CHAPTER 2

Analyzing Transactions and Their Effects on Financial Statement

SOLUTIONS TO DISCUSSION QUESTIONS

DQ2-1 The two fundamental qualitative characteristics are relevance and representational faithfulness. These fundamental characteristics ensure that information reported in financial statements is useful.

The four enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability. These characteristics further enhance useful information; however they cannot make useless information useful.

DQ2-2 The value of the land is most likely reported at its original purchase price, or historical cost. This is representationally faithful. It is verifiable, and is most likely accurate and free from error. However, historical cost may not be relevant if the market value of the land has increased significantly since it was purchased. Some users may find it more useful to know the current market value of the land.

DQ2-3 The conceptual framework provides guidance by focusing the financial statement preparer on presenting information that is relevant and faithfully represented. Even in highly unique situations for which there is no specific accounting standard, accountants must think about accounting for a transaction in a manner that provides information that is predictive or enables users to confirm their previous assessments as well as provide information that is complete, neutral, and free from error. The conceptual framework also directs the accountant to consider qualities like comparability, verifiability, timeliness, and understandably. Finally, the conceptual framework considers the cost and benefit of reporting information, to ensure that the efforts spent obtaining information is warranted in light of the benefits the information provides to the financial statement users.

DQ2-3 (Continued)

In short, the conceptual framework provides accountants with a basis for determining how to treat the item or transaction in a way that results in useful financial information in the absence of any specific standard.

DQ2-4 Material information is information that is useful to decision makers. Therefore, it is associated with the qualitative characteristic of relevance. It is information that, if known, would make a difference in the decisions that are made about investments in, or investments made by, a company. Normally, the greater the dollar value of an item, the more material it is. However, some small dollar items can be qualitatively material due to particular situations (i.e. even a small dollar fraud by senior management could be considered to be material).

DQ2-5 When transactions are recorded in the accounting system, the equality of the basic accounting equation (or statement of financial position equation), Assets = Liabilities + Shareholders' Equity, must be maintained. This implies that all transactions must affect at least two accounts in the financial statements to maintain the equality, although the effects may be within the same category of accounts. For example, the collection of cash from customers on account both increases an asset (cash) and decreases another asset (accounts receivable).

DQ2-6 Dividends are not normal business expenses. They are a distribution of profits to shareholders and not an expense incurred to generate revenues. Dividend payments involve an outflow of cash and are therefore recorded on the cash flow statement and the statement of changes in equity.

DQ2-7 Under the accrual basis of accounting, transactions are recorded in the period in which they occur (i.e. revenues when earned and expenses when incurred) regardless of when the cash related to these transactions flowed into or out of the company. Under the cash basis of accounting, transactions are only recorded when the cash is actually received or paid by the company.

DQ2-8 Advantages of using the accrual basis:

1. Revenue is recognized when earned which is more meaningful to users. Under the cash basis, the revenue is recognized when the cash is received, even if the work associated with has been done previously or may not be completed for several periods.
2. It results in statements of income that reflect the revenues and expenses of the period more accurately.
3. It increases the comparability of financial statements from one period to another.

Disadvantages of using the accrual basis:

1. It is more complicated for unsophisticated users to prepare or interpret.
2. Creates uncertainty regarding the collectability of future cash flows. Under the accrual basis, some of the revenues recognized may never be collected. This is a non-issue under the cash basis.
3. Net income determined under the accrual basis does not give a clear view of the amount of cash that an organization has generated in a given time period.

DQ2-9 The three major sections in the cash flow statement are:

1. **Operating Activities**: Includes transactions involved with the buying and selling of goods/services such as business expenditures and revenues, etc.
2. **Investing Activities**: Includes transactions involved with the buying and selling of assets such as property, plant, and equipment, long-term investments, etc.
3. **Financing Activities**: Includes transactions regarding the inflow and outflow of cash necessary for investment plans of the business such as issuance of shares, payment of dividends, proceeds from new loans and the repayment of loan principal, etc.

DQ2-10 The payment of cash dividends is an example of a cash outflow from financing activity. The sale of property, plant and equipment such as land or equipment held by a company for use is an example of a cash inflow from investing activity.

DQ2-11 The issuance of shares is an example of a cash inflow from financing activity. The purchase of property, plant, and equipment is an example of a cash outflow from investing activity.

DQ2-12
a. T
b. T
c. F
d. F
e. F
f. T
g. F
h. T

DQ2-13 Operating activities are normally expected to have a positive net cash flow, as cash collected from sales is expected to be greater than the cash spent to generate the sales.

Investing activities are normally expected to have a negative net cash flow, as more cash is spent on acquiring property, plant and equipment than is received from selling them once the company has finished using them.

Financing activities normally result in net cash inflow because companies generally borrow money and issue shares to finance their growth.

DQ2-14 Under the accrual basis of accounting, revenues are recorded when they have been earned regardless of whether the related cash has been received by the company. When a university bookstore sells a textbook, it 'earns' the revenue when the textbook is sold and provided to the student. In this case, most students pay for textbooks at the same time as receiving them, therefore the cash basis and the accrual basis would likely be the same for the sale of textbooks.

DQ2-14 (Continued)

The revenue earned from the parking would be recognized throughout the semester, as the student uses the parking space. Most likely, the university would recognize a portion of the parking revenue each month throughout the semester. Under the cash basis of accounting, the full amount of the parking pass would have been recognized as revenue in the month when the cash was received.

DQ2-15 Under accrual-basis accounting, a prepaid expense is brought forward as an asset on the statement of financial position and expensed as the related benefits are realized. For example, if rent is paid for future months, no expense is recognized immediately even though cash is paid. The prepaid expense is then expensed over the months that benefit from the advance payment (i.e. insurance expense would be recognized in each month covered by the insurance policy).

DQ2-16 Under accrual-basis accounting, an accrued expense is one that is recognized on the statement of income as an expense before any cash is paid out. In this case, a liability is also set up on the statement of financial position that will be eliminated once the cash has been paid to settle the liability.

DQ2-17 Depreciation is a method of allocating the cost of property, plant and equipment to each of the years in which these assets are expected to help generate revenues (i.e. its estimated useful life). Using the straight-line method, depreciation is calculated as (the total cost of the asset less the estimated residual value, if any) divided by the estimated useful life. It results in an equal portion of the asset's cost being allocated each period.

DQ2-18 The statement of changes in shareholders' equity includes changes in retained earnings. Retained earnings are increased or decreased by net income or losses from the period, therefore the statement or income must be completed first in order to know how much change to record in retained earnings. Then the rest of the statement of changes in shareholders' equity can be completed.

DQ2-19 Accrual accounting requires that revenue be recognized when it is earned, and that expenses be recognized in the period they are used to earn revenue. Buildings and equipment are often paid for when they are acquired, and then are used for generating revenue over a number of years. Depreciation enables the cost of the assets to be allocated to the periods in which they are used.

DQ2-20 The estimated residual value of an asset is the amount the company estimates to recover from the disposal of the asset when the company is finished using it. The purpose of depreciation is to allocate the net cash spent on the asset to the periods of its use.

Since some of the purchase price will be recovered through the eventual disposal of the asset, that portion of the cost should not be allocated as an expense during the period of use. Therefore, residual value is subtracted from the asset's cost when calculating depreciation.

