Financial Accounting Tools for Business Decision Making Canadian 6th Edition Kimmel Solutions Manual
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CHAPTER 2

A Further Look at Financial Statements

ASSIGNMENT CLASSIFICATION TABLE

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

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ASSIGNMENT CHARACTERISTICS TABLE

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

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ASSIGNMENT CHARACTERISTICS TABLE (Continued)

Problem Number	Description	Difficulty Level	Time Allotted (min.)
7B	Calculate ratios and comment on liquidity, solvency, and profitability.	Simple	10-20
8B	Comment on liquidity, solvency, and profitability.	Moderate	15-20
9B	Discuss financial reporting objective, qualitative characteristics, and elements.	Moderate	15-20
10B	Identify bases of measurement.	Moderate	20-30

ASSIGNMENT CHARACTERISTICS TABLE

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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 all assets that are not classified as 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.

   Showing items as current in nature matters because doing so assists the user of the financial statements to assess the business's liquidity.

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.

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Answers to Questions (Continued)

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

Difference	Current Liabilities	Non-Current Liabilities
Source of payment	Existing current assets or other current liabilities	Other than existing current assets or other 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 bank loans, appear on the statement of financial position with a current and non-current portion. Included in the balance of the bank loan payable are principal payments that will be due in the next year. 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, ie. cash, 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.

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Answers to 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 require 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.

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Answers to 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) Internationally, the conceptual framework may vary 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.

    (b) The main users of financial reporting are investors, lenders, and other creditors.

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Answers to Questions (Continued)

18. The going concern assumption states that the business will remain in operation for the foreseeable future. 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. If the company were about to be shut down, all of its assets and liabilities would be classified as current.

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 exits 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.

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.

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Answers to Questions (Continued)

24. The two bases 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.

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SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2-1

(a)	5	Accounts payable	(i)	2	Long-term Investments
(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	Patents	(n)	6	Mortgage payable, due in 20 years
(g)	8	Dividends	(o)	5	Current portion of mortgage payable
(h)	5	Income tax payable	(p)	1	Prepaid insurance
			(q)	5	Unearned revenue

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	3,900
Total current assets	$48,000

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	33,000	77,000
Equipment	$70,000	
Less: Accumulated depreciation—equipment	25,000	45,000
Total property, plant, and equipment		$187,000

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BRIEF EXERCISE 2-4

HIRJIKAKA 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
Unearned revenue	900
Current portion of mortgage payable	5,000
Total current liabilities	$43,900

BRIEF EXERCISE 2-5

(a) ($ in thousands)

2012	2011
Working capital:	Working capital:
$453,629 – $229,503 = $224,126	$336,980 – $235,365 = $101,615
Current ratio:	Current ratio:
$\frac{\$453,629}{\$229,503} = 2.0:1$	$\frac{\$336,980}{\$235,365} = 1.4:1$

(b) The working capital more than doubled in 2012 and the current ratio increased substantially when compared to 2011. Indigo's liquidity has improved in 2012 compared with 2011.

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BRIEF EXERCISE 2-6

(a) (in USD millions)

2012	2011
Debt to total assets ratio:	Debt to total assets ratio:
$\frac{(\$1,566.8 + \$711.8)}{(\$1,337.4 + \$3,115.8)} = 51.2\%$	$\frac{(\$977.4 + \$969.4)}{(\$1,242.2 + \$2,684.0)} = 49.6\%$

(b) The company's solvency was weaker in 2012 compared with 2011 because total debt has increased as a proportion of total assets.

BRIEF EXERCISE 2-7

(a) ($ in thousands)

2012	2011
Earnings per share:	Earnings per share:
$\frac{\$46,782}{70,033} = \$0.67$ per share	$\frac{\$56,666}{69,969} = \$0.81$ per share
Price-earnings ratio:	Price-earnings ratio:
$\frac{\$12.99}{\$\ 0.67} = 19.4$ times	$\frac{\$12.40}{\$\ 0.81} = 15.3$ times

(b) The decrease in profit and in the earnings per share during the year would indicate that profitability has deteriorated in 2012. In spite of the decline in profit, investors appear to have more confidence in Leon's future profit as indicated by the increase in the price-earnings ratio in 2012.

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BRIEF EXERCISE 2-8

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

BRIEF EXERCISE 2-9

(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 2-10

(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.

