

Chapter 1

The Financial Statements

Short Exercises

(5 min.) S 1-1

1. **Assets** are the economic resources of a business that are expected to be of benefit in the future.

Shareholders' equity represents the insider claims of a business, the claims to the assets held by the owners of the business.

Assets and **shareholders' equity** differ in that **shareholders' equity** is a claim to assets.

Assets must be at least as large as **shareholders' equity**.
Equity can be smaller than **assets**.

2. Both **liabilities** and **shareholders' equity** are claims to **assets**.

Liabilities are the *outsider* claims to the assets of a business. **Shareholders' equity** represents the *insider* claims to the assets of the business.

<u>Total assets = Total liabilities + Shareholders' equity</u>				
a)	\$300,000	=	\$150,000	+ \$150,000
b)	290,000	=	90,000	+ 200,000
c)	220,000	=	100,000	+ 120,000

A different presentation should be:

a) Total assets = Total liabilities + Shareholders' equity

$$= \$150,000 + \$150,000 = \$300,000$$

b) Shareholders' equity = Total assets – Total liabilities

$$= \$290,000 - \$90,000 = \$200,000$$

c) Total liabilities = Total assets – Shareholders' equity

$$= \$220,000 - \$120,000 = \$100,000$$

(5 min.) **S 1-3**

1. Owners' Equity = Assets – Liabilities

It would not change in analyzing a household or a neighbourhood restaurant's information.

2. Liabilities = Assets – Owners' Equity

(5-10 min.) **S 1-4**

- | | | | |
|----------------------|--------------|-----------------------------|--------------|
| a. Accounts payable | <u> L </u> | g. Accounts receivable | <u> A </u> |
| b. Common shares | <u> E </u> | h. Long-term debt | <u> L </u> |
| c. Cash | <u> A </u> | i. Merchandise inventories | <u> A </u> |
| d. Retained earnings | <u> E </u> | j. Notes payable | <u> L </u> |
| e. Land | <u> A </u> | k. Accrued expenses payable | <u> L </u> |
| f. Prepaid expenses | <u> A </u> | l. Equipment | <u> A </u> |

(5 min.) **S 1-5**

1. *Revenues and expenses*

2. Net earnings, or net income (or net loss)

(10 min.) **S 1-6**

Split Second Wireless Inc.
Statement of Income
For the Year Ended December 31, 2011
(In millions)

Net revenue	\$ 90
Expenses	<u>20</u>
Net income	<u>\$ 70</u>

(5 min.) **S 1-7**

Mondola Ltd.
Statement of Retained Earnings
For the Year Ended December 31, 2011
(In millions)

Retained earnings:	
Balance, beginning of year.....	\$200
Net income (\$400 – \$300)	100
Less: Dividends.....	<u>(40)</u>
Balance, end of year	<u>\$260</u>

Skate Sharp Limited
Balance Sheet
December 31, 2011

ASSETS**Current assets:**

Cash	\$ 13,000
Receivables	2,000
Inventory	<u>40,000</u>
Total current assets	55,000
Equipment.....	75,000
Other assets	<u>10,000</u>
Total assets	<u><u>\$140,000</u></u>

LIABILITIES**Current liabilities:**

Accounts payable	\$ 10,000
Short-term notes payable.....	<u>5,000</u>
Total current liabilities	15,000

Long-term liabilities:

Long-term debt.....	<u>70,000</u>
Total liabilities	<u><u>85,000</u></u>

SHAREHOLDERS' EQUITY

Contributed capital	15,000
Retained earnings	<u>40,000*</u>
Total shareholders' equity	<u>55,000</u>
Total liabilities and shareholders' equity.....	<u><u>\$140,000</u></u>

***Computation:**

Total assets (\$140,000) – current liabilities (\$15,000) – long-term debt (\$70,000) – contributed capital (\$15,000) = \$40,000

**Brazos Medical Inc.
Statement of Cash Flows
Year Ended December 31, 2011**

Cash flows from operating activities:

Net income	\$ 120,000
Adjustments to reconcile net income to net cash provided by operating activities	<u>(20,000)</u>
Net cash inflow from operating activities ...	100,000

Cash flows from investing activities:

Purchases of equipment	\$(300,000)
Sale of equipment	<u>60,000</u>
Net cash outflow from investing activities	(240,000)

Cash flows from financing activities:

Borrowing on long-term note payable	\$150,000
Payment of dividends	<u>(15,000)</u>
Net cash inflow from financing activities ...	<u>135,000</u>
Net increase (decrease) in cash	(5,000)
Cash balance, December 31, 2010	<u>24,000</u>
Cash balance, December 31, 2011	<u><u>\$ 19,000</u></u>

(5 min.) S 1-10

- 1. The *entity assumption* applies.**
- 2. Application of the entity assumption will separate Grant's personal assets from the assets of the business. This information will show how much in assets the business owns and this knowledge will help him evaluate the business realistically.**

(5 min.) S 1-11

Standards of professional conduct are designed to produce information that has predictive or confirming value and is completely free from bias and without material error. This is information that can be used for decision making.

If there were no standards, companies could be motivated to report information to make their company look good. This could provide external users with inappropriate information.

(10 min.) S 1-12

- a. Dividends SRE, SCF
- b. Salary expense IS
- c. Inventory BS
- d. Sales revenue IS
- e. Retained earnings SRE, BS
- f. Net cash provided by operating activities SCF
- g. Net income IS, SRE, SCF (if prepared by the indirect method)
- h. Cash BS, SCF
- i. Net cash provided by financing activities SCF
- j. Accounts payable BS
- k. Common shares BS
- l. Interest revenue IS
- m. Long-term debt BS
- n. Net increase or decrease in cash SCF

Exercises

(10 min.) E 1-13

- a. **Corporation.** If the corporation fails and cannot pay its liabilities, creditors cannot force shareholders to pay the business's debts from their personal assets. Therefore, the most an investor can expect to lose on an investment in a corporation is the amount invested.
- b. **Proprietorship.** There is a single owner of the business, so the owner has absolute control over the business.
- c. **Partnership.** If the partnership fails and cannot pay its liabilities, creditors can force the partners to pay the business's debts from their personal assets. A partnership affords more protection for creditors than a proprietorship because there are two or more owners to share this personal liability for the business's debts. If the partnership is a LLP (limited liability partnership) claims are limited to the partnership assets, similar to a corporation. Limited liability partnerships tend to be professional firms, i.e., accountants, lawyers.

