

PART A – 21 MC Questions (26 marks, 40 minutes)

1. Enron set up “Special Purpose Entities” that were controlled by the company to borrow money from the bank but did not consolidate the SPE’s financial statements with Enron’s. This is a violation of: **(1 mark)**

The Entity Concept

2. JIF Inc is a medium size private enterprise. JIF plans to issue shares on the Toronto Stock Exchange (TSX) in 2 years. Which of the following statements is true? **(1 mark)**

JIF must report under IFRS when it is listed on the TSX 2 years later

3. Shareholders of a company want to monitor how the manager makes use of the company’s resources to increase value for the company and require the manager to report annual financial results under IFRS. Without the monitoring, the shareholders are afraid that the manager may steal from the company. Which type information asymmetry is present? **(1 mark)**

Moral hazard

4. Which of the following is **NOT** an assumption that supports the historical cost principle? **(1 mark)**

The exchange must have commercial substance

5. Which of the following is **NOT** one of the enhanced qualitative characteristics under the IFRS conceptual framework? **(1 mark)**

Conservatism

6. Livent Inc. engaged in a sale repurchase transaction by signing two separate contracts with a third party: the first one involved selling assets and the second one involved buying back the same assets at a higher price. Livent Inc. only recorded the two contracts separately. Livent has violated which of the following principles/qualitative characteristics: **(1 mark)**

Representational Faithfulness

7. Showtime Corp. holds shares in a private company. Showtime Inc. follows IFRS and account for the shares using fair value. The shares are valued using traded market price of similar company listed on the Toronto Stock Exchange. Which level of fair value does this valuation represent?**(1 mark)**

Level 2 fair value

8. Super Mario Inc., a mushroom and banana processing company that follows IFRS, is being sued by one of its employees for not maintaining a proper work environment. The employee slipped on a banana peel while working. He was suing the company for \$100,000. Although the lawyers said that there were no precedent of similar cases, at this time, it is more likely than not that the company will have to pay for the damage. The amount to be paid out cannot be reliably be estimated yet. How should the company report this lawsuit on its financial statements? **(1 mark)**

Disclose the lawsuit in the notes only

9. Sammy Inc. changes its financial reporting from annually (12 months) to 13 months due to its lengthened operating cycle. This is based on the principle/assumption of **(1 mark):**

periodicity

10. When fraudulent financial reporting becomes a norm in the financial market, the following most likely will happen based on the theory under information asymmetry: **(1 mark):**

Cost of raising capital will be higher in the financial market

11. Which of the following does not appear in the notes of the financial statements? **(1 mark):**

Management Discussion and Analysis

12. Which of the following statements about materiality is FALSE? **(1 mark)**

An illegal payment which is well below the quantitative materiality guideline is not material to the financial statements.

13. Which of the following statements about the going concern assumption is true? **(1 mark)**

The current/non-current classification of assets/liability is a result of the going concern assumption

14. The following items appear on B&B Inc's trial balance as of December 31, 2018:

Cash & Cash Equivalent	\$350,000
Asset Held for sale (originally classified as long term asset)	\$237,000
Notes receivable due on June 30, 2020	\$120,000
Prepaid expenses	\$72,500
Contract asset arising from building contract in 2018	\$280,000

What is the amount reported under current assets on the balance sheet as of December 31, 2018? B&B follows IFRS. **(2 marks)**

\$939,500

15. Beaver Builders Ltd. has a \$2,000,000 long term contract that will take four years to complete by the end of 2019. Data at December 31, 2018 is presented below:

Costs incurred to date	\$925,000
Estimated costs to complete in 2019	231,250
Billings to date	850,000
Collections to date	700,000

Beaver Builders uses completed contract method to account for this contract. What is the amount of contract asset that should appear on the balance sheet on December 31, 2018? **(2 marks)**

\$75,000

Please use the following information for question 16&17.

