

John Molson School of Business  
Department of Accountancy  
ACCO 320 – Financial Accounting II  
Dr. Michael Bourne/ Dr. Kelly F. Gheyara/ Prof. Diane Henri  
**Midterm Examination, Winter 2016**  
**Saturday, February 20, 2016**

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

		<b>Estimated time</b>	<b>Marks</b>
Question I	Multiple Current Liabilities	77 Minutes	43 Marks
Question II	Long Term Liabilities	65 Minutes	36 Marks
Question III	Restructuring Of Debt	<u>38 Minutes</u>	<u>21 Marks</u>
<b>TOTAL</b>		<b><u>180 Minutes</u></b>	<b><u>100 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 3 Questions and 10 Pages including 3 pages containing present value tables.**
2. Financial calculators (non alphanumerical) and dictionaries are allowed; tables for time value of money are attached at the end of the exam. **One 8.5 x 11" sheet, written both sides, containing your notes may also be used during the exam.**
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 CURRENT LIABILITIES - Short Problems - [43 Marks]**

**MyTee Mouz, Inc.**, is a large international company which specializes in the manufacturing of pest control equipment for commercial users. Its accounting system follows IFRS and its accounting year ends December 31. You are a newly appointed financial accounting analyst and for you, each new day brings new challenging assignments. Currently, you are handling three files, as described below.

**FILE 1 - PRODUCT WARRANTY - [26 Marks]**

In 2014, the company began marketing its leading rodent controller, rZap which uses laser technology to keep rodents under control. Each unit sells for \$1,000 and comes with a **standard one-year warranty**. The cost of this warranty is estimated at 4% of total sales. The annual sales for 2014 amounted to \$11,200,000 and are assumed to have occurred uniformly throughout the year. Thus the annual warranty costs would be spread over two years, i.e., some in the year of sale and the balance in the year following the sales. In 2014, on an average, MyTee incurred actual costs of \$13 per unit sold for parts and labour, to service the units sold in 2014. **The expense method was used to account for the standard warranty.**

In addition, MyTee also offered an optional two-year extended warranty contract which follow the expiry of the standard warranty contract. In 2014, the company issued 8,000 such extended warranty contracts on the sales of rZap at a unit price of \$85 per contract. Further, the two-year extended warranty revenues are earned at \$35 in the first year it comes into effect and \$50 in the second year. **The revenue method was used to account for this extended warranty.**

**Required:**

**For the sales of 2014 only**

1. Prepare, **in proper format**, journal entries required to record the sales and all the warranty related transactions and adjustments for 2014.
2. What liabilities, relative to these transactions, would be reported on the December 31, 2014 Balance Sheet. Show how these would be classified.

**In 2015, MyTree incurred actual costs to service the standard warranty claims associated with the 2014 sales of rZap. These costs amounted to, on an average, \$27 per unit for parts and labour.**

**In addition in the same year, it also incurred additional actual costs of \$124,000 for parts and labour to service the claims associated with the extended warranty contracts. Use this additional information to answer the next two questions.**

3. Prepare, **in proper format**, journal entries for 2015 to record transactions related to both the 2014 standard and 2014 extended warranties.
4. What amounts, relative to the 2015 warranty transactions, would be reported on the December 31, 2015 Balance Sheet. Show how these would be classified.

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**[Continue On Next Page For File 2]**

**FILE 2 - ASSET RETIREMENT - [9 Marks]**

MyTree had acquired a tract of land in Northern Quebec to be the site for setting up its New Products Testing Laboratory. The testing procedures required the use of a set of large equipment erected on open land and the company decided that this acquisition would ideally serve its purposes. The acquisition was on a 20-year lease with a requirement that MyTee would eventually be responsible for dismantling and removing all installations, and restoring the site to its original environmental condition before or at the end of the lease term of the land. The equipment was acquired at a cost of \$9,000,000 with a 15-year expected life and no residual value.

The company commenced its operations on January 1, 2011 and recorded an amount of \$456,969 as the present value of the future restoration costs. On December 31, 2011, it recorded an amount of \$22,848.50 as interest expense on the asset restoration obligation. All assets are depreciated using the straight-line method.

