

John Molson School of Business  
Department of Accountancy  
ACCO 320 – Financial Accounting II  
Dr. Kelly F. Gheyara/ Prof. Trevor Hagyard  
**Midterm Examination, Fall 2016**  
**Friday, October 21, 2016**

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

		Estimated time	Marks
Question I	Multiple Accounting Issues	105 Minutes	58 Marks
Question II	ARO	43 Minutes	24 Marks
Question III	Accounting For Promotion Campaigns	<u>32 Minutes</u>	<u>18 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!! WE WISH YOU ALL WELL!**

**QUESTION I - MULTIPLE ACCOUNTING ISSUES - Short Problems - [58 Marks]**

You have been placed on the short list of candidates interviewing for the dream job of Financial Controller of **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. Following a sumptuous lunch, you have been led into a large conference room along with the other candidates to work on some current issues facing the company. The moderator informs the group that they would be presented with a sheet containing some issues for which you are required to prepare a feasible solution. **Each issue (case) is independent of the others except where otherwise indicated.** You would be required, for each issue, to address the questions specified in that case. You glance around the room, viewing some of the other candidates with some measure of confidence (after all you are a graduate of JMSB), twirl your pencil and get ready to go!

**ISSUE 1 - CONVERSION OF BONDS - [7 Marks]**

On January 1, 2014, our company had issued 8% convertible bonds, total par value \$7,000,000 for \$8,370,740 when the market rate was 5%. In addition to the issue price, a conversion premium of \$128 per each \$1000 bond was paid by the bondholders. The bonds pay interest on June 30 and December 31. The terms of the bond indenture require us to issue 6 common shares per bond converted.

- a] How would the bonds be reported on our balance sheet as at December 31, 2016?
- b] Next year, January 1, 2017, assume the bond holders would convert bonds with a par value of \$3,000,000 by issuing shares and we expect our shares to be trading at \$270.00 each. How would you record this transaction in the journal including gains or losses, if any, on the transaction?

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**ISSUE 2 - ACCOUNTING FOR WARRANTIES - [7 Marks]**

In 2014, we began selling a new line of hockey equipment to various NHL teams. These carry a two-year warranty against defects. We outsource all warranty related work to iFix Company, a local repair firm. They bill us for all their work undertaken and we pay 70% in the same year and the balance in the following year. Based upon our experience with similar products, the estimated warranty costs related to dollar sales were as follows:

First year of warranty	2%
Second year of warranty	5%

Sales and actual warranty expenditures for 2014 and 2015 are presented below:

	<u>2014</u>	<u>2015</u>
Sales	\$900,000	\$1,200,000
Warranty expenditures invoiced by iFix	30,000	60,000

- a] How would you record the warranty related transactions in 2014?
- b] How would the company report its liabilities at the end of 2015 for the warranty transactions?

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**ISSUE 3 - CONTINGENT LIABILITIES - [5 Marks]**

Our company is being sued by some misguided local residents who we feel are driven to profiting from us. They claim they have been suffering from illnesses allegedly resulting from being exposed to toxic chemicals from our plant and have charged us with negligence on our part in not controlling such emissions. Our lawyers have presented a very strong case of denial on our behalf, Despite this, they still hold the opinion that it is likely the company will lose this suit and thus be held liable for a judgement. They estimate that a reasonable award to the plaintiff could be between \$700,000 and \$4,000,000, with respective probabilities of 35% for \$800,000, 40% for \$2,500,000 (the most likely amount), and 25% for \$3,000,000. Our senior management find this position to be totally impossible and want us to take no action on our annual reports as they do not wish to receive unnecessary bad publicity. Provide your advice on the correct course of action to be taken with some briefly stated specific reasons and provide a journal entry if we should have to record any of this in our books of accounts at the year end.

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**ISSUE 4 - PRICING BOND ISSUES - [5 Marks]**

On January 1, 2015, our corporation issued 10-year, 7% \$9,000,000 bonds. Interest was payable semi-annually on January 1 and July 1. The market price on that date was 6%.

