Assignment 2 (Session 1 — Fall)

Print

This assignment requires you to apply the knowledge you have gained in *FA3* through to the end of Module 6 and in your previous financial accounting courses. It is estimated that this assignment should take approximately 13-15 hours to complete. It is graded out of 100 marks — 60 marks for Question 1, 30 marks for Question 2, and 10 marks for Question 3. It is worth 10% of your final grade.

Refer to the general instructions in Assignment 1.

Question 1

Estimated time to complete: 9-10 hours

Annapolis Group Ltd. (AGL) designs, develops, manufactures, and sells photonics-based solutions, including lasers, laser systems, and electro-optical components. The company has manufacturing operations in British Columbia, Ontario, and Nova Scotia, and sells primarily in North American markets.

In the past, the company has prepared its financial statements in accordance with ASPE, but is looking to comply with IFRS for the 2012 financial statements, in conjunction with a planned public offering. The public offering is still being negotiated, and depends on the stability of financial markets. However, the company has decided to draft financial statements that comply with IFRS to ensure that they are prepared for the eventuality.

The company has prepared a draft statement of financial position (Exhibit 1-1) and is satisfied that the format of this statement is compliant with IFRS. However, some differences in measurement between ASPE and IFRS have yet to be recorded (Exhibit 1-2). Additional information on financial statement elements is provided in Exhibit 1-3.

At this stage in the analysis, the company is concerned only with the statement of financial position, not earnings. AGL is required, as part of its bond agreement, to maintain a minimum current ratio of 1-to-1 and a maximum debt-to-equity ratio of 5-to-1. (Debt in this ratio is defined as "total liabilities.") Since a number of the outstanding items affect debt and/or equity, the CFO wants to ensure that these key financial targets continue to be met.

AGL's current concern is covenant compliance in 2012. Because the focus is on the statement of financial position, all of the impact of any adjustment to earnings, whether related to the current year or a prior year, will be recorded as an increase or decrease to retained earnings. AGL will further analyze these changes and restate comparative numbers for 2011 at a later date.

Requirements

1. Record journal entries to account for the transactions and information described in Exhibits 1-2 and 1-3. **(38 marks)**

2. Using Accpac, prepare the revised statement of financial position. **(10 marks)**

Procedure:

a. In Accpac, select Annapolis Group Limited. For assistance loading the Annapolis Group Limited file, refer to *CT3* . All data in Exhibit 1-1 are already recorded.

b. Record the transactions from Requirement 1 as journal entries in a batch in the G/L Transactions window. Post the batch. You may need to add accounts. (Refer to the instructions in Topic 3.10 for adding accounts.)

c. Prepare the statement of financial position in the financial reporter window. For the report, use the Statement of Financial Position.xls file.

d. Print the batch listing report and statement of financial position as separate files and save each in your solution Word document.

3. Evaluate the key financial targets and suggest action for the coming year if there are any concerns. **(12 marks)**

Notes :

- All submissions must be in Word. If you are unsure of how to export Accpac files to Word, refer to Resources/How to/Use software.
- Date all entries December 31, 2012. There is no income tax.
- Round all adjustments to the nearest thousand. All amounts are given in thousands, except share volumes and per-share amounts.

Exhibit 1-1: Annapolis Group Ltd. — Draft Statement of Financial Position as at December 31, 2012 (in thousands)

ANNAPOLIS GROUP LTD.
Statement of Financial Position
December 31, 2012
(in thousands)

ASSETS

	December 31, 2012
Current assets:	
Bank: Current account	1,240
Accounts receivable	35,350

Inventory	45,400
Prepaid expenses and deposits	2,820
	84,810
Non-current assets:	
Capital assets net	29,300
Intangible assets	21,643
	50,943
Total assets	135,753
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities:	
Accounts payable and accrued liabilities	31,742
Dividends payable	1,060
Current bank loan	38,760
	71,562
Non-current liabilities:	
Long-term debt	50,000
Discount	-9,009
	40,991
Equity:	
Share capital — common shares	7,350
Stock options outstanding	1,660
Retained earnings	14,190
	23,200
Total liabilities and equity	135,753

Exhibit 1-2: Annapolis Group Ltd. — Outstanding items

Note: Amounts are in thousands.

1. The $50,000 bond payable was issued on July 1, 2010. It was a 7.6%, 20-year bond that paid interest semi-annually on December 31 and June 30. The bond was sold to yield 10%. Straight-line amortization of the discount is reflected in the financial statements, over the 40-period life of the bond, but IFRS requires use of effective interest amortization.

2. During 2012, the company discovered an environmental issue at their manufacturing site in Nova Scotia. After consultation with environmental engineers and the relevant government departments, the company learned that it would cost approximately $300 per year for four years to remediate the site. AGL also learned that remediation is not required under government legislation. However, in late 2012, AGL announced plans to remediate the site, beginning in January of 2014. Planning has begun, and the community affected has been involved in consultation and the planning process. Under ASPE, no liability needed to be recorded, but this situation creates a constructive liability under IFRS.

