the board of directors to "recover the resulting loss in market value, relative to shareholders in companies with less conservative amortization policies, suffered by Designer's shareholders."

The president has asked you to help prepare a defense again the expected attach on the company's amortization policy.

**Required:**

Write a memo summarizing how you would recommend the president respond to this attack. (5 marks)

**<u>Question # 6 (4 marks)</u>**

Explain the following concepts:

A. "Higher $\beta$ leads to lower ERC." Why? (3 marks)
B. "Higher Debt to Equity Ratio leads to lower ERC." Why? (2 marks)

**Question # 7 (8 marks)**

On October 21, 2010, the Feel Safe Energy Inc, a large Canadian based mining and exploration company reported net income for its third quarter, 2010, of $364 million. This compares with a net loss for the same quarter of 2009 of $140 million. Sales for the quarter were up, to $3,056 million, and earnings excluding a low persistence were $164 million. The analyst forecast for the third quarter, 2010, excluding low persistence items, was a loss of $54 million.

The low persistence item was a gain of $478 million from foreign exchange conversion. Much of the company's long term debt is denominated in U.S. dollars. The foreign exchange gain arose because of the rising value of the Canadian dollar, relative to the U.S. dollar, during the quarter.

Comparable figures for the third quarter of 2003 were as follows: sales of $1,340 million, a loss before persistence items of $64 million, and foreign exchange conversion gain of $26 million.

There is no mention of R&D costs in the company third quarter report. Its 2009 annual report mentions R&D briefly, with reference to conservations. Presumably, R&D expenditures are relatively low.

Feel Safe Energy share price rose $1.18 to $14.58 on the Toronto Stock Exchange on October 21, 2010. The S&P/TSX index gained 128 points to close at 10,148 on the same day. According to the media reports, the increases were driven by a "red-hot" materials and energy sector (including Feel Safe Energy Inc). In a conference call accompanying its third quarter report, Feel Safe Energy Inc complained that investors are too pessimistic about the company. The company's beta, according to a leading website is 0.779. The risk-free interest rate at this time was approximately 0.00020 per day.

Required:

A. Evaluate (in words only) the persistence of Feel Safe Energy's net income for the third quarter of 2010. (2 marks)
B. Suppose that Feel Safe R&D costs were high. How would this affect earnings persistence? (2 marks)
C. Do you feel that the increase in Feel Safe Energy Inc share price on Oct 21 was consistent with efficient securities market theory or do you agree with CEO? Explain and show calculations. (4 marks)