	2018
Beginning inventory	\$100,000
Purchases	\$500,000
Ending inventory based on:	
Specific identification	\$112,000
First-in, first-out	\$120,000
Weighted average cost	\$116,000

16. Which costing method above yields the highest net income in 2018? **(1 mark)**

First-in, first-out

17. What is the inventory turnover ratio in 2018 assuming the company uses specific identification method? Round your answer to 2 decimal places **(2 marks)**

4.60

18. What is the main reason behind the criteria that specific identification method can only be applied to inventory items that are non-interchangeable? **(1 mark)**

To avoid income manipulation

19. On December 31, 2018, GGI had 600,000 shares of common stock and 300,000 shares of 8%, cumulative preferred stock issued and outstanding. Preferred stock is reported on the balance sheet at \$7,000,000. Net income for the year is \$2,810,000.

The following transactions occurred during the year:

- a) On March 1, 2018, GGI sold 60,000 common shares;
- b) On April 1, declared and issued a 20% stock dividend on its common stock

What is the weighted average number of shares for calculation of earnings per share in 2018? **(2 mark)**

\$588,000 (question voided)

20. Using the same facts in Question 19 but ignore your answer. Assume that the weighted average number of shares for 2018 is 500,000 and the company has not declared preferred dividends, what is the 2018 earnings per share? **(1 mark)**

\$4.5

21. A company has a standard markup on cost of 50%. The following information is available for the month of July:

Sales	\$510,000
Purchase	\$200,000
Beginning Inventory	\$185,000

Using the gross margin method, estimate the ending inventory at the end of July. **(2 marks)**

\$45,000

Part B (29 marks)

B.1 (13 marks) SB Inc. is a bicycle manufacturing company and MS Corp. is a bicycle rental company. On January 1st, 2018, SB Inc. has entered into a contract with MS Corp. to deliver 500 bicycles at \$300 each. The inventory was carried on SB Inc.'s books at \$175 each. Since the two companies have always maintained a long standing business relationship, SB Inc. agreed to a 45-day return policy for any reason. Based on past experience of selling this particular model, only 2% of sales will be returned within 30 days, which is SB's standard return period.

The delivery took place on January 8th, 2018 and MS Corp. paid in full on Feb 1st, 2018. On Feb 28th, 2018, MS Corp. returned 15 of these bicycles to SB Inc. for a same day cash refund.

Prepare all the journal entries on SB's books pertaining to this transaction between January 1st and Feb 28th. Make sure to label all parts of the journal entries, including dates and accounts.

Valid assumptions:
If follow IFRS:

January 8th

Dr. A/R	\$150,000		
	Cr Sales	\$147,000	
	Cr Refund Liability	\$3,000	
Dr. COS	\$85,750		
Dr Right to recover asset	\$1,750		
	Cr. Inventory		\$87,500

Feb 1st

Dr. Cash	\$150,000		
	Cr. A/R	\$150,000	

Feb 22nd

Dr. Refund Liability	\$3,000		
Dr. COGS	\$1750		
	Cr. Sales	\$3000	
	Cr. Right to recover asset	\$1750	

If assume returns are allowed by SB Inc.:

Feb 28th

Dr. Sales returns (or sales)	\$4500		
	Cr. Cash		\$4500
Dr. Inventory	\$2625		
	Cr. COGS		\$2625

ADMS 3585 Mid-term Exam –Fall 2018

Alternatively, I also accept the following, without the entries on Feb 22:

Feb 28th

Dr. Refund Liability	\$3000	
Dr. Sales returned (or sales)	2	\$1500
Cr Cash		\$4500

Dr. Inventory	\$2,625	
Cr. Right to recover asset		\$1,750
Cr. COGS		\$875

If assumes ASPE:

January 8th

Dr. A/R	\$150,000	
Cr Sales		\$150,000

Dr. Sales and returns allowance (contra to Sales)	\$3,000	
Cr. Allowance for sales and returns (contra to A/R)		\$3000

