**Department of Accountancy, John Molson School of Business**
**ACCO 320 – Intermediate Accounting II, Fall 2012**
**Dr. Kelly F. Gheyara/ Prof Trevor Hagyard**

**Final Examination**
**Friday, December 14, 2012, 7:00 - 10:00 PM**

**Student Name:**_____ **Student ID:**_____ **Section**:_____

| Part | | Marks | Proportionate Time | Score |
|---|---|---|---|---|
| Ques. I. | Multiple Choice Questions | (30 Marks) | 550 minutes | |
| Ques. II. | Pensions | (18 Marks) | 32 minutes | |
| Ques. III. | Income Taxes | (18 Marks) | 32 minutes | |
| Ques. IV. | Leases | (16 Marks) | 29 minutes | |
| Ques. V. | Earnings Per Share | (18 Marks) | 32 minutes | |
| **TOTAL** | | **100 Marks** | **180 minutes** | |

## Instructions:

1. Make sure you put your name, student ID, and section above as well as on the answer booklet AND put your ID on your desk, face up. **There are 5 Questions and 15 Pages including 3 pages for PV tables, in this booklet.**

2. For multiple choice questions in **Question I**, make sure to circle the alphabet related to one answer you consider best. **Answers FOR THIS QUESTION MUST BE MARKED on this exam booklet itself or they will not be marked.**

3. There is partial credit available on Questions II - V. So make sure you **SHOW ALL YOUR WORK AND COMPUTATIONS**.

4. Calculators (non alphanumerical) and dictionaries are allowed; tables for time value of money are attached at the end of the exam. **One 8.5 x 11" sheet, written both sides, containing your notes maybe used during the exam.**

5. 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 says the time is up.

6. You MUST return (1) this document without any missing pages, (2) your answer booklet.

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

## QUESTION I - Multiple Choice - (30 Marks)

**INSTRUCTIONS:** Answer on **THIS BOOKLET ONLY.** Answers to this question written anywhere else **WILL NOT BE GRADED.**

**Answer ALL QUESTIONS.**

**BEST TWELVE Will Be Graded**.

### Multiple Choice Questions [12 x 2.5 Marks each] 30 Marks

1. HabzKnot issues $3,000,000 of 6-year, 6% bonds to yield 8.0%. The bonds were dated January 1, 2X11 but some regulatory hurdles, were not issued till July 1, 2X11. Interest is paid annually on January 1.The entry to record the issue of these bonds plus interest would be
   A. Debit Cash $3,000,000 and Credit Bonds Payable $3,000,000.
   B. Debit Cash $2,925,000; Debit Interest Receivable $75,000 and Credit Bonds Payable $3,000,000.
   C. Debit Cash $3,025,000; Credit Bonds Payable $3,000,000 and Credit Interest Payable $75,000 .
   D. Debit Cash $2,737,183 and Credit Bonds Payable $2,737,183.
   E. **None of the above but Debit Cash $2,831,528; Credit Bonds Payable $2,741,528 and Credit Interest Expense/Payable $90,000.**

   OR E. **None of the above but Debit Cash $2,827,183; Credit Bonds Payable $2,737,183 and Credit Interest Expense/Payable $90,000.**

2. In accounting for a pension plan, any difference between the pension cost charged to expense and payments into the fund should be reported as:
   A. An offset to the liability for past service cost.
   **B. Accrued pension asset or liability.**
   C. An operating expense of the period.
   D. An actuarial gain or loss.
   E. None of the above.

3. On December 31, 20X6, CeeDee, Inc., reported its equity as follows:

| | |
|---|---|
| $1 cumulative preferred shares, no-par, convertible at the rate of 4-for-1; 350,000 shares outstanding | $ 9,000,000 |
| No-par common shares, 3,500,000 shares outstanding | 15,000,000 |
| Retained earnings | 30,600,000 |

   It also informed you that on July 1, 20X6, 150,000 preferred shares had been converted to 600,000 common shares. The preferred shares had been issued on January 1, 20X0 and has declared and paid dividends on June 30 and December 31 each year since its issue. The company reported net income of $2,289,000 for 20X6. Calculate the basic earnings per share which the company should report for the year.

   **A. $0.58 per share.**
   B. $0.65 per share
   C. $0.60 per share.
   D. $1.01 per share.
   E. None of the above but $ _____ per share.

4. For purposes of computing the weighted-average number of shares outstanding during the year, a mid-year event that must be treated as occurring at the beginning of the year is the:
   A. Issue of additional common shares. B. Purchase of treasury stock.
   C. Issuance of stock warrants. **D. Stock split.**
   E. Issue of nonconvertible cumulative preferred shares.

5. What are the three types of period costs that a lessee experiences with capital leases?
   A. Lease expense, interest expense, amortization expense.
   **B. Interest expense, amortization expense, executory costs.**
   C. Amortization expense, executory costs, lease expense.
   D. Executory costs, interest expense, lease expense.
   E. None of the above but _____.

