NATIONAL UNIVERSITY OF SINGAPORE

EC2204 Financial Accounting for Economists

Semester 1, AY2018-2019
Mid-Term Examination

Time allowed: 1 Hour

Suggested Solutions

Question 1:

Under accrual accounting, which of the following errors would most likely lead to an overstatement of net profit in the current year?

A. Recording revenue next year since the cash is collected next year, although the performance obligation is satisfied in the current year.

B. Recording an expense when paid next year although it is incurred this year.

C. Failing to adjust the Deferred Revenue account for the portion of rent earned this year.

D. None of the above

Solution: B or D

Not recording revenue even though it was earned would understate net profit in the current year. Hence, A is incorrect.

Under accrual accounting, that expenses should be recorded in the same period as the revenues they generate, not necessarily the period in which cash is paid for them. As a result, not recording an expense even though it was incurred this year would understate expenses and overstate net profit for the current year. B is correct.

However, it is unclear if we are recording an expense now or next year (from the phrasing of the question). Hence, I also accept D.

Failing to adjust the Deferred Revenue account for the portion earned this year would also understate net profit in the current year. C is incorrect.

Question 2:

Consider Noble Group. Assets totaled \$24,250 and liabilities totaled \$8,500 at the beginning of the year. During the year, assets decreased by \$3,500 and liabilities increased by \$2,800.

What is the amount of shareholders' equity at the end of the year?

A. \$9,450

B. \$14,450

C. \$15,750

D. None of the above

Solution: A

Shareholders' Equity = Assets − Liabilities
Shareholders' Equity at beginning of year = \$24,250 − \$8,500 = \$15,750

Change in shareholders' equity = Change in assets − Change in liabilities
= − \$3,500 − \$2,800 = − \$6,300
Ending shareholders' equity = \$15,750 − \$6,300 = \$9,450

Question 3:

Lanzini Inc. received payment from a customer in June for a service that was provided during July. How will this be reflected in the basic accounting equation for Lanzini Inc in July?

A. Assets will increase, liabilities will increase, and shareholders' equity will not change.

B. Assets will increase, liabilities will not change, and shareholders' equity will increase.

C. Assets will not change, liabilities will decrease, and shareholders' equity will increase.

D. None of the above

Answer: C

In June, when the payment from the customer was received, the company would increase assets (Cash) and increase liabilities (Deferred Revenue).

In July, revenues increase, which increases net profit and the shareholders' equity account Retained Earnings. In addition, since the company fulfilled its obligation to perform the service, the related liability (Deferred Revenue) decreases.

Question 4:

Yarmolenko Limited commenced with capital in cash of $1,000. Inventory costing $800 is purchased on credit, and half is sold for $1,000 cash plus sales tax of $175. The firm is liable to pay the sales tax to the government at the end of the year.

Determine the amount of assets and capital of the firm immediately after all the transactions have taken place.

A. Assets: $1,775; Capital: $1,200

B. Assets: $2,175; Capital: $1,775

C. Assets: $2,575; Capital: $1,600

D. None of the above

Solution: C

Assets	**$**
Opening Cash	1,000
Cash received (1,000+175)	1,175
Inventory (800-400)	400
	2575

Capital	$
Opening Capital	1,000
Profit on sale of inventory (1,000 – 400)	600
	1,600

For completeness, we can also find the amount of liabilities, and verify the accounting equation: Assets = Liabilities + Capital

Liabilities	$
Sales Tax	175
Accounts payable (due to Inventory)	800
	975

Use the following information to answer Questions 5 and 6. Fabianski Limited uses a periodic inventory system. At the end of 2017, the accounting records included the following information:

Inventory, 31 December 2016	$1,390
Inventory, 31 December 2017	$1,560
Revenue	$14,800
Purchases	$8,280

A review of inventory items revealed the need for some adjustments:

1. Items which had cost $80 and which would normally sell for $120 were found to have deteriorated. Remedial work costing $20 would be needed to enable the items to be sold for $90. The items have not been sold as of 31 December 2017.

2. Some items sent to customers on consignment had been omitted from inventory and included as sales in October 2017. The cost of these items was $16 and they were included in the sales at $24. The items have not been sold by the customers as of 31 December 2017.

Question 5:

Calculate Fabianski Limited's Revenue for 2017:

A. $14,776

B. $14,800

C. $14,884

D. None of the above

Correct Answer: A

$14,800 – 24= 14,776

Sales Revenue overstated by $24 (consignment not part of sales)

Question 6:

Calculate Fabianski Limited's Cost of Goods Sold for 2017:

A. $8,104

B. $8,110

C. $8,094

D. None of the above

Correct Answer: A

Inventory, 31 December 2017	$1,390
Add: Purchases during the year	<u>8,280</u>
Cost of goods available for sale	9,670
Less: Inventory, 31 December 2018 (1,560+16-10) - Lower of cost (80) and Net Realizable Adjustment (90-20=70) Therefore, adjustment of 10 - Also, inventory understated by 16.	<u>(1,566)</u>
Cost of Goods sold	<u>8,104</u>

Question 7:

Reid Enterprises receives $100,000 cash from its customers on account. Given that Reid Enterprises uses the cash to pay off $100,000 on a bank loan, the net result is:

A. Assets would increase by $100,000 while liabilities would decrease by $100,000.

B. Liabilities would decrease by $100,000 while stockholders' equity would increase by $100,000.

C. Assets would decrease by $100,000 and liabilities would decrease by $100,000.

D. None of the above

Solution: C

Receiving cash of $100,000 from customers in payment of their accounts will cause one asset (Cash) to increase and another asset (Accounts Receivable) to decrease. There is no change in the amount of total assets.

