

**MANAGEMENT STUDIES 259**  
**INTERMEDIATE ACCOUNTING**  
**Fall 2002**

**COURSE OUTLINE**

*“Nobody said accounting is an exact science”*. The variety of accounting treatments and estimates that are allowed by “Generally Accepted Accounting Principles” (**GAAP**) gives management considerable latitude. Two otherwise identical firms can report dramatically different net incomes and net asset positions by making different accounting choices. Managers often have a strong incentive to use the ambiguity in GAAP to report higher net income, more assets and fewer liabilities sometimes to the detriment of shareholders and creditors.

Why do you need to know more about financial accounting rules?

You may be thinking of becoming an accountant - GAAP will be your “stock in trade”. You may decide to become an audit professional (CPA) - it will be your job to ascertain whether or not the firms you audit followed the rules as they recorded and reported the transactions for an accounting period. It is easy to see why accountants must know GAAP but what about everyone else?

Suppose you have big dreams. You plan to become the CEO of an American corporation with publicly traded securities (stock and bonds). The Securities and Exchange Commission is now proposing to make you personally responsible for the information contained in your company’s financial statements. If those statements misrepresent the activities of the firm, you may be found guilty of fraud, a serious criminal offense (you may be have to pay a fine and/or go to jail).

You may be planning to invest your own money or to advise others about investments in the stocks and bonds of US corporations. Financial reports (income statement, balance sheet, statement of changes in stockholders’ equity, and the statement of cash flows) are one of the most important sources of information you will use to make investment decisions. You have to be able to read and understand what these reports tell you and what they don’t tell you about the company or you will make some very bad investment decisions

Finally, every citizen in a capitalist economy has a huge stake in the accuracy of financial reporting. Financial reporting has a special role in the allocation of resources in an economy like ours. We depend on financial markets to direct private sector investments to their best use. Investors rely on financial reports to measure the success or failure of past investments. This information helps them decide what investments to make in the future. Misleading financial reports lead to bad investment choices and inefficient use of the nation’s (world’s) scarce resources. Economists will tell you that using resources unwisely diminishes the output we get from the resources we use up and affects our wealth now and into the future.

If you look at the textbook for this course, you might conclude that there is an enormous amount of material to cover in intermediate accounting. At most schools the course is a year-long sequence – we will try to go over the material that is typically taught in the first semester so that you will be prepared to enroll in a second semester course at another school should you choose to do so. As is true of most accounting classes, this is a “relentless” course. You will need to keep up and be prepared for every class period. We will not be able to talk about everything that is included in the book in class. If you are planning to take the CPA examination you will need to know all of the material presented in the book. All students must practice in order to learn accounting. Do not let yourself get behind. Ask questions – take advantage of my office hours. As Stephan Leacock once said, ***“I am a great believer in luck and I find the harder I work the more I have of it.”***

## TEXTBOOK AND OTHER MATERIALS:

1. Spiceland, Sepe, and Tomassini, *Intermediate Accounting*, updated second edition
2. Schilit, Howard, *Financial Shenanigans, How to Detect Accounting Gimmicks & Fraud in Financial Reports*, 2<sup>nd</sup> Edition
3. Course Packet: Available in the Economics Department Office. Contains non-text readings for the course.
4. Financial Calculator : Although not required, you will find that having a financial calculator and knowing how to use it is extremely helpful every accounting and finance class.

## GRADES:

Grades in this class will be based upon the following activities:

Ten Homework Assignments	200 Points
Eight Topic Quizzes	200 Points
Three Take-Home Examinations	<u>300 Points</u>
	700 Points

In addition to graded work, you will have the opportunity to do practice problems and exercises with answers available the “courses” part of my webpage. This course outline and the answers to practice problems and exercises can also be reached through the “courses” page of the St Olaf Home Page. You will need a password to access the answers. I will give you the password in class.

## MAJOR TOPICS AND DATES:

<b><i>Dates</i></b>	<b><i>TOPIC</i></b>
<i>09/6-09/16</i>	<i>TOPIC I: Introduction – Structure of Accounting</i>
<i>09/18-09/27</i>	<i>TOPIC II: Income Statement and Balance Sheet in Detail</i>
<i>09/30-10/07</i>	<i>TOPIC III: Statement of Cash Flows</i>
	<b><i>FIRST TAKE HOME EXAMINATION</i></b>
<i>10/09-10/18</i>	<i>TOPIC IV: Revenue Recognition Issues</i>
<i>10/23-11/01</i>	<i>TOPIC V: Accounting for Assets – Current Receivables</i>
<i>11/04-11/08</i>	<i>TOPIC VI: Accounting for Assets – Investments</i>
	<b><i>SECOND TAKE HOME EXAMINATION</i></b>
<i>11/11-11/22</i>	<i>TOPIC VII: Accounting for Assets – Inventory</i>
<i>11/25-12/11</i>	<i>TOPIC VIII: Accounting for Assets – PP&amp;E and Intangibles</i>
	<b><i>THIRD TAKE HOME EXAMINATION</i></b>

## **TOPIC I: STRUCTURE OF ACCOUNTING**

### **09/06 through 09/16**

Investors and creditors use information contained in financial statements to make important financial decisions. These outside users have no control over the preparation and content of financial reports. They need some assurance that the information presented is a reasonably faithful representation of the results of operation of the entity. The accounting profession has developed an expansive set of accounting rules (GAAP) to guide the preparation of financial statements. What are the basic elements of GAAP? Why are they important? Who oversees GAAP and how are new rules developed?

