Evaluation

The overall grading will be out of 100. Below is a breakdown of the grade; note that simply meeting expectations garners an average grade. The rubric will be manually graded by your Professor

Activity/Competencies Demonstrated	% of Final Grade
Identification and Analysis of Issues	**/80**
Issue 1: Preferred Shares	/20
Issue 2: Compensatory Stock Option Plan	/10
Issue 3: Aluminum Forward Contract	/10
Issue 4: Revised Net Income	/10
Issue 5: Deferred Taxes	/15
Issue 6: Earnings Per Share Calculation	/15
Recommendation	**/10**
Provides appropriate recommendation given the case facts and analysis completed	/10
Attention to Detail	**/10**
Spelling, grammar, and formatting	/10
Total	**/100**

Car Toons Audio Inc.

Car Toons Audio Inc. (CTAI) is a young company that recently completed its initial public offering. The company designs and develops leading-edge car stereo equipment, including MP4 compatible decks, speakers, amplifiers, and subwoofers.

The company is investing heavily in research and development. In order to reduce strain on cash, the management team is compensated mostly through share-based compensation in the current year. In addition, the company has raised cash through the issuance of common shares in the open market and by offering various complex financial instruments. Management believes that all cash should be diverted toward the research and development process in order for the company to become the leader in automotive stereo equipment.

In addition to the stock options, management receives a bonus of 5% of net income if diluted EPS is greater than $0.10. The bonus is the only cash compensation that management receives at this stage of the company's life cycle. Management is excited because this year's draft income statement (Exhibit I) shows diluted EPS in excess of $0.10, and therefore, a bonus will be paid.

Exhibit I

Draft Income Statement

Car Toons Audio Inc.
As at December 31, 2020

REVENUE	$44,500,740
Cost of goods sold	23,540,891
Gross margin	20,959,849
EXPENSES	
Accounting and consulting fees	$ 175,000
Advertising and promotion	1,575,000
Amortization	1,276,758
Bad debt	87,500
Insurance	85,000
Interest on convertible bonds	80,000
Legal fees	225,500

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Accounting and consulting fees	$ 175,000
Advertising and promotion	1,575,000
Amortization	1,276,758
Bad debt	87,500
Insurance	85,000
Interest on convertible bonds	80,000
Legal fees	225,500
Office and general expenses	750,850
Rent	325,000
Repairs and maintenance	450,755
Research and development	11,345,000
Travel	133,750
Utilities	333,565
Wages and benefits	325,000
	$17,168,678
Earnings for the year before income taxes	$ 3,791,170
Income tax expense	1,137,351
Earnings for the year	$ 2,653,819
Earnings per share—basic	$ 0.13
Earnings per share—diluted	$ 0.11
Weighted average shares outstanding—basic	20,550,750*
Weighted average shares outstanding—diluted	25,880,750*

*Note that these values have been calculated and verified by the manager on the file and are deemed to be correct.

Lebeau and Liang LLP has been the auditor of CTAI since the company's inception. You are a senior accountant with the firm and have been assigned the year-end audit for CTAI. The partner, Sharmila Chaudary, has just met with the company's management and discussed various accounting issues. She has asked you to prepare a report to be provided to the client that addresses all of the accounting issues, along with any other issues that you feel are important. Sharmila's notes from the meeting can be found in Exhibit II. In addition, the company's current and future tax expenses must be calculated. Tax-related details can be found in Exhibit III.

Exhibit II

Notes from the Partner's Meeting with CTAI's Management

1. At the beginning of the year, the board of directors approved a compensatory stock option plan that grants options to the company's four executives to purchase 100,000 shares each of the company's common shares. The board expects that the period of benefit/service for these options is two years. The options can be exercised at a strike price of $1 per share any time over a three-year period commencing after the initial two-year service period ends. The fair value of the options, as determined using an option pricing model, is $1,550,000.
2. The company issued 500,000 preferred shares for $4 per share to an investment bank in June 2020. Each preferred share is convertible for a fixed number of common shares (six common shares), and has a mandatory 7% annual dividend that must be paid on December 31 of each fiscal year. The shares must be redeemed by the company for cash if the market price of the common shares exceeds $4 per share. Currently, the common shares are in a trading range around $1.25 per share. The board declared and paid the mandatory cash dividend on December 31.
3. At the beginning of the current year, the company issued $2.5 million convertible bonds, of which $2 million was correctly allocated to debt. The bonds' market yield is 4% annually, pays interest semi-annually, matures in five years, and can be converted into common shares at the ratio of 1,500 shares per $1,000 bond.
4. Given the volatility of commodity prices, CTAI entered into a forward contract with the Bank of Vancouver. On July 1, CTAI locked the price of 5 million kg of aluminum at $1.25/kg. Aluminum is important to the company's operation because it is used to create a cabinet that houses all of the components in the CD player deck. Upon its inception, CTAI did not have to put forth any cash. All cash transfers will take place on settlements in two years. As at December 31, the price of aluminum is trading on the Chicago Board of Trade at $1.15/kg.

Exhibit III

Tax-Related Details

5. The company's tax rate is 30%. The income statement tax expense is calculated with the taxes payable method.
6. The office and general expense account contains $85,000 in meals and entertainment

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Exhibit III

Tax-Related Details

5. The company's tax rate is 30%. The income statement tax expense is calculated with the taxes payable method.
6. The office and general expense account contains $85,000 in meals and entertainment.
7. There are $175,000 in nondeductible expenses included in the accounting and consulting fees line item on the income statement.
8. The net book value (NBV) and undepreciated capital cost (UCC) for the capital assets are as follows:

	NBV		UCC	
	2020	2019	2020	2019
Land	$ 1,250,000	$ 1,250,000	n/a	n/a
Buildings	4,500,750	4,650,775	$ 2,767,211	$ 3,255,543
Furniture and fixtures	650,000	693,333	412,533	485,333
Machinery and equipment	12,567,000	13,404,800	7,975,856	9,383,360
Leasehold improvements	2,456,000	2,701,600	1,607,452	1,891,120
	$21,423,750	$22,700,508	$12,763,052	$15,015,356

9. There were no capital asset additions or dispositions during the year.

Required

Prepare a report for Sharmila. IFRS is the appropriate accounting standards for CTAI.