CHAPTER 2

A Further Look at Financial Statements

ASSIGNMENT CLASSIFICATION TABLE

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

ASSIGNMENT CHARACTERISTICS TABLE

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| ProblemNumber |  | Description |  | DifficultyLevel |  | TimeAllotted (min.) |
|  |  |  |  |  |  |  |
| 5B |  | Prepare financial statements; discuss relationships. |  | Moderate |  | 15-25 |
|  |  |  |  |  |  |  |
| 6B |  | Calculate ratios and comment on liquidity, solvency and profitability. |  | Simple |  | 10-20 |
|  |  |  |  |  |  |  |
| 7B |  | Calculate ratios and comment on liquidity, solvency and profitability. |  | Moderate |  | 20-30 |
|  |  |  |  |  |  |  |
| 8B |  | Calculate ratios and comment on liquidity, solvency and profitability. |  | Simple |  | 10-20 |
|  |  |  |  |  |  |  |
| 9B |  | Comment on liquidity, solvency and profitability. |  | Moderate |  | 15-20 |
|  |  |  |  |  |  |  |
| 10B |  | Discuss financial reporting objective and qualitative characteristics. |  | Moderate |  | 15-20 |
|  |  |  |  |  |  |  |
| 11B |  | Discuss elements of financial statements. |  | Moderate |  | 15-20 |
|  |  |  |  |  |  |  |
| 12B |  | Identify measurement principles. |  | Moderate |  | 20-30 |

**ANSWERS TO QUESTIONS**

1. Current assets are assets that are expected to be converted into cash, sold, or used up within one year of the company’s financial statement date or its operating cycle, whichever is longer. Examples of current assets include: cash, accounts receivable, merchandise inventory and supplies.
2. The term operating cycle stands for the average time it takes to go from cash to cash in producing revenue. In a merchandising business, this means the time it takes to purchase inventory, pay cash to suppliers, sell the inventory on account, and then collect cash from customers. In a service business, it stands for the time it takes to pay employees, provide services on account, and then collect the cash from customers.

3. (a) Current assets are assets that are expected to be converted into cash, sold, or used up within one year of the company’s financial statement date or its operating cycle, whichever is longer. Non-current assets are assets that are not expected to be converted into cash, sold, or used up by the business within one year of the financial statement date or its operating cycle. In other words, non-current assets are everything that are not classified as a current assets.

 (b) Current assets are assets that are expected to be converted into cash, sold, or used up within one year of the company’s financial statement date or its operating cycle, whichever is longer. Current liabilities are obligations that are to be paid or settled within one year of the company’s financial statement date or its operating cycle, whichever is longer. Ideally, current assets will exceed current liabilities for a company.

4. (a) Current liabilities are obligations that are to be paid or settled within one year of the company’s financial statement date or its operating cycle, whichever is longer.

 (b) Examples of current liabilities include: bank indebtedness, accounts payable, accrued liabilities and current maturities of long-term debt.

Questions (Continued)

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

Difference Current Liabilities Non-current Liabilities

Source of payment Existing current assets Other than existing current

 or other current liabilities assets or creating current liabilities

Time of expected Within one year Beyond one year

payment

Nature of items Debts pertaining to the Mortgages, notes, loans,

 operating cycle and other bonds, and other non-

 short-term debts current liabilities

 (b) Some liabilities, such as notes payable, appear on the statement of financial position with a current and non-current portion. Included in notes payable payments that will be due in the next year is an amount of principal repayment. That amount must be shown as a current liability as of the company’s financial statement date. The remaining principal balance is classified as a non-current liability.

6. The two components of shareholders' equity and the purpose of each are: (1) Share capital is used to record investments of assets in the business by the owners (shareholders). If there is only one class of shares, it is known as common shares. (2) Retained earnings is used to record accumulated profit, net of any losses and dividends paid, retained in the business.

7. Statements using the common practice among North American companies are prepared by classifying the items on the statement of financial position in order of liquidity, ranking the items with the most liquidity first.

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

Questions (Continued)

8. (a) Liquidity ratios measure a company’s short-term ability to pay its current liabilities and meet its unexpected needs for cash. Examples of liquidity ratios include:  Working capital and current ratio.

 (b) Solvency ratios measure a company’s ability to survive over a long period of time. An example of a solvency ratio is the debt to total assets ratio.

 (c) Profitability ratios measure a company’s operating success for a given period of time. Examples of profitability ratios include:  Earnings per share and price-earnings ratio.

9. The current ratio is a better measure of liquidity than working capital when making comparisons between different businesses. The amount of working capital is an absolute amount. It could vary tremendously depending on the size of the operations of the business. The current ratio on the other hand presents a relationship of the amount of current assets compared to current liabilities and is therefore appropriate as a tool to compare the liquidity of different size businesses.

10. Current assets include accounts receivable and inventory. These may have increasing balances because of uncollectible receivables or slow-moving inventory. This would cause the current ratio to increase. Even though the current ratio may seem high, it is an artificial measure of liquidity if receivables and inventory cannot be easily or quickly convertible into cash. Consequently, the current ratio alone does not provide a complete assessment of liquidity.

