

CHAPTER 2

A Further Look at Financial Statements

ASSIGNMENT CLASSIFICATION TABLE

<u>Study Objectives</u>	<u>Questions</u>	<u>Brief Exercises</u>	<u>Exercises</u>	<u>A Problems</u>	<u>B Problems</u>	<u>BYP</u>
1. Identify the sections of a classified statement of financial position.	1, 2, 3, 4, 5, 6, 7	1, 2, 3, 4, 5, 6	1, 2, 3, 4, 5, 6	1, 2, 3, 4, 5	1, 2, 3, 4, 5	1, 8
2. Identify and calculate ratios for analyzing a company's liquidity, solvency and profitability.	8, 9, 11, 12, 13, 14, 15	7, 8, 9	7, 8, 9	6, 7, 8, 9	6, 7, 8, 9	2, 3, 5, 9
3. Describe the framework for the preparation and presentation of financial statements.	16, 17, 18, 19, 20, 21, 22, 23, 24, 25	10, 11, 12	10, 11	10, 11, 12	10, 11, 12	3, 4, 6, 7, 9

ASSIGNMENT CHARACTERISTICS TABLE

Problem Number	Description	Difficulty Level	Time Allotted (min.)
1A	Classify accounts.	Moderate	15-25
2A	List accounts in order of liquidity and reverse liquidity.	Moderate	15-25
3A	Prepare assets section.	Simple	15-25
4A	Prepare liabilities and equity sections.	Moderate	15-25
5A	Prepare financial statements; discuss relationships.	Moderate	15-25
6A	Calculate ratios and comment on liquidity, solvency and profitability.	Simple	10-20
7A	Calculate ratios and comment on liquidity, solvency and profitability.	Moderate	20-30
8A	Calculate ratios and comment on liquidity, solvency and profitability.	Simple	10-20
9A	Comment on liquidity, solvency and profitability.	Moderate	15-20
10A	Discuss financial reporting objective and qualitative characteristics.	Moderate	15-20
11A	Discuss qualitative characteristics.	Moderate	15-20
12A	Discuss measurement principles.	Moderate	20-30
1B	Classify accounts.	Moderate	15-25
2B	List accounts in order of liquidity and reverse liquidity.	Moderate	15-25
3B	Prepare assets section.	Simple	15-25
4B	Prepare liabilities and equity sections.	Moderate	15-25

<u>Problem Number</u>	<u>Description</u>	<u>Difficulty Level</u>	<u>Time Allotted (min.)</u>
5B	Prepare financial statements; discuss relationships.	Moderate	15-25
6B	Calculate ratios and comment on liquidity, solvency and profitability.	Simple	10-20
7B	Calculate ratios and comment on liquidity, solvency and profitability.	Moderate	20-30
8B	Calculate ratios and comment on liquidity, solvency and profitability.	Simple	10-20
9B	Comment on liquidity, solvency and profitability.	Moderate	15-20
10B	Discuss financial reporting objective and qualitative characteristics.	Moderate	15-20
11B	Discuss elements of financial statements.	Moderate	15-20
12B	Identify measurement principles.	Moderate	20-30

ANSWERS TO QUESTIONS

1. Current assets are assets that are expected to be converted into cash, sold, or used up within one year of the company's financial statement date or its operating cycle, whichever is longer. Examples of current assets include: cash, accounts receivable, merchandise inventory and supplies.
2. The term operating cycle stands for the average time it takes to go from cash to cash in producing revenue. In a merchandising business, this means the time it takes to purchase inventory, pay cash to suppliers, sell the inventory on account, and then collect cash from customers. In a service business, it stands for the time it takes to pay employees, provide services on account, and then collect the cash from customers.
3.
 - (a) Current assets are assets that are expected to be converted into cash, sold, or used up within one year of the company's financial statement date or its operating cycle, whichever is longer. Non-current assets are assets that are not expected to be converted into cash, sold, or used up by the business within one year of the financial statement date or its operating cycle. In other words, non-current assets are everything that are not classified as a current assets.
 - (b) Current assets are assets that are expected to be converted into cash, sold, or used up within one year of the company's financial statement date or its operating cycle, whichever is longer. Current liabilities are obligations that are to be paid or settled within one year of the company's financial statement date or its operating cycle, whichever is longer. Ideally, current assets will exceed current liabilities for a company.
4.
 - (a) Current liabilities are obligations that are to be paid or settled within one year of the company's financial statement date or its operating cycle, whichever is longer.
 - (b) Examples of current liabilities include: bank indebtedness, accounts payable, accrued liabilities and current maturities of long-term debt.

Questions (Continued)

5. (a) The major differences between current liabilities and non-current liabilities are:

<u>Difference</u>	<u>Current Liabilities</u>	<u>Non-current Liabilities</u>
Source of payment	Existing current assets or other current liabilities	Other than existing current assets or creating current liabilities
Time of expected payment	Within one year	Beyond one year
Nature of items	Debts pertaining to the operating cycle and other short-term debts	Mortgages, notes, loans, bonds, and other non-current liabilities

- (b) Some liabilities, such as notes payable, appear on the statement of financial position with a current and non-current portion. Included in notes payable payments that will be due in the next year is an amount of principal repayment. That amount must be shown as a current liability as of the company's financial statement date. The remaining principal balance is classified as a non-current liability.
6. The two components of shareholders' equity and the purpose of each are: (1) Share capital is used to record investments of assets in the business by the owners (shareholders). If there is only one class of shares, it is known as common shares. (2) Retained earnings is used to record accumulated profit, net of any losses and dividends paid, retained in the business.
7. Statements using the common practice among North American companies are prepared by classifying the items on the statement of financial position in order of liquidity, ranking the items with the most liquidity first.

The statement of financial position prepared using a reverse-liquidity order shows assets first, followed by shareholders' equity and liabilities. The assets section starts with non-current assets followed by current assets. Non-current assets include goodwill and intangible assets; property, plant, and equipment; and long-term investments, which are normally grouped under a non-current heading. This differs from the separate disclosure of non-current assets without a heading that is more usual in North America. Within the current assets section, items are listed in reverse order of liquidity; that is, cash is normally shown last. Items within the property, plant, and equipment section are normally listed in order of permanency. Shareholders' equity is shown next, followed by liabilities. The liabilities section presents non-current liabilities before current liabilities, and current liabilities are listed in reverse order of liquidity similar to current assets.

Questions (Continued)

8.
 - (a) Liquidity ratios measure a company's short-term ability to pay its current liabilities and meet its unexpected needs for cash. Examples of liquidity ratios include: Working capital and current ratio.
 - (b) Solvency ratios measure a company's ability to survive over a long period of time. An example of a solvency ratio is the debt to total assets ratio.
 - (c) Profitability ratios measure a company's operating success for a given period of time. Examples of profitability ratios include: Earnings per share and price-earnings ratio.
9. The current ratio is a better measure of liquidity than working capital when making comparisons between different businesses. The amount of working capital is an absolute amount. It could vary tremendously depending on the size of the operations of the business. The current ratio on the other hand presents a relationship of the amount of current assets compared to current liabilities and is therefore appropriate as a tool to compare the liquidity of different size businesses.
10. Current assets include accounts receivable and inventory. These may have increasing balances because of uncollectible receivables or slow-moving inventory. This would cause the current ratio to increase. Even though the current ratio may seem high, it is an artificial measure of liquidity if receivables and inventory cannot be easily or quickly convertible into cash. Consequently, the current ratio alone does not provide a complete assessment of liquidity.
11. Dong Corporation is more solvent as only 45% of its assets are financed by debt whereas 55% of Du's assets are financed by debt. A company carrying a higher proportion of debt has an increased likelihood of encountering financial difficulties and is therefore considered less solvent.
12. Raising money using debt adds more risk to a company than raising money through equity because the terms of repayment of debt requires cash outflows for the payment of interest and repayment of principal. These payments tap into cash balances that could hurt the company's liquidity. In contrast to debt, equity does not have to be repaid.
13. Earnings per share comparisons among different companies are difficult due to variations in the financing structure of the companies and in the number of shares issued. Hence, there is no industry average for earnings per share. On the other hand, since the price-earnings ratio uses earnings per share relative to the market price of the common shares, the ratio can be compared among companies.

Questions (Continued)

14. Investors appear to favour TD Bank. Its higher price-earnings ratio indicates that investors are willing to pay more for the company's shares and have more favourable expectations of future growth.
15. Increases in the earnings per share, price-earnings ratio, and the current ratio are considered to be signs of improvement because:
- An increase in the earnings per share means that the amount of profit per share is greater than in the previous period.
 - An increase in the price-earnings ratio means that the share price has increased at a greater rate than the company's earnings per share, which implies the market believes future profit will continue to increase.
 - An increase in the current ratio indicates that the company has more current assets available to settle its current liabilities and is more liquid (assuming the components of current assets (e.g., receivables and inventory) are also liquid).

On the other hand, the debt to total assets ratio measures how much of the company is financed by debt. The more debt a company has, the higher the debt to total assets ratio. A company with a higher debt level has increased financial risk due to higher fixed interest and principal repayments, and is less solvent than a company with a lower level of debt.

16. (a) The conceptual framework is a coherent system of interrelated objectives and fundamentals that can lead to consistent standards. The framework prescribes the nature, function, and limits of financial accounting statements. It guides choices about what to present in financial statements, decisions about alternative ways of reporting economic events, and the selection of appropriate ways of communicating such information.
- (b) The conceptual framework used internationally varies from country to country. Canadian companies use the same framework, whether they are reporting under IFRS or under ASPE.
17. (a) The primary objective of financial reporting is to provide information useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company.
- (a) The main users of financial reporting are investors, lenders, and other creditors.

