EXAMINATION: FINANCIAL ACCOUNTING

PROBLEM 1. MULTIPLE CHOICE QUESTIONS

1.	A
2.	B
3.	D
4.	B
5.	A
6.	D
7.	A
8.	A
9a.	A
9b.	A
10.	A
11.	C
12.	A
13.	B
14.	C
15.	C

PROBLEM 2. MINI PROBLEMS

MINI PROBLEM 1.

2015 balance sheet for PinPoint, Inc.

ASSETS	
INTANGIBLE ASSETS	$
Copyright	120,000
Patents	60,000
Goodwill	140,000
Less: amortization since inception	(89,000)
Total intangible assets:	**231,000**

2015 partial income statement for PinPoint, Inc.

		$
Revenue		170,000
Expenses		
Amortization expense	(32,000)	
Loss on sale of copyright	(12,000)	
Research and development costs	(160,000)	
		(204,000)
Net income		**(34,000)**

MINI PROBLEM 2.

2014 statement of cash flows for Wimbrow Images:

	$
Net Income	60,000
Unknown activities	20,000*
Cash flow from operations	80,000
Purchase of truck	(15,000)
Cash flow from investing activities	(15,000)
Dividends paid	(30,000)
Loan	40,000
Cash flow from financing activities	10,000
Total cash flow generated in 2014	**75,000**

*20,000 = 80,000 – 60,000

The reason there is a difference between net income and cash flows from operations, is that the net income reported in the income statement is based on the accrual basis of accounting. This means that revenue is recognized *when earned*, and not necessarily when cash is received. The same goes for expenses; they are recognized *when incurred*, which does not necessarily mean that cash has flown out of the company yet. The cash flow from operations adds back all the non-cash expenses (e.g. depreciation expense) and deducts all the non-cash revenues (e.g. sales on credit/an increase in accounts receivables), to get a net view of the actual cash generated by the company throughout the year.

Financial Accounting – final exam

MINI PROBLEM 3.

NB! *This problem is done under the assumption that current liabilities = $61,000*

Current ratio = $\frac{\text{Current assets}}{\text{Current liabilities}}$

Cargo's current ratio: $\frac{85,000}{61,000}$ = 1.39

Quick ratio = $\frac{\text{Cash+Marketable securities+Current receivables}}{\text{Current liabilities}}$

Cargo's quick ratio: $\frac{11,000+35,000}{61,000}$ = 0.75

Cargo's current ratio of 1.39 tells us that Cargo has $1.39 in current assets to meet every $1 of current liabilities. A general rule of thumb is that the current ratio should preferably be at least 2:1 to ensure that the company can meet all its current liabilities when they come due. Furthermore, the quick ratio of 0.75 shows that Cargo has *less* than $1 of very liquid assets to meet every $1 of current liabilities. These ratios do not look very good for Cargo; they show that a great part of Cargo's current assets consists of inventory, which first needs to be sold, and then, assuming they are paid on credit, payment needs to be collected before they are converted to cash that can be used to pay off Cargo's current liability. That is why these low ratios indicate possible liquidity problems for Cargo Corporation.

MINI PROBLEM 4.

NB! *This problem is done under the assumption that Revlon collected $12,000 of its accounts receivable and paid $11,000 on its note payable on* January 1*, and* ***not*** *on* January 31.
Furthermore, it is assumed that the trial balance is created at the end of the day, meaning all collections and payments in the assignment have had time to be recorded.

Trial balance for Revlon Inc., as of January 1, 2015:

Account	**Debit ($)**	**Credit ($)**
Retained earnings		49,000
Accounts receivable	8,000*	
Accounts payable		24,000
Capital stock		185,000
Land	153,000	
Cash	14,000**	

Equipment	20,000	
Notes payable		17,000***
Buildings	80,000	
Total:	275,000	**275,000**

*8,000 = 20,000 – 12,000

**14,000 = 13,000 + 12,000 – 11,000

***17,000 = 28,000 – 11,000

PROBLEM 3.

Journal entries:

		$	$
May 1	Cash	12,000	
	Capital stock		12,000

Contribution of $6,000 cash from each of the owners in exchange for shares of stock.