The double entry bookkeeping system is a useful way to record and summarize the results of business transactions. We will review the full accounting cycle in this part of the course with special emphasis on end-of-period adjustments. The amount of time and effort you spend on this topic will depend upon your familiarity with debits and credits. You must be sure that you thoroughly understand how transactions are recorded and reported and be able to work through the entire accounting cycle. It is your responsibility to make sure you are prepared to move on in this class.

#### **QUOTES YOU MIGHT ENJOY:**

*“When you are drowning in numbers you need a system to separate the wheat from the chaff...” Anthony Adams, VP Campbell Soup Company, New York Times, April 1988.*

*“It is best to do things systematically, since we are only human and disorder is our worst enemy.” Hesiod, Work and Days, 8<sup>th</sup> Century*

*“What advantages does the Merchant derive by Bookkeeping by double-entry? It is amongst the finest inventions of the human mind”, Johan Wolfgang Von Goethe*

*“Remember the bookkeeper, perched on his stool  
Green eyeshade tilted, quill for a tool?  
He wasn't too fast, but nowhere in town  
Did you hear the excuse ‘Our computer is down’”.... R.S. Sullivan*

#### **READING:**

1. Spiceland, Chapter 1
2. Schilit, “Appendix: Tutorial Understanding the Basics of Financial Reporting” p265-287.
3. Spiceland, Chapter 2

#### **PRACTICE EXERCISES AND PROBLEMS:**

E1-5, E1-6, E1-8, E1-9, E1-11, E1-12  
E2-1, E2-2, E2-3, E2-4, E2-6, E2-8, E2-9, E2-10, E2-12

#### **HOMEWORK ASSIGNMENT TOPIC I: Tentative Due Date is Wednesday 09/18**

1. P2-7
2. P2-8
3. P2-9
4. P2-10

#### **QUIZ I: Tentative Dates: 09/18 through 09/20**

## **TOPIC II: INCOME STATEMENT AND BALANCE SHEET IN MORE DETAIL 09/18 Through 09/27**

Proper presentation of financial statement items enhances the usefulness of the statements. In this section we will look at the income statement and balance sheet in more detail. The income statement information, for example, is reported in four sections – continuing operations, discontinued operations, extraordinary items, and effect of a change in accounting principle. What does each of these represent? How are amounts in each section reported? Why are accountants required to separate information in this way?

Balance sheet assets and liabilities are divided into current and non-current items. Again, what does each represent? Why is it important to distinguish between current and non-current assets and liabilities?

Finally we will look at how financial analysts use relationships and ratios to learn more about a firm and how and why corporation managers sometimes manipulate financial information to “make the company look better” than it really is.

### **QUOTES YOU MIGHT ENJOY:**

*“When you have mastered the numbers, you will in fact no longer be reading numbers any more than you read words when reading books. You will read meanings”....Harold Geneen, *Managing*, 1984.*

*“Nothing is good or bad but by comparison.” ... Thomas fuller, M.D., *Gnomologia*, 1732.*

*“Learn to read a financial report.” ... H. Jackson Brown, Jr., *Life’s Little Instruction Book*, #101.*

### **READING:**

1. Spiceland, Chapter 3 Part A
2. Spiceland, Chapter 4 Part B
3. Spiceland, Chapter 5
4. Dorfman, John, “10 Ways Earnings Lie”, *Bloomberg Personal Finance*, July/August 1998 (In packet)
5. Byrnes, Nanette and Henry, David, “Confused About Earnings?” *Business Week*, November 26, 2001, p77-84. (In packet)
6. Schilit, Chapters 1, 2, 3

### **PRACTICE EXERCISES AND PROBLEMS:**

E3-4, E3-5, E3-6, E3-7, E3-11, P3-3, P3-4  
E4-16, E4-17  
E5-2, E5-3, E5-5, E5-7, E5-9, E5-10, E5-13, E5-14, P5-3

### **HOMEWORK ASSIGNMENT TOPIC II: Tentative Due Date is Monday 09/30**

1. P3-5
2. P4-8
3. P5-5
4. P5-8

### **QUIZ II: Tentative Dates 10/02 through 10/04**

### TOPIC III: STATEMENT OF CASH FLOWS 09/30 through 10/07

Long-term survival of a business depends upon profitability – the firm has to be able to sell goods and/or services for more than the cost of resources used to produce those goods and services. Short-term survival however, requires cash flow. The statement of cash flows provides important information about the sources and uses of the firm’s cash and explains the change in the cash account over an accounting period. Cash flows are divided into three categories – operating, investing and financing.

The major problem you will encounter in preparing a statement of cash flows stems from the fact that the double-entry bookkeeping system was designed to accommodate the preparation of an income statement, statement of retained earnings and a balance sheet. Information for a statement of cash flows does not flow automatically from the accounting system. You must learn how to convert the accrual basis information that appears on the income statement, statement of retained earnings and balance sheet into cash basis amounts that appear on the statement of cash flows.

In this part of the course you will develop a T-account worksheet method of obtaining the information you need to prepare a statement of cash flows. You will also have a chance to think about the uses of this statement and why investors and creditors need the information provided by the statement of cash flows.

#### QUOTES YOU MIGHT ENJOY:

*“The only thing that matters is cash flow....where it’s coming from and where it is going and how much is left over. No company has ever gone bankrupt because it had a loss on its P&L.”....* William McGowan co-founder of MCI Communications Corporation

*“Happiness is ....Positive cash flow.” ...*Frederick R. Adler

*“Everything else is a poor substitute for cash.”... Louis Lowenwstein, 1991.*

*“I’ve got all the money I’ll ever need if I die by four o’clock.”.... Henny Youngman*

#### READING:

1. Spiceland, Chapter 3B
2. Spiceland, Chapter 22
3. Emery, *Intermediate Accounting I*, Chapter 9 (In Packet)
4. Emery, *Intermediate Accounting I*, Chapter 10 (In Packet)
5. Cassell, Bryan-Low and Opdyke, Jeff D., “How to Predict the Next Fiasco In Accounting and Bail Early”, *The Wall Street Journal*, January 24, 2002. (In packet)
6. Sender, Henny, “Cash Flow? It Isn’t Always What It Seems”, *The Wall Street Journal* (In packet)

#### PRACTICE EXERCISES AND PROBLEMS:

E3-12, E3-14, E3-15

Note: When appropriate, use T accounts to solve these problems rather than a spreadsheet.

