

John Molson School of Business  
Department of Accountancy  
ACCO 320 – Intermediate Accounting II  
Dr. Kelly F. Gheyara/ Prof. Trevor Hagyard  
**Midterm Examination, Winter 2015**  
**Friday, February 20, 2015**

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

		<b>Estimated time</b>	<b>Marks</b>
Question I	Short Questions	65 minutes	42 Marks
Question III	Transactional Situations	115 minutes	<u>78 Marks</u>
<b>TOTAL</b>		<b>180 minutes</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 2 Questions and 13 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 Question booklet document, and (2) your answer booklet/s. Failure to do so will invoke penalty.

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

**QUESTION I - MULTIPLE CHOICE [Short Problems] - 42 Marks**

**INSTRUCTIONS:** Write your answers to **THIS QUESTION** on **THIS BOOKLET ONLY**.

Answers written anywhere else **WILL NOT BE GRADED**.

**Attempt ALL FIFTEEN Questions.** Your **best 14** answers will be counted.

**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. During November 2014, a customer filed suit against Canada Garages, Inc., for over billing plus wrongful and careless repair work causing damage, claiming \$1,400,000 in damages. The company counsel advised the management that, in its opinion, it is possible that damages will be awarded to the plaintiff. The company's management estimated the potential damages to be \$800,000 [40% probability], \$1,000,000 [30% probability], \$1,200,000 [20% probability] and \$1,400,000 [10% probability]. Determine how should this be reported by Canada Garages, **under ASPE**, in its financial statements for the year ended December 31, 2014
- a. Report a liability of \$1,000,000 on the balance sheet with footnotes providing appropriate details.
  - b. Report a liability of \$1,100,000 on the balance sheet with footnotes providing appropriate details.
  - c. Report a liability of \$800,000 on the balance sheet with footnotes providing appropriate details.
  - d. Report NO liability on the balance sheet but disclose appropriate details in footnotes.**
  - e. None of the above but \_\_\_\_\_.

2. Digital Products, Inc., began operations at the beginning of 2012. It provides a two-year warranty with the sale of its product. Digital estimates that warranty costs will equal 4% of the selling price the first year after sale and 6% of the selling price the second year after the sale. The following data are available:

	<u>2012</u>	<u>2013</u>
Sales	\$8,000,000	\$10,000,000
Actual warranty expenditures	200,000	760,000

Under the expense approach, the balance of the Estimated Liability under Warranty at December 31, 2013, should be:

- a. \$240,000.
  - b. \$840,000.**
  - c. \$880,000.
  - d. \$1,000,000.
3. A company lacks fire insurance and it anticipates that in the likelihood of a fire happening, a significant loss could be suffered. Which of the following statements is true?
- a. This represents a contingent loss and should be accrued in the financial statements if estimable and note disclosed if not.
  - b. This represents a contingent loss with an undeterminable outcome and therefore should be estimated and disclosed in footnotes but not recorded.
  - c. This results in uncertainty as to amounts and timing of losses; however, no loss need be accrued since no asset has been impaired and no liability has been incurred due to the event (the fire).**
  - d. This represents an uncertain situation but which is likely to occur in the future and such that an asset would be impaired or that a liability would be incurred; however, therefore a note disclosure for an amount of expected loss is required.
  - e. None of the above but \_\_\_\_\_ . **[EXPLAIN]**.

4. Perfect Prints, Inc., reported an item in its liability accounts as at December 31, 2014, as follows:

12% Note Payable issued in 2009 for cash, due in May 2015      \$4,000,000

On February 1, 2015, **PPI** issued \$15 million of five-year bonds with the intention of using part of the bond proceeds to pay off the \$4 million note payable maturing in May and on March 2, 2015, **PPI** paid off the note payable accordingly. **PPI**'s financial statements for 2014 were issued on March 15, 2015. **Under ASPE**, how should the \$2 million note payable be classified by **PPI** on the December 31, 2014 balance sheet?

a. **Long term liability: \$4,000,000**

b. Current liability: \$1,600,000 and Long term liability: \$2,400,000

c. Current liability: \$2,000,000 and Long term liability: \$2,000,000

d. Current liability: \$2,000,000.

e. None of the above but \$ \_\_\_\_\_ as \_\_\_\_\_.

