

**SOLUTION TO PRACTISE QUESTIONS  
SCOTT SINCLAIR  
COMM SECTION 204**

**Question 1–Share transactions (25 minutes)**

Boot Camp Inc. was incorporated a few years ago. The main shareholder, who used to be the sole proprietor prior to Boot Camp Inc. being incorporated, was reviewing some income statements for the earlier proprietorship and is confused about some expenses that are present on Boot Camp Inc.'s income statement but were not on the proprietorship's income statement.

a) Specify two expenses that are usually on an incorporated business's income statement but are not on a proprietorship's income statement and briefly explain why each is absent from the proprietorship's income statement. **(4 marks)**

i. First expense: income tax expense

Why absent? Proprietorship doesn't pay income tax

ii. Second expense: Salary for owner

Why absent? Owner removes cash by distribution

b) Shareholders have certain rights as owners of a corporation. These rights may differ depending on the type of shares purchased.

**Required:**

List and briefly discuss the general rights of a common shareholder. **(4 marks)**

Common shareholders have the right to share proportionately in the following:

- (1) *Profits and losses of a corporation*: This is accomplished through the distribution and receipt of dividends.
- (2) *Management of a corporation*: This is accomplished by voting for members of the board of directors. Each common shareholder gets one vote per share. So, the shareholders elect the board that, in turn, hires and fires management.
- (3) *Assets upon liquidation*: This is accomplished by establishing an order in which creditors and owners are paid upon liquidation. Common shareholders come last and split any assets remaining in proportion to their relative number of shares.
- (4) *Subsequent issues of shares*: This is accomplished by guaranteeing the common shareholder the right to a proportionate share of any new shares (the pre-emptive right). This allows shareholders to maintain their ownership interest.

**Question 1 –Share transactions (25 minutes) continued**

a) Identify three requirements that normally must be satisfied before the declaration of a cash dividend. (3 marks)

- ***Must have cash***
- ***Must have retained earnings***
- ***Must have Board of Directors approval***
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b) On December 31, 2004 Canadian Cheese Company had the following shareholders' equity balances:

Preferred shares- \$5 cumulative redeemable preferred shares, 250,000 authorized, 30,000 issued and outstanding (1 year of dividends in arrears)	\$ 2,400,000
Common shares- unlimited authorized, 225,000 issued	\$ 1,125,000
Retained earnings	<u>\$ 750,000</u>
	<u>\$ 4,275,000</u>

The following transactions took place in 2005:

- i) On January 12, 2005, 125,000 common shares were issued at \$15 each and 25,000 preferred shares at \$80 per share.
- ii) On March 31, \$160,000 of cash dividends were declared and paid by the Board of directors.
- iii) On June 30, 2005 35,000 common shares were repurchased and cancelled at price of \$7 per share.
- iv) On September 30, the directors declared a dividend large enough to pay each common shareholder \$0.50 per share.
- v) On October 31, 2005 the Board of Directors declared a 2 for 1 stock split on the company's common shares.
- vi) On December 31, 2005 the company announced net income of \$575,000.
- vii) On December 31, 2005 the Board of Directors announced a 10% stock dividend to all common shareholders. The common shares were trading at \$8.50 per share.

**Required**

Prepare the journal entries necessary to record the above-noted transactions. Be specific to which shareholders receive the dividends. (10 marks)

**Question 1 –Share transactions (25 minutes) continued**

	<b>DR</b>	<b>CR</b>
Dr Cash	3,875,000	
Cr Common shares		1,875,000
Cr Preferred shares		2,000,000
Dr Preferred Dividends	160,000	
Cr Cash		160,000
Dr Common shares	299,950	
Cr Contributed surplus		54,950
Cr Cash		245,000
Dr Dividends Declared-preferred	265,000	
Dr Dividends Declared-common	157,500	
Cr Cash		422,500
Stock split no journal entry, increase number of shares outstanding		
Dr Income summary	575,000	
Cr Retained earnings		575,000
Dr Stock dividend declared	535,500	
Cr Common shares		535,500

**Question 2-Cash Flow statement (25 minutes)**

The Spring Valley Corporation prepared the following income statement and comparative balance sheets for 2007:

SPRING VALLEY CORPORATION  
Income Statement  
For the Year Ended December 31, 2007

Sales	\$1,900,000
Less: Cost of goods sold	<u>980,000</u>
Gross Profit	920,000
Less: Amortization expense—capital assets	200,000
Amortization expense—patents	27,000
Other operating expenses	197,000
Interest expense	160,000
Loss on sale of land	<u>100,000</u>
Income before taxes	236,000
Income taxes	<u>70,800</u>
Net Income	<u>\$ 165,200</u>