Dr. COS	\$87,50	
Cr. Inventory		\$87,500

Feb 1st

Dr. Cash	\$150,000	
Cr. A/R		\$150,000

Feb 22nd

Dr. Allowance for sales and returns	\$3,000	
Cr. Sales and returns allowance		\$3,000

If assume returns are allowed by SB Inc.:

Feb 28th

Dr. Sales returns (or sales)	\$4500	
Cr. Cash		\$4500

Dr. Inventory	\$2625	
Cr. COGS		\$2625

Alternatively, I also accept the following, without the entries on Feb 22:

Feb 28th

Dr. Sales and returns allowance	\$3,000	
Dr. Allowance for sales and returns	\$1,500	
Cr. Cash		\$4,500

Dr. Inventory	\$2625	
Cr. COGS		\$2625

B2. (16 marks) During 2017, Pillar Construction Company began construction on a shopping plaza for the City of Jays. The contract price is \$12,000,000, and the plaza will take approximately 3 years to complete. The company's fiscal year ends on December 31. The company follows IFRS and uses the percentage of completion method to account for long term contracts. The following information is related to the project in 2017, 2018, 2019:

2017:

- Construction costs including direct labour, materials, and overhead amount to \$3,500,000.
- A total of \$4,400,000 has been billed to the customer.
- The customer has paid \$3,000,000.
- Pillar has recorded revenue of \$4,800,000 and construction expense of \$3,500,000

2018:

- Construction costs including direct labour, material, and overhead has now accumulated to \$6,000,000 since inception of the project.
- A total of \$6,600,000 has been billed to the customer since inception of the project.
- The customer has paid \$9,000,000, since inception of the project.
- Estimated additional cost to complete the project is \$4,900,000

2019

- The project is completed at \$10,000,000 in total cost.
- The company has make the final billing to the customer and have received all remaining balance by December 31

Round all calculations to the nearest percent and dollar, i.e. 22.3% = 22%, \$22.5 = \$23

- a) (3 marks) Calculate the contract asset/liability to be presented on the Balance Sheet on **December 31, 2017**. Be sure to label it as either an asset or a liability.

Contract asset of \$400,000 (4,800,000-\$4,400,000)

- b) (1.5 mark) Provide the journal entry to record the billing in **2017**.

Dr. A/R 4,400,000
 Cr. Contract asset/liability \$4,400,000

- c) (9.5 marks) Calculate the gross profit/loss to be recorded in **2018** and prepare the journal entry for revenue recognition only.

Cost in 2018 = 6,000,000 – 3,500,000 = \$2,500,000 1 mark

% completion = 6,000,000/(6,000,000+4,900,000) = 55% 2 mark

Revenue in 2018 = 12,000,000 x 55% - 4,800,000 = 1,800,000 3 marks

Gross profit/loss in 2018 = 1,800,000 – 2,500,000 = (\$700,000) 2 marks

Dr. Cost of construction \$2,500,000
 Cr. Revenue \$1,800,000
 Cr. Contract asset/liability \$700,000

d) (2 marks) If Pillar follows IFRS and cannot reliably measure progress, how much revenue should be recorded in **2019**?

Zero-Profit method:

\$12,000,000 - \$6,000,000 = \$6,000,000

Part C (15 marks)

Select balances and transactions of San Me Co. are listed below:

		2018	2017
Assets			
Cash		\$ 37,000	\$ 32,000
A/R		\$ 1,030,000	\$ 980,000
Inventory		\$ 840,000	\$ 761,600
Equipment		\$ 3,520,000	\$ 2,418,000
Less: Acc. Dep		\$ (1,781,600)	\$ (1,756,000)
Land		\$ 700,000	\$ 300,000
Patent		\$ 186,000	\$ 194,000
Total		\$ 4,531,400	\$ 2,929,600
Liabilities and S/E			
A/P		\$ 885,200	\$ 915,200
Bond Payable		\$ 2,218,000	\$ 1,190,000
Common Shares		\$ 366,000	\$ 360,000
Retained Earnings		\$ 1,062,200	\$ 464,400
Total		\$ 4,531,400	\$ 2,929,600