E22-1, E22-2, E22-3, E22-5, E22-7, E22-8, E22-11, E22-13, E22-17, E22-18, E22-21, E22-23, P22-2, P22-3, P22-14

#### HOMEWORK ASSIGNMENT TOPIC III: Tentative due date: Wednesday 10/09

1. P22-4 Use a T account worksheet. Prepare a reconciliation of net income to cash flow from operations as a part of your answer.
2. P22-10
3. P22-13

#### QUIZ TOPIC III: Tentative Dates 10/9-10/11

**FIRST TAKE HOME EXMANATION: HANDED OUT ON WEDNESDAY 10/09  
AND DUE ON MONDAY 10/14**

**TOPIC IV: REVENUE RECOGNITION ISSUES  
10/09-10/18**

Revenue recognition is crucial to measurement of periodic profit as well as to asset, liability and equity values. The major revenue recognition issues include: What is revenue? When should revenue be recognized on the income statement? What amount of revenue should be recognized? How and where on the income statement should it be reported?

Many of the big issues in accounting revolve around revenue recognition. Howard Schilt, in his book *Financial Shenanigans, How to Detect Accounting Gimmicks & Fraud in Financial Reports*, lists five shenanigans directly related to revenue recognition that companies may use to “manage” their reported earnings. These include: Recording revenue too soon; Recording bogus revenue; Boosting income(revenue) with one-time gains; and Shifting current revenue to a later period. Companies also manipulate reported expenses in order to manage reported net income, but in general, shenanigans that inflate revenue are considered to be more serious than those that affect expenses.

The assigned reading in this part of the course is not extensive and the number of suggested/assigned problems is relatively small. We will spend most of the class time talking about revenue recognition issues and learning how to find out when companies are abusing GAAP to manipulate reported earnings. You will be expected to come to class prepared (having done the reading) to discuss specific cases of revenue manipulation.

**QUOTES YOU MAY ENJOY:**

*“Everyone lives by selling something.” ...Robert Louis Stevenson*

**READING:**

1. Spiceland, Chapter 4
2. Schilit, Chapters 4, 5, 9 and 14
3. Gross, Steve, “48-Hour Delay in completing \$32 Million Sale Will Force Cray to Report annual Loss for 1992”, (In packet)
4. Brown, Ken, “Creative Accounting: How to Buff a Company”, *The Wall Street Journal*, February 21, 2002.
5. Miller, Michael and Berton, Lee, “Softer Numbers: As IBM’s Woes Grew, Its Accounting Got Less Conservative”, *The Wall Street Journal*, April 7, 1993 (In packet)
6. Holmes, Stanley and France, Mike, “Boeing’s Secret”, *Business Week*, May 20, 2002, p110-120. (In packet)

**PRACTICE EXERCISES AND PROBLEMS:**

E4-1, E4-2, E4-3, E4-4, E4-6, E4-8, E4-12, E4-13, P4-5

Be sure to look at the Chapter 4 Exercises and Problems in “Alternate Exercises and Problems”, the booklet that accompanies your textbook.

**HOMEWORK ASSIGNMENT TOPIC IV: Tentative Due Date Friday 10/18**

1. P4-2
2. P4-3
3. P4-4
4. P4-6

**QUIZ TOPIC IV: Tentative Dates 10/23 through 10/25**

## **TOPIC V: ACCOUNTING FOR ASSETS – CURRENT RECEIVABLES**

### **10/23-11/01**

Accounting for assets may have seemed straightforward in the Principles of Accounting class. Unfortunately there are many circumstances when accounting for assets (and the other side of the transaction) is not so simple. For example, there are many things of value to a firm that never appear on the balance sheet as assets. Sometimes the value of the asset is hard to determine. What qualifies as an asset? When should the asset be recognized on the financial statements? How do you determine its value at any point in time? How should the asset be reported on the financial statements?

We will start our exploration of accounting for assets with the current receivables category of assets and proceed in later topics with other asset categories. Any discussion of asset accounting necessarily forces you to consider the liabilities, expenses, revenues, gains and/or losses that comprise the other side of the asset transaction so we will also be looking at other financial statement elements.

As a part of this topic we will be talking about an important concept – “reserve or allowance accounting”. Companies are required to establish valuation allowances to assure that receivables are valued at “net realizable value”. The procedure of valuing receivables at an amount equal to expected future collections forces firms to account for probable bad debts before specific accounts are identified as uncollectible. It is difficult for most students to really understand the process of accounting for an event before it actually occurs, but it is important that you spend time trying to comprehend this methodology in a general way. This is because we use similar procedures to account for many expenses such as warranty costs, costs associated with restructuring, contingent losses etc. We will diverge in this section from the basic receivables topic to look at allowance accounting as it is used in other parts of the accounting system.

There are a number of lively issues related to current or short-term receivables. Estimates of future bad debts associated with current receivables and entries made by firms when they sell off or securitize receivables provide opportunities for earnings and asset valuation manipulation.

