CHAPTER 2

A FURTHER LOOK AT FINANCIAL STATEMENTS

LEARNING OBJECTIVES

1. Identify the sections of a classified statement of financial position.

2. Identify and calculate ratios for analyzing a company’s liquidity, solvency, and profitability.

3. Describe the framework for the preparation and presentation of financial statements.

SUMMARY OF QUESTIONS BY LEARNING OBJECTIVES AND BLOOM’S TAXONOMY

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Item** | **LO** | **BT** | **Item** | **LO** | **BT** | **Item** | **LO** | **BT** | | **Item** | **LO** | **BT** | | **Item** | **LO** | **BT** |
| **Questions** | | | | | | | | | | | | | | | | |
| 1. | 1 | K | 7. | 1 | C | 13. | 2 | | C | 19. | 3 | | C | 25. | 3 | C |
| 2. | 1 | C | 8. | 1 | K | 14. | 2 | | K | 20. | 3 | | C | 26. | 3 | C |
| 3. | 1 | C | 9. | 2 | C | 15. | 2 | | C | 21. | 3 | | C | 27. | 3 | K |
| 4. | 1 | K | 10. | 2 | C | 16. | 2 | | C | 22. | 3 | | C | 28. | 3 | C |
| 5. | 1 | C | 11. | 2 | C | 17. | 2 | | K | 23. | 3 | | C | 29. | 3 | C |
| 6. | 1 | C | 12. | 2 | C | 18. | 2 | | C | 24. | 3 | | C |  |  |  |
| **Brief Exercises** | | | | | | | | | | | | | | | | |
| 1. | 1 | K | 3. | 1 | AP | 5. | 2 | | AP | 7. | 2 | | AN | 9. | 3 | C |
| 2. | 1 | K | 4. | 1 | AP | 6. | 2 | | AN | 8. | 3 | | K | 10. | 3 | C |
| **Exercises** | | | | | | | | | | | | | | | | |
| 1. | 1 | K | 3. | 1 | AP | 5. | 1 | | AP | 7. | 2 | | AN | 9. | 3 | K |
| 2. | 1 | AP | 4. | 1 | AP | 6. | 2 | | E | 8. | 2 | | AN | 10. | 3 | C |
| **Problems: Set A and B** | | | | | | | | | | | | | | | | |
| 1. | 1 | K | 3. | 1 | AP | 5. | 2 | | AN | 7. | 2 | | AN | 9. | 3 | E |
| 2. | 1 | AP | 4. | 1 | AP | 6. | 2 | | AN | 8. | 2 | | AN | 10. | 3 | E |
| **Cases** | | | | | | | | | | | | | | | | |
| 1. | 1 | K | 3. | 3 | S | 5. | 3 | | E |  |  | |  |  |  |  |
| 2. | 2 | C | 4. | 1,2 | AN | 6. | 2,3 | | E |  |  | |  |  |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| Legend**:** The following abbreviations will appear throughout the solutions manual file. | | | |
|  |  |  |  |
| LO | Learning objective | |  |
| BT | Bloom's Taxonomy | |  |
|  | K | Knowledge |  |
|  | C | Comprehension | |
|  | AP | Application |  |
|  | AN | Analysis |  |
|  | S | Synthesis |  |
|  | E | Evaluation |  |
| Difficulty: | Level of difficulty | |  |
|  | S | Simple |  |
|  | M | Moderate |  |
|  | C | Complex |  |
| Time: | Estimated time to complete in minutes | | |
| AACSB | Association to Advance Collegiate Schools of Business | | |
|  | Communication | | Communication |
|  | Ethics | | Ethics |
|  | Analytic | | Analytic |
|  | Tech. | | Technology |
|  | Diversity | | Diversity |
|  | Reflec. Thinking | | Reflective Thinking |
| CPA CM | CPA Canada Competency Map | | |
| cpa-e001 | Ethics | | Professional and Ethical Behaviour |
| cpa-e002 | PS and DM | | Problem-Solving and Decision-Making |
| cpa-e003 | Comm. | | Communication |
| cpa-e004 | Self-Mgt. | | Self-Management |
| cpa-e005 | Team & Lead | | Teamwork and Leadership |
| cpa-t001 | Reporting | | Financial Reporting |
| cpa-t002 | Stat. & Gov. | | Strategy and Governance |
| cpa-t003 | Mgt. Accounting | | Management Accounting |
| cpa-t004 | Audit | | Audit and Assurance |
| cpa-t005 | Finance | | Finance |
| cpa-t006 | Tax |  | Taxation |

ANSWERS TO QUESTIONS

1. (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.

(b) Examples of current assets include cash, accounts receivable, inventory, and supplies. Current assets are listed in order of liquidity in the current asset section of the statement of financial position.

LO 1 BT: K Difficulty: S Time: 3 min. AACSB: None CPA: cpa-t001 CM: Reporting

1. 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 on account, 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.

LO 1 BT: C Difficulty: M Time: 3 min. AACSB: None CPA: cpa-t001 CM: Reporting

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

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

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

LO 1 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**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. Current liabilities are listed in the order in which they are expected to be paid in the current liability section of the statement of financial position.