Questions (Continued)

18. The going concern assumption states that the business will remain in operation for the foreseeable future.
- (a) This assumption supports the cost basis of accounting in that the cost paid for an asset or the amount that must be paid in the future for liabilities can continue to be used for financial reporting purposes. This is the case because the business expects to use the assets or pay its liabilities during its operating cycle.
 - (b) The timing of when the asset will be converted to cash or used in operations and when liabilities are to be paid determines their classification on the statement of financial position. Since the business is expected to remain in operation for the foreseeable future, these elements can continue to be reported in accordance with their respective current or non-current classifications.
19. The fundamental qualitative characteristics are (1) relevance and (2) faithful representation.
- Relevant information will impact a user's decision by having predictive value, confirmatory value or both. Faithful representation means that the financial statements should reflect the economic reality of what really exists or has happened. The information must be complete, neutral, and free from material error.
20. Materiality is related to relevance in that they are both defined in terms of what influences or makes a difference to the decision-maker. In order to be relevant to a financial statement user, a transaction or amount must make a difference to the user in the making of a decision. An item is considered to be material if its omission or misstatement could influence the decision.
21. The four enhancing qualitative characteristics are (1) comparability, (2) verifiability, (3) timeliness, and (4) understandability. There is no prescribed order in applying these characteristics.
22. The cost constraint means that information will be presented only when the benefit associated with it exceeds the cost of providing it. In attempting to fulfill a completeness objective when obtaining financial information, one could expend considerable resources. The cost of this search may greatly outweigh any benefit in achieving the completeness objective. Consequently, the search for completeness will be restricted by this constraint.

Questions (Continued)

23. The elements of financial statements are broad categories or classes of financial statement effects of transactions and other events. They include assets, liabilities, equity, income (including gains), and expenses (including losses). The grouping is selected in accordance with the economic characteristics of the transactions.
24. The principles used in the measurement of elements are historical cost and fair value. The fair value basis of accounting is applied to those assets which are intended to be sold and whose fair value is readily available. Securities traded on the stock exchanges would be a good example of assets reported at their fair value. The historical cost basis of accounting is used for most of the remaining assets used by the business. Since in most cases the intention is to use the assets to earn revenue, the fair value of the asset is not as relevant as its cost.
25. In order to be relevant for decision making, the measurement of elements of financial statements need to reflect amounts that are reliable. For assets that are intended to be sold, the current fair value of the assets becomes the most relevant measurement as it approximates the current amount of cash that could be obtained on the sale of the asset. On the other hand, for assets held for use by the corporation, the value at resale is not as relevant to the financial statement user. In that case, the cost of the assets is the better measurement for reporting the financial statement element. For example, inventory will become cost of goods sold when sold. It is relevant to compare the actual cost of the inventory to the amount of the revenue generated from its sale. Using the cost basis of accounting gives a faithful representation of the transaction that has occurred from the sale of inventory.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2-1

a)	5	Accounts payable	(i)	2	Investment in long-term bonds
(b)	1	Accounts receivable	(j)	3	Land
(c)	3	Accumulated depreciation	(k)	1	Merchandise inventory
(d)	3	Buildings	(l)	7	Common shares
(e)	1	Cash	(m)	1	Supplies
(f)	4	Patent	(n)	6	Mortgage payable, due in 20 years
(g)	8	Dividends	(o)	5	Current portion of mortgage payable
(h)	5	Income tax payable			

BRIEF EXERCISE 2-2

SWANN LIMITED Statement of Financial Position (Partial)

Assets

Current assets

Cash	\$16,400
Accounts receivable	14,500
Merchandise inventory	9,000
Supplies	4,200
Prepaid insurance	<u>3,900</u>
Total current assets	<u><u>\$48,000</u></u>

BRIEF EXERCISE 2-3

SHUM CORPORATION Statement of Financial Position (Partial)

Property, plant, and equipment

Land		\$ 65,000
Buildings	\$110,000	
Less: Accumulated depreciation—buildings	<u>33,000</u>	77,000
Equipment	\$70,000	
Less: Accumulated depreciation—equipment	<u>25,000</u>	<u>45,000</u>
Total property, plant, and equipment		<u><u>\$187,000</u></u>

BRIEF EXERCISE 2-4

HIRJIKA INC.
Statement of Financial Position (Partial)

Current liabilities	
Accounts payable	\$22,500
Salaries payable	3,900
Interest payable	5,200
Income tax payable	6,400
Current portion of mortgage payable	<u>5,000</u>
Total current liabilities	<u>\$43,000</u>

BRIEF EXERCISE 2-5

	(a) Liquidity	(b) Reverse Liquidity
Accounts payable	6	8
Accounts receivable	3	3
Cash	1	5
Income tax payable	7	7
Merchandise inventory	5	1
Notes payable	8	6
Notes receivable	4	2
Short-term investments	2	4

BRIEF EXERCISE 2-6

	<u>Share Capital</u>	<u>Retained Earnings</u>
(a) Issued common shares	+	NE
(b) Paid a cash dividend	NE	-
(c) Purchased merchandise inventory for cash	NE	NE
(d) Reported a profit	NE	+
(e) Paid cash to creditors	NE	NE
(f) Reported a loss	NE	-
(g) Issued preferred shares	+	NE

BRIEF EXERCISE 2-7

(a) (\$ in thousands)

<u>2010</u>	<u>2009</u>
Working capital:	Working capital:
$\$351,044 - \$244,665 = \$106,379$	$\$335,125 - \$248,043 = \$87,082$
Current ratio:	Current ratio:
$\frac{\$351,044}{\$244,665} = 1.4:1$	$\frac{\$335,125}{\$248,043} = 1.4:1$

- (b) The working capital increased in 2010. The current ratio remained relatively unchanged (1.35:1 in 2009 and 1.43:1 in 2010 if rounded to two decimal points or 1.4:1 in both years if rounded to one decimal point). Indigo's liquidity is relatively constant, as measured by the current ratio.

BRIEF EXERCISE 2-8

(a) (in USD millions)

<u>2010</u>	<u>2009</u>
Debt to total assets ratio:	Debt to total assets ratio:
$\frac{\$882.9 + \$1,199.5}{\$1,031.0 + \$2,665.7} = 56.3\%$	$\frac{\$789.0 + \$1,140.9}{\$844.5 + \$2,411.4} = 59.3\%$

- (b) The company's solvency was stronger in 2010 compared with 2009 because total debt has decreased as a proportion of total assets.

BRIEF EXERCISE 2-9

(a) (\$ in thousands)

2010

Earnings per share:

$$\frac{\$63,284}{70,732} = \$0.89 \text{ per share}$$

Price-earnings ratio:

$$\frac{\$14.80}{\$0.89} = 16.6 \text{ times}$$

2009

Earnings per share:

$$\frac{\$56,864}{70,714} = \$0.80 \text{ per share}$$

Price-earnings ratio:

$$\frac{\$10.50}{\$0.80} = 13.1 \text{ times}$$

- (b) The increase in the earnings per share during the year would indicate that profitability has improved in 2010. Investors appear to have more confidence in Leon's profit as indicated by the increase in the price-earnings ratio in 2010.

BRIEF EXERCISE 2-10

- (a) Faithful representation
- (b) Verifiability
- (c) Understandability
- (d) Cost
- (e) Going concern
- (f) Fair value

BRIEF EXERCISE 2-11

- (a) 10
- (b) 5
- (c) 1
- (d) 2
- (e) 4
- (f) 13
- (g) 8
- (h) 12
- (i) 9
- (j) 3
- (k) 11
- (l) 6
- (m) 7

BRIEF EXERCISE 2-12

- (a) Sosa Ltd. has purchased the land for sale and not for use. The current fair value of the land becomes the most relevant measurement as it approximates the current amount of cash that could be obtained on the sale of the asset.
- (b) Mohawk has purchased land for use and not for sale. The current fair value is not as relevant to the financial statement user in this case. The historical cost of the land is the better measurement for reporting the land on the statement of financial position.

SOLUTIONS TO EXERCISES

EXERCISE 2-1

- (a) 5 Accounts payable and accrued liabilities
- (b) 1 Accounts receivable
- (c) 3 Accumulated depreciation
- (d) 3 Buildings and leasehold improvements
- (e) 7 Common shares
- (f) 5 Current maturities of long-term debt
- (g) 5 Dividends payable
- (h) 4 Goodwill
- (i) 5 Income and other taxes payable
- (j) 1 Income and other taxes receivable
- (k) 1 Inventories
- (l) 2 Investments
- (m) 3 Land
- (n) 6 Long-term debt
- (o) 6 Other long-term liabilities
- (p) 1 Prepaid expenses
- (q) 4 Spectrum licences (to use public frequencies)

EXERCISE 2-2

BIG ROCK BREWERY
Statement of Financial Position (partial)
December 31, 2010
(in thousands)

Assets

Current assets			
Cash		\$ 769	
Accounts receivable		1,789	
Inventories		4,471	
Prepaid expenses and other		<u>397</u>	
Total current assets			\$ 7,426
Property, plant, and equipment			
Land		\$ 2,516	
Buildings	\$11,879		
Less: Accumulated amortization*	<u>3,304</u>	8,575	
Furniture and fixtures	\$ 2,328		
Less: Accumulated amortization	<u>1,818</u>	510	
Production equipment	\$33,871		
Less: Accumulated amortization	<u>18,648</u>	15,223	
Vehicles	\$ 1,101		
Less: Accumulated amortization	<u>890</u>	<u>211</u>	
Total property, plant, and equipment			<u>27,035</u>
Total assets			<u>\$34,461</u>

* Note that Big Rock Brewery uses the term “amortization” rather than “depreciation” for its property, plant, and equipment.