5. XYZ began operations on January 1, 2013 with 5 employees who earn 10 vacation days per year each. They work 8 hours per day and earn \$12 per hour and cannot use vacation time until after being employed for one year. XYZ accrues vacation pay at the pay rate in effect when the vacation entitlement was earned and reverses the accruals in the order in which they are made. In 2014 when the pay rate was \$14 per hour, the 5 employees used an average of 8 vacation days each. What would be the vacation pay expense and the vacation pay accrual respectively at the year end for 2014?

a) **vacation pay expense- \$6,240; accrued vacation- \$6,560.**

b) vacation pay expense- \$5,600; accrued vacation-\$4,480.

c) vacation pay expense- \$4,800; accrued vacation- \$0.

d) vacation pay expense- \$5,600; accrued vacation- \$6,720.

e) none of the above but \$ \_\_\_\_\_.

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**Use the information to answer Questions 6 and 7.**

Rock Salt, Inc., acquired a site on a 20-year lease from the government on a beach in North Quebec and began operations on January 1, 2014. The cost of the site was \$23,000,000. Under the terms of the lease contract, the user company is mandated to restore the site to its pristine condition which Rock Salt estimates will cost \$5,000,000 at the time of restoration. The company's borrowing rate was 6%.

6. Determine the amount to be reported on the Balance sheet of Rock Salt on December 31, 2020 in the Asset Retirement Obligation Account and how should it be classified?

a. \$1,750,000 reported as a deferred expense.

b. \$1,559,000 reported as a current liability.

c. \$1,558,695 reported as a long-term asset.

**d. \$2,344,200 reported as a long-term liability.**

e. None of the above but \$ \_\_\_\_\_.

7. For the year 2014, how much will be the amount (being 6% of the outstanding balance of the recorded restoration cost) and how will it be recorded?

**a. \$93,540 as Interest expense and a long-term liability.**

b. \$1,380,000 as an expense and paid in cash as a tax to the government.

c. \$300,000 as Interest revenue and as a reduction of the long-term liability.

d. \$140,652 as Interest expense and paid in cash to the lending bank.

e. None of the above but \$ \_\_\_\_\_. [EXPLAIN].

8. A corporation issued convertible bonds with a face value of \$3,200,000 at a discount along with attached warrants. At a date when the unamortized discount was \$280,000, the Contributed Surplus - Warrants balance was \$136,000 and the Contributed Surplus - Conversion Rights balance was \$80,000 (related to these bonds), the bonds were converted to common shares. The market value of the shares were \$870,000 on the date of the conversion. Using the book value method, the amount of gain or loss to record on conversion would be:
- \$0.**
  - \$280,000.
  - \$480,000.
  - \$2,680,000.
  - None of the above but \$ \_\_\_\_\_.
9. Alberta Company has forward contracts to buy \$400,000 (U.S.) at a rate of CDN \$1.20 in 180 days. The U.S. exchange rate is currently CDN \$1.25 (at the balance sheet date). Alberta Company would show the following on its balance sheet:
- an asset of \$20,000 (U.S.) (in equivalent Canadian dollars).
  - a liability of \$20,000 (U.S.) (in equivalent Canadian dollars).
  - a liability of \$480,000 (Canadian).
  - an asset equal to CDN \$500,000 (being the fair value of the contract at the balance sheet date), with an offsetting credit to income.
  - None of the above but \$ 20,000 CDN ASSET .**

**Use the information to answer Questions 10 and 11.**

iSolve Company sells \$1,500,000 of 10% bonds on November 1, 2011. The bonds yield 12% and pay interest on May 1 and November 1. The bonds are due on May 1, 2015. Bond premium or discount is amortized at interest dates and at year-end. The accounting period is the calendar year and no reversing entries are made.

