

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

AP/ADMS 3585 Intermediate Financial Accounting I

Midterm Examination 1
Fall 2013

Instructor: L. Lai

Solutions

Version A

*The solutions for Version B is the same as Version A, except the order of the multiple choice questions is different.

Marks Breakdown			
Question	MC	Part B	Total
Maximum Score	40	40	80
Student Score			

Part A: Multiple Choice (2 marks each, 40 marks in total)

1. Under the IFRS Conceptual Framework, fundamental qualitative characteristics include

- a) relevance and comparability.
- b) representational faithfulness and timeliness.
- c) relevance and representational faithfulness.
- d) verifiability and relevance.
- e) relevance and reliability.

2. If a company has a going concern problem, which measurement basis should it use?

- a) Historical Cost
- b) Net Realizable Value
- c) Current Cost
- d) Present Value
- e) None of the above

3. The Internet's flexibility allows companies to continuously disclose their financial information and users can access such information by a few clicks. This way of disseminating financial information represents trade-offs between which pair of qualitative characteristics?

- a) Comparability and Reliability
- b) Understandability and Comparability
- c) Relevance and Understandability
- d) Reliability and Relevance
- e) Relevance and Conservatism

4. In the beginning of 2012, Sofia Inc. received \$500,000 from Amber Corp. on two conditions:

- Sofia Inc. shall repay Amber Corp. \$520,000 by January 31st, 2013.
- Should Sofia Inc. fail to repay the said amount, the company will transfer a building to Amber Corp.

The building has a recorded cost of \$200,000 on Sofia Inc.'s balance sheet.

By the end of 2012, Sofia Inc. knew that it would not be able to repay the said amount, therefore it recorded the entire transaction as a sale of asset and recognized a gain of $(\$500,000 - \$200,000)$ \$300,000.

Which of the following best describes the qualitative characteristic Sofia Inc. had violated?

- a) Timeliness
- b) Representational Faithfulness
- c) Understandability
- d) Conservatism
- e) Comparability

5. Mother and Son Ltd. is a private company specializes in children clothing. It is planning to get listed on a Canadian stock exchange in 2015. Currently, the major users of their financial statements are the different banks where the company borrows from. Which accounting standard is Mother and Son Ltd required to follow for year ended December 31, 2013?

- a) IFRS, if the plan to go public is serious.
- b) ASPE, since the company is not listed as a public company yet.
- c) **IFRS or ASPE, depending on the current users' requirements.**
- d) IFRS or ASPE, depending on the stock exchange's requirements.

Note that private company can choose to report under IFRS or ASPE. Since the banks are the major users, Mother and Son Ltd. is required to report following what the banks required.

6. Booklover Inc. is a small bookstore specializes in cookbooks. In June 2013, the sole owner paid \$15,000 out of his own pocket to completely renovate the storefront to modernize the store, which is owned by the bookstore. The expenditure includes replacing existing windows and installing some LED televisions for cooking demonstrations. The owner believes that this will help increase sales by attracting the growing population of gourmet food lovers. He did not take back any shares or notes in exchange. Which of the following about this event is correct?

- a) It should not be recorded in the financial statements of Booklover Inc. because the owner paid the amount out of his own pocket, based on the economic entity assumption.
- b) There should be a debit to renovation expense for \$15,000 and credit to payable-to owner \$15,000.
- c) There should be a debit to other long term assets for \$15,000 and credit to payable – to owner \$15,000.
- d) There should be a debit to renovation expense for \$15,000 and credit to shareholder's equity \$15,000.
- e) There should be a debit to other long term assets for \$ 15,000 and credit to **shareholder's equity \$15,000.**

Since the owner put \$15,000 into the business, and does not take out a note, it cannot be a liability as Booklover Inc. has no obligation to repay the amount. Thus, b and c are

incorrect. The money is spent on windows and TV, and is expected to generate future benefits, therefore asset should be debited. Answer a is incorrect because the \$15,000 represents resources that the owner has put into the bookstore.