SOLUTIONS TO APPLICATION PROBLEMS

AP2-1

a. E
b. F
c. E
d. E
e. E
f. F

AP2-2

a. R
b. F
c. F
d. R
e. R
f. F

AP2-3

a. Increase assets (cash) and increase shareholders' equity (common shares)
b. Decrease assets (cash) and increase assets (land)
c. Increase assets (accounts receivable) and increase shareholders' equity (sales revenue increases, which increases retained earnings)
d. Increase assets (cash) and decrease assets (accounts receivable)
e. Decrease assets (cash) and decrease shareholders' equity (dividends declared increases, which decreases retained earnings)
f. Increase assets (cash) and increase liabilities (bank loan)
g. Decrease assets (cash) and decrease shareholders' equity (interest expense increases, which decreases retained earnings)
h. Increase assets (inventory) and increase liabilities (accounts payable)
i. Decrease assets (cash) and decrease liabilities (accounts payable)
j. Decrease assets (cash) and decrease shareholders' equity (delivery expense increases, which decreases retained earnings)
k. Decrease assets (cash) and increase in assets (prepaid insurance) when payment is made. As insurance is used, decrease in assets (prepaid insurance) and a decrease shareholders' equity (insurance expense increases, which decreases retained earnings)
l. Decrease assets (increases accumulated depreciation, which is a contra asset) and decreases shareholders' equity (increases depreciation expense, which decreases retained earnings)

AP2-4

Account	Increase/Decrease
a. Cash (A)	Increase
Common Shares (SE)	Increase
b. Cash (A)	Increase
Bank Loan Payable (L)	Increase
c. Equipment (A)	Increase
Accounts Payable (L)	Increase
d. Inventory (A)	Increase
Cash (A)	Decrease
Accounts Payable (L)	Increase
e. Accounts Receivable (A)	Increase
Sales Revenue (SE)	Increase*
Cost of Goods Sold (SE)	Increase**
Inventory (A)	Decrease
f. Accounts Payable (L)	Decrease
Cash (A)	Decrease
g. Cash (A)	Increase
Accounts Receivable (A)	Decrease
h. Supplies (A)	Increase
Cash (A)	Decrease
i. Dividends Declared (SE)	Increase**
Cash (A)	Decrease
j. Interest Expense (SE)	Increase**
Interest Payable (L)	Increase
k. Accounts Payable (L)	Decrease
Cash (A)	Decrease
l. Supplies Expense (SE)	Increase**
Supplies (A)	Decrease

* Increase in Shareholders' Equity
** Decrease in Shareholders' Equity

AP2-5

AP2-5	Assets			Liabilities		S/H Equity		
Date	Cash	A/R	Inventory	A/P	Loan Payable	Common Shares	Retained Earnings	R/E/DD
Sept. 9	$8,500	$11,000					$19,500	R
Sept. 9			($11,200)				($11,200)	E
Sept. 11	$6,200	($6,200)						
Sept. 18			$7,800	$7,800				

AP2-6

AP2-6	Assets				Liabilities			S/H Equity		
Date Sept	Cash	A/R	Inv	Inflatable Equip	A/P	Unearned Revenue	Loan Payable	Common Shares	Retained Earnings	R/E/DD
1	260,000							260,000		
1	160,000						160,000			
3	(100,000)			140,000	40,000					
8			6,600		6,600					
11	2,500					2,500				
15	4,300	4,300							8,600	R
15			(5,700)						(5,700)	E
19	(1,700)				(1,700)					
23	3,400	(3,400)								
31	(3,000)						(3,000)			
31	(800)								(800)	E

$160,000 x 6% x 1/12 = $800

AP2-7

AP2-7	Assets					Liabilities		S/H Equity		
Date Sept	Cash	A/R	Inv.	Equip.	Delivery Van	A/P	Bank Loan Payable	Common Shares	R/E	R/E/DD
1	20,000							20,000		
4	10,000						10,000			
7	(4,500)			4,500						
9			2,500			2,500				
15		4,000							4,000	R
19			2,100			2,100				
20	(2,700)					(2,700)				
21	(15,000)				15,000					
28			(1,800)						(1,800)	E
28	(700)								(700)	E
29						400			(400)	E
30	(150)								(150)	E
30	2,200	(2,200)								

AP2-8

AP2-8	Assets				Liabilities			S/H Equity		
Date Jan	Cash	A/R	Inv.	Equip.	A/P	Wages Payable	Loan Payable	Common Shares	R/E	R/E/DD
1	12,500						12,500			
3	22,000							22,000		
5			24,700		24,700					
9	(4,000)			8,000	4,000					
15	16,000	9,000							25,000	R
15			(14,000)						(14,000)	E
19	(15,000)				(15,000)					
25	7,800	(7,800)								
27		10,500							10,500	R
28			(7,600)						(7,600)	E
28	(2,200)					200			(2,400)	E
28					800				(800)	E

AP2-9

AP2-9	Assets				Liabilities			S/H Equity		
Date Jan	Cash	A/R	Inv.	Prepaid Rent	A/P	Unearned Revenue	Loan Payable	Common Shares	R/E	R/E/D D
1	150,000							150,000		
1	100,000						100,000			
2	(8,000)			5,000					(3,000)	E
8			26,200		26,200					
12	6,500					6,500				
16	9,100	9,100							18,200	R
			(9,200)						(9,200)	E
19	(7,000)				(7,000)					
25	7,100	(7,100)								
31	(5,000)						(5,000)			
31	(750)*								(750)	E

*$100,000 x 9% x 1/12 = $750

AP2-10

	Net Income	Cash Flow
a.	No Effect	+$60,000
b.	No Effect	No Effect
c.	+$200 (sales revenue of $500, less cost of goods sold of $300)	No effect (sold on account, inventory already owned)
d.	No Effect	-$10,000
e.	No Effect	-$1,000
f.	-$300	No Effect
g.	No Effect	+$700
h.	No Effect	No Effect
i.	No Effect	-$2,000
j.	-$500	No Effect

AP2-11

	Assets						Liabilities		S/H Equity		
#	Cash	A/R	Inv.	Equip.	Land	Supplies	A/P	Bank Loan Payable	Common Shares	R/E	R/E /DD
A	150,000								150,000		
B	(25,000)				50,000		25,000				
C			45,000				45,000				
D		52,000								52,000	R
D			(35,000)							(35,000)	E
E	(1,000)						(1,000)				
F	25,000							25,000			
G				(1,200)						(1,200)	E
H	(750)					750					
I	(250)									(250)	E
J	(8,000)									(8,000)	DD

AP2-12

AP2-12	Assets					Liabilities		S/H Equity		
Date Nov	Cash	A/R	Prepaid Rent	Equip.	Supplies	A/P	Bank Loan Payable	Common Shares	R/E	R/E/ DD
1	30,000			20,000				50,000		
2	(1,500)								(1,500)	E
3					850	850				
4	2,400								2,400	R
5	(850)					(850)				
6		700							700	R
7					(350)				(350)	E
8	500	(500)								
9	(75)								(75)	E
10						250			(250)	E
11	(3,200)		3,200							

AP2-13

	Assets				Liabilities			S/H Equity		
#	Cash	A/R	Inven-tory	Equip-ment	A/P	Bank Loan Payable	Warranty Payable	Common Shares	R/E	R/E/DD
A			15,000		15,000					
B	(12,000)				(12,000)					
C	20,000	5,000							25,000	R
D	3,000	(3,000)								
E			(10,000)						(10,000)	E
F	25,000							25,000		
G	(500)				100				(600)	E
H	50,000					50,000				
I	(45,000)			45,000						
J	(9,000)								(9,000)	E
K					200				(200)	E

- All of the transactions with an “R” or and “E” will affect the statement of income.
- All of the transactions affecting the cash column will impact the statement of cash flows.

AP2-14

a. Selling inventory to customers for cash results in an increase in assets (cash) and a corresponding increase in shareholders’ equity (revenue increases) along with a decrease in assets (the inventory account) and a decrease in shareholders’ equity (cost of goods sold expense increases).

b. Selling inventory to customers on account results in an increase in assets (accounts receivable) and a corresponding increase in shareholders’ equity (revenue increases) along with a decrease in assets (the inventory account) and a decrease in shareholders’ equity (cost of goods sold expense increases).

c. Collecting cash from customers as payments on their accounts results in an increase in assets (cash) and a corresponding decrease in assets (accounts receivable).

AP2-14 (Continued)

d. Inventory purchased on account will increase the assets (inventory) and liabilities (accounts payable).

e. Paying suppliers for goods purchased on account results in a decrease in assets (cash) and a corresponding decrease in liabilities (accounts payable).

f. The purchase of equipment will increase the assets (equipment) and decrease the assets (cash).

g. If the insurance policy is paid in advance (as they usually are), assets (a prepaid insurance account) should be increased along with a decrease in assets (cash).

h. Borrowing money from the bank increases assets (cash) and liabilities (a bank loan payable).

i. The loan payment results in a decrease in assets (cash), a decrease in liabilities (bank loan payable) by the amount of the principal repayment, and a decrease in shareholders' equity (retained earnings is decreased by interest expense).