6. The following pertains to Kane Co.'s defined benefit pension plan (deferral and amortization method) for 2012:

| | |
|---|---|
| Prepaid pension cost, January 1, 2012 | $ 2,000 |
| Current service cost | 19,000 |
| Interest cost | 38,000 |
| Expected return on plan assets | 22,000 |
| Actual return on plan assets | (1,000) |
| Amortization of unrecognized past service cost | 52,000 |
| Contributions made | 40,000 |

The fair value of plan assets exceeds the ABO. In its December 31, 2012 balance sheet what amount should Kane report as unfunded accrued pension cost?

   **A. $45,000** B. $49,000
   C. $67,000 D. $87,000
   E. None of the above but $ _____.

7. LemonKorp had two types of securities outstanding: common shares and an 9% convertible bond with a maturity value of $4,000,000. Interest payment dates of the bond are July 1 and January 1. The bond indenture contains a conversion clause which entitles the bondholders to convert each $1,000 bond into 40 no par value common shares. The equity portion of the bond issue has a value of $30,000. On June 30, 2008, the holders of $600,000 face value bonds exercised their conversion privilege. The market price of the bonds on that date was $1,100 per bond and the market price of the common shares was $35. The balance of the total unamortized bond discount at the date of conversion was $250,000. In applying the book value method, what amount should LemonKorp credit to the Common Shares account as a result of this conversion?
   **A. $567,000.** B. $562,500
   C. $642,000.. D. $840,000.
   E. None of the above but $ _____ .

8. Quinn Co. reported a net deferred tax asset of $9,000 in its December 31, 2011 balance sheet. For 2012, Quinn reported pretax financial statement income of $300,000. Temporary differences of $100,000 resulted in taxable income of $200,000 for 2012. At December 31, 2012, Quinn had cumulative taxable differences of $70,000. Quinn's effective tax rate is 30%. In its December 31, 2012 income statement what amount should Quinn report as deferred income tax expense?

A. $12,000
B. $21,000
**C. $30,000.**
D. $60,000
E. None of the above but $_____ .

9. Glade Co. leases computer equipment to customers under direct-financing leases. The equipment has no residual value at the end of the lease and the leases do not contain bargain purchase options. Glade wishes to earn 8% interest on a five-year lease of equipment with a fair value of $323,400. The present value of an annuity due of $1 at 8% for five years is 4.312. What is the total amount of interest revenue that Glade will earn over the life of the lease?

**A. $51,600.**
B. $75,000.
C. $129,360.
D. $139,450.
E. None of the above but $ _____.

10. On December 1, 2008, SpaceKraftz Company issued at 103, five hundred (500) of 9%, $1,000 bonds. Attached to each bond was one detachable stock warrant entitling the holder to purchase 10 SpaceKraftz's common shares. On December 1, 2008, the market value of the bonds, without the stock warrants, was 95, and the market value of each stock warrant was $50. Using the proportional method, the initial carrying value of the bonds payable would be

A. $474,000.
**B. $489,250.**
C. $500,000.
D. $ 515,000.
E. None of the above but $_____ .

11. On January 1, 2011, the Anson Company leased a machine to Scovil Company. The lease was for a ten year period which is the useful life of the machine. Anson purchased the machine for $80,000 and expects to earn a 10% return on its investment, based upon an annual rental of $11,836 payable in advance each January 1. Assuming that the lease was a direct financing lease, what should be the interest entry on Anson's books on December 31, 2011, its fiscal year end.

A. Cash 3,836
Interest revenue 3,836

**B. Unearned interest revenue 6,816**
**Interest revenue 6,816**

C. Lease receivable 8,000
Interest revenue 8,000

D. Lease receivable 11,836
Interest revenue 8,000
Equipement 3,836

E. Unearned interest revenue 8,000
Interest revenue 8,000

12. The following information relates to the pension plan for the employees of NaChi Co.,:

| | 1/1/06 | 1/1/07 | 1/1/08 |
|---|---|---|---|
| Projected benefit obligation | 930,000 | 996,000 | 1,334,000 |
| Fair value of plan assets | 850,000 | 1,040,000 | 1,148,000 |
| Unrecognized net actuarial gain/(loss) | 144,000 | (310,000) | - 0 - |

NaChi estimates that the average remaining service life of employees is 16 years for each of the three years.

The amount of amortization, [either debited or (credited) to the expense account] of the actuarial (loss) or gain in each of the three years 2006, 2007 and 2008 using the 10% corridor approach would be (answer rounded to the nearest integer dollar)

A. Credit $3,188, Debit $12,875 and $zero.
**B. Debit $3,188, Credit $12,875 and $zero.**
C. Credit $3,313, Debit $4,082 and Debit $1,989.
D. $zero, Credit $2,500 and Debit $2,194.
E. None of the above but _____ .

