

# Star Gazer Ltd.

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Star Gazer Ltd. (SGL) is a manufacturer of telescopes and binoculars, offering products to amateurs and professionals. The company has experienced significant growth in the past five years due to an increase in the popularity of star gazing, combined with an effective branding campaign and enhanced distribution network.

The company has applied to the Bank of Winnipeg for a \$1-million long-term loan in order to finance further expansion plans. Specifically, the funds would be used to purchase additional capital assets.

SGL's application and financial statements have been provided to Peter Sparks, a newly hired junior analyst with the Bank of Winnipeg. Peter has been asked by his supervisor, Maria Simms, to conduct a preliminary review of SGL's financial statements and determine whether SGL should proceed further into a more detailed analysis. Maria has asked Peter to document his recommendation and supporting analysis in a report that will be maintained in SGL's file.

Maria: "SGL has provided us with a copy of their most recent balance sheet and income statement (Exhibit I). I know that this may not be enough to make the final decision, but it should be more than enough for you to get started."

Peter: "Yes, I can obtain much information from these two statements."

Maria: "Okay, that's great. I took a quick look at the balance sheet and am wondering what has caused the change in cash. Cash is needed to pay back the loan. Although I haven't done any rigorous analysis, it is a bit concerning to see the cash decline by such a large amount."

Peter: "I can definitely look into the decrease in cash."

Maria: "It may also be useful to give some thought to what the balance sheet may look like if the loan is approved. Historical statements are fine, but they will not be able to provide you with this information. Additional information on the use of the loan is provided in Exhibit II."

Peter: "That is a great point. I will take this into consideration."

Maria: "Alright. Let me know if I can be of any further assistance. I look forward to reading your report. If you recommend to proceed with future due diligence, can you prepare a list of additional information that would be useful in making our final decision?"

Peter: "Yes, I can most certainly do that. I will get started right away."

Peter is excited about his first assignment, and wants to impress Maria. Peter begins to conduct some preliminary research by searching the bank's database for industry comparables. Peter has located various industry ratios that can be used as a benchmark (Exhibit III).

## Required

Assume the role of Peter and prepare the report.

## EXHIBIT I – FINANCIAL STATEMENTS

### STAR GAZER LTD.

#### BALANCE SHEET

As at December 31	2014	2013
<b>Assets</b>		
<b>Current</b>		
Cash	\$ 235,359	\$ 134,550
Marketable securities	145,780	457,206
Accounts receivable	223,450	174,930
Inventory	425,770	355,790
Prepaid expenses	<u>17,500</u>	<u>19,500</u>
	<u>1,047,859</u>	<u>1,141,976</u>
Property and equipment, net	<u>2,756,950</u>	<u>2,492,655</u>
	<u>3,804,809</u>	<u>3,634,631</u>
<b>Liabilities and shareholders' equity</b>		
<b>Current</b>		
Accounts payable	294,305	95,700
Accrued and other liabilities	237,595	244,760
Current portion of long-term debt	<u>375,900</u>	<u>345,900</u>
	<u>907,800</u>	<u>686,360</u>
Long-term debt	<u>1,280,330</u>	<u>1,601,500</u>
Common shares (50,000 outstanding)	595,817	595,817
Retained earnings	<u>1,020,862</u>	<u>750,953</u>
	<u>1,616,679</u>	<u>1,346,771</u>
	<u>\$3,804,809</u>	<u>\$3,634,631</u>

## EXHIBIT I CONTINUED – FINANCIAL STATEMENTS

### STAR GAZER LTD. INCOME STATEMENT

For the year ended December 31	2014	2013
Sales	\$2,975,990	\$2,575,990
Cost of sales	<u>1,368,955</u>	<u>1,184,955</u>
Gross profit	<u>1,607,035</u>	<u>1,391,035</u>
Expenses		
Amortization	155,490	125,490
General and administrative	134,500	102,800
Marketing and sales	175,680	155,600
Interest expense	76,820	96,090
Office expense	295,980	255,000
Wages and benefits, administration	<u>315,000</u>	<u>315,000</u>
Total operating expenses	<u>1,153,470</u>	<u>1,049,980</u>
Operating income	453,565	341,055
Gain (losses) on marketable securities	25,475	9,800
Impairment loss on capital assets	<u>0</u>	<u>0</u>
Income (loss) before taxes	479,040	350,855
Provision for (benefit from) income taxes	<u>134,131</u>	<u>98,239</u>
Net income	<u>344,909</u>	<u>252,615</u>
Opening balance—retained earnings	750,953	573,338
Net income	344,909	252,615
Dividends	<u>75,000</u>	<u>75,000</u>
Closing balance—retained earnings	<u>\$1,020,862</u>	<u>\$750,953</u>