11. Dong Corporation is more solvent as only 45% of its assets are financed by debt whereas 55% of Du's assets are financed by debt. A company carrying a higher proportion of debt has an increased likelihood of encountering financial difficulties and is therefore considered less solvent.

12. Raising money using debt adds more risk to a company than raising money through equity because the terms of repayment of debt requires cash outflows for the payment of interest and repayment of principal. These payments tap into cash balances that could hurt the company’s liquidity. In contrast to debt, equity does not have to be repaid.

13. Earnings per share comparisons among different companies are difficult due to variations in the financing structure of the companies and in the number of shares issued. Hence, there is no industry average for earnings per share. On the other hand, since the price-earnings ratio uses earnings per share relative to the market price of the common shares, the ratio can be compared among companies.

Questions (Continued)

14. Investors appear to favour TD Bank. Its higher price-earnings ratio indicates that investors are willing to pay more for the company's shares and have more favourable expectations of future growth.

15. Increases in the earnings per share, price-earnings ratio, and the current ratio are considered to be signs of improvement because:

* An increase in the earnings per share means that the amount of profit per share is greater than in the previous period.
* An increase in the price-earnings ratio means that the share price has increased at a greater rate than the company’s earnings per share, which implies the market believes future profit will continue to increase.
* An increase in the current ratio indicates that the company has more current assets available to settle its current liabilities and is more liquid (assuming the components of current assets (e.g., receivables and inventory) are also liquid.

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

16. (a) The conceptual framework is a coherent system of interrelated objectives and fundamentals that can lead to consistent standards. The framework prescribes the nature, function, and limits of financial accounting statements. It guides choices about what to present in financial statements, decisions about alternative ways of reporting economic events, and the selection of appropriate ways of communicating such information.

 (b) The conceptual framework used internationally varies from country to country. Canadian companies use the same framework, whether they are reporting under IFRS or under ASPE.

17. (a) The primary objective of financial reporting is to provide information useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company.

1. The main users of financial reporting are investors, lenders, and other creditors.

Questions (Continued)

18. The going concern assumption states that the business will remain in operation for the foreseeable future.

1. This assumption supports the cost basis of accounting in that the cost paid for an asset or the amount that must be paid in the future for liabilities can continue to be used for financial reporting purposes. This is the case because the business expects to use the assets or pay its liabilities during its operating cycle.
2. The timing of when the asset will be converted to cash or used in operations and when liabilities are to be paid determines their classification on the statement of financial position. Since the business is expected to remain in operation for the foreseeable future, these elements can continue to be reported in accordance with their respective current or non-current classifications.

19. The fundamental qualitative characteristics are (1) relevance and (2) faithful representation.

 Relevant information will impact a user’s decision by having predictive value, confirmatory value or both. Faithful representation means that the financial statements should reflect the economic reality of what really 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.

Questions (Continued)

23. The elements of financial statements are broad categories or classes of financial statement effects of transactions and other events. They include assets, liabilities, equity, income (including gains), and expenses (including losses). The grouping is selected in accordance with the economic characteristics of the transactions.

24. The principles used in the measurement of elements are historical cost and fair value. The fair value basis of accounting is applied to those assets which are intended to be sold and whose fair value is readily available. Securities traded on the stock exchanges would be a good example of assets reported at their fair value. The historical cost basis of accounting is used for most of the remaining assets used by the business. Since in most cases the intention is to use the assets to earn revenue, the fair value of the asset is not as relevant as its cost.

25. In order to be relevant for decision making, the measurement of elements of financial statements need to reflect amounts that are reliable. For assets that are intended to be sold, the current fair value of the assets becomes the most relevant measurement as it approximates the current amount of cash that could be obtained on the sale of the asset. On the other hand, for assets held for use by the corporation, the value at resale is not as relevant to the financial statement user. In that case, the cost of the assets is the better measurement for reporting the financial statement element. For example, inventory will become cost of goods sold when sold. It is relevant to compare the actual cost of the inventory to the amount of the revenue generated from its sale. Using the cost basis of accounting gives a faithful representation of the transaction that has occurred from the sale of inventory.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2-1

a) 5 Accounts payable (i) 2 Investment in long-term bonds

(b) 1 Accounts receivable (j) 3 Land

(c) 3 Accumulated depreciation (k) 1 Merchandise inventory

(d) 3 Buildings (l) 7 Common shares

(e) 1 Cash (m) 1 Supplies

 (f) 4 Patent (n) 6 Mortgage payable, due in 20 years

(g) 8 Dividends (o) 5 Current portion of mortgage payable

(h) 5 Income tax payable

BRIEF EXERCISE 2-2

SWANN LIMITED

Statement of Financial Position (Partial)

Assets

Current assets Cash $16,400

 Accounts receivable 14,500

 Merchandise inventory 9,000

 Supplies 4,200

 Prepaid insurance 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

BRIEF EXERCISE 2-4

HIRJIKA INC.