What form of business organization would you choose?

The answer depends on your objective. If you want to maintain absolute control of the business, you may prefer to organize as a *proprietorship*. If your objective is to maintain a high degree of control but you need additional money or expertise, a *partnership* may work for you. If you want the business to grow large, or if you wish to avoid personal liability for business debts, you should organize as a *corporation*.

The *income statement* reports the revenues and expenses of a particular entity for a period such as a month or a year. Total *revenues* minus total *expenses* equals *net income*, or profit. A lender would require this information in order to predict whether the borrower can generate enough income to repay the loan.

The *balance sheet* reports the assets, liabilities, and owners' equity of the entity at a particular point in time. The *assets* show the resources that the business has to work with. Because borrowers pay loans with assets, a lender wants to know the business's assets (especially cash). *Liabilities*—debts—represent creditors' claims to the business's *assets*. *Owners' equity* is the portion of the business assets owned outright by the owners.

Note: Student responses may vary.

(5-10 min.) E 1-15

- a. Cost assumption – the amount received from the sale.
- b. Going-concern assumption – Trammel Crow Realtors will stay in business long enough to use existing assets for their intended purposes.
- c. Entity assumption – each division records information as a separate economic unit.
- d. Cost assumption – assets should be recorded at actual cost of purchase.

(5-15 min.) E 1-16

(Amounts in millions)

	Assets	=	Liabilities	+	Owners' Equity
Telus	\$16,987		\$10,061		\$6,926
Scotiabank	411,510		392,706		18,804
Shoppers Drug Mart	5,644		2,434		3,210

Banks in general are less risky than other types of corporations. This is why banks can operate with so high a ratio of liabilities to assets.

(continued) E 1-16

It is also the nature of banks to have large liabilities since these, for the most part, represent the deposits the banks are holding for their clients, which is not the case for businesses such as service providers and retailers.

(10-15 min.) E 1-17

Req. 1

<i>(Amounts in millions)</i>					
	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Shareholders' Equity</u>
Current	\$ 633.6		\$ 591.2		
Capital	1,126.7				
Other	<u>1,237.5</u>		<u>1,245.2</u>		
Total	\$2,997.8	=	\$1,836.4	+	\$1161.4
	↑		↑		↑
<i>Req. 2</i>	Resources to work with	<i>Req. 3</i>	Amount owed to creditors	<i>Req. 4</i>	Actually owned by the shareholders

(10-20 min.) E 1-18

	Situation		
	1	2	3
	<i>(Millions)</i>		
Total shareholders' equity			
December 31, 2010 (\$30 – \$8).....	\$22	\$22	\$22
Add: Issuance of shares	2	0	11
Net income	6	11	
Less: Dividends	0	(3)	(2)
Net loss	0	0	(1)
Total shareholders' equity,			
December 31, 2011 (\$40 – \$10)	\$30	\$30	\$30

1. Mortimer Limited

	Assets	= Liabilities +	Shareholders' Equity
Beginning	\$700,000	= \$400,000 +	\$300,000
Multiplier for increase	<u>× 1.20</u>		
Ending	<u>\$840,000</u>		

2. Aztec Associates

	Assets	– Liabilities =	Shareholders' Equity
Beginning amount	\$500,000	– \$200,000 =	\$300,000
Net income			<u>\$100,000</u>
Ending amount			<u>\$400,000</u>

- a. Balance sheet**
- b. Balance sheet**
- c. Statement of retained earnings, Statement of cash flows**
- d. Income statement**
- e. Balance sheet, Statement of retained earnings**
- f. Balance sheet**
- g. Balance sheet**
- h. Income statement**
- i. Statement of cash flows**
- j. Income statement**
- k. Statement of cash flows**
- l. Balance sheet, Statement of cash flows**
- m. Balance sheet**
- n. Income statement, Statement of retained earnings, Statement of cash flows**
- o. Income statement**

Torrance Associates Inc.
Balance Sheet as at
December 31, 2011
(in millions)

ASSETS		LIABILITIES	
Cash	\$28		
Investments	72	Current liabilities	\$290
Receivables	253	Long-term liabilities	73
Other assets	43		
Property and equipment, net	4	Total liabilities	<u>363</u>
		SHAREHOLDERS' EQUITY	
		Common shares	12
		Retained earnings	<u>25*</u>
		Total shareholders' equity	<u>37</u>
Total assets	<u>\$400</u>	Total liabilities and shareholders' equity	<u>\$400</u>

***Computation:**

Retained earnings = Total assets (\$400) – Total liabilities (\$363) – Common shares (\$12) = \$25

**Torrance Associates Inc.
Income Statement
For the Year Ended December 31, 2011**

	<i>(millions)</i>
Total revenue.....	\$35
Expenses:	
Salary and other employee expenses .	\$9
Interest expense.....	3
Other expenses	<u>14</u>
Total expenses	<u>26</u>
Net income before tax	<u>\$ 9</u>

**Torrance Associates Inc.
Statement of Retained Earnings
For the Year Ending December 31, 2011**

	<i>(millions)</i>
Retained earnings	
Balance, beginning of year	\$19
Net income.....	9
Less: Dividends	<u>(3)*</u>
Balance end of year	<u>\$25</u>

* $19 + 9 - 25 = \$3$

Dividends declared by Torrance Associates Inc. were
\$3 million

Groovy Limited
Statement of Cash Flows
For the Year Ended December 31, 2011

	<i>(Thousands)</i>
Cash flows from operating activities:	
Net income	\$300
Adjustments to reconcile net income to net cash provided by operating activities	<u>60</u>
Net cash provided by operating activities	360
 Net cash used in investing activities	 (400)
 Net cash provided by financing activities	 <u>70</u>
Net increase in cash	30
Beginning cash balance	<u>95</u>
Ending cash balance	<u><u>\$125</u></u>