## EXHIBIT II – INFORMATION ABOUT THE USE OF THE LOAN

- » The loan will be used to purchase \$1 million in additional capital assets. The additional assets will result in an increase in revenues of 20%.
- » The loan will bear interest at 6%. Principal payments of \$200,000 per annum will be required.
- » The company will withhold any dividend payment during the foreseeable future in order to support the debt to equity ratio.
- » The capital assets are expected to have a useful life of 15 years with no residual value.
- » All other fixed expenses are expected to remain consistent.
- » The existing loan will require a principal payment of approximately \$375,900 during the upcoming fiscal year. The payment for the following fiscal year is expected to be \$300,000.
- » Accounts receivable, inventory, prepaid expense, and accounts payable will all increase by 40% as a result of the increased sales.
- » The marketable securities will be converted to cash at the beginning of the year.

## EXHIBIT III – INDUSTRY BENCHMARK RATIOS

	Ratio	Industry Average
	<i>Profitability</i>	<b>2014</b>
1	Return on equity	15.0%
2	Return on assets	8.0%
3	Financial leverage percentage	7.0%
4	Earnings per share	\$4.40
5	Quality of income	75.0%
6	Profit margin	10.0%
7	Fixed asset turnover	2.00
	<i>Tests of liquidity</i>	
8	Cash ratio	7.0%
9	Current ratio	1.00
10	Quick ratio	0.75
11	Receivable turnover	13.00
12	Average days in accounts receivable	28.08
13	Payable turnover	19.00
14	Average days in accounts payable	19.21
15	Inventory turnover	6.50
16	Average days in inventory	56.15
	<i>Solvency and equity position</i>	
17	Times interest earned	5.40
18	Cash coverage	6.30
19	Debt to equity ratio	1.35
	<i>Miscellaneous</i>	
20	Book value per share	\$29.00

# Auto Parts Inc.

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Today is November 1, 2014. You, CMA, have just been hired by Auto Parts Inc. (API) as an accountant to provide financial expertise during its current expansion. API was founded in 1995 by John Blackman (sole shareholder) and API has remained a private corporation ever since. From its humble beginnings, API has grown substantially. API's operations focus on the production of both standard and unique car parts. API always strives to use modern technology to produce quality car parts. When API commenced, they produced car parts for Canadian automotive companies that were seeking to outsource their production. Soon after, as word spread on the quality of its parts, API's products were being sought after by companies outside of Canada. In addition, API began selling its products to individuals who were looking for unique car parts to restore older cars.

As a car buff, you are very excited about the position as it allows you to apply your accounting knowledge in an industry that interests you. On your first day, you met with API's CFO, Jeff Ahmad. Jeff begins by explaining how excited he is that you have joined API's team and he looks forward to the expertise that you will bring to API's accounting department.

Jeff continues by explaining that as API has grown, so has its dependency on external financing. Just this year, API had purchased additional equipment to handle its recent growth. API has had a long-standing relationship with its bank. However, given the recent credit crisis, the bank has changed its policies on all loans. Jeff has provided you with a copy of API's balance sheet (see Exhibit I) as at October 31, 2014, which is API's fiscal year-end date.

After the meeting, Jeff asks you to analyze the new accounting issues surrounding API and to provide recommendations on their resolution. He concludes by reminding you that the bank is eager to see the year-end financial statements. As you make your way back to your desk, you begin by reviewing a file outlining important transactions undertaken by API. You note the following issues:

1. On November 1, 2013 (the beginning of the fiscal year), API acquired a portion of its equipment through a lease agreement with Lessor Corp. The lease contract has the following terms and conditions:
  - API agrees to lease equipment from Lessor Corp. with a fair market value of \$900,000;
  - The term of the lease is for seven years, with annual rental payments of \$145,000 due at the beginning of each year. API knows the implicit interest rate on the lease agreement is 5%. However, API knows that it could borrow at an incremental rate of 6%, if it were to negotiate with its bank.
  - There is no residual value.
  - API will cover the executory costs associated with the lease. The executor costs will be approximately \$10,000 per annum and are included as part of the \$145,000 rental payment.
  - The lease offers a bargain purchase option to purchase the equipment for \$50,000 at the end of the seventh year. At the end of year seven, the fair market value of the asset is expected to be \$70,000.
  - The first payment was made on November 1, 2013, with annual payments thereafter.

