Name ____________________________

ID #____________________________

**ACCOUNTING 15.501/516**
**FALL 2003**
**MIDTERM I**

EXAM GUIDELINES

1. This exam contains 8 pages, in two parts. Please make sure your copy is not missing any pages.

2. The exam must be completed within 80 minutes.

3. The total number of points in this exam is also 80, so budget about 1 minute / point. Avoiding spending too much time on any one question.

| Question | Topic | Points |
|---|---|---|
| I | Recording the effects of transactions: William's Merchandize Distribution | 30 |
| II | Accounts receivable, inventories, and cash flow: Abercrombie & Fitch | 50 |

4. Please work the problems in a clear, readable manner and show all computations. We will not grade what we cannot read.

5. If you feel that assumptions are necessary to solve a problem, please state your assumption and why it was necessary.

6. Calculators may be used for computations on this exam.

7. Good luck.

**QUESTION I: TRANSACTIONS: WILLIAM'S MERCHANDIZE DISTRIBUTION (30 POINTS)**

William's Merchandize Distribution (WMD) is a wholesale grocery distributor. Using the Balance Sheet Equation worksheet provided below, record the effects of the transactions shown on page 6 (2 points each). Calculate the ending balances of each account when you are done recording the transactions (2 points). Compute net income for the year ended December 31, 2002 (2 points).

| | Cash | Receivables | Inventories | Prepaid Rent | Property, at Cost, Less Accum. Depr. | Current Liabilities | Noncurrent Liabilities | Contributed Capital | Retained Earnings | R/E Explanation |
|---|---|---|---|---|---|---|---|---|---|---|
| 1/1/2002 Balances | 150,000 | 95,000 | 896,000 | 51,000 | 1,372,000 | 988,000 | 579,000 | 240,000 | 757,000 | |
| 1. | | | | | | | | | | |
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| 13. | | | | | | | | | | |
| 12/31/2002 Balances | | | | | | | | | | |

**Net Income for the period ended December 31, 2002:**

## QUESTION II: ABERCROMBIE & FITCH (50 POINTS)

Abercrombie & Fitch (A&F) is a large and growing retail chain of 597 stores in the U.S (adding 112 stores in the last year). The last two pages of this exam contain the balance sheets and income statements from A&F's February 1, 2003 annual report to shareholders (with minor modifications).

### ACCOUNTS RECEIVABLE AND REVENUE RECOGNITION (15 POINTS)

1. As a retailer, A&F has only a minimal amount of accounts receivable, as shown on the balance sheets. Nevertheless, assume that the company wrote off $1,160k in uncollectible receivables in the year ended February 1, 2003. Reconstruct plausible transactions to record these write-offs and the recognition of bad debt expense in the Balance Sheet Equation for the year ended February 1, 2003. (6 points)

2. A&F has a policy that allows customers to return merchandise within 14 days for a full refund. Assume the company estimated that at the fiscal years ended February 1, 2003 and February 2, 2002, expected returns to be $3,500k and $2,900k, respectively. These amounts (allowances for returns) have been included in "Accrued Expenses" on the balance sheets. If A&F had <u>not</u> recorded these allowances for returns, estimate the following items: (ignore the effect of income taxes)

   a) Retained earnings on February 1, 2003 (3 points)

   b) Net income for the year ended February 1, 2003 (3 points)

   c) Cash on February 1, 2003 (3 points)

**INVENTORIES (15 POINTS)**

3. Compute the value of inventory purchased in the year ended February 1, 2003. (3 points)

4. a) Compute the inventory turnover ratio (COGS / average inventory) for the fiscal year ended February 1, 2003. (1 points)

   b) The notes to A&F's financial statements indicate that the company uses the FIFO cost flow assumption. Given this information, what adjustments, if any, would you make to the turnover ratio you calculated in part (a) in order for the ratio to be a good estimate of physical turnover. (A qualitative response is all that is expected here. 3 points)

5. a) Suppose that A&F had used the LIFO method instead. Assume that the LIFO inventory values would have been $89,000k and $57,000k on February 1, 2003 and February 2, 2002, respectively. Compute the cost of goods sold that A&F would have reported had it used LIFO instead of FIFO. (5 points)

   b) Compute the cumulative amount of taxes that A&F would have saved by using the LIFO method. Assume a tax rate of 35%. (3 points)

## CASH FLOWS (20 POINTS)

6. Shown below is the first portion of A&F's Statement of Cash Flows (indirect method) for the year ended February 1, 2003. Provide four other adjustments in the **Operating Activities** section of the statement. Be sure to indicate the direction of the adjustment (add or substract). (Note: Marketable securities are not an operating asset.) (8 points)

| | 000's |
|---|---|
| Net income | $194,335 |
| Add: depreciation | $56,925 |

7. For the year ended February 1, 2003, A&F reported Investing Cash Flow of –$26,802k and Financing Cash Flow of –$42,973k. Using this information and the balance sheets, compute Operating Cash Flow for the year ended February 1, 2003. (3 points)