Statement of Financial Position (Partial)

Current liabilities Accounts payable $22,500

 Salaries payable 3,900

 Interest payable 5,200

 Income tax payable 6,400

 Current portion of mortgage payable 5,000

 Total current liabilities $43,000

BRIEF EXERCISE 2-5

 (a) Liquidity (b) Reverse Liquidity

Accounts payable 6 8

Accounts receivable 3 3

Cash 1 5

Income tax payable 7 7

Merchandise inventory 5 1

Notes payable 8 6

Notes receivable 4 2

Short-term investments 2 4

BRIEF EXERCISE 2-6

 Share Capital Retained Earnings

(a) Issued common shares + NE

(b) Paid a cash dividend NE –

(c) Purchased merchandise

 inventory for cash NE NE

(d) Reported a profit NE +

(e) Paid cash to creditors NE NE

(f) Reported a loss NE –

(g) Issued preferred shares + NE

BRIEF EXERCISE 2-7

(a) ($ in thousands)

 2010 2009

Working capital:

$351,044 – $244,665 = $106,379 Working capital:

$335,125 – $248,043 = $87,082

Current ratio:

Current ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $351,044 | = 1.4:1 |  | $335,125 | = 1.4:1 |
| $244,665 |  | $248,043 |

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

BRIEF EXERCISE 2-8

(a) (in USD millions)

 2010 2009

 Debt to total assets ratio: Debt to total assets ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $882.9 + $1,199.5 | = 56.3% |  | $789.0 + $ 1,140.9 | = 59.3% |
| $1,031.0 + $2,665.7 |  | $844.5 + $ 2,411.4 |

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

BRIEF EXERCISE 2-9

(a) ($ in thousands)

 2010 2009

 Earnings per share: Earnings per share:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $63,284 | = $0.89 per share |  | $56,864 | = $0.80 per share |
|  70,732 |  |  70,714 |

 Price-earnings ratio: Price-earnings ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $14.80 | = 16.6 times |   | $10.50 | = 13.1 times |
|  $ 0.89 |  |  $ 0.80 |

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

BRIEF EXERCISE 2-10

(a) Faithful representation

(b) Verifiability

(c) Understandability

(d) Cost

(e) Going concern

(f) Fair value

BRIEF EXERCISE 2-11

1. 10
2. 5
3. 1
4. 2
5. 4
6. 13
7. 8
8. 12
9. 9
10. 3
11. 11
12. 6
13. 7

BRIEF EXERCISE 2-12

(a) Sosa Ltd. has purchased the land for sale and not for use. The current fair value of the land becomes the most relevant measurement as it approximates the current amount of cash that could be obtained on the sale of the asset.

(b) Mohawk has purchased land for use and not for sale. The current fair value is not as relevant to the financial statement user in this case. The historical cost of the land is the better measurement for reporting the land on the statement of financial position.

**SOLUTIONS TO EXERCISES**

EXERCISE 2-1

(a) 5 Accounts payable and accrued liabilities

(b) 1 Accounts receivable

(c) 3 Accumulated depreciation

(d) 3 Buildings and leasehold improvements

(e) 7 Common shares

(f) 5 Current maturities of long-term debt

(g) 5 Dividends payable

(h) 4 Goodwill

(i) 5 Income and other taxes payable

(j) 1 Income and other taxes receivable

(k) 1 Inventories

(l) 2 Investments

(m) 3 Land

(n) 6 Long-term debt

(o) 6 Other long-term liabilities

(p) 1 Prepaid expenses

(q) 4 Spectrum licences (to use public frequencies)

EXERCISE 2-2

BIG ROCK BREWERY

Statement of Financial Position (partial)

December 31, 2010

(in thousands)

Assets

Current assets

 Cash $ 769

 Accounts receivable 1,789

 Inventories 4,471

 Prepaid expenses and other 397

 Total current assets $ 7,426

Property, plant, and equipment

 Land $ 2,516

 Buildings $11,879

 Less: Accumulated amortization\* 3,304 8,575

 Furniture and fixtures $ 2,328

 Less: Accumulated amortization 1,818 510

 Production equipment $33,871

 Less: Accumulated amortization 18,648 15,223

 Vehicles $ 1,101

 Less: Accumulated amortization 890 211

 Total property, plant, and equipment 27,035

Total assets $34,461

\* Note that Big Rock Brewery uses the term “amortization” rather than “depreciation” for its property, plant, and equipment.EXERCISE 2-3

 SAPUTO INC.

Statement of Financial Position (partial)

March 31, 2010

(in thousands)

Liabilities and Shareholders' Equity

Current liabilities

 Accounts payable and accrued liabilities $471,106

 Income taxes payable 149,377

 Future income taxes payable 8,639

 Bank loans payable 61,572

 Total current liabilities $ 690,694

Non-current liabilities

 Long-term debt $380,790

 Future income taxes payable 143,675

 Other long-term liabilities 9,694

 Total non-current liabilities 534,159

Total liabilities 1,224,853

Shareholders' equity

 Common shares $ 584,749

 Retained earnings 1,603,373

 Other reductions in shareholders’ equity (159,524)

 Total shareholders’ equity 2,028,598

Total liabilities and shareholders' equity $3,253,451

EXERCISE 2-4

(a) Profit = Revenues – Expenses

 = $73,040 – $13,080 – $5,000 – $4,750 – $35,600

 = $14,610

 Retained earnings = Beginning retained earnings + Profit – Dividends

 = $66,520 + $14,610 – $0

 = $81,130

(b) SUMMIT'S BOWLING ALLEY LTD.

