

## Final Exam

### Intermediate Financial Accounting II

### Fall 2011

### ADM3340 Sections A & B

### (SUGGESTED SOLUTIONS)

**Name:** \_\_\_\_\_ **ID#:** \_\_\_\_\_

**Section:**    **Tuesday & Friday**                          **Tuesday evening**   

Instructions:

- Write your name and student ID number above.
- Turn off all cell phones.
- This examination “**SUGGESTED SOLUTION**” comprises **5** questions over **21** numbered pages.
- Answer Question 1’s multiple-choice questions on the SCANTRON sheet provided.
- Answer Questions 2-5 in this booklet. Booklet is **not** to be removed from the examination room. You may not separate the pages.
- Limit your answer to the space provided. Blank sheets for rough work and supporting calculations are given at the end of each question.
- This exam will be marked out of **100** marks for convenience and is **3 hours long**. You should budget approximately **1.8 minutes per mark**. The exam is worth **50%** of the overall course mark.
- Please do not ask the invigilator or the professor any questions, as they will not be answered. State reasonable assumptions, if you feel they are necessary.
- Present value tables are provided on pages **20-21**.
- Language (non-electronic) dictionaries are allowed if permitted by the professor.
- You **must** sign the Statement of Academic integrity on page 2 of this exam.

Question		Marks
<b>1</b>	20 x 1-mark multiple choice questions	/20
<b>2: part 1</b>	Financial instrument classification	/6
<b>2: part 2</b>	Convertible bond: issuance	/6
<b>2: part 3</b>	Convertible bond: conversion	/6
<b>2: part 4</b>	Non-financial derivative	/8
<b>3</b>	EPS	/15
<b>4: part 1</b>	Accounting changes and error analysis	/8
<b>4: part 2</b>		/6
<b>4: part 3</b>		/6
<b>4: part 4</b>		/6
<b>5</b>	Statement of Cash Flows	/13
<b>TOTAL</b>		<b>/100</b>

**Statement of Academic Integrity**

The Telfer School of Management does not condone academic fraud, an act by a student that may result in a false academic evaluation of that student or of another student. Without limiting the generality of this definition, academic fraud occurs when a student commits any of the following offences: plagiarism or cheating of any kind, use of books, notes, mathematical tables, dictionaries or other study aid unless an explicit written note to the contrary appears on the exam, to have in his/her possession cameras, radios (radios with head sets), tape recorders, pagers, cell phones, or any other communication device which has not been previously authorized in writing.

**Statement to be signed by the student:**

I have read the text on academic integrity and I pledge not to have committed or attempted to commit academic fraud in this examination.

Signed: \_\_\_\_\_

Note: an examination copy or booklet without that signed statement will not be graded and will receive an exam grade of zero.

**QUESTION 1 (20 marks: 1 mark each)**

**Answer ALL parts to this question on the SCANTRON sheet provided. Each part is independent. The marker will not assess anything you write on this or the following page.**

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## QUESTION 2 (26 marks)

Answer ALL parts to this question. Each part is independent.

### **PART 1: (6 marks)**

A description of several different financial instruments follows :

- a. Subordinated debentures payable, bearing an interest rate of 9%, interest reset every three years with reference to market rates; principal due to be repaid only on the dissolution of the company, if ever, although may be repaid at the company's option on interest re-pricing dates.
- b. Subordinated 8% debentures payable, interest payable semi-annually, due in the year 2020. At maturity, the face value of the debentures may be converted, at the company's option, into common shares at a price of \$12.50 per share.
- c. Series B preferred shares, annual \$6 cumulative dividend, redeemable at the investor's option for \$110 per share, plus dividends in arrears. The company may, at its option, redeem the total obligation for the Series B preferred shares in common shares issued at market values (i.e. the number of common shares to be exchanged for the preferred shares will fluctuate in direct proportion to changes in the market value per common share).
- d. Series F preferred shares, annual \$6 cumulative dividend, convertible into two common shares for every \$100 preferred share at the investor's option, redeemable at \$110 per share at the company's option in 2018.

### **Required**

Classify, from the issuer's point of view, each financial instrument as debt, equity, or hybrid. You must provide an explanation for the basis of your reasoning.

