

Name (please print) \_\_\_\_\_

Multiple Choice Points

Problem Points

Total Points

---

---

**Financial Accounting for MBAs**  
**EGADE**  
**Test 2 - Solutions**  
**Spring 2009**

Notes:

1. If you believe the information presented is inconsistent or incomplete make a note of any assumptions or corrections you made in your test booklet and continue to solve the problem.
2. Please note your answers in the space provided. Partial credit on problems can only be earned when you show your calculations.
3. I hope you do great!

Multiple Choice (40 points – 2 points each) - Identify the letter of the choice that best completes the statement or answers the question. Only one answer per question, circle your answer.

- \_\_\_ 1. During a year of rising prices and increasing inventory, which cost flow assumption would measure the smallest net income?  
**a. LIFO**  
 b. FIFO  
 c. Averaging  
 d. All methods measure income the same.
- \_\_\_ 2. When accounting for inventory consignments, the issue which helps determine whether or not the inventory cost should be included on a company's balance sheet is  
 a. whether the inventory is physically located in the company's warehouse.  
**b. who actually owns title to the inventory.**  
 c. who will ultimately sell the inventory to the consumer.  
 d. when the inventory will be sold.
- \_\_\_ 3. Selecting an inventory cost flow assumption will most likely be impacted by which one of the following?  
 a. The physical flow of the inventory goods  
 b. The cost of the company's plant and equipment  
**c. Income taxes**  
 d. The cost flow assumptions most often used by other companies
- \_\_\_ 4. The LIFO conformity rule requires a company that uses  
**a. the LIFO assumption for computing cost of goods sold on its tax return to also use the LIFO assumption in preparing its financial statements.**  
 b. any inventory cost assumption to use the LIFO cost assumption for tax purposes.  
 c. the LIFO assumption for computing cost of goods sold on its financial statements to also use LIFO on its tax return.  
 d. the LIFO assumption to avoid paying taxes on inventory profits.
- \_\_\_ 5. Under the lower-of-cost-or-market rule, market is  
 a. the selling price of inventory items.  
 b. the original cost paid for inventory.  
**c. used to value inventory if it is less than its recorded cost.**  
 d. the amount of cash the company expects to collect from the sale of an inventory item
- \_\_\_ 6. Tiger Corp. purchased available-for-sale securities from Mud Hen Company on December 23 for \$3,000. On December 31, the market value of those securities is \$3,500. Which one of the following is appropriate on December 31?
- |           |   |            |            |
|-----------|---|------------|------------|
| a.        | Available-for-Sale Securities   | 3,500      |            |
|           | Unrealized Gain on Available-for-Sale Securities                      |            | 3,500      |
| b.        | Available-for-Sale Securities   | 500        |            |
|           | Unrealized Gain on Available-for-Sale Securities                      |            | 500        |
| <b>c.</b> | <b>Available-for-Sale Securities</b>                                  | <b>500</b> |            |
|           | <b>    Unrealized Price Increase on Available-for-Sale Securities</b> |            | <b>500</b> |
| d.        | No entry is required.   |            |            |

- \_\_\_ 7. Trading securities of Lug Nuts Inc. were purchased by Blue Jay Company on December 14 for \$1,000. On December 31, the market value of those securities is \$1,200. Which one of the following adjusting journal entries is appropriate at December 31?
- |           |  |            |            |
|-----------|--|------------|------------|
| a.        | Trading Securities                               | 1,200      |            |
|           | Unrealized Gain on Trading Securities            |            | 200        |
|           | Cash   |            | 1,000      |
| <b>b.</b> | <b>Trading Securities</b>                        | <b>200</b> |            |
|           | <b>    Unrealized Gain on Trading Securities</b> |            | <b>200</b> |
| c.        | Trading Securities                               | 200        |            |
|           | Securities Revenue                               |            | 200        |
| d.        | No entry is required.                            |            |            |
- \_\_\_ 8. Trading securities were purchased on April 1 for \$900. On December 31, the market value of those securities is \$710. Which of the following is part of the adjusting entry necessary on December 31?
- Debit Unrealized Loss on Trading Securities for \$710
  - Debit Realized Loss on Trading Securities for \$190
  - Credit Trading Securities for \$190**
  - Credit Unrealized Loss on Trading Securities for \$190
- \_\_\_ 9. Trading securities are held primarily for the purpose of
- anticipated increases in value over extended time periods.
  - increasing the current ratio.
  - window dressing the balance sheet.
  - generating profits on short-term price increases.**
- \_\_\_ 10. Yankees, Inc. paid \$10,000 for a stock investment and classified it as available-for-sale. On December 31, 2006, the company appropriately recognized an unrealized increase of \$2,000. The stock is reported on Yankees' balance sheet at December 31, 2006 at
- \$10,000.
  - \$12,000.**
  - \$8,000.
  - Not enough information to determine.
- \_\_\_ 11. The purpose of recording depreciation expense is to
- provide cash necessary to replace plant assets when they are used up.
  - record the balance sheet amount of plant assets at replacement value.
  - match expenses with revenues using a reasonable systematic method.**
  - make it difficult to calculate net income.
- \_\_\_ 12. The process of allocating the cost of plant and equipment over the time period of which they are used is referred to as
- depreciation.**
  - depletion.
  - amortization.
  - deferred costs.
- \_\_\_ 13. The process of expensing the cost of patents over a period not exceeding forty years is referred to as
- intangilation.
  - depletion.
  - depreciation.
  - amortization.**