Other Information:

- Net income for 2018 is \$841,200
- Depreciation expense on equipment and amortization expense on patent totaled \$370,000
- Gain on sale of equipment of \$12,000 is included in the income statement
- Equipment with original cost of \$584,000 and accumulated depreciation of \$336,400 was sold for cash. The company also purchased new equipment for cash. There is no addition to patent.
- The company repaid bond payable of \$800,000 and issued new bonds.
- Land was purchased by issuing new common shares. The company also repurchased some common shares during the year.
- Other activities include dividends declared and paid

- a. (6 marks) Prepare the **operating activities section** of the Statement of Cash Flows for 2018. Show all steps for full marks.

Net Income			\$	841,200
Adjustments:				
Depreciation Expense		\$	370,000	
Gain on sale of Equip		\$	(12,000)	
Increase in A/R		\$	(50,000)	
Increase in Inventory		\$	(78,400)	
Decrease in A/P		\$	(30,000)	
Net cash provided by operating activities			\$	1,040,800

- b. (3 marks) How much new financing did the company obtain from the issuance of new bonds in 2018?

Bond beg	\$	1,190,000
Retire	\$	(800,000)
Add	\$	1,828,000
Bond End	\$	2,218,000

\$1,828,000 of new bonds have been issued.

- c. (3 marks) How much did the company pay for the new equipment in 2018?

Beg balance	\$	2,418,000
Equip sold	\$	(584,000)
Equip purchased	\$	1,686,000
End balance	\$	3,520,000

\$1,686,00 OF new equipment has been purchased.

d. (3 marks) How much did the company pay to repurchase its shares in 2018?

Shares beg	\$ 360,000
Issued for land	\$ 400,000
Repurchase	\$ (394,000)
Ending	\$ 366,000

\$394,000 issues have been repurchased.

Part D (16 marks; 17 minutes)

Western Travel Inc, a multi-national travel agency, specializes in guided tour around the world. On June 30th, 2018, the board of directors decided that its North American operation (NA) is no longer profitable and planned to sell it to its competitor GenX Travel Group. NA generated its own cashflows and operated independently from other groups in the company. Below is the financial situation of NA as at year end December 31, 2018:

- From January 1 to June 30 2018, NA generated \$700,000 in losses before tax
- From July 1 to December 30, 2018, NA generated further before tax loss of \$250,000
- Western Travel believed that the fair value of NA's net assets approximate \$1.9 million. The carrying value of the net assets on June 30th was \$2 million.
- Upon closing the deal in January 31, 2019, Western Travel will pay 5% of the proceeds received to cover all legal costs and commission on the sale.
- The sale was eventually completed on March 30th, 2019 and NA was sold to GenX Travel Group for \$2.2 million.
- NA stopped all its operations on December 31, 2018.
- Western Travel Inc has tax rate of 25% and follows IFRS.

- a) (9 marks) Prepare in good form the discontinued operations section on 2018 income statement, include all tax effects in your answer.

Discontinued Operations:

Loss from operations, net of tax recovery (\$237,500)	(\$712,500)*
Writedown of net assets, net of tax recovery (\$48,750)	(\$146,250)**
Total loss on discontinued operations, net of tax	(\$858,750)

***Loss from operations in 2018:**

(\$700,000) + (\$250,000)	(\$950,000)
Tax recovery 25%	<u>\$237,500</u>
After tax loss	(\$712,500)

****Writedown of net assets in 2018:**

Fair value less cost of sale	\$1,900,000 x 95% = \$1,805,000
Carrying value	<u>\$2,000,000</u>
Writedown before tax	(\$195,000)
Tax recovery 25%	<u>\$48,750</u>
Writedown after tax	(\$146,250)

Carrying value of net assets after writedown = 1,805,000

- b) (4 marks) Prepare in good form the discontinued operations section on 2019 income statement, include all tax effects in your answer.