AP2-15

AP2-15	Assets				Liabilities			S/H Equity	
#	Cash	A/R	Inven-tory	Equip-ment	A/P	Loan Payable	Wages Payable	R/E	R/E/DD
a	15,000					15,000			
b	(900)							(900)	E
c	(10,000)			10,000					
d				(1,500)				(1,500)	E
e			87,500		87,500				
f	17,500	130,000						147,500	R
g			(85,000)					(85,000)	E
h	(73,000)				(73,000)				
i	116,000	(116,000)							
j							48,400	(48,400)	E
k	(47,200)						(47,200)		
l	(1,000)							(1,000)	DD

$15,000 x 6% = $900
($10,000 - $1,000) ÷ 6 = $1,500

AP2-16

AP2-16	Assets					Liabilities		S/H Equity	
#	Cash	A/R	Inventory	Equip-ment	Prepaid Insurance	A/P	Dividends Payable	R/E	R/E/DD
A	(10,000)			10,000					
B			42,000			42,000			
C	24,000	36,000						60,000	R
D	(36,000)					(36,000)			
E	34,000	(34,000)							
F	(900)				900				
G			(39,000)					(39,000)	E
H	(7,000)							(7,000)	E
I					(675)[i]			(675)	E
J				(3,600)				(3,600)	E
K							1,600	(1,600)	DD
L	(1,200)						(1,200)		

i - $900/12 = $75 per month x 9 months (i.e. Apr.-Dec.) = $675

AP2-17

a. $95,000
b. $107,000
c. $60,000 (no change)
d. $31,000
e. $59,000

AP2-18

Case 1
Case 2

a. 19, 000	**f.** 4, 000
b. 7, 500	**g.** 3, 000
c. 16, 000	**h.** 25, 500
d. 15, 500	**i.** 29, 000
e. 5, 000	**j.** 5, 000

AP2-19

Shareholders' Equity, 2016: $125,000-$85,000 = $40,000
Shareholders' Equity, 2015: $110,000-$80,000 = $30,000
Increase in Shareholders' Equity: $10,000

$7,000 of the increase was from issuance of shares.
$4,000 dividends were declared.

$10,000 increase - $7,000 shares + $4,000 dividends = $7,000 net income

Alternate:
Step 1: $30,000 (2015) + $7,000 (shares) - $4,000 (dividends) + ? (net income) = $40,000
Step 2: $33,000 + ? (net income) = $40,000

Therefore, net income = $7,000

AP2-20

a. Total revenue: $448,800 + $4,800 + $2,200 = $455,800
b. Total expense: $272,000 + $63,300 + $38,800 + $1,200 + $26,400 = $401,700
c. Net earnings: $455,800 - $401,700 = $54,100
d. Dividends declared: $96,000 + $54,100 - $105,600 = $44,500

AP2-20 (Continued)

Alternate:

Beg. R/E + net income – dividends declared = End R/E
$96,000 + $54,100 - ? (div. decl.) = $105,600
$150,100 - ? (div. decl.) = $105,600
? (div. decl.) = $150,100 - $105,600

Therefore, dividends declared = $44,500

AP2-21

a.

i. Sales revenue = $8,000 (#5)

ii. Cost of goods sold = $5,000 (#4)

iii. Total expenses = $400 (#6) + $100 (#7) + $1,900 (#8) = $2,400

iv. Net earnings = $8,000 - $5,000 - $2,400 = $600

b.

i. Cash on hand: $10,000 + $4,000 - $4,000 - $500 - $2,500 - $1,900 - $200 = $4,900

ii. Total assets other than cash: $1,000 + $4,000 + $500 + $5,000 - $5,000 + 4,000 - $400 - $100 = $9,000

Alternate:

Office furniture & Equip. = $1,000 + $4,000 - $100 = $4,900

Supplies = $500 - $400 = $100

Accounts Receivable = $4,000

There total assets other than cash = $4,900 + $100 + $4,000 = $9,000

iii. Total liabilities: $5,000 - $2,500 = $2,500

iv. Share capital: $10,000 + $1,000 = $11,000

v. Retained earnings: $0 + $600 - $200 = $400

AP2-22

a. Cash basis

	Revenue	Expense
i.	0	0
ii.	$115,000	0
iii.	$30,000	0
iv.	0	0
v.	0	$75,000
vi.	0	$32,500
vii.	0	$ 1,000

Net income: $145,000 - $108,500 = $36,500

b. Accrual basis

	Revenue	Expense
i.	$35,000	0
ii.	$115,000	0
iii.	0	0
iv.	0	$85,000
v.	0	0
vi.	0	$35,000
vii.	0	$ 500

Net income: $150,000 - $120,500 = $29,500

AP2-23

a. Cash basis

	Revenue	Expense
i.	0	0
ii.	$80,000	0
iii.	$20,000	0
iv.	0	$13,000
v.	0	$ 5,500
vi.	0	$37,500

Net income: $100,000 - $56,000 = $44,000

b. Accrual basis

	Revenue	Expense
i.	0	0
iii.	$100,000	$60,000
iii.	0	0
iv.	0	$12,000
v.	0	0
vi.	0	$ 5,000
vii.	0	$38,000

Net income (loss): $100,000 - $115,000 = ($15,000)

AP2-24 Retained earnings represents a company's accumulated net income that has not been distributed to shareholders as dividends. It is not necessarily a reflection of the amount of cash a company has available. Even though a company has retained earnings, it is very likely that they will have been reinvested in the company (i.e. additional inventory purchased, property, plant and equipment purchased, etc.) or they may have been used to repay debt.

AP2-25 The statement of income shows the revenue and expenses for a period of time, based on accrual accounting. Transactions are included regardless of when cash payments occur. The purpose of the statement of income is to show a complete reporting of the actual events that occurred during the period (i.e. all revenues earned and expenses incurred). It is a good representation of the results of management's efforts. At the end of the period the net income minus any dividends declared is added to retained earnings on the statement of financial position.

The statement of cash flows covers the same time period as the statement of income, however it only includes amounts paid or received in cash. The purpose of the statement of cash flows is to explain the change in the cash balance on the statement of financial position, from the beginning to the end of the period. It also classifies each cash transaction as an operating, financing, or investing activity. This allows users of the financial statements to understand where cash came from and where it was spent by the company.

AP2-26

a.

Sara's Bakery
Statement of Income
For the year ended December 31, 2016

Sales revenue		$178,000
Less operating expenses:		
Cost of goods sold	$101,000	
Wage expense	42,000	
Supplies expense	14,000	
Depreciation expense	2,500	
Rent expense	12,000	
Total expenses		171,500
Net Income		$ 6,500

AP2-26 (Continued)

b. We did not use the following items on the statement of income:

1. **Cash** – This is an asset and belongs on the statement of financial position. It is measured at a point in time.
2. **Accounts payable** – This liability item represents an obligation that Sara's Bakery has to its suppliers/creditors. It is also measured at a point in time and belongs on the statement of financial position.
3. **Common shares** – This is a component of shareholders' equity on the statement of financial position. It represents the amount received by the company on the initial issuance of common shares. It does not measure performance of the company's operations, and thus, does not belong on the statement of income.
4. **Accounts receivable** – This asset arises when a customer buys goods or services on credit. Sales revenue on the statement of income *already includes* this amount (the sales made on credit) because accrual accounting records a transaction (like the sale of goods and services) in the period it occurs, not when cash is paid. Accounts receivable is not part of a company's operating performance. Rather, it tells us the amount of cash that is owed to a company by its customers.
5. **Equipment** – This is a part of the asset section of the statement of financial position. Equipment is not part of the statement of income.
6. **Retained Earnings** – This is a component of shareholder's equity on the statement of financial position. It represents the cumulative net earnings less any dividends declared over the life of the organization.
7. **Supplies –** This represents the supplies that Sara's Bakery purchased but have not used in the operations. These supplies are an asset and are a part of the statement of financial position.
8. **Prepaid Rent –** Is a component of the statement of financial position under the asset section. The prepaid rent has not been used so it is not an expense until it is used.

AP2-26 (Continued)

9. **Wages payable** – This liability item reflects the wages owed by Sara's Bakery to its employees for hours worked but not yet paid. Wage expense, however, already includes the amount of wages payable on the statement of income because accrual accounting records an expense in the period that it occurs, not when cash is paid. Wages payable is listed as a liability on the statement of financial position.