**a. Debt or Hybrid:** This is a effectively perpetual debt. However, it can be reasonably argued that this is a hybrid: pv of interest pymts = a financial liability; pv of principal = 0 and unlikely to be ever paid and hence equity.

**b. Hybrid:** Company can avoid paying the principal in cash or cash equivalent: thus, equity. Company cannot avoid paying the interest in cash: thus, debt.

**c. Debt:** Company extinguishes the principal by (i) issuing cash-equivalent of the total obligation or (ii) paying \$110 per prfd share in cash. Therefore, debt. Any dividends associated with these prfd shares are treated as interest in the financial statements.

**d. Equity:** Company can avoid paying cash by issuing a fixed number of common shares.

## QUESTION 2 (26 marks) (continued)

### **PART 2: (6 marks)**

BondTerrier Inc. issues a 10-year convertible (at the holder's option) bonds with a face value of \$3,000,000 and a coupon rate of 6.00% for \$2,700,000. The company is compliant with IFRS. Bond interest is paid semi-annually and the company amortizes any bond discount or premium using the effective interest rate method. When the bonds are issued, the prevailing market interest rate (yield or effective interest rate) for similar debt without a conversion option is 8.00%.

Assume the convertible option is a derivative that is not closely related to the bond liability and can be separately measured and that BondTerrier Inc. has decided not to treat the entire hybrid instrument as held for trading (at fair value through net income).

### **Required**

The journal entry to record the issuance of these bonds.

The solution below assumes IFRS [IAS 32 and IAS 39].

Beginning of semi- annual period 1 (date of issuance) using the IAS32_and_IAS39 approach.	Dr	Cr
Cash	2,700,000.00	
Bond discount	407,709.66	
Contributed capital: common stock conversion rights		107,709.66
Bond liability		3,000,000.00
<p>To record the issuance of 10-year bonds, face value \$3,000,000, stated interest rate 6.00% per year (compounded semi-annually), convertible into 20,000 common shares at the investors' option.                      Total issuance proceeds = \$2,592,290 + \$107,710 = \$2,700,000 (see below).                      Bond discount = \$3,000,000 + \$107,710 - \$2,700,000 = \$407,710.</p>		
Present value of the bond's 20 x \$90,000 (= \$3,000,000 x 6.000%/2) semi-annual interest payments discounted at 4.000% (=8.000%/2) semi-annually: [\$1,223,129 = 13.590326 x \$90,000]		1,223,129.34
Present value of the maturity value of \$3,000,000 at the end of 20 half-years discounted at 4.000% semi-annually: [\$1,369,161 = 0.456387 x \$3,000,000]		1,369,161.00
		2,592,290.34
Value of the conversion option.		107,709.66
Total proceeds on issuance (as given in the INPUT screens)		2,700,000.00

### **PART 3: (6 marks)**

BondTerrier Inc. issues 5-year callable (at the issuer's option) and convertible (at the holder's option) bonds with a face value of \$5,000,000 and a coupon rate of 4.00% for \$5,155,000. The company is compliant with IFRS and uses the incremental approach to allocate issuance proceeds between the bond liability [\$4,573,490.30] and conversion feature [\$581,509.70]. Bond interest is paid semi-annually and the company amortizes any bond discount or premium using the effective interest rate method. When the bonds are issued, the prevailing market interest rate (yield or effective interest rate) for similar debt without a call or conversion option is 6.00%.

Assume the convertible option is a derivative that is not closely related to the bond liability and can be separately measured and that BondTerrier Inc. has decided not to treat the entire hybrid instrument as held for trading (at fair value through profit or loss). Each \$1,000 face value bond can be converted by the holder into 20 shares.

40% of the \$5,000,000 face value bonds are converted after interest is paid at the end of semi-annual period 6 when the fair market value per share is \$55.00.

Assume all transactions occur on interest payment dates.

### **Required**

The journal entry to record the conversion at the end of semi-annual period 6.

