Core 1 — Week 5 Integrated Problem

Scenario — 120 minutes

Quality Cabinets Inc. (Quality) manufactures custom kitchen cabinets from its location in Squamish, B.C. The cabinets are then sold to contractors who install them in kitchens. Bruce MacDonald is the owner and has approached you, a CPA with a local CPA firm, to advise on some accounting issues that arose during the year and to help prepare the corporate tax returns.

It is January 31.

Task #1

Bruce has asked for an analysis of the accounting issues described in Appendix I. Quality reports its financial statements in accordance with Accounting Standards for Private Enterprises (ASPE).

Your response should not exceed four pages.

Task #2

Bruce also requires a calculation of taxable income for the most recent year ended December 31. The calculation should be prepared in Excel.

He has also requested that you prepare the year-end journal entry for taxes payable using a marginal rate of 14% on income less than the small business deduction. Bruce has provided you with the draft statement of income and retained earnings (Appendix II) and additional information you will need (Appendix III).

Your response, not including any Excel worksheets, should not exceed one half of a page.

Note: Unless otherwise noted, use the tax rates and tax regulations pertaining to the most recent calendar year end to your module. For instance, if you are writing Core 1 in May 2019, use the 2018 tax rates and regulations (the most recent year end being December 2018). If you are writing Core 1 in January 2020, use the 2019 tax rates and regulations.

Appendix I
Description of accounting issues

1. Quality entered into a leasing agreement with the provincial government at the beginning of the recently ended fiscal year. Quality was granted access to the timber resources from a parcel of province-owned land for a period of five years. Quality commenced harvesting the timber right away and as of year end, had harvested 10% of the land. A condition of this agreement is that Quality replant trees at the end of the five-year lease agreement. Quality estimates that this will cost $500,000 to reforest the full plot at the end of five years. Eight percent is the appropriate discount rate to reflect this transaction. This obligation has not been recorded in the financial statements.

   This lease has already been analyzed and is being properly treated as an operating lease in accordance with ASPE 3065.

2. On February 1 of the most recently ended fiscal year, Quality paid $400,000 for a 25% interest in the common shares of Hinge Buddy Inc. (HBI). HBI is one of Quality's main suppliers of kitchen hardware. Quality's board was very keen to acquire HBI shares as it was viewed as a "wise strategic move." The CFO and sales manager for Quality have been appointed to the board of directors of HBI. The remaining HBI shares are held by the founder and president of HBI. The journal entry recorded related to this acquisition were:

Investment in HBI	400,000	
Cash		400,000

   HBI has a December 31 year end and reported net income of $1,400,000 for the most recent fiscal year, which is its typical profit level. Bruce is not sure if this investment is being accounted for appropriately. He would like to account for the investment in a way that makes his financial statements "look good."

Appendix II

Quality Cabinets Inc.
Statement of income and retained earnings
For the period ended December 31
(Draft)

	Current year *(Draft)*	**Prior year** *(Audited)*
Sales	$ 8,959,800	$ 8,834,000
Cost of sales	5,949,648	6,129,709
Gross profit	3,010,152	2,704,291
Expenses:		
Advertising and promotion	357,900	266,500
Amortization	219,163	166,584
Automobile	140,800	102,600
Bad debts	17,250	19,110
Donations	1,200	1,000
Dues and fees	7,500	—
Insurance	69,600	57,200
Interest and bank charges	119,203	46,600
Office	101,200	108,700
Professional fees	67,700	34,800
Property taxes	44,700	40,900
Repairs and maintenance	207,100	155,100
Rent expense	84,654	—
Salaries and wages	1,160,460	1,175,600
Travel	117,666	103,900
Utilities	67,600	60,200
Warranty	72,059	69,482
Income before taxes	154,397	296,015
Income taxes (Note 1)	70,000	76,754
Net income	84,397	219,261
Retained earnings, opening	2,571,214	2,360,953
Dividends	48,750	9,000
Retained earnings, closing	$ 2,606,861	$ 2,571,214

Note 1: Current-year income taxes represent income tax instalments remitted.

Appendix III
Tax information
Prepared by Bruce MacDonald

1. Information regarding property, plant, and equipment at December 31:

   Additions to property, plant, and equipment:

Manufacturing equipment	$ 513,888
Delivery trucks	169,370
Office equipment	14,230
Computer hardware	12,110
Computer software	13,670
Leased asset	1,068,067
	$ 1,791,335

- All software additions this year were application software.
- Quality's building was purchased five years ago. At that time, Quality did not make an election to place the building in a separate Class 1 at the accelerated rate of 10%.
- $326,625 of amortization is included in current-year cost of sales in the income statement.
- Lease payments related to the capitalized lease asset for the year amounted to $98,000 and interest on the lease liability (included in interest and bank charges) was $48,503.
- Lease payments under the provincial land agreement totalled $36,000 and were included in rent expense.

2. Undepreciated capital cost balances at the beginning of the year were as follows:

Class 1	$ 416,400
Class 8	131,800
Class 10	76,300
Class 12	15,300
Class 43	765,775
Class 50	4,360
	$ 1,409,935

3. Bruce is a member of the Predator Ridge Golf and Country Club (PRGCC), where he entertains many of the company's customers and suppliers. Payments to PRGCC during the year are included in advertising and promotion and consisted of the following:

- Monthly dues: $8,280 (total for the year)
- Green fees: $4,360
- Restaurant and beverage costs: $10,290

Appendix III (continued)
Tax information
Prepared by Bruce MacDonald

4. Other meals and entertainment, which are included in advertising and promotion, included the following:
   - Business lunches and dinners: $9,010
   - Tickets to sporting events: $2,870
   - Christmas dinner (for all of the company's employees): $3,790

5. Insurance includes premiums for Bruce's key person life insurance policy of $12,000.

6. Warranty expense is equal to the cash paid.

7. The company was late in filing its corporate tax return last year and deficient in its instalment payments during the year. Interest and penalties of $690 were charged to the company. These have been expensed on the current-year income statement.

8. The company has a net capital loss carried forward from five years ago in the amount of $4,100 ($8,200 capital loss).

9. During the year, Quality sold its investments for $35,000. Bruce was happy that a profit was made on the original cost of $29,850. The gain of $5,150 was recognized on the financial statements and included as a credit in interest and bank charges. One of the investments paid a capital dividend of $2,000 in the current year. The dividend was also included as a credit to interest and bank charges.

10. All donations made in the year were to registered charitable organizations.

11. Quality incurred $10,000 as a refinancing fee for the term loan.

12. The balances in the refundable dividend tax on hand and capital dividend accounts at the beginning of the year were nil.

13. Quality uses the taxes payable method for recording income tax.

14. Quality is a Canadian-controlled private corporation that is eligible for the small business deduction. The marginal rate for small business income is 14%.

15. The marginal rate for income in excess of the small business deduction is 30%. The rate for aggregate investment income is 50%.

16. The $70,000 recorded as income tax expense represents instalment payments made for this tax year.