EXERCISE 2-3

SAPUTO INC.
Statement of Financial Position (partial)
March 31, 2010
(in thousands)

Liabilities and Shareholders' Equity

Current liabilities		
Accounts payable and accrued liabilities	\$471,106	
Income taxes payable	149,377	
Future income taxes payable	8,639	
Bank loans payable	<u>61,572</u>	
Total current liabilities		\$ 690,694
Non-current liabilities		
Long-term debt	\$380,790	
Future income taxes payable	143,675	
Other long-term liabilities	<u>9,694</u>	
Total non-current liabilities		<u>534,159</u>
Total liabilities		1,224,853
Shareholders' equity		
Common shares	\$ 584,749	
Retained earnings	1,603,373	
Other reductions in shareholders' equity	<u>(159,524)</u>	
Total shareholders' equity		<u>2,028,598</u>
Total liabilities and shareholders' equity		<u>\$3,253,451</u>

EXERCISE 2-4

$$\begin{aligned}
 \text{(a) Profit} &= \text{Revenues} - \text{Expenses} \\
 &= \$73,040 - \$13,080 - \$5,000 - \$4,750 - \$35,600 \\
 &= \$14,610
 \end{aligned}$$

$$\begin{aligned}
 \text{Retained earnings} &= \text{Beginning retained earnings} + \text{Profit} - \text{Dividends} \\
 &= \$66,520 + \$14,610 - \$0 \\
 &= \$81,130
 \end{aligned}$$

(b) SUMMIT'S BOWLING ALLEY LTD.
Statement of Financial Position
December 31, 2012

Assets			
Current assets			
Cash			\$ 15,040
Accounts receivable			13,780
Supplies			740
Prepaid insurance			<u>390</u>
Total current assets			29,950
Long-term investments			30,000
Property, plant, and equipment			
Land		\$54,000	
Buildings	\$128,800		
Less: Accumulated depreciation	<u>45,600</u>	83,200	
Equipment	\$ 62,400		
Less: Accumulated depreciation	<u>17,770</u>	<u>44,630</u>	
Total property, plant, and equipment			181,830
Total assets			<u>\$241,780</u>
Liabilities and Shareholders' Equity			
Current liabilities			
Accounts payable		\$14,050	
Interest payable		1,600	
Current portion of long-term debt		<u>13,600</u>	
Total current liabilities			\$ 29,250
Mortgage payable (\$95,000 – \$13,600)			<u>81,400</u>
Total liabilities			110,650
Shareholders' equity			
Common shares		\$50,000	
Retained earnings		<u>81,130</u>	
Total shareholders' equity			131,130
Total liabilities and shareholders' equity			<u>\$241,780</u>

EXERCISE 2-5

(a) Profit = Revenues – Expenses
 = \$73,040 – \$13,080 – \$5,000 – \$4,750 – \$35,600
 = \$14,610

Retained earnings = Beginning retained earnings + Profit – Dividends
 = \$66,520 + \$14,610 – \$0
 = \$81,130

(b) SUMMIT'S BOWLING ALLEY LTD.
 Statement of Financial Position
 December 31, 2012

Assets			
Non-current assets			
Property, plant, and equipment			
Land		\$54,000	
Buildings	\$128,800		
Less: Accumulated depreciation	<u>45,600</u>	83,200	
Equipment	\$62,400		
Less: Accumulated depreciation	<u>17,770</u>	<u>44,630</u>	
Total property, plant, and equipment			\$181,830
Long-term investments			30,000
Current assets			
Prepaid insurance		\$ 390	
Supplies		740	
Accounts receivable		13,780	
Cash		<u>15,040</u>	
Total current assets			<u>29,950</u>
Total assets			<u>\$241,780</u>
Shareholders' Equity and Liabilities			
Shareholders' equity			
Common shares		\$50,000	
Retained earnings		<u>81,130</u>	
Total shareholders' equity			\$131,130
Mortgage payable (\$95,000 – \$13,600)			81,400
Current liabilities			
Current portion of long-term debt		\$13,600	
Interest payable		1,600	
Accounts payable		<u>14,050</u>	
Total current liabilities			<u>29,250</u>
Total shareholders' equity and liabilities			<u>\$241,780</u>

EXERCISE 2-6

BATRA CORPORATION
Income Statement
Year Ended July 31, 2012

Revenues		
Commission revenue		\$81,100
Rent revenue		<u>18,500</u>
Total revenues		99,600
Expenses		
Salaries expense	\$44,700	
Rent expense	10,800	
Depreciation expense	3,000	
Utilities expense	2,600	
Interest expense	2,000	
Supplies expense	<u>900</u>	
Total expenses		<u>64,000</u>
Profit before income tax		35,600
Income tax expense		<u>5,000</u>
Profit		<u>\$30,600</u>

BATRA CORPORATION
Statement of Changes in Equity
Year Ended July 31, 2012

	<u>Common Shares</u>	<u>Retained Earnings</u>	<u>Total Equity</u>
Balance, August 1, 2011	\$ 6,000	\$ 17,940	\$ 23,940
Issued common shares	4,000		4,000
Profit		30,600	30,600
Dividends		<u>(12,000)</u>	<u>(12,000)</u>
Balance, July 31, 2012	<u>\$10,000</u>	<u>\$ 36,540</u>	<u>\$ 46,540</u>

EXERCISE 2-6 (Continued)

BATRA CORPORATION
Statement of Financial Position
July 31, 2012

Assets			
Current assets			
Cash	\$ 5,060		
Short-term investments	20,000		
Accounts receivable	17,100		
Supplies	<u>1,500</u>		
Total current assets		\$43,660	
Property, plant, and equipment			
Equipment	\$35,900		
Less: Accumulated depreciation	<u>6,000</u>		
Total property, plant, and equipment		<u>29,900</u>	
Total assets		<u><u>\$73,560</u></u>	
Liabilities and Shareholders' Equity			
Current liabilities			
Accounts payable	\$ 4,220		
Interest payable	1,000		
Bank loan payable	<u>21,800</u>		
Total liabilities		\$27,020	
Shareholders' equity			
Common shares	\$10,000		
Retained earnings	<u>36,540</u>		
Total shareholders' equity		<u>46,540</u>	
Total liabilities and shareholders' equity		<u><u>\$73,560</u></u>	

EXERCISE 2-7

(a) Current ratio:

$$\frac{\$60,000}{\$30,000} = 2:1$$

(b) Current ratio:

$$\frac{\$60,000 - \$20,000}{\$30,000 - \$20,000} = 4:1$$

(c) The request of the CFO to pay off an accounts payable ahead of the due date is clearly done to manipulate the current ratio. His instructions to make the payment came after he was presented with the calculation of the current ratio. In this case the current ratio which is meant to show Padilla's liquidity position has been artificially altered by a simple payment on account. Due to the motivation for the transaction, the CFO is acting unethically.

EXERCISE 2-8

(a) (in USD millions)

2010

Working capital:

$$\$3,825.3 - \$4,237.8 = \$ (412.5)$$

Current ratio:

$$\frac{\$3,825.3}{\$4,237.8} = 0.9:1$$

Debt to total assets ratio:

$$\frac{\$4,237.8 + \$5,779.4}{\$3,825.3 + \$11,138.3} = 66.9\%$$

2009

Working capital:

$$\$3,976.2 - \$4,499.2 = \$ (523.0)$$

$$\frac{\$3,976.2}{\$4,499.2} = 0.9:1$$

$$\frac{\$4,499.2 + \$6,199.3}{\$3,976.2 + \$13,508.5} = 61.2\%$$

(b) The working capital deficiency has improved somewhat, and the current ratio has remained relatively unchanged (0.88:1 in 2009 and 0.90 in 2010, if rounded to two decimal points or 0.9:1 in both years if rounded to one decimal point). There is still less than \$1 of current assets to satisfy each \$1 of current liabilities. Although Safeway's liquidity did not change in 2010, its solvency has deteriorated. Its debt to total assets ratio is higher (worse) in 2010 than in 2009.

(c)

	<u>2010</u>			
	<u>Safeway</u>	<u>Sobeys</u>	<u>Loblaws</u>	<u>Industry</u>
Working capital (in millions)	\$ (412.5)	\$ (17.5)	\$736.0	n/a
Current ratio	0.9:1	1.0:1	1.2:1	1.8:1
Debt to total assets ratio	66.9%	54.8%	58.2%	37.9%

	<u>2009</u>			
	<u>Safeway</u>	<u>Sobeys</u>	<u>Loblaws</u>	<u>Industry</u>
Working capital (in millions)	\$ (523.0)	\$ (190.0)	\$730.0	n/a
Current ratio	0.9:1	0.9:1	1.2:1	1.1:1
Debt to total assets ratio	61.2%	56.7%	58.4%	42.9%

EXERCISE 2-8 (Continued)

(c) (Continued)

Based on working capital and the current ratio, Loblaw's liquidity is the best (highest) of the three companies, although still lower than that of the industry average. Safeway's liquidity is the worst (lowest), with insufficient current assets to cover its current liabilities.

Based on the debt to total assets ratio, Sobeys's solvency is the best of the three companies, although not as good as the industry average. Safeway's solvency is the worst of the three companies, as is its liquidity.

EXERCISE 2-9

(a) (in thousands)

20102009

Earnings per share:

Earnings per share:

$$\frac{\$514,749}{393,169} = \$1.31 \text{ per share}$$

$$\frac{\$1,099,422}{387,956} = \$2.83 \text{ per share}$$

Price-earnings ratio:

Price-earnings ratio:

$$\frac{\$40.30}{\$1.31} = 30.8 \text{ times}$$

$$\frac{\$33.93}{\$2.83} = 12.0 \text{ times}$$

- (b) The decrease in the earnings per share during the year would indicate that profitability has deteriorated dramatically in 2010. However, investors appear to have more confidence in Cameco's future profitability as indicated by the increase in the price-earnings ratio in 2010.

EXERCISE 2-10

- | | | | |
|-----|----|-----|----|
| (a) | 7 | (g) | 1 |
| (b) | 10 | (h) | 6 |
| (c) | 11 | (i) | 4 |
| (d) | 3 | (j) | 5 |
| (e) | 2 | (k) | 9 |
| (f) | 8 | (l) | 12 |

EXERCISE 2-11

1.
 - (a) The cost basis of accounting is involved in this situation.
 - (b) The cost basis of accounting has been violated. The land was reported at its fair value when it should have remained at its historical cost.
2.
 - (a) The fair value basis of accounting is involved in this situation.
 - (b) The principle has not been violated since the parcel of land is being held for resale and not for use.
3.
 - (a) The assumption involved in this situation is the going concern assumption.
 - (b) The going concern assumption has been violated. The elements on the statement of financial position should have been classified between current and non-current.