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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)	3	Land
(m)	6	Long-term debt
(n)	1	Prepaid expenses

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EXERCISE 2-2

BIG ROCK BREWERY INC.
Statement of Financial Position (partial)
December 31, 2012
(in thousands)

Assets

Current assets			
Cash		$4,281	
Accounts receivable		2,358	
Inventories		3,892	
Prepaid expenses and other		364	
Total current assets			$10,895
Property, plant, and equipment			
Land		$ 2,516	
Buildings	$11,070		
Less: Accumulated depreciation	827	10,243	
Machinery and equipment	$20,800		
Less: Accumulated depreciation	6,480	14,320	
Mobile equipment	$645		
Less: Accumulated depreciation	149	496	
Office furniture	$310		
Less: Accumulated depreciation	140	170	
Total property, plant, and equipment			27,745
Intangible assets			128
Total assets			$38,768

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EXERCISE 2-3

SAPUTO INC.
Statement of Financial Position (partial)
March 31, 2012
(in thousands)

Liabilities and Shareholders' Equity

Current liabilities		
Accounts payable and accrued liabilities	$571,814	
Income taxes payable	163,996	
Bank loans payable	166,631	
Total current liabilities		$ 902,441
Non-current liabilities		
Long-term debt	$379,875	
Deferred income taxes payable	156,632	
Other long-term liabilities	54,486	
Total non-current liabilities		590,993
Total liabilities		1,493,434
Shareholders' equity		
Common shares	$ 629,606	
Retained earnings	1,467,108	
Total shareholders' equity		2,096,714
Total liabilities and shareholders' equity		$3,590,148

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EXERCISE 2-4

(a)

	Profit	=	Revenues – Expenses
		=	$73,040 – $5,000 – $4,750 – $48,680
		=	$14,610
	Retained earnings	=	Beginning retained earnings + Profit – Dividends
		=	$66,520 + $14,610 – $0
		=	$81,130

(b)

SUMMIT LTD.
Statement of Financial Position
December 31, 2015

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

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EXERCISE 2-5

BATRA CORPORATION
Income Statement
Year Ended July 31, 2015

Revenues		
Service revenue		$81,100
Rent revenue		18,500
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	900	
Total expenses		64,000
Profit before income tax		35,600
Income tax expense		5,000
Profit		$30,600

BATRA CORPORATION
Statement of Changes in Equity
Year Ended July 31, 2015

	Common Shares	Retained Earnings	Total Equity
Balance, August 1, 2014	$ 6,000	$17,940	$23,940
Issued common shares	4,000		4,000
Profit		30,600	30,600
Dividends		(12,000)	(12,000)
Balance, July 31, 2015	$10,000	$36,540	$46,540

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EXERCISE 2-5 (Continued)

BATRA CORPORATION
Statement of Financial Position
July 31, 2015

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

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EXERCISE 2-6

(a) Current ratio:

$$\frac{\$60{,}000}{\$40{,}000} = 1.5:1$$

(b) Current ratio:

$$\frac{(\$60{,}000 - \$20{,}000)}{(\$40{,}000 - \$20{,}000)} = 2:1$$

(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.

That said, it is not unethical to pay an account payable in advance of its due date. Rather, it is the motivation for the transaction that would lead one to conclude that the CFO is acting unethically.

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EXERCISE 2-7

(a) (in millions)

2012	2011
Working capital: $103.5 – $30.8 = $72.7	Working capital: $77.3 – $78.0 = $(0.7)
Current ratio: $\frac{\$103.5}{\$30.8} = 3.4:1$	$\frac{\$77.3}{\$78.0} = 1.0:1$
Debt to total assets ratio: $\frac{(\$30.8 + \$114.8)}{(\$103.5 + 217.8)} = 45.3\%$	$\frac{(\$78.0 + \$218.2)}{(\$77.3 + \$422.5)} = 59.3\%$

(b) Huntingdon's liquidity and solvency improved dramatically in 2012 when compared to 2011.

(c)

	2012			
	Huntingdon	Plazacorp	First Capital	Industry
Working capital (in millions)	$72.7	$(48.6)	$12.8	n/a
Current ratio	3.4:1	0.1:1	1.0:1	0.9:1
Debt to total assets ratio	45.3%	58.6%	55.4%	65.0%

	2011			
	Huntingdon	Plazacorp	First Capital	Industry
Working capital (in millions)	$(0.7)	$(8.9)	$(276.6)	n/a
Current ratio	1.0:1	0.7:1	0.5:1	2.0:1
Debt to total assets ratio	59.3%	63.9%	58.7%	71.0%

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EXERCISE 2-7 (Continued)

(c) (Continued)

Based on working capital and the current ratio, Huntingdon's liquidity is the best (highest) of the three companies, as the current ratio far exceeds the ratios for Plazacorp and First Capital as well as the industry average. Compared to 2011, all companies improved working capital and the current ratio except Plazacorp which has the worst (lowest), with insufficient current assets to cover its current liabilities and with a negative working capital position.

Based on the debt to total assets ratio, which improved for all three companies and for the industry as a whole, Huntingdon's solvency is the best of the three companies, exceeding the industry average by a large margin. Plazacorp's solvency is the worst of the three companies, as is its liquidity.