You remember from auditing a client in the past, that equipment such as this usually has an economic life of nine years. API has classified this lease as an operating lease. You remember from your discussion with Jeff that he was unsure of the benefits of leasing versus buying an asset. This information is important for Jeff for any future capital budgeting decisions.

2. After reviewing the balance sheet, you notice that there are preferred shares valued at \$100,000, which equals a total of 1,000 shares outstanding. The preferred shares are redeemable and have a 5% annual dividend. The dividend will double every three years up to a maximum 20% dividend yield. The preferred shares become convertible into common shares if API does not pay the specified dividend on the preferred shares.

3. The file also contained a letter from API's lawyer (Stonechild, Pilla, and Partners). The letter from the lawyers explained a current lawsuit undertaken against API. Apparently a customer had asked for 50,000 parts to be produced and delivered no later than July 15, 2014. However, due to major downtime in July, API could not produce the parts as scheduled. In turn the customer was late in delivering its vehicles to its distributors and had to pay a penalty equivalent of \$600,000. This customer is now suing API for retribution for these costs. The letter goes on to state that retribution will be inevitable; however, it is believed that a settlement between \$350,000 to \$550,000 can be reached.
4. On November 1, 2013, an additional \$500,000 of long-term loan was taken out to help finance the purchase of certain manufacturing equipment for \$600,000. (Note: the additional \$100,000 was paid for with cash.) The loan is repayable at \$100,000 per annum. Given this new loan and API's revised debt load, API must now maintain a maximum debt to equity ratio of 3:1 and its financial statements must comply with ASPE. If API breaches the covenant, the bank has the ability to call for the loan in full.

The manufacturing equipment that was purchased during the year will be amortized over 10 years. It is classified as class 39 and has a CCA rate of 25%. API is taxed at the highest possible rate of 45%, and the half-year rule applies. Jeff explained that API has not taken any consideration for potential tax consequences on the equipment purchase. (Note: for simplicity, assume that all other future tax considerations have been properly addressed.)

After reviewing this information, you realize that you have much to contemplate as to how these issues should be dealt with.

### **Required**

Provide a report to Jeff outlining your recommendation on the accounting issues and note other important issues.

# EXHIBIT I — API'S FINANCIAL POSITION

## AUTO PARTS INC. STATEMENT OF FINANCIAL POSITION AS AT OCTOBER 31

### Assets

#### Current assets

	2014	2013
Cash	\$ 35,000	\$ 20,000
Accounts receivable	13,000	10,000
Inventory	20,000	12,000
Prepays	3,000	3,000
<i>Total current assets</i>	<u>71,000</u>	<u>45,000</u>
Property, plant, and equipment (net)	2,800,000	2,200,000
<b><i>Total assets</i></b>	<b><u>2,871,000</u></b>	<b><u>2,245,000</u></b>

### Liabilities

#### Current liabilities

Accounts payable	25,000	20,000
Notes payable	13,000	25,000
Current portion of long-term debt	150,000	50,000
	<u>188,000</u>	<u>95,000</u>
Long - term debt	1,900,000	1,450,000
<b><i>Total liabilities</i></b>	<b><u>2,088,000</u></b>	<b><u>1,545,000</u></b>

#### Shareholders' equity

Share capital	100	100
Preferred shares	100,000	100,000
Retained earnings	682,900	599,900
<b><i>Total equity</i></b>	<b><u>783,000</u></b>	<b><u>700,000</u></b>
<b><i>Total liabilities and shareholders' equity</i></b>	<b><u>\$2,871,000</u></b>	<b><u>\$2,245,000</u></b>

Debt to equity	2.67	2.21
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# Mitten Manufacturing Ltd.

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Mitten Manufacturing Ltd. (MML) produces children's mittens and scarves, and sells their products to various large retailers in Canada. The company's sole shareholder and owner, Angela Mitten, is planning to pursue retirement in the near future and has decided to sell her ownership interest in the business.

John Kachurowski, a successful businessperson, has been in negotiations to purchase MML. John currently owns a company that manufactures winter jackets. He feels that an acquisition of MML would result in some synergies and economies of scale.

Angela has offered to sell the business to John for the book value of equity, calculated based on the December 31, 2014 balance sheet prepared in accordance with IFRS. John has approached the public accounting firm of Lebeau and Liang LLP (L&L) requesting assistance in determining an estimate of the purchase price.

The partner has assigned you, a recently qualified professional accountant, to this engagement. During an initial meeting with John, the following discussion took place:

John: "I am not sure how much the business is going to cost me!"