- \_\_\_ 14. Accumulated depreciation is an account which
- adjusts plant and equipment so that its balance sheet value approximates its replacement cost.
  - is a long-term liability.
  - is equal to total depreciation expense recorded and decreases total plant and equipment.**
  - reduces intangible assets.
- \_\_\_ 15. Wizards Inc. acquired machinery on January 1, 1992 at a cost of \$50,000. The machinery was depreciated over five years using the straight line method and a salvage value of \$2,000. In 2005 the machinery was sold for \$3,000. The income statement for 2005 will reflect which of the following:
- Gain of \$1,000**
  - Gain of \$3,000
  - Loss of \$ 48,000
  - No gain or loss
- \_\_\_ 16. Accounts payable typically arise because
- cash is received from a customer that will be paid back in the future.
  - cash is received from customers prior to the rendering of services or delivery of products.
  - the firm temporarily borrows cash for operations.
  - amounts are owed to others for goods, supplies, and services purchased on open account.**
- \_\_\_ 17. Unearned revenue typically arises because
- cash is received as security that will be paid back in the future.
  - cash is received from customers prior to the rendering of services or delivery of products.**
  - a company temporarily requires cash for operations.
  - merchandise is sold to customers prior to payment.
- \_\_\_ 18. Contingent liabilities whose ultimate payment is reasonably probable should be
- recorded in the body of the balance sheet.
  - disclosed in the footnotes to the financial statements.**
  - ignored.
  - disclosed in the auditor's report.
- \_\_\_ 19. A contingent liability
- is definite in existence, but its amount and due date are not yet known.**
  - has the same requirements as a contingent gain.
  - must be accrued even when it is not reasonably estimable.
  - is disclosed only in the financial statement notes if highly probable and the amount can be estimated.
- \_\_\_ 20. Gain contingencies
- should be accrued when probable and the amount can be reasonably estimated.
  - are reported as revenues on the income statement.
  - should be accrued for anticipated lottery winnings.
  - are almost never accrued and are rarely disclosed.**

Problems (60 points)

Problem 1 (9 points)

Southsoutheast's Gift Store's inventory and purchase information for July is as follows:

July 1	Beginning inventory	500 @ \$4
July 10	Purchase	300 @ \$5
July 31	Ending inventory	300

Consider each of the following questions independently.

1. Southsoutheast's Gift Store uses the FIFO cost flow assumption. Calculate its cost of goods sold for the month of July and its ending inventory at July 31. Show your computations and circle your answers.

$$\begin{aligned}\text{COGS} &= 500 @ 4 = 2,000 \\ \text{EI} &= 300 @ 5 = 1,500\end{aligned}$$

2. Southsoutheast's Gift Store uses the LIFO cost flow assumption. Calculate its cost of goods sold for July and its ending inventory at July 31. Show your computations and circle your answers.

$$\begin{aligned}\text{COGS} &= 300@5 + 200@4 = 2,300 \\ \text{EI} &= 300 @ 4 = 1,200\end{aligned}$$

3. Southsoutheast's Gift Store uses the averaging cost flow assumption. Calculate its cost of goods sold for July and its inventory at July 31. Show your computations and circle your answers.

$$\begin{aligned}3,500/800 &= 4.375 \\ \text{COGS} &= 500 \times 4.375 = 2,187.50 \\ \text{EI} &= 300 \times 4.375 = 1,312.50\end{aligned}$$

Problem 2 (6 points)

Upnorth Retail Store sold \$900 of merchandise with original cost of \$600, to Brat Inc. on April 3, terms, 2/10 N/30. On April 8, Brat returned \$200 of the merchandise that was defective. The returned merchandise had a cost of \$130. Upnorth received payment from Brat on April 10. Prepare the journal entries needed to record these transactions assuming that Upnorth uses a perpetual inventory system.

