

**John Molson School of Business  
Department of Accountancy  
ACCO 320 – Financial Reporting II  
Prof. Christopher Benk, Dr. Darlene Himick, Dr. Kelly F. Gheyara  
Midterm Examination, Winter 2014  
Friday, February 28, 2014**

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

		Estimated time	Marks
Question I	Multiple Choice	42 minutes	28 Marks
Question II	Transaction I	27 minutes	18 Marks
	Transaction II	51 minutes	34 Marks
	Transaction III	30 minutes	20 Marks
	Transaction IV	<u>30 minutes</u>	<u>20 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 5 Questions and 14 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 - 28 Marks**

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

**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. Sportzer Bikes approached its bank, Bank of Notre Dame, sometime late in 2012 for negotiations on its loan. The loan consisted of a 10%, 4-year note payable [Note A], dated January 1, 2010 for an amount of \$190,000. The parties agreed to the following revised terms, applicable to years 2013 and 2014:

- the principal payable was reduced to \$150,000 [Note B] and was due December 31, 2014; and
- the annual interest payments are to be reduced to 6% of the revised principal for the years, 2013 and 2014; and
- the current market rate was determined to be 9% .

What would be the amount recorded by Sportzer on its books as notes payable, on January 1, 2013?

- a. \$150,000
- b. **\$153,446**
- c. \$151,983
- d. \$160,000
- e. none of the above but \$ \_\_\_\_\_ .

2. A convertible bond issue, par value of \$7,000,000 , with remaining unamortized premium of \$898,000 and a balance of \$1,800,000 in the Contributed Surplus - Conversion account was converted according to the terms of the bond indenture, by the issuing of 360,000 common shares. Each share, with an average cost of \$21, was currently being quoted in the market at \$27. What would be the gain or loss to be recorded on the conversion?

- a. **No gain or loss is to be recorded.**
- b. \$2,160,000 gain.
- c. \$22,000 loss.
- d. \$2,160,000 loss.
- e. None of the above but \$ \_\_\_\_\_ .

3. Nukes, Inc., is being sued for illnesses caused to local residents resulting from the negligence on the company's part in permitting the local residents to be exposed to highly toxic chemicals from its plant. Nukes' lawyer holds the opinion that it is likely the company will lose the suit and thus be held liable for a judgement. A reasonable estimate of the award to the plaintiff is between \$700,000 and \$4,000,000, with respective probabilities of 30% for \$700,000, 60% for \$1,500,000 (the most likely amount), and 10% for \$4,000,000. As a result of the above facts, **under IFRS**, Nukes should accrue

- a. a loss contingency of \$210,000 and disclose an additional contingency of up to \$3,790,000.
- b. a loss contingency of \$1,500,000 and disclose an additional contingency of up to \$2,500,000.
- c. a loss contingency of \$700,000 and disclose an additional contingency of up to \$3,300,000.
- d. **a loss contingency of \$1,510,000 and disclose in notes an additional contingency of up to \$2,490,000.**
- e. no loss contingency but disclose in notes a contingency of \$700,000 to \$4,000,000.
- f. None of the above but \_\_\_\_\_ .

4. An asset retirement obligation should be recognized when
  - a. an asset is impaired or when it is available for sale.
  - b. operation of an asset has resulted in an additional obligation such as the cost of cleaning up an oil spill.
  - c. **there is a legal obligation to make expenditures to restore the site of the asset at the time of closure.**
  - d. an obligation exists to purchase a long-lived asset.
  - e. None of the above but \_\_\_\_\_ .

**Use the information stated below to answer Questions 5 and 6. Each Question is independent of the other.**

On January 1, 2013, Marbles Inc., reported its shareholders' equity as follows:

Common shares, no par value, authorized 400,000 shares	
issued and outstanding 150,000 shares	\$1,350,000
Contributed Surplus	150,000
Retained earnings	<u>700,000</u>
Total shareholders' equity	<u>\$2,200,000</u>

5. On March 1, 2013, it declared a 12% stock dividend on its common shares when the market value of the common shares was \$30 per share. The effect on Marbles' shareholders' equity as a result of the above transaction would be
  - a. Retained earnings **decrease** \$162,000; Common shares **increase** \$162,000.
  - b. Retained earnings **decrease** \$540,000; Common shares **increase** \$162,000; Contributed Surplus **increase** \$378,000.
  - c. Retained earnings **decrease** \$390,000; Contributed Surplus **decrease** \$150,000; Common shares **increase** \$540,000.
  - d. Retained earnings **decrease** \$540,000; Common shares **increase** \$540,000.
  - e. None of the above but \_\_\_\_\_ .
  
