

NEW YORK UNIVERSITY
Leonard N. Stern School of Business
Financial Accounting & Reporting: Sample Proficiency Exam

Question 1. Multiple Choice (Choose the best response)

1. On 12/31/97, the accountant for ACME Company forgot to accrue interest payable. Accordingly on the balance sheet ended 12/31/97:
 - a. Assets are overstated and liabilities are understated
 - b. Assets are understated and liabilities are understated
 - c. Owners Equity is understated and liabilities are understated
 - d. Owners Equity is overstated and liabilities are understated
 - e. Owners Equity is understated and liabilities are overstated

2. In December 1997, XYZ Company received an advance of \$1,000 for goods to be delivered in 1998. XYZ Company instantly recognized sales revenue. As a result, on the balance sheet ended 12/31/97:
 - a. Assets are overstated and liabilities are understated
 - b. Assets are understated and liabilities are understated
 - c. Owners Equity is understated and liabilities are understated
 - d. Owners Equity is overstated and liabilities are understated
 - e. Owners Equity is understated and liabilities are overstated

3. Assume that the cost per unit of inventory has always risen over time, that the number of units of inventory rose during the period, and that the firm is profitable for tax purposes and pays its taxes immediately in cash. The use of LIFO rather than FIFO for inventory valuation leads to:
 - a. a lower cash balance, a higher ending inventory balance, and a lower current ratio
 - b. a higher cash balance, a higher ending inventory balance, and a higher current ratio
 - c. a lower cash balance, a higher ending inventory balance, and a higher current ratio
 - d. a higher cash balance, a lower ending inventory balance, and a lower current ratio
 - e. a lower cash balance, a lower ending inventory balance, and a lower current ratio
 - f. cannot say without more information

4. Charlie Company accrues bad debt expense in reporting to shareholders. If it had, instead, recognized bad debt expense only as customers accounts were written off, it would:
 - a. have reported less bad debt expense in each of the past years than it has under its chosen method
 - b. have reported more bad debt expense in each of the past years than it has under its chosen method
 - c. have reported cumulatively more bad debt expense in the past years than it has under its chosen method
 - d. have reported cumulatively less bad debt expense in the past years than it has under its chosen method

5. For external reporting, generally accepted accounting principles require that:
 - a. all variable costs be treated as product costs
 - b. only variable manufacturing costs be treated as product costs
 - c. all manufacturing costs other than fixed manufacturing overhead be treated as product costs
 - d. all manufacturing costs be treated as product costs

6. In 1994, the RestInPeace funeral home reported tax expense of \$200,000. On its tax return for the year, the IRS assessed tax of \$210,000. The tax rate is 25%. Thus for 1994, RestInPeace had a temporary (or timing) difference that:
- \$10,000 that increased taxable income in comparison to pretax income
 - \$10,000 that decreased taxable income in comparison to pretax income
 - \$40,000 that decreased taxable income in comparison to pretax income
 - \$40,000 that increased taxable income in comparison to pretax income
7. TroubleFree Cars accrues warranty expense for reporting to shareholders, and in 1994, its balance of Warranty Obligations increased by \$12,000. The IRS, however, allows a deduction only for costs incurred for warranty work performed. There are no other differences between tax and financial reporting. The tax rate is 20%. In 1994 these facts will result in:
- an increase in deferred tax assets of \$9,600
 - a decrease in deferred tax assets of \$9,600
 - a decrease in deferred tax assets of \$2,400
 - an increase in deferred tax assets of \$2,400

Question 2. Trusty Appliances, a retailer of major appliances, reports the following for the first two years of its operation.