3. AGL leases equipment under operating leases. Analysis indicates that one of these lease contracts, signed on March 1, 2012, is a financial lease under IFRS, because the lease is for (specialized) equipment using technology under patent with AGL. Accordingly, the lease must be capitalized under IFRS even though it was not a capital lease under ASPE. Payment of $3,150 was made

on this lease in March 2012, of which $525 is recorded as a prepaid asset on the SFP at the end of 2012. Details of the lease are in Exhibit 1-3.

4. Interest on both general borrowing and the bond is expensed; this expense is $6,405 in 2012 before any adjustments. In early August of 2012, the company placed a $1,400 deposit on manufacturing equipment that will be delivered in 2013. A long-term prepaid account was created for $1,400 and grouped with capital assets on the statement of financial position. (Separate disclosure will be provided in the disclosure notes.) The $1,400 payment was financed out of general borrowing. Under IFRS, related interest must be capitalized.

5. Compensation expense of $320 was recorded with respect to stock options outstanding in 2012. All stock options are held by senior administrative staff. Under IFRS, forfeiture is estimated in advance, and, as a result, the compensation expense recorded annually is lower. Valuation models indicate that the amount of compensation expense recorded for 2012 should be reduced to $275.

6. IFRS requires depreciation of capital assets by component, whereas ASPE deals with whole assets. The approach to impairment tests is also different. The accounting group of AGL has ascertained that an additional $620 of accumulated depreciation and $2,200 of impairment of intangible assets are required.

Exhibit 1-3: Annapolis Group Ltd. — Additional information

Note : Amounts are in thousands.

1. Lease obligation

The following terms are associated with the lease:

Inception date	March 1, 2012
Lease term #1 (first 2 years)	
Duration	2 years
Annual lease payment due at the beginning of each lease year	$3,150
Lease term #2 (remainder of lease)(renewed at option of lessor)	
Duration	1 year
Annual lease payment due at the beginning of each year	$1,050

Residual value at the end of lease	Unknown; leased asset reverts to lessor
Implicit interest rate	6%
Annual maintenance costs, paid by lessor in each of years 1-3	$75

Notes: A formal entry is needed to reclassify part of the lease liability as a short-term liability at December 31, 2012. Include the short-term amount in accrued liabilities.

The company uses straight-line depreciation for all manufacturing assets and claims a full year of depreciation in the year of acquisition and no depreciation in the year of disposal.

Question 2 (30 marks)

Estimated time to complete: 3½-4 hours

Case analysis question: Case 15-1, Software Incorporated, pages 906-907.

Deal with the tax issues and the listed issues 1, 2, and 3 only. No marks will be rewarded for analysis of information included in points 4, 5, 6, and 7.

For guidance on case analysis for *FA3*, refer to Topic 1.7 and "Analyzing a case" under Resources/How To/Analyze a Case.

Required

Perform the following tasks for this case:

1. Provide an overall assessment of the corporate financial reporting objectives. **(2 marks)**

2. Identify the ethical challenge for the accountant who must, as part of SI's management team, make recommendations with respect to accounting policy. **(3 marks)**

3. Analyze the issues, and provide recommendations and adjustments. Begin this segment with a list of the issues. **(25 marks)**

Question 3 (10 marks; 2 marks for each question)

Estimated time to complete: ½ hour

The following disclosure notes have been taken from the consolidated annual report of a Canadian public company that complies with IFRS standards. Assume that the effective tax rate is 35% for this company.

Note 17 Income tax

Deferred tax liabilities

Deferred tax liabilities reported on the statement of financial position arise as follows:
($ thousands)

Source of temporary difference	Amount
Current asset	$ (345)
Non-current asset	(6,320)
Current liability	110
Total deferred tax liabilities at December 31, 2012	**$(6,555)**

Loss carryforwards

The gross value of unused tax loss carryforwards which have, or have not, been recognized as tax assets, along with their expiry dates, are as follows:
($ thousands)

Expiry date	Recognized	Not recognized
One year		$ 1,300
Two years		3,200
Three years		400
Four years		3,900
Five years	$ 2,800	
More than five years	5,600	
Total at December 31, 2012	**$8,400**	**$8,800**

Required

1. In general, what is the meaning of a deferred tax liability? That is, why is it a liability?

2. The disclosure note above refers to the SFP accounts that cause deferred taxes for this company. From the course material, suggest one current asset, one non-current asset, and one current liability that might cause deferred taxes, and explain for each one why the tax basis and accounting basis are different.

3. In general, explain two situations that would cause a deferred tax liability caused by a temporary difference to *decrease* in a future year.

4. For tax loss carryforwards in the note disclosure above, why are some amounts recognized and some *not* recognized?

5. How much would assets and earnings change if tax loss carryforwards were de-recognized (written off)?

100