#### **QUOTES YOU MIGHT ENJOY:**

*“One asset is omitted... and its worth I want to know  
The asset is the value of the men who run the show.” Mathew Webster Jenkinson*

*“In business a reputation for keeping absolutely to the letter and spirit of an agreement, even when it is unfavorable, is the most precious of assets, although it is not entered in the balance sheet.” ... Lord Chandos (Oliver Lyttleton)*

*“Some day, on the corporate balance sheet, there will be an entry which reads, “Information”, for in most cases, the information is more valuable than the hardware which processes it”....Grace Murray Hopper, Speech 1987*

*“Short accounts make long friends”... Honore De Balzac*

*“Creditors have better memories than debtors.” ...Ben Franklin*

*“No man’s credit is as good as his money.” ...Ed Howe*

#### **READING:**

1. Spiceland, Chapter 7 Part B
2. Spiceland, Chapter 13, Part B
3. Emery, *Intermediate Accounting Volume I*, “Chapter 14: Accounts Receivable” (In packet)
4. Emery, *Intermediate Accounting Volume I*, “Chapter 15: Short-term Notes Receivable”, (In packet)

5. Sender, Henny; "WorldCom's Disclosure Highlights Estimates That Underlie Reserves", *The Wall Street Journal*, July 7, 2002.
6. "Enron Hid Profits During California Crisis, Ex-employees say", *Star Tribune*, June 23, 2002 reprint from *New York Times*.
7. Notes Receivable Case (In packet)

**PRACTICE EXERCISES AND PROBLEMS:**

E7-6, E7-7, E7-8, E7-10, E7-12, E7-13, E7-14, E7-15, E7-16, E7-17, E7-18, E7-19, E7-20, E7-22, P7-3, P7-4, P7-5, P7-10  
E13-10, E13-11, E13-12, E13-13, P13-6

**HOMEWORK ASSIGNMENT TOPIC V: Tentative Due Date Monday 11/04**

1. P 7-9

2. **Accounts Receivable Problem:** Lynch Supply produces paints and related products for sale to the construction industry. While sales have remained relatively stable despite a decline in the amount of new construction, there has been a noticeable change in the timeliness with which Lynch's customers are paying their bills.

Lynch sells its products on payment terms of 2/10/n30. In the past, over 75% of the credit customers have taken advantage of the discount by paying within 10 days of the invoice date. During the fiscal year ended November 30, 2001, the number of customers taking the full 30 days to pay has increased. Current indications are that less than 60% of the customers are now taking the discount. Uncollectible accounts as a percentage of total credit sales have risen from 1.5% provided in past years to 4.0% in the current year.

In response to a request for more information on the deterioration of accounts receivable collections Lynch's controller has prepared the following report:

*LYNCH SUPPLY*  
*Accounts Receivable Collections*  
*November 30, 2001*

*The fact that some credit accounts will prove uncollectible is normal, and annual bad debt write-offs had been 1.5% of credit sales for many years. However, during the 2000-01 fiscal year, this percentage increased to 4.0%. The current accounts receivable balance is \$1,500,000, and the condition of this balance in terms of age and probability of collections is shown below:*

<i>Prportions (%) of Total A/R</i>	<i>Age Categories</i>	<i>Probability (%) of Collection</i>
64.0	1 to 10 days	99.0
18.0	11 to 30 days	97.5
8.0	Past due 31 to 60 days	95.0
5.0	Past due 61 to 120 days	80.0
3.0	Past due 121 to 180 days	65.0
2.0	Past due over 180 days	20.0

*At the beginning of the fiscal year, December 1, 2000, the Allowance for Doubtful Accounts had a credit balance of \$27,300. Lynch has provided for a monthly bad debt expense accrual during the fiscal year just ended based on the assumption that 4% of total credit sales will be uncollectible. Total credit sales for 2000-01 fiscal year amounted to \$8,000,000, and write-offs of uncollectible accounts during the year totaled \$292,500.*

**INSTRUCTIONS:**

- a) Show the general journal entries that the firm made throughout the fiscal year with regard to credit sales, write-offs of uncollectible accounts, cash collections from credit customers, and total monthly accruals of estimated bad debt expense.
- b) Using "T" accounts determine the unadjusted year-end balances in A/R, the Allowance for Doubtful Accounts, and Bad Debt Expense.
- c) Prepare an accounts receivable aging schedule at November 30, 2001 using the age categories identified in the controller's report.
- d) Prepare a journal entry to record the year-end adjustment necessary to bring Lynch Supply's Allowance for Doubtful Accounts to the balance indicated by the aging analysis.
- e) At what amount will Lynch Supply report its Bad Debt Expense on the income statement for the year ended 11/30/01? At what amount will the firm report Accounts Receivable on its 11/30/01 balance sheet?
- f) Suppose the firm did not make the final adjusting entry that you prepared in part d) above. What would its reported bad debt expense have been? If the firm's tax rate is 40%, by how much would Lynch increase or decrease its reported net income by ignoring the final adjustment for bad debt expense?

**3. Premiums and Warranties:** Gloria Estefan's Music Emporium carries a wide variety of musical instruments, sound reproduction equipment, recorded music and sheet music. Estefan's uses two sales promotion techniques – warranties and premiums – to attract customers.

Musical instruments and sound equipment are sold with a one-year warranty for replacement of parts and labor. The estimated warranty cost, based on past experience, is 2% of sales.

The premium is offered on the recorded and sheet music. Customers receive a coupon for each dollar spent on recorded music or sheet music. Customers may exchange 200 coupons and \$20 for a CD player. Estefan's pays \$34 for each CD player and estimates that 60% of the coupons given to customers will be redeemed.

