

5071 Management I

Examination:

Financial Accounting

Summer semester 2005

Examiner:

Prof. Dr. Alfred Luhmer

The following aid can be used:

non-programmable calculator without
communication and word processing tools

Hints:

- You must enter your solutions into the answer sheet.
- A total of 120 points can be achieved. There are 5 problem sets. The achievable points for each problem set are given in parentheses. You are advised to base your time allocation on the points.

Problem set 1 - transaction analysis (30 points)

Jane and Amanda started their business - a clothing store in a new winter sports area - in January 2005. They had a good start but February was a disaster. Unseasonably mild weather and rain kept the winter visitors away. Read what happened to them during that month (February):

1. The company could not sell any goods in February. To make things worse, a customer who bought team gear for € 4.000 on credit in January also experienced problems. Negotiations took place and eventually the customer signed a six-month note agreeing to pay, at the end of July, the principal of the note plus accrued interest. Interest is to accrue from 1 February at the rate of 1,5% a month.
2. In an effort to generate revenues, Jane had the idea of starting a monthly magazine for all the people who moved to the area. This magazine was called "Grapevine". The annual subscription price was € 24, payable in advance. Four hundred subscriptions were sold in February. The first issue came out at the end of February.
3. Local firms decided to advertise in the magazine. Jane and Amanda generated advertising revenue of € 900 in February although no cash was received.
4. They incurred costs of € 3 per copy (printing and distribution) for the February issue, all paid in cash during the month.
5. Utility costs paid were € 500.
6. In February, Tim (the only employee of the business) received his January wage which amounted to € 1.500. As he is now supposed to write a regular gossip column for the magazine his February wages earned were € 1.700.
7. Finally, adjustments were made in the accounts for the use of shop space and equipment in the month.
Equipment was purchased in early January for € 9.000 and has a useful life of three years. Also in January, three months' rent of € 9.000 was paid.

Required:

- a) Prepare the journal entries to record what happened in February.
- b) Calculate the company's profit (or loss) for February.

Problem set 2 - Income statement and balance sheet accounts (20 points)

"Rent-a-bike-or-hike" started business just recently. However, nobody prepared an opening balance for the enterprise. The following is a list of accounts and balances that the accountant of "Rent-a-bike-or-hike" has determined for the first month, i.e. at the end of the first month. Important: All accounts have normal balances.

Name:	Balance
Accounts receivable	4.000
Wages payable	1.000
Cash	14.450
Owners' investments	25.000
Bikes (summary account)	30.000
Hiking shoes	2.000
Utility expense	800
Prepaid rent	2.500
Rent expense	1.250
Loan payable	10.000
Owners' withdrawal	1.050
Unearned revenue	2.000
Accumulated depreciation (bikes)	5.000
Depreciation expense (bikes)	5.000
Accrued interest payable	1.000
Interest expense	1.000
Rental revenues	7.050
Other short-term liabilities	11.000

Required:

- Prepare a trial balance using the information given above.
- Given your finding for a), judge the quality of the accountant's work.
- Prepare a balance sheet in good form.

Problem set 3 - Accounting for long-term liabilities (20 points)

On 1 July 2005 the following bonds were issued (Source: CSFB):

Face Value in millions	Currency	Stated rate of interest	Issuer	Maturity	Credit rating (Moody's)	Issue price in %
1.250	€	5,25	Royal Bank of Scotland Group Plc	perpetual	A1	100,0000
3.000	€	3,375	German Postal Pensions Securitisation Plc	2016	Aaa	99,2020
500	£	5,625	Telecom Italia SpA	2015	Baa2	98,8500
50.000	Yen	0,55	Toyota Motor Credit Corp.	2010	Not available	101,3260

Required:

- Prepare the journal entries to record the issuance of each of the four bonds.
- What can explain the difference in stated rate of interest between German Postal Pensions Securitisation Plc and Telecom Italia SpA?
- Assume the market rate of interest is 3,5%. Prepare the journal entry to record accrued interest expense on 31 December 2005 for German Postal Pensions Securitisation Plc.
- Briefly explain the relation between interest rates and bond prices.