EXERCISE 2-8

(a) (in thousands)

2012

Earnings per share:

$$\frac{\$264,583}{395,234} = \$0.67 \text{ per share}$$

Price-earnings ratio:

$$\frac{\$19.59}{\$0.67} = 29.2 \text{ times}$$

2011

Earnings per share:

$$\frac{\$449,844}{394,662} = \$1.14 \text{ per share}$$

Price-earnings ratio:

$$\frac{\$18.41}{\$1.14} = 16.1 \text{ times}$$

(b) The decrease in the earnings per share during the year would indicate that profitability has deteriorated dramatically in 2012. However, investors appear to have more confidence in Cameco's future profitability as indicated by the increase in the price-earnings ratio in 2012 and by the increase in the share price in 2012.

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EXERCISE 2-9

(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 2-10

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.

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SOLUTIONS TO PROBLEMS

PROBLEM 2-1A

Item	Statement of Financial Position Category
Accumulated depreciation	Contra asset to plant, equipment, and vehicles in the property, plant, and equipment section
Cash	Current assets
Common (ordinary) shares	Share capital
Current income tax payable	Current liabilities
Current income tax recoverable	Current 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
Plant, equipment, and vehicles	Property, plant, and equipment
Trade and other payables	Current liabilities
Trade and other receivables	Current assets
Trademarks	Intangible assets

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PROBLEM 2-2A

(a)

Item	Statement of Financial Position Category
Accounts receivable	Current assets
Accumulated depreciation—aircraft	Property, plant, and equipment (contra account)
Accumulated depreciation—buildings	Property, plant, and equipment (contra account)
Accumulated depreciation—ground property and equipment	Property, plant, and equipment (contra account)
Accumulated depreciation—leasehold Improvements	Property, plant, and equipment (contra account)
Accumulated depreciation—spare engines and parts	Property, plant, and equipment (contra account)
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

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PROBLEM 2-2A (Continued)

(b)

WESTJET AIRLINES LTD.
Statement of Financial Position (partial)
December 31, 2012
(in thousands)

Assets

Current assets			
Cash		$1,459,822	
Accounts receivable		37,576	
Inventory		35,595	
Prepaid expenses, deposits and other		101,802	
Total current assets			$1,634,795
Property, plant, and equipment			
Aircraft	$2,605,277		
Less: Accumulated depreciation	1,127,889	$1,477,388	
Ground property and equipment	$136,167		
Less: Accumulated depreciation	79,052	57,115	
Spare engines and parts	$146,422		
Less: Accumulated depreciation	44,713	101,709	
Buildings	$135,924		
Less: Accumulated depreciation	20,025	115,899	
Leasehold improvements	$16,538		
Less: Accumulated depreciation	5,536	11,002	
Total property, plant, and equipment			1,763,113
Intangible assets			50,808
Other assets			297,899
Total assets			$3,746,615

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PROBLEM 2-3A

(a)

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

(b)

WESTJET AIRLINES LTD.
Statement of Financial Position (partial)
Liabilities and Shareholders' Equity
December 31, 2012
(in thousands)

Current liabilities		
Accounts payable and accrued liabilities	$460,003	
Advanced ticket sales	480,947	
Other current liabilities	47,859	
Current portion of long-term debt	199,044	
Total current liabilities		$1,187,853
Non-current liabilities		
Long-term debt	$574,139	
Other long-term liabilities	155,570	
Deferred income tax	356,748	
Total non-current liabilities		1,086,457
Total liabilities		2,274,310
Shareholders' equity		
Share capital	$614,899	
Retained earnings	793,296	
Other shareholders' equity items	64,110	
Total shareholders' equity		1,472,305
Total liabilities and shareholders' equity		$3,746,615

(c) Yes, these two amounts agree. Assets of $3,746,615 thousand equal total liabilities plus shareholders' equity of the same amount.

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PROBLEM 2-4A

(a)

MBONG CORPORATION
Income Statement
Year Ended December 31, 2015

Revenues		
Service revenue	$81,700	
Interest revenue	500	
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	1,000	
Total expenses		52,700
Profit before income tax		29,500
Income tax expense		6,000
Profit		$23,500

MBONG CORPORATION
Statement of Changes in Equity
Year Ended December 31, 2015

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

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PROBLEM 2-4A (Continued)

(a) (Continued)

MBONG CORPORATION
Statement of Financial Position
December 31, 2015

Assets			
Current assets			
Cash		$ 5,200	
Trading investments		20,000	
Accounts receivable		14,200	
Supplies		200	
Prepaid insurance		2,000	
Total current assets			$ 41,600
Property, plant, and equipment			
Land		$40,000	
Building	$72,000		
Less: Accumulated depreciation—building	18,000	54,000	
Equipment	$66,000		
Less: Accumulated depreciation—equipment	17,600	48,400	
Total property, plant, and equipment			142,400
Total assets			$184,000
Liabilities and Shareholders' Equity			
Current liabilities			
Accounts payable		$8,300	
Salaries payable		3,000	
Current portion of bank loan payable		1,500	
Total current liabilities			$ 12,800
Non-current liabilities			
Bank loan payable ($15,000 - $1,500)			13,500
Total liabilities			26,300
Shareholders' equity			
Common shares		$ 34,200	
Retained earnings		123,500	
Total shareholders' equity			157,700
Total liabilities and shareholders' equity			$184,000

(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.