Statement of Financial Position

December 31, 2012

Assets

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 long-term debt 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

EXERCISE 2-5

(a) Profit = Revenues – Expenses

 = $73,040 – $13,080 – $5,000 – $4,750 – $35,600

 = $14,610

 Retained earnings = Beginning retained earnings + Profit – Dividends

 = $66,520 + $14,610 – $0

 = $81,130

(b) SUMMIT'S BOWLING ALLEY LTD.

Statement of Financial Position

December 31, 2012

Assets

Non-current assets

 Property, plant, and equipment

 Land $54,000

 Buildings $128,800

 Less: Accumulated depreciation 45,600 83,200

 Equipment $62,400

 Less: Accumulated depreciation 17,770 44,630

 Total property, plant, and equipment $181,830

 Long-term investments 30,000

Current assets

 Prepaid insurance $ 390

 Supplies 740

 Accounts receivable 13,780

 Cash 15,040

 Total current assets 29,950

Total assets $241,780

Shareholders' Equity and Liabilities

Shareholders' equity

 Common shares $50,000

 Retained earnings 81,130

 Total shareholders’ equity $131,130

Mortgage payable ($95,000 – $13,600) 81,400

Current liabilities

 Current portion of long-term debt $13,600

 Interest payable 1,600

 Accounts payable 14,050

 Total current liabilities 29,250

Total shareholders' equity and liabilities $241,780

EXERCISE 2-6

BATRA CORPORATION

Income Statement

Year Ended July 31, 2012

Revenues Commission 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, 2012 |
|  |  |  |  |
|  | Common | Retained |  |
|  | Shares  | Earnings | Total Equity |
|  |  |  |  |
| Balance, August 1, 2011 |  $ 6,000  |  $ 17,940  |  $ 23,940  |
| Issued common shares |  4,000  |  |  4,000  |
| Profit |  |  30,600  |  30,600  |
| Dividends | 000000 |  (12,000)  |  (12,000) |
| Balance, July 31, 2012 | $10,000  | $ 36,540  | $ 46,540  |

EXERCISE 2-6 (Continued)

BATRA CORPORATION

Statement of Financial Position

July 31, 2012

Assets

Current assets

 Cash $ 5,060

 Short-term investments 20,000

 Accounts receivable 17,100

 Supplies 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

EXERCISE 2-7

(a) Current ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $60,000 | = 2:1 |  |  |  |
| $30,000 |  |  |

(b) Current ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $60,000 – $20,000 | = 4:1 |  |  |  |
| $30,000 – $20,000 |  |  |

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

EXERCISE 2-8

(a) (in USD millions)

 2010 2009

Working capital: Working capital:

  $3,825.3 – $4,237.8 = $(412.5) $3,976.2 – $4,499.2 = $(523.0)

 Current ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $3,825.3 | = 0.9:1 |  | $3,976.2 | = 0.9:1 |
| $4,237.8 |  | $4,499.2 |

 Debt to total assets ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $4,237.8 + $5,779.4  | = 66.9% |  | $4,499.2 + $6,199.3 | = 61.2% |
| $3,825.3 + $11,138.3 |  | $3,976.2 + $13,508.5 |

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

(c)

|  |  |
| --- | --- |
|  | 2010 |
|  | Safeway |  | Sobeys |  | Loblaw |  | Industry |
|  |  |  |  |  |  |  |  |
| Working capital (in millions) | $(412.5)  |  | $(17.5 ) |  |  $736.0  |  | n/a |
| Current ratio | 0.9:1 |  | 1.0:1 |  | 1.2:1 |  | 1.8:1 |
| Debt to total assets ratio | 66.9% |  | 54.8% |  | 58.2% |  | 37.9% |
|  |  |  |  |  |  |  |  |
|  | 2009 |
|  | Safeway |  | Sobeys |  | Loblaw |  | Industry |
|  |  |  |  |  |  |  |  |
| Working capital (in millions) | $(523.0) |  | $(190.0)  |  |  $730.0  |  | n/a |
| Current ratio | 0.9:1 |  | 0.9:1 |  | 1.2:1 |  | 1.1:1 |
| Debt to total assets ratio | 61.2% |  | 56.7% |  | 58.4% |  | 42.9% |

EXERCISE 2-8 (Continued)

(c) (Continued)

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

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

EXERCISE 2-9

(a) (in thousands)

 2010 2009

 Earnings per share: Earnings per share:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $514,749 | = $1.31 per share |  | $1,099,422 | = $2.83 per share |
|  393,169 |  |  387,956 |

 Price-earnings ratio: Price-earnings ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $40.30 | = 30.8 times |  | $33.93 | = 12.0 times |
| $1.31 |  | $2.83 |

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

EXERCISE 2-10

(a) 7 (g) 1

(b) 10 (h) 6

(c) 11 (i) 4

(d) 3 (j) 5

(e) 2 (k) 9

(f) 8 (l) 12

EXERCISE 2-11

1. (a) The cost basis of accounting is involved in this situation.