- a) We were expecting a funding of \$9,500,000 but our bankers gave us a different number which surprised our management. Please determine the correct issue price for the bonds.
  - b) Provide us with the appropriate entry to record any bond related activity only on December 31, 2015.
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**ISSUE 5 - DEBT RESTRUCTURING AND SETTLEMENT - [10 Marks]**

Sometime late in 2015, one of our customers, Sportz Bykes approached us seeking for accommodation on a debt it owed us. The said debt consisted of a 10%, 4-year note payable, issued at par and due December 31, 2015 for an amount of \$380,000. All interest due on the debt was settled by Sportz Bykes. We agreed to consider the following revised terms presented by Sportz Bykes:

- ☞ if accepted, the amended terms would have been effective January 1, 2016;
- ☞ the principal payable was reduced to \$300,000 and was due December 31, 2017; and
- ☞ the annual interest payments are to be reduced to 6% of the revised principal for the years, 2016 and 2017; and
- ☞ the current market rate was determined to be 9% .

- a) Provide the appropriate journal entry to record this transaction, assuming we agreed to the revised terms. Are we looking at a loss?
- b) Would this lead to a gain or loss for Sportz Bykes? Provide the journal entry which they would prepare to record this transaction in their books.

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### **ISSUE 6 - DEBT RESTRUCTURING AND SETTLEMENT - [6 Marks]**

**Please go back to the case described above in [5].** We ultimately turned down the request of Sportz Bykes. The company then came up with a different settlement proposition. They offered to turnover ownership of a warehouse property which we could find useful in our distribution operations. Upon further audit of the records concerning this property, we found that the property was carried in the books of Sportz at a net book value of only \$175,000 which we thought was very disappointing. Besides, the firm insisted on a receiving a cash payment of \$120,000 from us on the exchange. Based on the advice of our property management, we estimated the market value of the property to be about \$487,000. The customer was adamant and refused to budge from these terms. The only other alternative would be to send the firm into bankruptcy which presented some serious risks for the recovery of our debt. And so after a careful review of all factors, we decided to accept the proposed terms. The deal was settled on January 31, 2016 and we incurred an additional cost of \$15,000 as legal fees.

- a) Provide the appropriate journal entry to record this transaction, assuming we agreed to accepting the property at the debtor's terms. Are we looking at a loss?
- b) Would this lead to a gain or loss for Sportz Bykes? Provide the journal entry which they would prepare to record this transaction in their books.

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### **ISSUE 7 - DEBT REPORTING - [4 Marks]**

Last year, 2015, our company owed the Universal Bank [UB] a 6% interest, \$1,200,000 loan as at the end of the fiscal year end, on December 31. This was due in annual payments of \$300,000 over the following 4 years with payment dates of June 30. This year on March 4, 2016, our company issued \$500,000 in 5% preferred shares which were not callable or retractable/redeemable. Our management intended to use a part of the proceeds from this issue to pay the instalment which was coming due in June. Further, it also placed \$300,000 into an irrevocable bank account for that purpose. Our company planned to issue the financial statements of 2015 on March 31, 2016.

- a) How should our company have classified the \$1.2 million debt due to **UB** on the balance sheet at December 31, 2015?
- b) Would the classification been any different had we been using ASPE instead? If different, show how the loan would have been classified?

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**ISSUE 8 - ISSUE OF HYBRID DEBT - [14 Marks]**

On January 1, 2012, our company had issued 4,000 9% 10-year convertible bonds at 108. Interest was being paid on July 1 and January 1. Each \$1,000 bond could be converted at the option of the holder into 40 common shares. Included with each bond were six detachable warrants. Each warrant entitled the holder to purchase one share at \$26 from the company. The underwriter estimated the market value of the bonds alone, excluding warrants and conversion rights, to be \$4,150,000. The warrants had a market value of \$5 each at the date of issue.

- a] How would we record this issue of the bonds? We had credited the full amount received to the liability.
- b] On January 1, 2014, after paying off all interest and recording it, 30% of the bondholders submitted their respective bonds for conversion. Our shares were being traded at \$31 on that day. We must admit that our accountants in order to simplify matters for them, decided to use the straight line approach to amortize any bond premium or discount. Prepare the appropriate journal, using straight line amortization, to record the conversion transaction. Did we make any gain on this transaction?
- c] In your opinion, did our accountants amortize the bond premium correctly? After all, the total amortization over the lifetime of the bonds would be the same under any method. Give some brief reasons for your position.
- d] How many shares would have been issued from the bond conversion of January 1, 2014?
- e] Further, on the same date, one third of the warrant holders submitted their warrants and purchased shares. Did we make any loss on this transaction? Remember the market price of our shares was \$31 each.

