

**John Molson School of Business  
Department of Accountancy  
ACCO 320 – Intermediate Accounting II  
Dr. Kelly F. Gheyara  
Midterm Examination, Summer I 2016  
Friday, May 27, 2016**

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

		<b>Estimated time</b>	<b>Marks</b>
Question I	Multiple Liabilities	85 minutes	47 Marks
Question II	Long Term Liabilities	<u>95 minutes</u>	<u>53 Marks</u>
<b>TOTAL</b>		<b><u>180 minutes</u></b>	<b><u>100 Marks</u></b>

**Instructions:**

1. Make sure you write 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 8 Pages which includes present value tables.**
2. There is partial credit available on **ALL** Questions and so please make sure you **show ALL your work and computations.**
3. 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.
4. You **MUST** return (1) this Question booklet document, and (2) your answer booklet/s. Failure to do so will invoke penalty.
5. You are permitted to use a non-programmable financial calculator, language dictionaries and one 8.5 x 11" sheet, both sides, containing your notes transcribed in any manner of your choice.

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

## **QUESTION I - MULTIPLE LIABILITIES [Short Problems] - 47 Marks**

### **FIRST SCENARIO - 22 Marks**

Wee Dee Owe, Inc., is large national company with its shares being traded on the stock market. It manufactures several different video gaming equipment and related software. One of its leading products is iLearn, an electronic game box which it sells at \$450 each along with a standard three-year warranty. It determines an amount of \$63 as being the revenues from this warranty which is included in the selling price of the product. The warranty requires the company, when necessary, to either perform appropriate repair services or to replace the defective unit. Based upon prior experience, the WDO estimates the total warranty costs to average \$28 per unit of the product. These costs are \$5 for parts and \$23 for labour. Further, it also expects the average three-year extended warranty revenues to be earned equally in each year over the three-year period.

WDO had launched iLearn with much fanfare and celebrations on January 1, 2011. During this year, it company sold 4,000 units of iLearn for cash. Also, during the year, WDO incurred actual costs of \$23,400 related to the standard warranty contracts associated with the 2011 sales of iLearn, being \$5,500 for parts and the balance for labour. The company uses the revenue method to record all warranty transactions.

#### **Required: For the sales of 2011 only**

- 1, Prepare, **in proper format**, journal entries required to record all the warranty related transactions and adjustments for 2011.
2. What liabilities, related to these transactions, would be reported on the December 31, 2011 Balance Sheet? Show how these would be classified.

**In 2012, WDO incurred actual costs related to the warranty contracts of 2011 sales of \$8,820 for parts and \$5,880 for labour.**

3. Prepare, **in proper format**, journal entries for 2012 to record transactions related to the warranty transactions of 2012.
  4. What amounts would be reported on the December 31, 2012 Balance Sheet? Show how these would be classified.
-

## **SECOND SCENARIO - 25 Marks**

Hu Kan Pae, Inc., approached its creditor, The Lending and Investment Banking Corporation of Canada in early November, 2015. The debtor was experiencing a severe downturn in its business operations and came to seek some concessions on its total debt coming due on December 31, 2015. The Bank is holding a 10-year, 5% note for \$3,500,000 which was issued at par plus the accrued interest of \$175,000. HKP was attempting to negotiate for terms whereby the creditor would forgive the amount of the accrued interest, lower the interest rate to 3% , reduce the maturity value of the note to \$2,900,000 and extend the term of the note by an additional 6 years.

The Bank agrees to these terms, effective January 1, 2016 with one additional condition. It insisted that HKP makes a payment, on January 1, 2016, of a sum of \$200,000 either in cash or by the delivery of a property which it owns in downtown Halifax. HKP agrees to the terms for delivering the property which had a fair market value of \$200,000 with an acquisition cost of \$120,000 and accumulated amortization of \$78,000. The market rate on January 1, 2016 is 7%. Both parties have adopted IFRS.

### **Required:**

1. Determine if this transaction is to be classified as a modification [minor restructure] or as a settlement [major restructure].? Be sure to provide 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 HKP under the new terms? Show clearly all your computations and work.
3. Prepare all necessary journal entries, on January 1, 2016, on the books of HKP after the revised terms of this transaction, take effect.

**SOLUTION I - 47 Marks**

**FIRST SCENARIO - 22 Marks**

1. Prepare, **in proper format**, all journal entries to record the warranty related transactions and adjustments for 2011.