You: "Okay, well, I can help you with that."

John: "When I look at the balance sheet, I see net equity of \$3,517,789; however, I know that there are some accounting issues that need to be considered. In order to get started, I can give you MML's balance sheet (Exhibit I) and some notes that I took from my discussion with Angela, MML's management (Exhibit II)."

You: "Okay, well, this should give me enough to get started on a report."

John: "Sounds good. I look forward to your report. Please keep in mind that MML's financial statements were prepared for internal purposes and have not been audited."

After your meeting with John, you head back to your office and think about how to approach the engagement.

## **Required**

It is now January 10, 2015. The partner has asked you to prepare a memo addressing John's concerns. The partner reminds you that the memo should provide adequate discussions of any alternative accounting treatments with IFRS. In addition, the partner has asked to provide as many journal entries as possible. The journal entries may be provided to Angela in order to update the financial statements.

# EXHIBIT I – FINANCIAL STATEMENTS

## MITTEN MANUFACTURING INC.

### BALANCE SHEET

December 31	2014
<b>Assets</b>	
Current	
Cash and cash equivalents	
Receivables	\$2,381,368
Inventories	2,352,949
Due from a shareholder	514,639
Prepays	78,058
	<u>5,327,014</u>
Capital assets	<u>3,917,157</u>
	<u>\$9,244,171</u>
<b>Liabilities</b>	
Current	
Bank indebtedness	\$ 111,565
Payables and accruals	3,835,200
Deferred revenue	58,308
Current portion of long-term debt	129,368
	<u>4,134,441</u>
Long-term debt	1,137,161
Accrued benefit liability	169,969
Due to related company	—
Deferred credits	284,811
	<u>5,726,382</u>
<b>Shareholders' equity</b>	
Capital stock	510,010
Retained earnings	3,007,779
	<u>3,517,789</u>
	<u>\$9,244,171</u>

## EXHIBIT II – NOTES FROM MEETING WITH MML'S MANAGEMENT

The financial statements are prepared internally, and have not been audited. Based on a review of the financial information, the following accounting issues emerged:

- » MML incurred a loss during the year of \$500,000. The loss was the result of a one-time event that reduced operating profitability. The company is expected to return to profitability next year.
- » On January 1, 2014, MML entered into a new lease agreement. The terms of the lease are as follow:

Annual lease payment (due at the beginning of year, starting Jan. 1)	\$20,066.26
Bargain purchase option at the end of lease term	\$4,500
Lease term	5 years
Economic life of lease equipment	10 years
Lessor's cost	\$60,000
Fair value of asset at January 1, 2014	\$88,000
Lessor's implicit rate	9%
Lessee's incremental borrowing rate	9%

The lease has not yet been recorded in the financial statements.

- » The accrued benefit obligation of \$163,969 is based on plan assets of \$525,000 and plan liabilities of \$694,969. No entries have been made to reflect changes in the plan asset and liability for the current year. A review of an actuary report reveals that the discount rate for the accrued benefit obligation (ABO) is 7%, while the expected and actual return on the plan assets is 7% and 10%, respectively. Service costs for the current year are \$35,000, and the benefits paid to retirees were \$40,000.
- » The provision for income taxes included in the financial statements is recorded based on the taxes payable in the current period (i.e., the amount payable based on taxable income). Management has done this because there are very few differences between taxable income and accounting income. The only significant difference is related to the depreciation of capital assets. A review of Schedule 8 of the Corporate T2 reveals undepreciated capital cost (UCC) balances of \$3,550,000. The average tax rate for MML is 30% on the current year's income.
- » Management of MML made a comment regarding a \$200,000 accounts receivable with Super Shopper, a large Canadian retailer. It appears that the receivable from Super Shopper is over 90 days old. Recent headlines shed some light into the financial difficulties confronting Super Shopper.
- » MML is currently being sued by Tech Outerwear (TO) for patent infringement regarding the design of a new glove. The lawsuit was filed on December 15, 2014. MML's lawyers have not had enough time to properly assess the lawsuit, and therefore cannot determine the likelihood of losing the suit. Similar, past lawsuits have settled for anywhere between \$200,000 and \$700,000.
- » Included in the \$510,010 of capital stock is \$50,000 of preferred shares. The preferred shares are retractable by the holders if there is a change in the ownership of the business.
- » During the year, MM's management was issued employee stock options. The options can be exercised anytime during the next three years, which is the expected period of benefit. No options were exercised during the year. As such, the options are not reflected in the financial statements.