 (b) The cost basis of accounting has been violated. The land was reported at its fair value when it should have remained at its historical cost.

2. (a) The fair value basis of accounting is involved in this situation.

(b) The principle has not been violated since the parcel of land is being held for resale and not for use.

3. (a) The assumption involved in this situation is the going concern assumption.

 (b) The going concern assumption has been violated. The elements on the statement of financial position should have been classified between current and non-current.

**SOLUTIONS TO PROBLEMS**

PROBLEM 2-1A

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

PROBLEM 2-2A

(a)

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

PROBLEM 2-2A (Continued)

(b)

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

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

PROBLEM 2-3A

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

PROBLEM 2-3A (Continued)

(b)

WESTJET AIRLINES LTD.

Balance Sheet (partial)

December 31, 2010

(in thousands)

Assets

Current assets

 Cash $1,187,899

 Accounts receivable 17,518

 Inventory 20,181

 Prepaid expenses, deposits and other 41,716

 Total current assets $1,267,314

Property, plant, and equipment

##  Aircraft $2,471,806

 Less: Accumulated depreciation 622,997 $1,848,809

##  Ground property and equipment $121,814

 Less: Accumulated depreciation 61,895 59,919

 Spare engines and parts $106,198

 Less: Accumulated depreciation 28,251 77,947

 Buildings $135,817

 Less: Accumulated depreciation 13,154 122,663

 Leasehold improvements $ 9,965

 Less: Accumulated depreciation 3,348 6,617

##  Total property, plant, and equipment 2,115,955

Intangible assets 13,018

Other assets 166,557

Total assets $3,562,844

PROBLEM 2-4A

|  |  |
| --- | --- |
| (a)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 |
| Future income tax (long-term) | Non-current liabilities |
| Long-term debt | Non-current liabilities |
| Other current liabilities | Current liabilities |
| Other long-term liabilities | Long-term liabilities |
| Other shareholders’ equity items | Shareholders’ equity |
| Retained earnings | Shareholders’ equity |
| Share capital | Shareholders’ equity |

PROBLEM 2-4A (Continued)

(b)

WESTJET AIRLINES LTD.

Balance Sheet (partial)

### Liabilities and Shareholders' Equity

December 31, 2010

(in thousands)

Current liabilities

 Accounts payable and accrued liabilities $303,583

 Advanced ticket sales 308,022

 Other current liabilities 36,778

 Current portion of long-term debt 183,789

 Total current liabilities $ 832,172

Non-current liabilities

 Long-term debt $866,745

 Other long-term liabilities 18,838

 Future income tax 337,410

 Total non-current liabilities 1,222,993

 Total liabilities 2,055,165

Shareholders' equity

 Share capital $647,637

 Retained earnings 807,978

 Other shareholders’ equity items 52,064

 Total shareholders’ equity 1,507,679

Total liabilities and shareholders' equity $3,562,844

1. Yes, these two amounts agree. Assets equal total liabilities plus shareholders’ equity.

PROBLEM 2-5A

(a)

MBONG CORPORATION

Income Statement

Year Ended December 31, 2012

Revenues

 Service revenue $81,700

 Interest revenue 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, 2012 |
|  |  |  |  |
|  | Common | Retained |  |
|  | Shares  | 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  |

PROBLEM 2-5A (Continued)

(a) (Continued)

MBONG CORPORATION

Statement of Financial Position

December 31, 2012

Assets

Current assets

 Cash $ 5,200

 Short-term investments 20,000

 Accounts receivable 14,200

 Supplies 200

 Prepaid insurance 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 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

PROBLEM 2-5A (Continued)

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

PROBLEM 2-6A

(a)

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

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 2.  | Current ratio |  | Current assets |  |  |  |  |
|  | Current liabilities |  |  |  |  |
|  |  |  | $446,900 | = | 3.1 | :1 |  |  |
|  | $142,500 |  |
|  |  |  |  |  |  |  |  |  |
| 3. | Debt to total assets |  | Total liabilities |  |  |  |
|  | Total assets |  |  |  |
|  |  |  | $452,500  | = | 42.2% |  |  |  |
|  | $1,072,200  |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| 4. | Earnings per share |  | Profit available to common shareholders |
|  | Weighted average number of common shares |
|  |  |  | $160,000  | = |  $4.00  |  |  |  |
|  |  |  |  40,000  |  |  |  |
|  |  |  |  |  |  |  |  |  |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| 5. | Price-earnings ratio |  | Market price per share |  |  |  |
|  | Earnings per share |  |  |  |
|  |  |  | $35.00  | = |  8.8  | times |  |  |
| $4.00  |  |  |

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

PROBLEM 2-7A

(a)

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

Current ratio = ****

 Chen Caissie

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| $407,200 | = | 2.4  | :1 |  | $190,400 | = |  1.4  | :1 |
| $166,325 |  | $133,700 |

 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) Debt to total assets = ****

 Chen Caissie

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| $166,325 + $108,500 | = | 29.3% | $133,700 + $40,700 | = | 52.8% |
| $407,200 + $532,000 | $190,400 + $139,700 |

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

PROBLEM 2-7A (Continued)

(c)