**End Question I**

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## QUESTION II - ARO Transactions - [24 Marks]

On January 1, 2015, MyTree, Inc., had acquired premises plus land which was converted into an operating plant. This plant has to be dismantled and the land to be restored into a nature sanctuary for birds, squirrels and other small animal to reside after the company terminated the operating plant. This was expected to happen after 16 years. The land was leased from the provincial government without cost and the plant cost \$2.4 million. Restoration costs in 16 years are expected to total \$650,000, of which \$400,000 is due to the usage of the plant equally over the 16 years (and is to be recognized at the end of each year). The balance amount of \$250,000 was to be recognized initially when the plant was acquired. The company applies IFRS and has been using an annual interest rate of 5%.. All assets are depreciated using the straight-line method.

Next, assume that it is NOW January 1, 2031 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, 2030, invited bids for the upcoming restoration. It negotiated terms with GreenLand Contractors, Inc., to undertake the dismantling and restoration at a contract price of \$700,000. MyTee would pay this amount in 4 instalments. The first instalment would be a down payment of \$250,000 on January 1, 2031 when the restoration work was scheduled to begin. Thereafter the remaining amount was to be paid in equal instalments with interest at 5% on the balance owed , on January 1 of each of the following three years.

### **Required:**

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

- 1] The costs associated with the asset restoration obligation on January 1, 2015 upon the acquisition of the plant on January 1, 2015.
  - 2] The additional restoration costs due to the usage of the plant during the year, 2015, on December 31.
  - 3] The annual depreciation expense to be recorded on **December 31, 2016.**
  - 4] The finance costs on the outstanding liability for the year ended **December 31, 2016.**
  - 5] **Now assume the company is applying ASPE.** The additional restoration costs due to production for the year, ending December 31, 2015.
  - 6] The compensation for the dismantling and cleanup contract on January 1, 2031.
  - 7] The payment for the second instalment made on January 1, 2032.
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**QUESTION III - ACCOUNTING FOR PROMOTION CAMPAIGNS - [18 Marks]**

Mr. Kount, president of Premium Cup Coffee Roasters Co., a high end coffee producer and distributor, informs you, a newly hired senior accountant, that in order to stimulate sales of its best selling brand the marketing department decided to start a promotional campaign whereby one coupon would be included in each can of coffee sold. By redeeming 4 coupons along with payment of \$5.00, customers would be entitled to receive an attractive Canadian handmade stoneware coffee mug or by redeeming 5 coupons and paying \$7.00 they would receive an authentic Canadian made wooden coffee grinder. Both products tastefully display the Canadian origin of Premium Cup Coffee Co. with prominence. He exclaims: “What nicer products to receive during the Winter when everyone drinks more coffee than a coffee grinder or a coffee mug with our logo on it?” The two products are proudly displayed in Mr. Kount’s office.

Mr. Kount suggests that your lunch break would need to be put on hold since no accounting for this campaign has been done during the first quarter of January 1 to March 31, 2017. “Only the sales/costs of coffee were recorded and the accounting for these promotional costs would follow the expense method. You will have to do it right away. The folks preparing the quarterly financial statements are waiting for your feedback and you do know that the need to issue them is of top priority. And oh, the purchases of the mugs and grinders have been totally paid for”.

In total, it is expected that 60% of the coupons will be redeemed and of those coupons redeemed, 30% would be for the coffee grinder and the remainder for the mug. The Mug costs \$11.00 and the Coffee grinder costs \$17.00 and both prices include shipping. The sales volumes and coupon redemptions during the first quarter are as follows:

<u>Quarter</u>	<u>Cans of coffee sold</u>	<u>Coupons redeemed- mug</u>	<u>Coupons redeemed-coffee grinder</u>
I- 2017	1,720,000	660,000	316,000

The purchases of mugs and coffee grinders respectively are stated below. Another order to restock won’t arrive until April, 2017.

	<u>Mugs</u>	<u>Coffee grinders</u>
January, 2017	180,000	67,000

**Required:**

- a) Prepare the journal entries required for the first quarter of 2017 to record all transactions related to this promotional campaign, as follows:
  - ☞ Purchase of coffee mugs and coffee grinders;
  - ☞ To set up a liability estimate for the promotional expenses;
  - ☞ To record the redemption of coupons and the receipt of cash on redemption.
- b) How much is the liability at the end of the first quarter?
- c) Mr. Kount is concerned that they may run out of mugs and grinders due to the programs’ popularity. And so, he further asks you to compute how many of each item remain on hand at the end of the first quarter.