Problem set 4 - Cash flow statements (25 points)

The comparative balance sheet for Liquid Inc. looks as follows:

	2004	2003
Cash	€ 98,000	€ 31,000
Receivables	44,000	39,000
Inventory	80,000	60,000
Prepaid expenses	14,000	9,000
Plant assets	550,000	550,000
Accumulated depreciation	(150,000)	(100,000)
Goodwill	22,000	40,000
	<u>€658,000</u>	<u>€629,000</u>
Accounts payable	€ 49,000	€ 56,000
Accrued liabilities	28,000	22,000
Loan payable	—	129,000
Preference shares	100,000	—
Share premium—preference shares	38,000	—
Ordinary shares	400,000	400,000
Retained profit	43,000	22,000
	<u>€658,000</u>	<u>€629,000</u>

1. The Accumulated Depreciation account has been credited only for the depreciation expense for the period.
2. The Retained profit account has been charged for dividends of €46,000 and credited for the net income for the year.

The income statement for 2004 is as follows:

Sales	€660,000
Cost of sales	363,000
	<u> </u>
Gross profit	297,000
Operating expenses	230,000
	<u> </u>
Net income	<u>€ 67,000</u>

Required:

- a) Prepare a statement of cash flows for the year 2004 using the indirect method.
- b) Two ratios to evaluate the liquidity of a company are the *current ratio* (current assets / current liabilities) and *operating expenses held in cash* (cash / daily operating expenses). Explain what these ratios mean and how they can help you in assessing a company's liquidity.
- c) Explain why a cash flow statement is useful information!

Problem set 5 - Miscellaneous issues (20 points)

- a) Explain the terms "separate accounting entity" and "separate legal entity". Which forms of business organisations are separate legal entities and which are not? (5 points)
- b) Explain the going-concern assumption. Why do we need this assumption? (3 points)
- c) Briefly discuss why corporations sometimes repurchase their own shares. (4 points)
- d) Describe some institutional aspects of accounting standard setting in either Bulgaria, Germany or the USA. (8 points)

Good luck!

Name:

Student identification number:

Problem set 1:

a)

Hint: AE stands for adjusting entry

1.	Dr.	Cr.	
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1. AE	Dr.	Cr.	
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2.	Dr.	Cr.	
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2. AE	Dr.	Cr.	
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3.	Dr.	Cr.	
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4.	Dr.	Cr.	
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5.	Dr.	Cr.	
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6.	Dr.	Cr.	
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6. AE	Dr.	Cr.	
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7a.AE	Dr.	Cr.	
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7b.AE	Dr.	Cr.	
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b)

Total revenues in February

Total expenses in February

Profit (loss) in February

Problem set 2

a) trial balance

Accounts receivable		
Wages payable		
Cash		
Owners' investments		
Bikes (summary account)		
Hiking shoes		
Utility expense		
Prepaid rent		
Rent expense		
Loan payable		
Owners' withdrawal		
Unearned revenue		
Accumulated depreciation (bikes)		
Depreciation expense (bikes)		
Accrued interest payable		
Interest expense		
Rental revenues		
Other short-term liabilities		
Total		

b) evaluation of accountant's work

c) balance sheet in good form

Problem set 3

a) recording bond issues

Royal Bank of Scotland Group

Dr.	
Cr.	

German Postal Pension Securitisation Plc

Dr.	
Cr.	

Telecom Italia SpA

Dr.	
Cr.	

Toyota Motor Credit Corp.

Dr.	
Cr.	

b) Reasons for the difference in stated interest rates

c) journal entry to record accrued interest expense on 31 December 2005

Dr.	
Cr.	

d) explanation for relation between interest rates and bond prices

c) Explain why a cash flow statement is useful.

Problem set 5

a)

b)