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PROBLEM 2-5A

(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) Johanssen’s liquidity has improved dramatically as the working capital is greater in 2015 and the current ratio is almost double that of 2014. On the other hand, the solvency has deteriorated as the debt to total assets ratio is higher in 2015. Johanssen’s profitability has improved as the earnings per share ratio has increased in 2015, as has investors’ expectations for future profitability as indicated by the increasing price-earnings ratio.

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PROBLEM 2-6A

(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

$$\frac{\$407{,}200}{\$166{,}325} = 2.4\ :1$$

Caissie

$$\frac{\$190{,}400}{\$133{,}700} = 1.4\ :1$$

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

$$\frac{(\$166{,}325 + \$108{,}500)}{(\$407{,}200 + \$532{,}000)} = 29.3\%$$

Caissie

$$\frac{(\$133{,}700 + \$40{,}700)}{(\$190{,}400 + \$139{,}700)} = 52.8\%$$

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.

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PROBLEM 2-6A (Continued)

(c)

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

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

Chen

$$\frac{\$247,000}{76,000} = \$3.25$$

Caissie

$$\frac{\$142,600}{62,000} = \$2.30$$

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

Chen

$$\frac{\$25.00}{\$3.25} = 7.7 \text{ times}$$

Caissie

$$\frac{\$15.00}{\$2.30} = 6.5 \text{ times}$$

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.

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PROBLEM 2-7A

(a) (in thousands)

		Le Château	Reitmans
1.	Working capital	$132,223 – $47,382 = $84,841	$301,374 – $86,914 = $214,460
2.	Current ratio	$\frac{\$132,223}{\$47,382}$ = 2.8:1	$\frac{\$301,374}{\$86,914}$ = 3.5:1
3.	Debt to total assets	$\frac{\$80,412}{\$220,210}$ = 36.5%	$\frac{\$139,537}{\$594,555}$ = 23.5%
4.	Earnings per share	$\frac{\$(8,717)}{25,659}$ = $(0.34)	$\frac{\$26,619}{65,188}$ = $0.41
5.	Price-earnings ratio	= N/A	$\frac{\$12.39}{\$0.41}$ = 30.2 times

(b) Liquidity

With a current ratio of 2.8:1, Le Château is less liquid than Reitmans and both have stronger ratios than the industry average of 2.0:1.

Solvency

Reitmans is more solvent than Le Château as evidenced by its lower debt to total assets ratio, which is almost identical to the industry average of 24%.

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 Reitmans as evidenced by its price-earnings ratio, which is also much higher than that of the industry. Le Château does not have a price-earnings ratio because it has negative earnings.

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PROBLEM 2-8A

(a) The higher the amount of working capital, the better a company' liquidity. From 2013 to 2014 Pitka Corporation's working capital significantly deteriorated. It then went on to deteriorate even further from 2014 to 2015, decreasing by $15,000.

A higher current ratio is evidence of better liquidity for a company (assuming the components of the current assets are also liquid). The current ratio for Pitka has been steady from 2013 to 2014, but deteriorated slightly from 2014 to 2015.

A smaller (lower) debt to total assets ratio shows evidence of better solvency. The percentage of total liabilities to total assets increased from 2013 to 2014, showing deterioration in the solvency for Pitka. On the other hand, the ratio improved substantially from 2014 to 2015.

The higher the earnings per share, the better the profitability. Profitability decreased from 2013 to 2014, but improved from 2014 to 2015.

The investors appeared to have less confidence in the future profit of Pitka as evidenced by Pitka's price-earnings ratio, which declined from 2013 to 2014. This view changed as demonstrated by the climb in the price-earnings ratio from 2014 to 2015.

(b) <u>Liquidity</u>

Pitka's current ratio, although steady in 2013 and 2014, declined slightly in 2015. This trend is of concern given the low level of liquidity the company has with a current ratio of 1.1:1.

<u>Solvency</u>

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 2013.

<u>Profitability</u>

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 2015.