Discontinued Operations

Gain from disposal, net of tax (\$72,500) \$213,750*

*Gain on disposal 2019:

Net Proceeds	\$2,200,000 x 95% = \$2,090,000
Carrying value	<u>\$1,805,000</u>
Gain on disposal before tax	\$285,000
Tax 25%	<u>(\$71,250)</u>
Gain on sale after tax	<u>\$213,750</u>

- c) (3 marks) Explain why Western Travel can report NA as a discontinued operation in 2018.

Criteria: Component held for sale that has its own distinct cashflows and operations, represents a major geographical area (North America)

Held for sale criteria satisfied:

1. Actively looking for a buyer (GenX)
2. Available for immediate sales
3. Sale probable within one year (expected January 31, 2019)
4. Asking price reasonable (1.8 million vs carrying value of \$2 million)
5. Board approval
6. Not likely to change plan – stopped operations on Dec 31, 2018

Part E (9 marks; 10 minutes)

Somersby Inc. uses a periodic system of inventory. Each of the following independent scenarios happen in 2018 and 2019:

- a. Ending inventory was overstated by \$20,000 at the end of 2018. Ending inventory in 2019 was correct.
- b. Goods in transit (from supplier to Somersby Inc.) in the amount of \$45,000 were omitted from inventory count at the end of 2018 but were included in inventory in January 2019 when the invoice was received.

Indicate the effect of each of the above independent error on

- i) 2018 net income
- ii) 2019 net income
- iii) 2019 ending retained earnings

Answer:

a) Beg. inventory + Purchases – Ending Inventory = COGS	NI	R/E
2018: Over \$20K under \$20K	over \$20K	
2019: Over 20K Over 20K	under \$20K	no effect

- i) overstated by \$20,000
- ii) understated by \$20,000
- iii) no effect

b) Beg. inventory + Purchases – Ending Inventory = COGS	NI	R/E
2018: Under\$45K Under \$45K No effect	No effect	No effect
2019: Under\$45K Over \$45K No effect	No effect	No effect

- i) no effect
- ii) no effect
- iii) no effect

Part F (20 marks; 40 minutes)

Dahlia inc (DI) grew from a single-store operation, selling high-quality postcards and stationary (such as agendas, calendars etc) into a chain retailer. Currently, DI has six corporate-owned stores in Ontario. Products are ordered on a custom basis and purchased from the finest manufacturers. That is, DI sources inventory from manufacturers in Europe and brings it to Canada for resale. However, DI also has a small manufacturing facility producing high-end pens. DI's founder, Dorothy Soto, is set to retire from running the day-to-day business. Luckily, she recently received an offer from a young entrepreneur, Lilly Water. Sale of the company to Lilly will depend on the net income reaching a desirable level in 2018. DI follows IFRS. Dorothy has asked for your help in recording the following transactions that occurred during the 2018 fiscal year which ends on October 31:

Role, reporting constraints, stakeholders

Lilly – purchaser who is interested in assessing profitability and cash flows of the business;
constraint - IFRS

Potential bias on net income

DI signed a contract with Hero Inc to produce 1000 units of high-end pens. DI will produce the pens over a period of 2 months (from October 1 to November 30). Based on the customer's request, DI will engrave Hero's logo on all pens. Once the engraving is done, Hero can request delivery of any units anytime, regardless of whether the rest of the order is finished or not. DI estimated that 500 pens will be finished by October 31. Hero paid an upfront deposit of \$12,000 which is 75% of the total sales price for the order. DI offers 5% volume discounts on order over \$20,000 and encourage Hero to order more before October 31. Hero is a newer customer who have never ordered from DI before.

Step 1. Identify the contract with the customer – DI has a contract to deliver 1000 units

Step 2. Identify separate performance obligations only one performance obligation.

Step 3. Determine the overall contract price \$12,000 is 75%, therefore, the purchase price is \$16,000 .