Next, assume that you are NOW on January 1, 2026 and the company is seeking to dismantle all its used equipment and restore the land on which these were installed. The company had earlier, in November, 2025, invited bids for the upcoming restoration. It negotiated terms with Rebuild Contractors, Inc., to undertake the dismantling and restoration contract. For this job MtTee would issue to Rebuild, as compensation, 5% \$1,100,000 five-year bonds with interest payable on December 31. The job commenced on January 1, 2026 and the bonds were issued to Rebuild on the same date with the market rate being 6%.

**Required:**

1. Determine the annual discount rate used for the January 1, 2011, transaction.
2. Determine the estimated future cost of the restoration to be incurred at the end of the life of the equipment.
3. Determine the depreciation expense for 2011 to be recorded on December 31, 2011.
4. Prepare the journal entry required to record the settlement of the Asset Retirement Obligation.  
**[HINT:** You will need to compute the issue price of the bonds on January 1, 2026].

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**[Continue On Next Page For File 3]**

**FILE 3 - CONTINGENCIES - [8 Marks]**

You have just returned from a 30-minute meeting with the company's attorneys. In that meeting, you reviewed three separate legal situations, occurring during the current year, involving pending lawsuits pertaining to the company's products and operations. The following situations were reviewed.

- a] A product liability lawsuit brought against MyTee by a competitor for a patent infringement. The attorney assessed the likelihood of losing the lawsuit as reasonably possible at 60%. The attorney also assessed the possible estimates of damages to be \$500,000 (at 25%), \$750,000 (at 40%), \$1,000,000 (15%), \$1,250,000 (at 10%) and \$1,500,000 (at 10%).
- b] MyTee had brought a claim against the provincial government for non-fulfillment of contractual terms. The attorney is highly optimistic of receiving damages from the government with estimates ranging from \$9,000,000 to \$1,600,000.
- c] A personal liability lawsuit brought against the company by an ex-employee in which the claimant is seeking substantial unspecified damages for alleged injuries suffered while at work. The attorney assesses the likelihood of losing to be at 10% but yet recommends a settlement by offering a \$50,000 payment. In his opinion, it would be more economical for the company to settle at this amount than to proceed to the trial stage. The management has agreed to this suggestion and an offer has been made to the claimant.

**Required:** *For each of the above situations,*

1. Explain how each lawsuit would be accounted for under IFRS. Be sure to briefly relate to the requirements of IFRS.
2. For each case, prepare the journal entries, as required at the end of the year.



Unearned Warranty Revenue	280,000	
Warranty Revenue		280,000
(8,000 X \$35)		

4. What amounts, relative to the 2015 transactions for both the warranty types, would be reported on the December 31, 2015 Balance Sheet. Show how these would be classified.

**Current Liabilities:**

Unearned Warranty Revenue	<u>\$400,000</u> *
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\*(680,000 - 280,000) = **400,000**

**FILE 2 - ASSET RETIREMENT - [9 Marks]**

1. Determine the annual discount rate used for this transaction.

Interest / PV of ARO = (22,848.50 / 456,969) = **5%**

2. Determine the estimated future cost of the restoration to be incurred at the end of the life of the equipment.

PV of ARO / PV Factor (15 Years, 5%) = 456,969 / 0.48102 = **\$950,000**

**ALTERNATIVELY SOLUTION WITH A CALCULATOR**

3. Determine the depreciation expense for 2011 to be recorded on December 31, 2011.

(\$9,000,000 + 456,969) / 15 Years = \$630,465

4. Prepare the journal entry required to record the settlement of the Asset Retirement Obligation.

[**HINT:** You will need to compute the issue price of the bonds on January 1, 2026].

Issue Price Of Bonds:

PV of Maturity Value, (5 Years, 6%): 1,100,000 x 0.74726	= \$	821,986
PV 5% Cash Annuity, (5 Years, 6%): 55,000 x 4.21236	=	<u>231,680</u>
Total Issue Price		<b><u>\$1,053,666**</u></b>

ARO	950,000*	
Loss on Restoration	103,666	
Cash		1,053,666**

**FILE 3 - CONTINGENCIES - [8 Marks]**

The criterion used to account for contingencies under IFRS is to determine the chance of confirming the occurrence of a future event is “*probable*,”\* interpreted to mean “*more likely than not*.”\* Further, if the amount cannot be measured reliably, no liability is recognized under IFRS.\* However, this is considered as being extremely rare.\* IFRS requires that the *best estimate* and an “*expected value*”\* be used to measure this liability. We shall apply these requirements to consider the three given cases.