| | Balance Sheet | | | Income Statement | | |
|----------------------------|---------------|----------|---------|-----------------------|----------|----------|
| | Year 1 | Year 2 | Change | Year 1 | Year 2 | |
| Cash | \$10,000 | \$12,000 | 2,000 | Sales revenue | \$38,000 | \$80,000 |
| Accts. Receivable (Gross) | 30,000 | 65,000 | 35,000 | COGS | 20,000 | 45,000 |
| Prepaid rent | 2,000 | 4,000 | 2,000 | | ----- | ----- |
| Inventory | 20,000 | 26,000 | 6,000 | GM | 18,000 | 35,000 |
| P&E (Net) | 70,000 | 61,000 | (9,000) | Wage & Salary expense | 2,000 | 3,000 |
| | ----- | ----- | | Depreciation | 5,000 | 5,000 |
| | 132,000 | 168,000 | | Rent | 3,000 | 4,000 |
| Accounts Payable (Merch.) | 16,000 | 12,000 | (4,000) | Bad debt expense | 1,000 | - |
| Misc. Op. Expenses payable | - | 2,000 | 2,000 | Warranty expense | - | 5,000 |
| Long-term Note payable | - | 26,000 | 26,000 | Misc. Op. expense | 1,000 | 3,000 |
| Paid-in-capital | 110,000 | 110,000 | - | | ----- | ----- |
| Retained Income | 6,000 | 18,000 | 12,000 | Operating Income | 6,000 | 15,000 |
| | ----- | ----- | | Loss on sale of P&E | - | 1,000 |
| | 132,000 | 168,000 | | | ----- | ----- |
| | | | | Net Income | 6,000 | 14,000 |

NOTE: Trusty did not purchase any P&E in year 2. There are no taxes.

REQUIRED:

- Prepare a statement of cash flows for **year 2**, using the direct method for the cash from operations section.
- Also, prepare a reconciliation of Net Income to CFO for **year 2**.
- In one brief sentence, identify the most important thing these statements tell you about Trusty's financial management in **year 2**.

Question 3. Continuing with Trusty Appliances from the previous problem, suppose Trusty had from the outset, alternatively, accrued an allowance for bad debts at 5% of the ending accounts receivable, and accrued warranty expense at 10% of sales.

REQUIRED:

- A. Indicate the amounts of any line item on Trusty's income statements and balance sheets for years 1 and 2 that changes from Question 2.
- B. What would be the impact of the accruals you have made above on cash flow from operations?

Question 4. XYZ Retailers uses periodic LIFO for inventory valuation. Its ending inventory for 1991 was 100 units @ \$5 each. Through 1992, it made purchases in the following order: 50 units @ \$7 each and then 100 units @ \$8 each. It sold 150 units in 1992. XYZ also reports in its footnotes that its LIFO reserve at the end of 1991 was \$100.

REQUIRED:

- A. Compute the COGS and ending inventory balance (in dollars) reported by XYZ for 1992.
- B. Compute the COGS and ending inventory balance (in dollars) that would have been reported by XYZ for 1992 if it used FIFO instead of LIFO.
- C. How much less (or more) tax has XYZ paid in 1992 because it used LIFO rather than FIFO? The tax rate is 30%. Taxes are promptly paid.
- D. How much less (or more) tax has XYZ paid up to end 1992 because it used LIFO rather than FIFO?

Question 5. ABC Manufacturing Company sells a single product. The following parameters apply for the first year of its operations (1991):

| | |
|--|--------------------------------------|
| Selling price | \$ 20.00 per unit. |
| Direct material | \$ 4.00 per completed unit |
| Direct labor | \$ 2.00 per completed unit |
| Variable manufacturing overhead | \$ 3.00 per completed unit |
| Depreciation on factory facilities (fixed) | \$ 10,000 |
| Other fixed manufacturing overhead | \$ 5,800 |
| Variable selling costs (commission) | \$ 0.20 per dollar of sales revenue. |
| Fixed Selling and admin. Expenses | \$ 15,800 |

ABC starts and finishes production of 15,800 units and sells 10,000 units in 1991.

REQUIRED:

- A. What NI and Finished Goods Inventory (in dollars) would ABC report for 1991 if it treated all fixed manufacturing overhead as a period cost (i.e., used variable costing)?
- B. What NI and Finished Goods Inventory (in dollars) would ABC report to its investors for 1991 as per GAAP?

Question 6. For all the following multiple choice questions use the following information:

ABC Co. issued a bond some time ago with a coupon rate of 10%. The market interest rate was then 9%. The bond is not due to mature for some time. The current market interest rate is 12%.