10. **Dividends declared** - The payment of dividends is not recorded as an expense on the statement of income because it is not part of the operating performance of Sara's Bakery. Dividends are declared when the company's Board of Directors decides that it does not need to retain all of a company's past profits in the business to fund expansion. If the company has no need for these profits, they are paid out to the shareholders with the declaration of a dividend. Dividends declared appear on the statement of changes in equity.

AP2-27

a.

The Garment Tree Ltd.
Statement of Income
For the year ended December 31, 2016

Sales revenue		$110,000
Less expenses:		
Cost of goods sold	$57,000	
Wage expense	32,000	
Rent expense	12,000	
Advertising expense	5,000	
Miscellaneous expense	3,000	
Total expenses		109,000
Net income		$ 1,000

AP2-27 (Continued)

b. We did not use the following items on the statement of income:

1. **Wages payable** – This liability item reflects the wages owed by The Garment Tree Ltd. to its employees for hours worked but not yet paid. Wage expense, however, already includes the amount of wages payable on the statement of income because accrual accounting records an expense in the period that it occurs, not when cash is paid. Wages payable is listed as a liability on the statement of financial position.

2. **Prepaid Rent –** Is a component of the statement of financial position under the asset section. The prepaid rent has not been used so it is not an expense until it is used.

3. **Accounts payable** - This liability item represents an obligation that The Garment Tree Ltd. has to its suppliers/creditors. It is also measured at a point in time and belongs on the statement of financial position.

4. **Accounts Receivable -** This asset arises when a customer buys goods or services on credit. Sales revenue on the statement of income *already includes* this amount (the sales made on credit) because accrual accounting records a transaction (like the sale of goods and services) in the period it occurs, not when cash is paid. Accounts receivable is not part of a company's operating performance. Rather, it tells us the amount of cash that is owed to a company by its customers.

5. **Inventory** – This asset on the statement of financial position is not placed on the statement of income because it represents the cost of inventory that is sitting on shelves or in a warehouse. Once the products are sold to customers, accrual accounting takes the cost of the inventory and records it as cost of goods sold. In the meantime, inventory remains an asset on the statement of financial position, representing the cost of products not yet sold.

6. **Retained Earnings** – This is a component of shareholder's equity on the statement of financial position. It represents the cumulative net earnings less any dividends declared over the life of the organization.

AP2-27 (Continued)

7. **Cash** – This is a statement of financial position account representing the cash held by the organization at one point in time.

8. **Dividends declared** – The payment of dividends is not recorded as an expense on the statement of income because it is not part of the operating performance of The Garment Tree Ltd. Dividends declared occurs when the company's Board of Directors decides that it does not need to retain all of a company's past profits in the business to fund expansion. If the company has no need for these profits, they are paid out to the shareholders with the declaration of a dividend.

9. **Common shares** – This is a component of shareholders' equity on the statement of financial position. It represents the amount received by the company on the initial issuance of common shares. It does not measure performance of the company's operations, and thus, does not belong on the statement of income.

AP2-28

Tree Top Restaurant Ltd.
Statement of Financial Position
As at December 31, 2016

ASSETS	
Current assets	
Cash	$ 53,000
Accounts receivable	90,000
Inventory	46,000
Prepaid insurance	8,000
	197,000
Non-current assets	
Equipment	80,000
Buildings	230,000
Land	100,000
	410,000
Total Assets	$607,000

AP2-28 (Continued)

LIABILITIES & SHAREHOLDERS' EQUITY	
Current liabilities	
Accounts payable	$ 82,000
Income taxes payable	5,000
Wages payable	10,000
	97,000
Non-current liabilities	
Bank loan payable	250,000
Total liabilities	347,000
Shareholders' equity	
Commons shares	200,000
Retained earnings	60,000
Total Shareholders' equity	260,000
Total Liabilities and Shareholders' Equity	$607,000

AP2-29

a.

Sales revenue		$69,900
Less expenses:		
Cost of goods sold	$34,900	
Wage expense	26,000	
Rent expense	3,600	
Advertising expense	800	
Utilities expense	300	
Interest expense	100	
Depreciation expense	500	
Miscellaneous expenses	400	
Total expenses		66,600
Net income		$ 3,300

b.

Beginning balance	$ 0
Plus: Net income	3,300
Less: Dividends declared	1,200
Ending balance	$ 2,100

AP2-29 (Continued)

c.

Little Tots Ltd.
Statement of Financial Position
As at December 31, 2016

ASSETS	
Current assets	
Cash	$3,500
Accounts receivable	2,500
Prepaid rent	300
Inventory	8,000
	14,300
Non-current assets	
Equipment	5,000
Total Assets	$19,300
LIABILITIES & SHAREHOLDERS' EQUITY	
Current liabilities	
Accounts payable	$2,000
Wages payable	400
	2,400
Non-current liabilities	
Bank loan payable	4,800
Total Liabilities	7,200
Shareholders' equity	
Common shares	10,000
Retained earnings	2,100
Total Shareholders' equity	12,100
Total Liabilities and Shareholders' equity	$19,300

AP2-30

a. To identify the statement of income accounts and calculate net income, a statement of income for Minute Print Company is presented below.

Minute Print Company
Statement of Income
For the year ended December 31, 2016

Sales		$486,000
Less expenses:		
Supplies expense	$214,500	
Wage expense	93,000	
Interest expense	2,500	
Rent expense	12,000	
Miscellaneous expenses	9,000	
Total expenses		331,000
Net Income		$ 155,000

b.

Net Income	$155,000
Less: dividends declared	3,000
Retained earnings at Dec 31, 2016	$152,000

AP2-30 (Continued)

c.

Minute Print Company
Statement of Financial Position
As at December 31, 2016

ASSETS		
Current assets		
Cash	$ 24,000	
Accounts receivable	30,000	
Supplies	68,000	
Prepaid rent	2,000	
		$124,000
Non-current assets		
Equipment		112,000
Total Assets		$236,000
LIABILITIES & SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$8,000	
Wages payable	4,500	
Dividends payable	1,500	
		$14,000
Non-current liabilities		
Bank loan payable		40,000
Total Liabilities		$54,000
Shareholders' equity		
Common shares	$ 30,000	
Retained earnings	152,000	
Total shareholders' equity		182,000
Total Liabilities and Shareholders' Equity		$236,000

AP2-31

a.

The Wizard's Corner
Statement of Income
For the year ended June 30, 2016

Sales		$160,000
Less expenses:		
Cost of goods sold	$103,000	
Wage expense	36,000	
Rent expense	12,000	
Advertising expense	6,000	
Depreciation expense	2,000	
Total expenses		159,000
Net Income		$ 1,000

b.

Retained Earnings at July 1, 2015	$21,000
Plus: Net Income	1,000
Less: dividends declared	3,000
Retained earnings at June 30, 2016	$19,000

AP2-31 (Continued)

c.

The Wizard's Corner
Statement of Financial Position
As at June 30, 2016

ASSETS	
Current assets	
Cash	$ 10,000
Accounts receivable	15,000
Inventory	28,000
Prepaid rent	1,000
	$ 54,000
Non-current assets	
Equipment	11,000
Total Assets	$ 65,000
LIABILITIES & SHAREHOLDERS' EQUITY	
Current liabilities	
Accounts payable	$11,000
Wages payable	2,000
	13,000
Total liabilities	13,000
Shareholders' equity	
Common shares	$ 33,000
Retained earnings	19,000
Total Shareholders' Equity	52,000
Total Liabilities and Shareholders' Equity	$ 65,000

AP2-32

a.

AP2-32	Assets					Liabilities				S/H Equity		
#	Cash	A/R	Inventory	Land	Building	A/P	Bank Loan Payable	Wages Payable	Dividends Payable	Common Shares	R/E	R/E/ DD
1	250,000									250,000		
2	50,000						50,000					
3	(200,000)			60,000	140,000							
4			130,000			130,000						
5	30,000	175,000									205,000	R
6			(120,000)								(120,000)	E
7	(115,000)					(115,000)						
8	155,000	(155,000)										
9	(55,000)							2,000			(57,000)	E
10	(3,000)*										(3,000)	E
11					(4,000)**						(4,000)	E
12									7,000		(7,000)	DD
Total	112,000	20,000	10,000	60,000	136,000	15,000	50,000	2,000	7,000	250,000	14,000	

***$50,000 x 6% = $3,000**
**** ($140,000 - $ 20,000) ÷ 30 = $4,000**

AP2-32 (Continued)

b.