Estefan's total sales for 2001 were \$7,200,000 - \$5,400,000 from musical instruments and sound reproduction equipment and \$1,800,000 from recorded music and sheet music. Replacement parts and labor for warranty work totaled \$164,000 during 2001. A total of 6,500 CD players used in the premium program were purchased during the year and there were 1,200,000 coupons redeemed in 2001.

For financial reporting purposes, Estefan uses the "allowance or accrual" method to account for warranty and premium costs. The balances in the accounts related to warranties and premiums on January 1, 2001, were shown below:

<i>Inventory of Premium CD Players</i>	<i>\$39,950</i>
<i>Estimated Premium Claims Outstanding</i>	<i>\$44,800</i>
<i>Estimated Liability from Warranties</i>	<i>\$136,000</i>

**INSTRUCTIONS:**

Gloria Estefan's Music Emporium is preparing its financial statements for the year ended December 31, 2001. Determine the amounts that will be shown on the 2001 financial statements for the following:

- a) Warranty Expense
- b) Estimated Liability from Warranties
- c) Premium Expense
- d) Inventory of Premium CD Players
- e) Estimated Premium Claims Outstanding

**QUIZ TOPIC V: Tentative Dates 11/06 through 11/08**

**TOPIC VI: ACCOUNTING FOR ASSETS – INVESTMENTS**  
**11/04-11/08**

Companies often invest in the debt and equity securities of other firms. There has been considerable recent controversy about how these investments should be valued on each balance sheet date. The rules adopted by the FASB are fairly complicated but in most situations investments in marketable equity securities, when the firm does not exert substantial control over the investee, will be valued at an amount equal to their market value on the balance sheet date. The valuation of debt securities depends upon whether or not the company intends to hold them until they mature. As you study these rules, you might want to think about how firms might use the rules to “manage” reported earnings.

**QUOTES YOU MAY ENJOY:**

*“Don’t gamble; take all your savings and buy some good stock and hold it til it goes up, then sell it. If it don’t go up, don’t buy it”.... WillRogers*

*“It is not the return on my investment that I am concerned about; it is the return of my investment”... Will Rogers*

*“Gentlemen prefer bonds.”... Andrew Mellon*

*“October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.”.... author unknown*

*“It is far better to buy a wonderful company at a fair price than a fair company at a wonderful price”.... Warren Buffett*

**READING:**

1. Spiceland, Chapter 12 Part A
2. Schilit, Chapter 6

**PRACTICE EXERCISES AND PROBLEMS**

E12-1, E12-2, E12-, E12-4, E12-5, E12-6, E12-7, E12-8, E12-10, E12-11, P12-1, P12-2, P12-3, P12-4

**HOMEWORK ASSIGNMENT TOPIC VI: Tentative Due Date Monday 11/11**

1. Spiceland: P12-5
2. **Accounting for an investment in debt securities:** Presented below is an amortization schedule related to Kathy Baker company’s 5-year, \$100,000 bond with 7% interest rate and a 5% yield, purchased on December 31, 1999 for \$108,660.

<i>Date</i>	<i>Cash Received</i>	<i>Interest Revenue</i>	<i>Bond Premium Amortization</i>	<i>Book Value of Bonds</i>
<i>12/31/99</i>				<i>108,660</i>
<i>12/31/00</i>	<i>7,000</i>	<i>5,433</i>	<i>1,567</i>	<i>107,093</i>
<i>12/31/01</i>	<i>7,000</i>	<i>5,354</i>	<i>1,646</i>	<i>105,447</i>
<i>12/31/02</i>	<i>7,000</i>	<i>5,272</i>	<i>1,728</i>	<i>103,719</i>
<i>12/31/03</i>	<i>7,000</i>	<i>5,186</i>	<i>1,814</i>	<i>101,905</i>
<i>12/31/04</i>	<i>7,000</i>	<i>5,095</i>	<i>1,905</i>	<i>100,000</i>

The following schedule presents a comparison of the amortized cost and the fair value of the bonds at year end:

	<i>12/31/00</i>	<i>12/31/01</i>	<i>12/31/02</i>	<i>12/31/03</i>	<i>12/31/04</i>
<i>Amortized Cost</i>	<i>107,093</i>	<i>105,447</i>	<i>103,719</i>	<i>101,905</i>	<i>100,000</i>
<i>Fair Value</i>	<i>106,500</i>	<i>107,500</i>	<i>105,650</i>	<i>103,000</i>	<i>100,000</i>

**INSTRUCTIONS:**

- Explain why the amortized cost and the fair value of the bonds diverges. Why is the fair value sometimes more and sometimes less than the amortized cost?
- Prepare the journal entry to record the purchase of these bonds on December 31, 1999, assuming the bonds are classified as “held-to-maturity” securities.
- Prepare the journal entry(ies) related to the held-to-maturity bonds for each of the five years assuming that the firm does in fact hold the bonds until they mature and is pay their face value on 12/31/04.
- Repeat part (b) and (c) above assuming that the bonds are classified as available-for-sale.

**3. Available-for-Sale Securities – Statement Presentation:** Maryam Alvarez Corp. invested its excess cash in “available-for-sale” securities during 2000. As of December 31, 2000, the portfolio of available-for-sale securities consisted of the following common stocks:

<i>Security</i>	<i>Quantity</i>	<i>Cost</i>	<i>Fair Value</i>
<i>Keesha Jones, Inc.</i>	<i>1,000 shares</i>	<i>15,000</i>	<i>21,000</i>
<i>Eola Corp.</i>	<i>2,000 shares</i>	<i>50,000</i>	<i>42,000</i>
<i>Yvette Aircraft</i>	<i>2,000 shares</i>	<u><i>72,000</i></u>	<u><i>60,000</i></u>
		<i>\$137,000</i>	<i>\$123,000</i>

- What should be reported on Alvarez’ December 31, 2000, balance sheet relative to these securities? What should be reported on Alvarez’s 2000 income statement?

