

**Intermediate Accounting – BUSI450 – Midterm Exam #2**  
**Wednesday, November 6, 2013 - 6:30PM – 8:30PM**

Family name (**PRINT**): \_\_\_\_\_ Check if:  Online

First/called name (**PRINT**): \_\_\_\_\_

Student number: \_\_\_\_\_

1. Do not start until told to do so. Stop writing when told to do so otherwise a penalty will apply.
2. Manage your time. Times provided are estimates. **Bring a time piece to the exam.** Times may not be provided or posted.
3. No electronic devices are permitted to be visible except for calculators (non-programmable), including, but not limited to, cell phones, electronic dictionaries, and personal digital assistants.
4. This is a CLOSED BOOK examination. Present value tables will be available. If a financial calculator is used, the variables applied must be indicated.
5. **All answers are to be written in the space provided.** You may use the margins or the back of the pages for any scratch work. Anything written outside of the space provided **will NOT be marked.**
6. If the exam paper is taken apart, it **must** re-stapled – in sequence; otherwise a penalty will apply. **Bring a stapler** if you think taking apart the exam will assist.
7. Marks are awarded for proper written English, where applicable.
8. Round all calculations to the nearest dollar except EPS. **Round EPS to two decimal places.**

**Scope: Earnings-Per-Share, Corporate Taxes, Leases**

#	Area/Time estimate minutes	Marks/Min	Achieved
1	Lease reporting	10/30	
2	Earnings-Per-Share	10/40	
3	Income Taxes	16/50	
	Bonus	2	
	Total	38/36/120	

**Question #1 ( marks)**

Po-Co Limited (PCL), a December 31 year-end private company applying ASPE, leased a specialized German manufactured equipment from Tri-City Leasing Limited (TCL).

The terms are as follows:

PCL's lease quote from TCL: Payments of \$78,341 beginning each lease year with the first payment due at the time of signing

Lease term: 7 years

Estimated useful life: 10 years

Lease start date: September 30, 2012

Purchase option at the end of lease: \$100,000; well below estimated future market value for such high re-sale equipment

Included in the payments above is \$6,000 for annual maintenance package.

PCL's incremental cost of capital is 12% and estimated fair value of the equipment is \$420,000.

**Required #1**

Applying all of the appropriate standards with any supporting numeric analysis, determine if this is a capital or operating lease in the hands of PCL.

Private Enterprise standards have numeric thresholds; any one met will require capital lease treatment:

1. Does title transfer or is there a Bargain Purchase Option? – YES
2. Does the lease term exceed 75% of the assets useful life? – 7/10 – NO
3. [PV of lease payments + BPO] > 90% FMV - \$415,000/420,000 = 98.8% - YES

Calculator: [BGN] PMT=\$72,341; i = 12%; n = 7; FV = 100,000; CMP PV = \$415,000

Tables: [annuity due for payments; single sum for BPO]

Minimum lease payments: (\$78,341 - \$6,000) = \$72,341 x 5.11141 = \$369,765

PV of BPO: \$100,000 x .45238 = \$ 45,238

(rounding) \$415,003

<b>1 1/2</b>
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**Required #2**

Prepare entries required at September 30, 2012 and December 31, 2012 for PCL.

**September 30:**

<b>Dr. Assets under capital lease.....</b>	<b>\$415,000</b>	
<b>Cr. Lease liability.....</b>	<b>\$415,000</b>	<b>1</b>

<b>Dr. Lease liability.....</b>	<b>\$72,341</b>	
<b>Dr. Prepaid maintenance.....</b>	<b>6,000</b>	
<b>Cash.....</b>	<b>\$78,341</b>	<b>1</b>

**December 31**

**Dr. Depreciation expense ( $\$415,000/10$ ) x 3/12 ...\$10,375**  
**Cr. Accumulated depreciation.....\$10,375** **1**

**Dr. Maintenance expense ( $\$6,000$  x 3/12).....\$1,500**  
**Cr. Prepaid maintenance.....\$1,500** **1/2**

**Dr. Interest expense.....\$10,280**  
 ( $\$415,000 - \$72,341 = 342,659$ ) x 12% =  $\$41,119$  x 3/12  
**Cr. Interest payable.....\$10,280** **1**

**Required #3**

Prepare, in good form for PCL, an excerpted balance sheet at December 31, 2012 with all accounts arising from entering into this lease. Show supporting calculations where applicable.

