

## FINANCIAL ACCOUNTING EXAM 2.3

Professors G. Peter and Carolyn R. Wilson

- The exam packet is comprised of :
  1. This 18-page document, which contains the questions you are to answer. Write all of your answers in this document, put your name on each page, and submit it for grading.
  2. The Exam Supplement, which contains a chart of accounts for **all** exam entries, BSE matrix for a fictitious company, financial statements for related exam questions, and the essay background text, tabular data, and essay companies' financial statements.
  3. Scrap paper. Additional scrap paper is available at the front of the room.
- **For the purpose of this exam, assume all companies have a policy to report working-capital reconciliation adjustments that reflect the net effects of all operating entries during the period on the related accounts.**
- There are 20 possible points on the exam that can be applied to your course grade. Except for the essay portion of the exam, partial credit will not be awarded, so check your answers carefully.
- If, in our sole judgment, we cannot read your essay, you will not receive full credit. If it's determined we cannot read your responses, you will be contacted and given an opportunity to type up your responses EXACTLY as written in your exam by a given time. No content changes are allowed. In this case, you will be penalized 1 point for not writing clearly.
- The exam is closed book and closed notes.
- You cannot use a laptop, tablet, cell phone, or other communication or mobile device.
- You may use a basic calculator (not to be shared with others). However, your calculator must not contain course related information. Additionally, your calculator must not be capable of storing "text" or communicating with others (no cell phones or other text messaging devices are permitted). We reserve the right to inspect your calculator and, in our sole judgment, deem it inappropriate for use during the exam. We will have basic calculators available for you to borrow.
- You are required to TURN IN ALL MATERIALS when you have finished the exam, including the exam document, the exam supplement, and all scrap paper (provided). Moreover, once the exam starts, you may not take any materials from the room.
- You may not discuss or otherwise exchange information about the exam with anyone until the exams are graded and returned.
- To protect the vast majority of students who will not cheat on the exam, there may be alternative versions of the exam that are the same in all respects except the questions contain some numbers that differ or are arranged differently.
- Regardless of one's intent, staring at classmates' exams is inappropriate. If you wish to take a break from staring at your exam, stare directly ahead or to either side without looking down.
- More generally, you are to honor the school's core values in all respects.

**Question 1**

For parts (a) - (b) you are to record journal entries in the spaces provided **using accounts from the chart of accounts in the supplement**. *Check your work carefully, no partial credit.*

(1/2 point each, for a total of 1 point)

**Part 1(a)**

During December 2013, Ellen’s Wellness Spa had a very successful holiday marketing promotion and collected \$1,200 of annual service fees from customers for services to be rendered during 2014. Ellen’s policy is to recognize service revenues evenly over twelve months. No earlier entries have been recorded. **Record a journal entry for the December 2013 collections.**

Note: If no entry is needed, write “NONE” in the space below. No credit if the space is left blank.

*Note: Four rows have been provided, but you may not need them all.*

	Debit	Credit
_____		
_____		
_____		
_____		

**Part 1(b)**

On December 31, 2013, Tim’s Custom Bikes discovered that chains on bikes recently sold to customers were defective and needed to be replaced within two months to ensure customers wouldn’t find themselves stranded with broken chains. The company was not aware of the defective chains prior to this date and had not previously recorded any entries in anticipation of the defects. Tim’s immediately notified affected customers to come to its repair shop to have the chains replaced under warranty during January and February, 2014. On December 31, 2013 the company estimated the total cost to replace the chains would be \$250: \$150 for the new chains and \$100 for labor. **What journal entry, if any, should Tim’s record on December 31, 2013.**

Note: If no entry is needed, write “NONE” in the space below. No credit if the space is left blank.