Step 4. Allocate the price to the separate performance obligation. In this case, there is only one performance obligation

Step 5. Determine when the performance obligation is complete and revenue can be recognized. The question is whether control passes when pens are delivered or if it passes with the passage of time as the product is finished. If control passes only upon delivery, then we cannot recognize revenue as the production of the pen is completed. Since the pens will have Hero's logo engraved, DI will not be able to sell it to another customer without substantial rework. Delivery is upon request, thus it satisfies the bill and hold criteria as well. Therefore, control is transferred over time and therefore revenue can be recognized as pens are produced. From October 1 to October 31, we can assume that approximately half of the pens was produced and therefore approximately \$8000 can be recognized.

The total order of \$16,000 is very close to the \$20,000 cut-off. If it is probable that Hero will order more pens before Oct 31 to reach for the volume discount, then the transaction price of the 1000 pens will be 95% x 16,000. Since Hero is a new customer and there is no prior history, we should wait until Oct 31 to see whether Hero will make the additional purchase or not and apply the discount retrospectively.

By recognizing revenue as control passes (production is finished), the 2018 net income will look more favourable to Lilly.

In 2017, DI ordered 10,000 leather-bound, high-end desktop agendas that cover for the 15-month from January 2018 to March 2019 from one of its suppliers. The cost of each agenda was \$10. DI started selling the agendas for \$30 a piece in December 2017. After the holiday sales, DI still had 4,000 of agendas left in February and DI discounted the agendas by 80%. Dorothy decided that further reduction in price would not be appropriate as it would be 'embarrassing' in front of customers. Since February until May, another 500 units were sold. The remaining are still available for sale but Dorothy admits sales have been 'few and far between'. In October 2018, DI decides to sell 2019-2020 calendars together with these older agendas as a bundle for a total price of \$22. DI normally sells the calendars for \$22 each. DI believes that this strategy is better than offering discounts on the new calendars which the company sometimes does ahead of the holiday season.

All inventory should be recorded at the lower of cost or NRV. Since the agendas have been discounted and have not been selling, a write-down is appropriate. The main question is by how much the agendas should be written off

Alternative 1: currently the agendas are priced at \$6 (80% off \$30) which is below cost of \$10. It could be argued that the agendas should be written down by \$2.50.

Alternative 2: however, they are now being sold together with the new calendar and the bundled is being sold at \$22 = the standalone selling price of the calendar. One can argue that the value of the calendar is zero.

Alternative 3: Assume the bundle does attract more sales, so there is some value to the agenda. Using IFRS 15, we can allocate based on transaction price of \$22, and total fair value of \$28, thus $\$22 \times 6/\$28 = \$4.7$ will be the NRV of the inventory

Similarly, since the timing of revenue recognition of the calendar and the agenda is the same (upon sale), therefore, we do not need to allocate the transaction price. However, it does matter if management want to calculate individual gross margins of its products.

Conclusion: Therefore, the agendas should be written down to \$4.7. There will be a negative impact on the 2018 net income.

In determining inventory cost for custom orders, DI has always used the specific identification method. The following costs are included in custom ordered finished goods inventory: inbound shipping costs of raw materials, direct labour and direct manufacturing overhead, temporary storage cost while waiting for outbound shipping. DI would like to know whether they should use the same costing method for non-custom orders as well.

Inventory includes: product costs, conversion costs, and costs necessary to bring the goods to its location and condition for sale. DI is correct in including inbound shipping costs, direct labour and manufacturing overhead. However, temporary storage cost should not be part of inventory and should be expensed. Specific identification method is only allowed for items that are not generally interchangeable. In this case, if all the custom orders are shipped and sold at same time, then it may be fine to use specific identification method. However, if controls pass onto customers over time, then the custom orders are interchangeable and specific identification should not be used, but instead the company should use weighted average or FIFO. DI should not use specific identification method for non-custom orders as they are not interchangeable.

Marks allocation:

A = Overview (stakeholders/needs, Reporting constraints/bias, tying conclusions to user's needs) (4 marks)

B= Issues Identifications (3 marks)

C= Use of criteria (6 marks)

D= Discuss alternatives (4 marks)

E = Use of case facts (3 marks)