Cash (450 x 4,000)	1,800,000	
Sales (4,000 X \$387)		1,548,000
**Unearned Warranty Revenue (4,000 X \$63)		252,000

**OR**

Cash (450 x 4,000)	1,800,000	
Sales (4,000 X \$387)		1,548,000
Unearned Warranty Revenue (4,000 X \$42)		168,000
Warranty Revenue (21 x 4,000)		84,000

Warranty Expenses	23,400	
Parts Inventory		5,500
Labour (23,400 - 5,500)		17,900

**Unearned Warranty Revenue (4,000 X \$21)	84,000	
Warranty Revenue (21 x 4,000)		84,000

2. What liabilities, relative to the these transactions, would be reported on the December 31, 2011 Balance Sheet? Show how these would be classified.

**Current Liabilities:**

Unearned Warranty Revenue	<u>\$84,000</u>
---------------------------	-----------------

**Long-term Liabilities:**

Unearned Extended Warranty Revenue	<u>\$84,000</u>
------------------------------------	-----------------

**In 2012, WDO incurred actual costs related to the warranty contracts of 2011 sales of \$8,820 for parts and \$5,880 for labour.**

3. Prepare, **in proper format**, journal entries for 2012 to record transactions related to the warrantt transactions of 2012.

Warranty Expenses	14,700	
Parts Inventory		8,820
Labour		5,880

Unearned Extended Warranty Revenue	84,000	
Warranty Revenue		84,000

4. What amounts would be reported on the December 31, 2012 Balance Sheet? Show how these would be classified.

**Current Liabilities:**

Unearned Extended Warranty Revenue	<u>\$84,000</u>
------------------------------------	-----------------

**SECOND SCENARIO - 25 Marks**

1. Determine if this transaction is to be classified as a modification [minor restructure] or as a settlement [major restructure].? Be sure to provide appropriate reasons for your answer which are supported by computations.

**Present value of current Debt**

Face value of existing note	\$3,500,000
Less: Payment	( 200,000)
Accrued interest Owed	<u>175,000</u>
<b>Total PV</b>	<b><u>3,475,000</u></b>

**Similarly, Present value of the 6% \$2,900,000 new note at current market rate of 5% :**

PV Face Value, 6 years, 5%	[0.74622 x 2,900,000]	2,164,038
PV Interest Instalments, \$87,000, 6 years, 5%	[5.07569 x 87,000]	<u>441,585</u>
<b>Total PV</b>		<b><u>2,605,623</u></b>

Since the present value of the future cash flows, **2,605,623**, of the new note is less than 90% of the present value of the existing debt, **3,475,000**, the renegotiated debt is considered **to be a settlement**.

2. What is the amount at which the debt is to be carried in the books of HKP under the new terms? Show clearly all your computations and work.

**Present value of new debt is to be determined at the current market rate which is 7%.**

PV Face Value, 2,900,000, 6 years, 7%	[0.66634 x 2,900,000]	1,932,386
PV Interest Instalments, \$87,000, 6 years, 7%	[4.76654 x 87,000]	<u>414,689</u>
<b>Total PV</b>		<b><u>2,347,075</u></b>

3. Prepare all necessary journal entries, on January 1, 2016, on the books of HKP after the revised terms of this transaction, take effect.

Compensation	200,000	
Accumulated Amortization -Property	78,000	
Property/Building		120,000
Gain on Transfer of Property		158,000
Interest Payable	175,000	
Notes Payable	3,500,000	
Compensation		200,000
Notes Payable		2,347,075
Gain on Restructuring of Debt		1,127,925

**Question II - Long Term Liabilities And Complex Financial Instruments - 53 MARKS**

**A) Bonds Payable - 14 Marks**

On January 1, 2011, I-Play Corporation issued bonds due on December 31, 2025 years. Interest payment dates are June 30 and December 31. The accountant, Mr. Ken I. Kount who is your best friend, had very little information to offer about these bonds. With a look of immense desperation, he pleads, “Okay buddy. Just help me out by providing me with the answers to these questions which my boss asked me. If I don’t work this out by this evening, I’m gone”. He pulled out a small sheet of paper with the following information written on it and hands it over to you.

<b>Period</b>	<b>Cash</b>	<b>Interest Expense</b>	<b>Amortization</b>	<b>Carrying Value</b>
June 30, 2019	8,000	x,xxx	x,xxx	181,212.85
Dec. 31, 2019	x,xxx	9,060.64	x,xxx	xxx,xxx
June 30, 2020	x,xxx	x,xxx	x,xxx	xxx,xxx
December 31, 2020	x,xxx	x,xxx	x,xxx	xxx,xxx

**Required: (SHOW ALL WORK)**

- a] Determine the following:
  - i) the effective rate of the bonds;
  - ii) the issue price of the bonds on January 1, 2011.
  - iii) the maturity value of the bonds.