On December 31, 2001, Alvarez’ portfolio of available-for-sale securities consisted of the following common stocks:

<i>Security</i>	<i>Quantity</i>	<i>Cost</i>	<i>Fair Value</i>
<i>Keesha Jones, Inc.</i>	<i>1,000 shares</i>	<i>15,000</i>	<i>20,000</i>
<i>Keesha Jones, Inc.</i>	<i>2,000 shares</i>	<i>2,000</i>	<i>40,000</i>
<i>King Company</i>	<i>1,000 shares</i>	<i>16,000</i>	<i>12,000</i>
<i>Yvette Aircraft</i>	<i>2,000 shares</i>	<u><i>72,000</i></u>	<u><i>22,000</i></u>
		<i>\$141,000</i>	<i>\$94,000</i>

During the year 2001, Alvarez Corp. sold 2,000 shares of Eola Corp for \$38,200 and purchased 2,000 more shares of Keesha Jones, Inc. and 1,000 shares of King Company.

- What should be reported on Alvarez’s December 31, 2001 balance sheet? What should be reported on Alvarez’s 2001 income statement?

On December 31, 2002, Alvarez’s portfolio of available-for-sale securities consisted of the following common stocks:

<i>Security</i>	<i>Quantity</i>	<i>Cost</i>	<i>Fair Value</i>
<i>King Company</i>	<i>500 shares</i>	<i>8,000</i>	<i>6,000</i>
<i>Yvette Aircraft</i>	<i>2,000 shares</i>	<u><i>72,000</i></u>	<u><i>82,000</i></u>
		<i>\$80,000</i>	<i>\$88,000</i>

During the year 2002 Alvarez Corp. sold 3,000 shares of Keesha Jones, Inc. for \$39,900 and 500 shares of King Company at a loss of \$2,700.

- What should be reported on the face of Alvarez’s December 31, 2002 balance sheet? What should be reported on Alvarez’s 2002 income statement?
- What would be reported in a statement of comprehensive income at (1) December 31, 2000; and (2) December 31, 2001?

**QUIZ TOPIC VI: Tentative Dates 11/11-11/13**

**SECOND TAKE HOME EXAMINATION: HANDED OUT ON WEDNESDAY 11/13 AND DUE ON MONDAY 11/18**

**TOPIC VII: ACCOUNTING FOR ASSETS – INVENTORY**  
**11/11 – 11/22**

Inventories represent a major current asset for many firms. Accounting for inventory presents special challenges because GAAP allows firms to choose between many alternative methods. Valuation is generally at lower of cost or market applied either on an item-by-item, category, or aggregate basis. Firms can choose between several cost-flow assumptions and apply the chosen assumption in a number of different ways. The basic accounting system may keep track of the inventory on a periodic or perpetual basis. You should understand how to determine inventory value given the information about the choices made by the firm. It is also important to understand the impact of the choice of method has on the firm's financial statements.

**SOME QUOTES YOU MIGHT ENJOY:**

*“3,628,000 rules are available for valuing inventory.”... R. Sterling, 1966*

*Beaver: “Gee, there’s something wrong with just about everything, isn’t there Dad?”*

*Ward(Dad): “Just about, Beav.” ..... Leave It to Beaver*

*“Every management mistake ends up in inventory (permanently).” ....Mary Kay Ash founder Mary Kay Cosmetics, Inc.*

**READING:**

- 1) Spiceland, Chapter 8
- 2) Spiceland, Chapter 9, Part A and Part D
- 3) Revsine, *Financial Reporting and Analysis, Second Edition*, Chapter 9: Inventories p 400-416 (In packet)

**PRACTICE EXERCISES AND PROBLEMS:**

- E8-3, E8-6, E8-11, E8-12, E8-13, E8-14, E8-15, E8-16, E8-17, E8-21, P8-5  
 E8-19, E8-20, P8-9, P8-10  
 E9-1, E9-2, E9-19, E9-21, P9-1

**HOMEWORK ASSIGNMENT TOPIC VII(A): Tentative Due Date Monday 11/18**

1. **Compute FIFO, LIFO, Average Cost – Periodic and Perpetual:** Iowa Company is a multi-product firm. Presented below is information concerning one of its products, the Hawkeye:

<i>Date</i>	<i>Transaction</i>	<i>Quantity</i>	<i>Price/Cost</i>
01/01	Beginning Inventory	1,000	\$12
02/04	Purchase	2,000	\$18
02/20	Sale	2,500	\$30
04/02	Purchase	3,000	\$23
11/04	Sale	2,000	\$33

**INSTRUCTIONS:**

- a) Compute the cost of goods sold, assuming Iowa uses:
  - b) Periodic system, FIFO cost flow
  - c) Perpetual system, FIFO cost flow
  - d) Periodic system LIFO cost flow.
  - e) Perpetual system, LIFO cost flow
  - f) Period System, weighted-average cost flow
  - g) Perpetual system, moving-average cost flow

2. Spiceland P8-7
3. Spiceland P8-8

4. **Financial Statement Effects of FIFO and LIFO:** The management of Maine Company has asked its accounting department to describe the effect upon the company's financial position and its income statements of accounting for inventories on the LIFO rather than the FIFO basis during 2002 and 2003. The accounting department is to assume that the change to LIFO would have been effective on January 1, 2002, and that the initial LIFO base would have been the inventory value on December 31, 2001. Presented below are the company's financial statements and other data for the years 2002 and 2003 when the FIFO method was employed.