**Case A**

The likelihood of losing the lawsuit has been assessed as reasonably possible at 60%. Thus we can determine the best estimate of the loss to be:  $(500,000 \times 0.25) + (750,000 \times 0.4) + (1,000,000 \times 0.15) + (1,250,000 \times 0.1) + (1,500,000 \times 0.1) = \mathbf{\$850,000}$

<b><u>Entry:</u></b> Cost of Damages For Patent Infringement	850,000	
Estimated Liability For Patent Infringement		850,000

**Case B**

This is a contingency with a possible gain.\* No recognition of any gain contingencies is called for under IFRS\* and any gain can be recorded only when the receipt of the funds become a certainty\*. Since the likelihood of the receipt of the funds is “probable” \* which appears to be so, given the attorney’s optimism, then according to IAS 37.10, the company should disclose the claim. \* However, it would only be accrued if it was “virtually certain”.\*

**Case C**

The likelihood of losing the lawsuit has been assessed as being possible at only 10%.\* So there is really no need for the company to either record a journal entry\* or disclose in footnotes.\* However, since an offer of settlement has been made by the company, it should disclose the details of the case in a footnote along with the particulars of the offer.\*

## **Question II - Long Term Liabilities And Complex Financial Instruments [36 Marks]**

### **PART A - Complex Financial Instruments (17.5 Marks)**

Datatron, Inc., is a newly established telecommunication company which has been operating for just over five years. It seeks to provide telephone, data transmission, television and network services to users throughout the country. In order to become more competitive in its pricing and in providing service, it embarked on a plan to expand its operations by setting up additional transmission centers. On January 1, 2012, it issued 20-year, 8% convertible bonds with a par value of \$15,000,000 and paying interest semi-annually on June 30 and December 31. The market rate on the issue date was 12%.

In order to make the bond issue more attractive to investors, the company also issued two detachable warrants attached to each \$1,000 bond. Each warrant entitled the holder to purchase one share of the company at \$52.00 each and similar warrants were selling in the market at \$18.00 each.

The total issue price of the bonds, without either the warrants or conversion rights, was estimated to be \$10,486,080. The bonds together with the warrants and conversion rights were issued at 80. On March 31, 2016, 20% of the warrant holders exercised their options.

The bond holders could convert their bonds, at their option, into shares, three years after the issue date. The 15,000 bonds issued could be converted into 750,000 shares. On January 1, 2016, following the payment of the interest on December 31, 2015, 30 % of the bondholders submitted their bonds for conversion.

**Required:** Prepare journal entries, using IFRS, to record the transactions which occurred on the following dates:

1. **January 1, 2012** to record the issue of the bonds.
2. **January 1, 2016** to record the conversion of 30% of the bonds.
3. **March 31, 2016** to record the exercise of warrants by 20% of the holders.

**[BE SURE TO SHOW ALL YOUR COMPUTATIONS TO RECEIVE PART CREDIT].**

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**[Continue On Next Page For Part B]**

## **B) Long Term Liabilities (18.5 Marks)**

On January 1, 2011, WingZ N ThingZ, Inc., issued \$1,200,000 convertible bonds dated the same day. The bonds mature on January 1, 2015 and interest is paid semi-annually on June 30 and December 31. The fiscal year ends December 31 and the company uses **ASPE** for reporting purposes. Furthermore, the company had decided **to not record any portion of the bond issue to equity** and that it would use the effective rate method to amortize any bond premium or discount.

Neither the coupon rate nor the effective rate is being given to you. However, you are told that the bonds were issued for \$1,161,220 and the amortized balances of the bonds payable as at July 1, 2011 and January 1, 2012 were \$1,165,281 and \$1,169,545 respectively. And finally, you are also told that the cash payment made at each interest date (coupon amount) was \$54,000.

