

**John Molson School of Business**  
**Department of Accountancy**  
**ACCO 320 – Financial Reporting II**  
**Prof. Trevor Hagyard, Prof. D. Henri, Dr. Kelly F. Gheyara**  
**Midterm Examination, Winter 2013**  
**Sunday, February 17, 2013**

Student Name: \_\_\_\_\_ Student ID: \_\_\_\_\_ Section: \_\_\_\_\_

		Estimated time	Marks
Question I	Multiple Choice	45 minutes	30 Marks
Question II	Liabilities	72 minutes	44 Marks
Question III	Shareholders' Equity	40 minutes	27 Marks
Question IV	Complex Financial Instruments	<u>23 minutes</u>	<u>19 Marks</u>
<b>TOTAL</b>		<b><u>180 minutes</u></b>	<b><u>120 Marks</u></b>

**Instructions:**

1. Make sure you put your name, student ID, and section above on this exam booklet as well as on each answer booklet you use. **There are 4 Questions and XX Pages.**
2. **ANSWER QUESTION I IN THIS QUESTION BOOKLET. ALL OTHER ANSWERS** must be written on the **ANSWER BOOKLET** and **their number clearly stated**. **Answers written elsewhere or unmarked answers will not be marked.**
3. There is partial credit available on **ALL** Questions and so please make sure you **show ALL your work and computations.**
4. Allocate your time wisely... You have **3** hours to complete this exam. **You MUST STOP all your work** and turn in the exam when the invigilator declares the examination ended.
5. **You MUST return (1) this exam booklet document, and (2) your answer booklet/s. Failure to do so will invoke penalty.**

**READ EACH PROBLEM AND THINK CAREFULLY.**  
**GOOD LUCK!! WE WISH YOU ALL WELL!**

**QUESTION I - Multiple Choice - 30 Marks**

**INSTRUCTIONS:** Write your answers to **THIS QUESTION** on **THIS BOOKLET ONLY**. Answers written anywhere else **WILL NOT BE GRADED**. Attempt **ALL Questions**.

**Circle** the alphabet corresponding to the one single statement which **best** answers each question. Multiple markings on any question will be marked as an incorrect response. **Your answers must be based on IFRS unless otherwise indicated or stated.**

1. Hagman Inc., pays its salespersons salaries based on fixed monthly salaries and commissions on net sales. A fixed salary is paid each month and is treated as an advance against commissions earned in that month. Sales commissions are computed on a monthly basis and the amount exceeding the fixed salary advance, is paid in the month following the month of sale. However, if the fixed salaries for salespersons exceed their sales commissions earned for any month, such excess is not charged back to them. Pertinent data for the month of March 2012 for the three salespersons employed are as follows:

<u>Salesperson</u>	<u>Fixed salary</u>	<u>Net sales</u>	<u>% Commission</u>
A	\$10,000	\$ 200,000	4%
B	14,000	400,000	6%
C	18,000	600,000	6%
Totals	<u>\$42,000</u>	<u>\$1,200,000</u>	

What amount should Hagman accrue for sales commissions payable at March 31, 2012?

- a. \$70,000  
b. \$68,000  
c. **\$28,000**  
d. \$26,000  
e. \$42,000  
f. none of the above but \$ \_\_\_\_\_.
2. Mayberry Co. sells appliances that include a three year warranty. Service calls under the warranty are performed by an independent mechanic under a contract with Mayberry. Based on experience, warranty costs are estimated at \$30 for each machine sold. When should Mayberry recognize these warranty costs if it uses the expense approach?
- a. Evenly over the life of the warranty.  
b. When the service calls are performed.  
c. When payments are made to the mechanic.  
d. When the warranty expires.  
e. **When the machines are sold.**
3. On January 1, 2007, Fox Corp issued 1,000 of its 10%, \$1,000 bonds for \$1,040,000. These bonds were to mature on January 1, 2017 but were callable at 101 any time after December 31, 2010. Interest was payable semiannually on July 1 and January 1. On July 1, 2012, Fox called 60% of all of the bonds and retired them. Fox uses **PE GAAP (ASPE)** and amortizes bond premiums and discounts on a straight line basis.

The gain or loss in 2012 on this early extinguishment of debt was:

- a. \$18,000 gain.  
b. \$ 7,200 gain.  
c. \$ 6,000 loss.  
d. **\$ 4,800 gain.**  
e. \$ 8,000 loss.