**(8 marks)**
  
- b. Prepare the appropriate journal entry required on December 31, 2019. **(4 marks)**
  
- c. Show, in good format, how the balance of the bonds payable will be reported on the balance sheet as at December 31, 2019 . **(2 marks)**

**Solution II [A] - 14 Marks**

a] Determine the following:

i) the effective rate of the bonds;

$$(9,060.64/181,212.85) \text{ 5\% Per Period} = \underline{\underline{10\% \text{ per annum}}} \text{ (3 marks)}$$

ii) the issue price of the bonds on January 1, 2011.

$$\text{PV } 8,000, \text{ 5\%, 18P} = 8,000 \times 11.68959 = 93,516.72$$

$$\text{PV } 182,273.50, \text{ 5\%, 18P} = 182,273.50 \times 0.41552 = \underline{\underline{75,738.28}}$$

$$\text{(2 marks)} \qquad \qquad \qquad \underline{\underline{169,255.00}}$$

iii) the maturity value of the bonds.

$$\text{PV } 8,000, \text{ 5\%, 12P} = 8,000 \times 8.86325 = 70,906$$

$$\text{PV SA, 5\%, 12P} = \text{SA} \times 0.55684 = \underline{\underline{\text{SA} \times 0.55684}}$$

$$\underline{\underline{182,273.50}}$$

$$\text{Solving, we get SA} \qquad \qquad \qquad = 111,367.50/0.55684 = \underline{\underline{200,000}}$$

**(3 marks)**

b. Prepare the appropriate journal entry required on December 31, 2019. **(4 marks)**

Interest Xp	9,061	
Cash		8,000
Bonds Payable		1,061

**[JE 3 Marks + Amt. 1 Mark]**

c. Show, in good format, how the balance of the bonds payable will be reported on the balance sheet as at December 31, 2019. **(2 marks)**

**\*Long-term debt:**

Bonds Payable \$182,274

**B] Complex Financial Instruments - 19 Marks**

On January 1, 2001, O-Lim-Piks Corporation issued 6% convertible bonds due on December 31, 2012. The bonds, with a maturity value of \$400,000 were issued to yield an effective rate of 4%. Interest payment dates are June 30 and December 31. The company has been using IFRS for its accounting purposes.

Each convertible bond could be converted into 6 common shares at the option of either the bond holder or the company. On the date of the issue, the company decided to charge \$45 per bond for granting the conversion rights.

Along with the bonds, the company also issued 4 warrants with each \$1,000 bond. Each warrant entitled its holder to purchase one share in O-Lim-Piks for \$152. The market value of the warrants was \$34 each and of the bonds without the warrants and conversion rights, was \$475,656. O-Lim-Piks uses the effective interest method to account for its bonds.

Two transactions occurred in subsequent years following the year of issue. Firstly, because of a lower interest rate and a significant change in the corporation's credit rating, O-Lim-Piks decided to call 40% of the bonds outstanding on March 31, 2004 in exchange for common shares. The shares were being traded in the market on that date at \$195. **You are further aware that the company reported an amount of \$459,968.12 as the balance of the net amortized cost of the bonds on December 31, 2003.**

Secondly, on March 31, 2006, 70% of the warrant holders exercised their option when the strike price of O-Lim-Piks' shares reached \$205.

**Required: (SHOW ALL WORK)**

- a. Prepare the appropriate journal entry to record the transaction related to the bonds on January 1, 2001.  
**(10 marks)**
  - b. Prepare the appropriate journal entry to record all effects of the transaction on March 31, 2004.  
**(4 marks)**
  - c. Prepare all appropriate journal entries required to record the transactions on March 31, 2006.  
**(5 marks)**
-

**Solution II [B] - 19 Marks**

a.	Cash	548,056	
	Bonds Payable		475,656
	Contributed Surplus - Conversion [400 x 45]		18,000
	Contributed Surplus - Warrants [400 x 34 x 4]		54,400
	<b>[JE 2 Marks + Amt. 3 Mark]</b>		
b.	Interest Xp [9,199.36 x 0.5 x 0.4]	1,840	
	Bonds Payable [2,800.64 x 0.5 x 0.4]		560
	Cash [.04 x 12,000 x 0.5]		2,400
	<b>[JE 2 Marks + Amt. 3 Mark]</b>		
	Bonds Payable ((459,968 x 0.4) - 560))	183,427	
	Contributed Surplus - Conversion	7,200	
	Cash		190,627
	<b>[JE 2 Marks + Amt. 2 Mark]</b>		
c.	Cash [4 x 400 x 152 x 0.7]	170,240	
	Contributed Surplus Warrants [0.7 x 54,400]	38,080	
	Common shares		208,320
	<b>[JE 3 Marks + Amt. 2 Mark]</b>		