The solution below assumes IFRS [IAS 32 and IAS 39].			
End of semi-annual period	6	Dr	Cr
Interest expense		143,130.39	
Bond discount			43,130.39
Cash			100,000.00
To record, before the conversion at the end of semi-annual period 6: the interest payment of \$100,000, the interest expense of \$143,130 and \$43,130 amortization of the bond discount (see semi-annual period 6 on the amortization table).			
Interest expense		\$143,130 = \$4,771,015 [the amortized cost (net bond liability) at the beginning of semi-annual period 6] x 3.000% [the IRR or yield per semi-annual period]. Or \$143,130 = \$100,000 cash + \$43,130.	
Cash		\$100,000 = \$5,000,000 x (4.00%/2).	
Bond discount amortization		\$43,130 [see the amortization table].	
Bond liability		2,000,000.00	
Contributed capital: common stock conversion rights		232,603.88	
Bond discount			74,341.89
Common shares			2,158,261.99
Note; the above journal entry employs the 'Book Value Method' required by IAS32.AG32 for recording the conversion: the Common Shares account is credited with \$2,158,262 which is equal to the amortized cost (net bond liability) at the end of semi-annual period 6 of the 40.00% of bonds converted (\$1,925,658 = \$2,000,000 - \$74,342) plus \$232,604, their 40.00% share of the \$581,510 Contributed capital: common stock conversion rights (as shown on the Issuance screen).			
'Market Value Method': if the market value at the end of semi-annual period 6 of the 40,000 (100,000 x 40.00%) shares issued upon conversion is \$2,200,000 (\$55 x 40,000 as you have specified in the INPUT_1 screen) the 'Market Value Method' would credit the Common Shares account with \$2,200,000 and debit the Loss On Conversion of Bonds account (an income statement account) with \$41,738 = [\$2,200,000 - (\$2,000,000 - \$74,342) - \$232,604], as shown below. Please note that the 'Market Value Method', while conceptually attractive, is not permitted by IAS32.			
Bond liability		2,000,000.00	
Contributed capital: common stock conversion rights		232,603.88	
Loss on conversion of bonds		41,738.01	
Bond discount			74,341.89
Common shares			2,200,000.00

The journal entries above for (i) interest expense and (ii) the “market value method” are not required but are provided for information purposes only.

## QUESTION 2 (26 marks) (continued)

### **PART 4: (8 marks)**

On 1/1/2011 Duqu Inc pays \$4,000 for an option, with a 'net settlement' clause, to buy land at \$100,000 any time on or before 1/1/2013. On 1/1/2011 the fair value of the land is \$95,000. The company's accounting year-end is 31 December.

On 31/12/2011 the land's fair value is \$90,000 and an options pricing model estimates the option's fair value to be \$3,000. On 31/12/2012 the land's fair value is \$108,000.

#### **Required**

- Provide any entries necessary in Duqu Inc's books on 1/1/2011, 31/12/2011, and 31/12/2012.
- Provide the entry in Duqu Inc's books on 1/1/2013 if Duqu exercises the option to acquire the land.
- Provide the entry in Duqu Inc's books on 1/1/2013 if Duqu 'net settles' the option.
- Provide the entry in Duqu Inc's books on 1/1/2013 if Duqu lets the option expire (without either exercising it to acquire the land or "net settling" it).

		Dr	Cr
1/1/2011	Derivative: land (an asset account)	4,000	
	Cash		4,000
31/12/2011	Loss on derivative: land (an I/S account)	1,000	
	Derivative: land (an asset account)		1,000
31/12/2012	Derivative: land (an asset account)	5,000	
	Gain on derivative: land (an I/S account)		5,000
1/1/2013	Cash	8,000	
	Derivative: land (an asset account)		8,000
	(only if the option contract includes a "net settlement" feature and the option is "net settled").		
	OR		
	Land	108,000	
	Derivative: land (an asset account)		8,000
	Cash		100,000
	(if the option is exercised to purchase the land)		
	OR		
	Loss on expiry of Derivative: land (an I/S account)	8,000	
	Derivative: land (an asset account)		8,000
	(if the option is not exercised and expires)		

### QUESTION 3 (15 marks)

Ice King Products Incorporated reported after-tax profit of \$6.5 million in 2011. Its capital structure included the following as of 31 December 2011, the *end* of the company's fiscal year:

Long-term debt:

Bonds payable, due 2016, 12%:	\$ 5,000,000
Bonds payable, due 2020, 9%, convertible into common shares at the rate of two shares per \$100:	\$10,000,000

Shareholders' equity:

Preferred shares, \$4.50, no-par, cumulative, convertible into common shares at the rate of two common shares for each preferred share, shares outstanding, 150,000:  
Preferred shares, \$2.50, no-par, cumulative, convertible into common shares at the rate of one common share for each preferred share, shares outstanding, 400,000:  
Common shares, shares outstanding, 1,500,000:

Options to purchase common shares (options have been outstanding all year):

Purchase price, \$20; expire 2015, 100,000 options:  
Purchase price, \$52; expire 2019, 200,000 options:  
Each option allows the purchase of one share.