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PROBLEM 2-9A

(a) The objective of financial reporting is to provide information that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company. In this case, the information will be used by the team's bank. Bucky's suggestions concerning how elements should be reported on the financial statements do not meet the objective of financial reporting. His suggestions would lead to a violation of the fundamental basis on which financial statements are prepared: accrual accounting. The suggested changes to the financial statements would not portray economic reality and would not faithfully represent the performance of the team and the financial position at December 31, 2015. Bucky's suggestions show bias and an attempt to portray a financial picture that would be perceived as more favourable than it is in reality.

(b)

1. Failing to include the estimated expenses for utilities and the corresponding liability for the utilities already consumed by December 31, 2015 violates accrual accounting. The expense was incurred and a liability exists and although the exact amount is not known, a reasonable estimate can be made as this type of expense occurs often. The definitions of the elements have been met. Failing to include the expense would represent an error of omission done on purpose to increase the profitability and reduce the liabilities of the team at December 31, 2015.

2. Unless the company uses the revaluation model for all of its long-lived assets, the suggestion of increasing the value of building to its fair value would violate the cost basis of accounting. It is likely far more relevant to the financial statement user of this type of company to see the original purchase price of the building rather than its fair value as it is unlikely to be resold soon. Consequently, assets and revenue (from the recording of an unrealized gain from the increase in the value of the asset) would be overstated if the Bucky's instructions were followed.

3. The signing bonus paid to Wayne Crosby does not represent an asset at December 31, 2015. No future benefit can be derived from this payment as it was not conditional upon the occurrence of a future event. Consequently, the expenditure does not fit the definition of an asset.

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PROBLEM 2-10A

(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 statement of financial position 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 statement of financial position 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.

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PROBLEM 2-1B

Item	Statement of Financial Position Category
Accumulated amortization—patents and trademarks	Intangible assets (contra account)
Accumulated depreciation—industrial machinery and equipment	Property, plant, and equipment (contra account)
Bank overdraft	Current liabilities
Cash	Current assets
Common (ordinary) shares	Share capital
Current borrowings and debts	Current liabilities
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
Non-current borrowings and debts	Non-current liabilities
Patents and trademarks	Intangible assets
Prepaid expenses	Current assets
Trade accounts payable	Current liabilities
Trade accounts receivable	Current assets

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PROBLEM 2-2B

(a)

Item	Statement of Financial Position Category
Accounts receivable	Current assets
Accumulated amortization—patents	Intangible assets (contra account)
Accumulated depreciation—buildings	Property, plant, and equipment (contra account)
Accumulated depreciation—equipment	Property, plant, and equipment (contra account)
Buildings	Property, plant, and equipment
Cash	Current assets
Equipment	Property, plant, and equipment
Goodwill	Goodwill (after intangibles)
Patent	Intangible assets
Land	Property, plant, and equipment
Trading investments	Current assets
Merchandise inventory	Current assets
Prepaid expenses	Current assets

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PROBLEM 2-2B (Continued)

(b)

DEVON LIMITED
Statement of Financial Position (partial)
December 31, 2015
(in thousands)

Assets

Current assets			
Cash		$97,625	
Trading investments		71,630	
Accounts receivable		4,145	
Merchandise inventory		93,320	
Prepaid expenses		25,950	
Total current assets			$292,670
Property, plant, and equipment			
Land		$ 5,860	
Buildings	$53,150		
Less: Accumulated depreciation	22,470	30,680	
Equipment	$166,750		
Less: Accumulated depreciation	85,900	80,850	
Total property, plant, and equipment			117,390
Intangible assets			
Patents		$29,415	
Less: Accumulated amortization		10,190	19,225
Goodwill			42,425
Total assets			$471,710

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PROBLEM 2-3B

(a)

Item	Category
Accounts payable	Current liabilities
Current portion of mortgage payable	Current liabilities
Mortgage payable	Non-current liabilities
Retained earnings	Shareholders' equity
Common shares	Shareholders' equity
Unearned revenue	Current liabilities

(b)

DEVON LIMITED
Statement of Financial Position (partial)
December 31, 2015
(in thousands)

Liabilities and Shareholders' Equity

Current liabilities		
Accounts payable	$ 2,900	
Unearned revenue	16,295	
Current portion of mortgage payable	3,570	
Total current liabilities		$ 22,765
Non-current liabilities		
Mortgage payable		71,430
Total liabilities		94,195
Shareholders' equity		
Common shares	$ 39,225	
Retained earnings	338,290	
Total shareholders' equity		377,515
Total liabilities and shareholders' equity		$471,710

(c) Yes, the total assets of $471,710 agree to total liabilities and shareholders' equity of the same amount.

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PROBLEM 2-4B

(a)

BEAULIEU LIMITED
Income Statement
Year Ended December 31, 2015

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

BEAULIEU LIMITED
Statement of Changes in Equity
Year Ended December 31, 2015

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

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PROBLEM 2-4B (Continued)

(a) (Continued)

BEAULIEU LIMITED
Statement of Financial Position
December 31, 2015

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

(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.