7. Comprehensive income includes all changes in equity during a period EXCEPT
- a) gains and losses from discontinued operations.
 - b) unrealized gains and losses on revaluation of land.
 - c) dividends paid to shareholders.
 - d) realized gains and losses from sale of investments.
 - e) Impairment loss on equipment.
8. Which of the following is not a requirement under which a company must meet in order to classify a group of assets as Assets Held for Sale?
- a) There is an authorized plan to sell.
 - b) The asset is available for sale in its current state.
 - c) There is a buyer identified.
 - d) Sale is probable within one year.
 - e) Changes to the plan are unlikely.

The company need only be actively looking for a buyer.

9. Super Mario Inc., a mushroom and banana processing company, is being sued by one of its employees for not maintaining a proper work environment. The employee slipped on a banana peel while working in the food processing facility in September 2012, which resulted in some head injuries. He was suing the company for \$100,000. The lawyers believe that the potential loss could be in the range of \$30,000 to \$60,000 based on past precedent, if the claim is successful, but the likelihood of success is not known yet. The case will not be tried in court until a year from the financial reporting date and the company has a December 31 year end. How should Super Mario Inc. report this lawsuit in its financial statements?

- a) No disclosure or recognition of the lawsuit is necessary because the outcome is still highly uncertain.
- b) To be conservative, the entire \$100,000 should be recognized as a liability because it has material impact on investors' decision.
- c) The amount of \$30,000 should be recognized as a liability because it is at the lower range of the estimate and will not adversely affect the liquidity ratios.
- d) No recognition or disclosure of the lawsuit is necessary because this is a subsequent event.
- e) No recognition of a liability is necessary but a disclosure of the lawsuit with the range of possible losses should be made.

No disclosure is necessary because the likelihood of losing the case is unknown. If the likelihood is probable and the amount is estimable, then it should be recognized as a

liability. If the likelihood is probable but only a range is estimable, then it should be disclosed.

10. Dracula Ltd. records its long-term construction contracts using the completed contract method. During 2011, Dracula Ltd. started work on a \$1,350,000 fixed-price contract for which costs were originally estimated at \$1,200,000. Information related to this contract for fiscal years ended December 31, 2011, December 31, 2012, and December 31, 2013 follows:

	<u>2011</u>	<u>2012</u>	<u>2013</u>
Costs incurred during the year	\$400,000	\$780,000	\$200,000
Estimated costs to complete	\$850,000	\$220,000	\$0
Progress billings during the year	\$300,000	\$700,000	\$350,000
Collections on billings during the year	\$250,000	\$750,000	\$350,000

Which one of the following amounts represents the gross profit that Dracula Ltd. should recognize for 2013?

- a. \$0
- b. \$20,000 profit
- c. \$30,000 loss
- d. \$50,000 loss
- e. None of the above

Overall profitability of the contract calculated at the end of 2011, 2012, 2013: \$100K, (\$50K), (30K), respectively. Since (\$50K) loss has been recognized in 2012, but the actual loss at the end of the contract is (\$30K), that means a 20K profit will need to be recognized in 2013.

11. Under which of the following circumstances should the completed contract revenue recognition method be used?

- a) The company follows IFRS.
- b) The contract extends over several annual reporting periods
- c) The enterprise cannot reasonably estimate the extent of progress towards completion
- d) The enterprises wishes to defer revenue recognition for taxation purposes
- e) Both a and b

Use the following to answer Question 12 and 13:

Jackson Corporation records its long-term construction contracts using the completed contract method. Contract #160 is a \$2 million contract for which costs were originally estimated at \$1.6 million.

The records to date show:

	2011	2012
Cost incurred during the year	\$900,000	\$600,000
Estimated costs to complete	\$900,000	\$375,000
Progress billings during the year	\$500,000	\$625,000
Collections on billings during the year	\$450,000	\$525,000

12. Which one of the following amounts represents the balance in the construction in process account at the end of 2012?

- a) \$0
- b) \$900,000
- c) \$975,000
- d) \$1,500,000
- e) \$1,800,000

Since the company uses the completed contract method and at the end of 2012, this is still a profitable contract, only construction costs incurred would be accumulated in the construction in process account (\$900K + \$600K)

13. If the company cannot reliably estimate the costs to complete and uses the zero-profit method, what is the current asset/liability related to this contract (apart from accounts receivable) that should be presented on the Statement of Financial Position at the end of 2012?

