

Study Session 9 Sample Questions

Investment Tools Financial Statement Analysis: Assets

1A Analysis of Inventories

1. When comparing ending inventories using the FIFO and LIFO methods of valuation, from a balance sheet perspective
 - A. inventories based on LIFO are preferable to those presented under FIFO as carrying values most closely reflect current cost
 - B. inventories based on FIFO are preferable to those presented under LIFO as carrying values do not reflect current cost
 - C. inventories based on LIFO are preferable to those presented under FIFO as carrying values do not reflect current cost
 - D. inventories based on FIFO are preferable to those presented under LIFO as carrying values most closely reflect current cost

Answer

D.

Comparison of inventories using FIFO and LIFO methods of valuation

When comparing ending inventories using the FIFO and LIFO methods of valuation, from a balance sheet perspective, inventories based on FIFO are preferable to those presented under LIFO as carrying values most closely reflect current cost.

Reference

*The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Inventories, Los 1A,b*

2. When comparing FIFO to LIFO, in periods of rising prices and increasing inventory quantities, the use of LIFO for inventory valuation results in
- A. the same cash flows regardless of accounting method used
 - B. higher cash flows for LIFO than FIFO
 - C. higher cash flows with FIFO perpetual than LIFO periodic
 - D. higher cash flows for FIFO than LIFO

Answer

A.

Comparison of FIFO and LIFO in periods of rising prices

When comparing FIFO to LIFO, in periods of rising prices and increasing inventory quantities, the use of LIFO for inventory valuation results in the same cash flows regardless of accounting method used.

Reference

*The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Inventories, Los 1A,c*

Use the following information in answering **Questions 3 - 4**

Assume the following:

Quarter	Units purchased	Per unit cost	Dollar purchases	Unit sales
I	300	\$30	9,000	300
II	400	35	14,000	300
III	400	36	14,400	300
IV	300	37	11,100	300
	1,400		48,500	1,200

Inventory at the beginning of quarter I: 500 units at \$25 per unit = \$12,500
Inventory at end of quarter IV: 700 units

3. Using the FIFO method, the reported inventory at the end of the year is:
- A. \$23,000
 - B. \$25,500
 - C. \$35,500
 - D. \$22,474

Answer

B.

Calculating ending inventory using FIFO

Using the FIFO method, the reported inventory at the end of the year is **\$25,500**

Beginning inventory + Purchases = Cost of goods sold + Ending Inventory

Opening inventory	500 units @ \$25	\$12,500
Purchases	<u>1,400 units</u>	<u>\$48,500</u>
Total	1,900 units	\$61,000

Under FIFO, ending inventory consists of 700 units:

300 purchased in quarter IV @ \$37	\$11,100
<u>400 purchased in quarter III @ \$36</u>	<u>\$14,400</u>
700 units total	\$25,500

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session, Analysis of Inventories, Los 1A,a

4. Using the LIFO method, the reported inventory at the end of the year is:
- A. \$25,500
 - B. \$22,474
 - C. \$23,000
 - D. \$35,500

Answer

C.

Calculating ending inventory using LIFO

Using the LIFO method, the reported inventory at the end of the year is **\$23,000**

Beginning inventory + Purchases = Cost of goods sold + Ending Inventory

Opening inventory	500 units @ \$25	\$12,500
Purchases	<u>1,400 units</u>	<u>\$48,500</u>
Total	1,900 units	\$61,000

Under LIFO, ending inventory consists of 700 units:

300 purchased in quarter I @ \$30	\$9,000
<u>400 purchased in quarter II @ \$35</u>	<u>\$14,000</u>
700 units total	\$23,000

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session, Analysis of Inventories, Los 1A,a

5. The following information relates to Bex Company:
- Inventory at the beginning of the accounting period was one unit at \$45.
 - Two more units were purchased during the period, the first at \$49 and the second at \$53.
 - One unit was sold at \$75.

Replacement cost at the close of the accounting period was \$56.

Using the FIFO basis, Bex's ending inventory is:

- A. \$94
- B. \$102
- C. \$100
- D. \$98

Answer

B.

Calculating ending inventory using FIFO

Using the FIFO basis, Bex's ending inventory is **\$102**

Ending inventory: $49 + 53 = \$102$

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session, Analysis of Inventories, Los 1A,a

B. Analysis of Long-Lived Assets – Part I

1. The accounting treatment of computer software development costs is as follows:
 - A. all costs incurred to establish the technological and/or economic feasibility of software are capitalized and once economic feasibility has been established, subsequent costs are also capitalized
 - B. all costs incurred to establish the technological and/or economic feasibility of software are expensed as incurred and once economic feasibility has been established, subsequent costs can be capitalized
 - C. all costs incurred to establish the technological and/or economic feasibility of software are expensed as incurred and once economic feasibility has been established, subsequent costs are expensed
 - D. all costs incurred to establish the technological and/or economic feasibility of software are capitalized as incurred and once economic feasibility has been established, subsequent costs are expensed

Answer**B.****The accounting treatment of computer software development costs**

The accounting treatment of computer software development costs is as follows:

All costs incurred to establish the technological and/or economic feasibility of software are expensed as incurred and once economic feasibility has been established, subsequent costs can be capitalized.

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Long-Lived Assets – Part I, Los 1B,c

2. As compared with expensing costs, the effect of capitalization on a firm's assets is as follows:
- A. capitalizing decreases reported assets
 - B. capitalizing has no effect on reported assets
 - C. capitalizing increases reported assets when there is inflation
 - D. capitalizing increases reported assets

Answer

D.