1. The bond was issued at: (a) a premium; (b) a discount; (c) at par; (d) cannot determine without more information.

2. The interest expense reported by ABC will: (a) increase over time; (b) decrease over time; (c) stay constant; (d) cannot determine without more information.

3. Relative to its face (i.e., par) value, the current market value of the bond is: (a) the same (b) lower (c) higher (d) cannot determine without more information.

4. Relative to its net value in ABC's books, the current market value of the bond is: (a) the same; (b) lower; (c) higher; (d) cannot determine without more information.

5. If ABC purchases back the bond at market value and retires it, it will report: (a) an accounting gain on early retirement of debt; (b) an accounting loss on early retirement of debt; (c) neither an accounting gain nor loss; and (d) cannot determine without more information.

Question 7. For the year 1994, Charlie Company reported bond interest expense of \$19,400 on its Income Statement.

| | Dec 31, 1993 | Dec 31, 1994 |
|--------------------------|---------------------|---------------------|
| Bonds payable | 200,000 | 178,000 |
| Premium on bonds payable | 25,000 | 26,400 |

\$30,000 was raised from bonds issued at a premium on 12/31/94. [Since these were issued on the last day of the year, no interest expense was accrued on them for 1994.] Bonds with a face value of \$50,000 matured on 12/31/94.

REQUIRED:

- A. What was the face value of the new bonds issued?
- B. What were the coupon payments on bonds during 1994?
- C. If the bonds in the opening balance all have the same coupon rate, what is this coupon rate?

Question 8. On 12/31/89, Roy Enterprises reported 9000 shares outstanding and a book value per share of \$20. **During 1990**, it sold 1000 shares of treasury stock for \$46 each. These shares had been acquired some years ago for \$40 each. There were no other capital stock transactions. There are no taxes.

REQUIRED:

- A. What was the impact of the **treasury stock sale** (increase or decrease and by how much) on: (a) NIBT for 1990; (b) ending balance of Retained Earnings for 1990; and (c) ending balance of Owners Equity for 1990
- B. What is the number of shares outstanding on 12/31/90?

Question 9. On 1/1/98, Tasmania Airlines leased and put into service an airplane with a fair value of \$6,000,000. The manufacturer is willing to lease the plane to Tasmania for eleven years, which is less than the economic life of the airplane. The interest rate implicit in the lease payments is 10%. The lease payments are paid in ten annual installments beginning on 12/31/99 (i.e., at the end of the second year of the lease) and ending on 12/31/08 (i.e., the end of the lease term). There are no taxes. Using a 10% interest rate, the present value of an annuity of \$1 of 10 annual payments with the first payment beginning in one year is \$6.14456, and the present of \$1 to be received in one year is \$.90909.

REQUIRED:

- A. Compute the annual lease payments.
- B. Is this a capital lease or an operating lease?
- C. Record the journal entries required for Tasmania on 1/1/98 and 12/31/98.

Question 10. On 1/1/90, Falstaff Productions acquired 100 shares (**at book value**) in Slapstick Theater for \$30,000. It reported the following for 1990 and 1991, classifying the shares as available for sale. Falstaff has no other inter-corporate investments.

| | 12/31/90 | 12/31/91 | | 1990 | 1991 |
|-------------------------------------|-----------------|-----------------|-----------------|---------------|---------------|
| Inv. in Slapstick | 32,000 | 29,000 | Op. Revenue | 30,000 | 32,000 |
| Other assets | <u>90,000</u> | <u>95,000</u> | Op. Expenses | <u>25,000</u> | <u>26,000</u> |
| | 122,000 | 124,000 | Op. Income | 5,000 | 6,000 |
| Payables | 60,000 | 60,000 | Dividend income | <u>2,000</u> | <u>-</u> |
| OE: | | | Net income | 7,000 | 6,000 |
| PIC | 40,000 | 40,000 | | | |
| Retained Inc. | 20,000 | 25,000 | | | |
| Valuation allowance for Equity Inv. | <u>2,000</u> | <u>(1,000)</u> | | | |
| | 122,000 | 124,000 | | | |

Slapstick reported net income of \$30 per share for 1990 and a net loss of \$15 per share for 1991.