Items given that do not appear on the statement of cash flows:

 Total assets — Balance sheet
 Total liabilities — Balance sheet

FEDEX KINKO'S AT UNIVERSITY OF SASKATCHEWAN INCOME STATEMENT FOR THE MONTH ENDED JULY 31, 2011		
Revenue:		
Service revenue		\$14,000
Expenses:		
Rent expense	\$ 700	
Office supplies expense	1,200	
Utilities expense	200	
Salary expense	<u>4,000</u>	
Total expenses		<u>6,100</u>
Net income		<u>\$ 7,900</u>

FEDEX KINKO'S AT UNIVERSITY OF SASKATCHEWAN STATEMENT OF RETAINED EARNINGS FOR THE MONTH ENDED JULY 31, 2011		
Retained earnings, July 1, 2011	\$ 0	
Add: Net income for the month	<u>7,900</u>	
	7,900	
Less: Dividends	<u>(2,000)</u>	
Retained earnings, July 31, 2011	<u>\$5,900</u>	

**FEDEX KINKO'S AT UNIVERSITY OF SASKATCHEWAN
BALANCE SHEET
JULY 31, 2011**

Assets		Liabilities	
Cash	\$ 8,100	Accounts payable.....	<u>\$ 3,200</u>
Equipment	<u>36,000</u>	Shareholders' Equity	
		Common shares	35,000
		Retained earnings	<u>5,900</u>
		Total shareholders' equity.	40,900
Total assets	<u>\$44,100</u>	Total liabilities and	
		shareholders' equity.....	<u>\$44,100</u>

<p align="center">FEDEX KINKO'S AT UNIVERSITY OF SASKATCHEWAN STATEMENT OF CASH FLOWS FOR THE MONTH ENDED JULY 31, 2011</p>
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Cash flows from operating activities:

Net income.....	\$ 7,900
Adjustments to reconcile net income to cash provided by operations	<u>3,200</u>
Net cash provided by operating activities...	11,100

Cash flows from investing activities:

Acquisition of equipment	<u>\$(36,000)</u>	
Net cash used for investing activities		(36,000)

Cash flows from financing activities:

Issuance (sale) of shares to owners	\$ 35,000	
Payment of dividends	<u>(2,000)</u>	
Net cash provided by financing activities....		<u>33,000</u>

Net increase in cash	\$ 8,100
Cash balance, July 1, 2011	<u>0</u>
Cash balance, July 31, 2011.....	<u>\$ 8,100</u>

TO: Owner of FedEx Kinko's at University of Saskatchewan

FROM: Student Name

SUBJECT: Opinion of operating results, financial position, and cash flows

Your first month of operations appears to have been successful. Revenues totalled \$14,000 and net income was \$7,900. These operating results look very strong.

The store was able to pay a \$2,000 dividend, and this should make you happy with so quick a return on your investment.

Your financial position looks secure, with assets of \$44,100 and liabilities of only \$3,200. Your shareholders' equity is \$40,900.

Operating activities generated cash of \$11,100. You ended the month with cash of \$8,100. Based on the above facts, I believe you should keep the University of Saskatchewan store operating.

Note: Student responses may vary.

- a. ***Paying large dividends*** will cause retained earnings to be low.
- b. Heavy ***investing activity*** and ***paying off debts*** can result in a cash shortage even if net income has been high. High non-cash current assets such as accounts receivable and inventories will do the same.
- c. The single best source of cash for a business is ***collections from customers*** based on delivery of goods and/or services. This source of cash is best because it results from the core operating activity of the business. Collections from customers do not create liabilities that must be paid back to anyone.
- d. ***Borrowing money, issuing (selling) shares to shareholders, and selling capital assets*** such as land, buildings, and equipment can bring in cash even during a period when the company has experienced net losses.

Quiz

Q1-29 a

Q1-30 a

Q1-31 c

Q1-32 a ($\$20,000 - \$4,000 = \$16,000$)

Q1-33 b

Q1-34 d

Q1-35 b

Q1-36 b

Q1-37 d

Q1-38 b ($\$140,000 - \$59,000 - \$8,000 - \$3,000 = \$70,000$)

Q1-39 a ($\$145,000 + \$90,000 - \$30,000 = \$205,000$)

Q1-40 c

Q1-41 c

Q1-42 a	Assets	= Liabilities + Shareholders' Equity
beg.	\$25,000	\$15,000
change	+11,000	+8,000
end	\$36,000	\$18,000

Q1-43 c	Assets	=	Liabilities + Shareholders' equity
2008	\$520,000		\$200,000 \$320,000
2009	\$750,000		\$300,000 \$450,000

$$\text{\$450,000} + \text{\$50,000} - 320,000 = \text{\$180,000}$$

Problems

Group A

(15-20 min.) **P 1-44A**

Req. 1

**FedEx Kinko's Special Contract Division
Income Statement
For the Year Ended December 31, 2011**

Sales revenue	\$250,000	
Other revenue	<u>50,000</u>	
Total revenue		\$300,000
Cost of goods sold	\$ 20,000	
Other expenses	<u>240,000</u>	
Total operating expenses		<u>260,000</u>
Income before income tax		40,000
Income tax expense (\$40,000 × 0.30) ...		<u>(12,000)</u>
Net income		<u><u>\$ 28,000</u></u>

Req. 2

- a. Faithful representation characteristic. Report revenues at their actual sale value because that amount is supported by verifiable data and free from bias. What management believes the goods are worth is based on opinion and subject to dispute.**
- b. Cost assumption. Account for expenses at their actual cost, not a hypothetical amount that the company might have incurred.**
- c. Cost assumption. Account for expenses at their actual cost.**
- d. Entity assumption. Each operating division of the company is a separate entity with its own financial statements. Kinko's as a whole constitutes an entity for accounting purposes.**
- e. Stable-monetary-unit assumption. Accounting in Canada ignores the effect of inflation as the dollar's purchasing power is relatively stable.**

- f. Going-concern assumption. There is no evidence that Kinko's is going out of business, so it seems safe to assume that the division is a going concern. Therefore, the potential sale value of Kinko's assets is not relevant, nor recorded.**

Computed amounts are shown in boxes.
Amounts in millions.