12. In May, 2012, ABC (December 31 year-end) guaranteed a \$100,000 bank loan provided to DEF Ltd. DEF Ltd. was in a relatively strong financial position at December 31, 2012 but this had worsened by December 31, 2013 and it seemed likely on that date that ABC would be required to honour its guarantee. ABC uses IFRS to report in both years. ABC should provide the following in its financial statements for both years:

- a. **disclose the guarantee-2012; accrue the \$100,000 loss for 2013.**
- b. accrue the \$100,000 loss- 2012; accrue the \$100,000 loss- 2013.
- c. disclose the guarantee-2012; disclose the guarantee- 2103.
- d. neither accrue nor disclose-2012; accrue 50% of the amount guaranteed-2013.
- e. neither accrue nor disclose-2012; disclose the guarantee- 2013.

13. Holiday Resorts Corporation [HRC] had reported 16,000 common shares as issued and outstanding. The shares had been issued at \$45 each. The company also reported \$20,000 as Retained earnings. Its contributed surplus was \$5,000 as related to preferred shares and \$12,000 for common shares. HRC reacquires and cancels 2,000 of its common shares on the open market for \$52 each. The journal entry would be the following:

- a. DR. Contributed Surplus common shares \$14,000; CR. Cash \$14,000.
- b. **DR. Common shares, \$90,000; DR. Contributed Surplus common shares \$12,000; DR. R/E, \$2,000; CR. Cash \$104,000.**
- c. DR. Common shares, \$90,000; DR. R/E, \$14,000; CR. Cash \$104,000.
- d. DR. Common shares, \$104,000; CR. Common shares, \$14,000; CR. Cash \$90,000.
- e. none of the above but \_\_\_\_\_.

14. Vynn Big, Inc., carried the following balances in its equity accounts on December 1, 2012:

5,000 Common Shares Subscribed	\$ 250,000
10,000 Common Shares Capital, No par, outstanding	310,000
Subscriptions Receivable	80,000
Retained Earnings	\$1,340,000
Contributed surplus	560,000

On December 10, 2012, it declared and paid a cash dividend of \$65,000.

The journal entry to record this transaction would be

- a. DR. Cash Common Shares Subscribed \$65,000 and CR.\$65,000.
- b. DR. Contributed surplus \$65,000 and CR. Cash \$65,000.
- c. DR. Subscriptions Receivable \$65,000 and CR. Cash \$65,000.
- d. DR. Dividends \$65,000 and CR. Common Shares \$65,000.
- e. DR. Retained Earnings \$65,000; CR. Common Shares Subscribed \$26,000 and CR. Common Shares \$39,000.
- f. **None of the above but DR. Retained Earnings \$65,000 and CR. Cash \$65,000 .**

15. Tipo Co., recorded gross salaries for the month amounting to \$80,000. QPP deductions were \$1,260, EI deductions were \$910. Income tax withheld was \$25,000 and \$1,200 was withheld for investment in company stock per agreement with certain employees. What would be the total amount to remit to the government given that Tipo must remit income tax deducted, QPP and EI deducted as well as employer portion of QPP (match deduction from employee) and EI of 1.4 times deduction from employees?

- a. \$30,904
- b. **\$29,704**
- c. \$25,000
- d. \$29,584
- e. none of the above, but \$ \_\_\_\_\_ .

## **QUESTION II - Liabilities - 44 Marks**

### **Situation A - 12 Marks**

Green Thumb International [GTI], Inc., constructs and operates garbage recycling plants all over North America. It set up and began operating a new plant in Sherbrooke, Quebec on January 1, 2011. The province requires all companies to return the land to its natural state at the end of their operations activity. GTI estimates that it will operate the plant for 25 years, at which time it will cost \$25,000,000 for the land restoration project. GTI uses IFRS, an 8% discount rate and has a fiscal year ending December 31.

#### **REQUIRED:**

- a) Record any obligation for land reclamation costs, related to the acquisition of the plant as at January 1, 2011.
- b) Record any entry required related to this obligation at December 31, 2011 .

Now assume for part (c) and (d) that the ongoing recycling operations discharge non-toxic waste water into a nearby lake. The company has to undertake the cleanup of the lake waters after the plant has ceased operations. As a result, it estimates additional recurring cleanup costs of \$140,000 each year for such cleanup to be paid in 25 years.

- c) Record ONLY the future cleanup costs from ongoing operations as at December 31, 2011.
- d) On December 31, 2012, record all increases in asset retirement obligation occurring for that year.