LO 1 BT: K Difficulty: S Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**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 other 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 bank loans, appear on the statement of financial position with a current and non-current portion. Included in the balance of the bank loan payable are principal payments that will be due in the next year. That amount must be shown as a current liability as at the company’s financial statement date. The remaining principal balance is classified as a non-current liability.

LO 1 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

**6.** (a) Contra accounts are accounts that offset the account to which they relate. Contra accounts serve to keep track of and disclose the amount of the reduction to the balance of the related account and arrive at its carrying amount. An example is accumulated depreciation, which is offset against the related asset account to arrive at the asset’s carrying amount.

(b) In the case of property, plant, and equipment, users find it useful to know the historical cost of assets as well as the cumulative amount of depreciation (contra account called accumulated depreciation) that has been recorded to date on them. The difference between cost and accumulated depreciation is referred to as the carrying amount, also commonly known as net book value or just simply book value.

LO 1 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

**7.** Current assets and liabilities are listed in the statement of financial position in the order in which they are expected to be converted into cash, sold or used up in the case of assets and paid or settled, in the case of liabilities; that is, in their order of liquidity. Liquidity is enhanced when an asset can be converted to cash more quickly than another asset. In the case of liabilities, some liabilities will be paid more quickly than others and so they would be deemed to be more liquid. Other assets are listed in the order of permanency. Long-term assets, such as property, plant, and equipment, are usually presented in order of permanence, with the most permanent (land) being presented first.

LO 1 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

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

(b) Under ASPE, the ending balances of share capital and retained earnings would appear on the statement of financial position and the ending balance of retained earnings would also appear on the statement of retained earnings. Under IFRS, the presentation on the statement of financial position would be the same, and both share capital and retained earnings would appear on the statement of changes in shareholders’ equity.

LO 1 BT: K Difficulty: S M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

**9.** Intracompany ratio comparisons compare elements and ratios within the same financial statements (example, current assets and current liabilities) or between the income statement and the statement of financial position (example, basic earnings per share) from the same company. Intracompany ratio comparisons can also involve comparing elements or ratios in two or more accounting periods for the same company.

Intercompany ratio comparisons compare elements or ratio results between different companies.

LO 2 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**10.** (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 ratios.

(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 basic earnings per share and the price-earnings ratio.

LO 2 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

**11.** (a) Working capital is arrived at by deducting current liabilities from current assets.

(b) Positive working capital means that there are more current assets than current liabilities. Whenever there is positive working capital, the current ratio is greater than 1:1.

(c) Having positive working capital does not mean that a company has lots of cash. It could mean the company has significant accounts receivable or inventory. The working capital may be a very large amount and yet the company may have no cash as it is instead borrowing all of the necessary cash from the bank to make day-to-day payments to suppliers and employees.

LO 2 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

**12.** 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 current assets to current liabilities and is therefore appropriate as a tool to compare the liquidity of different size businesses.

LO 2 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**13.** 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 converted into cash. Consequently, the current ratio alone does not provide a complete assessment of liquidity.

LO 2 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**14.** 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.

LO 2 BT: K Difficulty: S Time: 5 min. AACSB: None CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

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

LO 2 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**16.** Basic 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 basic earnings per share. On the other hand, since the price-earnings ratio uses basic earnings per share relative to the market price of the common shares, the ratio can be compared among companies.

LO 2 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

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

LO 2 BT: K Difficulty: S Time: 5 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

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

* An increase in the basic earnings per share means that the amount of net income 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 basic earnings per share, which implies the market believes future net income 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.

LO 2 BT: C Difficulty: M Time: 10 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

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

(b) Internationally, the conceptual framework may vary from country to country. Canadian companies use the same framework, whether they are reporting under IFRS or under ASPE.

LO 3 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

**20.** (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.

LO 3 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**21.** The going concern assumption states that the business will remain in operation for the foreseeable future. The timing of when the asset will be converted to cash or used in operations and when liabilities are to be paid determines their classification on the statement of financial position. Since the business is expected to remain in operation for the foreseeable future, these elements can continue to be reported in accordance with their respective current or non-current classifications. If the company were about to be shut down, all of its assets and liabilities would be classified as current.

LO 3 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

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

Relevant information will impact a user’s decision by having predictive value, confirmatory value, or both. Faithful representation means that the financial statements should reflect the economic reality of what really exists or has happened. The information must be complete, neutral, and free from material error.

LO 3 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**23.** Enhancing qualitative characteristics make useful financial information more useful (i.e. they enhance its usefulness). To be useful, financial information must reflect the two fundamental qualitative characteristics of relevance and faithful representation. Enhancing characteristics bring more specific support to the objectives achieved by using the fundamental qualitative characteristics. Enhancing qualitative characteristics cannot enhance the usefulness of financial information that is not useful (i.e. information which does not reflect the fundamental qualitative characteristics).

LO 3 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**24.** 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, a narrative explanation in the notes to the financial statements, or an amount reported for an element 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.