Singh Company
Statement of Income
For the Year Ending December 31, 2016

Revenues		
Sales		$205,000
Expenses		
Cost of goods sold	$120,000	
Wage expense	57,000	
Interest expense	3,000	
Depreciation expense	4,000	184,000
Net income		$ 21,000

Singh Company
Statement of Changes in Equity
For the year ended December 31, 2016

	Number of Common Shares	Share Capital - Common Shares	Retained Earnings	Total
Balance, Beginning of Year			$0	$0
Net Income			21,000	21,000
Declaration of Dividends			(7,000)	(7,000)
Issuance of Common Shares	10,000	$250,000		250,000
Balance, End of Year	10,000	$250,000	$14,000	$264,000

AP2-32 (Continued)

Singh Company
Statement of Financial Position
As at December 31, 2016

ASSETS	
Cash	$112,000
Accounts Receivable	20,000
Inventory	10,000
Land	60,000
Building	136,000
TOTAL ASSETS	$338,000
LIABILITIES	
Accounts Payable	$ 15,000
Wages Payable	2,000
Dividends Payable	7,000
Bank Loan Payable	50,000
TOTAL LIABILITIES	$ 74,000
SHAREHOLDERS' EQUITY	
Common Shares	250,000
Retained Earnings	14,000
TOTAL SHAREHOLDERS' EQUITY	$264,000
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$338,000

AP2-32 (Continued)

Singh Company
Statement of Cash Flows
For the Year Ending December 31, 2016

Cash Flow from Operating Activities:	
Cash collections from customers	$185,000
Cash payments to suppliers	(115,000)
Cash payments for wages	(55,000)
Cash payments for interest	(3,000)
Cash flows from operating activities	$12,000
Cash Flow from Investing Activities:	
Purchase of land and building	(200,000)
Cash used in investing activities	(200,000)
Cash Flow from Financing Activities:	
Cash proceeds from issuance of shares	$ 250,000
Cash proceeds from bank loan	50,000
Cash from financing activities	300,000
TOTAL INCREASE IN CASH	112,000
Cash, beginning of year	0
Cash, end of year	$112,000

AP2-33

a.

	Assets					Liabilities		S/H Equity		
#	Cash	A/R	Inven-tory	Prepaid Rent	Equip-ment	A/P	Note Payable	Common Shares	R/E	R/E/ DD
1	175,000							175,000		
2	225,000						225,000			
3	(75,000)			75,000						
3				(60,000)					(60,000)	E
4	(220,000)				220,000					
5	(90,000)		90,000							
6			570,000			570,000				
7	80,000	720,000							800,000	R
8	650,000	(650,000)								
9	(510,000)					(510,000)				
10			(560,000)						(560,000)	E
11	(82,500)					4,000			(86,500)	E
12	(47,500)						(25,000)		(22,500)*	E
13					(20,000)				(20,000)**	E
14	(7,000)								(7,000)	DD
Totals	98,000	70,000	100,000	15,000	200,000	64,000	200,000	175,000	44,000	

*$225,000 x 10% = $22,500
** ($220,000 - $ 20,000) ÷ 10 = $20,000

b.

Hughes Tools Company
Statement of Income
For the year ended September 30, 2016

Sales revenue		$800,000
Expenses		
Cost of goods sold	$560,000	
Rent expense	60,000	
Depreciation expense	20,000	
Interest expense	22,500	
Selling and administrative	86,500	749,000
Net earnings		$ 51,000

AP2-33 (Continued)

The Hughes Tool Company
Statement of Changes in Equity
For the year ended September 30, 2016

	Number of Common Shares	Share Capital - Common Shares	Retained Earnings	Total
Balance, Beginning of Year			$0	$0
Net Income			51,000	51,000
Declaration of Dividends			(7,000)	(7,000)
Issuance of Common Shares	10,000	$175,000		175,000
Balance, End of Year	10,000	$175,000	$44,000	$219,000

Hughes Tools Company
Statement of Financial Position
As at September 30, 2016

Assets	
Cash	$ 98,000
Accounts receivable	70,000
Inventory	100,000
Prepaid rent	15,000
Equipment	200,000
Total assets	$483,000
Liabilities	
Accounts payable	$ 64,000
Notes payable	200,000
Total liabilities	264,000
Shareholders' equity	
Common shares	175,000
Retained earnings	44,000 *
Total shareholders' equity	219,000
Total liabilities and shareholders' equity	$483,000

*Net income – dividends declared = $51,000 – $7,000 = $44,000

AP2-33 (Continued)

Hughes Tools Company
Statement of Cash Flows
For the year ended September 30, 2016

Cash flows from operating activities		
Cash receipts from customers	$730,000	
Cash paid for inventory	(600,000)	
Cash paid for interest	(22,500)	
Cash paid for selling and administrative expenses	(82,500)	
Cash paid for rent	(75,000)	
Cash used in operating activities		$(50,000)
Cash flows from investing activities		
Purchase of equipment		(220,000)
Cash flows from financing activities		
Issuance of shares	175,000	
Issuance of note payable	225,000	
Repayment of note payable	(25,000)	
Payment of dividends	(7,000)	
Cash from financing activities		368,000
Increase in cash		$98,000
Cash, beginning of the year		0
Cash, end of the year		$98,000

c. The results of the first year of operations are generally very good. The sales are excellent, with a healthy profit margin ($51,000/$800,000) 6.4%, and the business has a very substantial cash balance. However, cash flow from operations is negative, which may be a cause for concern.

The company's return on assets measures 10.6% ($51,000/$483,000) and their return on equity comes in at 23.3% ($51,000/$219,000). As it is their first year of operations we will want to compare these results to industry averages to have a better understanding of this company's performance.

AP2-34

a.

	Assets						Liabilities					S/H Equity		
#	Cash	A/R	Inventory	Land	Building	Equipment	A/P	Unearned Revenue	Interest Payable	Dividends Payable	Notes Payable	Common Shares	R/E	R/E/ DD
1	300,000											300,000		
2	(80,000)			57,500	172,500							150,000		
3	30,000							7,500					22,500	R
4	(60,000)					120,000					60,000			
5			250,000				250,000							
6	50,000	250,000											300,000	R
7			(190,000)										(190,000)	E
8	(205,000)						(205,000)							
9	200,000	(200,000)												
10	(50,000)												(50,000)	E
11*					(7,125)								(7,125)	E
12**						(5,750)							(5,750)	E
13	(15,000)									5,000			(20,000)	DD
14***									3,000				(3,000)	E
Totals	170,000	50,000	60,000	57,500	165,375	114,250	45,000	7,500	3,000	5,000	60,000	450,000	46,625	

*($172,500 – $30,000) ÷ 20 = $7,125

**($120,000 – $5,000) ÷ 10 x 1/2 = $5,750

***$60,000 x 10% x 6/12 = $3,000

AP2-34 (Continued)

b.

A.J. Smith Company
Statement of Income
For the year ended December 31, 2016

Sales revenue		$300,000
Rent revenue		22,500
Total revenues		$322,500
Expenses		
Cost of goods sold	$190,000	
Depreciation expense	12,875	
Interest expense	3,000	
Operating expenses	50,000	255,875
Net earnings		$ 66,625

A. J. Smith Company
Statement of Changes in Equity
For the year ended December 31, 2016

	Number of Common Shares	Share Capital - Common Shares	Retained Earnings	Total
Balance, Beginning of Year			$0	$0
Net Income			66,625	66,625
Declaration of Dividends			(20,000)	(20,000)
Issuance of Common Shares	12,000	$300,000		300,000
Issuance of Common Shares	6,000	$150,000		150,000
Balance, End of Year	18,000	$450,000	$46,625	$496,625

AP2-34 (Continued)

A.J. Smith Company
Statement of Financial Position
As at December 31, 2016

Assets	
Cash	$170,000
Accounts receivable	50,000
Inventory	60,000
Land	57,500
Building, net	165,375
Equipment, net	114,250
Total assets	$617,125
Liabilities	
Accounts payable	$ 45,000
Notes payable	60,000
Interest payable	3,000
Unearned revenue	7,500
Dividends payable	5,000
Total liabilities	120,500
Shareholders' Equity	
Common shares	$450,000
Retained earnings	46,625
Total retained earnings	496,625
Total liabilities and shareholders' equity	$617,125