	<i>12/31/01</i>	<i>12/31/02</i>	<i>12/31/03</i>
<b>BALANCE SHEET:</b>			
<i>Cash</i>	<i>\$90,000</i>	<i>\$130,000</i>	<i>\$141,600</i>
<i>Accounts Receivable</i>	<i>80,000</i>	<i>100,000</i>	<i>120,000</i>
<i>Inventory</i>	<i>120,000</i>	<i>140,000</i>	<i>180,000</i>
<i>Other Assets</i>	<u><i>160,000</i></u>	<u><i>170,000</i></u>	<u><i>200,000</i></u>
<i>Total Assets</i>	<i>\$450,000</i>	<i>\$540,000</i>	<i>\$641,600</i>
<i>Accounts Payable</i>	<i>\$40,000</i>	<i>\$60,000</i>	<i>\$80,000</i>
<i>Other Liabilities</i>	<i>70,000</i>	<i>80,000</i>	<i>110,000</i>
<i>Common Stock</i>	<i>200,000</i>	<i>200,000</i>	<i>200,000</i>
<i>Retained Earnings</i>	<u><i>140,000</i></u>	<u><i>200,000</i></u>	<u><i>251,600</i></u>
<i>Total Equities</i>	<i>\$450,000</i>	<i>\$540,000</i>	<i>\$641,600</i>
<b>INCOME STATEMENT:</b>			
<i>Sales</i>		<i>\$900,000</i>	<i>\$1,350,000</i>
<i>Cost of Goods Sold</i>		<i>(505,000)</i>	<i>(770,000)</i>
<i>Other Expenses</i>		<u><i>(205,000)</i></u>	<u><i>(304,000)</i></u>
<i>Net Income Before Income Taxes</i>		<i>\$190,000</i>	<i>\$276,000</i>
<i>Income Taxes (40%)</i>		<u><i>(76,000)</i></u>	<u><i>(110,400)</i></u>
<i>Net Income</i>		<i>\$114,000</i>	<i>\$165,600</i>

Other data:

1. Inventory on hand at 12/31/01 consisted of 40,000 units valued at \$3.00 each
2. Sales (all units sold at the same price in a given year):  
**2002:** 150,000 units @ \$6.00 each      **2003:** 180,000 units @ \$7.50 each
3. Purchases (all units purchased at the same price in given year):  
**2002:** 150,000 @ \$3.50      **2003:** 180,000 units @ \$4.50 each
4. Income taxes at the effective rate of 40% are paid on December 31 each year.

**INSTRUCTIONS:**

Name the account(s) presented in the financial statements that would have different amounts for 2002 and 2003 if LIFO rather than FIFO had been used and state the new amount for each account that is named. Show your computations. (This problem was adapted from the CMA exam. Be sure to consider how you would present your answer to a grader who might be looking at thousands of these responses. Your work should be clearly labeled and formatted so that it is easy to follow.) *This problem is actually easier than it should be because the same number of units are purchased and sold each year.*

## HOMEWORK ASSIGNMENT VII(B): Tentative Due Date: Monday 11/25

1. **Dollar Value LIFO – Internal Indexes:** Presented below is information related to Mellon Collie Corporation for the last 3 years:

<i>Item</i>	<i>Quantities in Ending Inventories</i>	<i>Base-Year Cost</i>		<i>Current-Year Cost</i>	
		<i>Unit Cost</i>	<i>Amount</i>	<i>Unit Cost</i>	<i>Amount</i>
<i>December 31, 2000</i>					
<i>A</i>	<i>9,000</i>	<i>2.00</i>	<i>18,000</i>	<i>2.40</i>	<i>21,600</i>
<i>B</i>	<i>6,000</i>	<i>3.00</i>	<i>18,000</i>	<i>3.55</i>	<i>21,300</i>
<i>C</i>	<i>4,000</i>	<i>5.00</i>	<u><i>20,000</i></u>	<i>5.40</i>	<u><i>21,600</i></u>
		<i>Totals</i>	<i>\$56,000</i>		<i>\$64,500</i>
<i>December 31, 2001</i>					
<i>A</i>	<i>9,000</i>	<i>2.00</i>	<i>18,000</i>	<i>2.60</i>	<i>23,400</i>
<i>B</i>	<i>6,800</i>	<i>3.00</i>	<i>20,400</i>	<i>3.75</i>	<i>25,500</i>
<i>C</i>	<i>6,000</i>	<i>5.00</i>	<u><i>30,000</i></u>	<i>6.40</i>	<u><i>38,400</i></u>
		<i>Totals</i>	<i>\$68,400</i>		<i>\$87,300</i>
<i>December 31, 2002</i>					
<i>A</i>	<i>8,000</i>	<i>2.00</i>	<i>16,000</i>	<i>2.70</i>	<i>\$21,600</i>
<i>B</i>	<i>8,000</i>	<i>3.00</i>	<i>24,000</i>	<i>4.00</i>	<i>32,000</i>
<i>C</i>	<i>6,000</i>	<i>5.00</i>	<u><i>30,000</i></u>	<i>6.20</i>	<u><i>37,200</i></u>
		<i>Totals</i>	<i>\$70,000</i>		<i>\$90,800</i>

**INSTRUCTIONS:**

- a) Compute the ending inventories under the dollar-value method for 2000, 2001 and 2002. The base period is January 1, 2000 and the beginning inventory cost at that date was \$45,000. Compute indexes to two decimal places. Use the “double extension method” to create the index.
- b) What would the index for 2002 have been if the accountant had used the “chain-link” method of determining the index for the year?