SOLUTIONS TO PROBLEMS

PROBLEM 2-1A

<u>Item</u>	<u>Statement of Financial Position Category</u>
Accumulated depreciation	Contra asset to plant, equipment, and vehicles in property, plant, and equipment
Cash	Current assets
Current income tax payable	Current liabilities
Current income tax recoverable	Current assets
Deferred income tax asset (non-current)	Non-current assets
Deferred income tax liability (non-current)	Non-current liabilities
Goodwill	Intangible assets
Interest-bearing loans and borrowings (current)	Current liabilities
Interest-bearing loans and borrowings (non-current)	Non-current liabilities
Inventories	Current assets
Investments	Non-current assets
Ordinary shares	Share capital
Plant, equipment, and vehicles	Property, plant, and equipment
Retained earnings	Shareholders' equity
Trade and other payables	Current liabilities
Trade and other receivables	Current assets
Trademarks	Intangible assets

PROBLEM 2-2A

(a)

<u>Item</u>	<u>Statement of Financial Position Category</u>
8 Accumulated depreciation	Contra asset to plant, equipment, and vehicles in property, plant, and equipment section
1 Cash	Current assets
12 Current income tax payable	Current liabilities
3 Current income tax recoverable	Current assets
6 Deferred income tax asset (non-current)	Non-current assets
15 Deferred income tax liability (non- current)	Non-current liabilities
10 Goodwill	Intangible assets
13 Interest-bearing loans and borrowings (current)	Current liabilities
14 Interest-bearing loans and borrowings (non-current)	Non-current liabilities
4 Inventories	Current assets
5 Investments	Non-current assets
16 Ordinary shares	Share capital
7 Plant, equipment, and vehicles	Property, plant, and equipment
17 Retained earnings	Shareholders' equity
11 Trade and other payables	Current liabilities
2 Trade and other receivables	Current assets
9 Trademarks	Intangible assets

PROBLEM 2-2A (Continued)

(b)

<u>Item</u>	<u>Statement of Financial Position Category</u>
4 Accumulated depreciation	Contra asset to plant, equipment, and vehicles in property, plant, and equipment section
10 Cash	Current assets
16 Current income tax payable	Current liabilities
8 Current income tax recoverable	Current assets
5 Deferred income tax asset (non- current)	Non-current assets
14 Deferred income tax liability (non- current)	Non-current liabilities
1 Goodwill	Intangible assets
15 Interest-bearing loans and borrowings (current)	Current liabilities
13 Interest-bearing loans and borrowings (non-current)	Non-current liabilities
7 Inventories	Current assets
6 Investments	Non-current assets
11 Ordinary shares	Share capital
3 Plant, equipment, and vehicles	Property, plant, and equipment
12 Retained earnings	Shareholders' equity
17 Trade and other payables	Current liabilities
9 Trade and other receivables	Current assets
2 Trademarks	Intangible assets

(c) Students' answers may vary. A company should choose an order of most use to its readers. Regardless, it should not matter which order the company uses as the same information is presented in the statement of financial position.

PROBLEM 2-3A

(a)

<u>Item</u>	<u>Statement of Financial Position Category</u>
Accounts receivable	Current assets
Accumulated depreciation – aircraft	Property, plant, and equipment
Accumulated depreciation – buildings	Property, plant, and equipment
Accumulated depreciation – ground property and equipment	Property, plant, and equipment
Accumulated depreciation – leasehold improvements	Property, plant, and equipment
Accumulated depreciation – spare engines and parts	Property, plant, and equipment
Aircraft	Property, plant, and equipment
Buildings	Property, plant, and equipment
Cash	Current assets
Ground property and equipment	Property, plant, and equipment
Inventory	Current assets
Intangible assets	Intangible assets
Leasehold improvements	Property, plant, and equipment
Other assets	Other assets
Prepaid expenses, deposits and other	Current assets
Spare engines and parts	Property, plant, and equipment

PROBLEM 2-3A (Continued)

(b)

WESTJET AIRLINES LTD.
Balance Sheet (partial)
December 31, 2010
(in thousands)

Assets

Current assets

Cash		\$1,187,899	
Accounts receivable		17,518	
Inventory		20,181	
Prepaid expenses, deposits and other		<u>41,716</u>	
Total current assets			\$1,267,314

Property, plant, and equipment

Aircraft	\$2,471,806		
Less: Accumulated depreciation	<u>622,997</u>	\$1,848,809	
Ground property and equipment	\$121,814		
Less: Accumulated depreciation	<u>61,895</u>	59,919	
Spare engines and parts	\$106,198		
Less: Accumulated depreciation	<u>28,251</u>	77,947	
Buildings	\$135,817		
Less: Accumulated depreciation	<u>13,154</u>	122,663	
Leasehold improvements	\$ 9,965		
Less: Accumulated depreciation	<u>3,348</u>	<u>6,617</u>	
Total property, plant, and equipment			2,115,955

Intangible assets

13,018

Other assets

166,557

Total assets

\$3,562,844

PROBLEM 2-4A

(a)

<u>Item</u>	<u>Statement of Financial Position Category</u>
Accounts payable and accrued liabilities	Current liabilities
Advance ticket sales	Current liabilities
Current portion of long-term debt	Current liabilities
Future income tax (long-term)	Non-current liabilities
Long-term debt	Non-current liabilities
Other current liabilities	Current liabilities
Other long-term liabilities	Long-term liabilities
Other shareholders' equity items	Shareholders' equity
Retained earnings	Shareholders' equity
Share capital	Shareholders' equity

PROBLEM 2-4A (Continued)

(b)

WESTJET AIRLINES LTD.
 Balance Sheet (partial)
 Liabilities and Shareholders' Equity
 December 31, 2010
 (in thousands)

Current liabilities		
Accounts payable and accrued liabilities	\$303,583	
Advanced ticket sales	308,022	
Other current liabilities	36,778	
Current portion of long-term debt	<u>183,789</u>	
Total current liabilities		\$ 832,172
Non-current liabilities		
Long-term debt	\$866,745	
Other long-term liabilities	18,838	
Future income tax	<u>337,410</u>	
Total non-current liabilities		<u>1,222,993</u>
Total liabilities		2,055,165
Shareholders' equity		
Share capital	\$647,637	
Retained earnings	807,978	
Other shareholders' equity items	<u>52,064</u>	
Total shareholders' equity		<u>1,507,679</u>
Total liabilities and shareholders' equity		<u>\$3,562,844</u>

(c) Yes, these two amounts agree. Assets equal total liabilities plus shareholders' equity.

PROBLEM 2-5A

(a)

MBONG CORPORATION
Income Statement
Year Ended December 31, 2012

Revenues		
Service revenue	\$81,700	
Interest revenue	<u>500</u>	
Total revenues		\$82,200
Expenses		
Salaries expense	\$37,000	
Depreciation expense	6,200	
Repair and maintenance expense	2,800	
Insurance expense	2,200	
Utilities expense	2,000	
Interest expense	1,500	
Supplies expense	<u>1,000</u>	
Total expenses		<u>52,700</u>
Profit before income tax		29,500
Income tax expense		<u>6,000</u>
Profit		<u><u>\$23,500</u></u>

MBONG CORPORATION
Statement of Changes in Equity
Year Ended December 31, 2012

	<u>Common Shares</u>	<u>Retained Earnings</u>	<u>Total Equity</u>
Balance, January 1	\$30,000	\$105,000	\$135,000
Issued common shares	4,200		4,200
Profit		23,500	23,500
Dividends		<u>(5,000)</u>	<u>(5,000)</u>
Balance, December 31	<u>\$34,200</u>	<u>\$123,500</u>	<u>\$157,700</u>

PROBLEM 2-5A (Continued)

(a) (Continued)

MBONG CORPORATION
Statement of Financial Position
December 31, 2012

Assets			
Current assets			
Cash		\$ 5,200	
Short-term investments		20,000	
Accounts receivable		14,200	
Supplies		200	
Prepaid insurance		<u>2,000</u>	
Total current assets			\$ 41,600
Property, plant, and equipment			
Land		\$40,000	
Building	\$72,000		
Less: Accumulated depreciation—building	<u>18,000</u>	54,000	
Equipment	\$66,000		
Less: Accumulated depreciation—equipment	<u>17,600</u>	<u>48,400</u>	
Total property, plant, and equipment			<u>142,400</u>
Total assets			<u><u>\$184,000</u></u>
Liabilities and Shareholders' Equity			
Current liabilities			
Accounts payable		\$ 8,300	
Salaries payable		3,000	
Current portion of bank loan payable		<u>1,500</u>	
Total current liabilities			\$ 12,800
Non-current liabilities			
Bank loan payable			<u>13,500</u>
Total liabilities			26,300
Shareholders' equity			
Common shares		\$ 34,200	
Retained earnings		<u>123,500</u>	
Total shareholders' equity			<u>157,700</u>
Total liabilities and shareholders' equity			<u><u>\$184,000</u></u>

PROBLEM 2-5A (Continued)

- (b) The income statement reports the profit or loss for the period. This figure is then used in the statement of changes in equity, along with dividends and any issues (or repurchases) of shares to calculate the balances in common shares and retained earnings at the end of the period. These ending balances are then used in the statement of financial position to determine shareholders' equity and complete the accounting equation.