AP2-34 (Continued)

A.J. Smith Company
Statement of Cash Flows
For the year ended December 31, 2016

Cash flows from operating activities		
Cash receipts from customers	$250,000	
Cash receipts from rent revenue	30,000	
Cash paid for inventory	(205,000)	
Cash paid for operating expenses	(50,000)	
Cash from operating activites		$25,000
Cash flows from investing activities		
Purchase of capital assets		(140,000)
Cash flows from financing activities		
Issuance of shares	300,000	
Payment of dividends	(15,000)	
Cash from financing activities		285,000
Increase in cash		$170,000
Beginning cash balance		0
Ending cash balance		$170,000

c. Students should utilize the three performance measures introduced in the chapter:
Profit margin ratio (using total revenues): $66,625/$322,500 = 20.7%
Return on Assets: $66,625/$617,125 = 10.8%
Return on Equity: $66,625/$496,625 = 13.4%
Ideally, they should consider these numbers with respect to industry averages; however, these are not provided.
Students should also identify from the cash flow statement that positive cash flows were generated from operating activities, which is a good sign – especially in the company's first year of operations.

AP2-35

a. Borrower: + Assets (Cash) = + Liabilities (Bank Loan Payable)
Bank: - Assets (Cash) = + Assets (Loans Receivable)

b. Seller: + Assets (Cash) = + Equity (Sales Revenue)
Customer: - Assets (Cash) = - Equity (Operating Expense)

c. Company A: - Assets (Cash) = + Assets (Investments)
Company B: + Assets (Cash) = + Equity (Common Shares)

d. Company A: - Assets (Cash) = + Assets (Investments)
Company B: no impact: shares have been previously issued

e. Buyer: + Assets (Inventory) = + Liabilities (A/P)
Seller: + Assets (A/R) = + Equity (Sales Revenue)
- Assets (Inventory) = - Equity (Cost of Goods Sold)

USER PERSPECTIVE SOLUTIONS

UP 2-1 Most public companies operate internationally and a significant number of them are also cross-listed, meaning that they are listed on stock exchanges both inside and outside of Canada. This common set of financial reporting standards was developed to minimize the differences in financial reporting across countries and to reduce the need for companies to generate different sets of financial information in each country in which they operate or raise funds. ASPE, on the other hand, represents a set of simplified standards that Canadian standards setters have established to reduce the financial reporting burden for private companies.

The objective of both IFRS and ASPE is to produce financial reporting that is useful to the financial statement users. Both IFRS and ASPE focus on the needs of shareholders (current and potential) and creditors in determining the financial information that would be useful. Specifically, the standards' aim is to provide financial information that assists these two user groups in making decisions about providing resources to the reporting company, such as whether they should buy or sell the reporting company's shares, and whether they should extend credit to the reporting company. The needs of these two user groups often correspond with the needs of other users, such as employees, unions, and governments, but they may not completely overlap.

UP2-2 Following are some suitable answers. There may be other valid responses.

I would like to know how the additional funds will be used by the borrower. If the business demonstrates that it will be able to increase profitability and cash flows from operations from the use of the additional funds, the request will be viewed in a positive light.

I would want to know how much profit the company has made to date. I would look at retained earnings for this information. I would want to know if past sales levels and profits are sustainable in the future.

I would also look at the company's current and non-current liabilities to find out what other obligations the company currently has that require repayment. I would want to know whether the company was paying its current loan payments on schedule.

UP2-2 (Continued)

I would look at the mix between liabilities and equity to determine how the company has funded its operations so far. I would want to know how much was funded through debt and how much was funded through investments from shareholders.

I would want to know what capital assets the company owns, and the age and condition of those assets in order to determine whether they will need replacing in the near future. If they do, that could possibly compromise the company's ability to use them to generate revenue. I could determine the age of the assets by looking at their original cost vs. the amount of cost that has been depreciated to date.

UP2-3

a. From the perspective of a shareholder of the company, treating the cost of a piece of equipment as an expense at the date of purchase is likely to misstate net income in the current period as well as in future periods. The current period's income would be understated because the full cost of the equipment would be deducted in the current period rather than being depreciated and allocated to each of the future periods in which it is expected to help generate revenue (i.e. the estimated useful life of the asset). Future periods' income will be overstated since there will be revenue shown in those periods, but no expense related to the cost of the equipment being used to do so. In addition there would be no equipment on the statement of financial position.

b. From the perspective of a buyer, the concern would be the equipment would not be listed on the statement of financial position of the company (since it would already have been expensed). In attempting to value the assets of the company, the buyer would have to recognize that there are some assets that do not appear on the statement of financial position, but should be considered in valuing the company. In addition, the balance of retained earnings would be lower because the full cost of the equipment had been charged to an expense at its purchase.

UP2-4 When the cash is received in August, the university would record a liability, unearned revenue. As each month passes, a portion of the unearned revenue would be recognized as revenue, thus decreasing the liability and increasing retained earnings. Most likely, the university would recognize the revenue evenly over the months of September through December, as the tuition would cover the December exam period.

UP2-5 The statement of income and the statement of financial position are both prepared using accrual accounting. These financial statements may show strong earnings, yet the company may have problems making loan payments if most of its sales were on credit, and if it then has problems collecting from its customers.

On the statement of financial position, a user can see the change in cash from the beginning of the year to the end of the year. There may be a very small change; however there may be thousands of cash transactions during the year. The statement of cash flows categorizes all cash transactions into operating, investing, and financing activities. This allows the user to determine where cash is coming from and where it is going. It is particularly important to know whether the company can pay for its current obligations to vendors and employees through cash generated from operations. If the company has to sell its property, plant and equipment in order to pay for its operating expenses, then the company may be in serious jeopardy of not being able to continue.

UP2-6 I would tell my friend NOT to invest in this company because it is not generating enough cash from operations (i.e. it has negative cash flows from operating activities) to cover its operating expenses. It appears that the company is selling its property, plant and equipment (i.e. it has positive cash flows from investing activities). The normal balance for investing should be negative, indicating that the company is using cash to acquire property, plant and equipment to grow its business and increase its operating profits. A company that sells its property, plant and equipment may soon have to go out of business as it has no means to generate income.

READING AND INTERPRETING PUBLISHED FINANCIAL STATEMENTS SOLUTIONS

RI2-1: New Flyer Industries

All dollar amounts are expressed in thousands of US dollars.

a. Growth from 2012 to 2013.

i.	Revenue	+38.6%	((1,199,424 – 865,250) / 865,250)
Ii	Cost of sales	+36.3%	((1,078,657 – 791,480) / 791,480)
iii.	Net earnings	+188.1%	((26,761 – 9,290) / 9,290)
iv.	Total assets	+26.6%	((1,135,852 – 897,224) / 897,224)
v.	Total equity	+32.3%	((455,180 – 343,988) / 343,988)

We would not generally expect all of these accounts to grow at the same rate for a variety of reasons. For example:

- Sales can increase as a result of a more aggressive pricing policy or as a result of increased spending on advertising, which would each lead to a lower profit as a percentage of sales.
- An investment in assets may not immediately lead to an increase in sales.
- Cost of sales increased at a lower rate than sales, indicating that some cost savings or efficiencies were achieved. Overall profit increase of 188.1% was achieved through increase earnings from operations and lower interest expense.
- Equity balances are affected by the issuance of new shares, by the rate of profitability, and by the dividend policy, among other things. New Flyer issued shares in 2013, increasing the company's share capital by US$112,290, ($589,208 – $476,918) a 23.5% increase. While share issuances are made more attractive by increased sales or profits, it is unlikely that they will change at exactly the same rate.

RI2-1(Continued)

It appears that New Flyer is in a phase of healthy growth, and that investments in the firm and its assets are leading to increased sales. Additional information, especially in the Management Discussion and Analysis section of the annual report, should help to clarify the meaning of these changes and the prospects for further growth.

b.

	2013		2012	
Total liabilities	$680,672	59.9%	$553,236	61.7%
Total S/H equity	455,180	40.1%	343,988	38.3%
Total Assets	$1,135,852	100%	$897,224	100%

The equity investors financed slightly more of the company in 2013 than they did in 2012. In 2012, equity investors had financed 38.3% of the company's assets. In 2013, this grew to 40.1%.

c. (Note: ratios are computed using ending equity and assets, and interest expense is not added back to income for the ROA calculation, as that idea has not been introduced in the text).