**C] Asset Retirement Obligation - 20 Marks**

Silwar Brite, Inc., is a Canadian company engaged in the mining and processing of lithium. Some years ago, it started a new operating unit in Northern Alberta. On January 1, 2008, the company placed into production equipment costing \$36 million for a new electric arc furnace. The equipment was estimated to have a useful operating life of 20 years and the company expects to recover \$6 million from the sale of scrap from the equipment at the end of its useful life. As part of the regulatory requirements committed to by the company, at the time of securing a business permit, Silwar Brite had to dismantle the plant and clean up the property when the furnace would be de-installed. It estimates the total dismantling and removal costs to amount to \$12 million at the end of the asset's useful life.

In addition to these costs, the company also expected to and did incur additional restoration costs, related to a special production process, for the first two years only. These costs, amounted to \$1.25 million annually (to be accrued at the end of each relevant production year), and will also be paid in total (\$2.5 million) when the equipment is dismantled. Silwar Brite considers an annual discount rate of 3% to be appropriate.

Sometime in January 1, 2028, the company commissions N-Vironment Kleenerz, Inc., to dismantle and remove the equipment, and to clean up the site for a total payment of \$14.65 million.

**Required:**

Prepare all appropriate entries (under IFRS unless specifically mentioned otherwise), to record the following:

- a] The dismantling costs and the asset retirement obligation on January 1, 2008.
- b] The additional restoration costs during production for the year, ending December 31, 2008.
- c] The depreciation expense for 2009 to be recorded on December 31, 2009.
- d] The accretion costs for the period ended December 31 2009.
- e] Determine the additional restoration costs during production for the year, 2009, to be recorded on December 31, 2009. **No Journal Entry Required.**
- f] The payment for the dismantling and cleanup contract in January, 2028.

Now assume the company was governed under PE GAAP. Answer the next two questions under this assumption.

- g] The additional restoration costs during production for the year, ending December 31, 2008.
  - h] Determine the depreciation expense for 2009 to be recorded on December 31, 2009. **No Journal Entry Required.**
-

**Solution II [C] - 20 Marks**

Prepare all appropriate entries (under IFRS unless specifically mentioned otherwise), to record the following:

- a] The dismantling costs and the asset retirement obligation on January 1, 2008.

**[The present value of \$12 million due in 20 years at 3% per year discount rate]  
12,000,000 x 0.55368 = \$6,644,140**

Equipment	6,644,160	
Asset Retirement Obligations		6,644,160
<b>[JE 1 + Amt 2]</b>		

- b] The additional restoration costs during production for the year, ending December 31, 2008.

**[Present value of estimated clean up costs of \$1,250,000 at 3% per year in 19 periods]  
\$1,250,000 x 0.57029 months = \$712,863.**

Production Overhead Costs	712,863	
Asset Retirement Obligations		712,863
<b>[JE 1 + Amt 2]</b>		

- c] The depreciation expense for 2009 to be recorded on December 31, 2009.

**[\$30M + \$6,644,160]/20 Periods = \$1,832.208**

Depreciation Expense	1,832.208	
Accumulated Depreciation – Equipment		1,832.208
<b>[JE 1 + Amt 2]</b>		

- d] The accretion costs for the period ended December 31 2009.

Interest Expense	226,690	
Asset Retirement Obligations		226,690
[0.03 x (6,644,160 + 712,863 + 199,325)]		
<b>[[JE 1 + Amt 2]</b>		

- e] Determine the additional restoration costs during production for the year, 2009, to be recorded on December 31, 2009. **No Journal Entry Required.**

**[Present value of estimated clean up costs of \$1,250,000 at 3% per year in 18 periods]  
\$1,250,000 x 0.58739 months = \$734,238.  
[[Amt 2]**

f] The payment for the dismantling and cleanup contract in January, 2028.

Asset Retirement Obligations	14,500,000	
Loss on Settlement of ARO	150,000	
Cash		14,650,000
<b>[JE 1.5 + Amt 1.5]</b>		

Now assume the company was governed under PE GAAP. Answer the next two questions under this assumption.

g] Record the additional restoration costs during production for the year, ending December 31, 2008.

Equipment	712,863	
Asset Retirement Obligations		712,863
<b>[JE 1] Amount Calculated in (b) above.</b>		

h] Determine the depreciation expense for 2009 to be recorded on December 31, 2009. **No Journal Entry Required.**  
**[Amt 2]**

$$[(\$30M + \$6,644,160 - 1,832,208) + 712,683] / 19 \text{ Periods} = \$1,869.718$$

*The End - - - Time To Party*