10. Determine the total price at which the bonds were issued on November 1, 2011.
- \$1,500,000
  - \$1,416,269**
  - \$1,583,732
  - \$1,586,793
  - None of the above but \$ \_\_\_\_\_.
11. Determine the interest expense upto December 31, 2011.
- \$25,000
  - \$28,325**
  - \$90,000
  - \$75,000
  - None of the above but \$ \_\_\_\_\_.

**Use the information to answer Questions 12 and 13.**

On May 1, 2010, Canz Salmon Corporation issued bonds payable with a face value of \$1.4 million at 104 **plus accrued interest**. They are dated January 1, 2010, bearing interest at 9% payable semi-annually on June 30 and December 31, and maturing on January 1, 2020. The company uses the straight-line method of amortization

12. Determine the total cash received by Canz Salmon on the issue of the bonds.
- \$1,400,000
  - \$1,456,000
  - \$1,344,000
  - \$1,526,000
  - None of the above but \$ 1,498,000 .**

13. Determine the interest expense recorded on June 30 and on December 31
- a. \$63,000 and \$63,000
  - b. \$21,000 and \$63,000
  - c. \$18,200 and \$60,200
  - d. **\$20,034 and \$60,103.**
  - e. **None of the above but \$ \_\_\_\_\_.**

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**Use the information to answer Questions 14 - 15.**

On September 1, 2011, Skeez Co. issued \$700,000, 6% convertible bonds at 105, which are due on August 31, 2021. It is reporting under IFRS. Ten detachable stock warrants were attached to each \$1,000 bond. Each warrant entitles the holder to purchase one share of Skeez' no par value common shares at a price of \$86. Each \$1,000 bond could be exchanged for 12 common shares. The bonds without the warrants and conversion options would sell at 94. On September 1, 2011, the fair value of each of Skeez' common shares and warrants was \$85 and \$3, respectively.

14. On September 1, 2011, Skeez should
- a. Credit Bonds Payable, Contributed Surplus - Warrants and Contributed Surplus - Conversion for \$700,000, \$21,000 and \$14,000 respectively.
  - b. Credit Bonds Payable, Contributed Surplus - Warrants and Contributed Surplus - Conversion for \$735,000, \$21,000 and \$59,500 respectively.
  - c. Credit Bonds Payable, Contributed Surplus - Warrants and Contributed Surplus - Conversion for \$654,500, \$21,000 and \$59,500 respectively.
  - d. **Credit Bonds Payable, Contributed Surplus - Warrants and Contributed Surplus - Conversion for \$658,000, \$21,000 and \$56,000 respectively.**
  - e. None of the above but \$ \_\_\_\_\_.
15. On July 1, 2018, 30% of the warrant holders exercised their option and purchased shares in Skeez. The shares were being traded in the market on that date at an average price of \$96 each. The company should record this transaction as follows:
- a. Debit cash \$201,600; Debit Contributed Surplus - Warrants \$6,300; and Credit Common Shares \$207,900.
  - b. Debit cash \$180,600; Debit Contributed Surplus - Warrants \$6,300; Debit Loss on Warrants \$14,700; and Credit Common Shares \$201,600.
  - c. Debit cash \$201,600; Debit Contributed Surplus - Warrants \$6,300; Credit Common Shares \$180,600; and Gain on Warrants \$27,300.
  - d. **Debit cash \$180,600; Debit Contributed Surplus - Warrants \$6,300; and Credit Common Shares \$186,900.**
  - e. None of the above but \_\_\_\_\_.