8. Provide your qualitative assessment of A&F's ability to generate cash flows. (3 points)

9. Assume that "Accounts Payable" relates entirely to inventory purchases. Estimate the amount of cash A&F paid for inventory purchases in the year ended February 1, 2003. (6 points)

## TRANSACTIONS FOR QUESTION I

1. During 2002, the company purchased $6,320,000 of groceries on account.

2. The company made $7,900,000 of credit sales to grocery retailers during 2002.

3. On June 30, 2002, the company prepaid $108,000 for one year of store rental.

4. The company had beginning accounts payable of $430,000 on January 1, 2002 and accounts payable of 445,000 on December 31, 2002. Record the cash payments, noting that accounts payables were increased by transaction 1.

5. On December 15, 2002, a consulting firm issued a report stating that the "WMD" brand name has declined in value by $500,000 because of negative associations with "Weapons of Mass Destruction." WMD had no brand name asset recorded on its December 31, 2001 balance sheet.

6. WMD collected $7,820,000 from customers during 2002.

7. During 2002, the company paid debt holders $67,000 for interest incurred in the year.

8. The company declared and paid $42,000 of dividends.

9. WMD employees took a physical count of inventory on December 31, 2002. The cost of goods in the company's possession on that date was $929,000. The cost of goods in the company's possession on January 1, 2002 was $896,000.

10. During 2002, the company paid its employees $1,230,000 in wages and benefits for work performed in 2002.

11. The last payday for the company was December 30, 2002. Employees had earned, but the company had not yet recorded, $4,000 of wages for work done on December 31, 2002.

12. Adjust for the unused rent at December 31, 2002. Note that Prepaid Rent on January 1, 2002 was 51,000 and that Food Lion never prepays rent for more than one year.

13. WMD calculates that $70,000 should be recorded as depreciation on its warehouses and machinery.

# Abercrombie & Fitch

## BALANCE SHEETS

| (*Thousands*) | February 1 2003 | February 2 2002 |
|---|---|---|
| **Assets** | | |
| **Current Assets** | | |
| Cash and Equivalents | $391,035 | $167,664 |
| Marketable Securities | 10,000 | 71,220 |
| Receivables, net of allowance for doubtful accounts of $900 and $1,300, respectively | 10,462 | 20,456 |
| Inventories | 144,218 | 108,876 |
| Store Supplies and Other | 45,441 | 36,979 |
| **Total Current Assets** | 601,156 | 405,195 |
| **Property and Equipment, Net** | 392,941 | 365,112 |
| **Other Assets** | 725 | 239 |
| **Total Assets** | $994,822 | $770,546 |

| | | |
|---|---|---|
| **Liabilities and Shareholders' Equity** | | |
| **Current Liabilities** | | |
| Accounts Payable | $ 50,153 | $ 31,897 |
| Accrued Expenses | 120,438 | 109,586 |
| Income Taxes Payable | 40,879 | 22,096 |
| **Total Current Liabilities** | 211,470 | 163,579 |
| **Deferred Income Taxes** | 20,781 | 1,165 |
| **Other Long-Term Liabilities** | 13,044 | 10,368 |
| **Shareholders' Equity** | | |
| Common Stock – $.01 par value: 150,000,000 shares authorized, 97,268,877 and 98,871,478 shares outstanding at February 1, 2003 and February 2, 2002, respectively | 1,033 | 1,033 |
| Paid-In Capital | 142,577 | 141,394 |
| Retained Earnings | 714,475 | 519,540 |
| | 858,085 | 661,967 |
| Less: Treasury Stock, at Average Cost | (108,558) | (66,533) |
| **Total Shareholders' Equity** | 749,527 | 595,434 |
| **Total Liabilities and Shareholders' Equity** | $994,822 | $770,546 |

## Abercrombie & Fitch

### STATEMENTS OF INCOME

| (*Thousands*) For years ended | February 1, 2003 | February 2, 2002 | February 3, 2001 |
|---|---|---|---|
| **Net Sales** | $1,595,757 | $1,364,853 | $1,237,604 |
| Cost of Goods Sold | 939,708 | 806,819 | 728,229 |
| **Gross Income** | 656,049 | 558,034 | 509,375 |
| General, Administrative and Store Operating Expenses | 343,432 | 286,576 | 255,723 |
| **Operating Income** | 312,617 | 271,458 | 253,652 |
| Interest Income, Net | (3,768) | (5,064) | (7,801) |
| **Income Before Income Taxes** | 316,385 | 276,522 | 261,453 |
| Provision for Income Taxes | 121,450 | 107,850 | 103,320 |
| **Net Income** | $ 194,935 | $ 168,672 | $ 158,133 |