Using $100,000 of cash received to pay off a bank loan will cause an asset (Cash) to decrease and a liability (Notes Payable) to decrease.

Considering both transactions, assets (Accounts Receivable) decrease by $100,000 and liabilities (Notes Payable) decrease by $100,000.

Question 8:

The following account balances were listed on the trial balance of Hernandez Company at the end of the period (with the usual debit/credit sign associated with it):

Account	Balance
Accounts Payable	$ 90,600
Cash	48,900
Common Stock	30,000
Equipment	13,500
Land	45,000

The company's trial balance is not in balance and the company's accountant has determined that the error is in the cash account. What is the correct balance in the cash account?

A. $31,500

B. $57,900

C. $62,100

D. None of the above

Solution: C

Total credits = Accounts Payable $90,600 + Common Stock $30,000 = $120,600
Total debits = Cash (unknown) + Equipment $13,500 + Land $45,000
Total debits must also equal $120,600

$120,600 = Cash (unknown) + Equipment $13,500 + Land $45,000
Cash = $120,600 − Equipment $13,500 − Land $45,000 = $62,100

Question 9:

The employees of Wilshere Inc. worked during July but are not paid their wages totaling $800 until August. Which of the following best indicates how to account for this transaction in July?

A. A journal entry with a debit to Salaries and Wages Payable and a credit to Salaries and Wages Expense for $800 should be recorded.

B. A journal entry with a debit to Salaries and Wages Expense and a credit to Salaries and Wages Payable for $800 should be recorded.

C. No journal entry needs to be made because payment has not yet been made.

D. None of the above

Solution: B

This period's wages are reported as Salaries and Wages Expense on the income statement and any unpaid wages are reported as Salaries and Wages Payable on the balance sheet.

The related entry would include a debit to Salaries and Wages Expense and a credit to Salaries and Wages Payable for $800.

Question 10:

Which of the following statements are **correct**:

A. If a company decides to record an expenditure made this period as an expense, when it should have been recorded as an asset, net income will be overstated in the current period as a result.

B. If a company forgot to record depreciation on equipment for a period, total shareholder's equity would be understated on the balance sheet.

C. If a company forgot to prepare an adjusting entry to record salaries and wages incurred but unpaid at the end of the period, Retained Earnings would be understated on the balance sheet.

D. None of the above

Solution: D

Statement A is false. Erroneously recording an asset as an expense would overstate total expenses, which would understate net profit.

Statement B is false. If the adjusting entry to record depreciation for the period is not made, the Accumulated Depreciation account will be understated, which means that Total Assets will be overstated. Depreciation Expense would also be understated, which means that expenses would be understated and net income will be overstated. This overstatement of net income causes shareholder’s equity to be overstated.

Statement C is false. If the adjusting entry to accrue unpaid salaries and wages is not made (Salaries and Wages Payable) a liability account will be understated, which means that Total Liabilities will be understated. Salaries and Wages Expense would also be understated, which means that expenses would be understated and net income will be overstated. This overstatement of net income causes shareholder’s equity to be overstated.

Question 11:

Which of the following statements about depreciation methods is **not correct**?

A. The amount of depreciation expense recorded in each year of an asset's life depends on the method that is used.

B. The total depreciation over the asset's useful life will be the same regardless of the depreciation method used.

C. The amount of net income reported each year will be the same regardless of the depreciation method used.

D. None of the above

Solution: C

The straight-line, units-of-production, and declining-balance methods are acceptable methods of depreciation.

They will produce the same total depreciation over the asset's useful life, but the amount of depreciation expense and book value will differ from year-to-year.

As a result, the amount of net profit reported in a given year can vary depending on the depreciation method used.

Question 12:

On 1 January, Perez Coffee Shop paid $24,000 for a full year of rent beginning on 1 January. The rent payment was appropriately recorded in the Cash and Prepaid Rent accounts. If financial statements are prepared on 31 January, the journal entry to record the adjustment would be:

A. Debit Rent Expense and credit Prepaid Rent for $2,000.

B. Debit Rent Expense and credit Prepaid Rent for $24,000.

C. Debit Prepaid Rent and credit Rent Expense for $24,000.

D. None of the above

Answer: A

When the company first made the payment, it provided an economic resource to the company (building space for twelve months), so it was initially recorded as an asset called Prepaid Rent.