*Note: Four rows have been provided, but you may not need them all.*

	Debit	Credit
_____		
_____		
_____		
_____		

**Question 2**

You are to create an indirect cash flow statements for **Valbona's Company, which experienced the events or circumstances recorded in the BSE matrix included in the separate exam supplement.**

(1 point)

Complete the following:

<b>Valbona's Company</b>	
<b>2013 Indirect Cash Flow Statement</b>	
<i>In Dollars, for year ended December 31, 2013</i>	
<b>Operating activities</b>	
Net income	_____
Depreciation	_____
Accounts receivable	_____
Inventories	_____
Prepaid expenses	_____
Accounts payable	_____
Accrued taxes	_____
Other accrued liabilities	_____
Deferred revenues	_____
Net cash from operations	_____
<b>Investing activities</b>	
Purchase property, plant, and equipment	_____
Net cash from investing activities	_____
<b>Financing activities</b>	
Issue common stock	_____
Net cash from financing activities	_____
<b>Net change in cash during year</b>	_____
<b>Beginning cash balance</b>	_____
<b>Ending cash balance</b>	=====

**Question 3****RELEVANT INFORMATION for QUESTION 3**

The format for parts (i)-(ii) of question 3 is the same as the format for clicker questions discussed during class. **You MUST CIRCLE the letter associated with the best response to receive credit.** (1/2 point each for a total of 1 point)

**Question 3(i)**

**CIRCLE the letter associated with the best response.**

Based on the available information in **Harley-Davidson's** financial statements and related footnotes in the exam supplement, it is reasonable to conclude:

- (a) Harley-Davidson's \$60,008 thousand Provision for credit losses adjustment on the cash flow information footnote for fiscal 2013 increased net cash from operations.
- (b) Harley-Davidson's (\$46,474) thousand inventories adjustment on the cash flow information footnote represents a \$46,474 thousand net increase in inventories due to operating activities during fiscal 2013.
- (c) Harley-Davidson's (\$36,653) thousand accounts receivable, net adjustment on the cash flow information footnote for fiscal 2013 differs from \$30,986 thousand change in accounts receivable, net on the balance sheet (from 2012 to 2013) because this cash flow adjustment does not include the net effects of an allowance for doubtful accounts.
- (d) (b) and (c)
- (e) none of the above

**Question 3(ii)**

**CIRCLE the letter associated with the best response.**

Based on the available information in **Harley-Davidson's** financial statements and related footnotes in the exam supplement, it is reasonable to conclude:

- (a) Harley-Davidson spent \$27,013 thousand cash during fiscal 2013 on property, plant and equipment as reflected in the change on the balance sheet from 2012 to 2013.
- (b) Harley-Davidson declared and paid the same amount for dividends during fiscal 2013.
- (c) Harley-Davidson spent \$479,231 cash to repurchase its common stock during 2013.
- (d) (b) and (c)
- (e) all of the above

**Question 4****RELEVANT INFORMATION for QUESTION 4**

Base your responses to questions 4 (a) - (b) on information in the exam supplement and on the company disclosures and guidance below:

**Harley-Davidson Disclosures**

- **Accrued liabilities**

	2013	2012
Payroll, employee benefits and related expenses	\$ 166,346	\$ 215,461
Restructuring reserves	2,181	27,223
Warranty and recalls	46,571	60,263
Sales incentive programs	42,541	43,938
Tax-related accruals	21,970	19,923
Fair value of derivative financial instruments	3,925	7,920
Other	143,801	138,863
	<u>\$ 427,335</u>	<u>\$ 513,591</u>

*Harley-Davidson's 2013 10K, page 63*

- **Product Warranty and Safety Recall Campaigns**

The Company currently provides a standard two-year limited warranty on all new motorcycles sold worldwide, except for Japan, where the Company provides a standard three-year limited warranty on all new motorcycles sold. In addition, the Company started offering a one-year warranty for Parts & Accessories (P&A) in 2012. The warranty coverage for the retail customer generally begins when the product is sold to a retail customer. The Company maintains reserves for future warranty claims which are based primarily on historical Company claim information. Additionally, the Company has from time to time initiated certain voluntary safety recall campaigns. The Company reserves for all estimated costs associated with safety recalls in the period that the safety recalls are announced.

Changes in the Company's warranty and safety recall liability were as follows:

	2013	2012	2011
Balance, beginning of period	\$ 60,263	\$ 54,994	\$ 54,134
Warranties issued during the period	59,022	54,394	44,092
Settlements made during the period	(64,462)	(67,247)	(55,386)
Recalls and changes to pre-existing warranty liabilities	9,297	18,122	12,154
Balance, end of period	<u>\$ 64,120</u>	<u>\$ 60,263</u>	<u>\$ 54,994</u>

*Harley-Davidson's 2013 10K, page 60*

**Simplifying assumptions**

- All of Harley-Davidson's warranty and recall work is completed by third-party dealerships.
- Harley-Davidson pays the dealerships cash to compensate them for the labor costs associated with warranty and recall work and provides them with the necessary parts to complete this work.
- During the year ended December 31, 2013, 30% of the total cost to meet warranty and recall claims was labor and 70% was parts.