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PROBLEM 2-5B

(a)

1. Working capital

   Current assets – 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 2015 and the current ratio is greater than that of 2014. The solvency has improved as the debt to total assets ratio is a smaller percentage in 2015 than in 2014. Fast’s profitability has improved dramatically as the earnings per share ratio has increased by a large amount in 2015, as has the price-earnings ratio, suggesting that investors are excited about the company’s future prospects.

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PROBLEM 2-6B

(a)

Working capital	=	Current assets – Current liabilities				
Belliveau	=	$180,000	–	$75,000	=	$105,000
Shields	=	$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.

(b)

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

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

The debt to asset ratios are similar and both companies 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.

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PROBLEM 2-6B (Continued)

(c)

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

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

Belliveau	Shields
$\frac{\$44,000}{200,000} = \$0.22$	$\frac{\$136,000}{200,000} = \$0.68$

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

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

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 (for example, Shields has a lot more debt).

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PROBLEM 2-7B

(a) (in USD millions)

		Walmart	Target
1.	Working capital	\$59,940 – \$71,818 = \$(11,878)	\$16,388 – \$14,031 = \$2,357
2.	Current ratio	$\frac{\$59,940}{\$71,818}$ = 0.8:1	$\frac{\$16,388}{\$14,031}$ = 1.2:1
3.	Debt to total assets	$\frac{\$121,367}{\$203,105}$ = 59.8%	$\frac{\$31,605}{\$48,163}$ = 65.6%
4.	Earnings per share	$\frac{\$16,999}{3,374}$ = \$5.04	$\frac{\$2,999}{657}$ = \$4.56
5.	Price-earnings ratio	$\frac{\$69.95}{\$5.04}$ = 13.9 times	$\frac{\$61.15}{\$4.56}$ = 13.4 times

(b) Liquidity

With a current ratio of 1.2:1, Target is more liquid than Walmart. Both Walmart and Target have current ratios that are lower (worse) than the industry average.

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 that is much 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 Walmart as evidenced by Walmart's price-earnings ratio. Both Target and Walmart have lower price-earnings ratio than the industry.

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PROBLEM 2-8B

(a) The higher the amount of working capital, the better a business' liquidity. From 2013 to 2014, Giasson Corporation's working capital improved. It then deteriorated from 2014 to 2015, 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 2013 to 2015.

A smaller debt to total assets ratio shows evidence of better solvency. The percentage of total liabilities to total assets increased from 2013 to 2014, showing deterioration in the solvency for Giasson. On the other hand the ratio remained somewhat stable from 2014 to 2015, declining (improving) slightly.

The higher the earnings per share, the better evidence of an improved profitability. Profitability increased from 2013 to 2014 but declined significantly from 2014 to 2015 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 2013 to 2015.

(b) <u>Liquidity</u>

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.

<u>Solvency</u>

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

<u>Profitability</u>

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

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PROBLEM 2-9B

(a) The objective of financial reporting is to provide information that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company. Virginia's suggestions concerning how elements should be reported on the financial statements do not meet the objective of financial reporting. Her suggestions would lead to a violation of the fundamental basis on which financial statements are prepared: accrual accounting. The suggested changes to the financial statements would not portray the economic reality and would not faithfully represent the performance of the construction company and the financial position at its year end. Virginia's suggestions show bias and an attempt to portray a financial picture that would be perceived as more favourable than it is in reality.

(b)

1. Failing to include the estimated expense and the related liability for the damages that have already occurred by the end of the year violates accrual accounting. The expense was incurred and a liability exists that can be estimated. The definitions of the elements have been met. Failing to include the expense would represent an error of omission done on purpose to increase the profitability and reduce the liabilities of the construction company at its year end.

2. The suggestion of increasing the revenues from construction would result not only in the recording of revenue but the recording of an accounts receivable. The revenue from construction has not been earned as no work has been performed. Furthermore, no account receivable should be recorded because no asset exists yet. Because revenue would be overstated if recorded, equity would also be overstated if the Virginia's instructions were followed. Virginia's suggestions would not faithfully represent the reality of the performance of Ace Construction Limited for the current fiscal year.

3. Although there are no fixed repayment terms for the bank overdraft, the bank can require repayment on demand since no contract or agreement has been entered into to delay the repayment of the overdraft. For this reason, the classification of the bank overdraft as a non-current liability would falsely portray the financial position of Ace Construction Limited at the year end. When assessing the construction company's liquidity, the users of the financial statements would be misinterpreting the financial position because of this misclassification. Classifying the debt as non-current would not faithfully represent the economic reality of the construction company's liquidity position.

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PROBLEM 2-10B

(a) The advantage of the fair value basis of accounting it 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 basis of measurement that should be used for the following purchases:

1. Due 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.

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.