At January 31, one month has passed.

The adjusting entry will include a debit to Rent Expense (to increase this expense account) and a credit to Prepaid Rent (to decrease this asset account) for $2,000 [or ($24,000 ÷ 12 months) × 1 month].

Question 13:

Which of the following statements are correct:

A. An overstatement of ending inventory will cause an overstatement of assets and an understatement of stockholders' equity on the balance sheet.

B. An overstatement of beginning inventory causes net income to be overstated.

C. In an inflationary environment, net income will be higher under the weighted average cost method as compared to the First in, First Out (FIFO) method.

D. None of the above

Solution: D

Statement A is false. If ending inventory is overstated, then assets will be overstated. Cost of goods sold will be understated, so net profit will be overstated and stockholders' equity will be overstated.

Statement B is false. Beginning inventory is added in the equation to determine cost of goods sold, so if it is overstated, then cost of goods sold is overstated. If the cost of goods sold expense on the Income Statement is overstated, then net profit will be understated.

Statement C is false. In an inflationary environment, the ending inventory will be lower under the weighted average cost method and the cost of goods sold will be higher (compared to FIFO), resulting in lower net profit.

Question 14

Anderson Company has a periodic inventory system and uses the Last in, First Out (LIFO) method to assign costs to inventory and cost of goods sold.
Consider the following information:

Date	Description	# of units	Cost per unit
1 January	Beginning inventory	100	$ 5
5 October	Purchase	75	$ 4
13 December	Sales	125	

What amounts would be reported as the cost of goods sold and ending inventory balances for the period?

A. Cost of goods sold $550; Ending inventory $250

B. Cost of goods sold $625; Ending inventory $175

C. Cost of goods sold $755; Ending inventory $225

D. None of the above

Solution: A

Ending inventory (in units)
= Beginning inventory + Purchases − Units sold
= 100 + 75 − 125
= 50

LIFO – Periodic

Beginning inventory	100 units × $5	$ 500
+ 5 October purchase	75 units × $4	300
= Goods available for sale		$ 800
− Ending inventory	50 units × $5	250
= Cost of goods sold	(75 × $4) + (50 × $5)	$ 550

Question 15

Arnautovic Limited bought a machine for $40,000 and expects to use it for eight years. The residual value is $3,500. Given that the company uses the double-declining-balance method and has already recorded accumulated depreciation of $35,995, what is the company's annual depreciation expense for the upcoming year?

A. $505

B. $1,001

C. $9,125

D. None of the above

Solution: A

Depreciation expense = Book value × (2 ÷ Useful life)

<u>Initial calculation:</u>
Depreciation expense
= (Cost − Accumulated depreciation) × (2 ÷ Useful life)
= ($40,000 − $35,995) × 2 / 8
= $1,001.25 (rounded to $1,001)

Book value at end of the upcoming year
= ($40,000 − $35,995 − $1,000)
= $3,005, which is less than the residual value of $3,500.

Recording this amount of depreciation expense in the upcoming year would cause the book value to drop below the residual value.

<u>Revised calculation:</u>
Depreciation expense
= Beginning book value of $4,005 (or Cost of $40,000 − Accumulated depreciation of $35,995) − residual value of $3,500
= $505

Question 16

During the current accounting period, revenue from credit sales is $536,800. The Accounts Receivable balance is $41,184 at the beginning of the period and $41,760 at the end of the period. Which of the following statements is correct?

A. On average, it takes 12.9 days to collect payment from credit customers.

B. The receivables turnover ratio is 12.9.

C. On average, the company sells its inventory every 28.3 days.

D. None of the above

Answer: B

Receivables turnover ratio
= Net sales revenue ÷ Average net receivables
= $536,800 ÷ [($41,184 + $41,760) ÷ 2] = 12.9

Days to collect
= 365 ÷ 12.9
= 28.3

Question 17

A company has a debt-to-assets ratio of 0.45. If the company then borrows cash from the bank to finance a building acquisition, which of the following is a correct statement?

A. The debt-to-assets ratio will be unchanged.

B. The debt-to-assets ratio will increase

C. The debt-to-assets ratio will decrease

D. I don't know.

Answer: B

Debt-to-assets ratio = Total Debt ÷ Total assets

Currently, the company's total debt (liabilities) are 45% of its total assets; as such, the numerator was less than the denominator when this ratio was calculated.

Borrowing cash will increase the company's total liabilities and total assets by the same amount. The effect on the numerator will be greater since it is a smaller number, so the debt-to-assets ratio will increase.

Question 18

Which of the following would improve a current ratio that is now 1.2?

A. Selling long-term assets for cash

B. Collecting cash from accounts receivables

C. Buying inventories using cash

D. I really don't know.

Answer: A

The current ratio measures the company's ability to pay its current liabilities. It is calculated by dividing current assets by current liabilities.

Selling long-term assets for cash would increase the numerator and have no effect on the denominator; as such, it would improve the company's current ratio.

Collecting cash from accounts receivable and buying inventories using cash will have no impact on the current asset.

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