## Question II - Transactional Situations (78 MARKS)

Stated below are several *separate* situations which were encountered during 2011. You are required to prepare appropriate journal entries, *where required and in proper format*, to record ALL transaction effects. Where entries are not required, specifically state so and give any alternative treatment. **Follow IFRS unless otherwise specifically stated and a December 31 year end.**

### Situation I - 29 Marks

#### Part A

You have just been appointed as the Internal Auditor of Reck-N-Fix Corporation. Early in the morning, a very agitated Mr. Don Keez, the junior accountant, comes to you for help. He informs you that, in his haste, he just shredded the active file instead of the archived file. He produces a very damaged piece of paper which Keez had rescued at great risk to his hand and fingers. The document, representing a bond amortization table, was totally shredded except for the lines of data which were as follows:

Date	Cash	Interest	Difference	Balance
Jan. 1, 2011	...	...	...	...
...	...	...	...	...
...	...	...	...	...
...	...	...	...	...
...	...	...	...	\$771,073
June 30, 2020	\$40,000	\$53,975	\$13,975	\$785,048
Dec. 31, 2020	...	...	...	...

He sounded pretty desperate as he pleaded that if this table was not reproduced, “the big guy is going to can me tonight”. Amused and intrigued by the sight of his plight, you agreed to help him. He did not know the maturity value, stating “I am pretty young and will be called mature after a long time”. Upon further questioning about the coupon and market rates, he again pleaded his lack of any knowledge. “I really do not clip any coupons; my wife does. And since she does all the shopping, I have no idea about all the market prices”. The bonds were issued on January 1, 2011 (he was sure of that) and also that these were ten-year bonds with interest payments on June 30 and December 31. Well, now that you agreed to help out, go ahead and determine the answers to the questions stated below.

#### Required:

1. Determine the market rate of the bonds.
2. Determine the coupon rate of the bonds.
3. Determine the par (maturity) value of the bonds.
4. Calculate the issue price of the bonds.
5. Show how will the bonds be reported and the amounts on the balance sheet as at December 31, 2011.

**[9 Marks]**

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## **Part B**

On 1 July 20X2, Copz Corporation issued \$600,000 of 5% (payable each 30 June and 31 December), 10-year bonds payable for a cash price of \$555,370. The bonds were issued to yield 6%. The company uses effective interest amortization for the discount.

Due to an increase in interest rates, these bonds were selling in the market at the end of June 20X5 at an effective rate of 8%. Because the company had available cash, \$200,000 (face amount) of the bonds were purchased in the market for \$168,312 and retired on 1 July 20X5.

### **Required:**

1. Give the entry by Copz Corporation to record the issuance of the bonds on 1 July 20X2.
2. Give the entry required on December 31, 20X2.
3. Give the entry by Copz Corporation to record the retirement of \$200,000 of the debt on 1 July 20X5.

**[8 Marks]**

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## **Part C**

NewTech Ltd. has a 31 December fiscal year-end. The company issued convertible bonds on 1 July 2004 at 110. The \$5,000,000 bonds pay annual interest of 8% each 30 June and mature on 30 June 2019. At the investor's option, each \$1,000 bond is convertible into 50 common shares prior to the bond's maturity date.

In addition, each bond came with 5 detachable warrants having no expiry date. Each warrant could be exchanged for two common shares at \$20 each and similar warrants were being traded in the market at \$6 each. Bond market analysts indicated that if the bonds had not been convertible, they would likely have sold for \$4,597,000 with a market rate of 9%.

### **Required:**

1. Provide the journal entry to record the initial issuance of the bond.
2. Assume that, on July 1, 2007, after all interest payments were settled, 25% of the bonds were submitted for conversion. Use the book value for accounting for the converted bonds. Provide the journal entry to record the transaction.
3. On March 31, 2006, 40% of the warrant holders exercised their option and acquired shares in the company. Provide the journal entry to record this transaction.
4. Assume that the remaining bonds were redeemed on maturity date [JOURNAL ENTRY NOT REQUIRED FOR THIS]. What will happen to the remaining warrants and how will they be accounted for after the bonds have been paid off?