REQUIRED. What would the above statements show if Falstaff's shareholding in Slapstick were to be deemed a controlling interest, instead?

SOLUTION

Question 1. All parts d.

Question 2.

A. Cash Flow Statement: Year 2

Operations

| | | | |
|-----------------------------|---------------------------------------|------------------|----------|
| From customers | = Sales revenue – ↑ in Acc. Rec | = \$45,000 | |
| To suppliers of merchandise | = – COGS – ↑ in Inv. – ↓ Acc. Pay (M) | = (55,000) | |
| For Salaries & Wages | = – Sal. & Wage exp. | = (3,000) | |
| For rent | = – rent exp. – ↑ in prepaid rent | = (6,000) | |
| For Warranty services | = – Warranty exp. | = (5,000) | |
| For Misc. Op. Exp. Items | = – Misc. exp. + ↑ in Misc. payables | = <u>(1,000)</u> | |
| CFO | | | (25,000) |

Investing

| | | | |
|----------------|--|--------------|-------|
| From P&E sales | | <u>3,000</u> | |
| CFI | | | 3,000 |

Financing

| | | | |
|---------------------|--|----------------|---------------|
| From L-T Borrowings | | 26,000 | |
| Dividends paid | | <u>(2,000)</u> | |
| CFF | | | <u>24,000</u> |
| Net cash flow | | | 2,000 |

B. Reconciliation of NI to CFO: Year 2

| | | |
|---------------------|--------------|--|
| Net Income | 14,000 | |
| Loss on Sale of P&E | 1,000 | |
| Depreciation | 5,000 | |
| ↑ in Acc. Rec | (35,000) | |
| ↑ in Inv. | (6,000) | |
| ↓ Acc. Pay | (4,000) | |
| ↑ in prepaid rent | (2,000) | |
| ↑ in Misc. payables | <u>2,000</u> | |
| | (25,000) | |

C. Trusty is borrowing long-term to finance its operating deficit, which is not a good sign!

Question 3.

A.

| | Balance Sheet | | | Income Statement | |
|----------------------------|----------------------|---------------|-----------------------|-------------------------|---------------|
| | Year 1 | Year 2 | | Year 1 | Year 2 |
| Cash | \$10,000 | \$12,000 | Sales revenue | \$38,000 | \$80,000 |
| Acc. Rec. | 30,000 | 65,000 | COGS | <u>20,000</u> | <u>45,000</u> |
| Allowance for bad debts | (1,500) | (3,250) | GM | 18,000 | 35,000 |
| Prepaid rent | 2,000 | 4,000 | Wage & Salary expense | 2,000 | 3,000 |
| Inventory | 20,000 | 26,000 | Depreciation | 5,000 | 5,000 |
| P&E (Net) | <u>70,000</u> | <u>61,000</u> | Rent | 3,000 | 4,000 |
| | 130,500 | 164,750 | Bad debt expense | 2,500 | 1,750 |
| Acc. Payable (Merch) | 16,000 | 12,000 | Warranty expense | 3,800 | 8,000 |
| Misc. Op. Expenses payable | - | 2,000 | Misc. Op. expense | <u>1,000</u> | <u>3,000</u> |
| Reserve for warranties | 3,800 | 6,800 | Operating Income | 700 | 10,250 |
| Long-Term Note payable | - | 26,000 | Loss on sale of P&E | <u>-</u> | <u>1,000</u> |
| Paid-in-capital | 110,000 | 110,000 | Net Income | 700 | 9,250 |
| Retained Income | <u>700</u> | <u>7,950</u> | | | |
| | 130,500 | 164,750 | | | |

B. The accruals have no effect on operating cash flow.

Question 4.