Date	Accounts	Debit	Credit
4/3	Accounts Rec.	900	
	Sale		900
	Cost of Goods Sold	600	
	Inventory		600
4/8	Sales Returns & Allowance	200	
	Accounts Rec.		200
	Inventory	130	
	Cost of Goods Sold		130
4/10	Cash	686	
	Sales Discounts	14	
	Accounts Rec.		700

Problem 3 (9 points)

Mets, Inc. acquired 30% of Cyclone Corporation for \$500,000 on January 1, 2008. During the calendar year 2008, Cyclone had net earnings of \$600,000 and paid total dividends of \$100,000. The fair value of Cyclone Corporation's stock at year-end was \$160,000. Prepare the journal entries necessary to record this investment using the equity method.

Date	Accounts	Debit	Credit
	Long-Term Investment in Equity	500,000	
	Cash		500,000
	Long-Term Investment in Equity	180,000	
	Income from Long-Term Investment		180,000
	Cash	30,000	
	Long-Term Investment in Equity		30,000

Problem 4 (6 points)

On April 1, 2009, Pirate Company purchased 100% of the outstanding voting common stock of Hillcat Corporation for \$400,000. At that date the fair market value of Hillcat's assets less liabilities was \$300,000. What amount, if any, of goodwill must Pirate report in its consolidated balance sheet on December 31, 2009? Show your computations and circle your answer.

Amount Paid	400,000
Fair Market Value of Net assets	300,000
Goodwill	100,000

Problem 5 (15 points)

1. On January 1, Hawks Co. paid \$80,000 for a new truck. It was estimated that the truck would be driven for the next 8 years, at which time it would have a salvage value of \$8,000. Calculate depreciation expense for year 1 and 2 using the straight line method. Show your computations and circle your answers.

$$80,000 - 8,000 / 8 = 9,000 \text{ per year}$$

2. On January 1, Timberwolf Company paid \$80,000 for a copy machine. It was estimated that the machine could be used for the next 8 years, at which time it would have a salvage value of \$8,000. Calculate depreciation expense for year 1 and 2 using the double-declining balance method. Show your computations and circle your answers.

$$80,000 \times 2 \times 1/8 = 20,000$$
$$60,000 \times 2 \times 1/8 = 15,000$$

3. On January 1, Sonic Company paid \$88,000 for a copy machine. It was estimated that the machine would produce 1,000,000 copies over the next 8 years, at which time it would have a salvage value of \$8,000. During the first and second years, the copies totaled 180,000 and 300,000, respectively. Calculate depreciation expense using the activity method for each of the first two years. Show your computations and circle your answers.

$$88,000 - 8,000 / 1,000,000 = .08 \text{ per copy}$$

$$180,000 \times .08 = 14,400$$
$$300,000 \times .08 = 24,000$$

Problem 6 (6 points)

A lawsuit for breach of contract seeking damages of \$2,000,000 was filed against Predator Corporation on March 1, 2008. Predator's legal counsel (lawyer) believes that an unfavorable outcome is highly probable. A reasonable estimate of the court's award to the plaintiff is \$600,000. Settlement is expected to occur during the latter part of 2008. Identify the amount if any that should appear as a contingent liability in the June 30, 2008 balance sheet. Circle the amount and explain your answer.

Predator should accrue and report at contingent liability for \$600,000

Problem 7 (9 points)

Lightening Company estimates warranty expense as 5% of sales. On January 1, warranties payable was \$10,000. During the year, Lightening paid \$8,000 to meet its warranty obligations and recorded sales of \$300,000. Calculate the December 31 balance that should be reported in the Warranties Payable account. Show your computations and circle your answer.

Beginning Balance	10,000
Add: Warranty expense accrued for sales during the year ( $300,000 \times .05$ )	15,000
Less: Warranty claims paid	<u>(8,000)</u>
Ending Balance	<u>17,000</u>