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|

|  |  |  |  |
| --- | --- | --- | --- |
|  | 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  |

 |  |  |  |
| Earnings per share = | Profit available to common shareholders |
| Weighted average number of common shares |

 Chen Caissie

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $247,000 | = $3.25 |  | $142,600 | = $2.30 |
| 76,000 |  | 62,000 |  |

 Price-earnings ratio: ****

 Chen Caissie

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $25.00 | = 7.7 times |  | $15.00 | = 6.5 times |
| $3.25 |  | $2.30 |  |

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

PROBLEM 2-8A

1. (in millions)

##  Le Château H&M

 (CAD) (SEK)

1. Working capital $135 – $43 36,081 – 11,090

 = $92 = 24,991

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 2. | Current ratio | $135 | = 3.1:1 | 36,081 | = 3.3:1 |
|  |  | $43 |  | 11,090 |  |
|  |  |  |  |  |  |
| 3. | Debt to total assets | $79 | = 33.5% | 13,750 | = 25.3% |
|  |  | $236 |  | 54,363 |  |
|  |  |  |  |  |  |
| 4. | Earnings per share | $30 | = $1.25 | 16,384 | = $19.81 |
|  |  | 24 |  | 827 |  |
|  |  |  |  |  |  |
| 5. | Price-earnings ratio | $13.82 | = 11.1 times | 412.30 | = 20.8 times |
|  |  | $1.25 |  | 19.81 |  |

(b) Liquidity

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

 Solvency

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

PROBLEM 2-8A (Continued)

1. (Continued)

 Profitability

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

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

PROBLEM 2-9A

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

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

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

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

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

PROBLEM 2-9A (Continued)

(b) Liquidity

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

 Solvency

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

 Profitability

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

PROBLEM 2-10A

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

PROBLEM 2-11A

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

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

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

PROBLEM 2-12A

1. 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.
2. The reason a company might choose to adopt the fair value basis of accounting for real estate is that assets reported on the balance sheet will have higher values than they would using the historical cost of these assets. It is inherent in the nature of real estate that the land will increase in value over time. Creditors will find the fair value a more relevant basis for making lending decisions. The increase in the assets will have a corresponding increase in equity.
3. The reason a company might choose to adopt the cost basis of accounting for real estate is that assets reported on the balance sheet will have more faithful representation because it reports the actual cost of the asset when it was acquired and this measurement can be easily verified and it is neutral. There is also a significant cost to obtaining reliable fair value information on a regular basis to be reported in the financial statements.

(d) When comparing real estate companies, the reader is well advised to read the accounting policy note to the financial statements disclosing the measurement policy used for the real estate property. One would need to determine the corresponding fair value for real estate for the company using the cost basis of accounting. In fact, this information is required to be disclosed for real estate companies even if they adopted the cost basis of accounting to improve comparability and disclosure. Otherwise, trying to compare businesses that use different bases of accounting would be very difficult.

PROBLEM 2-1B

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

PROBLEM 2-2B

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

PROBLEM 2-2B (Continued)

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

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

PROBLEM 2-3B

(a)

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

PROBLEM 2-3B (Continued)

(b)

REITMANS (CANADA) LIMITED

Balance Sheet (partial)

January 30, 2010

(in thousands)

Assets

Current assets

 Cash $228,577

 Marketable securities 48,026

 Accounts receivable 2,926

 Merchandise inventories 63,127

 Prepaid expenses 11,873

 Future income tax assets 2,395

 Total current assets $356,924

## Property, plant, and equipment

 Land $ 5,935

 Buildings and improvements $ 52,336

 Less: Accumulated depreciation 19,499 32,837

 Fixtures and equipment $177,874

 Less: Accumulated depreciation 97,398 80,476

 Leasehold improvements $194,782

 Less: Accumulated depreciation 103,418 91,364

 Total property, plant, and equipment 210,612

Intangible assets

 Software $17,072

 Less: Accumulated amortization 7,108 9,964

Goodwill 42,426

Future income tax assets 11,466

Total assets $631,392

PROBLEM 2-4B

(a)

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

PROBLEM 2-4B (Continued)

(b)

REITMANS (CANADA) LIMITED

Balance Sheet (partial)

January 30, 2010

 (in thousands)

Liabilities and Shareholders' Equity

Current liabilities

 Accounts payable and accrued items $77,766

 Income taxes payable 4,677

 Current portion of mortgage payable 1,300

 Total current liabilities $ 83,743

Non-current liabilities

 Mortgage payable $11,431

 Other long-term liabilities 26,052

 Total non-current liabilities 37,483

 Total liabilities 121,226

Shareholders' equity

 Common shares $ 31,052

 Retained earnings 480,622

 Other shareholders’ equity items (1,508)

 Total shareholders’ equity 510,166

Total liabilities and shareholders' equity $631,392

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

PROBLEM 2-5B

(a)

BEAULIEU LIMITED

Income Statement

Year Ended December 31, 2012

Revenues

 Service revenue $80,500

 Interest revenue 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, 2012 |
|  |  |  |  |
|  | Common | Retained |  |
|  | Shares  | 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  |

PROBLEM 2-5B (Continued)

(a) (Continued)