PROBLEM 2-6A

(a)

1. Working capital	Current assets – Current liabilities
	\$ 446,900 – \$142,500 = \$304,400

2. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$ $\frac{\$446,900}{\$142,500} = 3.1 :1$
------------------	---

3. Debt to total assets	$\frac{\text{Total liabilities}}{\text{Total assets}}$ $\frac{\$452,500}{\$1,072,200} = 42.2\%$
-------------------------	---

4. Earnings per share	$\frac{\text{Profit available to common shareholders}}{\text{Weighted average number of common shares}}$ $\frac{\$160,000}{40,000} = \4.00
-----------------------	--

5. Price-earnings ratio	$\frac{\text{Market price per share}}{\text{Earnings per share}}$ $\frac{\$35.00}{\$4.00} = 8.8 \text{ times}$
-------------------------	--

(b) Johannsen's liquidity has improved dramatically as the working capital is greater in 2012 and the current ratio is almost double that of 2011. On the other hand, the solvency has deteriorated as the debt to total assets ratio is higher in 2012. Johannsen's profitability has improved as the earnings per share ratio has increased in 2012, as has investors' expectations for future profitability as indicated by the increasing price-earnings ratio.

PROBLEM 2-7A

(a)

Working capital	=	Current assets – Current liabilities		
Chen	=	\$407,200	– \$166,325	= \$240,875
Caissie	=	\$190,400	– \$133,700	= \$56,700

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Chen		Caissie
$\frac{\$407,200}{\$166,325} = 2.4 :1$		$\frac{\$190,400}{\$133,700} = 1.4 :1$

Chen is significantly more liquid than Caissie. It has a higher current ratio and more current assets available to pay current liabilities as they come due.

(b) $\text{Debt to total assets} = \frac{\text{Total liabilities}}{\text{Total assets}}$

Chen		Caissie
$\frac{\$166,325 + \$108,500}{\$407,200 + \$532,000} = 29.3\%$		$\frac{\$133,700 + \$40,700}{\$190,400 + \$139,700} = 52.8\%$

Caissie is considerably less solvent than Chen. Caissie's debt to total assets ratio of 52.8% is almost double that of Chen's ratio of 29.3%. The lower the percentage of debt to total assets, the lower the risk that a company may be unable to pay its debts as they come due.

PROBLEM 2-7A (Continued)

(c)

	<u>Chen</u>	<u>Caissie</u>
Sales revenue	<u>\$1,800,000</u>	<u>\$620,000</u>
Cost of goods sold	1,175,000	340,000
Operating expenses	283,000	98,000
Interest expense	10,000	4,000
Income tax expense	<u>85,000</u>	<u>35,400</u>
Total expenses	<u>1,553,000</u>	<u>477,400</u>
Profit	<u>\$ 247,000</u>	<u>\$142,600</u>

$$\text{Earnings per share} = \frac{\text{Profit available to common shareholders}}{\text{Weighted average number of common shares}}$$

<u>Chen</u>	<u>Caissie</u>
$\frac{\$247,000}{76,000} = \3.25	$\frac{\$142,600}{62,000} = \2.30

$$\text{Price-earnings ratio: } \frac{\text{Market price per share}}{\text{Earnings per share}}$$

<u>Chen</u>	<u>Caissie</u>
$\frac{\$25.00}{\$3.25} = 7.7 \text{ times}$	$\frac{\$15.00}{\$2.30} = 6.5 \text{ times}$

Based on the price-earnings ratio, investors believe that Chen will be more profitable than Caissie in the future. It is difficult to compare earnings per share because Caissie has more common shares issued than Chen, as well as having a different debt structure.

PROBLEM 2-8A

(a) (in millions)

	Le Château (CAD)	H&M (SEK)
1. Working capital	$\$135 - \43 $= \$92$	$36,081 - 11,090$ $= 24,991$
2. Current ratio	$\frac{\$135}{\$43} = 3.1:1$	$\frac{36,081}{11,090} = 3.3:1$
3. Debt to total assets	$\frac{\$79}{\$236} = 33.5\%$	$\frac{13,750}{54,363} = 25.3\%$
4. Earnings per share	$\frac{\$30}{24} = \1.25	$\frac{16,384}{827} = \$19.81$
5. Price-earnings ratio	$\frac{\$13.82}{\$1.25} = 11.1 \text{ times}$	$\frac{412.30}{19.81} = 20.8 \text{ times}$

(b) Liquidity

With a current ratio of 3.1:1, Le Château is less liquid than H&M but both still have strong current ratios. In addition, their current ratios are both far better than the industry which stands at 2.3:1.

Solvency

H&M is more solvent than Le Château as evidenced by its lower debt to total assets ratio. However, both companies debt to total assets ratios are higher than the industry average indicating that both H&M and Le Chateau are less solvent than the average company in the industry.

PROBLEM 2-8A (Continued)

(b) (Continued)

Profitability

Although the earnings per share ratio does not provide a basis for comparison, investors appear to have more confidence in the future profit of H&M as evidenced by H&M's price-earnings ratio. H&M has a higher price-earnings ratio than the industry while Le Château has a lower price-earnings ratio than the industry.

(c) Except for the earnings per share value, all of the other values and ratios are not expressed in currency. This permits comparison among companies that report using different currencies.

PROBLEM 2-9A

- (a) The higher the amount of working capital, the better a business' liquidity. From 2010 to 2011 Pitka Corporation's working capital deteriorated substantially. It then went on to deteriorate even more dramatically from 2011 to 2012, decreasing by \$15,000.

A higher the current ratio is evidence of better liquidity for a business (assuming the components of the current assets are also liquid). The current ratio for Pitka has been steady from 2010 to 2011, but deteriorated slightly from 2011 to 2012.

A smaller (lower) debt to total assets ratio shows evidence of better solvency. The percentage of total liabilities to total assets increased from 2010 to 2011, showing deterioration in the solvency for Pitka. On the other hand, the ratio improved substantially from 2011 to 2012.

The higher the earnings per share, the better the profitability. Profitability decreased from 2010 to 2011, but improved from 2011 to 2012.

The investors appeared to have less confidence in the future profit of Pitka as evidenced by Pitka's price-earnings ratio which declined from 2010 to 2011. This view changed as demonstrated by the climb in the price-earnings ratio from 2011 to 2012.

PROBLEM 2-9A (Continued)**(b) Liquidity**

Pitka's current ratio, although steady in 2010 and 2011, declined slightly in 2011. This trend is of concern given the low level of liquidity flexibility the company has with a current ratio of 1.1:1.

Solvency

Pitka's debt to total assets ratio improved in the last year. It appears to be reasonable in size, as does the solvency of the company in 2010.

Profitability

Pitka's profitability declined and then recovered as is demonstrated by the earnings per share ratio. The price-earnings ratio indicates expectations of improving profitability in 2012.

PROBLEM 2-10A

- (a) The objective of financial reporting is to provide information that is useful to individuals who are making investment and credit decisions. In this case, the information will be used by individuals being asked to become investors. While providing information that is useful to potential investors, Phase I clinical trial results are not part of the financial statements of a company. Details of scientific findings would be included in press releases or annual reports which present management's opinion concerning the likelihood of success of the new health care product and management's corresponding justification for seeking financing for its development.
- (b) While useful and relevant, the scientific findings do not represent a guaranty of future profitability. Potential investors would have to decide the likelihood of financial success of the new health care product. The fundamental and enhancing qualitative characteristics of faithful representation and verifiability are not satisfied by management's opinion about a potential future positive outcome. Consequently, the inclusion of the clinical trial results would not be in conformity with the disclosure requirements for financial reporting.

PROBLEM 2-11A

- (a) The fundamental qualitative characteristics are relevance and representational faithfulness. Useful financial information must have an impact on the person making a decision and provide a faithful representation of what really exists or has happened.

The enhancing qualitative characteristics include comparability, verifiability, timeliness and understandability. These enhancing characteristics contribute to the objective of providing financial information that is relevant and portrays the economic reality of a situation or transaction. While seeking to provide complete and accurate information and disclosure, there is nevertheless a constraint in achieving proper financial reporting. The cost of obtaining the information should not exceed the additional value the information provides the decision maker.

- (b) The reason why Ryan cannot find much information about Empire Theatres in Empire's financial statements is that shareholders of Empire do not require the level of detail in financial reporting that Ryan expects, in order to make their investment decisions. The type of detailed information Ryan expects exists, but is relevant to the management team of the division of Empire Company Limited that operates movie theatres. Management is not an external user of financial information. Empire is not required to report non financial operational information which, if publicised would provide a competitive disadvantage to Empire.

PROBLEM 2-12A

- (a) The advantage of the fair value basis of accounting is that it represents a more up-to-date measurement of the value of the asset reported. Consequently, the amounts reported are more relevant to the financial statement users. The disadvantage of the fair value basis of accounting and corresponding advantage of historical cost is that historical cost is more reliable and shows the amount paid for the asset. The historical cost might provide a more faithful representation because it can be easily verified and is neutral.
- (b) The reason a company might choose to adopt the fair value basis of accounting for real estate is that assets reported on the balance sheet will have higher values than they would using the historical cost of these assets. It is inherent in the nature of real estate that the land will increase in value over time. Creditors will find the fair value a more relevant basis for making lending decisions. The increase in the assets will have a corresponding increase in equity.
- (c) The reason a company might choose to adopt the cost basis of accounting for real estate is that assets reported on the balance sheet will have more faithful representation because it reports the actual cost of the asset when it was acquired and this measurement can be easily verified and it is neutral. There is also a significant cost to obtaining reliable fair value information on a regular basis to be reported in the financial statements.
- (d) When comparing real estate companies, the reader is well advised to read the accounting policy note to the financial statements disclosing the measurement policy used for the real estate property. One would need to determine the corresponding fair value for real estate for the company using the cost basis of accounting. In fact, this information is required to be disclosed for real estate companies even if they adopted the cost basis of accounting to improve comparability and disclosure. Otherwise, trying to compare businesses that use different bases of accounting would be very difficult.