6. Ignore the transaction in [5] above. Now assume that on March 1, 2013, the company purchased in the market, 12% of its issued and outstanding shares and cancelled them. The market value of the common shares on that date was \$30 per share. The effect on Marbles' shareholders' equity as a result of the above transaction would be
  - a. Retained earnings **increase** \$378,000; Common shares **decrease** \$162,000.
  - b. Common shares **decrease** \$162,000, Contributed Surplus **decrease** \$150,000; Retained earnings **decrease** \$228,000
  - c. Retained earnings **decrease** \$540,000.
  - d. Common shares **decrease** \$390,000; Contributed Surplus **decrease** \$150,000.
  - e. None of the above but \_\_\_\_\_ .
  
7. The preemptive right refers to the shareholder's right to:
  - a. veto the management's decision to not declare a dividend.
  - b. vote for members of the board of directors.
  - c. receive a share of dividends.
  - d. share in profits proportionally with all other stockholders.
  - e. **none of the above actions.**



12. Moscow Oil Company, Inc., reported the following equity balances on December 31, 2012:

Common Shares, 8,000 shares issued and outstanding	\$312,000
Contributed surplus	18,000
Retained Earnings	847,000

During 2013, it entered into 4 equity related transactions in the chronological order as stated.

Day 1 - Declared a 10% cash dividend but not yet paid.

Day 2 - Acquired 500 shares at \$78 each and cancelled them.

Day 3 - Issued 200 shares when the market value was \$67 each in exchange for a plot of land which had been appraised at \$10,000 by the local town municipality only for property tax purposes.

Day 4 - Issued a 6% stock dividend when the shares were being quoted at \$65.

After recording these transactions, determine the balances of the three equity accounts which the company would report on December 31, 2013, assuming it had a zero net income.

- a. **Common Shares \$335,930; Contributed surplus \$0; Retained Earnings \$784,270.**
- b. Common Shares \$309,130; Contributed surplus \$0; Retained Earnings \$846,670.
- c. Common Shares \$289,630; Contributed surplus \$18,000; Retained Earnings \$787,270.
- d. Common Shares \$374,930; Contributed surplus \$0; Retained Earnings \$764,770.
- e. None of the above but Common Shares \$ \_\_\_\_\_; Contributed surplus \$ \_\_\_\_\_; Retained Earnings \$ \_\_\_\_\_.

13. Which of the following statements is **INCORRECT** regarding the recording of the related increase or accretion in the carrying amount of an asset retirement obligation (ARO)?

- a. **Under private enterprise standards, it is recognized as interest expense.**
- b. Under private enterprise standards, it is recognized as an operating expense (but not as interest expense).
- c. Under IFRS, it is recognized as a borrowing cost.
- d. The amount should be calculated using the same discount (interest rate) as was used to calculate the initial present value of the ARO.

14. When non-par value shares are reacquired at a cost greater than their average issue price and cancelled, what account(s) should be debited?

- a. The share account for the total cost.
- b. **The share account for the average issue price, contributed surplus for the additional amount, and lastly retained earnings for any remaining amount.**
- c. The share account for the average per share amount, retained earnings for the additional amount, and lastly contributed surplus for any remaining amount.
- d. The share account for the average per share amount and a loss account for the additional amount

15. Chokolade, Inc., issued 2,000 common shares and 6,000 preferred shares for a lump sum of \$150,000. The fair market value of each share on the date of issue was \$12 per common share and \$16 per preferred share. How much of the proceeds received should be allocated to the common and preferred shares respectively on the date of issue?

- a. Common: \$24,000; Preferred: \$126,000.
- b. Common: \$150,000; Preferred: \$0.
- c. Common: \$54,000; Preferred: \$96,000.
- d. Common: \$37,500; Preferred: \$112,500.
- e. None of the above but **Common: \$30,000; Preferred: \$120,000.**



## QUESTION II - Transactional Situations - 92 Marks

### Transaction I - 18 Marks

The following situation sums up a debt restructuring effort and you are required to help out with the case.

#### Situation:

Tsang Corporation is currently facing bankruptcy and so has negotiated a revised debt agreement with Shenzhen International Bank. Tsang's current debt consisting of a \$600,000, 10-year, 12% note, issued at par, is coming due at the end of the current year. So it is being refinanced with a \$600,000 10-year, 5% note. Assume the market rate of interest is 14% at the refinancing date. Both Tsang and Shenzhen Bank prepare financial statements in accordance with IFRS.