	Link Ltd.	Chain Inc.	Fence Corp.
Beginning			
Assets.....	\$78	\$ 30	\$7
– Liabilities.....	<u>–47</u>	<u>–19</u>	<u>–2</u>
= Common shares	6	1	2
+ Retained earnings	<u>\$25</u>	\$10	\$3
Ending			
Assets.....	<u>\$81</u>	\$48	\$9
– Liabilities.....	<u>–48</u>	<u>–30</u>	<u>–3</u>
= Common shares	6	1	2
+ Retained earnings	\$27	<u>\$17</u>	<u>\$4</u>
Owner's equity			
Dividends	\$3	2	0
Income statement			
Revenues	\$216	<u>\$153</u>	20
Expenses.....	<u>–211</u>	<u>–144</u>	<u>–19</u>
Net income	<u>\$ 5</u>	<u>\$ 9</u>	<u>\$ 1</u>
Statement of retained earnings			
Beginning retained earnings	\$25	\$10	\$3
+ Net income (Net loss)	5	9	1
– Dividends	<u>–3</u>	<u>–2</u>	<u>0</u>
= Ending retained earnings	<u>\$27</u>	<u>\$17</u>	<u>\$4</u>

Link	Chain	Fence
Retained earnings = Assets – Liabilities – Common shares $\$78 - \$47 - \$6 = \25 Assets = Liabilities + Owner's equity $\$48 + \$6 + \$27 = \81 Net income = Revenues – Expenses $\$216 - 211 = \5	Retained earnings = Assets – Liabilities – Common shares $\$48 - \$30 - \$1 = \17 Revenues = Net income + Expenses $\$9 - \$144 = \$153$	Assets = Liabilities + Common shares + Retained earnings $\$2 + \$2 + \$3 = \7 Liabilities = Assets – Common shares – Retained earnings $\$9 - \$2 - \$4 = \3

	Link Ltd.	Chain Inc.	Fence Corp.
Highest net income	\$5	\$9	\$1

Chain has the highest \$ income

Percentage of net income to revenues	=	$\frac{\$5}{\$216}$	$\frac{\$9}{\$153}$	$\frac{\$1}{\$20}$
	=	2.3%	= 5.9%	= 5.0%

Chain has the highest % of net income to revenues.

Req. 1

**Strides Inc.
Balance Sheet
July 31, 2011**

ASSETS		LIABILITIES	
Cash	\$25,000	Accounts payable	\$16,000
Accounts receivable	20,000	Note payable	<u>9,000</u>
Store fixtures	10,000	Total liabilities	25,000
Land	44,000	SHAREHOLDERS' EQUITY	
		Shareholders' equity	<u>74,000*</u>
Total assets	<u>\$99,000</u>	Total liabilities and shareholders' equity	<u>\$99,000</u>

***Total assets (\$99,000) – Total liabilities (\$25,000) = Shareholders' equity (\$74,000).**

Req. 2

Strides is in a *better* financial position as shareholders' equity has increased by \$66,800, and liabilities have decreased by \$84,800.

Req. 3

The amounts that are not presented on the balance sheet because they are revenues or expenses, but that are presented on the income statement, are as follows:

**Rent expense
Salaries expense
Advertising expense
Sales revenue
Interest expense**

Req. 1

Alexa Markowitz Realtor Inc.
Balance Sheet
March 31, 2011

ASSETS		LIABILITIES	
Cash	\$ 14,000	Accounts payable	\$ 6,000
Office supplies	1,000	Note payable	<u>60,000</u>
Furniture	10,000	Total liabilities	<u>66,000</u>
Land	110,000	SHAREHOLDERS'	
Franchise	25,000	EQUITY	
		Common shares	60,000
		Retained earnings	<u>34,000*</u>
		Total shareholders' equity	<u>94,000</u>
		Total liabilities and	
Total assets	<u>\$160,000</u>	shareholders' equity	<u>\$160,000</u>

*Total assets (\$160,000) – Total liabilities (\$66,000) –
Common shares (\$60,000) = Retained earnings (\$34,000).

Req. 2

The business can pay its debts as cash is greater than accounts payable and income was earned in the first month which can be applied to the note payable.

Req. 3

Items not reported on the balance sheet of the business were personal and therefore not part of the business.

- a. Personal cash (\$5,000)**
- e. Personal residence (\$350,000) and mortgage payable (\$100,000)**
- f. Personal account payable (\$1,800)**

Req. 1

Web Services Inc. Income Statement For the Year Ended December 31, 2011		
<hr/>		
Revenue		
Service revenue		\$150,000
Expenses		
Salary expense	\$40,000	
Rent expense	15,000	
Interest expense	4,000	
Utilities expense	3,000	
Property tax expense	<u>2,000</u>	
Total expenses		<u>64,000</u>
Net income		<u>\$ 86,000</u>

Req. 2

Web Services Inc. Statement of Retained Earnings For the Year Ended December 31, 2011		
<hr/>		
Retained earnings, beginning of year		\$ 60,000
Add: Net income for the year		<u>86,000</u>
		146,000
Less: Dividends		<u>(30,000)</u>
Retained earnings, end of year		<u>\$116,000</u>

Req. 3

**Web Services Inc.
Balance Sheet
December 31, 2011**

ASSETS		LIABILITIES	
Cash	\$ 8,000	Accounts payable	\$ 15,000
Accounts receivable	25,000	Interest payable	2,000
Supplies	2,000	Note payable	<u>32,000</u>
Equipment	11,000	Total liabilities	<u>49,000</u>
Building	126,000	SHAREHOLDERS'	
Land	8,000	EQUITY	
		Common shares	15,000
		Retained earnings	<u>116,000</u>
		Total shareholders' equity	<u>131,000</u>
		Total liabilities and	
Total assets	<u>\$180,000</u>	shareholders' equity	<u>\$180,000</u>

* Total assets (\$180,000) – Total liabilities (\$49,000) –
Common shares (\$15,000) = Retained earnings (\$116,000).