PROBLEM 2-1B

<u>Item</u>	<u>Statement of Financial Position Category</u>
Accumulated amortization—patents and trademarks	Contra asset to patent and trademarks in intangible assets section
Accumulated depreciation—industrial machinery and equipment	Contra asset to industrial machinery and equipment in property, plant, and equipment section
Bank overdraft	Current liabilities
Cash	Current assets
Current borrowings and debts	Current liabilities
Goodwill	Intangible assets
Income tax payable (current)	Current liabilities
Industrial machinery and equipment	Property, plant, and equipment
Inventories	Current assets
Investments	Non-current assets
Land	Property, plant, and equipment
Marketable securities	Current assets
Non-current borrowings and debts	Non-current liabilities
Ordinary shares	Share capital
Patents and trademarks	Intangible assets
Prepaid expenses	Current assets
Retained earnings	Shareholders' equity
Trade accounts payable	Current liabilities
Trade accounts receivable	Current assets

PROBLEM 2-2B

(a)

	<u>Item</u>	<u>Statement of Financial Position Category</u>
11	Accumulated amortization—patents and trademarks	Contra asset to patent and trademarks in intangible assets section
9	Accumulated depreciation—industrial machinery and equipment	Contra asset to industrial machinery and equipment in property, plant, and equipment section
13	Bank overdraft	Current liabilities
1	Cash	Current assets
16	Current borrowings and debts	Current liabilities
12	Goodwill	Intangible assets
15	Income taxes payable (current)	Current liabilities
8	Industrial machinery and equipment	Property, plant, and equipment
4	Inventories	Current assets
6	Investments	Non-current assets
7	Land	Property, plant, and equipment
2	Marketable securities	Current assets
17	Non-current borrowings and debts	Non-current liabilities
18	Ordinary shares	Share capital
10	Patents and trademarks	Intangible assets
5	Prepaid expenses	Current assets
19	Retained earnings	Shareholders' equity
14	Trade accounts payable	Current liabilities
3	Trade accounts receivable	Current assets

PROBLEM 2-2B (Continued)

(b)

	<u>Item</u>	Statement of Financial Position <u>Category</u>
3	Accumulated amortization—patents and trademarks	Contra asset to patent and trademarks in intangible assets section
6	Accumulated depreciation—industrial machinery and equipment	Contra asset to industrial machinery and equipment in property, plant, and equipment section
19	Bank overdraft	Current liabilities
12	Cash	Current assets
16	Current borrowings and debts	Current liabilities
1	Goodwill	Intangible assets
17	Income tax payable (current)	Current liabilities
5	Industrial machinery and equipment	Property, plant, and equipment
9	Inventories	Current assets
7	Investments	Non-current assets
4	Land	Property, plant, and equipment
11	Marketable securities	Current assets
15	Non-current borrowings and debts	Non-current liabilities
13	Ordinary shares	Share capital
2	Patents and trademarks	Intangible assets
8	Prepaid expenses	Current assets
14	Retained earnings	Shareholders' equity
18	Trade accounts payable	Current liabilities
10	Trade accounts receivable	Current assets

(c) Students' answers may vary. The company should list its accounts in an order that is of most use to its readers. Regardless, it should not matter which order the company uses as the same information is presented in the statement of financial position.

PROBLEM 2-3B

(a)

<u>Item</u>	<u>Category</u>
Accounts receivable	Current assets
Accumulated amortization – software	Intangible assets
Accumulated depreciation – buildings and improvements	Property, plant and equipment
Accumulated depreciation – fixtures and equipment	Property, plant and equipment
Accumulated depreciation – leasehold improvements	Property, plant and equipment
Buildings and improvements	Property, plant and equipment
Cash	Current assets
Fixtures and equipment	Property, plant and equipment
Future income tax assets (current)	Current assets
Future income tax assets (non-current)	Non-current (other) assets
Goodwill	Intangible assets
Land	Property, plant and equipment
Leasehold improvements	Property, plant and equipment
Marketable securities	Current assets
Merchandise inventories	Current assets
Prepaid expenses	Current assets
Software	Intangible assets

PROBLEM 2-3B (Continued)

(b)

REITMANS (CANADA) LIMITED
 Balance Sheet (partial)
 January 30, 2010
 (in thousands)

Assets

Current assets

Cash	\$228,577	
Marketable securities	48,026	
Accounts receivable	2,926	
Merchandise inventories	63,127	
Prepaid expenses	11,873	
Future income tax assets	<u>2,395</u>	
Total current assets		\$356,924

Property, plant, and equipment

Land		\$ 5,935	
Buildings and improvements	\$ 52,336		
Less: Accumulated depreciation	<u>19,499</u>	32,837	
Fixtures and equipment	\$177,874		
Less: Accumulated depreciation	<u>97,398</u>	80,476	
Leasehold improvements	\$194,782		
Less: Accumulated depreciation	<u>103,418</u>	<u>91,364</u>	
Total property, plant, and equipment			210,612

Intangible assets

Software	\$17,072		
Less: Accumulated amortization	<u>7,108</u>	9,964	

Goodwill

42,426

Future income tax assets

11,466

Total assets

\$631,392

PROBLEM 2-4B

(a)

<u>Item</u>	<u>Category</u>
Accounts payable and accrued items	Current liabilities
Current portion of mortgage payable	Current liabilities
Income taxes payable	Current liabilities
Mortgage payable	Non-current liabilities
Other long-term liabilities	Non-current liabilities
Other shareholders' equity items	Shareholders' equity
Retained earnings	Shareholders' equity
Common shares	Shareholders' equity

PROBLEM 2-4B (Continued)

(b)

REITMANS (CANADA) LIMITED
 Balance Sheet (partial)
 January 30, 2010
 (in thousands)

Liabilities and Shareholders' Equity

Current liabilities

Accounts payable and accrued items	\$77,766	
Income taxes payable	4,677	
Current portion of mortgage payable	<u>1,300</u>	
Total current liabilities		\$ 83,743

Non-current liabilities

Mortgage payable	\$11,431	
Other long-term liabilities	<u>26,052</u>	
Total non-current liabilities		<u>37,483</u>
Total liabilities		121,226

Shareholders' equity

Common shares	\$ 31,052	
Retained earnings	480,622	
Other shareholders' equity items	<u>(1,508)</u>	
Total shareholders' equity		<u>510,166</u>

Total liabilities and shareholders' equity		<u><u>\$631,392</u></u>
--	--	-------------------------

(c) Yes, the total assets and the total liabilities and shareholders' equity agree.

PROBLEM 2-5B

(a)

BEAULIEU LIMITED
Income Statement
Year Ended December 31, 2012

Revenues		
Service revenue	\$80,500	
Interest revenue	<u>500</u>	
Total revenues		\$81,000
Expenses		
Salaries expense	\$33,000	
Interest expense	8,000	
Depreciation expense	5,400	
Utilities expense	3,700	
Insurance expense	<u>2,400</u>	
Total expenses		<u>52,500</u>
Profit before income tax		28,500
Income tax expense		<u>5,000</u>
Profit		<u><u>\$23,500</u></u>

BEAULIEU LIMITED
Statement of Changes in Equity
Year Ended December 31, 2012

	<u>Common Shares</u>	<u>Retained Earnings</u>	<u>Total Equity</u>
Balance, January 1	\$15,000	\$34,000	\$49,000
Issued common shares	5,000		5,000
Profit		23,500	23,500
Dividends		<u>(3,500)</u>	<u>(3,500)</u>
Balance, December 31	<u><u>\$20,000</u></u>	<u><u>\$54,000</u></u>	<u><u>\$74,000</u></u>

PROBLEM 2-5B (Continued)

(a) (Continued)

BEAULIEU LIMITED
Statement of Financial Position
December 31, 2012

Assets			
Current assets			
Cash		\$8,000	
Accounts receivable		7,500	
Prepaid insurance		<u>250</u>	
Total current assets			\$ 15,750
Investments			20,000
Property, plant, and equipment			
Land		\$50,000	
Building	\$80,000		
Less: Accumulated depreciation - building	<u>12,000</u>	68,000	
Equipment	\$32,000		
Less: Accumulated depreciation - equipment	<u>19,200</u>	<u>12,800</u>	
Total property, plant, and equipment			<u>130,800</u>
Total assets			<u><u>\$166,550</u></u>
Liabilities and Shareholders' Equity			
Current liabilities			
Accounts payable		\$ 9,550	
Salaries payable		3,000	
Current portion of mortgage payable		<u>10,000</u>	
Total current liabilities			\$ 22,550
Non-current liabilities			
Mortgage payable			<u>70,000</u>
Total liabilities			92,550
Shareholders' equity			
Common shares		\$20,000	
Retained earnings		<u>54,000</u>	
Total shareholders' equity			<u>74,000</u>
Total liabilities and shareholders' equity			<u><u>\$166,550</u></u>

PROBLEM 2-5B (Continued)

- (b) The income statement reports the profit or loss for the period. This figure is then used in the statement of changes in equity, along with dividends and issues (or repurchases) of shares to calculate the balances in common shares and retained earnings at the end of the period. These ending balances are then used in the statement of financial position to determine shareholders' equity and complete the accounting equation.

PROBLEM 2-6B

(a)

1. Working capital	$\text{Current assets} - \text{Current liabilities}$ $\$253,850 - \$156,550 = \$97,300$
--------------------	---

2. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$ $\frac{\$253,850}{\$156,550} = 1.6 : 1$
------------------	--

3. Debt to total assets	$\frac{\text{Total liabilities}}{\text{Total assets}}$ $\frac{\$288,550}{\$719,150} = 40.1\%$
-------------------------	---

4. Earnings per share	$\frac{\text{Profit available to common shareholders}}{\text{Weighted average number of common shares}}$ $\frac{\$96,600}{40,000} = \2.42
-----------------------	---

5. Price-earnings ratio	$\frac{\text{Market price per share}}{\text{Earnings per share}}$ $\frac{\$30.00}{\$2.42} = 12.4 \text{ times}$
-------------------------	---

- (b) Fast's liquidity has improved as the working capital is larger in 2012 and the current ratio is greater than that of 2011. The solvency has improved as the debt to total assets ratio is a smaller percentage in 2012 than in 2011. Fast's profitability has improved dramatically as the earnings per share ratio has increased by a large amount in 2012, as has the price-earnings ratio, suggesting that investors are excited about the company's future prospects.