#### REQUIRED:

- (a) Firstly, determine if the revision to the debt should be accounted for as a **settlement** (major restructure), or as a **modification** (minor restructure) of the old debt. Show clearly your computations to support your answer.
- (b) Prepare the journal entry, *in proper format*, to record the transaction in the books of Tsang, the debtor.
- (c) Similarly, prepare the journal entry, *in proper format*, to record the transaction in the books of Shenzhen, the creditor.

### Transaction II - 34 Marks

#### Situation:

ChemKleen, Inc., is a major company in the industrial cleaning and reconstruction industry. It had recently acquired and had installed four underground storage containers on land donated by the provincial government, located south of Montreal. These containers or tanks were placed into operation, at a total cost of \$440,000 on January 1, 2012. Since the tanks were to be used for the storage of liquid chemicals which were of a hazardous nature, the provincial government regulated their use. The company was required to extract these tanks from their underground location at the end of their useful life, dispose them securely and restore the land surface to its natural status. The company estimates that the cost of these operations after the end of their useful lives of 10 years would approximate \$112,000. It also decided to use a discount rate of 6% per year.

On January 1, 2022, the company accepted a quotation from Reliance Restorators, Inc., to dismantle and remove the equipment, and clean up the site. Their bid for the job was for a total payment of \$176,900.

*[Question Continued on next page]*

The company also manufactures commercial cleaning equipment which it sells to large laundry and clothing operators. During 2012, it sold 40 machines at \$12,000 each. These machines carry a three-year warranty on on-site parts and labor, commencing from the date of sale. Similar warranties are available from independent agents for \$970 each. You are to assume that the sales occurred uniformly throughout the year and any revenues related to such warranties were earned evenly over the two-year term as follows: 2012 - 10%; 2013 - 60% and 2014 - 30% . The total cost of servicing these warranties for the units sold in 2012 was estimated to amount to \$10,800 over the two-year term of the contracts. The company incurred actual warranty related costs of \$2,700 in 2012.

**Required:**

Prepare all answers and entries under the assumption that the company has adopted IFRS unless specifically mentioned otherwise).

- a] Record the costs incurred which are associated with the asset restoration obligation on January 1, 2012 upon the installation of the storage containers.
- b] Assuming straight-line depreciation and zero residual value, show how the balance in the Storage Containers Account will be presented on the Balance Sheet ending December 31, 2014.
- c] Determine the amount reported as the balance in the Asset Retirement Obligation Account as at December 31, 2014.
- d] The dismantling and cleanup under the contract agreed upon on January 1, 2022 was completed and the contractor was paid under the terms of the agreement. Record this transaction.
- e] For this **question only**, assume that the company estimates incurring additional restoration costs in the future, arising from the operating process for 2013. Assume these costs were to accrue as at December 31, 2013 and are to be recorded on that date. The costs amounted to \$18,000. The company recorded these costs at the end of the year. Assume the company **had adopted ASPE**. Record the transaction.
- f] Prepare all required warranty related journal entries for the sales in 2012, assuming the company **used the Expense Approach**.
- g] Prepare all required warranty related journal entries for 2012, assuming the company **used the Revenue Approach**.

### **Transaction III - 20 Marks**

#### **Situation:**

Sochi, Inc., is a company that manufactures sporting equipment for athletes. Since its incorporation in early 1996 with an authorized capital of 20,000,000 common shares and 8,000,000 preferred shares, it has grown very rapidly. However due to a major expansion plan, it last declared dividends in 2010. It has reported a net income of \$11,000,000 for the year 2012.

The company reported the following shareholders' equity on January 1, 2013:

Preferred Shares, 8%, \$50 par value, 140,000 shares issued, Cumulative and participative	\$ 7,000,000
Common Shares, 300,000 shares issued	60,000,000
Contributed surplus-common shares	3,700,000
Retained earnings	8,800,000

The following transactions with respect to the company's equity occurred during the year, 2013:

January 15 Declared dividends such that the common shares were to receive dividends of \$6 per share. Preferred shares would participate in dividend distributions in excess of \$4 per share.

March 1 The company had outstanding, \$4,000,000 bonds payable at par. It called in these bonds and in exchange, issued common shares. Each \$1,000 bond received 5 common shares which were being traded in the market at \$240 each on that day. The bonds were retired by the company.