13. On the first day of its fiscal year, Lessor Inc. leased out certain property. 10 annual lease payments are due at the beginning of each year of $100,000. The first payment was received immediately on signing the lease. The leased property is new, cost $650,000 and has an economic life of 13 years with no residual value. The lessor has an implied rate of interest in the lease of 8%. The lessor had no other costs associated with this lease.
Assuming that the lessor should have accounted for the lease as a capital lease but mistakenly accounted for it as an operating lease, what would be the effect **on net earnings** during the first year of the lease by having misclassified this lease?

A. No effect.
**B Understated.**
C. Overstated.
D. Insufficient information to determine any effects.
E. The effect depends on the method selected for income tax purposes.

## SOLUTION

1.E. **None of the above but Debit Cash $2,831,528; Credit Bonds Payable $2,741,528 and Credit Interest Expense/Payable $90,000.**

| | | | |
|---|---|---|---|
| PV Annuity Factor @8%, 6 years | | = | 4.62288 |
| PV Annuity Factor @8%, 5 years | | = | 3.99271 |
| Average Annuity Factor | | = | 4.307795 |
| | | | |
| PV Single Amount Factor @8%, 6 years | | = | 0.63017 |
| PV Single Amount @8%, 5 years | | = | 0.68058 |
| Average Annuity Factor | | = | 0.655375 |
| | | | |
| PV Annuity, $180,000 as above, | $180,000 x 4.307795 | = | 775,403 |
| PV Single Amt., $3M as above, | $3M x 0.655375 | = | 1,966,125 |
| **Bond Issue Price** | | | **2,741,528** |
| Cash interest | | | 90,000 |
| **Cash received** | | | **2,831,528** |

OR

1.E. **None of the above but Debit Cash $2,827,183; Credit Bonds Payable $2,737,183 and Credit Interest Expense/Payable $90,000.**

| | | | |
|---|---|---|---|
| PV Annuity, $90,000 @4%, 11 periods | 8.76048 x $90,000 | = | 788,443 |
| PV Single Amt., $3M @3% 11 periods | 0.64958 x $3M | = | 1,948,740 |
| **Bond Issue Price** | | | **2,737,183** |
| Cash interest | | | 90,000 |
| **Cash received** | | | **2,827,183** |

2.B.

3.A

| | |
|---|---|
| Basic: | |
| Net earnings | $2,289,000 |
| Pref dividends | |
| 500,000 x $.25 x 2 | (250,000) |
| 350,000 x $.25 x 2 | (175,000) |
| | $1,864,000 |
| Weighted average shares | |
| 2,900,000 x 6/12 | 1,450,000 |
| 3,500,000 x 6/12 | 1,750,000 |
| | 3,200,000 |
| | |
| Basic EPS | **$0.58** |

4.D

5. B

6. A **$45,000**

**Soln:** The pension expense is as follows:

| | |
|---|---|
| Current service cost | 19K |
| Int cost | 38K |
| Expected return | (22K) |
| PSC amort | 52K |
| Pension exp | 87K |

**Balance at 31/12/12 = -2K + 87K - 40K funded = 45K**

7.**A. $567,000.**

| | |
|---|---|
| Book value = (4,000,000 - 250,000) x 0.15 = | 562,500 |
| Equity = 30,000 x 0.15 = | 4,500 |
| **Credit to Common shares** | **567,000** |

8.C. **$30,000.**

soln: at year end, cumulative taxable differences = 70K*.3 = $21K

| | |
|---|---|
| beginning of year | (9K) |
| **difference, during the year (100K * 0.30)** | **$30K** |

9.**A. $51,600.**

**Soln:** The annual lease payment is $75K (323K / 4.312). Total lease payments after 5 yrs will be $375K and the interest revenue is the excess of payments over PV of them ($323.4) thus $51.6K

10.**B. $489,250.**

| | | |
|---|---|---|
| Issue Price (500 x 1.03 x1000) | = | 515,000 |
| FMV Bonds (0.95 x 500 x 1000) | = 475,000 | |
| FMV Warrants (500 x 1 x 50) | = 25,000 | |
| **Amount Credited to B/P (515,000 x 475)/500** | | **489,250** |

11.**B.**

| | | |
|---|---|---|
| **Unearned interest revenue** | **6,816** | |
| **Interest revenue** | | **6,816** |

(80,000 - 11,836) x 0.1

12. **B.Debit $3,188, Credit $12,875 and $zero.**

| | | | |
|---|---|---|---|
| **Year 06:** | [144,000 - 0.1 x (930,000)]/16 | | 3.188 Debit |
| **Year07:** | [(- 310,000) - (1,040,000 x 0.1)]/16 | 4,074 Credit | 12,875 Credit |
| **Year 08:** | | | -0- |

**OR**

**B.$zero, Debit $2,500 and Credit $2,194.**

| | | | | |
|---|---|---|---|---|
| **Year 06:** | | | -0- | |
| **Year07:** | [144,000 - 0.1 x (1,040,000)]/16 | | 2,500 Debit | |
| **Year 08:** | [(144,000 -2,500 - 310,000) - (1,334,000 x 0.1)]/16 | | 2,194 Credit | -0- |