PROBLEM 2-7B

(a)

Working capital	=	Current assets – Current liabilities		
Belliveau	=	\$180,000	– \$75,000	= \$105,000
Caissie	=	\$700,000	– \$300,000	= \$400,000

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Belliveau		Shields
$\frac{\$180,000}{\$75,000} = 2.4 :1$		$\frac{\$700,000}{\$300,000} = 2.3 :1$

Belliveau is slightly more liquid than Shields as it has a higher current ratio, even though its absolute working capital amount is lower.

(c) $\text{Debt to total assets} = \frac{\text{Total liabilities}}{\text{Total assets}}$

Belliveau		Shields
$\frac{\$75,000 + \$190,000}{\$180,000 + \$600,000} = 34.0\%$		$\frac{\$300,000 + \$200,000}{\$700,000 + \$800,000} = 33.3\%$

Both companies have close debt to asset ratios and are solvent. The lower the percentage of debt to total assets, the lower the risk that a company may be unable to pay its debts as they come due.

PROBLEM 2-7B (Continued)

(c)

	<u>Belliveau</u>	<u>Shields</u>
Sales revenue	<u>\$450,000</u>	<u>\$890,000</u>
Cost of goods sold	260,000	620,000
Operating expenses	130,000	59,000
Interest expense	6,000	10,000
Income tax expense	<u>10,000</u>	<u>65,000</u>
Total expenses	<u>406,000</u>	<u>754,000</u>
Profit	<u>\$ 44,000</u>	<u>\$136,000</u>

$$\text{Earnings per share} = \frac{\text{Profit available to common shareholders}}{\text{Weighted average number of common shares}}$$

<u>Belliveau</u>	<u>Shields</u>
$\frac{\$44,000}{200,000} = \0.22	$\frac{\$136,000}{200,000} = \0.68

$$\text{Price-earnings ratio: } \frac{\text{Market price per share}}{\text{Earnings per share}}$$

<u>Belliveau</u>	<u>Shields</u>
$\frac{\$2.50}{\$0.22} = 11.4 \text{ times}$	$\frac{\$6.00}{\$0.68} = 8.8 \text{ times}$

Investors have higher expectations for Belliveau's future profitability, as evidenced by the price-earnings ratio. It is difficult to compare the earnings per share even though both companies have the same number of shares because of the different financing avenues each company has used (e.g., Shields has a lot more debt).

PROBLEM 2-8B

(a) (in USD millions)

	<u>Walmart</u>		<u>Target</u>
1. Working capital	$\$48,331 - \$55,561$ $= \$ (7,230)$		$\$18,424 - \$11,327$ $= \$7,097$
2. Current ratio	$\frac{\$48,331}{\$55,561} = 0.9:1$		$\frac{\$18,424}{\$11,327} = 1.6:1$
3. Debt to total assets	$\frac{\$97,777}{\$170,706} = 57.3\%$		$\frac{\$29,186}{\$44,533} = 65.5\%$
4. Earnings per share	$\frac{\$14,335}{3,866} = \3.71		$\frac{\$2,488}{752} = \3.31
5. Price-earnings ratio	$\frac{\$53.43}{\$3.71} = 14.4 \text{ times}$		$\frac{\$48.26}{\$3.31} = 14.6 \text{ times}$

PROBLEM 2-8B (Continued)

(b) Liquidity

With a current ratio of 1.6:1, Target is more liquid than both Walmart and the industry.

Solvency

Walmart is more solvent than Target as evidenced by its lower debt to total assets ratio. However, since both companies have a debt to total assets ratio higher than the industry average, they are less solvent than the average company in the industry.

Profitability

Although the earnings per share ratio does not provide a basis for comparison, investors appear to have slightly more confidence in the future profit of Target as evidenced by Target's price-earnings ratio. Both Target and Walmart have slightly higher price-earnings ratio than the industry.

PROBLEM 2-9B

- (a) The higher the amount of working capital, the better a business' liquidity. From 2010 to 2011, Giasson Corporation's working capital improved. It then deteriorated from 2011 to 2012, decreasing by \$6,000.

A higher current ratio is evidence of better liquidity for a business, assuming all components of current assets are also liquid. The current ratio for Giasson has been deteriorating steadily from 2010 to 2012.

A smaller debt to total assets ratio shows evidence of better solvency. The percentage of total liabilities to total assets increased from 2010 to 2011, showing deterioration in the solvency for Giasson. On the other hand the ratio remained somewhat stable from 2011 to 2012, declining (improving) slightly.

The higher the earnings per share, the better evidence of an improved profitability. Profitability increased from 2010 to 2011 but declined significantly from 2011 to 2012 indicating poorer profitability.

The investors appear to have less confidence in the future profitability of Giasson as evidenced by Giasson's price-earnings ratio which declined from 2010 to 2012.

PROBLEM 2-9B (Continued)

(b) Liquidity

Giasson's current ratio, although declining over the last two years, demonstrates adequate liquidity. There are \$1.50 of current assets available to cover each \$1 of current liabilities.

Solvency

Giasson's debt to total assets ratio, although deteriorating remains modest in size and so the solvency of the company continues to be good.

Profitability

Giasson's profitability is declining steadily as is demonstrated by the earnings per share ratio and the price-earnings ratio.

PROBLEM 2-10B

- (a) The objective of financial reporting is to provide information that is useful to individuals who are making investment and credit decisions. Bre-X's reporting did not meet this objective. The information that was provided was false and led shareholders to purchase shares in Bre-X Minerals Ltd. on the basis of that false information.
- (b) Useful financial information must be relevant and provide a faithful representation of what really exists or has happened. In the case of Bre-X, the reporting of the presence of large gold deposits in Indonesia was false. Consequently, shareholders expecting a large return on their investment in shares of Bre-X could not accurately predict the outcome of their investment decision. The information had not been objectively verified to reveal the fraud.

The fundamental qualitative characteristic that was violated was representational faithfulness and the enhancing qualitative characteristic that was violated was verifiability.

PROBLEM 2-11B

- (a) The assets listed below will provide future economic benefit in the following way:
1. Land owned by Shoppers Drug Mart: the use of the property to house the stores or warehouses used to sell the product to customers or store inventory.
 2. The BlackBerry trademark: used to attract sales from the name recognition obtained from advertising, and the goodwill generated from past service and products.
 3. Accounts receivable: will be converted to cash when collected and will provide funds for the operations of the business.
- (b) The three liabilities listed likely arose from the following events or transactions:
1. Accounts payable: increased from the purchase of merchandise for resale or from obtaining services from another business on credit terms.
 2. Unearned revenue: arose from the receipt of cash from customers in advance of providing goods and services to earn the revenue. An example is magazine subscriptions which are paid in advance. The company does not earn the revenue until they meet their future obligation by providing the magazines for the period for which the customer subscribed.
 3. Bank loan payable: increased when negotiating a debt to the bank and the outstanding loan balance is increased by drawing cash for purchase of goods or for operating cash flow.

PROBLEM 2-12B

- (a) The advantage of the fair value basis of accounting is that it represents a more up-to-date measurement of the value of the asset reported. Consequently, the amounts reported are more relevant to the financial statement users. The disadvantage of the fair value basis of accounting and corresponding advantage of historical cost is that historical cost is more reliable and shows the amount paid for the asset. The historical cost might provide a more faithful representation because it can be easily verified and is neutral.
- (b) The following is the recommended measurement principle that should be used for the following purchases:
1. Due to the nature of the asset, a textbook purchase should be recorded at the cost basis of accounting because of its intended use. The objective of owning the asset is to use it and not to resell it.
 2. In the case of an iPad, the use of the asset will be limited due to technological obsolescence. Because of this obsolescence, the iPad purchase should be recorded and reported using the cost basis of accounting.
 3. Software is very similar to the iPad of item 2 above in that it becomes technologically obsolete very quickly. On the other hand, the manufacturer has recognized this problem and has included in the sale of the software, automatic upgrades to attempt to deal with the future needs and demands of the purchaser. This asset is purchased for use and not for resale at a gain and consequently the cost basis of accounting should be used for its recording and reporting.
 4. If the purchase of the used car is for use in the business, the cost basis of accounting should be used. On the other hand, if the purchase is for resale, the fair value basis of accounting should be used.

PROBLEM 2-12B (Continued)**(b) (Continued)**

5. Since the intention of the buyer of land is to eventually build a home on the land, the purchase of the land should be recorded using the cost basis of accounting. If the intention changes over the years and the buyer decides to resell the property and intends to hold the land for resale at a gain, the reporting of the asset should change to the fair value basis of accounting used for investments, assuming the fair value is readily available.

BYP 2-1 FINANCIAL REPORTING

- (a) Total current assets were U.S. \$392,911,000 at December 31, 2010, and U.S. \$55,621,000 at December 31, 2009.

Total assets were U.S. \$1,126,975,000 at December 31, 2010, and U.S. \$706,850,000 at December 31, 2009.

- (b) Current assets are listed in the order of liquidity. Cash and cash equivalents is the most liquid asset and is reported first, followed by short-term investments. Non-current assets are listed in order of permanency, with property, plant, and equipment listed first.
- (c) The current liabilities total U.S. \$30,220,000 at December 31, 2010 and U.S. \$23,845,000 at December 31, 2009. The total liabilities at December 31, 2010 and 2009 were in the amount of U.S. \$85,796,000 and U.S. \$77,338,000, respectively.
- (d) The current liabilities are listed in order of due date, with accounts payable and accrued liabilities listed first. It is not clear what order was chosen for non-current liabilities.

BYP 2-2 COMPARATIVE ANALYSIS

(a)

	Anglo American Platinum Limited (in R millions, except per share information)	Eastern Platinum Limited (in USD thousands, except per share information)
1. Working capital	$18,393 - 9,009 = 9,384$	$\$392,911 - \$30,220 = \$362,691$
2. Current ratio	$\frac{18,393}{9,009} = 2.0:1$	$\frac{\$392,911}{\$30,220} = 13.0:1$
3. Debt to total assets	$\frac{19,774 + 9,009}{83,801} = 34.3\%$	$\frac{\$85,796}{\$1,126,975} = 7.6\%$
4. Earnings per share	39.09 (3,909 cents = R39.09)	\$0.02
5. Price earnings ratio	$\frac{664.00}{39.09} = 17.0 \text{ times}$	$\frac{\$1.77}{\$0.02} = 88.5 \text{ times}$

- (b) Liquidity: Working capital is not comparable, because of the differing currencies and amounts used above. However, using the current ratio to assess liquidity, we can determine that Eastplats is significantly more liquid than Amplats and well ahead of the industry average.