- a) \$400,000 asset
- b) \$25,000 liability
- c) \$150,000 asset
- d) \$375,000 asset
- e) \$575,000 liability

CIP balance @2012 = \$1,500K; Billings balance @2012 = (\$500K + \$625K) = \$1,125K;
CIP > Billings: Asset = \$1,500K - \$1,125K = \$375K.

Use the following information to answer Question 14 - 16:

Below is selected financial information on Nebula Corporation:

Nebula Corporation
Income Statement
For the Year Ended December 31, 2013

Net sales	620,000
Operating expenses	<u>410,000</u>
Income from operations	210,000
Other revenues and expenses	

Gain on sale of equipment.....	30,000	
Interest expense.....	8,000	<u>22,000</u>
Income before income taxes		232,000
Income taxes		<u>92,800</u>
Net income.....		<u>139,200</u>

Nebula Corporation
Comparative Account Information
Relating to Operations
For the Year Ended December 31, 2013

	<u>2013</u>	<u>2012</u>	Adjust:
Net Income 139.2K			
Current Assets:			
Cash	103,000	156,000	
Accounts receivable	56,000	40,000	-16K
Prepaid insurance	5,000	6,000	+1K
Current Liabilities:			
Accounts payable	59,000	47,000	+12K
Interest payable	600	1,500	-0.9K
Income taxes payable	4,200	6,000	-1.8K
Unearned revenue	<u>20,000</u>	<u>14,000</u>	
Average current liabilities	76,150	68,500	+6K
		Gain on sale of equip	-30K
			109.5K

14. What is the net cash flows provided by operating activities in 2013?

- a) \$109,500
- b) \$138,900
- c) \$139,500
- d) \$168,900
- e) None of the above

15. What is the Current Cash Debt Coverage Ratio in 2013?

- a) 1.31
- b) 1.35
- c) 1.44
- d) 1.82
- e) 2.28

$109,500 / 76,150 = 1.44$

16. What is the Profit Margin in 2013?

- a) 22%
- b) 34%
- c) 37%
- d) 39%
- e) None of the above

$$139,200/620,000=22\%$$

Use the following information to answer Question 17 and 18:

On the Best Buy website, you saw the following promotion:

Purchase any 42inch LED Smart TV and you can receive one of the Geek Squad services for \$99*

*Geek squad service includes TV installation and wall mounting.

On October 1st, 2013, You went to the store and decided to purchase a new 42 inch LED Smart TV for \$899 and the Geek Squad service as well. The sales person also persuaded you to purchase additional 3 year extended warranty that cost \$380. Since you were such a good customer, the sales person gave you a 20% discount on the total.

To save on delivery charge, you took the TV with you the same day but have arranged installation to be done on October 31st 2013.

Later, you found out on the website that you had scored a very good deal because the TV installation and wall mounting service alone worth \$299.

17. What is the price that should be allocated to the TV based on the fair value method?

- a) \$628.05
- b) \$719.20
- c) \$785.06
- d) \$899.00
- e) None of the above

TV	899	57%	628.05
Install	299	19%	208.88
Warranty	<u>380</u>	24%	<u>265.47</u>
	1578		1102.4*

$$*(899+99+380)*0.8$$

18. Determine the amount of revenue that should be recognized by Best Buy on the above transaction by the year end of December 31, 2013.

- a) \$851.68
- b) \$859.05

- c) \$903.30
- d) \$983.73
- e) None of the above

TV \$628.05 + Installation \$208.88+ 3 months warranty \$265.47*3/36= \$859.05

19. Seagull and Bobolink signed a contract whereby Seagull would ship 5000 books to Bobolink on March 31st, 2013.

Details of the arrangement are as follows:

- Seagull is responsible for shipping charges of \$4,000.
- Bobolink is responsible for advertising the new books for \$3,000.
- Bobolink will send Seagull a check at the end of each month for the sale of the books, less 25% on gross sales.

On September 30th, 2013, 80% of the books were sold. The books were originally in Seagull's inventory account for \$75,000 and the list price for each book was \$30.

What should Seagull record on its books with regard to inventory on March 31, 2013?