Req. 4

- a. Web Services was profitable in 2011, earning a net income of \$86,000.**
- b. Retained earnings increased by \$56,000 after paying dividends to shareholders of \$30,000.**
- c. Shareholders' equity exceeds liabilities by (\$131,000 – \$49,000) \$82,000. Shareholders own more of Web Services' assets.**
As CEO, you would be pleased with the results of Web Services Inc.

Req. 1

Stuart Inc.
Statement of Cash Flows
For the Fiscal Year Ended March 1, 2011

	<i>(Millions)</i>
Cash flows from operating activities:	
Net income (loss)	\$(251)
Adjustments to reconcile net income (loss) to cash provided by operations	<u>397</u>
Net cash provided by operating activities ..	146
Cash flows from investing activities:	
Purchases of capital assets and other assets	\$(144)
Sales of capital assets and other assets	<u>1</u>
Net cash used for investing activities	(143)
Cash flows from financing activities:	
Issuance of long-term debt	164
Repayment of long-term debt	(1)
Issuance of common shares	1
Redemption of common shares	(177)
Payment of dividends	<u>(31)</u>
Net cash used for financing activities	<u>(44)</u>
Net decrease in cash	(41)
Cash, beginning	<u>41</u>
Cash, ending	<u>\$ 0</u>

Req. 2

Operating activities provided the bulk of Stuart Inc.'s cash. This is normally a sign of financial strength. Cash available was used to invest in capital asset purchases and pay dividends. The result of investing and financing activities reduced cash available at fiscal year end to 0. This is a negative statement of cash flows.

Req. 1

		2011		2010	
		(Thousands)			
STATEMENT OF OPERATIONS					
Revenues	16,800	=	\$ k	\$16,000	
Cost of goods sold			11,500	a	= 11,100
Other expenses			<u>1,300</u>	<u>1,200</u>	
Earnings before income taxes			4,000	3,700	
Income taxes (35% tax rate)	1,400	=	<u>l</u>	<u>1,300</u>	
Net earnings	2,600	=	<u>\$ m</u>	<u>\$ b</u>	= 2,400
STATEMENT OF RETAINED EARNINGS					
Beginning balance	5,700	=	\$ n	\$ 3,500	
Net earnings	2,600	=	o	c	= 2,400
Dividends			<u>(300)</u>	<u>(200)</u>	
Ending balance	8,000	=	<u>\$ p</u>	<u>\$ d</u>	= 5,700
BALANCE SHEET					
Assets:					
Cash	2,400	=	\$ q	\$ e	= 2,000
Capital assets			3,000	1,800	
Other assets	12,000	=	<u>r</u>	<u>11,200</u>	
Total assets	17,400	=	<u>\$ s</u>	<u>\$15,000</u>	
Liabilities:					
Current liabilities	4,520	=	\$ t	\$ 5,600	
Notes payable and long-term debt			4,500	3,200	
Other liabilities			<u>80</u>	<u>200</u>	
Total liabilities			9,100	f	= 9,000
Shareholders' Equity:					
Common shares			\$ 300	\$ 300	
Retained earnings	8,000	=	<u>u</u>	<u>g</u>	= 5,700
Total shareholders' equity	8,300	=	<u>v</u>	<u>6,000</u>	
Total liabilities and shareholders' equity	17,400	=	<u>\$ w</u>	<u>\$ h</u>	= 15,000
STATEMENT OF CASH FLOWS					
Net cash provided by operating activities	2,100	=	\$ x	\$ 1,900	
Net cash provided by investing activities			(1,000)	(900)	
Net cash used for financing activities			<u>(700)</u>	<u>(1,010)</u>	
Increase (decrease) in cash			400	i	= (10)
Cash at beginning of year	2,000	=	<u>y</u>	<u>2,010</u>	
Cash at end of year	2,400	=	<u>\$ z</u>	<u>\$ j</u>	= 2,000

Req. 2

- a. Operations improved during 2011. Revenues increased by \$800 thousand and net earnings increased from \$2,400 thousand to \$2,600 thousand.**
- b. The company retained most of its net earnings for use in the business. Dividends were only \$200 thousand in 2010 and \$300 thousand in 2011, which are much less than net earnings.**
- c. Total assets at the end of 2011 were \$17,400 thousand. This is the amount of total resources that the company has to work with as it moves into the year 2012.**
- d. At the end of 2010 the company owed total liabilities of \$9,000 thousand. At the end of 2011 the company owed \$9,100 thousand. Although total liabilities increased marginally, there was a larger increase in total assets, which means that total shareholders' equity is increasing.**
- e. The company's major source of cash is operating activities, and cash increased in 2011 by \$400 thousand. Based on these two facts, it appears that the company's ability to generate cash is strong.**

Problems

Group B

(15-20 min.) **P 1-51B**

Req. 1

**Snap Fasteners Inc.
Income Statement
For the Year Ended December 31, 2011**

	<i>(Millions)</i>
Sales revenue	\$56.2
Cost of goods sold	\$40.0
Other expenses	<u>14.9</u>
Total expenses	<u>54.9</u>
Income before income tax	1.3
Income tax expense (\$1.3 × 0.35) ..	<u>0.5</u>
Net income	<u><u>\$ 0.8</u></u>

Req. 2

- e. Faithful representation characteristic. Report revenues at their actual sale value because they can be verified by sales transactions and are free from bias.**
- f. Cost assumption. Account for expenses at their actual cost, not a hypothetical amount that the company might have incurred if the products were purchased outside.**
 - a. Cost assumption. Account for expenses at their actual cost.**
 - b. Entity assumption. Each division of the company is a separate entity, and the company as a whole constitutes an entity for accounting purposes.**
 - c. Stable-monetary-unit assumption. Accounting in Canada ignores the effect of inflation as the dollar's purchasing power is relatively stable.**
 - d. Going-concern assumption. There is no evidence that Snap Fasteners Inc. is going out of business, so it seems safe to assume that the company is a going concern. Therefore, the potential sale value of Snap's assets is not relevant, nor recorded.**

Computed amounts are shown in boxes. Amounts are in millions.