*Use this information to answer the following questions and prepare journal entries where asked for.*  
**HINT: It could be useful for you to construct a partial amortization table but this is not a requirement for this problem.**

- 1] Determine the coupon rate of the bonds.
- 2] Determine the effective rate of the bonds.
- 3] Prepare the journal entry to record the interest payment on December 31, 2012.
- 4] How would the balance of the bonds payable as at December 31, 2011 be reported? Show this in a proper format.

*Now assume that following the payment of the period's interest, the amortized balance of the bonds was \$1,183,659 on June 30, 2013. Use this information to answer the next question.*

- 5] The company converted 40% of the bonds by issuing 6,000 common shares. The shares of the company were being traded on that date at \$85 each. Prepare the required journal entry, **in proper format**, to record this transaction.

**SOLUTION II - [36 Marks]**

**PART A Complex Financial Instruments (17.5 Marks)**

**Item 1**

Cash (0.8 x 15,000,000)	12,000,000*	
Bonds Payable [Given]		10,486,080*
Contributed Surplus-Warrants [15K x 2 x \$18]		540,000**
Contributed Surplus-Conversion Rights [Plug]		973,920

**Item 2**

Amortized Balance of the bonds on January, 2016:

PV \$15,000,000 (32, 6%) 0.15496	\$ 2,324,400 *
PVA \$600,000 (32, 6%) 14.08404	<u>8,450,424 *</u>
TOTAL	<u>10,774,824</u>
30% Converted	<u>3,232,447 *</u>

**ALTERNATIVELY SOLUTION WITH A CALCULATOR**

Contributed Surplus - Conversion Rights [0.3 x 973,920]	292,176
Bonds Payable (Above)	3,232,447
Contributed Surplus - Conversion Rights	292,176
Common stock	3,524,623

**Item 3**

Warrants [15,000 x 2W x 1S x \$52 x 0.2]      **\$312,000 and [0.2 x 540,000] 108,000**

Cash	312,000 *	
Contributed Surplus - Warrants	108,000 *	
Common Shares		420,000 *

**PART B Long Term Liabilities [18.5 Marks]**

Date	Cash	Interest Xp	Amortization	Balance
Balance				<b>1,161,220</b>
June 30, 2011	<b>54,000</b>	58,061	4,061	<b>1,165,281</b>
Dec. 31, 2011	<b>54,000</b>	58,264	4,264	<b>1,169,545</b>
June 30, 2012	<b>54,000</b>	58,477	4,477	1,174,022
Dec. 31, 2012	<b>54,000</b>	58,701	4,701	1,178,723

Figures In Bold Are Given

1] Determine the coupon rate of the bonds.

$$(54,000/1,200,000) \times 2 = 9\%$$

2] Determine the effective rate of the bonds.

$$\begin{aligned} 1,165,281 - 1,161,220 &= 4,061 \\ 54,000 + 4,061 &= 58,061 \text{ and} \\ (58,061/1,161,220) \times 2 &= 10\% \end{aligned}$$

**ALTERNATIVELY SOLUTION WITH A CALCULATOR**

To Confirm, repeat the process for the next period:

$$\begin{aligned} 1,169,545 - 1,165,281 &= 4,264 \\ 54,000 + 4,264 &= 58,264 \text{ and} \\ (58,264/1,165,281) \times 2 &= 10\% \end{aligned}$$

3] Prepare the journal entry to record the interest payment on December 31, 2012.

Use the computations in [1] and [2] above to extend the amortization table.

Interest Expense	58,701 *	
Cash		54,000 *
Bonds/P		4,701 *

- 4] How would the balance of the bonds payable as at December 31, 2011 be reported? Show this in a proper format.

**Balance Sheet (in Part), December 31, 2011**

**Long Term Liabilities**

Bonds Payable (Long Term Component)      \$1,169,545

*Now assume that following the payment of the period's interest, the amortized balance of the bonds was \$1,183,659 on June 30, 2013. Use this information to answer the next question.*

- 5] The company converted 40% of the bonds by issuing 6,000 common shares. The shares of the company were being traded on that date at \$85 each. Prepare the required journal entry, **in proper format**, to record this transaction.

Bonds Payable Balance     $[0.4 \times \$1,183,659] = \$473,464$

There would no balance for Contributed Surplus-Conversion.