*Continued on next page.*

**Part 4(a)**

(i) Write your journal entry in the space provided below. (ii) Use the *most* appropriate accounts from the chart of accounts in the supplement (it contains some accounts that are not appropriate). (iii) *Check your work carefully, no partial credit.*

**Record a single journal entry that summarizes the entries Harley-Davidson recorded during fiscal 2013 to meet customers' warranty and recall claims. That is, to repair motorcycles under warranty programs.**  
(1 point)

	<u>Debit</u>	<u>Credit</u>
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

**Part 4(b)**

Identify the Harley-Davidson financial-statement line items that were affected by the journal entries Harley-Davidson recorded during fiscal 2013 to meet customers' warranty and recall claims recorded in Part 4(a) and the direction of these effects (as indicated below).

(1/2 point per statement, for a total of 2 points.)

If an incorrect entry in part 4(a) leads to errors here, you won't receive credit here. Thus, check your response to part 4(a) entry carefully.

**Guidance:**

- (1) Determine the appropriate line item(s) affected using Harley-Davidson's statements. For example, write "cash and cash equivalents" rather than "cash" because this is on Harley-Davidson's balance sheet. DON'T write accounts below; write line item titles.
- (2) Include line item(s) directly affected, including the effect(s) of closing entries for events affecting income. Ignore taxes.
- (3) **Identify the subtotal "Net cash provided by operating activities of continuing operations" if operating cash flows were affected by the entry. This subtotal is conceptually different from other subtotals.**
- (4) Don't include totals or sub-totals other than Net cash provided by operating activities of continuing operations indirectly affected by the entry. For example, don't report "Net income (loss)" on the income statement. However, net income is NOT a total on the statement of shareholders' equity.
- (5) Four lines were included below for each statement, but you may need none or more than one line. **Write "NONE" if no line item is effected on the statement.**
- (6) Indicate if the effect(s) of the entries associated with the above event increased or decreased the line item. Put an X in the appropriate column if the above event increases or decreases that line item. For full credit, be sure to mark only one box in each statement's row. **NOTE: If a reported negative number changes from -2 to -3, it decreases; if it changes from -2 to -1, it increases.**
- (7) You won't receive credit for a statement if you list line items not affected by the entry: don't guess!

<b>Harley-Davidson Financial Statements, fiscal 2013</b>					
<b>Balance Sheet</b>			<b>Statement of Shareholders' Equity</b>		
Line Items	Increases	Decreases	Line Items	Increases	Decreases
	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
<b>Statements of Operations</b>			<b>Statements of Cash Flows Plus Cash Flow Information footnote for Operating Section</b>		
Line Items	Increases	Decreases	Line Items	Increases	Decreases
	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
	<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

**Question 5**

**RELEVANT INFORMATION for QUESTION 5**

Base your responses to questions 5 (a) - (c) on information in the exam supplement and on the company's Schedule II disclosures.

**Guidance**

- The chart of accounts in the Exam supplement includes two bad debt expense accounts: one for accounts receivables and one for finance receivables.
- Harley-Davidson's balance sheet reports financing receivables, net as both current and non-current assets. This means the company maintains separate current and non-current accounts for gross financing receivables and for the related allowance for bad debts.
- The Valuation and Qualifying Accounts disclosure (Schedule II) doesn't report separate current and non-current allowances. This means you can't perfectly replicate Harley-Davidson's related entries (into current and non-current accounts). Instead, as indicated in the chart of accounts in the Exam supplement, you are to record entries into fictitious accounts that combine the current and non-current effects for financing receivables into the related single account.
- However, in questions 5(b) and 5(c) consider the separate effects of the current and non-current line items and ratio effects, even though you can't determine the exact amounts. For the purpose of this exam, assume both the current and non-current amounts are not zero.