May 1	Equipment	300	
	Accounts payable		300

Purchased lighting equipment on open account*.

May 5	Vendor fee	25	
	Cash		25

Registered as a vendor with the city for a $25 monthly fee.

May 9	Tent	2,400	
	Cash		2.400

Purchase of event tent to set up at parties.

May 10	Supplies	100	
	Accounts payable		100

Purchased miscellaneous supplies on account.

May 15	Advertising expense**	75	
	Cash		75

Paid bill to local printer for advertisement signs.

**I have chosen to think of this transaction as an expense. If the advertisement signs were considered an asset, the debit would not be to an expense, but to an asset account.

May 17	Cash	1,500	
	Service revenue		1,500

Customers paid cash for services.

May 24	Accounts receivable	800	

	Service revenue		800
Billed park district for entertainment.			
May 29	Cash	400***	
	Accounts receivable		400
Received half the amount billed to the park district.			
***400 = 800*50%			
May 30	Cash	2,000	
	Service revenue		2,000
Received cash payment for parties.			
May 30	Salary expense	300	
	Cash		300
Paid wages for help over the weekend.			
May 31	Accounts payable	100	
	Cash		100
Paid balance due on the supplies.			

*In the assignment, it says that the company has 30 days to pay for the lighting equipment. As the purchase happened on May 1st, this means the company should have paid for the supplies no later than May 31st. However, as nothing more is mentioned about this transaction, I have assumed the company has not paid this account yet, and therefore not recorded any further entries in the regard.

May 2015 Income Statement: Hart Concerts Inc.

		$
Revenue		4,300
Expenses		
Vendor fee	(25)	
Advertising expense	(75)	
Wages and salaries	(300)	
		(400)
Net income		**3,900**

May 2015 Classified Balance Sheet: Hart Concerts Inc.

ASSETS		LIABILITIES + STOCKHOLDERS' EQUITY	
CURRENT ASSETS		CURRENT LIABILITIES	
Cash	13,000	Accounts payable	300
Accounts receivable	400		

Supplies	100		
Total current assets	13,500	Total current liabilities	300
PROPERTY, PLANT & EQUIPMENT		STOCKHOLDERS' EQUITY	
Lighting equipment	300	Capital stock	12,000
Event tent	2,400	Retained earnings	3,900
Total PP&E	2,700	Total stockholders' equity	15,900
TOTAL ASSETS	16,200	TOTAL LIABILITIES & SE	16,200

PROBLEM 4: CASE QUESTION

I have chosen to comment on the profitability and long-term assets of **DONG**.

In order to do so, it is necessary with some insights from DONG's financial statements.
One of the first things noticed when looking at DONG's income statement with profitability in mind, is the large decrease in profit for the year 2014. They have gone from a loss of 1,591 million DKK to an even greater loss of 2,310 million DKK. At first sight, this makes prospects for the company look very bad. However, a horizontal analysis of the income statement, comparing 2014 to the previous year 2013, might provide more information as to why this increase in loss has happened.

Item	2014	2013	Change (%)
Revenue	71,829	72,199	-0.5%
Cost of sales	(43,063)	(47,123)	-8.6%
Other external expenses	(7,147)	(6,955)	2.8%
Employee costs	(3,336)	(3,491)	-4.4%
Share of profit (loss) from associates and joint ventures	(93)	(711)	-86.9%
Other operating income	2,466	705	249.8%
Other operating expenses	(323)	(425)	-24%
EBITDA	**20,333**	**14,199**	**43.2%**
Depreciation, amortization and impairment losses on intangible assets and PPE	(17,566)	(12,963)	35.6%
EBIT	**2,767**	**1,236**	**123.9%**
Gain (loss) on divestment of enterprises	1,253	2,045	-38.7%
Share of profit (loss) from associates and joint ventures	(484)	(57)	749.1%
Financial income	5,261	3,273	60.7%
Financial expenses	(6,971)	(7,071)	-1.4%
Profit (loss) before tax	**1,826**	**(576)**	**417%**
Tax on profit (loss) for the year	(4,136)	(1,015)	307.49%
Profit (loss) for the year	**(2,310)**	**(1,591)**	**-45.2%**