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*The End - - - Time To Party*



**ISSUE 3 - CONTINGENT LIABILITIES - [5 Marks]**

The company should recognize a **loss contingency of \$2,030,000 and disclose in footnotes an additional contingency of up to \$1,970,000.** IFRS requires entities to record a loss if there exists a likelihood of such loss occurring. The amount would be the best estimate of all possible expected losses. **[(0.35 x 800,000) + (0.40 x 2,500,000) + (0.25 x 3,000,000)]**

The journal entry would be as follow:

Contingent Loss for Damages	2,030,000	
Contingent Liability for Damages		\$2,030,000

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**ISSUE 4 - PRICING BOND ISSUES - [5 Marks]**

a) PV SA (9,000,000 @3% , 20 periods) = (9,000,000 x 0.55368) = 4,983,120  
PV Ann (315,000 @ 3%, 20 Periods Annuity) = (315,000 x 14.87747) = 4,686,403  
**Issue Price** **9,669,523**

b) Interest Expense 290,086  
Bonds Payable 29,914  
Interest Payable 315,000  
[(0.03 x 9,669,523) - 315,000] = (24,914); and  
[(0.03 x (9,669,523 - 24,914)) - 315,000]

	3%	3.5%	
	Int. exp.	cash	book value
1/1/15			9669523
6/30/15	290,086	315,000	9694437
12/31/15	290,833	315,000	9670,270

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**ISSUE 5 - DEBT RESTRUCTURING AND SETTLEMENT - [10 Marks]**

a) **Cash flow Test**  
PV SA [300K, 10%, 2 Years] = 0.82645 x 300K = 247,962  
PV SA [18,000, 10%, 2 Years] = 1.73554 x 30,000 = 31,240  
**PV Revised Debt** **279,202**  
**Difference from \$380,000 Being A Loss** 100,798

Bad Debt Expense	100,798	
Notes Receivable		100,798

b) **Revalue New Debt at Current Market Rate**  
PV SA (9%, 2 P) = 300,000 x 0.84168 = 252,504  
PV An (9%, 2P) = 18,000 x 1.75911 = 31,664  
**PV New Debt** **284,168**  
Gain (380,000 - 284,168) 95,832

Notes Payable (Old)	380,000	
Notes Payable (New)		284,168
Gain on Settlement		95,832

**ISSUE 6 - DEBT RESTRUCTURING AND SETTLEMENT - [6 Marks]**

a)	Warehouse Property	\$502,000	
	Loss on Settlement	13,000	
	Note Receivable		380,000
	Cash		120,000
	Cash		15,000
b)	Note Payable	380,000	
	Cash	120,000	
	Warehouse Property		175,000 [NBV]
	Gain on Disposal of Property		312,000 [487,000 - 175,000]
	Gain on Settlement of Debt		13,000 [Plug]

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**ISSUE 7 - DEBT REPORTING - [4 Marks]**

- a) When reporting under IFRS, the company should report all \$1,200,000 as Long term Liabilities on its Balance sheet as at December 31, 2015.
- b) When reporting under ASPE, the company should report \$300,000 as Current Liabilities and \$900,000 as Long term Liabilities on its Balance sheet as at December 31, 2015.
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**ISSUE 8 - ISSUE OF HYBRID DEBT - [14 Marks]**

a)	Cash	4,320,000	
	Bonds/P		4,150,000
	C/S - Warrants		120,000 [4,000 x 6W x \$5]
	C/S - Conversion		50,000
b)	Straight line amortization upto January 1, 2014: $[(150,000/20) \times 4 \text{ Periods}] = 30,000$		
	Balance of Amortized Cost = 4,150,000 - 30,000 = 4,120,000		
	Conversion:		
	Bonds/P	1,236,000	
	C/S - Conversion	15,000	
	Common Shares		1,251,000
	[0.3 x 50,000]		