	<u>Gas Limited</u>	<u>Groceries Inc.</u>	<u>Bottlers Corp.</u>
Beginning:			
Assets	\$11,200	\$ 3,256	\$ 909
– Liabilities	<u>(4,075)</u>	<u>(1,756)</u>	<u>(564)</u>
= Owners' equity	<u>\$ 7,125</u>	<u>\$ 1,500</u>	<u>\$ 345</u>
Ending:			
Assets	\$12,400	\$ <u>3,389</u> ²	\$1,025
– Liabilities	<u>(4,400)</u>	<u>(1,699)</u>	<u>(565)</u>
= Owners' Equity	<u>\$ 8,000</u>	<u>\$ 1,690</u>	<u>\$ 460</u>
Owners' Equity:			
Issuance (repurchase) of shares	\$ (36)	\$ (0)	\$ <u>20</u> ³
– Dividends	(341)	(30)	(0)
Income Statement:			
Revenues	\$11,288	\$11,099	\$1,663
– Expenses	<u>(10,036)</u> ¹	<u>(10,879)</u>	<u>(1,568)</u>
= Net income (Net loss)	<u>\$ 1,252</u>	<u>\$ 220</u>	<u>\$ 95</u>
Statement of owners' equity			
Beginning owners' equity	\$ 7,125	\$ 1,500	\$ 345
+ Issuance (repurchase) of stock	(36)	(0)	<u>20</u> ³
+ Net income (Net loss)	<u>1,252</u> ¹	220	95
– Dividends	<u>(341)</u>	<u>(30)</u>	<u>0</u>
= Ending owners' equity	<u>\$ 8,000</u>	<u>\$ 1,690</u>	<u>\$ 460</u>

(continued) P 1-52B

¹Net income = Ending owners' equity – beginning owners' equity + repurchase of stock + dividends

Net income =

\$8,000 – 7,125 + 36 + 341 = \$1,252

Revenue – expenses = net income

\$11,288 – expenses = \$1,252

Expenses = \$10,036

²Assets – liabilities = OE

Assets = \$1,699 + \$1,690

Assets = \$3,389

³\$345 + Issuances of stock + 95 – \$0 = \$460

Issuances of stock = \$20

		<u>Gas Limited</u>	<u>Groceries Inc.</u>	<u>Bottlers Corp.</u>
Highest net income	=	\$1,252 highest	\$220	\$95
Percentage of net income to revenues	=	$\frac{\$1,252}{\$11,288}$	$\frac{\$220}{\$11,099}$	$\frac{\$95}{\$1,663}$
		= 11.1% highest	= 2.0%	= 5.7%

Req. 1

Lunenberg Times Inc.
Balance Sheet
October 31, 2011

ASSETS		LIABILITIES	
Cash	\$ 25,000	Accounts payable	\$ 8,000
Accounts receivable	10,000	Note payable	<u>16,000</u>
Inventory	30,000	Total liabilities	<u>24,000</u>
Office furniture	15,000	SHAREHOLDERS'	
Land	34,000	EQUITY	
		Shareholders' equity	<u>90,000*</u>
Total assets	<u>\$114,000</u>	Total liabilities and shareholders' equity	<u>\$114,000</u>

*Total assets (\$114,000) – Total liabilities (\$24,000) =
 Shareholders' equity (\$90,000).

Req. 2

Lunenberg Times Inc. is in a *better* financial position. Shareholders' equity has increased by \$71,500, while liabilities have decreased by \$84,000.

Req. 3

The accounts that are not presented on the balance sheet because they are revenues or expenses, but which are presented on the income statement, are as follows:

Sales revenue
 Rent expense
 Advertising expense
 Salary expense

Req. 1

**Luis Fontano Realtor Inc.
Balance Sheet
July 31, 2011**

ASSETS		LIABILITIES	
Cash	\$ 10,000	Accounts payable	\$ 10,000
Office supplies	1,000	Note payable	<u>80,000</u>
Furniture	18,000	Total liabilities	<u>90,000</u>
Land	135,000	SHAREHOLDERS'	
Franchise	35,000	EQUITY	
		Common shares	75,000
		Retained earnings	<u>34,000*</u>
		Total shareholders' equity	<u>109,000</u>
		Total liabilities and	
Total assets	<u>\$199,000</u>	shareholders' equity	<u>\$199,000</u>

*Total assets (\$199,000) – Total liabilities (\$90,000) –
Common shares (\$75,000) = \$34,000.

Req. 2

The realty business has \$10,000 in cash and owes \$10,000 as a current liability. The value of the land likely exceeds the note payable. Therefore, it does appear that the realty business can pay its debts.

Req. 3

Personal items not reported on the balance sheet of the business:

- a. Personal accounts payable (\$5,000)
- c. Personal cash (\$5,000)
- f. Personal residence (\$300,000) and mortgage payable (\$125,000)

Req. 1

Auto Mechanics Ltd. Income Statement For the Year Ended December 31, 2011		
<hr/>		
Revenue		
Service revenue		\$210,000
Expenses		
Salary expense	\$85,000	
Rent expense	6,000	
Advertising expense	10,000	
Interest expense	4,000	
Property tax expense	<u>5,000</u>	
Total expenses		<u>110,000</u>
Net income		<u><u>\$100,000</u></u>

Req. 2

Auto Mechanics Ltd. Statement of Retained Earnings For the Year Ended December 31, 2011		
<hr/>		
Retained earnings, beginning of year		\$ 40,000
Add: Net income for the year		<u>100,000</u>
		140,000
Less: Dividends		<u>(50,000)</u>
Retained earnings, end of year		<u><u>\$ 90,000</u></u>

Req. 3

**Auto Mechanics Ltd.
Balance Sheet
December 31, 2011**

ASSETS		LIABILITIES	
Cash	\$ 10,000	Accounts payable	\$ 21,000
Accounts receivable	25,000	Salary payable	12,000
Supplies	3,000	Note payable	<u>95,000</u>
Furniture	20,000	Total liabilities	128,000
Building	140,000	SHAREHOLDERS'	
Land	95,000	EQUITY	
		Common shares	75,000
		Retained earnings	<u>90,000</u>
		Total shareholders' equity	<u>165,000</u>
		Total liabilities and	
Total assets	<u>\$293,000</u>	shareholders' equity	<u>\$293,000</u>