13. **B Understated.**

**Solution** - recorded $100,000 revenue and depreciation of $650,000/13 = $50,000 thus income $50,000

***For capital lease, int revenue = 650,000 * 8% = $52,000***

***Difference- thus understated.***

## QUESTION II - Accounting for Pensions (18 Marks)

Marko Consultants Limited began planning for setting up a pension fund in the year 20X3 to begin effectively from January 1, 20X4. It uses the deferral and amortization method within PE GAAP (defers experience gains and losses on plan assets and actuarial revaluations over the appropriate number of years). Terms of the pension plan follow:

-The expected earnings rate on plan assets and the discount rate is 6%;

-Employees, in service on January 1, 20X4, would receive a partial credit for their past service. This past service obligation with which the plan began, valued using the projected benefit actuarial cost method, was $216,000 as of January 1, 20X4;

-Past service cost will be funded over 15 years. The initial payment on January 1, 20X4, was $20,000. After that, an additional $20,000 will be added, for each year including for 20X4, to the 31 December current service funding amount. The amount of past service funding will be reviewed every five years to ensure its adequacy; The average vesting period for past service cost was five years;

-Current service cost will be fully funded each December 31, plus or minus any actuarial losses or gains related to the pension liability. **Experience gains and losses related to the difference between actual and expected earnings on fund assets will not affect plan funding**. As they are expected to offset over time, these gains and losses were to be amortized over the expected average remaining service life.

Additional data for 20X4 and 20X5

| | **20X4** | **20X5** |
|---|---|---|
| Current service cost for the year | $51,000 | $57,000 |
| Funding amount, January 1, 20X4 | 20,000 | |
| Funding amounts, December 31 | ?? | ?? |
| Actual return on fund assets | 1,000 | 6,800 |
| Increase in actuarial liability at year-end due to change in assumptions | 34,000 | 0 |
| EARSL for all employees | 26 years | 25 years |

**Required:** Preparing a pension worksheet would help you answer these questions more accurately

a) Compute the 20X4 and 20X5 ending balances of ABO, plan assets, experience gain or loss and unamortized past service cost;

b) Prepare the journal entries for 20X4 and 20X5 to record pension expense and the funding contribution.

c) At the end of 20X5, show a reconciliation of the balance of the accrued pension asset/liability and its funding status.

## SOLUTION: QUESTION II - Accounting for Pensions (18 Marks)

1. Pension Worksheet

| | Pension Xp | Cash | Net Pension Asset/Liab | ABO | Plan Assets | Unamort PSC | Exper G/L |
|---|---|---|---|---|---|---|---|
| **1/1/04** | | | | (216,000) | | 216,000 | |
| **PSC amort** | 43,200 | | | | | (43,200) | |
| **Funding** | | (20,000) | | | 20,000 | | |
| **Int exp** | 12,960 | | | (12,960) | | | |
| **Expect return** | (1,200) | | | | 1,000 | | 200 |
| **Current service** | 51,000 | | | (51,000) | | | |
| Funding | | (105,000) | | | 105,000 | | |
| Act G/L | | | | (34,000) | | | 34,000 |
| **Balance 31/12/X4** | 105,960 | (125,000) | (19,040) | | | | |
| **1/1/05** | | | 19,040 | (313,960) | 126,000 | 172,800 | 34,200 |
| **Current service** | 57,000 | | | (57,000) | | | |
| **Int exp** | 18,838 | | | (18,838) | | | |
| **return** | (7,560) | | | | 6,800 | | 760 |
| **PSC amort** | 43,200 | | | | | (43,200) | |
| **Amort exper G/L** | 112 | | | | | | (112) |
| **Funding** | | (77,000) | | | 77,000 | | |
| Balance **31/12/05** | 111,590 | (77,000) | (34,590) | | | | |
| **1/1/06** | | | (15,550) | (389,798) | 209,800 | 129,600 | 34,848 |

**2.** **Entries** **20X4** **20X5**

| | | | | |
|---|---|---|---|---|
| Pension Fund Expenses | 105,960 | | 111,590 | |
| Net Pension Asset/Liability | | 105,960 | | 111,590 |
| Net Pension Asset/Liability | 125,000 | | 77,000 | |
| Cash | | 125,000 | | 77,000 |

**3. Schedule of Net Pension Asset/Liability**

| | |
|---|---|
| Balance, ABO | (389,798) |
| Balance, Plan assets | 209,800 |
| Underfunded | (179,998) |
| Unamortized PSC | 129,600 |
| Unamortized Act. G/L | 34,848 |
| Net Pension Assets/Liabilities | (15,550) |