- a) Dr Inventory on consignment \$75,000
 Cr. Finished Goods Inventory \$75,000
- b) Dr. Inventory on consignment \$79,000
 Cr. Finished Goods Inventory \$79,000
- c) Dr. Inventory on consignment \$82,000
 Cr. Finished Goods Inventory \$82,000
- d) Dr. Inventory on consignment \$60,000
 Cr. Finished Goods Inventory \$60,000
- e) Dr. Inventory on consignment \$63,200
 Cr. Finished Goods Inventory \$63,200

*75K+\$4K=\$79K

20. If in addition to the above terms in question 19, the following term also applies:

- In the event that the books are not sold by the end of September 30th, 2013, Bobolink will keep the books and pay Seagull the higher of
 - i) cost of the unsold books
 - ii) \$2,000.

What should Seagull record on its books with regard to the total revenue recognized by the end of September 30th?

- a) \$15,800
- b) \$90,000
- c) \$105,000
- d) **\$105,800**
- e) None of the above

Cost of each book = $\$79000 / 5000 = 15.8$

Cost of unsold books = $(5000 \times 20\% \times \$15.8) = \$15,800$

Revenue from sold books = $(5000 \times 80\% \times \$30 \times 75\%) = \$90,000$

Total revenue = $\$15,800 + \$90,000 = \$105,800$

Part B: Calculation Question (40 marks in total)

My Melody Inc. is a cruise ship manufacturer, specializing small passenger vessels for river sailings.

Below is a summary of selective activities that occur each year:

2012:

- On April 13, the company entered into a three-year construction contract to build a new cruise ship Mimmy for a price of \$24,000,000. During 2012, costs of \$9,000,000 were incurred with estimated costs of 11,000,000 yet to be incurred. Billings of \$6,000,000 were sent and cash collected was \$5,000,000.
- On May 1st, the company issued 400,000 common shares. Also, preferred dividends of \$200,000 and common dividends of \$150,000 were declared.
- On December 31, 2012, My Melody decided to discontinue a major line of production. The estimated loss on disposal before tax was \$2,350,000 and loss from operation before tax was \$700,000.
- The reported net income for 2012 is \$1,250,000.

2013:

- During the year, costs incurred were \$10,750,000 with remaining costs estimated to be \$4,750,000. My Melody billed Mimmy for \$10,000,000 and collected 8,000,000 cash from the customer.

2014:

- The project was completed in 2014 after an additional cost 5,000,000 were incurred. Mimmy was billed \$8,000,000 and cash of \$9,000,000 was collected.

The company has a year end of December 31. My Melody Inc. is a public company that follows IFRS. In the beginning of 2012, It has 5,000,000 common shares issued and outstanding. The company has a tax rate of 35%.

- a) Compute the overall profitability of the contract calculated at the end of 2012, 2013, and 2014. (3 marks)

2012: $\$24,000,000 - \$20,000,000 = \$400,000$
 2013: $\$24,000,000 - \$24,500,000 = (\$500,000)$
 2014: $\$24,000,000 - \$24,750,000 = (\$750,000)$

- b) What are the gross profits/losses that will be recognized at the end of 2012, 2013, 2014? If there is a loss, list the components that make up the loss. (10 marks)

	2012	2013	2014
Contract Price (a)	\$ 24,000,000	\$ 24,000,000	\$ 24,000,000
Less: Estimated Costs			
Costs incurred during the year	\$ 9,000,000	\$ 10,750,000	\$ 5,000,000
Costs incurred to date	\$ 9,000,000	\$ 19,750,000	\$ 24,750,000
Est. Cost to Complete	\$ 11,000,000	\$ 4,750,000	
Est. Total Costs (b)	\$ 20,000,000	\$ 24,500,000	\$ 24,750,000
Percent Complete (c)			
	45%	81%	100%
Estimated Total Gross Profit (a – b)	\$ 4,000,000	\$ (500,000)	\$ (750,000)
Revenue recognized:			
Revenue to date (a x c)	\$ 10,800,000	\$ 19,346,938.78	\$ 24,000,000
Less Prior years revenue		\$ 10,800,000	\$ (19,346,939)
Current year revenue	\$ 10,800,000	\$ 8,546,939	\$ 4,653,061
Construction Costs Recognized:	\$ 9,000,000	\$ 10,750,000	\$ 5,000,000
Gross Profit recognized:			
Gross Profit to date	\$ 1,800,000.00	\$ (500,000.00)	\$ (750,000.00)
Less Gross Profit in prior years		\$ 1,800,000.00	\$ 500,000.00
Current year Gross Profit	\$ 1,800,000.00	\$ (2,300,000.00)	\$ (250,000.00)
* 2013 Loss includes:			
Entire loss of contract \$500k calculated at the end of the 2013 + reversal of 1.8M			
*2014 Loss includes:			
Additional construction costs 250K not recognized as a loss in 2013.			