### SOLUTION - Question II - Situation A

a) **January 1, 2011**

Plant and Assets	3,650,500	
Asset Retirement Obligation		3,650,500

\$3,650,500 is the present value of the \$25,000,000 estimated cost discounted for 25 years at 8%.  
[0.14602 x \$25,000,000]

b) **December 31, 2011**

Interest Expense	292,040	
Asset Retirement Obligation		292,040

[3,650,500 x 8% = 292,040]

c) **December 31, 2011**

Manufacturing Overhead	22,078	
Asset Retirement Obligation		22,078

\$22,078 is the present value of the \$140,000 estimated cost discounted for 24 years at 8%.  
[0.15770 x \$140,000]

d) **December 31, 2012**

Manufacturing Overhead	23,845	
Asset Retirement Obligation		23,845

\$\$140,000 is the present value of the \$\$140,000 estimated cost discounted for 23 years at 8%.  
[0.17032 x \$140,000]

  

Interest Expense	317,169	
Asset Retirement Obligation		317,169

[(3,650,500 + 292,040 + 22,078) x 8% ] = 371,169

## **QUESTION II - Situation B - 13 Marks**

At the beginning of 2011, Kool DrinX, Inc., [**KDX**] started a sales program for one of its products. It requires its customers to collect the caps from the bottles of its drinks. In return for ten such caps, customers would receive a key chain with the company's logo which it purchases for \$0.65 each. **KDX's** experience indicates that 70% of the caps circulated would be redeemed. During 2011, 8,100,000 bottles were sold, 520,000 key chains were purchased, and 3,500,000 caps were redeemed. During 2012, 9,300,000 bottles were sold, 262,000 key chains were purchased, and 5,520,000 caps were redeemed. On December 31, 2010, **KDX** held 218,000 key chains in inventory carried over from an earlier adopted program at the same cost.

### **REQUIRED:**

- 1) Prepare appropriate journal entries for all transactions stated in the given problem for years 2011 and 2012.
- 2) Which items (amounts not required) are to be included in the financial statements for 2012 and show how these will be classified.

**SOLUTION - Question II - Situation B**

	Premium <u>Inventory</u>	Expected <u>Redemption</u>	Actual Redemption	Balance Liability
2010	218,000 units			
2011	520,000			
	<u>(350,000)</u>	567,000	\$368,550	350,000
2012	388,000			\$227,500
	262,000			
	<u>(552,000)</u>	651,000	\$423,150	552,000
	98,000			\$358,800

1) <b>2011</b>	Premium Inventory (520,000 x 0.65)		338,000	
	Cash/AP			338,000
	Premium Expense (810,000 x 0.7 x 0.65)		368,550	
	Estimated Liability for Premiums			368,550
	Estimated Liability for Premiums (350,000 x 0.65)		227,500	
	Premium Inventory			227,500
<b>2012</b>	Premium Inventory (262,000 x 0.65)		170,300	
	Cash/AP			170,300
	Premium Expense (930,000 x 0.7 x 0.65)		423,150	
	Estimated Liability for Premiums			423,150
	Estimated Liability for Premiums (552,000 x 0.65)		358,800	
	Premium Inventory			358,800

2) **Income Statement**  
Premium Expense

**Balance Sheet**

Current Assets: Premium Inventory

Current Liabilities: Estimated Liability for Premiums

## **QUESTION II - Situation C - 19 Marks**

BildTek, Inc., produces custom designed machinery and equipment for individual customers. It manufactured and delivered, sometime early in 20X1, heavy equipment for Lunar Spacecrafts Corporation at a selling price of \$20.0 million with a two-year guarantee for correcting any defects or operational problems arising during that period without cost to the buyer. The company uses a December 31 year end.

At the time of the sale, BildTek estimated the eventual warranty costs to be no more than \$1.00 million. Subsequent events unfolded as follows:

- a) Repair costs during the remainder of the 20X1 year amounted to \$250,000. Further, in early 20X2 (and before the financial statements for 20X1 were published), the company estimated that the total warranty cost for the two years could amount to as much as \$1.3 million.
- b) During 20X2, the company incurred actual repair costs related to the warranty amounting to \$703,000. From this amount, \$27,000 being costs on credit, was paid in 20X3.

### **REQUIRED:**

***Expense Method:*** Use this method and IFRS to answer Parts 1 and 2

- 1) Prepare, in good format, journal entry/entries to record both the cost and liability (if any) associated with the warranty for 20X1 and 20X2.
- 2) What should be done to resolve any balances related to the warranty remaining on December 31, 20X2 and prepare any journal entry required.