## 1. Pension Worksheet Under Revised IFRS

| | Pension Xp | Cash | OCI | Net Pension Asset/Liab | ABO | Plan Assets |
|---|---|---|---|---|---|---|
| **1/1/04** | | | 216,000 | | (216,000) | |
| Funding | | (20,000) | | | | 20,000 |
| Net Int exp | 11,760 | | 200 | | (12,960) | 1,000 |
| Current service | 51,000 | | | | (51,000) | |
| Funding | | (105,000) | | | | 105,000 |
| Act G/L | | | 34,000 | | (34,000) | |
| Expense Entry, 04 | (62,760) | | 250,200 | (312,960) | | |
| Funding Entry | | (125,000) | | 125,000 | | |
| **Balance, 1/1/05** | | | | **(187,960)** | **(313,960)** | **126,000** |
| Current service | 57,000 | | | | (57,000) | |
| Net Int exp | 11,278 | | 760 | | (18,838) | 6,800 |
| Funding | | (77,000) | | | | 77,000 |
| Expense Entry, 05 | 68,278 | | 760 | (69,038) | | |
| Funding Entry | | (77,000) | | 77,000 | | |
| **Balance, 1/1/06** | | | **34,200** | **(179,998)** | **(389,798)** | **209,800** |

**NOTE:** In this version of the problem, the fund technically began with a zero balance. Therefore the first transaction would be to recognize all past service costs in OCI. Similarly, at the end of 04, the fund recognized the change in the ABO ending balance from a revaluation of $34,000 as given in OCI.

## QUESTION III - Accounting for Income Taxes (18 Marks)

### Section A

Bluehaven Inc., a boat manufacturer located in Sherbrooke, Quebec, adopted PE GAAP upon its incorporation for its accounting policies and accounts for its corporate income tax using the future income tax method. The income tax rate for all years is 30%. In 2010 a loss for tax purposes of $156,000 was incurred of which $126,000 is available to carryforward to future years and it is more likely than not to be fully realized in the loss carryforward period.

The following data for the first two years of operations follow:

| | **2011** | **2012** |
|---|---|---|
| Pretax accounting income | $160,000 | $205,000 |

Amounts giving rise to timing difference between accounting and taxable income:

| | | |
|---|---|---|
| 1) Estimated warranty expense (included in pretax accounting income) for a 3-year warranty | 15,000 | 16,000 |
| Cash payments on warranties for 2011 sales | 10,000 | 2,000 |
| Cash payments on warranties for 2012 sales | 0 | 11,000 |
| 2) Rent revenue collection (2 year lease, is received in advance) | 12,000 | |
| Rent revenue included in accounting income | 6,000 | 6,000 |
| 3) Gross profit on installment sales on delivery basis included in accounting income | 175,000 | 230,000 |
| Gross profit based on cash collections-2011 sales | 65,000 | 110,000 |
| -2012 sales | 0 | 75,000 |
| 4) Fine due to unlawful dumping included in accounting Income, not tax deductible | 35,000 | 0 |

**Required:**

a) Compute income taxes payable for 2011 and 2012 and prepare the appropriate journal entries to record these amounts.

b) For the timing differences identified above, prepare the journal entry/entries required for each year.

c) Prepare the section of the income statement for 2011 and 2012 including Net income before income tax, income taxes, and Net income after income tax.

d) Show how the future tax balance would be shown on the balance sheet as at 2011 year end only.

## Section B

Pharmacorp Inc., experienced a loss in 2010. A permanent difference (a non-tax deductible $16,000 fine) was considered in the calculation of the 2009 taxable income. The company reported taxable income (loss) for 2009 through 2012 as follows:

| | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|
| Taxable income (loss) | $16,000 | ($64,000) | $40,000 | $20,000 |
| Tax rate | 34% | 34% | 37% | 37% |

All tax rates were enacted in 2009. There were no other timing differences or permanent differences in 2009 through 2012. PI reports under PEGAAP, future income tax method.

**Required:**

Prepare the journal entries to record income taxes for the years 2009 through 2012 assuming the company met the requirement of more likely than not to generate sufficient taxable income in the carryforward period.

## SOLUTION: QUESTION III - Accounting for Income Taxes (18 Marks)

### Section A

| A] | 2011 | 2012 |
|---|---|---|
| Accounting income | $160K | $205K |
| Warranty expense | +15K | +16K |
| Warranty paid | -10K | -13K |
| Rent revenue | +6K | -6K |
| Instalment sales- acctng | -175K | -230K |
| Instalment sales-cash | + 65K | +185K |
| Perm difference- fine | +35K | |
| Taxable income before LCF | 96K | 157K |
| Loss carry forward (126K) | (96K) | (30K) |
| Taxable income | 0 | 127K |
| Taxes payable current | 0 | 38.1K (30%) |