Bonds/P	473,464	
Common shares		473,464

### Question III - Restructuring Of Debt (21 MARKS)

VillPae, Inc., owes a 10%, 10-year, \$600,000 note payable to its banker, The Rock National Bank. The note had been issued at par, and was coming due, along with the interest for 2015 on January 1, 2016. Due to a temporary cash problem, VillPae felt that it was not in a position to pay this debt commitment. Therefore in early November, 2015, it approached its banker to renegotiate the terms of its impending debt. After satisfying the banker of its sound long term solvency position and its business viability, VillPae succeeded in obtaining several effective concessions. The bank agreed to forgo the annual interest due on the note for 2015. Further, it agreed to extend the term of the note by 4 years commencing January 1, 2016, and to reduce the maturity value of the note to \$450,000 provided Villpae makes a cash payment of \$90,000 on January 1, 2016. And finally, the bank agreed to reduce the coupon rate to 8%. The deal was finalized by the end of the year and became effective as at January 1, 2016. The market rate was 12% on that date. Both parties have adopted IFRS.

#### Required:

1. Is this transaction a modification [minor restructure] or a settlement [major restructure]? Give appropriate reasons for your answer which are supported by computations.
2. What is the amount at which the debt is to be carried in the books of VillPae under the new terms? Show your computations and work clearly.
3. Prepare all necessary journal entries, on January 1, 2016, on the books of VillPae after the revised terms of this transaction, take effect.

*The End - - - Time To Party*

### SOLUTION III

1. Review the economic substance of the debt renegotiation. Determine if it should be accounted as a settlement or a modification/exchange related to the old debt. The test is to establish whether there is a settlement or not revolves around the cash flows.

**Present value of current Debt**

Face value of existing note	\$ 600,000
Less: Cash Payment	( 90,000)
Accrued interest Owed	<u>60,000</u>
<b>Total PV</b>	<b><u>570,000</u></b>

**Similarly, present value of the 8% \$450,000 new note at current market rate of 10%:**

PV Face Value, 4 years, 10%	[0.68301 x 450,000]	307,355
PV Interest Instalments, \$36,000, 4 years, 10%	[3.16986 x 36,000]	<u>114,115</u>
<b>Total PV</b>		<b><u>421,470</u></b>

The present value of the future cash flows, **421,470**, of the new note differs from the present value of the existing debt, **570,000**, by an amount which is greater than 10% of the present value of the existing debt [(421,470)/570,000) = 73.9%]. \* Therefore, the renegotiated debt is considered **to be a settlement**.

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### **THE ABOVE ALTERNATIVELY DETERMINED**

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- Review the economic substance of the debt renegotiation. Determine if it should be accounted as a settlement or a modification/exchange related to the old debt. The test is to establish whether there is a settlement or not revolves around the cash flows.

**Present value of current Debt**

Face value of existing note	\$ 600,000
Accrued interest Owed	<u>60,000</u>
<b>Total PV</b>	<b><u>660,000</u></b>

**Similarly, present value of the 8% \$450,000 Revised Debt at current market rate of 10%:**

PV Face Value, 4 years, 10%	[0.68301 x 450,000]	307,355
PV Interest Instalments, \$36,000, 4 years, 10%	[3.16986 x 36,000]	114,115
Less: Cash Payment		<u>90,000</u>
<b>Total PV</b>		<b><u>511,470</u></b>

The present value of the future cash flows, **511,470**, of the new note differs from the present value of the existing debt, **660,000**, by an amount which is greater than 10% of the present value of the existing debt [(511,470)/660,000) = 77.5%]. \* Therefore, the renegotiated debt is considered **to be a major restructure and so a settlement**. \*

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2. **Debt To Be Recorded In The Books Of VillPae**

**Present value of new debt is to be determined at the current market rate which is 12%.**

PV Face Value, 4 years, 12%	[0.63552 x 450,000]	285,984
PV Interest Instalments, \$36,000, 4 years, 12%	[3.03735 x 36,000]	<u>109,345</u>
<b>Total PV</b>		<b><u>395,329</u></b>

**ALTERNATIVELY SOLUTION WITH A CALCULATOR**

3. Interest Payable	60,000	
Notes Payable	600,000	
Cash		90,000
Notes Payable		395,329
Gain on Restructuring of Debt		174,671