SPRING VALLEY CORPORATION  
Balance Sheet  
As at December 31, 2007

<u>Assets</u>	<u>2007</u>	<u>2006</u>
Cash	\$ 405,200	\$ 200,000
Accounts Receivable	180,000	350,000
Temporary Investments	460,000	320,000
Merchandise Inventory	2,336,000	2,090,000
Property, Plant, and Equipment	880,000	800,000
Less: Accumulated Amortization	(760,000)	(560,000)
Patents	<u>192,000</u>	<u>219,000</u>
Total Assets	<u>\$3,693,200</u>	<u>\$3,419,000</u>
 <u>Liabilities and Shareholders' Equity</u>		
Accounts Payable	\$ 389,000	\$ 265,000
Other Accrued Payables	160,000	240,000
Dividends Payable	90,000	80,000
Income Taxes Payable	17,000	42,000
Note Payable (Long-Term)	180,000	560,000
Bonds Payable	900,000	400,000
Common Shares	1,600,000	1,600,000
Retained Earnings	<u>357,200</u>	<u>232,000</u>
Total Liabilities & Shareholders' Equity	<u>\$3,693,200</u>	<u>\$3,419,000</u>

**Question 2 Cash Flow statement (25 minutes) continued**

Additional data:

- (1) Equipment was purchased for \$400,000.
- (2) Cash dividends of \$40,000 were declared in 2007.
- (3) Land was sold for cash proceeds of \$220,000.

**Required**

a) Prepare a cash flow statement for 2007 using the indirect approach. **(17 marks)**

**Solution:**

Spring Valley Corporation  
Cash Flow Statement—Indirect Approach  
For the Year Ended December 31, 2007

Cash flows from operating activities:		
Net Income	\$165,200	
Add: Amortization—capital assets	200,000	
Amortization—patents	27,000	
Loss on sale of land	100,000	
Decrease in accounts receivable	170,000	
Increase in accounts payable	124,000	
Less: Increase in inventory	(246,000)	
Decrease in income taxes payable	(25,000)	
Decrease in other accrued payables	<u>(80,000)</u>	
Cash provided by operating activities		\$435,200
Cash flows from investing activities:		
Proceeds from sale of land	220,000	
Purchase of temporary investments	(140,000)	
Purchase of equipment	<u>(400,000)</u>	
Cash used by investing activities		(320,000)
Cash flows from financing activities:		
Proceeds from sale of bonds	500,000	
Payment on notes payable	(380,000)	
Payment of cash dividend	<u>(30,000)</u>	
Cash provided by financing activities		<u>90,000</u>
Increase in cash		205,200
Cash balance, January 1, 2007		<u>200,000</u>
Cash balance, December 31, 2007		<u><u>\$405,200</u></u>

**Question 2-Cash Flow statement (22 marks, 31 minutes) continued**

- b) Attached is the cash flow statement of Spring Valley Corporation. As a shareholder, comment on whether you are satisfied with management's performance in 2007.  
**( 5 marks)**

**cash from operations positive**

**Significant reinvestment in capital assets**

**small payment of dividends**

**Repayment of notes, issuance of new debt**

**Question 3-Property, Plant and Equipment (22 minutes)**

McIntosh Corporation negotiated a lump-sum purchase of land, building, and equipment from Scott Corporation. The purchase was completed on June 2, 2005 at a total cash price of \$507,000. The estimated market value of each asset was land \$187,000; building, \$150,000; and machinery, \$170,000.

**Required**

a) Prepare journal entries to record:

i) Amortization expense for the year ended December 31, 2005 assuming the building is amortized on a straight-line basis over a useful life of 12 years and has a salvage value of \$12,000. The machinery is amortized using the double-declining balance method assuming a 5-year service life and a \$10,000 residual life. ( 5 marks)

**Building**

$$(150,000-12,000)/12=12,167$$

**Equipment**

$$(1/5)*2=.40$$

$$170,000*.4=68,000$$

Dr Amortization expense equip	39,667	
Dr Amortization expense-build	6,708	
Cr	Acc Amort-equip	39,667
Cr	Acc Amort-build	6,708

**Question 3-Property, Plant and Equipment (22 minutes)** continued

- ii) On January 2, 2008, McIntosh Corporation traded all of the machinery for a new machinery and paid the difference of \$80,000. The new machinery is to be recorded at the book value of the old machinery plus the cash payment. **(4 marks)**

2005	170,000	39,667	130,333
2006	130,333	52,133	78,200
2007	78,200	31,280	46,920

Dr Machinery-new 126,920  
Dr Acc Amort-old 123,080  
Cr Machinery-old 170,000  
Cr Cash 80,000

- iii) Amortization expense of the building for the year ended December 31, 2010 taking into account that on January 2, 2010, management estimated, based on the experience of the previous 5 years, that the building's service life would continue for a further 10 years and that the salvage value would equal \$5,000. **( 4 marks)**

Amortization from 2005-2009 =  $6,708 + (4 * 11,500) = 52,708$

$(150,000 - 52,708 - 5,000) / 10 = 9,229$

Dr Amortization expense-building 9,229  
Cr Accumulated amortization-building 9,229

**Question 3-Property, Plant and Equipment (22 minutes)**continued

b) You are the accountant for McIntosh Corporation. The president has just received your monthly report, which is prepared only for internal purposes. He asks, "What is this ROA calculation? I don't know what purpose it serves."