A. Under LIFO: $COGS = (100 @ 8 + 50 @ 7) = \$1,150$; $EB\ Inv. = (100 @ 5) = \$500$

B. Since the LIFO reserve at the end of 1991 was \$100, under FIFO inventory at the beginning of 1992 would 100 units for a total of \$600 (=500+100). Then the EB of Inventory for 1992 (FIFO being same as Last-In-Still-Here) would be the last 100 @ 8 = \$800 and COGS would be $(\$600 + 50 @ 7) = \950 ;

C. $LIFO\ tax - FIFO\ tax = 0.3 \times (950 - 1,150) = (\$60)$

D. $\sum(LIFO\ tax - FIFO\ tax) = 0.3 \times (500 - 800) = (\$90)$

Question 5.

| | | |
|-----------|--------------------------------------|---------------|
| A. | Revenue (10,000 × 20) | 200,000 |
| | Less COGS (At var. mfg. of \$9 each) | 90,000 |
| | Variable selling | 40,000 |
| | Fixed mfg. overhead | 15,800 |
| | Fixed S&A | <u>15,800</u> |
| | Net income | 38,400 |

The 5,800 units in Finished goods would be carried at variable manufacturing cost (\$9 each) for a total of \$52,200.

B. Under absorption costing (as required by GAAP) the Fixed mfg. overhead of \$15,800 would be spread over all the production for 1991, i.e., 15,800 units. Thus, at \$1 per unit, \$5,800 of fixed mfg. overhead would be held back on the balance sheet rather than expensed on the income statement. Thus, NI and Finished goods inventory would both be \$5,800 higher than in part a) above. That is, NI reported to investors will be \$44,200 and Finished goods inventory reported to investors will be \$58,000.

Question 6. 1, a; 2, b; 3, b; 4, b; 5, a.

Question 7.

A. The face value of the new bonds issued is found by balancing the bonds payable account. Since bonds with a face value of \$50,000 also matured on 12/31/94, the face value of the new bonds is \$28,000.

B. First, we note that the new bonds were issued at a premium of \$2,000, since \$30,000 was raised and the face value was \$28,000. However, the premium account has increased only \$1,400. Thus \$600 of premium was amortized (i.e., debited) during the year. Thus the coupon payment in 1994 was \$600 greater than the interest expense for 1994, i.e., the coupon payment was \$20,000.

C. Coupon rate = coupon payment / face value = 20,000/200,000 = 10%

Question 8.

A. (a) NONE (b) NONE (c) + \$46,000

B. 10,000

Question 9.

A. Denoting the annual lease payment by X and noting that the first payment starts at the end of the second period, solve $X \times 6.14456 \times .90909 = 5,585,970$ to get $X = \$1,000,000$

B. Capital lease. The present value of the lease payments exceeds 90% of the fair value of the airplane.

C.

| | | | | |
|----------|---|-------|-----------|-----------|
| 1/1/98 | Leasehold Airplane | Debit | 5,585,970 | |
| | Lease Liability | | Credit | 5,585,970 |
| 12/31/98 | Depn. on Leasehold Airplane | Debit | 507,815 | |
| | Leasehold Airplane | | Credit | 507,815 |
| | (St. line depreciation over the life of the lease – 11 years) | | | |
| | Interest expense | Debit | 558,597 | |
| | Lease Liability | | Credit | 558,597 |

Question 10.

| | 12/31/90 | 12/31/91 | | 1990 | 1991 |
|-------------------|-----------------|-----------------|---------------------|-------------|-------------|
| Inv. in Slapstick | 31,000 | 29,500 | Op. Revenue | 30,000 | 32,000 |
| Other assets | 90,000 | 95,000 | Op. Expenses | 25,000 | 26,000 |
| | ----- | ----- | | ----- | ----- |
| | 121,000 | 124,500 | Op. Income | 5,000 | 6,000 |
| Payables | 60,000 | 60,000 | Inc. from Slapstick | 3,000 | (1,500) |
| OE: | | | | ----- | ----- |
| PIC | 40,000 | 40,000 | Net income | 8,000 | 4,500 |
| Retained Inc. | 21,000 | 24,500 | | | |
| | ----- | ----- | | | |
| | 121,000 | 124,500 | | | |