

# Management 1

Examination: 5071 Financial Accounting Winter semester 04/05

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 6 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 - Bookkeeping and Income Statement (40 points)

Tom and Jerry decide to found a partnership "Cartoon Rental" on June 30, 2004. A little later, on December 31, 2004, they would like to know how they are doing and decide to prepare financial statements.

Tom volunteers and prepares the following alphabetical list of accounts that contains the account balances before any adjusting entries have been made (all amounts in €; accounts have normal balances):

Accounts payable	3.710	Revenues	15.240
Accounts receivable	2.100	Jerry's investment	5.000
Cash	8.000	Jerry's withdrawal	740
Equipment	15.000	Supplies	500
Expenses	6.340	Tom's investment	5.000
Note payable	5.000	Tom's withdrawal	1.000
Prepaid insurance	2.400	Unearned revenue	2.130

After that, Tom looks through the source documents and discovers the following items:

1. The equipment, purchased on November 1, has an estimated useful live of five years
2. The insurance policy, bought on September 30, is good for a period of two years.
3. The note payable is a short-term note and was signed on October 1. On the note an annual interest of 12% must be paid in equal installments on January 1 and July 1.
4. By December 31, half of the unearned revenue has been earned
5. An inventory count shows that supplies have been used up fully.
6. An additional withdrawal of € 360 by Jerry has been unrecorded so far.

Required:

- a) Prepare an unadjusted trial balance.
- b) Tom is worried about errors in the recording process. Given the total of debits and credits in the unadjusted trial balance what statement can you make regarding recording errors? And why?
- c) Prepare the journal entries for the adjustments.
- d) Indicate the type of each adjustment as (D) deferral, (A) accrual, or (N) neither deferral nor accrual.
- e) Prepare the adjusted trial balance.
- f) Prepare the income statement.

**Problem set 2 - Balance sheet (10 points)**

For a fictitious company the following balances of accounts at year end 2004 are available (numbers in €):

Bond payable:	5.000
Bond receivable:	2.000
Salary expense:	800
Accounts receivable:	1.000
Interest payable:	500
Net income (2004):	3.000
Cash:	???

Required:

- What does the basic accounting equation state? Does this equation hold at any time? Briefly explain.
- Determine the balance in the cash account by simple application of the basic accounting equation (assume that no other accounts than the ones mentioned exist).
- Prepare the balance sheet in good form indicating the three broad balance sheet categories.

**Problem set 3 - Long-term liabilities (10 points)**

Assume a bond issue has a stated rate of interest of 6.5%. The market rate of interest at the issue date is 5.85%

Required:

- Indicate whether the bond will be issued at a discount or at a premium.
- If the bond issue is recorded, which accounts are affected and how?
- During the life of the bond is there any difference between interest expense and interest payments? If yes, explain the difference.

**Problem set 4 - Miscellaneous topics (15 points)**

Give short and precise answers!

- What is the essence of the going-concern assumption and why do we need it? [2 points]
- What are the four types of transactions that affect owner's equity and how do they affect it? [4 points]
- "When I give credit, I debit my customer's account." Is this statement true? If so, why? [3 points]
- Name two different cost flow assumptions for inventory valuation purposes and explain one of them. [3 points]
- What is a normal balance of an account? Indicate whether the following accounts' normal balances are debit or credit. [3 points]
  - insurance expense
  - property and equipment
  - revenues from sales
  - discount on bonds payable

**Problem set 5 - Accounting terms (10 points)**

What accounting term is defined or indicated by the word or phrase?

- a. The adjusting entry for this type of deferral involves an asset and an expense account.
- b. Statement showing financial condition at a point in time.
- c. This bond can be retired before maturity at the issuer's option.
- d. Probable future sacrifices of economic benefits.
- e. It apportions recorded cost or revenues among two or more accounting periods.

**Problem set 6 - Depreciation of long-lived assets (35 points)**

On January 1, 2005, Bill acquired a new machine for his company. The cost of the machine amounted to € 70.000. Bill estimates the useful life of the machine will be 5 years with a salvage value of € 10.000.

Required:

- a) Prepare schedules of depreciation charges for the
  - straight-line method and
  - sum-of-the-years digits method
- b) Assume that there will be increasing maintenance costs. Sketch a figure that shows the graph of total cost of using the machine given the straight line method. Sketch another figure that shows the graph of total cost given the sum-of-the-years digits method.
- c) Again assume increasing maintenance cost but suppose the output of the machine will remain rather constant. Which of the two depreciation methods from (a) would you apply in this situation and why? What is the relevant accounting principle then?
- d) Assume that Bill's estimate of a useful live of 5 years for the machine is longer than the minimum useful life under current accounting and tax regulation. Can he stick to his estimate for (I) financial reporting purposes and/or (II) tax purposes? Why?

**Good luck!**