Solvency: The higher a company's percentage of debt to total assets is, the greater the risk that this company may be unable to meet its maturing obligations. Eastplats's debt to total assets is extremely low at 7.6% which means that it is primarily financed by equity. Amplats's debt to total assets ratio of 34.3% is higher (worse) than that of Eastplats and the industry average of 23.7%.

BYP 2-2 (Continued)**(b) (Continued)**

Profitability: The earnings per share between two companies are not comparable. However, based on the price-earnings ratio, Eastplats is favoured by investors. Amplats's price-earnings ratio falls far below that of Eastplats.

- (c) Ratios (except for working capital and earnings per share, which are amounts of money) eliminate the differences between currencies. The findings would not be different when comparing ratios if common currencies were used for both financial statements.

BYP 2-3 INTERPRETING FINANCIAL INFORMATION

- (a) The early implementation of IFRS will make the comparison to companies using Canadian GAAP in 2008 difficult. When different standards are used, the impact on reported profit and financial performance can be significant. In order to compare apples to apples, a conversion of one of the sets of statements may be required. This may require significant time and expertise.
- (b) Assuming the financial statements of the private enterprise using ASPE are available, the comparison of these financial statements to those prepared using IFRS for a public company could be difficult as the use of different policies can have an impact on reported profit and financial performance. In many cases, there are no differences between IFRS and ASPE—it really depends on whether one company or the other has financial items for which the accounting differs substantially.
- (c) The comparison of these financial statements to those prepared using U.S. GAAP will hinder comparison. When different standards are used the impact on reported earnings and financial performance can be significant. In order to compare apples to apples, a conversion of one of the sets of statements may be required. This may require significant time and expertise. Often, a reconciliation of amounts is provided between IFRS and U.S. GAAP in the notes to the financial statements to help with this comparison.
- (d) If different measurement principles are used by two different public companies following IFRS, a comparison will be more difficult although it will be limited to those elements of the financial statements to which the measurement basis applies. Should a company determine that comparisons with other companies in its industry would be made too difficult for potential investors, additional disclosure can be provided in the notes to the financial statements to give details of elements calculated using the alternate basis of measurement.

BYP 2-4 COMPARING IFRS AND ASPE

- (a) McCain's multinational structure means that accounting personnel from various countries are involved with providing financial information and preparing financial statements. Since IFRS is a global standard used by over 125 countries, most of the accounting personnel would be familiar with IFRS. Also, by using one standard across all subsidiaries, there is no need to make adjustments for various GAAP differences (this was often the case for Canadian multinationals prior to the adoption of IFRS).

If you consider GAAP to be the language of accounting, this means that everyone is will use one accounting language world-wide. For McCain, it means that the company will reduce cost as well as the chance for errors.

- (b) **Relevance** – Researchers have found that companies who voluntarily adopt IFRS find that IFRS' accounting measures are better tools for evaluating performance. This means that the IFRS statements are more relevant to McCain's management. Also, when global lenders are looking at financial statements prepared according to IFRS, they are no longer concerned about differences in GAAP. This increases the relevance to lenders.

Faithful Representation – In comparison to ASPE, IFRS has a requirement for more detailed information to be disclosed in the notes to the financial statements. From a user's perspective, more information and explanation is provided to help understand the economic event being depicted.

Comparability - McCain Foods is a global company that competes against various other global companies (most of whom follow IFRS). By adopting IFRS, it is easier for McCain to compare its results to other similar companies. This information would be useful to both internal users (management and shareholders) as well as external (lenders).

Understandability – When multiple GAAPs are used, it can often cause confusion. Users often have a difficult time understanding financial statements that are presented in a GAAP that they are not familiar with. For instance, a McCain manager in a United States subsidiary that follows U.S. GAAP may have difficulty understanding the statements of a McCain subsidiary located in the U.K (that follows IFRS).

- (c) **Examples of why private companies may adopt IFRS:**
- Private companies that plan to be public sometime in the near future, may choose to adopt IFRS.
 - Private companies that have global shareholders or lenders (who are more familiar with IFRS).
 - Private companies that are suppliers in foreign countries (that have adopted IFRS). These companies may borrow from lenders in those countries or may provide their financial statements to customers in that country.
 - Private companies that have a foreign venture partner.

BYP 2-5 COLLABORATIVE LEARNING ACTIVITY

A suggested solution is not included here as the solution will vary according to the companies selected by the students.

BYP 2-6 COMMUNICATION ACTIVITY

In preparation for the one-hour meeting, I will review the events that have occurred in my life or that have impacted my life during the last four years and identify those that I feel would have the most bearing on my discussion with my friend.

Similarly, with financial reporting, many events and transactions have taken place and management must identify those events and transactions that are relevant (would have the most bearing on a user's decision) for disclosure in the financial statements. Therefore, information that is relevant is said to have predictive value, feedback value and must be timely. Otherwise, the amount of information would be too unwieldy.

BYP 2-7 ETHICS CASE

- (a) The stakeholders in this case are:

Kathy Johnston, accountant

Redondo's vice-president

Users of the company's financial statements, including shareholders and creditors

- (b) The ethical consideration in this situation is whether or not the early implementation of the new standard would affect the decisions of the users of the financial statements. Because early adoption is only suggested and not required, the vice-president is fully within his rights to delay implementation of the standard. However, it is ethically preferable to disclose the most financially relevant information to the users of the financial statements so that they can make informed decisions. One should question the reasoning of Redondo's vice-president who is focusing on the effect of the implementation on the profit for the year.
- (c) As the accountant, by supporting early implementation, Kathy could gain the trust and respect of the board of directors and the shareholders in general. The users of the company's financial statements will be affected by the decision against early implementation as their decision-making may be influenced by the presentation of the company's financial results using the old standards.

BYP 2-8 “ALL ABOUT YOU” ACTIVITY

NAME _____			
Personal Statement of financial position			
Date _____			
Assets			
Current assets			
Cash			\$ 1,500
Total current assets			<u>1,500</u>
Property, plant, and equipment			
Vehicle	\$3,000		
Laptop and accessories	750		
Clothes and furniture	<u>4,500</u>		
Total property, plant and equipment			<u>8,250</u>
Total assets			<u>\$ 9,750</u>
Liabilities and Personal Equity (Deficit)			
Current liabilities			
Student fees	\$2,300		
Credit cards	<u>900</u>		
Total current liabilities			\$ 3,200
Non-current liabilities			
Student loan	\$20,500		
Due to parents	<u>2,400</u>		<u>22,900</u>
Total liabilities			26,100
Personal deficit			<u>(16,350)</u>
Total liabilities and personal equity (deficit)			<u>\$ 9,750</u>

Note: Technically, this person is insolvent—not an infrequent occurrence for students in this age group.

BYP 2-9 SERIAL CASE

- (a) Biscuits' financial statements likely include the statement of financial position, income statement, statement of changes in equity, and statement of cash flows. It may or may not also include a statement of comprehensive income combined with, or separate from, the income statement (not covered as yet in the text).

The statement of financial position reports the assets, liabilities, and shareholders' equity of a company at a specific date. The income statement presents the revenues and expenses and resulting profit or loss of a company for a specific period of time. The statement of changes in equity summarizes the changes in equity accounts, including common shares and retained earnings, for a specific period of time. Finally, the statement of cash flows provides information about the cash inflows and cash outflows for a specific period of time.

- (b) By looking at the statement of financial position and determining the composition of Biscuits' current assets and current liabilities, we can assess its ability to pay its short-term obligations. We can also calculate liquidity ratios, such as working capital and the current ratio, for the current and prior periods. Liquidity ratios will help determine whether Biscuits has had any difficulty in the past with respect to its ability to meet its current obligations. This will not guarantee that Biscuits will be able to pay your invoices in the future but will provide some assurance with respect to how they have performed in the past. The statement of cash flows will also provide information to determine if Biscuits generates positive cash flows from its operations.
- (c) By looking at the types of revenues and expenses reported in the income statement, we can determine if Biscuits is profitable. If revenues earned by Biscuits exceed expenses incurred, then Biscuits is profitable. As well, profitability ratios can be determined which measure a company's ability to generate profit over a period of time. These profitability ratios include earnings per share and price-earnings ratio. The latter measures investors' expectations about Biscuits' future profitability.
- (d) By looking at the statement of financial position, we can determine if Biscuits has any non-current debt. We can also calculate solvency ratios, such as the debt to total assets ratio, to determine whether Biscuits has the ability to repay its non-current debt. Solvency ratios help measure a company's ability to survive over a long period of time.

Reviewing the company's income statement and statement of cash flows will help in determining whether Biscuits is able to pay its interest expense. The more profitable the company, the better able it is to make the interest payments on its debt and generate sufficient cash to repay its non-current obligations.

BYP 2-9 (Continued)

- (e) Be aware that the financial statements of Biscuits provide a historical perspective of what has already taken place. The financial statements may prove to be the best indicator of what will happen in the future. Consumer tastes change and as a result the demand for Biscuits' product may also change.

As well, consider this business opportunity from your perspective. Ask yourself if the price obtained for the cookies is reasonable considering some of the risks involved. There is a risk that by taking on this obligation, additional opportunities cannot be pursued. Does Koebel's Family Bakery have the ability to meet the demands of Biscuits? Is it able to produce 1,500 dozen cookies a week? Does it have enough staff to enable the company to do so? Does it have a large enough oven and other equipment required to do so? Does it have enough cash to pay for the staff that will be required, for supplies, for utilities, etc. and wait 30 days from the time in which the invoice is received by Biscuits until it is paid?

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