The horizontal analysis instantly provides a brighter outlook for DONG's future. It is seen that despite the fact that the net income has decreased, the operating profit before depreciation, amortization and impairment losses (EBITDA) was of 20,333 million DKK, a 43% increase from the previous year. This profit can be credited to the large increase in other operating income, as well as the decrease in loss from associates and joint ventures. This suggests DONG has been successful in its operations, and that the loss is not attributed to these. A growing, large and positive EBITDA indicates high levels of profitability, as it suggests profitable operations, and operations are what carry the profits of the company in the long run. Looking at EBITDA therefore indicates that DONG might be a profitable company despite the great loss in net income.
The operating profit after adjusting for depreciation, amortization and impairment losses (EBIT) points us in the same direction as EBITDA. It is positive and has grown by 123.9% since last year; however this is solely due to the increase in EBITDA, as depreciation, amortization and impairment losses have actually increased significantly. According to their annual report, this negative increase was due to the declining oil prices in 2014, which led to greater impairment losses for DONG. If this is the case, one can hope that the increase in impairments is only temporary, and not something that will affect DONG's profitability in the long run.
Proceeding down the income statement, it is seen that despite a great increase in loss from associates and joint ventures, profit before tax has increased tremendously, going from a loss of DKK576 million in 2013, to a profit of 1,826 in 2014. This is because the loss from associates and joint ventures, as well as the loss from divestment of enterprises are more than offset by the increase in financial income.
Finally, we arrive at the main reason for DONG's large decrease in net income: the tax on profit/loss for the year. This has increased by 307% since 2013, meaning DONG paid around 3 million DKK more in taxes in 2014 than in 2013, leading to a decrease in net income of 45.2%. According to their annual report, the increase in taxes was especially due to a Norwegian tax on some of their operations of more than 80%.

The analysis of the income statement so far suggests that DONG is a profitable company despite the large loss in net income for the year, as this loss in mainly due to taxes; a factor that cannot be controlled by the company. The gross profit ratio of around 40% suggests the same; that DONG's *operations* are profitable, which indicates that DONG might be able to turn their current situation around; at least if the large impairment costs are due to the decline in oil prices, and assuming they find a way to control their tax expenses. Looking at the balance sheet, we also see that cash has increased from DKK million 2,894 to 6,034, also suggesting liquidity and good cash management despite the loss in net income. A cash flow statement would have been relevant for this analysis to provide insight into where exactly this cash came from.

Looking at the non-current assets of DONG, we see that property, plant and equipment, and especially the production assets are what constitute the greatest part of this. Things worth noting in the non-current assets section include:

- Exploration assets have decreased by 67%
- Investments in associates and joint ventures have decreased by 35%

- Deferred tax has increased by 386%
- Other receivables have increased 85%

These changes have resulted in a total decline in non-current assets of 6.5%, meaning the overall relative change is not immense, despite being a decline in non-current assets of around DKK6 million. Of the changes mentioned above, the significant increase in deferred taxes is of special interest, as this might have something to do with the large increase in impairment, depreciation, and amortization losses. From the note 3.1 regarding intangible assets and PP&E we see that the depreciation of PP&E throughout 2014 was of DKK million 52,466 while impairments were 16,106. Of these impairment losses, they highlight a power station impaired by 1,000 million DKK and the impairment of PP&E under construction of 339 million, proving this might be part of the cause of their decline in long-term assets and in net income.
In 2014, the return on assets was 3.15%. The return on assets can be said to be constituted by the return on sales and the asset turnover. For DONG, the return on sales was roughly 23%, while the asset turnover was 0.14. This shows us that the return on assets of 3.15% was mainly due to the return on sales, and not the asset turnover. However, it makes sense for a company like DONG to not have a very high asset turnover, as most of their assets are non-current assets.

From these brief observations, it can be concluded that if the depreciation and impairment of their long-term assets decreases in the future, and if they manage to somehow reduce whatever pollution/operation caused such a huge tax payment in 2014, all else equal, DONG has the potential of being a very profitable company, despite their negative net income for the past years.