BEAULIEU LIMITED

Statement of Financial Position

December 31, 2012

Assets

Current assets

 Cash $8,000

 Accounts receivable 7,500

 Prepaid insurance 250

 Total current assets $ 15,750

Investments 20,000

Property, plant, and equipment

 Land $50,000

 Building $80,000

 Less: Accumulated depreciation - building 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 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

PROBLEM 2-5B (Continued)

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

PROBLEM 2-6B

(a)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 1. | Working capital |  | Current assets – Current liabilities |  |
|  |  |  |  $253,850  |  – | $156,550  | = | $97,300  |  |

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 2.  | Current ratio |  | Current assets |  |  |  |  |
|  | Current liabilities |  |  |  |  |
|  |  |  | $253,850 | = | 1.6 | :1 |  |  |
|  | $156,550 |  |
|  |  |  |  |  |  |  |  |  |
| 3. | Debt to total assets |  | Total liabilities |  |  |  |
|  | Total assets |  |  |  |
|  |  |  | $288,550  | = | 40.1% |  |  |  |
|  | $719,150  |  |  |

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

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| 5. | Price-earnings ratio |  | Market price per share |  |  |  |
|  | Earnings per share |  |  |  |
|  |  |  | $30.00  | = | 12.4  | times |  |  |
| $2.42  |  |  |

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

PROBLEM 2-7B

(a)

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

Current ratio = ****

 Belliveau Shields

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| $180,000 | = | 2.4  | :1 |  | $700,000 | = |  2.3  | :1 |
| $75,000 |  | $300,000 |

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

(c) Debt to total assets = ****

 Belliveau Shields

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| $75,000 + $190,000 | = | 34.0% |  | $300,000 + $200,000 | = | 33.3% |
| $180,000 + $600,000 |  | $700,000 + $800,000 |

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

PROBLEM 2-7B (Continued)

(c)

|  |  |  |  |
| --- | --- | --- | --- |
|  | 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  |

|  |  |
| --- | --- |
| Earnings per share = | Profit available to common shareholders |
| Weighted average number of common shares |

 Belliveau Shields

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $44,000 | = $0.22 |  | $136,000 | = $0.68 |
| 200,000 |  | 200,000 |  |

 Price-earnings ratio: ****

 Belliveau Shields

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $2.50 | = 11.4 times |  | $6.00 | = 8.8 times |
| $0.22 |  | $0.68 |  |

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

PROBLEM 2-8B

(a) (in USD millions)

 Walmart Target

1. Working capital $48,331 – $55,561 $18,424 – $11,327

 = $(7,230) = $7,097

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 2. | Current ratio | $48,331 | = 0.9:1 | $18,424 | = 1.6:1 |
|  |  | $55,561 |  | $11,327 |  |
|  |  |  |  |  |  |
| 3. | Debt to total assets | $97,777 | = 57.3% | $29,186 | = 65.5% |
|  |  | $170,706 |  | $44,533 |  |
|  |  |  |  |  |  |
| 4. | Earnings per share | $14,335 | = $3.71 | $2,488 | = $3.31 |
|  |  | 3,866 |  | 752 |  |
|  |  |  |  |  |  |
| 5. | Price-earnings ratio | $53.43 | = 14.4 times | $48.26 | = 14.6 times |
|  |  | $3.71 |  | $3.31 |  |

PROBLEM 2-8B (Continued)

(b) Liquidity

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

 Solvency

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

 Profitability

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

PROBLEM 2-9B

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

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

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

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

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

PROBLEM 2-9B (Continued)

(b) Liquidity

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

 Solvency

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

 Profitability

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

PROBLEM 2-10B

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

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

PROBLEM 2-11B

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

PROBLEM 2-12B

1. 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.
2. The following is the recommended measurement principle that should be used for the following purchases:
3. 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.
4. 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.
5. 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.
6. If the purchase of the used car is for use in the business, the cost basis of accounting should be used. On the other hand, if the purchase is for resale, the fair value basis of accounting should be used.

PROBLEM 2-12B (Continued)

(b) (Continued)

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

BYP 2-1 FINANCIAL REPORTING

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

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

(b)   Current assets are listed in the order of liquidity. Cash and cash equivalents is the most liquid asset and is reported first, followed by short-term investments. Non-current assets as listed in order of permanency, with property, plant, and equipment listed first.

(c) The current liabilities total U.S. $30,220,000 at December 31, 2010 and U.S. $23,845,000 at December 31, 2009. The total liabilities at December 31, 2010 and 2009 were in the amount of U.S. $85,796,000 and U.S. $77,338,000, respectively.

(d) The current liabilities are listed in order of due date, with accounts payable and accrued liabilities listed first. It is not clear what order was chosen for non-current liabilities.