**BE SURE TO SHOW ALL YOUR WORK AND COMPUTATIONS IN AN ORGANIZED MANNER TO RECEIVE PART CREDIT FOR YOUR WORK.**

**[12 Marks]**

**SOLUTION: Situation I - 29 Marks**

**Part A - Refer To Table I on the Following Page**

1. Market Rate of return =  $53,975/771,073 = 14\%$
  2. Coupon Rate =  $40,000/800,000 = 10\%$
  3. Maturity Value =  $40,000 \times 10 \times 2 = 800,000$
  4.  $\$40,000 \times PVF A (7\%, 20 P) + 800,000 \times PVF SA (7\%, 20 P) = \$630,496$
  5. Bonds Payable, Long term                      \$639,055
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**Part B - Refer To Table II on the Following Page**

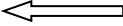
1.	Cash	555,370	
	Bonds Payable		555,370
2.	Interest Xp	16,661	
	Bonds Payable		1,661
	Cash		15,000
3.	Bonds Payable	188,705	
	Cash		168,312
	Gain on Redemption		20,393

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**Part C**

1.	Cash	5,500,000	
	Contributed Surplus - Warrants* [5,000x5x6]		150,000
	Contributed Surplus - Conversion		753,000
	Bonds Payable		4,597,000
2.	Bonds Payable [0.25 x 4,642,008]	1,160,502	
	Contributed Surplus - Conversion	188,250	
	Common Stock		1,348,752
3.	Cash	400,000	
	Contributed Surplus - Warrants*	60,000	
	Common Stock		460,000
4.	No expiry date exists on the warrants. Therefore, \$90,000 (0.6 x 150,000) is reported in Contributed Surplus - Warrants.		

	0.05	0.07		630496.00
1	40000	44134.72	4134.72	634630.72
2	40000	44424.15	4424.15	639054.87
3	40000	44733.84	4733.84	643788.71
4	40000	45065.21	5065.21	648853.92
5	40000	45419.77	5419.77	654273.70
6	40000	45799.16	5799.16	660072.85
7	40000	46205.10	6205.10	666277.95
8	40000	46639.46	6639.46	672917.41
9	40000	47104.22	7104.22	680021.63
10	40000	47601.51	7601.51	687623.14
11	40000	48133.62	8133.62	695756.76
12	40000	48702.97	8702.97	704459.74
13	40000	49312.18	9312.18	713771.92
14	40000	49964.03	9964.03	723735.95
15	40000	50661.52	10661.52	734397.47
16	40000	51407.82	11407.82	745805.29
17	40000	52206.37	12206.37	758011.66
<b>18</b>	<b>40000</b>	<b>53060.82</b>	<b>13060.82</b>	<b>771072.48</b>
<b>19</b>	<b>40000</b>	<b>53975.07</b>	<b>13975.07</b>	<b>785047.55</b>
20	40000	54953.33	14953.33	800000.88

	0.025	0.03		555370.00	
1	15000	16661.10	1661.10	557031.10	
2	15000	16710.93	1710.93	558742.03	
3	15000	16762.26	1762.26	560504.29	
4	15000	16815.13	1815.13	562319.42	
5	15000	16869.58	1869.58	564189.01	
6	15000	16925.67	1925.67	566114.68	
7	15000	16983.44	1983.44	568098.12	
8	15000	17042.94	2042.94	570141.06	
9	15000	17104.23	2104.23	572245.29	
10	15000	17167.36	2167.36	574412.65	
11	15000	17232.38	2232.38	576645.03	
12	15000	17299.35	2299.35	578944.38	
13	15000	17368.33	2368.33	581312.71	
14	15000	17439.38	2439.38	583752.09	
15	15000	17512.56	2512.56	586264.66	
16	15000	17587.94	2587.94	588852.60	
17	15000	17665.58	2665.58	591518.17	
<b>18</b>	15000	<b>17745.55</b>	<b>2745.55</b>	<b>594263.72</b>	
<b>19</b>	15000	<b>17827.91</b>	<b>2827.91</b>	<b>597091.63</b>	
20	15000	17912.75	2912.75	600004.38	

**Situation II - 15 Marks**

iSkon, Inc., sells electronic scanners under a two-year warranty contract that requires it to replace defective parts and provide necessary repair labour. During 2011 the corporation sold 400 scanners for cash at a unit price of \$2,000. On the basis of past experience, the per-unit, two-year warranty costs are estimated to be \$90 for parts and \$100 for labour.