Prepare journal entries for 2013 to record all related transactions. Use the balance sheet account "Payables" for the journal entries to record the costs incurred. Label all your journal entries. (8 marks)

		2013	
1. To record cost of construction:			
Construction in Process		\$ 10,750,000	
	Payables		\$ 10,750,000
2. To record progress billings:			
Accounts Receivable		\$ 10,000,000	
	Billings on Construction in Process		\$ 10,000,000
3. To record collections:			
Cash		\$ 8,000,000	
	Accounts Receivable		\$ 8,000,000
4. To recognize revenue and gross profit:			
Construction Expenses		\$ 10,846,939	
	Construction in Process		\$ 2,300,000
	Revenue from Long-Term Contract		\$ 8,546,939

FYI: Note construction expenses includes construction cost of \$10,750,000 and expected loss in 2014 of \$96,939.

- c) Prepare journal entries for 2014 to record revenue recognized in the year. (4 marks)

Construction Expenses		\$	4,903,061	
Construction in Process				\$ 250,000
Revenue from Long-Term Contract				\$ 4,653,061

FYI: since \$96,939 of construction expense was already recognized in 2013, in 2014, construction expense = \$5,000,000 - \$96,939 = \$4,903,061.

- d) Prepare the partial income statement and balance sheet relating to this contract for year ended December 31, 2012. (5 marks)

	<u>2012</u>
Revenue from long-term contracts	\$ 10,800,000
Construction expenses	<u>\$ 9,000,000</u>
Gross Profit	<u>\$ 1,800,000</u>

Hardhat Construction Ltd	
Statement of Financial Position	
	<u>2012</u>
Current Asset	
Construction in process	\$ 10,800,000
Less: Billings	<u>\$ 6,000,000</u>
Recognized revenues in excess of billings	\$ 4,800,000

- e) Prepare the partial income statement presentation of discontinued operations starting from income from continuing operation before tax to net income for 2012. (5 marks)

Income from Continuing Operations before tax		\$ 4,973,076.92
Less: tax		<u>\$ 1,740,576.92</u>
Income from Continuing Operations		\$ 3,232,500
Discontinued Operations		
Loss from Disposal		
Tax recovery of \$ 822,500	\$ (1,527,500)	
Loss from operation		
Tax recovery of \$ 245,000	<u>\$ (455,000)</u>	
		<u>\$ (1,982,500)</u>
Net Income		\$ 1,250,000

FYI: You have work backwards from Net income up to Income from Continuing Operations.

f) Prepare the 2012 earnings per share information as required by IFRS. (5 marks).

Weighted average common shares				
500,000,000 x 4/12		1,666,666.67		
(500,000,000+400,000) x 8/12		3,600,000.00		
		<u>5,266,666.67</u>		
EPS:				
Continuing operation		0.58	(3,232,500-200,000)/5,266,666.67	
less discontinued operations		(0.38)	(1,982,500)/5,266,666.67	
Net income		0.20		

End of Examination

Formulae

Current ratio = current assets/current liabilities

Quick ratio = cash, marketable securities, and receivables(net)/current liabilities

Current cash debt coverage ratio = Net cash provided by operating activities/average current liabilities

Profit margin = net income/net sales

Rate of return on assets = net income/average total assets

Rate of return on common share equity = $\frac{\text{net income minus preferred dividends}}{\text{average common shareholders' equity}}$

Debt to total assets = $\frac{\text{total debt}}{\text{total assets}}$

Times Interest earned = $\frac{\text{Income before interest charges and taxes}}{\text{interest charges}}$

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You may use this area for draft/notes