(a)

BYP 2-2 COMPARATIVE ANALYSIS

|  |  |  |
| --- | --- | --- |
|  | Anglo American Platinum Limited(in R millions, except per share information) | Eastern Platinum Limited(in USD thousands, except per share information) |
|   |   |   |   |   |   |   |   |   |
| 1. Working capital |   | 18,393 – 9,009 | = | 9,384 |   | $392,911 – $30,220 | = | $362,691 |
|   |   |
|   |   |   |   |   |   |   |   |   |
|   |   |   |   |   |   |   |   |   |
| 2. Current ratio |   | 18,393 | = | 2.0:1 |   | $392,911 | = | 13.0:1 |
|  |   | 9,009 |  |  |   | $30,220 |  |  |
|   |   |   |   |   |   |   |   |   |
|  |  |  |  |  |  |  |  |  |
| 3. Debt to  |   | 19,774 + 9,009 | = | 34.3% |   | $85,796 | = | 7.6% |
| total assets |   | 83,801 |  |  |   | $1,126,975 |  |  |
|   |   |   |   |   |   |   |   |   |
|   |   |  |  |  |   |  |  |   |
| 4. Earnings per share |   | 39.09 (3,909 cents = R39.09) |  |  |   | $0.02 |  |  |
|   |   |  |  |  |   |  |  |  |
|   |   |  |  |  |   |  |  |   |
| 5. Price earnings ratio | 664.0039.09 | = | 17.0 times | $1.77$0.02 | = | 88.5 times |
|  |  |  |  |  |  |  |  |

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

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

**BYP 2-2 (Continued)**

(b) (Continued)

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

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

BYP 2-3 INTERPRETING FINANCIAL INFORMATION

(a) The early implementation of IFRS will make the comparison to companies using Canadian GAAP in 2008 difficult. When different standards are used, the impact on reported profit and financial performance can be significant. In order to compare apples to apples, a conversion of one of the sets of statements may be required. This may require significant time and expertise.

(b) Assuming the financial statements of the private enterprise using ASPE are available, the comparison of these financial statements to those prepared using IFRS for a public company could be difficult as the use of different policies can have an impact on reported profit and financial performance. In many cases, there are no differences between IFRS and ASPE—it really depends on whether one company or the other has financial items for which the accounting differs substantially.

1. The comparison of these financial statements to those prepared using U.S. GAAP will hinder comparison. When different standards are used the impact on reported earnings and financial performance can be significant. In order to compare apples to apples, a conversion of one of the sets of statements may be required. This may require significant time and expertise. Often, a reconciliation of amounts is provided between IFRS and U.S. GAAP in the notes to the financial statements to help with this comparison.
2. If different measurement principles are used by two different public companies following IFRS, a comparison will be more difficult although it will be limited to those elements of the financial statements to which the measurement basis applies. Should a company determine that comparisons with other companies in its industry would be made too difficult for potential investors, additional disclosure can be provided in the notes to the financial statements to give details of elements calculated using the alternate basis of measurement.

BYP 2-4 COMPARING IFRS AND ASPE

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

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

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

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

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

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

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

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

BYP 2-5 COLLABORATIVE LEARNING ACTIVITY

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

BYP 2-6 COMMUNICATION ACTIVITY

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

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

BYP 2-7 ETHICS CASE

(a) The stakeholders in this case are:

 Kathy Johnston, accountant

 Redondo’s vice-president

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

(b) The ethical consideration in this situation is whether or not the early implementation of the new standard would affect the decisions of the users of the financial statements. Because early adoption is only suggested and not required, the vice-president is fully within his rights to delay implementation of the standard. However, it is ethically preferable to disclose the most financially relevant information to the users of the financial statements so that they can make informed decisions. One should question the reasoning of Redondo’s vice-president who is focusing on the effect of the implementation on the profit for the year.

(c) As the accountant, by supporting early implementation, Kathy could gain the trust and respect of the board of directors and the shareholders in general. The users of the company’s financial statements will be affected by the decision against early implementation as their decision-making may be influenced by the presentation of the company’s financial results using the old standards.

BYP 2-8 “ALL ABOUT YOU” ACTIVITY

NAME

Personal Statement of financial position

Date

Assets

Current assets

 Cash $ 1,500

 Total current assets 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—not an infrequent occurrence for students in this age group.

BYP 2-9 SERIAL CASE

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

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

(b) By looking at the statement of financial position and determining the composition of Biscuits’ current assets and current liabilities, we can assess its ability to pay its short-term obligations. We can also calculate liquidity ratios, such as working capital and the current ratio, for the current and prior periods. Liquidity ratios will help determine whether Biscuits has had any difficulty in the past with respect to its ability to meet its current obligations. This will not guarantee that Biscuits will be able to pay your invoices in the future but will provide some assurance with respect to how they have performed in the past. The statement of cash flows will also provide information to determine if Biscuits generates positive cash flows from its operations.

(c) By looking at the types of revenues and expenses reported in the income statement, we can determine if Biscuits is profitable. If revenues earned by Biscuits exceed expenses incurred, then Biscuits is profitable. As well, profitability ratios can be determined which measure a company’s ability to generate profit over a period of time. These profitability ratios include earnings per share and price-earnings ratio. The latter measures investors’ expectations about Biscuits’ future profitability.

(d) By looking at the statement of financial position, we can determine if Biscuits has any non-current debt. We can also calculate solvency ratios, such as the debt to total assets ratio, to determine whether Biscuits has the ability to repay its non-current debt. Solvency ratios help measure a company’s ability to survive over a long period of time.

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

BYP 2-9 (Continued)

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

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

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