	2013	2012
Profit margin	26,761/1,199,424 = 2.2%	9,290/865,250 = 1.1%
ROA	26,761/1,135,852 = 2.4%	9,290/897,224 = 1.0%
ROE	26,761/455,180 = 5.9%	9,290/343,988 = 2.7%

These ratios each indicate a positive change in performance, with all ratios improving significantly. This is good news for a company that has negative retained earnings (deficit). It appears that problems from the past may have been solved, and the company has returned to profitability.

Comments could include:

- The profit margin doubled, which is consistent with the growth in profitability having been greater than the growth in sales.
- Return on assets also more than doubled, suggesting that assets are being used more efficiently.

RI2-1(Continued)

- Return on equity aligns with the previous two indicators, more than doubling from 2012 to 2013. This indicated that shareholders' investments are being used to generate profit.
- The results from part (a) do help interpret the ratios in part (c) because where we see growth year over year we would expect to see increased ROA and ROE.

RI2-2: High Liner Foods

All dollar amounts are expressed in thousands of US dollars.

a. The $80,260 in common shares represent the net proceeds received from shareholders at the time the shares were issued.

b. The $90,792 in retained earnings represents the cumulative lifetime income that the company has earned, less all dividends paid out during that period. In other words, it represents the company's cumulative earnings that have been retained and reinvested in the company, rather than being distributed to shareholders as dividends.

c. 2013: $491,807 / $676,456 = 72.7%
2012: $478,473 / $631,827 = 75.7%

There is a slight decrease in the percentage of High Liner's assets that were financed by creditors.

d. Total assets grew to $676,456 in 2013 from $631,827 in 2012. This increase of $44,629 (7.1%) comes largely from three accounts, accounts receivable, inventory, and property, plant and equipment.

e. If High Liner were to pay the income taxes payable, both assets and liabilities would decrease by the same amount and shareholders' equity would not change. The expense related to these income taxes has already been recognized (i.e. it was recorded at the same time as the payable). The basic accounting equation would remain in balance.

RI2-2 (Continued)

f. Gross Profit Percent

2013 $215,417 / $947,301 = 22.7%
2012 $206,661 / $942,631 = 21.9%

High Liner's gross profit was slightly higher in 2013 relative to 2012. Sales have increased at a greater rate than the cost of sales. The company is making slightly more gross profit on each dollar of sales revenue.

g. Gross profit from the Operating Segment Information, two countries:

Canada	2013	$73,190 / $303,589 = 24.1%
	2012	$69,214 / $312,884 = 22.1%
US	2013	$142,227 / $643,712 = 22.1%
	2012	$137,447 / $629,747 = 21.8%

As a percentage, High Liner's Canadian operations were more profitable than its US operations in both 2013 and 2012. Both operations experienced increases in gross profit in 2013, with the Canadian operations seeing the larger percentage increase. However, in dollars, the US operations are almost twice the size of the Canadian operations.

RI2-3: DHX Media

All dollars amounts are expressed in thousands of Canadian dollars.

a. At June 30, 2013, DHX had $12,640 cash available to use.

b. 2013: $162,875 / $324,397 = 50.2%
2012: $78,900 / $134,961 = 58.5%

The percentage of DHX's assets financed by shareholders decreased by 8.3% in 2013. This trend means that the company's creditors financed a greater proportion of the company's assets than in the previous year.

RI2-3 (Continued)

c. Accounts (Amounts) receivable increased by $31,026 (74.2%). Revenue increased by $24,616 (33.9%). This may means that credit sales have increased quicker than other sales, that customers are taking longer to pay, or that credit terms have changed.

d. Direct production costs: 2013: $45,117 / $97,263 = 46.4%
2012: $47,928 / $72,647 = 66.0%

Selling, general, admin: 2013: $31,886 / $97,263 = 32.8%
2012: $16,077 / $72,647 = 22.1%

The percent of costs spent on direct production has dropped significantly, while the percent spent on selling, general, and admin has increased. These inverse trends may be related to the company's strategy of spending relatively less on direct production costs in fiscal 2013, because the major investment was made earlier in fiscal 2012. On the other hand, the administrative and selling expenses had to increase to generate the increased revenue.

Other explanations could be that the company produced less expensive programs that required more promotion or that they generated revenues from older programs that had been produced in previous years (i.e. syndication).

e. The financing section of the statement of cash flows shows $1,535 of dividends paid in 2013.

f. The company acquired $1,455 of property and equipment. It sold property and equipment for proceeds totalling 5,214. The company generated more cash from the sale of property and equipment than it invested purchasing new property and equipment.

g.

	2013	2012
Profit margin:	$1,860 / $97,263 = 1.9%	$3,047 / $72,647 = 4.2%
ROA	$1,860 / $324,397 = 0.6%	$ 3,047 / $134,961 = 2.3%
ROE	$1,860 / $162,875 = 1.1%	$3,047 / $78,900 = 3.9%

RI2-3 (Continued)

h. These ratios indicate significant declines in the margins and returns realized, and would be a cause for concern especially since revenues increased 33.9% (($97,263 – $72,647) / $72,647).

RI2-4: WestJet Airlines Ltd.

(Amounts in thousands of Canadian dollars)

a. Cash collected from customers in 2013 =
opening accounts receivable + sales – ending accounts receivable
$37,576 + $3,662,197 – $42,164 = $3,657,609

b. WestJet does not report a cost of goods sold account on their statement of income because the nature of the business does not involve the sale of goods.

c. *Advance ticket sales,* among the current liabilities, represent the selling price of tickets that had been purchased by the statement of financial position date (i.e. the company's year-end) relating to travel that will take place after that date. It is essentially unearned revenue. This liability decreases when the tickets are used for completed air travel or refunded to the customer.

d. WestJet spent $112,362 in 2013 to reacquire shares. This would have the effect of decreasing Assets and Shareholders' Equity by that amount. The accounting equation would remain in balance.

e. WestJet spent $639,592 on acquiring new aircraft in 2013. If these acquisitions were financed with long-term debt, the accounts "property and equipment" and "long term debt" would both increase by that amount (i.e. assets and liabilities would both increase).

RI2-5: WestJet Airlines Ltd.

a.

i. Profit margin ratio	2013: \$268,722 / \$3,662,197 = 7.3%
	2012: \$242,392 / \$3,427,409 = 7.1%
ii. Return on assets	2013: \$268,722 / \$4,143,463 = 6.5%
	2012: \$242,392 / \$3,746,615 = 6.5%
iii. Return on equity	2013: \$268,722 / \$1,589,840 = 16.9%
	2012: \$242,392 / \$1,472,305 = 16.5%

b. WestJet's profitability shows positive results from 2012 to 2013, with a slight increase in the profit margin ratio and a slight increase in the return on equity. Return on assets held steady, showing that the company's rate of return remained constant in spite of an increase in total assets (i.e. the return on those additional assets was the same as the return on the existing assets). The company generated almost a 17% return on equity which is a solid return enabling it to continue to grow its operations while also distributing \$52,188 of its profits as dividends to its shareholders.

RI2-6: Cineplex Inc.

All dollars amounts are express in thousands of Canadian dollars).

a. The amount of dividends *declared* during fiscal 2013, as shown in the statement of changes in equity, was \$88,619.

b. The declaration of dividends affects the accounting equation by reducing shareholders equity and increasing liabilities (i.e. dividends payable) by the amount of the dividends declared.

c. The amount of dividends actually *paid* during fiscal 2013 was \$88,130, as shown on the statement of cash flows.

RI2-6 (Continued)

d. The payment of dividends affects the accounting equation by reducing cash by the amount paid and reducing the dividends payable liability by the same amount.

e. Gross margin on concession sales:

	2013	2012
Concession Revenues	$350,353	$329,332
Concession Costs	74,693	68,398
Gross Margin	$275,660	$260,934
	78.7%	79.2%

The gross margin on concession sales decreased by approximately 0.05%, meaning that the company's gross margin on concession sales stayed almost constant from 2012 to 2013. Based on these calculations, we see that the company's product costs represented about $0.21 for every $1 in concession sales.

f. Cineplex's cash flow pattern in 2013 was +/-/+, which fits the "normal" pattern discussed in the chapter.

g. The largest two expenses included in "Other Costs" on Cineplex's statement of income are employee salaries and benefits at $191,286 and rent at $127,745. Significant staff costs makes sense as a high staff level is required to manage ticket and concession sales, and to assist with customers attending movies. Movie theaters are also dependant on having good, accessible locations like shopping malls to show movies, so high rent expense is expected in this line of business.