***Total assets (\$293,000) – Total liabilities (\$128,000) –
Common shares (\$75,000) = Retained earnings (\$93,000).**

Req. 4

- a. Auto Mechanics Ltd. was profitable in 2011. The company's net income was \$100,000.**
- b. Retained earnings increased by \$50,000.**
- c. Shareholders' equity is greater than liabilities by (\$165,000 – \$128,000) \$37,000. The shareholders own more Auto Mechanics Ltd. assets than do the creditors.**

Req. 1

Long Boat Ltd.
Statement of Cash Flows
For a Recent Year (*in thousands*)

Cash flows from operating activities:

Net income	\$ 180
Adjustments to reconcile net income to cash provided by operations	<u>65</u>
Net cash flow from operating activities	245

Cash flows from investing activities:

Purchases of capital assets	\$(123)
Sales of capital assets	2
Net cash outflow for investing activities	(121)

Cash flows from financing activities:

Payment of dividends	(24)
Issuance of common shares	4
Change in bank loan	(44)
Payment of long-term debt	<u>(26)</u>
Net cash inflow from financing activities	<u>(90)</u>

Net increase in cash	\$ 34
Cash, beginning	<u>(11)</u>
Cash, ending	<u><u>\$ 23</u></u>

Req. 2

Operations were the main source of cash, which is a sign of strength. Funds from operations provided funds for investing and financing needs with a net increase in cash indicating financial strength.

Req. 1

		2011	2010		
		(Thousands)			
STATEMENT OF INCOME					
Revenues		\$94,500	a	=	88,250
Cost of goods sold	\$73,195	= k	65,400		
Other expenses		<u>15,660</u>	<u>13,550</u>		
Income before income taxes		5,645	9,300		
Income taxes (35%)		<u>1,975</u>	<u>3,450</u>		
Net income	3,670	= \$ l	\$ b	=	5,850
STATEMENT OF RETAINED EARNINGS					
Beginning balance	15,400	= \$ m	\$10,000		
Net income	3,670	= n	c	=	5,850
Dividends		<u>(480)</u>	<u>(450)</u>		
Ending balance	18,590	= \$ o	\$ d	=	15,400
BALANCE SHEET					
Assets:					
Cash	450	= \$ p	\$ 400		
Capital assets		23,790	e	=	20,200
Other assets	19,250	= q	<u>17,900</u>		
Total assets	43,490	= \$ r	<u>\$38,500</u>		
Liabilities:					
Current liabilities		\$11,100	\$10,000		
Long-term debt and other liabilities	13,400	= s	<u>12,500</u>		
Total liabilities		<u>24,500</u>	f	=	22,500
Shareholders' Equity:					
Common shares		\$ 400	\$ 600		
Retained earnings	18,590	= t	g	=	15,400
Total shareholders' equity	18,990	= u	<u>16,000</u>		
Total liabilities and shareholders' equity	43,490	= \$ v	<u>\$ h</u>	=	38,500
STATEMENT OF CASH FLOWS					
Net cash provided by operating activities	2,500	= \$ w	\$ 3,600		
Net cash used for investing activities		(2,700)	(4,150)		
Net cash provided by financing activities		<u>250</u>	<u>900</u>		
Increase (decrease) in cash		50	i	=	350
Cash at beginning of year	400	= x	<u>50</u>		
Cash at end of year	450	= \$ y	\$ j	=	400

Req. 2

- a. Operations deteriorated during 2011. The income statement reports that revenues increased, but net income fell from \$5,850 thousand to \$3,670 thousand. Cost of goods sold increased as a percentage of revenue (77.5% vs. 74.1%).**
- b. The company retained most of its net income for use in the business. The statement of retained earnings reports that paid dividends were \$480 thousand in 2011 and \$450 thousand in 2010, which are much less than net income.**
- c. The balance sheet reports total assets at the end of 2011 were \$43,490 thousand. This is the amount of total resources that the company has to work with as it moves into the year 2012. At the end of 2010 the balance sheet shows that the company had total assets of \$38,500 thousand.**
- d. The balance sheet shows that at the end of 2010, the company owed total liabilities of \$22,500 thousand and at the end of 2011, the company owed \$24,500 thousand.**
- e. The statement of cash flows reports that the company's major source of cash is operating activities, and cash is**

(continued) P 1-57B

increasing. Based on these two facts, it appears that the company's ability to generate cash is strong despite the dip in 2011 net income. The company is using most of its cash to invest. It is clear from the large amounts of cash used for investing activities that the company is growing.

Decision Cases

(20-30 min.) Decision Case 1

Req. 1

Based solely on these balance sheets, PC Providers Inc. (PPI) appears to be the better credit risk than Web Services Corporation (WSC) because,

1. WSC has more assets (\$430,000) than PPI (\$223,000), but WSC owes much more in liabilities than PPI (\$390,000 versus \$40,000). PPI's shareholders' equity is far greater than WSC's (\$183,000 compared to \$40,000). PPI is not heavily in debt, but WSC is.
2. The student should consider the borrower's ability to pay the loan. WSC has large liabilities to pay, and has very little shareholders' equity. PPI has little debt to pay before undertaking a new loan. The income statement and statement of cash flows should also be considered.

Req. 2

1. The student should request that the borrower present the entity's *income statement* for a recent period, such as the most recent month, the most recent three months, and the last year. The income statement reports the revenues earned by the entity, the expenses it incurred, and the net income or net loss for the periods. Income statement data (especially the amount of net income or net loss) provide an important measure of business success or failure, in particular over recent fiscal periods.

(continued) Decision Case 1

- 2. The student should request that the borrower present the entity's statement of cash flows for the most recent period. In particular he or she would want to know how the borrower generates cash—from operating, investing, or financing activities. If cash from operations is strong, WSC may be able to cover large debt obligations.**
- 3. What the borrower plans to do with the loan will affect the decision – investment in assets to generate greater revenue would provide greater opportunity for a loan provision.**

(15-20 min.) Decision Case 2

1.