April 30 The company declared and distributed a 10% stock dividend on all common shares outstanding. The market value of a common share is \$230 on this date.

June 30 Since the company was holding a significant amount of cash, it decided to repurchase in the market, 23,000 shares at \$260 each. The shares were immediately cancelled.

December 1 A two-for-one stock split was declared for common share capital and the share certificates were issued.

#### **Required (SHOW ALL WORK):**

1. Determine the amount of dividends which the company would have to declare for each group of shareholders. Show detailed working of the distribution in a well organized schedule.
2. Prepare all required journal entries necessary to record the transactions on the five dates stated above. Where an entry is not required, specify what alternate action is to be taken.

## **Transaction IV - 20 Marks**

### **Situation:**

Delhi Electronics and Lighting, Ltd., [DELL] issued \$6,000,000 par value, 16-year 8% bonds on July 1, 2011 at 103. To help the sale succeed, detachable stock warrants were issued with the bonds at the rate of eight warrants for each \$1,000 bond. Each warrant entitles its owner to acquire one common share at \$70 cash. Similar bonds without the warrants were being traded in the market at 95. The warrants are estimated to have a market value of \$420,000. The convertible bonds with the warrants were issued at 103. The bonds were also convertible and each \$1000 bond could be converted into 15 shares. The company uses *private enterprise GAAP* to record both the liability and equity components. It amortizes the bond discount on a straight line basis.

On January 1, 2012, after the payment of interest due, the company converted 40% of the bonds into equivalent shares. On that date, these shares were being traded at \$65 each.

On March 1, 25% of the warrants were exercised.

**Required:** Prepare appropriate journal entries, in proper format, to record

1. The issue of the bonds on July 1, 2011.
2. The conversion of the bonds on January 1, 2012.
3. The exercise of the warrants on March 1.

**SOLUTION: QUESTION II - 92 Marks**

**Transaction I (18 Marks)**

- (a) First, determine the economic substance of the debt renegotiation to see if this should be accounted for as a **settlement** or a **modification/exchange**. In this case, since the creditor is the same, the test to establish whether there is a settlement or not, depends on the cash flows. The present value of the cash flow streams of the new debt are calculated **using the historical interest rate of 12%** for consistency and comparability.

Pre-restructure carrying amount		\$600,000
Present value of restructured cash flows of the revised debt:		
\$600,000 due in 10 years at 12%, interest payable annually; (\$600,000 X .32197)	\$193,182	
\$30,000 interest payable annually for 10 years at 12% (\$30,000 X 5.65022)	<u>169,507</u>	<u>(362,689)</u>
Difference representing loss on restructure for Shenzhen		<b><u>\$237,311</u></b>

As the present value of the new debt is more than 10% different from the present value of the old debt (using the original rate), **this is a substantial change** and the transaction is accounted for as a **settlement** by Perkins and **new debt is recorded**.

For Tsang, the new debt is recorded at the present value of the new cash flows using the current market interest rate of 14%.

Pre-restructure carrying amount		\$600,000
Present value of restructured cash flows:		
\$600,000 due in 10 years at 14%, interest payable annually; (\$600,000 X .26974)	\$161,844	
\$30,000 interest payable annually for 10 years at 14% (\$30,000 X 5.21612)	<u>156,484</u>	<u>(318,328)</u>
Difference representing gain on restructure for Tsang		<b><u>\$281,672</u></b>

(b) **Journal Entries - Tsang**

Notes Payable A	\$600,000	
Gain on Restructuring of Debt		281,672
Notes Payable B		318,328

**Journal Entries - Shenzhen**

Bad Debt (OR Allowance FDA)	\$237,311	
Notes Receivable A		\$237,311

**Transaction II - (34 Marks)**

- a] **To record the costs incurred which are associated with the asset restoration obligation on January 1, 2012 upon the installation of the storage containers.:**  
 [The present value of \$112,000 due in 10 years at 6% per year discount rate]  
 $112,000 \times 0.55839 = \$62,540$

Storage Containers	62,540	
Asset Retirement Obligations		62,540

- b] **Assuming straight-line depreciation and zero residual value, show how the balance in the Storage Containers Account will be presented on the Balance Sheet ending December 31, 2014.:**