Transactions during 2011:

On 1 July, 400,000 common shares were issued on the conversion of 200,000 of the \$4.50 preferred shares.  
On 1 December, 100,000 common shares were issued for cash.

Other information:

Average common share price, stable during the year, \$40:  
Tax rate, 25%:  
Quarterly dividends on the preferred shares were declared on 31 March, 30 June, 30 September, and 31 December:

**Required**

Calculate basic and diluted earnings per share. Show all supporting calculations.

**QUESTION3 (15 marks) (continued)**

	Earnings Available to Common Shares	Weighted- Average Number of Shares	Earnings Per Share
<b>Basic EPS:</b>			
Net profit	\$6,500,000		
Less dividends on \$4.50 preferred:			
(\$4.50 ÷ 4) X 350,000 shares X 2 quarters	(787,500)		
(\$4.50 ÷ 4) X 150,000 shares X 2 quarters	(337,500)		
Less dividends on \$2.50 preferred:			
400,000 shares X \$2.50	(1,000,000)		
WAOS:			
1,000,000 shares X 6/12		500,000	
1,400,000 shares X 5/12		583,333	
1,500,000 shares X 1/12		125,000	
<b>Basic EPS</b>	<b><u>\$4,375,000</u></b>	<b><u>1,208,333</u></b>	<b><u>\$3.62</u></b>
<i>Individual effect; dilution test</i>			
9% Bonds:			
Interest, (\$10,000,000 X 9%) X (1.00 - .25)	\$675,000		
Shares, (\$10,000,000 ÷ \$100) X 2 X 12/12		200,000	\$3.38
\$4.50 preferred actual conversion:			
Dividend adjustment:			
(4.50 ÷ 4) X 200,000 shares X 2 quarters	\$450,000		
Add'l weighted-average shares: 400,000 X 6/12		200,000	\$2.25
\$4.50 preferred			
Dividends, \$4.50 X 150,000 shares	\$675,000		
Shares, 150,000 X 2 X 12/12 common shares		300,000	\$2.25
\$2.50 preferred			
Dividends, \$2.50 X 400,000	\$1,000,000		
Shares, 400,000 X 1 share X 12/12		400,000	\$2.50
<b>Diluted EPS</b>			
Basic EPS	\$4,375,000	1,208,333	\$3.62
\$20 options - shares issued		100,000	
- shares retired (100,000 X \$20) ÷ \$40	_____	<u>(50,000)</u>	
\$52 options – excluded, \$52 > \$40			
Subtotal	\$4,375,000	1,258,333	\$3.48
\$4.50 preferred actual conversion:			
Dividend adjustment:			
(4.50 ÷ 4) X 200,000 shares X 2 quarters	450,000		
Add'l weighted average shares 400,000 X 6/12		200,000	
\$4.50 preferred:			
Dividends, \$4.50 X 150,000 shares	675,000		
Shares, 150,000 prfd X 2 common shares x 12/12		<u>300,000</u>	
Subtotal	5,500,000	1,758,333	3.13
\$2.50 preferred shares: dividends:			
\$2.50 X 400,000 x 12/12	<u>1,000,000</u>	<u>400,000</u>	
Subtotal	\$6,500,000	2,158,333	3.01
9% Bonds			
Bonds, with an individual effect of \$3.38, are anti-dilutive as their inclusion would increase diluted EPS above \$3.01.			
	_____	_____	
<b>Diluted EPS</b>	<b><u>\$6,500,000</u></b>	<b><u>2,158,333</u></b>	<b><u>\$3.01</u></b>

**QUESTION 3 (15 marks) (continued)**

**QUESTION 3 (15 marks) (continued)**

## QUESTION 4 (26 marks)

The Dart Thrower Company (DTC), located in Ontario, manufactures components for automobiles. In preparing its year-end financial statements as at December 31, 2011, the accountant discovered the following four independent items which have not yet been corrected or changed. Assume the books have not yet been closed by DTC for 2011.