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BYP 2-1 FINANCIAL REPORTING

(a) Total current assets were $2,764,997,000 at December 29, 2012, and $2,695,647,000 at December 31, 2011.

Total assets were $7,473,721,000 at December 29, 2012, and $7,300,310,000 at December 31, 2011.

(b) Current assets are listed in the order of liquidity from most to least liquid. Cash is the most liquid asset and is reported first. Non-current assets are listed in order of permanency, with property, plant, and equipment listed first.

(c) The current liabilities total $2,334,917,000 at December 29, 2012 and $1,776,238,000 at December 31, 2011. The total liabilities at December 29, 2012 and December 31, 2011 were in the amount of $3,150,394,000 and $3,032,480,000, respectively.

(d) The current liabilities are listed in order of due date from those due first to those due last, with bank indebtedness and commercial paper listed first. It is not clear what order was chosen for non-current liabilities. Accounting standards do not suggest any particular order for the presentation of non-current liabilities.

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BYP 2-2 COMPARATIVE ANALYSIS

(a)

	Jean Coutu (in millions, except per share information)		Shoppers Drug Mart (in thousands, except per share information)	
1. Working capital	\$421.9 – \$265.3	= \$156.6	\$2,764,997 – \$2,334,917	= \$430,080
2. Current ratio	\$421.9 / \$265.3	= 1.6:1	\$2,764,997 / \$2,334,917	= 1.2:1
3. Debt to total assets	\$281.9 / \$1,392.7	= 20.2%	\$3,150,394 / \$7,473,721	= 42.2%
4. Earnings per share	\$2.57		\$2.92	
5. Price-earnings ratio	\$15.78 / \$2.57	= 6.1 times	\$42.80 / \$2.92	= 14.7 times

(b) Liquidity: Working capital is not comparable, because of the differing sizes of the two companies involved. However, using the current ratio to assess liquidity, we can determine that Jean Coutu is significantly more liquid than Shoppers 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. Jean Coutu's debt to total assets is very low at 20.2%, which means that it is primarily financed by equity. Shoppers' debt to total assets ratio of 42.2% is higher (worse) than that of Jean Coutu and the industry average of 30.6%.

Profitability: The earnings per share between two companies are not comparable. However, based on the price-earnings ratio, Shoppers is favoured by investors. Jean Coutu's price-earnings ratio falls far below that of Shoppers, but both are well below the industry average of 42.0 times.

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BYP 2-3 COMPARING IFRS AND ASPE

(a) McCain's multinational structure means that accounting personnel from various countries are involved with preparing financial statements. Since IFRS is a global standard, 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). For McCain, it means that the company will reduce cost as well as the chance for errors.

In addition, the users of McCain's financial statements are located throughout the world. Those located in countries using IFRS, or wishing to compare McCain's statements to other global companies, would better understand financial statements prepared using this standard.

(b) Relevance – Researchers have found that companies who voluntarily adopt IFRS find that IFRS' accounting measures are better tools for evaluating performance. Therefore 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 different accounting standards are used by various companies within a corporate group they are less understandable. Furthermore, when users are not resident in the country where the head office of the company is located, they often have a difficult time understanding financial statements that are presented using standards 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).

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BYP 2-3 (Continued)

(c) Examples of why private companies may adopt IFRS:

- Private companies that plan to be public sometime in the near future or who have foreign private investors, may choose to adopt IFRS.
- Private companies that have global shareholders or lenders (who are more familiar with IFRS). They may also want to provide financial statements to customers.

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BYP 2-4 CRITICAL THINKING CASE

Note to instructors: All of the material supplementing this group activity, including a suggested solution, can be found in the Collaborative Learning section of the Instructor Resource site accompanying this textbook as well as in the Prepare and Present section of *WileyPLUS*.

(a) Sheila paid $25,000 for 10,000 common shares of Kenmare Architects Ltd. (or $2.50 per share) when the company was formed. This amount is reported as the balance in the Common Shares account on the statement of financial position of December 31, 2014.

Sheila's mother paid $10,000 for 1,000 common shares (or $10.00 per share) in early 2015. This amount paid can be determined by calculating the increase of $10,000 ($35,000 less $25,000) in the Common Shares account on the statement of financial position of December 31, 2015.

(b) By December 31, 2014, Uncle Harry wanted $8,000 of the loan paid off in 2015. This amount is classified as the current portion of the loan due at December 31, 2014. The actual amount of principal paid in 2015 was $30,000. This amount paid can be determined by calculating the total decrease in the loan payable from December 31, 2014 to December 31, 2015: [($52,000 + $8,000) less ($26,000 + $4,000)]. During 2014 Uncle Harry received interest only in the amount of $3,600 as indicated in the statement of income for interest expense. In 2015, Uncle Harry received $32,700. This amount is equal to the principal repayment of $30,000 and the interest of $2,700.