**B]**

| | | | | |
|---|---|---|---|---|
| Prov-I/T-C | 0 | | 38.1K | |
| I/T payable | | 0 | | 38.1K |
| ***Use of LCF:*** | | | | |
| Prov-I/T-F (96K*0.3) | 28.8K | | 9K (30K*0.3) | |
| FIT asset | | 28.8K | | 9K |
| ***Warranty:*** | | | | |
| FIT asset (5K * 0.3) | 1.5K | | 0.9K | |
| Prov-I/T-F | | 1.5K | | 0.9K |
| ***Rent:*** | | | | |
| FIT asset (6K*0.3) | 1.8K | | | |
| Prov-I/T-F | | 1.8K | | |
| Prov-I/T –F | | | 1.8K | |
| FIT asset | | | | 1.8K |
| ***Instalment sales*** | | | | |
| Prov-I/T-F (110K*0.3) | 33.0K | | 13.5K | |
| FIT liab | | 33.0K | | 13.5K |

| C) | | | 2011 | | 2012 |
|---|---|---|---|---|---|
| NIBT | | | $160K | | $180K |
| Less taxes: | | | | | |
| | -C | 0 | | 38.1K | |
| | -F | 58.51K | 58.5K | 23.4 | 61.5K |
| NIAT | | | $101.5K | | $143.5K |

**D) PE GAAP- show FIT asset and liability as offsets within classification to current or long-term**

| | FIT asset | FIT liability | |
|---|---|---|---|
| (LCF) 31/12/11= 30K * 0.3 = | 9K (current) | | |
| (warranty) = | 0.6 (long term) | | |
| (warranty) = | 0.9 (current) | | |
| (rent) = | 1.8K (current) | | |
| (install sales) = | | 33K (current) | |
| | 11.7K (current) | 33K (current) | = net liab 21.3K |
| | 0.6K (long term) | 0 | = net asset 0.6 |
| Total | 12.3K | 33K | = net liab 20.7K |

## Section B

| | | | |
|---|---|---|---|
| 2009 | Prov.-I/T- C (16K*0.34) | $5,440 | |
| | Income tax payable | | $5,440 |
| 2010 | I/T recoverable (16K * 0.34) | $5,440 | |
| | FIT asset (48K * 0.37) | 17,760 | |
| | Prov-I/T-F | | $23,200 |
| 2011 | Prov-I/T- F (40K * 0.37) | $14,800 | |
| | FIT asset | | $14,800 |
| 2012 | Prov-I/T- F (8K * 0.37) | $2,960 | |
| | FIT asset (8 * 0.37) | | $2,960 |
| | Prov- I/T – C (12K *0.37) | $4,440 | |
| | I/T payable | | $4,440 |

## QUESTION IV - Accounting for Leases (16 Marks)

Concord Corporation leased a construction crane to Vanier Construction on January 1, 2011. The following information relates to the lease agreement and the leased asset:

| | |
|---|---|
| Cost of the crane | $100,000 |
| Concord's normal selling price for similar cranes | $146,913 |
| Useful life of the crane | 10 years |
| Lease term | 7 years |
| Estimated salvage value | $ 4,000 |
| Estimated residual value at the end of the lease (**unguaranteed**) | $ 10,000 |
| Lease instalment, **payable December 31** | $ 31,200 |
| Lessor's implicit rate known to the lessee | 12% |
| Lessee's incremental borrowing rate | 15% |

The crane will revert back to the lessor at the end of the lease term, title does not pass at anytime to the lessee, and there are no options for a bargain purchase. Both companies use the straight-line amortization method, both have December 31 year ends and both have adopted IFRS. The lessor agrees to bear all executory costs

**Required:** Preparing an amortization table for the lease would help you answer these questions more accurately. Use the information given above, **unless indicated otherwise**, to answer the following EIGHT (8) questions. Where Journal Entries are asked for but in your opinion, they are not necessary, you are required to state that specifically as part of your answer.

1. Classify the lease from the viewpoint of both corporations giving specific reasons for your answer.

2. Prepare all related journal entries for the lease as at January 1, 2011 for -
   (a) the lessor corporation;
   (b) the lessee corporation.

3. Prepare all related journal entries for the lease as at December 31, 2011 for -
   (a) the lessor corporation;
   (b) the lessee corporation.

4. Prepare the entry for the lessee upon the end of the lease period. However, assume the entry for the payment of the lease instalment has already been made and that is not required.

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**Questions 5-6, and 7, 8 are independent of each other**

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5. Assume for this **Question and Question 6 ONLY** that the lease agreement contained a guarantee from the lessee for the market value of the leased asset being returned to be $10,000. Determine the amount at which the lease will be capitalized on January 1, 2011 by the
   a] lessee.
   b] lessor.

6. In **Question 5** above, prepare the entry required to be made by the lessee upon the return of the crane at the end of the lease term, assuming that the market value was $7,200.

7. Assume for this **Question ONLY**, that the lease agreement contained an option for the lessee to

purchase the asset at a bargain price of $10,000. Determine the amount

a) at which the crane under lease would be capitalized on January 1, 2011 by the lessee.
b) at which the lease will be capitalized [net investment in the lease of the crane] on January 1, 2011 by the lessor.
c) of the amortization on the leased asset which will be recorded by the lessee on December 31, 2011.

8. Assume for this **Question ONLY** that both parties followed PE GAAP and also that leasing to the lessee was a high credit risk for the lessor. Prepare the entry/entries necessary for
   a) the lessor on January 1, 2011 and on December 31, 2011;
   b) the lessee on January 1, 2011 and on December 31, 2011.