**Po-Co Limited**  
**Partial Balance Sheet**  
**As at December 31, 2012**

<p><b>Current assets</b></p> <p>Prepaid Maintenance.....\$4,500</p> <p><b>Non-current assets</b></p> <p>Leased equipment..\$415,000</p> <p>Accumulated Depreciation..... <u>10,375</u> ...\$404,625</p>	<p><b>Current liabilities</b></p> <p>Interest payable.....\$10,280</p> <p>Lease liability.....\$31,222</p> <p><b>Non-current liabilities</b></p> <p>Lease liability.....\$311,437</p> <p>Liability.....\$415,000</p> <p>PMT #1.....(<u>72,341</u>)</p> <p>Financed.....\$342,659</p> <p>Lease year</p> <p>Interest x 12%   \$ <u>41,119</u></p> <p>Payment</p> <p>next year.....\$72,341</p> <p>Interest therein....\$(<u>41,119</u>)</p> <p>Liability payment</p> <p>next year.....\$<u>31,222</u></p> <p>Non-current: <math>\\$342,659 - \\$31,222 = \\$311,437</math></p>
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**Required #4**

If Po-Co Limited exercises the bargain purchase option at the end of year #7, what entry would **Tri-City Leasing Limited** make?

<b>Dr. Cash.....</b>	<b>\$100,000</b>		<b>1/2</b>
<b>Cr. Lease Receivable.....</b>	<b>\$100,000</b>		

**Required #5**

Notwithstanding the lease amount quoted to PLC by TCL, assume that PCL determined the fair value of the leased equipment to be \$400,000. All other terms of the lease agreement remain unchanged. Present the fixed asset section of the balance sheet for PCL as at December 31, 2012.

**Although not required here, PCL would have to derive the internal rate on the lease such that its present value would equal \$400,000 as the asset cannot be capitalized in excess of its fair market value.**

**Therefore, the fixed asset section at December 31, 2012 would be:**

<b>Assets under capital lease.....</b>	<b>\$400,000</b>		<b>1/2</b>
<b>Accumulated depreciation.....</b>	<b><u>\$10,000</u></b>	<b>\$390,000</b>	
	<b>(400,000/10) x 3/12</b>		

**Question #2 ( marks)**

North Shore Limited (NSL), a publicly traded, December 31 year end company, had the following selected securities outstanding as at December 31, 2012:

Long term debt:

Notes payable, 5%.....\$4,500,000  
 8% convertible debentures, par value \$2,500,000  
 net of discount..... 2,420,000

Equity:

Preferred shares, \$1.75 annual dividend, payable quarterly, no-par, cumulative and convertible shares; 100,000 shares authorized, 40,000 issued and outstanding.....5,000,000

Common shares, no-par, 5,000,000 authorized 1,200,000 issued and outstanding.....2,500,000

Common share conversion rights..... 210,000

Other information:

- a) Under the provisions of the company bylaws only common dividends of \$1.45 per share were declared in 2012. Dividends had not been paid on preferred shares for 2011 as permitted by the company's bylaws.
- b) Comprehensive Income and Other Comprehensive Income for the year ended December 31, 2012 was \$1,068,500 and \$246,000 respectively.
- c) Bond discount amortization for 2012 was \$16,000 on the 8% debentures.
- d) The 8% convertible debentures are convertible at a rate of seven shares for each \$100 bond.
- e) Options were outstanding all year to purchase 200,000 common shares at \$11 (the "\$11 Plan") per share beginning in 2015.
- f) Options were issued on May 1, 2012 to purchase 55,000 common shares at \$18 (the "18 Plan") per share beginning in 2014.
- g) The preferred shares, issued in 2009 are convertible into common shares at a rate of 1.75 common share for 1 preferred share.
- h) The tax rate for the year is 40%. Common shares traded for the entire year at an average of \$40 and at an average of \$39.60 for the last 8 months of the year. The common shares traded at \$50 on the last trading day of the year.
- i) 900,000 common shares were issued on August 31, 2012.

Required: Prepare all EPS disclosures.

*common shareholders    number of shares    per Share*

Basic EPS			
Net income	\$822,500	<b>(CI: 1,068,500 – OCI: 246,000 = NI; NI is basis for EPS)</b>	
Less: preferred dividend 40,000 x \$1.75	<u>(70,000)</u>	(cumulative claim)	<b>3</b>
	\$752,500		
300,000 x 8/12 =	200,000		
1,200,000 x 4/12 =	400,000		
	600,000		
Weighted average shares		<u>600,000</u>	
Basic EPS			<u>\$1.25</u>

**ALL POTENTIALLY DILUTIVE ITEMS MUST BE EVALUATED; IRRESPECTIVE OF THEIR EXERCISE DATE**

Diluted EPS, individual effect			
8% Debentures	$\frac{\$200,000 + \$16,000 (1 - .4)}{\$2,500,000 \times 1/100 \times 7} = \frac{\$129,600}{175,000} =$	\$0.74	<b>(#2) 1</b>
\$11 Options	Shares issued: 200,000	} = 55,000	} <b>(#1) 1 1/2</b>
	Shares retired: (200,000 x \$11 =		
	Dilution (\$2,200,000)/\$40	145,000	
\$18 Options	Shares issued: 55,000	} = 25,000	} <b>1 1/2</b>
	Shares retired: (55,000 x \$18 =		
	Dilution (\$990,000)/\$39.6	30,000 x 8/12 = 20,000	
Preferred Shares	$\frac{(40,000 \times \$1.75)}{40,000 \times 1.75} = \frac{\$70,000}{70,000} =$	\$1.00	<b>(#3) 1</b>

Arrears are irrelevant; calculation on current year claim on earnings only.