**Part 5(a)**

(i) Write your journal entry in the space provided below. (ii) Use the *most* appropriate accounts from the chart of accounts in the supplement (it contains some accounts that are not appropriate). (iii) *Check your work carefully, no partial credit.*

**Record a single journal entry that summarizes the entries Harley-Davidson recorded during fiscal 2013 to replenish its allowance for doubtful accounts receivable AND replenish its allowance for credit losses for finance receivables. Ignore adjustments.**

(1 point)

	Debit	Credit



**Part 5(b)**

Identify the Harley-Davidson financial-statement line items that were affected by the journal entries recorded during fiscal 2013 to replenish its allowance for doubtful accounts receivable AND replenish its allowance for credit losses for finance receivables recorded in Part 5(a) and the direction of these effects (as indicated below).

**IMPORTANT:** INDICATE THE SEPARATE CURRENT AND NON-CURRENT LINE ITEMS, IF EFFECTED.

(1/2 point per statement, for a total of 2 points.)

**If an incorrect entry in part 5(a) leads to errors here, you won't receive credit here.**

**Guidance:**

- (1) Determine the appropriate line item(s) affected using Harley-Davidson's statements. For example, write "cash and cash equivalents" rather than "cash" because this is on Harley-Davidson's balance sheet. DON'T write accounts below.
- (2) Include line item(s) directly affected, including the effect(s) of closing entries for events affecting income. Ignore taxes.
- (3) **Identify the subtotal "Net cash provided by operating activities of continuing operations" if operating cash flows were affected by the entry. This subtotal is conceptually different from other subtotals.**
- (4) Don't include totals or sub-totals other than Net cash provided by operating activities of continuing operations indirectly affected by the entry. For example, don't report "Net income (loss)" on the income statement. However, net income is NOT a total on the statement of shareholders' equity.
- (5) **Write "NONE" if no line item is effected on the statement.**
- (6) Indicate if the effect(s) of the entries associated with the above event increased or decreased the line item. Put an X in the appropriate column if the above event increases or decreases that line item. For full credit, be sure to mark only one box in each statement's row. **NOTE: If a reported negative number changes from -2 to -3, it decreases; if it changes from -2 to -1, it increases.**
- (7) You won't receive credit for a statement if you list line items not affected by the entry: don't guess!

<b>Harley-Davidson Financial Statements, fiscal 2013</b>					
<b>Balance Sheet</b>			<b>Statement of Shareholders' Equity</b>		
Line Items	Increases	Decreases	Line Items	Increases	Decreases
_____	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
_____	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
_____	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
_____	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
<b>Statements of Operations</b>			<b>Statements of Cash Flows Plus Cash Flow Information footnote for Operating Section</b>		
Line Items	Increases	Decreases	Line Items	Increases	Decreases
_____	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
_____	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
_____	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
_____	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>

**Part 5(c)**

Determine the direct effect(s) on the following Harley-Davidson metrics, everything else equal (ignore taxes) from replenishing its allowance for doubtful accounts receivable AND replenish its allowance for credit losses for finance receivables recorded in Part 5(a) during fiscal 2013.

**IMPORTANT:** CONSIDER SEPARATE CURRENT AND NON-CURRENT LINE ITEMS, IF EFFECTED.

(1/4 point per ratio, for a total of 1 point.)

**Guidance:**

Include the direct affects, including the effect(s) of closing entries for events affecting income.

You must put an "X" in the appropriate box to receive credit. You will not receive credit if you put an X in more than one box per metric.

	Increases	Decreases	No Effect
<b>Working capital</b> (current assets - current liabilities)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>Financial leverage</b> (liabilities / assets)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>EBITDA</b> (earnings before interest, taxes, depreciation & amortization)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<b>Net cash provided by operating activities of continuing operations</b>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

## Question 6

### RELEVANT INFORMATION for QUESTION 6

The format for question 6 requiring analyses is similar to the group assignments.

While there aren't correct responses to the question, some are definitely better than others. Generally, responses are better to the extent they are well organized, concise, use proper grammar, identify the most important arguments, counterarguments, and rebuttals, include appropriate qualifiers, and provide insights regarding the way you assessed the relative merits of the arguments, counterarguments and rebuttals.

Additionally, responses must cite sources and use quotation marks when copying word for word.