## SOLUTION: QUESTION IV - Accounting for Leases (16 Marks)

1. Satisfies: a) Lease covers major part of asset's useful life:
7/10 years = 70%

b) PV of MLP is substantially all of the fair value
$31,200× 4.56376/$146,913 = 97%

Concord [Lessor] should classify the lease as a Manufacturer/Dealer type lease;
Vanier [Lessee] should classify the lease as a Finance type lease.

2. a)

| | | |
|---|---|---|
| Lease Property Receivable | 146,913 | |
| Cost of goods sold [100,000 - 4524] | 95,476 | |
| Sales [146,913 - 4,524] | | 142,389 |
| Inventory | | 100,000 |

OR

| | | |
|---|---|---|
| GIL | 228,400 | |
| Cost of goods sold [100,000 - 4524] | 95,476 | |
| Sales [146,913 - 4,524] | | 142,389 |
| Inventory | | 100,000 |
| Unearned interest | | 81,487 |

b) Lessee capitalizes the lease at $142,389 [$31,200× 4.56376]

| | | |
|---|---|---|
| Leased Equipment | 142,389 | |
| Lease Obligation | | 142,389 |

3. **Lessor:**

| | | |
|---|---|---|
| Cash | 31,200 | |
| Interest revenue | | 17,630 |
| Lease Property Receivable | | 13 ,570 |

| | | |
|---|---|---|
| Cash | 31,200 | |
| Unearned interest | 17,630 | |
| Interest revenue | | 17,630 |
| GIL | | 31,200 |

**Lessee:**

| | | |
|---|---|---|
| Interest Xp [0.12 x 142,389] | 17,087 | |
| Lease obligation | | 14,113 |
| Cash | | 31,200 |

| | | |
|---|---|---|
| Amortization Xp | 20,341 | |
| Acc. Depreciation [Leased Equipment] | | 20,341 |

[$142,389/7]

4. The leased crane is returned. No Journal Entry.

OR

| | | |
|---|---|---|
| Acc. Depreciation | 142,389 | |
| Leased Equipment | | 142,389 |

5. a] Lessee will capitalize the property at $146,913 [142,389 + 4,524] which would include the present value of the guaranteed salvage value.

b] There will be no difference in the amount capitalized by the lessor.

6.

| | | |
|---|---|---|
| Lease Obligation | 10,000 | |
| Leased Equipment | | 10,000 |
| | | |
| Loss on Leased Equipment | 2,800 | |
| Cash | | 2,800 |

7. a] Lessee will capitalize the property at $146,913 [142,389 + 4,524] which would include the present value of the guaranteed salvage value.

b] There will be no difference in the amount capitalized by the lessor.

c] The amortization Xp recorded would now be $14,691 [146,913/10]

8. a] **Lessor**

January 1 - No Journal Entry

| | | |
|---|---|---|
| December 31 | | |
| Cash | 31,200 | |
| Rent revenues | | 31,200 |

b] **Lessee**

January 1 - No Journal Entry

| | | |
|---|---|---|
| December 31 | | |
| Rent expenses | 31,200 | |
| Cash | | 31,200 |

## QUESTION V - Earnings Per Share (18 Marks)

### Section A

Simple Solutions, Inc., reported the following capital structure on January 1, 2X11:

- 500,000 **common shares** authorized; 250,000 issued and outstanding;
- 10,000 non-cumulative **Preferred Shares A**, issued and outstanding; each share entitled to dividends of $3.00 per annum;
- 100,000 $100 cumulative **Preferred Shares B**, issued and outstanding, entitled to dividends of 4% per annum; and
- **Retained Earnings** $3,455,000

During the year, the company reported the following equity transactions:

March 11, 2011 - declared and issued a 2-for-1 stock split;
July 1, 2011 - issued 70,000 additional common shares;
September 1, 2011 - repurchased 60,000 common shares in the market and cancelled them;
October 1, 2011 - issued 30,000 common shares to the public.

The company reported a net income of $3,300,000 and was subjected to a 25% tax rate. Simple Solutions declared dividends totaling $500,000 on December 15, 2010 and payable on January 15, 2011. No dividends were declared for 2011.

### Required:

Calulate the basic EPS which Simple Solutions must report for the year 2X11. Indicate and identify clearly in your answer, the income effect and the weighted average shares for the year, required for your computation.

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**Section B**

At the end of 20X2, the records of Great Accounting Solutions, Inc., (**GAS**), (which reports under IFRS) showed the following:

- Common shares, authorized 500,000 shares, issued and outstanding 200,000 shares, average market price in 20X2 was $14.00 per share.
- A 10% common stock dividend was distributed to shareholders on November 1, 20X2.
- 5%, Non-cumulative Preferred stock-class A- 10,000 shares, par $100, and each convertible into 7 common shares, outstanding throughout the year.
- 6%, Cumulative and non-convertible Preferred stock-class B- 20,000 shares, par $100, outstanding throughout the year.
- Bonds payable, Series A- 5%, $100,000 at par, each $1,000 bond is convertible to 27 shares of common stock, due 20X6.
- Bonds payable, Series B- 7%, $500,000, each $1,000 bond is convertible to 80 shares of common stock, due 20X5, book value of bonds payable at end of 20X1 = $515,000 to yield 6.5%.
- Dividends on all shares were declared and paid during the year.
- Options, Series A, to purchase **GAS**' common stock outstanding during the year on 10,000 shares for $15 each.
- Options, Series B, to purchase **GAS**' common stock outstanding during the year on 21,000 shares for $12 each.
- Average tax rate for 20X2 = 40%.
- Net income after tax for 20X2 was $302,000.