### ITEM NO. 1 (8 MARKS)

On January 2, 2011, **DTC** had purchased as a strategic investment 22% of the outstanding common voting shares of Cork Corporation for **\$90,000**. This investment was correctly accounted for using the equity method. On the date of purchase, the fair value and book value of Cork's net identifiable assets were \$300,000 and \$290,000 respectively. **The \$10,000 difference was attributed to overvalued depreciable assets based upon an estimated useful life of 5 years and no estimated residual value. Cork Corporation uses the straight-line method for its depreciable assets.** Although the transaction was properly recorded by **DTC** on the purchase date, no adjustment has been made during the year for dividends received from Cork, impairment of goodwill, **excess depreciation on overvalued depreciable assets**, or income earned by Cork. Pertinent data follow:

Total dividends paid by Cork	\$16,000
Impairment of goodwill	50%
Income earned by Cork	50,000

### ITEM NO. 2 (6 MARKS)

**On July 1, 2011, DTC purchased a truck for \$48,400**, for which it paid \$9,000 in cash and signed a 3-year, \$39,400 non-interest bearing note for the balance. For notes of this equivalent risk and type, a rate of interest of 12% is considered appropriate. DTC always uses the effective interest method for amortizing any discounts or premiums. The truck and the note were erroneously recorded at \$48,400 and \$39,400 respectively. The truck is being depreciated using the double-declining balance method of depreciation based on a five-year life and a residual value of \$7,500.

### ITEM NO. 3 (6 MARKS)

DTC operates its offices from Monday to Friday. Employees are paid every Friday. The next payday was Friday, January 3, 2012. Assume all employees worked the five-day work week ending January 3, 2012 including New Years Day. DTC failed to record a portion of its 2011 payroll for the week ended January 3, 2012. Details of the weekly payroll follow:

Gross payroll	\$ 42,700
Deductions from employees for Employment Insurance (EI)	2,700
Deductions from employees for income taxes	4,260
Deductions from employees for Canada Pension Plan (CPP)	<u>1,800</u>
Net payroll	33,940

The employer's portion of the deductions for EI was also \$2,700. However, the employer's deduction for CPP was 1.4 times the amount withheld from employees. Amounts withheld will be remitted to the appropriate governmental programs within the first 31 days of 2012.

## QUESTION 4 (26 marks) (continued)

ITEM NO. 4 (6 MARKS)

DTC failed to accrue certain miscellaneous expenses at the end of each of the last three years, as follows:

December 31, 2009	\$ 11,200
December 31, 2010	4,000
December 31, 2011	2,500

ITEM NO. 5 (X MARKS) NOT ASKED

In reviewing the December 31, 2011 inventory of automobile parts, DTC discovered errors in its inventory-taking procedures that have caused ending inventories for the last three years to be incorrect as follows:

December 31, 2009	Overstated	\$ 16,000
December 31, 2010	Understated	\$ 21,000
December 31, 2011	Overstated	\$ 6,700

### Required

Prepare the necessary journal entries on the books of The Dart Thrower Company (DTC) at December 31, 2011 to record the above corrections and changes, as appropriate. You must show, in a clear and organized manner, your supporting calculations. Disregard income tax implications.

ITEM NO. 1 (8 MARKS)

#### Total purchase price discrepancy:

Cash paid	\$90,000
Ownership interest at BV (22% x \$290,000)	<u>63,800</u>
Difference	26,200
Attributed to unrecorded goodwill*	24,000
Attributed to overvalued depreciable assets	2,200

\* Computation of unrecorded goodwill:

$$\$90,000 \text{ purchase price} - (22\% \times \$300,000 \text{ FMV}) = \underline{\underline{\$24,000}}$$

DTC's share of excess depreciation on overvalued depreciable assets:

$$22\% \times \frac{(\$10,000 - \$0)}{5 \text{ years}} = \underline{\underline{\$440}}$$

Cash (.22 x 16,000).....	3,520	
Long-Term Investment in Cork .....		3,520
<b>Investment income (share of excess depreciation).....</b>	<b>440</b>	
<b>Long-Term Investment in Cork .....</b>		<b>440</b>
Investment income (50% x \$24,000) .....	12,000	
Long-Term Investment in Cork (goodwill impairment)		12,000
Long-Term Investment in Cork (.22 x 50,000).....	11,000	
Investment Income .....		11,000

**QUESTION 4 (26 marks) (continued)**

**ITEM NO. 2 (6 MARKS)**

(Discount on) Note Payable..... 11,356  
 Truck ..... 11,356  
 Truck purchased, in part, with the note should have been recorded at \$9,000 + PV of \$39,400 = \$9,000 + (\$39,400 x .71178) = \$37,044 (rounded). Therefore, correction is \$48,400 – \$37,044 = \$11,356.