Prepare a response to the president. **(3 marks)**

ROA, return on investment, is an important ratio that is used to calculate how well management has managed the corporation's assets. This ratio expresses the total return earned as a percentage of total assets. The return on the investment in assets should be calculated prior to any payments or returns to the debtholders or shareholders. Net income must be adjusted for the effects of interest expense net of any related tax savings. The ROA ratio is calculated as follows:

$$\text{ROA} = \frac{\text{Net income} + \text{interest expense} - \text{tax savings of interest expense}}{\text{Average total assets}}$$

ROA is used to compare different corporations or one company over periods of time. It allows you to evaluate performance by comparing ROA to a benchmark or by comparing performance to industry standards.

**Question 4- Ratios (15 minutes)**

a) Lowride Inc. is a manufacturer of custom motorcycle and automotive parts. The company's shares have recently traded on the Toronto Stock Exchange for \$5.50.

In 2006, the company earned net income of \$665,200 and had average shareholders' equity of \$3,457,000. During 2006, the company had shareholders' equity consisting of 500,000 common shares and no preferred shares. There were no common shares sold or repurchased in 2006.

**Required:**

Given the above-noted information, how a shareholder would determine whether the current price is reasonable? **(6 marks)**

$$\begin{aligned} \text{a. Earnings per share} &= \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Average Number of Common Shares Outstanding}} \\ &= \frac{\$665,200 - 0}{500,000 \text{ shares}} \\ &= \$1.33 \end{aligned}$$

$$\begin{aligned} \text{b. Price/earnings ratio} &= \frac{\text{Share Price}}{\text{EPS}} \\ &= \frac{\$5.50}{\$1.33} \\ &= 4.13 \end{aligned}$$

$$\begin{aligned} \text{c. Return on shareholders' equity} &= \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Average Common Shareholders' Equity}} \\ &= \frac{\$665,200 - 0}{\$3,457,000} \\ &= 19.2\% \end{aligned}$$

**Question 4 Ratios (15 minutes)**continued

- b). Presented below are a series of financial ratios for two companies in the same industry:

	<u>LABAR INC.</u>			<u>CAROK CO.</u>		
	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Inventory turnover	11.8	13.6	15.5	8.4	8.5	8.0
Accts. receivable turnover	15.1	14.5	16.0	10.5	10.2	10.6
Current ratio	2.2	2.0	2.1	2.2	2.9	3.6
Quick ratio	1.3	1.2	1.1	1.7	2.3	2.8

**Required:**

Write an analysis of the two companies. Include any comments you might have about their relative ability to manage their current assets and to meet their current obligations.

**(8 marks)**

It appears that Labar has been more successful in collecting their receivables and selling their inventory than Carok, based on the inventory and receivable turnovers. This may, in fact, indicate that Labar is the more efficient firm; however, it may also indicate that Labar's credit policy is too strict and that they have a conservative inventory policy. Such policies would restrict sales and have a negative effect on profits. It is impossible to know if either set of ratios for the companies is acceptable or not without industry comparisons.

Carok's current and quick ratios are significantly better than Labar's; however, this may indicate that Carok has excessive funds tied up in low-yielding current assets. Additionally, Labar's numbers are within the traditional rule of thumb amounts: 2.0 for the current ratio and 1.0 for the quick ratio. Again, without industry statistics it is impossible to tell if these numbers are acceptable.

At present, it appears that both companies do have sufficient current assets to meet their currently maturing liabilities. However, if the trend in inventory and receivable turnovers continues for Labar Inc., they will have difficulty meeting their current obligations.

**Question 5- Bonds (20 minutes)**

a) A company issued a \$400,000, 6%, 10-year bond to a yield of 8%. Interest is to be paid semi-annually.

**Required:**

- a. Determine the sales price of the bond.
- b. Prepare the journal entry to record the issuance.
- c. Prepare the journal entry to record the first interest payment.
- d. Determine the book value of the bond after the first coupon payment.

a.  $\$400,000 \times 0.45639 = \$ 182,555$   
 $12,000 \times 13.5903 = \underline{163,084}$   
Sales price                    \$345,639

b. Cash (A)	345,639	
Discount on bonds payable (XL)	54,361	
Bonds payable (L)		400,000

c. Interest expense* (SE)	13,826	
Interest payable (L)		12,000
Discount on bonds payable (XL)		1,826
*(345,639 × .08 × 1/2)		

d. Bonds payable	\$400,000	
Discount on bonds payable	<u>(52,535)</u>	
Book value		<u><u>\$347,465</u></u>

- b) Your grandmother has some of her money invested in corporate bonds. She has just come from a meeting with her investment advisor and asks you the following: "What is all this confusion about interest rates? There is a coupon rate, a market rate, and the current yield. And, as I understand it, some of the rates change during the life of a bond and some don't. Why is it so confusing?"

**Required:**

Explain what is meant by the coupon rate and the market rate. Also, indicate which rates change and which remain constant during a bond's life.

The coupon rate is the rate stated in the bond indenture. It is used to calculate the semi-annual interest payments. This rate remains constant during the bond's life.

The market rate is the rate the market place demands on its investments. It is the rate used to determine the market value of a bond, i.e., the sales price of the bond. As the rate increases, the price of the bond will decrease. When the price increases, this rate will change as the market place changes its perception of a particular bond.