***Revenue Method:*** Use this method and IFRS to answer Part 3. Assume, for these two questions only, that the company builds into the sales price, a margin of 10% of final selling price, as revenues related to warranties. It was considered reasonable to allocate 30% of the revenue to 20X1 and the balance to 20X2.

- 3) Prepare, in good format, journal entry/entries to record all effects associated with the warranty for 20X1 and 20X2.

**SOLUTION - Question II - Situation C**

1) <b><u>2011</u></b>		
Warranty Expense	1,000,000	
Estimated Liability for Warranty		1,000,000
Estimated Liability for Warranty	250,000	
Misc. Accounts		250,000
Warranty Expense	300,000	
Estimated Liability for Warranty		300,000
<b><u>2012</u></b>		
Estimated Liability for Warranty	703,000	
Misc. Accounts		676,000
Ac/ P		27,000
2) Estimated Liability for Warranty	347,000	
Warranty Expenses		347,000
[1,300,000 - (250,000 + 703,000)]		
3) <b><u>2011</u></b>		
Accounts Receivable	20,000,000	
Sales		18,000,000
Warranty Revenue (2,000,000 x 0.3)		600,000
Unearned Warranty Revenue (2,000,000 x 0.7)		1,400,000
Warranty Expense	250,000	
Misc. Accounts		250,000
<b><u>2012</u></b>		
Unearned Warranty revenue	1,400,000	
Warranty Revenue		1,400,000
Warranty Expense	703,000	
Misc. Accounts		676,000
Acs/ P		27,000

### **QUESTION III - Shareholders' Equity - 27 Marks**

Stable Pipelines, Inc., reports the following items in shareholders' equity as at December 31, 20X8:

Preferred Share Capital: 15,000 authorized and 4,000 issued in 20X5; \$0.60, participating after \$0.30 per share common dividend is received by common shareholders	\$ 36,000
Common Share Capital: Authorized 200,000 shares; 92,000 shares outstanding	1,080,000
Contributed surplus on share retirement	17,000
Retained earnings	4,356,900

The following transactions and events happened **in 20X9** in **chronological** order:

- a] A cash dividend of \$42,800 was declared and paid. Dividends were last declared in 20X6. Assume the preferred shares were cumulative.
- b] 4,000 common shares were issued for land. The land was valued for \$60,000; recent trading activities indicated that the market value of the shares was \$18.75 per share.
- c] A 10% common stock dividend was declared and the shares were issued. Common shares were being traded at \$26.78 when the dividends were declared.
- d] 10,000 common shares were subscribed for at \$23.00 per share. All subscribers paid the first instalment of \$4.00 per share on application.
- e] The second and final subscription instalment was called. 9,200 shares were paid in full and issued. The remaining 800 shares were not paid by the subscribers and the company treated their earlier payments as forfeited.
- f] In 20X5, the company had issued \$2 million, 9% 20-year convertible bonds at 98. Similar bonds were valued at 92 around the date of the issue. Each \$1,000 bond could be converted into 20 shares. Exactly, four calendar years later, 35% of the bonds were converted when the market price of the shares were \$58.00 each. All interest related entries have already been made and the bonds payable, on this date, are carried at their amortized cost. Straight-line amortization was used.

#### **REQUIRED:**

- 1) Determine the amounts to be distributed to each of the two shareholder groups as cash dividends, using the information given in the problem.
- 2) Assume for (a) above that the preferred shares were non-cumulative. Determine the amounts to be distributed to each of the two shareholder groups as cash dividends, using the remaining information given in the problem.
- 3) Prepare the appropriate journal entry, in good format, to record the transaction in (b) above.
- 4) Prepare the appropriate journal entry, in good format, to record the transaction in (c) above.
- 5) Prepare the appropriate journal entry, in good format, to record the transaction in (d) above.
- 6) Prepare the appropriate journal entry, in good format, to record the transaction in (e) above.
- 7) Prepare the appropriate journal entry, in good format, for the transaction in (f) above, assuming the company has adopted ASPE
  - a] to record the issue of the bonds; and
  - b] to record the conversion of the bonds.