**My Dream Inc.
Income Statement
For the Year Ended December 31, 2011**

Revenues (\$80,000 + \$10,000)	\$90,000
Expenses (\$60,000 + \$20,000 + \$10,000)	<u>90,000</u>
Net income	<u><u>\$ 0</u></u>

**My Dream Inc.
Balance Sheet
December 31, 2009**

Cash	\$13,000	Liabilities (\$35,000 + \$10,000)	\$45,000
Accounts receivable	10,000	Equity (\$45,000 – \$20,000)	<u>25,000</u>
Other assets			
(\$67,000 – \$20,000)	<u>47,000</u>		
	<u><u>\$70,000</u></u>		<u><u>\$70,000</u></u>

2. The balance sheet indicates that My Dream has greater debt than shareholder equity. The statement of cash flows would provide information as to how much of the debt relates to investment in assets to generate revenue in the future.

The income statement indicates the company broke even with neither a profit nor a loss in its first year.

3. I would buy shares in the company if my friend would invest more or find other investors, and if she would also commit to getting a competent accountant to keep her records and prepare her financial statements.

Note: Student responses may vary.

Ethical Issue

Req. 1

The fundamental ethical issue is that the financial statements should “present fairly” information that is useful to investors, creditors, regulators, and other users to help them make decisions. In the case of Enron, WorldCom, and Livent, the financial statements presented incorrect information to users in order to deceive them into believing the companies were doing better than they actually were.

Req. 2

Enron

Assets – Liabilities = Owners’ Equity

Liabilities were understated and so Owners’ Equity was overstated. Liabilities were transferred off the balance sheet.

WorldCom

Assets – Liabilities = Owners’ Equity.

Assets were overstated and so Owners’ Equity was overstated. Expenses were understated and so net income was overstated leading to Owners’ Equity being overstated.

Livent Inc.

Owner’s Equity = Assets – Liabilities

Expenses were understated and so net income was inflated leading to Owners’ Equity being overstated.

The principal stakeholders affected were the investors. The overstatement of owners' equity caused the price of common shares to be overstated. When the accounting abuses were discovered, the investors lost their investments, Enron and Livent failed, World Com was bankrupt, and employees lost their jobs.

Req. 3

The management of the companies should have considered that although management would gain through bonus payments:

1. Investors would lose as their investments would be overstated or the choice to invest would be based on overstated value.
2. Employees would lose as the companies' future and their employment would be put in jeopardy.

Management made decisions based on their own self-interest.

Req. 4

The consequences of the management's decisions in all three cases were devastating.

1. Management representatives received jail sentences.
2. Investors lost their savings, many of which were retirement savings.
3. Employees lost their jobs and future pensions.

(30 min.) Gildan Activewear Inc.

1. **Net earnings**, This item is important as it expresses the net result of all the revenues minus all the expenses for a period. Net earnings give the results of operations in a single figure.

During fiscal year 2009, net income decreased from \$146,350 thousand to \$95,329 thousand. This reflects the economic environment of 2009. The company will need to maintain its market share of 57% and increase sales in 2010.

2. Gildan's largest expense is cost of sales, which amounted to 77.8% of net sales in fiscal 2009 (72.9% in 2008). Cost of sales includes all costs to produce goods for sale. These costs include all raw material costs, manufacturing conversion costs (including depreciation, sourcing and transportation costs), costs relating to purchasing, receiving and manufacturing administration, insurance, internal transfer of inventories, customs, and duties. *Notes to the Financial Statements 1: Significant Accounting Policies (n) Cost of Sales.*

The expense is less than revenue because Gildan runs its business to earn a profit. If cost of sales exceeded net sales revenue, the company would be in financial difficulty.

(continued) Gildan Activewear Inc.

3. Total resources (total assets) at the end of 2009.....\$1,082,408 thousand
Amount owed (total liabilities) at the end of the year
(\$139,003 thousand \$1,584 thousand + \$23,764
thousand + \$7,272 thousand)\$171,623 thousand

Portion of the company's assets owned by the
company shareholders (this is shareholders'
equity)\$910,785 thousand

Gildan's accounting equation is (*in thousands*):

Assets	=	Liabilities	+	Shareholders' equity
\$1,082,408	=	\$171,623	+	\$910,785

4. At the beginning of fiscal year 2009, Gildan had cash of \$12,357 thousand and at the end of the year Gildan had cash of \$99,732 thousand. Gildan gets most of its cash from operating activities.

The company spent its cash to reduce debt (\$47,711 thousand) and to purchase property, plant and equipment (\$44,938 thousand).

Note: Page 6 of the Gildan Annual Report summarized Gildan's financial position.

Focus on Analysis

(30 min.) Gildan Activewear Inc.

1. **Assets = Liabilities + Owners' Equity**
 \$1,082,408 thousand \$171,623 thousand + \$910,785 thousand

Gildan's financial condition looks strong because assets significantly exceed liabilities on the balance sheet.

2. Net earnings for 2009 amounted to \$95,329 thousand. This is shown under the line "Net earnings and other comprehensive income." This is a decrease of 34.8% over 2008. While a decrease in net earnings is not "good news" for Gildan, the company did achieve net earnings of 9% of net sales during a severe down turn in economic conditions. The President's report (page 4 of the Gildan Annual Report) indicates "strong positive momentum for 2010."
3. Retained earnings increased from \$689,190 thousand in 2008 to \$784,519 thousand in 2009 because the company earned \$95,329 thousand in fiscal 2009.
4. The balance sheet reports cash as part of Gildan's financial position. The statement of cash flow tells why cash increased or decreased during the year. The items that caused the most changes in Gildan's cash were:

- | | |
|---|-------------|
| • Net earnings | \$ 95,329 |
| add back depreciation | 65,407 |
| Cash from operations (ignoring small adjustments) | \$160,736 |
| • Repayment of long-term debt | (\$ 45,000) |
| Purchase of property, plant and equipment | (\$ 44,938) |

5. Cash increased \$87,375 thousand and long-term debt decreased \$47,864 thousand. A review of the statement of cash flows indicates that cash increased because management did not make a large acquisition during the year and long-term debt decreased because management paid down long-term debt during the year.

Group Project 1

Answers will vary with the company chosen by students.

Group Project 2

Answers will vary with the company created by students.