(c)

	2015		2014	
Current ratio	$\frac{\$46,000}{\$33,580}$	= 1.4:1	$\frac{\$31,000}{\$22,490}$	= 1.4:1

Although the current ratio is unchanged, we need to examine further, the account balances that make up the ratio components. There has been deterioration in liquidity due to the declining cash balance and the significant rise in accounts receivable which may indicate difficulty in collecting amounts owed from customers. This decreased cash flow from customers has probably caused the increase in accounts payable as the company seems to have delayed payment to suppliers.

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BYP 2-4 (Continued)

(d)

	2015		2014	
Debt to total assets	$\frac{\$59,580}{\$106,000}$	= 56.2%	$\frac{\$74,490}{\$103,000}$	= 72.3%

Kenmare's solvency improved significantly. The decrease in the ratio occurred mainly because of changes in the numerator rather than in the denominator. Total liabilities fell because of the large pay down of the loan from the uncle even though accounts payable rose. This had an impact on the income statement by lowering interest expense because of the lower loan balance. Because Kenmare's debt level is lower, the amount of interest expense is also lower making the business more profitable.

(e)

	2015		2014	
Earnings per share	$\frac{\$7,910}{11,000}$	= $0.72	$\frac{\$3,510}{10,000}$	= $0.35

The earnings per share more than doubled because profit more than doubled while there was only a 10% increase in the number of shares.

(f) Sheila paid $2.50 per share for her shares ($25,000 ÷ 10,000). The amount Sheila's mother paid for her shares was $10.00 per share ($10,000 refer to part (a) above ÷ 1,000).

	2015		2014	
Price-earnings ratio	$\frac{\$10.00}{\$0.72}$	= 13.9 times	$\frac{\$2.50}{\$0.35}$	= 7.1 times

The service revenue increased 20% from 2014 to 2015 [($120,000 – $100,000) ÷ $100,000]. The profit increased by 125% from 2014 to 2015 [($7,910 – $3,510) ÷ $3,510]. Sheila's salary increased by 25% from 2014 to 2015 [($74,000 – $59,000) ÷ $59,000].

The value of the price-earnings ratio changed mostly because of the price difference paid by the two shareholders. Sheila's mother paid four times the price Sheila paid for her shares. This increase is very dramatic taking into account other ratios for measurement of performance.

The fourfold increase in the share price is not justified by the financial performance of the business. The future profitability of the business is based on the amount of service revenue that can be generated by the single employee, Sheila, and is therefore limited.

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BYP 2-4 (Continued)

(g) The likely reason for the sale in shares in 2015 was to obtain $10,000, which was used to repay the debt to Uncle Harry earlier than originally scheduled.

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BYP 2-5 ETHICS CASE

(a) The stakeholders in this case are:

Kathy Onishi, controller
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 switching from ASPE to IFRS would affect the decisions of the users of the financial statements. Because Redondo Corporation is a private corporation, the use of IFRS is not required. 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 controller, by supporting the conversion from ASPE to IFRS, 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 find the information provided under IFRS to be more useful in making comparisons with Redondo's competitors. This in turn will lead to better decisions being made by users of the financial statements.

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BYP 2-6 "ALL ABOUT YOU" ACTIVITY

(a)

NAME
Personal Statement of Financial Position
Date

Assets

Current assets		
Cash		$1,500
Total current assets		1,500
Property, plant, and equipment		
Vehicle	$3,000	
Laptop and accessories	750	
Clothes and furniture	4,500	
Total property, plant and equipment		8,250
Total assets		$9,750

Liabilities and Personal Equity (Deficit)

Current liabilities		
Student fees	$2,300	
Credit cards	900	
Total current liabilities		$ 3,200
Non-current liabilities		
Student loan	$20,500	
Due to parents	2,400	22,900
Total liabilities		26,100
Personal deficit		(16,350)
Total liabilities and personal equity (deficit)		$ 9,750

Note: Technically, this person is insolvent because they have such a large personal deficit—not an infrequent occurrence for students in this age group.

$$\text{Debt to total assets} \quad \frac{\$26,100}{\$9,750} = 267.7\%$$

(b) Answers will vary with each student.

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BYP 2-7 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). It will also include the notes to the financial statements.

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) Because Biscuits is public company, it is required to have its financial statements audited by an independent licensed public accountant. The date appearing on the auditor's report which appears immediately before the financial statements is the date when the audit was completed and the financial statements were made available to the public.

(c) 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 to help determine 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.

(d) 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.

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BYP 2-7 (Continued)

(e) 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.

(f) Be aware that the financial statements of Biscuits provide a historical perspective of what has already taken place. The financial statements may not 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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Financial Accounting Tools for Business Decision Making Canadian 6th Edition Kimmel Solutions Manual
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