**There is no gain/loss on the conversion.**

- c) Under IFRS, the bonds should be amortized using the effective rate method. The use of the straight line method is incorrect and would be disallowed under IFRS.
- d)  $4,000B \times 0.3 \times 40S = 48,000 \text{ shares}$
- |    |                   |         |         |
|----|-------------------|---------|---------|
| e) | Cash              | 208,000 |         |
|    | C/S Warrants      | 40,000  |         |
|    | Common Shares     |         | 248,000 |
|    | [1/3 x \$120,000] |         |         |

**There is no gain or loss on the issue of shares on warrants exercised.**

**SOLUTIONS: QUESTION II - ARO Transactions - [24 Marks]**

1 To record the costs associated with the asset retirement obligation:

[The present value of \$250,000 due in 16 years at 5% per year discount rate]

$250,000 \times 0.45811 = \$114,528$

Equipment	114,528	
Asset Retirement Obligations		114,528

2] To record the additional restoration costs related to the production process and the asset retirement obligation at December 31, 2015:

[Present value of estimated clean up costs of (\$400,000/16) at 5% per year in 15 years]

$\$25,000 \times 0.48102 = \$12,026.$

Production Overhead Costs	12,026	
Asset Retirement Obligations		12,026

3] The depreciation expense for 2016 on the total equipment to be recorded on December 31, 2016.

1.  $[\$2.4M + \$114,528]/16 \text{ Periods} = \$157,158 \leftarrow \leftarrow$  Same throughout the asset's useful life

Depreciation Expense	157,158	
Accumulated Depreciation – Equipment		157,158

4] The finance (interest) costs for 2016 on December 31.

Interest Expense	6,614	
Asset Retirement Obligations		6,614

$[0.05 \times (114,528 + 12,026 + (0.05 \times 114,528))]$

5] Now assume ASPE. The additional restoration costs during production for the year, ending December 31, 2015.

[Present value of estimated clean up costs of (\$400,000/16) at 5% per year in 15 years]

$\$25,000 \times 0.48102 = \$12,026.$

Equipment	12,026	
Asset Retirement Obligations		12,026

6] The payment for the dismantling and cleanup contract on Jan 1, 2031.

Asset Retirement Obligations	650,000	
Loss on Settlement of ARO	50,000	
Cash		250,000
Loan Payable		450,000

7] Payment for the second instalment made on January 1, 2032

Interest Expense	22,500	
Loan Payable	150,000	
Cash		172,500

$[(0.05 \times 450,000) = 22,500]$

**QUESTION III - ACCOUNTING FOR PROMOTION CAMPAIGNS - [18 Marks]**

a) **Provide the Journal Entries for the Promotional Campaign**

	<u>Coffee Mugs</u>	<u>Coffee Grinder</u>
Cost	\$11	\$17
Paid by buyer	<u>( 5)</u>	<u>( 7)</u>
Net cost	<u>\$ 6</u>	<u>\$10</u>

**January, 2017- Purchase of Coffee Mugs and Coffee Grinders:**

Inventory Promo - coffee mugs	\$1,870,000	[180,000*11]
Inventory Promo - Coffee Grinders	\$1,139,000	[67,000*17]
Cash		\$3,119,000

**To Set Up a Liability Estimate**

Mugs	(1,720,000 coupons * 0.60 red. Rate * 0.70 * \$6)/4 coupons	= \$1,083,600
Grinders	(1,720,000 coupons * 0.60 red. rate * 0.30 * \$10)/5 coupons	= <u>\$ 619,200</u>
		<u>\$1,702,800</u>

Promotion expense	\$1,702,800	
Promotion liability		\$1,702,800

**To record redemption of coupons and receipt of cash**

Mugs	(660,000/4 = 165,000 mugs @ \$11	=	\$1,815,000
Grinders	(316,000/5 = 63,200 grinders @ \$17	=	1,074,400
Liability reduction	= 165,000 * 6 + 63,200 * 10	=	1,622,000
Cash received	= 165,000 * \$5 + 63,200 * \$7	=	1,267,400

Promotion liability	1,622,000	
Cash	1,267,400	
Inventory promo - coffee mugs		1,815,000
Inventory promo-coffee grinders		1,074,400

b) The liability at the end of Q1 would be 1,702,800 - 1,622,000 = \$80,800

c) The number of items remaining at the end of Q1 is as follows:

Mugs-	180,000 – 165,000 = <b>15,000</b> ;
Grinders-	67,000 – 63,200 = <b>3,800</b>

*The End - - - Time To Party*