2. Spiceland P9-2

3. **LIFO – Comprehensive Problem:** Sirotko Retail Company began business in 1999. The following information pertains to Sirotko for the first three years of its operations:

<i>Year</i>	<i>Operating Expenses</i>	<i>Purchases</i>		<i>Sales</i>	
		<i>Units</i>	<i>Unit Cost</i>	<i>Units</i>	<i>Unit Price</i>
<i>1999</i>	<i>\$60,000</i>	<i>15,000</i>	<i>20.00</i>	<i>12,000</i>	<i>35.00</i>
<i>2000</i>	<i>\$90,000</i>	<i>20,000</i>	<i>25.00</i>	<i>18,000</i>	<i>40.00</i>
<i>2001</i>	<i>\$65,000</i>	<i>5,000</i>	<i>30.00</i>	<i>10,000</i>	<i>40.00</i>

Assume the following:

- The income tax rates is 40%
- Purchase and sale prices change only at the beginning of the year.
- Sirotko uses the LIFO cost flow assumption.
- Operating expenses are primarily selling and administrative expenses.

**INSTRUCTIONS:**

- a) Compute cost of goods sold and the cost of ending inventory for each of the three years. (Identify the number of units and the cost per unit for each LIFO layer in the ending inventory.)

- b) Prepare income statements for each of the three years.
- c) Compute the LIFO reserve at the end of 1999, 2000, 2001.
- d) Compute the effect of LIFO liquidation (if any) on the net income of the company for the years 2000 and 2001.
- e) Compute the inventory turnover ratio for the years 2000 and 2001. Do not make adjustments for any potential biases in LIFO accounting.
- f) Use all of the available information to compute the “true” inventory turnover for 2000 and 2001.
- g) Compute the gross margin rates for the years 2000 and 2001. Does the change in gross margin rates reflect the change in Sirotko’s economic condition from 2000 to 2001?
- h) Provide an estimate of the FIFO cost of goods sold for the years 1999, 2000, and 2001 using the information that would be available in the financial statements.
- i) Estimate Sirotko’s tax savings for 1999, 2000, 2001.
- j) Assuming a discount rate of 10%, compute the present value as of December 31, 1998 of the tax savings over the period 1999-2001 from using LIFO.

**QUIZ TOPIC VI: Tentative Dates 12/02 through 12/04.**

## **TOPIC VIII: ACCOUNTING FOR ASSETS – OPERATIONAL ASSETS**

### **11/25 – 12/11**

Significant problems that the accountant deals with when accounting for plant property and equipment, the first category of operational assets that we will deal with in this section of the course, include the following. (1) Acquisition valuation is often difficult to determine because plant assets may be acquired in complex transactions. (2) Disposition of a plant asset may also involve a complicated transaction. (3) There are many acceptable ways of allocating the cost of PP&E to the accounting periods of use. (4) In addition the accountant has to deal with impairment of value and changes in estimate.

Accounting for natural resources and intangibles presents similar accounting problems. The rules here seem to be under constant scrutiny and have been subject to many changes in recent years. We will highlight the fundamental principles of accounting for natural resources and various intangibles such as patents and goodwill.

#### **QUOTES YOU MAY ENJOY:**

*“ Little of all we value here  
Wakes on the morn of its hundredth year.”,... \*Oliver Wendell Holmes*

*“What do accountants suffer from that ordinary people don't?  
.....Depreciation”*

#### **READING:**

1. Spiceland, Chapter 10
2. Spiceland, Chapter 11
3. “Worldcom's Sorry Legacy”, *Business Week*, July 8, 2002, p38-41. (In packet)
4. Weil, Jonathan and Young, Shawn, “Goodwill Hunting: After AOL Who Will Take Accounting Hit”, *The Wall Street Journal*, January 11, 2002. (In packet)
5. Schilit, Chapters 7, 10, 11 and 12

#### **PRACTICE EXERCISES AND PROBLEMS:**

E10-1, E10-2, E10-3, E10-4, E10-5, E10-6, E10-7, E10-8, E10-9, E10-11, E10-12, E10-13, E10-14, E10-15, E10-16, E10-17, E10-18, E10-19, E10-20, E10-21, E10-23, E10-24  
E11-1, E11-2, E11-3, E11-4, E11-5, E11-6, E11-9, E11-10, E11-11, E11-12, E11-13, E11-14, E11-18, E11-20, E11-21

#### **HOMEWORK ASSIGNMENT VIII(A): Tentative Due Date Friday 12/06**

1. P10-3
2. P10-4
3. P10-9
4. P10-11

#### **HOMEWORK ASSIGNMENT VIII(B): Tentative Due Date Thursday 12/12**

1. P11-2
2. P11-3
3. P11-9
4. **Impairment:** Olsson Company uses special strapping equipment in its packaging business. The equipment was purchased in January 2001 for \$8,000,000 and had an estimated useful life of 8 years with no salvage value. At December 31, 2002, new technology was introduced that would accelerate the obsolescence of Olsson's equipment. Olsson's controller estimates that expected future net cash flows on the equipment will be \$5,300,000 and that the fair value of the equipment is \$4,400,000. Olsson intends to continue using the equipment, but it is estimated that the remaining useful life is 4 years. Olsson uses straight-line depreciation.

**INSTRUCTIONS:**

- a) Prepare the journal entry (if any) to record the impairment at December 31, 2002.
- b) Prepare any journal entries for the equipment at December 31, 2003. The fair value of the equipment at December 31, 2003 is estimated to be \$4,600,000.
- c) Repeat the requirements for a) and b) assuming that Olsson intends to dispose of the equipment and that it has not been disposed of as of December 31, 2003.

**QUIZ TOPIC VIII: Available during the final examination period.**

**THIRD TAKE HOME EXAMINATION: DUE AT THE FINAL EXAMINATION PERIOD – TO BE HANDED OUT AT LEAST FIVE DAYS PRIOR TO THE DUE DATE**