	<i>Earnings available to common shareholders</i>	<i>Weighted average number of shares</i>	<i>Earnings per Share</i>	
Basic numbers, above	\$752,500	600,000	<b>\$1.25</b>	<b>2</b>
\$11 Options [161,667]		145,000		
\$18 Options		<u>20,000</u>		
Subtotal	<u>752,500</u>	765,000	\$0.98	
8% Debentures				
Income	129,600			
Shares	<u>\$882,100</u>	<u>175,000</u>	<b>\$0.94</b>	
		940,000		
			<b>Diluted EPS</b>	
Preferred shares	<u>\$70,000</u> <b>[non-dilutive]</b>	<u>70,000</u>		
	<u>\$952,100</u>	<u>1,010,000</u>	\$0.94	

Preferred shares are non-dilutive.

**Question #3 (16 marks – 45 minutes)**

Okanagan Wineries Limited (OWL), a December 31 year-end public company, reported normal income from operations before taxes of \$510,000 and \$610,000 in total comprehensive income in 2011 with a 38% tax rate which was enacted during the year.

At the end of 2010, *selected amounts* from the general ledger reported:

- net book value of depreciable assets of \$875,000
- long term receivable of \$120,000 (taxed when cash is collected),
- estimated warranty liability of \$56,000,
- a future tax balance arising from the estimated warranty liability of \$19,600.

In 2011, related information as follows:

- dividends received from taxable Canadian corporations amounted to \$26,000
- penalties and interest levied by CRA in a tax dispute were \$4,000.
- CCA allowance claimed was \$50,000 and depreciation expense was \$63,000. The balance of UCC at the beginning of the year was \$560,000. No additions were made this year.
- warranty expenses of \$45,000 equaled the amount of warranty claims paid
- none of the long term receivable at December 31, 2010 was collected in 2011; there were no such sales in 2011

At the end of 2010 OWL had a non-capital tax loss carry-forward of \$601,000. Management had determined at the end of 2010 that it was more likely than not that there would not be sufficient future taxable incomes to recognize the benefit of this loss carry-forward at that time. At the end of 2011, management was more confident and decided to recognize the full benefit of any remaining carry-forward.

1. Prepare, *in good form*, all applicable tax entries for 2011. Show all supporting calculations.

<b>Current tax reconciliation:</b>		
Pre-tax operating income.....	\$510,000	} 4
Dividends.....	(26,000)	
CRA levies.....	4,000	
Depreciation.....	63,000	
CCA.....	(50,000)	
Warranty 45-45.....	-0-	
Taxable income.....	501,000	
Apply LCF.....	(501,000)	
Current tax expense/pay.....	-0-	
LCF balance: 601-501 = 100		
No current tax entry -		} 1

Deferred Tax Analysis: 2010 rate 19,600/56,000 = 35%

1

Item	Book 31/12/11	Tax 13/12/11	Temp. Diff FT/FD	Ending DTA/DTL @38%	Begin DTA/DTL @35%	Adjmt	
Assets	812,000 <sup>1</sup>	510,000 <sup>2</sup>	302,000FT	114,760DTL	110,250DTL <sup>5</sup>	4,510 L▲	2
Receivable	120,000 <sup>3</sup>	-0-	120,000FT	45,600DTL	42,000DTL <sup>4</sup>	3,600L▲	2
Warranty	56,000	-0-	56,000FD	21,280TA	19,600DTA	1,680A▲	2
LCF	100,000	-0-	100,000	38,000	-0-	38,000A▲	2 ½
Comp Inc	100,000	-0-	100,000	38,000	-0-	38,000A	

<sup>1</sup>875,000 - 63,000 = 812,000

<sup>2</sup>560,000 - 50,000 = 510,000

<sup>3</sup>120,000 unchanged, no collections this year

<sup>4</sup>120,000 x 35% = 42,000

<sup>5</sup>(875,000 - 560,000) x 35% = 110,250

Deferred tax entry:		
Cr. DTL - Assets.....	4,510	} Entries as part of 2 marks above
Dr. DTL - Receivable.....	3,600	
Dr. DTA - Warranty .....	1,680	
Dr. DTA - LCF.....	38,000	
Cr. Income tax expense .....	31,570	

2. Prepare, *in good form*, the partial **Statement of Comprehensive Income** beginning with... "income before taxes..."

Net income before taxes.....	\$510,000	} 1	
Provision for income taxes:			
Current.....	-0-		
Deferred benefit.....	\$31,570		
Net income.....	\$541,570		
Other Comprehensive Income			
net tax of \$38,000.....	\$62,000		½
Comprehensive Income.....	\$603,570		