**Required:**

1. **Using the expense method**, prepare the entry to record the sales and the warranty transactions.
2. For [1] above, now assume that the actual repair costs incurred during 2011 were \$14,800 and \$18,200 for parts and labour costs respectively. Prepare the journal entry to record this transaction.
3. Show, with appropriate amounts, how these transactions would be reported on the financial statements.

Now assume for Questions [4] - [6] that the company **uses the revenue method**. It estimates that from the product revenues, \$250 per unit relates to warranty sales. Also assume it is estimated that 40% of the revenues relate to year 2011 and the balance to year 2012. All other information is as given above.

4. Prepare the entry to record the sales and the warranty transactions.
5. For [4] above, now assume that the actual repair costs incurred during 2011 were \$14,800 and \$18,200 for parts and labour costs respectively. Prepare the journal entry to record this transaction.
6. Show, with appropriate amounts, how these transactions would be reported on the annual financial statements.

**SOLUTION: Situation II - 15 Marks**

1]	Cash [400 x 2,000]	800,000	
	Sales		800,000
	Warranty Expense [190 x 400]	76,000	
	Estimated Liability for Warranties		76,000
2]	Estimated Liability for Warranties	33,000	
	Cash		18,200
	Parts Inventory		14,800
3]	Income Statement:	Sales	800,000 Credit
		Warranty expenses	76,000 Debit
	Balance Sheet:	Estimated Liability for Warranties	43,000 Current Liability
4]	Cash/Accounts Receivable	800,000	
	Sales [92,000 -250) x 400]		700,000
	Unearned warranty revenue		100,000
5]	Warranty Expense	33,000	
	Cash		18,200
	Parts Inventory		14,800
	Unearned warranty revenue	40,000	
	Warranty revenue		40,000
6]	Income Statement:	Sales	700,000 Credit
		Warranty revenue	40,000 Credit
		Warranty expenses	33,000 Debit
	Balance Sheet:	Unearned warranty revenue	60,000 Current Liability

**Situation III - 12 Marks**

Cleen Air Power, Inc., [CAP] is a new company engaged in the generation of electricity with the use of windmills. The company erects large windmills, made of plastic and aluminum compounds, in rural areas. Each windmill costs \$110,000 and has a useful life of ten years. The provincial environment ministry requires these mills to be taken down at the end of their lives. The future cost of dismantling and disposing it after its use is estimated to be \$28,000 per windmill. On January 1, 2013, the company installed and set into operation, 5 windmills. CAP uses IFRS, a 6% discount rate, straight-line amortization and has a fiscal year ending December 31.

**REQUIRED:**

1. Record construction cost plus any obligation for restoration costs, related to the acquisition of the plant as at January 1, 2011.
2. Record all entries required related to this asset and obligation at December 31, 2013.
3. Now assume that at the end of 10 years, the company calls for competitive bids from independent contractors to undertake the dismantling and disposing off the equipment. Bild-N-Tear, a local construction firm, has made a bid of \$130,000 plus an additional 20% charge to restore the land around the site which CAP accepts as being fair. Under the terms of this contract, CAP is required to make a cash payment of \$16,000 plus issue 10,000 common shares which are currently being traded in the market at \$15.56. Record this cost of dismantling the plant.