Interest expense..... 1,683  
 (Discount on) Note Payable..... 1,683  
 To accrue interest expense that should have been recorded on the N/P from July 1 to December 31, we have \$28,044\* x 12% x 6/12 = \$1,682.64 (\$1,683 rounded).  
 \* 28,044 = 39,400-11,356.

Accumulated **depreciation** – truck..... 2,271.20  
**Depreciation expense** ..... 2,271.20  
 To correct **depreciation** on truck that should have been recorded as \$7,408.80 [**\$37,044 x 40% x ½**] but was erroneously recorded as \$9,680 [**\$48,400 x 40% x ½**].  
 The difference is \$2,271.20

**ITEM NO. 3 (6 MARKS)**

Payroll expense ..... 17,080  
 EI expense (40% x \$2,700)..... 1,080  
 CPP expense (40% x \$1,800 x 1.4)..... 1,008  
 EI Payable (40% x \$2,700) + (40% x \$2,700) ..... 2,160  
 CPP Payable (40 % x \$1,800) + (40% x \$1,800 x 1.4) ..... 1,728  
 Employee-withheld Income Tax Payable (40% x \$4,260) ..... 1,704  
 Net salary payable..... 13,576

**ITEM NO. 4 (6 MARKS)**

Miscellaneous expense ..... 2,500  
 Accrued expenses payable ..... 2,500  
 Retained earnings..... 4,000  
 Miscellaneous expense ..... 4,000

or shown as a single compound journal entry

Retained earnings..... 4,000  
 Accrued expenses payable ..... 2,500  
 Miscellaneous expenses ..... 1,500

	2009	2010	2011
Accrued expenses (understated)	\$(11,200)	\$11,200	
Accrued expenses (understated)		(4,000)	\$4,000
Accrued expenses (understated)			<u>(2,500)</u>
Net income overstated/(understated)	<u>\$11,200</u>	<u>\$(7,200)</u>	<u>\$1,500</u>

**QUESTION 4 (26 marks) (continued)**

**ITEM NO. 5 (X MARKS) NOT ASKED**

Cost of goods sold.....	27,700	
Retained earnings.....		21,000
Inventory .....		6,700

	<u>2009</u>	<u>2010</u>	<u>2011</u>
Beginning inventory		\$ 16,000 O	\$21,000 U
Ending inventory	<u>\$16,000</u> O	<u>21,000</u> U	<u>6,700</u> O
Cost of Goods Sold	<u>16,000</u> U	<u>37,000</u> O	<u>\$27,700</u> U
Net income	<u>\$16,000</u> O	<u>\$37,000</u> U	

## QUESTION 5 (13 marks)

Comparative balance sheet accounts and supplemental information of Zippo Hosiery Inc., which complies with IFRS, follow:

### Zippo Hosiery Inc. Income Statement Year Ended December 31, 2015

Sales	\$1,432,000
Cost of sales	<u>756,000</u>
Gross profit	676,000
Other expenses	256,600
Interest expense	75,000
Depreciation expense	<u>334,400</u>
Income before income taxes	10,000
Income tax expense	<u>4,000</u>
Net income before discontinued operations	6,000
Discontinued operations, net of taxes (\$100,000)	<u>283,100</u>
Net income	<u>\$ 289,100</u>