### SOLUTION - Question III

	Preferred	Common	
1] Arrears	\$ 4,800		
Current <u>Base</u> dividend - Preferred	2,400		
Common		\$27,600	(\$0.30 x 92,000)
Balance**	258	7,742	
<b>Total</b>	<b>\$ 7,458</b>	<b>\$35,342</b>	

\*\* **Remaining pool** = \$42,800 - \$4,800 - \$2,400 - \$27,600 = \$8,000  
 preferred: \$8,000 × (36/1,116)  
 common: \$8,000 × (1,080/1,116)

	Preferred	Common	
2] Arrears	\$ 0		
Current <u>Base</u> dividend - Preferred	2,400		
Common		\$27,600	(\$0.30 x 92,000)
Balance**	413	12,387	
<b>Total</b>	<b>\$ 2,813</b>	<b>\$39,987</b>	

\*\* **Remaining pool** = \$42,800 - \$0 - \$2,400 - \$27,600 = \$12,800  
 preferred: \$12,800 × (36/1,116); common: \$12,800 × (36/1,116)

3] Land	60,000		
Common Shares		60,000	
[FMV of land < FMV of shares traded]			

4] Retained earnings	257,088		
Common shares (96,000 x 0.1 x 26.78)		257,088	
[(92K + 4K)]			

5] Subscriptions Receivable (23 x 10,000)	230,000		
Common Shares Subscribed		230,000	

Cash	40,000		
Subscriptions Receivable (4 x 10,000)		40,000	

6] Cash (19 x 9,200)	174,800		
Subscriptions Receivable		174,800	

Common Shares Subscribed (23 x 800)	18,400		
Subscriptions Receivable		15,200	
Contributed Surplus - Forfeited Subscriptions (4 x 800)		3,200	

Common Shares Subscribed (23 x 9,200)	211,600		
Common shares (23 x 9,200)		211,600	

7a] Cash (0.98 x 2,000,000)	1,960,000		
Bonds Payable (0.92 x 2,000,000)		1,840,000	
Contributed Surplus - Conversion Rights		120,000	

7b] Bonds Payable	655,200*	
Contributed Surplus - Conversion (0.35 x 120,000)	42,000	
Common shares		697,200
*[(1,840,000 + ((160,000 x 4)/20))] x 0.35]		

**QUESTION IV - Complex Financial Instruments - 19 Marks**

On January 1, 20X1, the Moon Travels, Inc., [MTI], issued \$1,000,000, 8% , five-year bonds for a cash price of \$1,250,000. Interest is payable semi-annually on June 30 and December 31. Each \$1,000 bond includes 20 warrants. Each warrant can be exchanged for one common share on MTI at an exercise price of \$10 per share. The market rate of interest is 6% for similar bonds and the fair market value of these bonds was determined to be \$1,085,302.

**REQUIRED:**

1. Prepare the appropriate journal entry, in good format, to record the issue of the bonds on January 1, 20X1.
2. Prepare the appropriate journal entry, in good format, required on December 31, 20X1.
3. How would the bonds be reported on the balance sheet, December 31, 20X1.
4. 30% of the warrants were exercised on July 1, 20X3 when the shares of **MTI** were being traded at \$11.50. Prepare the appropriate journal entry or entries, in proper format, which the company should make on July 1, to record this transaction.

**NOTE:** You may find it useful and easier to answer this question by preparing a bond amortization table.

**SOLUTION - Question IV - Situation A**

Period	Cash interest paid	Int. expense (3%)	Amortization	Closing net liability
Jan 1, 2001 (open)				1,085,302.00
June 30, 2001	40,000.00	32,559.06	7,440.94	1,077,861.06
Dec. 31, 2001	40,000.00	32,335.83	7,664.17	1,070,196.89
June 30, 2002	40,000.00	32,105.91	7,894.09	1,062,302.80
Dec. 31, 2002	40,000.00	31,869.08	8,130.92	1,054,171.88
June 30, 2003	40,000.00	31,625.16	8,374.84	1,045,797.04
Dec. 31, 2003	40,000.00	31,373.91	8,626.09	1,037,170.95
June 30, 2004	40,000.00	31,115.13	8,884.87	1,028,286.08
Dec. 31, 2004	40,000.00	30,848.58	9,151.42	1,019,134.66
June 30, 2005	40,000.00	30,574.04	9,425.96	1,009,708.70
Dec. 31, 2005	40,000.00	30,291.26	9,708.74	999,999.96
	0.04	0.03		

1. Cash	1,250,000	
Bonds Payable		1,085,302
Contributed Surplus - Conversion		164,698
2. Interest Expense	32,336	
Bonds Payable	7,664	
Cash		40,000
3. <b>Balance Sheet</b>		
<b>Current Liabilities</b>		
Bonds Payable, Current		16,025
[7,894 + 8,131]		
<b>Non-Current Liabilities</b>		
Bonds Payable, Non-Current		1,054,172
4. Cash [10,000 x 0.3 x 20 x 10]	600,000	
Contributed Surplus - Warrants	49,409	
Common Shares		649,409