**SOLUTION: Situation III - 12 Marks**

1]	Equipment	550,000	
	Cash		550,000
	Equipment	78,175	
	Asset Retirement Obligation		78,175
	[5 x 28,000 x 0.55839]		
2]	Interest expense	4,691	
	Asset Retirement Obligation		4,691
	[78,175 x 0.06]		
	Amortization Expense	1,166.104	
	Accumulated Amortization – Equipment		1,166.104
	[628,175/10]		
3]	Asset Retirement Obligation	140,000	
	Loss on Retirement of Equipment	16,000	
	Cash		16,000
	Common shares		140,000
	[(130,000 x 1.2) - 16,000]		

**Situation IV - 22 Marks**

**Part A**

On December 31, 2014, Penneez, Inc., approaches Dollarz Corporation for new terms for its debt. On that date, Penneez owes Dollarz \$220,000, 10-year, 10% note issued at par. It also owes the current year's unpaid interest. Dollarz agrees to writeoff the outstanding interest; reduce the amount due on maturity by \$20,000 and extend the due date of the debt to December 31, 2017. The coupon rate due on the note would remain at 10%. The current market rate is 12%. Both parties have adopted IFRS.

**Required:**

1. Determine if this transaction is a modification [minor restructure] or a settlement [major restructure]. State your reasons supported by a clearly organized set of computations.
2. Determine the amount at which the debt is to be carried in the books of Penneez under the new terms. Show clear computations to support your answer.
3. Prepare all necessary journal entries, on December 31, 2014, on the books of Penneez after the revised terms of this transaction take effect.
4. Similarly, prepare journal entries where necessary, on December 31, 2014, on the books of Dollarz after the revised terms of this transaction take effect. Since Dollarz had no prior information on the financial condition of Penneez, it had not provided for any loss on the loan.

**[14 Marks]**

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**Part B**

Fire Foundry, Inc., took out a two-year loan with a note payable to Flush Funds Financial Corporation. The note for \$300,000 was issued at par on January 1, 2015 and carried a 9% interest rate, payable annually. On September 30, Fire Foundry approached Flush Funds with a troublesome scenario. It was in a dire liquidity position and declared that it would be unable to pay neither the annual interest nor the principal upon maturity. It offered a part of its inventory costing \$240,000 but with a market value of \$315,000 in full settlement. Flush Funds verified the inventory and accepted the terms specified.

**Required:**

1. Prepare the journal entry in the books of Fire Foundry to record this transaction.
2. Also prepare the journal entry in the books of Flush Funds to record this transaction.

**[8 Marks]**

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*The End - - - Time To Party*

**SOLUTION: Situation IV - 20 Marks**

**Part A**

- 1] **Present value of old debt is \$220,000 + accrued interest of 10% of \$220,000 for a total of \$242,000. Present value of the 10% \$200,000 new debt at 10% is calculated as follows:**

PV Single amount, 3 years, 10%	[0.75131 x 200,000]	150,262
PV Annuity, \$20,000, 3 years, 10%	[2.48685 x 20,000]	<u>49,738</u>
		<b><u>200,000</u></b>

Since the present value of the future cash flows, **200,000**, of the new debt differs by an amount larger than 10% of the present value, **242,000**, of the future cash flows of the old debt,  $[(200,000/242,000) = .826]$  OR  $[(42,000/242,000) = 0.174]$  of the old debt, the renegotiated debt is considered **a settlement or a major restructure.**

- 2] New debt at market rate:  $[(PV\ 200,000\ at\ 3\ years,\ 12\%) + (PVA\ 20,000\ at\ 3\ years,\ 12\%)] = [(200,000 \times 0.71178) + (20,000 \times 2.40183)] = \$190,393$

3] Notes Payable - Old	220,000	
Interest Payable on Old Note	22,000	
Notes Payable - New		190,393
Gain on Restructuring of Debt		51,607

- 4] New Note value for the lender:  $[(PV\ 200,000\ at\ 3\ years,\ 10\%) + (PVA\ 20,000\ at\ 3\ years,\ 10\%)] = [(200,000 \times 0.75131) + (20,000 \times 2.48685)] = \$200,000$

Bad Debt Expense	42,000	
Interest Receivable		22,000
Note Receivable		20,000