### Zippo Hosiery Inc. Comparative Balance Sheet As at December 31, 2015 and 2014

	2015	2014	Change
<b>Assets</b>			
Cash and cash equivalents	\$ 172,000	\$ 210,000	\$(38,000)
Accounts receivable	150,000	170,000	(20,000)
Inventory	575,000	498,000	77,000
Investments (FV/Ni)	<u>140,000</u>	<u>190,000</u>	(50,000)
Current assets	1,037,000	1,068,000	
Property, plant, and equipment at cost	1,984,000	1,396,000	588,000
Accumulated depreciation	(650,400)	(487,000)	(163,400)
Patents	<u>690,000</u>	<u>552,000</u>	138,000
Total assets	<u>\$3,060,600</u>	<u>\$2,529,000</u>	
<b>Liabilities</b>			
Trade payables	<u>\$ 93,000</u>	<u>\$ 86,000</u>	\$7,000
Current liabilities	93,000	86,000	
Bank loan	-0-	100,000	(100,000)
Bonds payable	<u>659,500</u>	<u>674,000</u>	(14,500)
Total liabilities	752,500	860,000	
<b>Shareholders' Equity</b>			
Ordinary shares	1,150,000	700,000	450,000
Retained earnings	<u>1,158,100</u>	<u>969,000</u>	189,100
Total shareholders' equity	<u>2,308,100</u>	<u>1,669,000</u>	
Total liabilities and shareholders' equity	<u>\$3,060,600</u>	<u>\$2,529,000</u>	

#### Supplemental information:

- The decrease in bonds payable is due entirely to the amortization of the related premium.
- Zippo's policy is to report interest and dividends paid as a cash outflow from financing activities.
- \$10,000 of FV/Ni investments were purchased during the year; none were sold.
- Property, plant, and equipment costing \$570,000 was sold for \$422,000.
- 100,000 ordinary shares were issued to acquire \$450,000 of property, plant, and equipment.
- The \$212,000 cost of successfully suing a competitor for patent infringement was capitalized during the year.
- "Other Expenses" includes gains and losses on asset sales, holding losses, and patent amortization.
- Income from discontinued operations represents the operating profits of a plant that is in the process of being decommissioned. The recorded profit was received in cash.

## QUESTION 5 (13 marks) (continued)

### Required

Prepare Zippo Hosiery Inc.'s cash flow statement, in good form, for the year ended December 31, 2015 using the indirect method, with all appropriate disclosures. A worksheet is provided for your convenience but will not be marked.

**Zippo Hosiery Inc.**  
**Statement of Cash Flows**  
**Year Ended December 31, 2015**

<b>Cash flows from operating activities</b>		
Net income from continuing operations	\$6,000	
Net income from discontinued operations	283,100	
<b>Adjustments for:</b>		
Holding loss on FV/Ni investment	60,000	
Gain on sale of property, plant, and equipment	(23,000)	
Depreciation and amortization expense	408,400	
Interest expense	75,000	
Income tax expense – continuing operations*	4,000	
Income tax expense – discontinued operations*	<u>100,000</u>	
Subtotal	913,500	
Decrease in accounts receivable	20,000	
Increase in inventory	(77,000)	
Increase in trade payables	<u>7,000</u>	
Subtotal	863,500	
Income taxes paid – continuing operations*	(4,000)	
Income taxes paid – discontinued operations*	<u>(100,000)</u>	
<b>Net cash from operating activities</b>		<b>\$759,500</b>
<b>Cash flows from investing activities</b>		
Purchase of property, plant, and equipment	(708,000)	
Purchase of FV/Ni investment	(10,000)	
Sale of property, plant, and equipment	422,000	
Patent	<u>(212,000)</u>	
<b>Net cash used in investing activities</b>		<b>(508,000)</b>
<b>Cash flows from financing activities</b>		
Retire bank loan	(100,000)	
Dividends paid	(100,000)	
Interest paid	<u>(89,500)</u>	
<b>Net cash from financing activities</b>		<b>(289,500)</b>
<b>Net increase (decrease) in cash</b>		<b>(38,000)</b>
Cash, January 1, 2015		<u>210,000</u>
Cash, December 31, 2015		<u>\$172,000</u>

\* or disclosed as shown in Note 2 below.

### Required disclosure – Notes to financial statement

Notes:

1) During the year the company issued \$450,000 of ordinary shares in exchange for property, plant, and equipment having a fair market value of \$450,000.

2) Income taxes paid:

Continuing operations	\$4,000
Discontinued operations	\$100,000

### Supporting comments and calculations as per the references in SCF

- Income and income taxes pertaining to discontinued operations must be separately disclosed.
- Non-cash transactions relating to financing and investing activities must be disclosed.

**QUESTION 5 (13 marks) (continued)**

**QUESTION 5 (13 marks) (continued)**

## Financial Tables