**Required:** Ignore the equity component of the conversion option for the bonds..

a) Determine the basic EPS for the company for the year, 20X2.

b) Show in a well formatted schedule the income effect, share effect, and the incremental EPS for each of the aforementioned securities that is convertible into common shares. Rank each security by order of its dilutiveness and indicate if it is dilutive (D) or non-dilutive (ND) for purposes of calculating the diluted EPS.

c) Determine **GAS**' diluted EPS for the year ended December 31, 20X2.

## SOLUTIONS: QUESTION V - Earnings Per Share (18 Marks)

### Section A

| Date | Activity | Shares`O/S | Period Factor | Split | Average |
|---|---|---|---|---|---|
| Jan. 1–Mar. 1 | Opening balance | 250,000 | 2/12 | 2 | 83,333 |
| Mar 1 - July 1 | | 500,000 | 4/12 | | 166,667 |
| July 1 - Sept 1 | Issued 70,000 shares | 570,000 | 2/12 | | 95,000 |
| Sept 1 - Oct.1 | Repurchased 60,000 shares | 510000 | 1/12 | | 42,500 |
| Oct. 1 - Dec. 31 | Issued 30,000 shares | 540000 | 3/12 | | 135,000 |
| Weighted Average Number of Common Shares | | | | | 522,500 |

### ALTERNATE

| Date | Activity | Shares`O/S | Period Factor | Split | Average |
|---|---|---|---|---|---|
| Jan. 1 | Opening balance | 250,000 | 1 | | 250,000 |
| Mar 1 | Split | 250,000 | 1 | | 250,000 |
| July 1 - Sept 1 | Issued 70,000 shares | 70,000 | 0.5 | | 35,000 |
| Sept 1 - Oct.1 | Repurchased 60,000 shares | 60000 | 0.333333 | | (20,000) |
| Oct. 1 - Dec. 31 | Issued 30,000 shares | 30000 | 0.25 | | 7,500 |
| Weighted Average Number of Common Shares | | | | | 522,500 |

Income Available To Common Shareholders:

| | |
|---|---|
| Net Income, 2011 | $3,300,000 |
| Noncumulative Preferred Shares Dividends A | -0- |
| Cumulative Preferred Shares Dividends [100,000 x 100 x0.04] | (400,000) |
| Available To Common Shareholders | $2,900,000 |

Basic EPS [2,900,000/522,500] $5.55

### Section B

a) Income Available To Common Shareholders:

| | |
|---|---|
| Net Income, 2011 | $302,000 |
| Noncumulative Preferred Shares Dividends [1,000,000 x 0.05] | (50,000) |
| Cumulative Preferred Shares Dividends [2,000,000 x 0.06] | (120,000) |
| Available To Common Shareholders | $132,000 |
| | |
| Weighted Average Number of Common Shares | 200,000 |
| | |
| **Basic EPS [132,000/200,000]** | **$0.66** |

**b) Incremental EPS**

| Potential Dilutive Securities | Income Effect | Share Effect | Incremental EPS | Rank |
|---|---|---|---|---|
| Convertible Preferred Shares | $1,000,000 × 5% = $50,000 | (10,000 x 7) = 70,000 | $50,000 / 70,000 = $0.71 | AD |
| Stock Options A | Exercise price ($15.00) > average market price ($14.00) | NA | therefore antidilutive | AD |
| Stock Options B | -0- | 21,000(1 – $12/$14) = 3,000 | -0- | 1D |
| Convertible Bonds A | ($100,000 × .05) × (1 – 40%) = $3,000 | $100,000 / $1,000 × 27 = 2,700 shares | $3,000 / 2,700 = $1.11 | AD |
| Convertible Bonds B | ($515,000 × .065) × (1 – 40%) = $20,085 | $500,000 / $1,000 × 80 = 40,000 shares | $20,085 / 40,000 = $0.50 | 2D |

**c) Diluted EPS:**

| | Income | Shares | EPS |
|---|---|---|---|
| Basic EPS | 132,000 | 200,000 | 0.66 |
| Stock Option B | -0- | 3,000 | |
| | 132,000 | 203,000 | $0.65 |
| Bonds B | 20,085 | 40,000 | |
| **Diluted EPS** | **152,085** | **243,000** | **$0.63** |

Both Convertible Bonds A and Stock Options A are antidilutive and are excluded.