**Depreciation for 3 Years:**  
 $[(\$440,000 + \$62,540)/10] \times 3 \text{ Years} = \$150,762$

**Balance Sheet Presentation, December 31, 2014:**

Storage Containers at cost,	\$502,540	
Less: Accu. Depreciation	<u>(150,762)</u>	\$351,778

- c] **Determine the amount reported as the balance in the Asset Retirement Obligation Account as at December 31, 2014.**

Asset retirement obligation (ARO), Jan 1, 2012 + Compounded Interest for 3 years, 6 years:  
 $[62,540 \times 1.19102] = \$74,486 \text{ CR } \underline{\text{OR}}$

$(62,540 \times 1.06)$	\$66,292.4
$(66,292.4 \times 1.06)$	\$70,269.9
$(70,269.9 \times 1.06)$	\$74,486.14 CR

- d] **The dismantling and cleanup under the contract agreed upon on January 1, 2022 was completed and the contractor was paid under the terms of the agreement. Record this transaction.**

Asset Retirement Obligations	112,000	
Loss on Settlement of ARO	64,900	
Cash		176,900

- e] **Assume that the company estimates incurring additional restoration costs in the future, arising from the operating process for 2013. Assume these costs were to accrue as at December 31, 2013 and are to be recorded on that date. The costs amounted to \$18,000. Record these costs at the end of the year. Assume the company had adopted ASPE**

[Present value of estimated clean up costs of \$18,000 at 6% per year in 8 periods]  
 $\$18,000 \times 0.62741 = \$11,293.$

Storage Containers	11,293	
Asset Retirement Obligations		11,293

[NOTE: Also Please accept: Present value of estimated cleanup costs of \$18,000 at 6% per year in 9 periods.  $\$18,000 \times 0.59190 = \$10,654.$ ]

f] Warranty related journal entries for the sales in 2012, assuming the company used the Expense Approach

Warranty expenses	10,800	
Estimated warranty liabilities		10,800
Estimated warranty liabilities	2,700	
Misc. A/Cs (Cash, Invty, etc.)		2,700

g] Warranty related journal entries for 2012, assuming the company used the Revenue Approach.

Cash or A/R	38,800	
Warranty revenues		3,880
Unearned warranty revenues		34,920
Warranty expenses	2,700	
Misc. A/Cs (Cash, Invty, etc.)		2,700

### Transaction III - 20 Marks

#### 1] Distribution Of Dividends

Item		Preferred	Common	Total Available
Preferred Arrears ( $\$7,000,000 \times 0.8$ ) x 2		1,120,000		1,120,000
Current Dividend Preferred ( $\$7,000,000 \times 0.8$ )		560,000		560,000
Current Dividend Common [ $\$4 \times 300,000$ ]			1,200,000	1,200,000
Distribute Surplus: ratio		70,000	600,000	670,000
<b>Total Dividends Distributed</b>		<b>1,750,000</b>	<b>1,800,000</b>	<b>3,550,000</b>

$[(600,000/60,000,000)) \times 7,000,000)$

2] ✓ Retained Earnings	3,550,000	
Preferred Dividends Payable		1,750,000
Common Dividends Payable		1,800,000
✓ Bonds Payable	4,000,000	
Loss on Retirement of bonds payable	800,000	
Common shares $[4,000 \times 5 \times \$240]$		4,800,000
✓ Retained Earnings	7,360,000	
Common shares		7,360,000
$[(300,000 + 20,000) \times 0.1 \times \$230]$		

✓ Common shares [205 x 23,000]	4,715,000	
Contributed surplus	1,265,000	
Cash		5,980,000

**Avg. Cost [(60,000K + 4,800K + 7,360K)/(300K + 20K + 32K)]: \$205**

- ✓ **No JE - Just A Memorandum Entry**  
**2:1 stock-split; 658,000 shares issued in lieu of 329,000 shares**

**Transaction IV - 20 Marks**

Cash (\$6,000,000 x 103)	6,180,000	
Bonds Payable (\$6,000,000 x 0.95)		5,700,000
Contributed Surplus - Warrants [Given]		420,000
Contributed Surplus - Conversion [Residual]		60,000

Bonds Payable	2,283,750	
Contributed Surplus - Conversion [60,000 x 0.4]	24,000	
Common Shares [Book Value]		2,307,750

**Net Amortized Costs, Bonds [(5,700,000 x 0.4) + (300,000/32) x 0.4]**

Cash (6,000 x 8 x \$70 x 0.25)	840,000	
Contributed Surplus - Warrants [420,000 x 0.25]	105,000	
Common Share Capital		945,000