**YOU MUST WRITE CLEARLY WITHIN THE GIVEN LINES TO RECEIVE CREDIT. YOU DO NOT NEED TO USE ALL THE SPACE TO RECEIVE FULL CREDIT. THE MARGINS ARE RESERVED FOR GRADING COMMENTS.**

**If, in our sole judgment, we can not read your response you will not receive full credit.**

(total of 10 points)

### Required

In this question, you will explore **Starwood Hotel & Resorts Worldwide, Inc.** and **Marriott International, Inc.**'s future return-on-equity (ROE), growth rates, and risks.

Based solely on concepts covered thus far in the course and the provided background text information and tabular data IN THE EXAM SUPPLEMENT, **which company, Starwood or Marriott, appears to have the better future prospects at the most recent balance sheet dates, taking into consideration expected future ROEs, growth rates, and risks?**

- In the event you conclude one company doesn't dominate on all three dimensions, your claim must still identify the one company with the better overall future prospects. For example, if you conclude company X's future ROE and growth are only slightly better than company Y's; but X's future risks are considerably more problematic, you might claim that company Y has better overall future prospects because the risks outweigh the other factors. You should briefly discuss this decision in your opening remarks.
- Use the **Companies' financial statements** near end of this Exam Supplement to help you interpret the tabular data.
- Use the **Analysis Consideration Map** in the Exam Supplement to help you develop a response that integrates the qualitative and quantitative background information.
- Respond to this question by completing the templates in Parts I-III.

### Background Information

**The provided background text information, tabular data, and company's financial statements are IN THE EXAM SUPPLEMENT.**

**NOTE: For the purpose of the exam, ignore the reimbursements included in revenues and expenses as they net to zero. As indicated in the Exam supplement, the income statement tabular data templates exclude these reimbursements.**

As an aside, cost reimbursements revenue or other revenues from managed and franchised properties represents reimbursements of costs incurred on behalf of managed and franchised properties. For both companies, these costs relate primarily to payroll costs at managed properties where the company is the employer. The company records cost reimbursements based upon costs incurred so this revenue and related expense has no impact on either operating income or net income.

## Part I: Your qualified claim and opening remarks

### Claim:

Fill in the blank with either **Starwood** or **Marriott**:

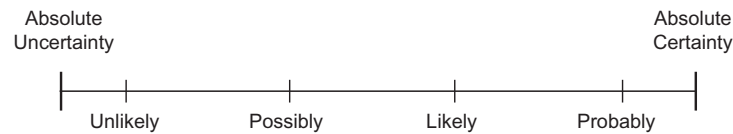
\_\_\_\_\_ appears to have the better future prospects at the most recent balance sheet dates, taking into consideration expected future ROEs, growth rates, and risks.

### Qualifiers:

Put an X at the spot on the scale below that indicates the likelihood your claim is correct, given the available information and concepts covered thus far.

After completing Parts II and III, put an X at the spot on the scale below that indicates the likelihood your claim is correct, given the available information and concepts covered thus far. Your response should depend on the strength of your arguments, counterarguments, and rebuttals to counterarguments. For example, when you conclude your arguments and counterarguments are equally strong, your X will be near the middle of the scale. By contrast, when you conclude your arguments are very strong and there are no viable counterarguments, your X will be near the right end of the scale.

Given these directions, your response should ignore the possibility that other relevant information exists that could change your arguments, counterarguments, or rebuttals, and thus the confidence you have in your claim.



The Toulmin Method of Argumentation: The Second Triad, Keith Green  
[http://www.youtube.com/watch?v=-gRaC\\_vZiD8](http://www.youtube.com/watch?v=-gRaC_vZiD8)



**Part II: Your arguments**

In Part II, you are to present no more than three arguments in support of your claim. Each separate argument should focus on one of the three factors you are to consider: future ROEs, risks, and growth. Regardless of the number of arguments you present, they should be ordered according to their relative merits in support for your claim, after considering counterarguments in Part III.

For example, if you claim in Part I that company Y has the best overall future prospects, you can make three arguments in Part II: your strongest argument supporting company Y having (1) better future ROEs; (2) better future growth; and (3) better future risks. You will have fewer arguments if you can't find supporting evidence for one or more of the three factors.

**Arguments:**

**Write your arguments below, conditional on concepts covered thus far and the provided information:**

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