The effect of capitalization on a firm's assets

As compared with expensing costs, the effect of capitalization on a firm's assets is an increase in reported assets.

Reference

*The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Long-Lived Assets – Part I, Los 1B,a*

Use the following information in answering **Questions 3 - 4**

Vasco Construction is developing a townhouse complex in New Jersey. The average balance of the "building under construction" account for 20x2 was \$12 million. Vasco had the following debt outstanding during 20x2 (\$ in millions):

	Average Balance	Interest Rate
Development loan	\$ 8	13%
Mortgage debt	12	10
Senior debentures	50	12

Assume that the development loan applies solely to the New Jersey construction:

3. The *interest payable* for 20x2 is:

- A. \$8,240
- B. \$7,200
- C. \$7,040
- D. \$6,000

Answer

A.

Calculating interest payable

The *interest payable* for 20x2 is **\$8,240**

	Debt (\$000s)	Interest rate	Interest (\$000s)
Development loan	8,000	13	1,040
Mortgage debt	12,000	10	1,200
Debentures	50,000	12	6,000
Interest payable			8,240

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Long-Lived Assets – Part I, Los 1B,a

4. The *capitalized interest* for 20x2 is:

- A. \$8,240
- B. \$1,520
- C. \$6,720
- D. \$8,240

Answer

B.

Calculating interest to be capitalized

The *capitalized interest* for 20x2 is **\$1,520**

	Debt (\$000s)	Interest rate	Interest (\$000s)
Development loan	8,000	13	1,040
Debentures	4,000	12	480
Capitalized interest			1,520

Notes

1. The development loan is assumed to be related to the townhouse complex.
2. The mortgage debt is assumed to be related to specific projects; the remaining balance (12-8) is assumed to be financed by debentures.

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Long-Lived Assets – Part I, Los 1B,a

C. Analysis of Long-Lived Assets – Part II

1. When the replacement cost of an asset increases, the depreciation expense based on the original cost is:
- A. independent of original cost
 - B. excessive
 - C. insufficient
 - D. sufficient

Answer**A.**

When the replacement cost of an asset increases, the depreciation expense based on the original cost is insufficient.

The impact on depreciation when the replacement cost of an asset increases.

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Long-Lived Assets – Part II, Los 1C,a

2. A firm pays \$30,000 for equipment with an economic life of six years and estimated salvage value of \$6,000.

The depreciation expense for the first and sixth year using the straight-line method is:

- A. Year 1 \$4,000; Year 6 \$4,000
- B. Year 1 \$5,000; Year 6 \$5,000
- C. Year 1 \$6,000; Year 6 \$6,000
- D. Year 1 \$3,000; Year 6 \$3,000

Answer**A.****Calculating straight-line depreciation**

The depreciation expense for the first and sixth year using the straight-line method is **Year 1 \$4,000; Year 6 \$4,000**

Straight-line depreciation = (Acquisition cost – salvage value) / useful life

$(30,000 - 6,000)/6 = 24,000/6 = 4,000$ per year every year

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Long-Lived Assets – Part II, Los 1C,a

3. The impact on the trend of depreciation expense when using an accelerated method instead of the straight-line method of depreciation is as follows:
- A. using the same economic life, accelerated methods will report lower depreciation expense than the straight-line method during the early years and lower expense thereafter
 - B. using the same economic life, accelerated methods will report higher depreciation expense than the straight-line method during the early years and lower expense thereafter
 - C. using the same economic life, accelerated methods will report higher depreciation expense than the straight-line method during the early years and even higher expenses thereafter
 - D. using the same economic life, accelerated methods will report lower depreciation expense than the straight-line method during the early years and higher expenses thereafter

Answer**B.**

The depreciation expense when using an accelerated method

The impact on the trend of depreciation expense when using an accelerated method instead of the straight-line method of depreciation method is that when using the same economic life, accelerated methods will report higher depreciation expense than the straight-line method during the early years and lower expense thereafter .

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Long-Lived Assets – Part II, Los 1C,c

4. Modlin's 20x2 *Annual Report* contains the following disclosure:

In fourth quarter 20x2, Modlin adopted an accounting approach for the Impairment of Long-Lived Assets and for Long-Lived Assets to be disposed of, resulting in a before-tax, \$786 million non-cash charge to "Depreciation, depletion and amortization" on the Consolidated Statement of Income (\$558 million after tax). The charge relates to impairment of upstream producing properties. Now the company ensures that long-lived assets with book values that cannot be recovered by estimated undiscounted future cash flows be written down to fair value. The fair value of the impaired assets was determined by calculating the net present value of future cash flows; previously, the Company's policy was to write down to breakeven significant properties determined to be permanently impaired.

20x2 pretax income for Modlin was \$2,675 million.

The impact of the impairment charge on the comparison of 20x2 income with reported 20x1 income is:

- A. 20x2 income was increased relative to reported 20x1 income
- B. 20x1 income was reduced relative to reported 20x2 income
- C. 20x2 income was reduced relative to reported 20x1 income
- D. there is no impact on the reported incomes if 20x1 and 20x2

Answer**D.****Impairment charges and the financial statements**

The impact of the impairment charge on the comparison of 20x2 income with reported 20x1 income is that there is no impact on the reported incomes if 20x1 and 20x2.

Reference

The Analysis and Use of Financial Statements, 2nd edition, Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried (Wiley, 1998)
Study Session 9, Analysis of Long-Lived Assets – Part II, Los 1C,i