RI2-7

Answers to this question will depend on the company selected.

CASE SOLUTIONS

C2-1a.

	Cash	A/R	Car	A/P	Interest Payable	Loan - Parents	Loan - Car	Common Shares	R/E	
1	1,800							1,800		
2	3,000					3,000				
3	(3,000)		8,000				5,000			
4	(623)						(500)		(123)	E - Int
5					60				(60)	E - Int
6	(6,000)								(6,000)	E - Wages
7	(9,600)			100					(9,700)	E - Op
8	19,200	300							19,500	R
9			(2,000)						(2,000)	E - Dep
Total	4,777	300	6,000	100	60	3,000	4,500	1,800	1,617	
					11,077				11,077	

Depreciation calculation: ($8,000 - $6,000)
Interest expense on loan from parents: $3,000 x 6% x 4 / 12 = $60

C2-1 (Continued)

Wroad Wrunner Ltd.
Statement of Income
For the four months ending August 31, 2XXX

Revenue		$ 19,500
Expenses:		
Interest expense – Loan from parents	$ 60	
Interest expense – Car loan	123	
Wage expense	6,000	
Operating expenses	9,700	
Depreciation expense	2,000	
		17,883
Net Earnings		$ 1,617

Wroad Wrunner Ltd.
Statement of Financial Position
As at August 31, 2XXX

Assets:		
Cash	$ 4,777	
Accounts Receivable	300	
Car	6,000	
Total Assets		$11,077
Liabilities:		
Accounts Payable	$ 100	
Interest Payable	60	
Notes Payable	3,000	
Loan Payable – Car	4,500	
Total Liabilities		$ 7,660
Shareholder's Equity:		
Common Shares	$1,800	
Retained Earnings	1,617	
Total Shareholder's Equity		3,417
Total Liabilities and Shareholder's Equity		$11,077

C2-1 (Continued)

b. Profit Margin = Net earnings / Total revenues
Profit margin = $1,617 / $19,500 = 8.3%

Wroad Wrunner Ltd. made $1,617 before income taxes in the first four months of operation, which is quite impressive – especially in light of the small amount she invested in the business. This profit is after Nola paying $6,000 in salaries to herself.

c. Nola presently owes $7,660 as of August 31. If she sells the car for $6,000, collects the outstanding receivables and uses the existing cash of $4,777, Nola would have more than enough money to pay off all her liabilities. In fact, she would have $1,617 (the shareholders' equity) leftover.

C2-2 Daisy-Fresh Dry Cleaning

1. The payment of the insurance policy should have been recorded as a prepaid expense when it was purchased. A prepaid expense is a current asset because there is a future benefit associated with the policy. As the year progresses, the benefits of the policy are used up because the company has been provided with insurance coverage for that time period. As the benefits of the policy expire, the related costs should be expensed. At the end of the first year, one-third of the three-year policy would have expired; therefore, one-third of the policy costs should be expensed. The remaining two-thirds should remain as a prepaid expense on the asset side of the statement of financial position.
2. The full amount of the cost of the new dry-cleaning machine ($8,000) should have been recorded as an asset when it was purchased. As time passes and the machine is used, it should be depreciated as an expense on the statement of income which would reduce the carrying value of the machine on the statement of financial position. The machine's depreciation expense should be reported in the same period in which it is used to help generate revenue.
3. The company should report all future claims on its assets even when those claims don't become due for four years. The loan should be recorded as a long-term liability until the end of the third year, at which point it becomes a current liability, payable within the normal operating year of the company. Recording the loan on the books now provides a complete listing of total liabilities owed by the organization.
4. The interest on the loan to the bank should be recorded in the period in which it is incurred. Even though the owner did not yet pay any of the interest, there is an obligation to pay the interest in the near future, thus there is a claim on the assets of the company that should be recorded in the financial statements. The company should report an interest expense on the statement of income and an interest payable on the statement of financial position as a current liability.
5. Dividends represent a distribution of profits to the shareholders. Dividends are not recorded as an expense but rather directly reduce the retained earnings of the business. Because dividends are a distribution of profit and not an expense, their payment should not be reported on the statement of income. The payment of dividends appears on the

   statement of retained earnings (ASPE) or the statement of changes in equity (IFRS), and also as financing activity on the statement of cash flows.

C2-3 Mega Manufacturing

Mega Manufacturing appears to be improving its financial position to be more In line with the performance of other companies in the same industry.

Profit margin has decreased in the past year, which indicates that the level of profit generated by each dollar of sales revenue declined. The company remains well above the industry average.

Currently the company is able to generate a return of 10% on its assets. This means that for every $100 invested in assets the company is able to generate profits of $10. The company appears to be performing slightly below the average for companies in the industry, but has improved these results in the last year.

Finally, the return on equity ratio compares the profits earned in the business to the amount invested by shareholders. Shareholders will use this ratio to evaluate the ability of the business to provide them with an acceptable return on their investment. Investors will often compare the return on equity for businesses of similar risk to make decisions about buying new shares or selling their existing shares. With a return on shareholders' equity of 12%, Mega Manufacturing is providing investors with a return that is below the industry average. The 2% increase over the past year should make this company an attractive investment, especially if it continues to increase and it becomes closer to the industry average.

C2-4 Canadian Cookies and Cakes Ltd.

	Cash	Supplies	Equipment	A/P	Interest Payable	Bank Loan	Common Shares	R/E	
1	30,000					30,000			
2	(10,000)					(10,000)			
3	30,000						30,000		
4		42,000		42,000					
5		(33,600)						(33,600)	E - COGS
6	(37,000)			(37,000)					
7	(12,000)							(12,000)	E - Rent
8	(46,000)		46,000						
9	(27,000)			3,000				(30,000)	E - Wage
10					1,600			(1,600)	E - Int
11	(13,500)			1,500				(15,000)	E - Op
12	98,000							98,000	R
Total	12,500	8,400	46,000	9,500	1,600	20,000	30,000	5,800	
			66,900					66,900	

C2-4 (Continued)

a. Calculation of cash on hand at end of year:

See template, or…

Cash received:		
Bank loan	$ 30,000	
Shareholders' contribution	30,000	
Sale of products	98,000	$158,000
Cash paid out:		
Purchase of baking supplies ($42,000 – $5,000)	$ 37,000	
Rent payments on ovens	12,000	
Payment on bank loan	10,000	
Payment of salaries ($30,000 – $3,000)	27,000	
Payment of other expenses	13,500	
Purchase of ovens	46,000	(145,500)
		$ 12,500

Calculation of net earnings for the year:

See template, or…

Sales		$98,000
Cost of goods sold ($42,000 x 80%)	$33,600	
Wage expense	30,000	
Oven rental expense	12,000	
Interest expense	1,600	
Other expenses	15,000	(92,200)
Net Earnings		$ 5,800

C2-4 (Continued)

b. See template for calculations

Canadian Cookie and Cakes Ltd.
Statement of Financial Position
December 31, 20xx

Cash	$12,500	Accounts payable	$ 9,500
Baking supplies	8,400	Interest payable	1,600
Baking ovens	46,000	Bank loan payable	20,000
		Total liabilities	$31,100
		Common shares	$30,000
		Retained earnings	5,800
		Shareholders' equity	35,800
Total assets	$66,900	Total liabilities and shareholders' equity	$66,900

c. The shareholder's proportionate claim on the reported net assets (assets less liabilities) is $11,933 ($35,800 x 33.33%). In light of the profitable operations during the first year of operations, the company should be worth more than its book value and the shareholder should be able to sell her shares for more than this. On the other hand, if she is desperate to sell she may be willing to take less than the book value of her share of the company and accept something less than $11,933.
It is worth noting that the income tax expense was not taken into consideration in the calculation of the results and revisions would be required once the calculation of amounts owing are made.

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