LO 3 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**25.** The four enhancing qualitative characteristics are (1) comparability, (2) verifiability, (3) timeliness, and (4) understandability. There is no prescribed order in applying these characteristics.

LO 3 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**26.** The cost constraint means that information will be presented only when the benefit associated with it exceeds the cost of obtaining and 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.

LO 3 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**27.** 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, and expenses (which include losses). The grouping is selected in accordance with the economic characteristics of the transactions.

LO 3 BT: K Difficulty: S Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**28.** The two bases are historical cost and current value. The current value basis of accounting is applied to those assets that are intended to be sold and whose current value is readily available. Securities traded on the stock exchanges would be a good example of assets reported at their current 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 current value of the asset is not as relevant as its historical cost.

LO 3 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

**29.** 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 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 historical cost of the assets is the better measurement for reporting the financial statement element. An example of a revenue generating asset is land used for a parking lot. It is relevant to compare the actual cost of the land to the amount of the revenue generated from its use. Using the historical cost basis of accounting gives a faithful representation to the financial statement users.

LO 3 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

SOLUTIONS TO BRIEF EXERCISES

**BRIEF EXERCISE 2-1**

(a) 5 Accounts payable (i) 8 Dividends declared

(b) 1 Accounts receivable (j) 5 Income tax payable

(c) 3 Accumulated depreciation (k) 2 Long-term Investments

(d) 3 Buildings (l) 3 Land

(e) 1 Cash (m) 1 Inventory

(f) 7 Common shares (n) 1 Supplies

(g) 5 Current portion of mortgage (o) 6 Mortgage payable, due in 20

Payable years

(h) 4 Patents (p) 1 Prepaid insurance (q) 5 Unearned revenue

LO 1 BT: K Difficulty: S Time: 10 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**BRIEF EXERCISE 2-2**

(a) 1 Accounts receivable (i) 1 Inventory

(b) 2 Accumulated depreciation (j) 1 Notes receivable, due in six months

(c) 4 Bank indebtedness (k) 1 Prepaid rent

(d) 5 Bank loan payable, due in

three years (l) 6 Retained earnings

(e) 1 Cash (m) 4 Salaries payable

(f) 6 Common shares (n) 1 Supplies

(g) 2 Equipment (o) 4 Unearned revenue

(h) 3 Goodwill (p) 1 Prepaid insurance (q) 4 Accounts payable

LO 1 BT: K Difficulty: S Time: 10 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**BRIEF EXERCISE 2-3**

SHUM CORPORATION

Statement of Financial Position (Partial)

Assets

Current assets

Cash $16,400

Accounts receivable 14,500

Inventory 9,000

Supplies 4,200

Prepaid insurance 3,900

Total current assets 48,000

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

Total assets $235,000

(Assets = Liabilities + Shareholders’ equity)

LO 1 BT: AP Difficulty: M Time: 10 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**BRIEF EXERCISE 2-4**

HIRJIKAKA INC.

Statement of Financial Position (Partial)

Current liabilities

Accounts payable $22,500

Salaries payable 3,900

Interest payable 5,200

Income tax payable 6,400

Unearned revenue 900

Current portion of mortgage payable 5,000

Total current liabilities $43,900

LO 1 BT: AP Difficulty: M Time: 5 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**BRIEF EXERCISE 2-5**

(a) ($ in thousands)

2016 2015

Working capital:

$453,254 – $235,400 = $217,854 Working capital:

$421,955 – $223,239 = $198,716

Current Assets – Current Liabilities

Current ratio:

Current ratio:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| $453,254 | | = 1.9:1 |  | $421,955 | = 1.9:1 |
| $235,400 | |  | $223,239 |
|  | |  |  |  |  |
| Current Assets | |
| Current Liabilities | |

(b) The working capital increased slightly in 2016 and the current ratio remained the same. Indigo's liquidity is slightly stronger in 2016 compared with 2015.

LO 2 BT: AP Difficulty: M Time: 10 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

**BRIEF EXERCISE 2-6**

(a) (in US$ millions)

2016 2015

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

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| ($2,705.5 + $4,554.8) | = 59.0% |  | ($2,470.3 + $4,655.1) | = 64.6% |
| ($2,934.8 + $9,369.1) |  | ($2,742.3 + $8,286.1) |

|  |
| --- |
| Total Liabilities |
| Total Assets |

(b) The company’s solvency was stronger in 2016 compared with 2015 because total debt has decreased as a proportion of total assets.

LO 2 BT: AN Difficulty: M Time: 10 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

**BRIEF EXERCISE 2-7**

(a) ($ in thousands)

2015 2014

Basic earnings per share: Basic earnings per share:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| $76,629 | = $1.08 per share |  | | $75,524 | = $1.07 per share |
| 71,218 |  | | 70,899 |
| Income available to common shareholders | | | |
| Weighted average number of common shares | | | |

Price-earnings ratio: Price-earnings ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $13.99 | = 13.0 times |  | $17.31 | = 16.2 times |
| $ 1.08 |  | $ 1.07 |

|  |
| --- |
| Market price per share |
| Basic earnings per share |

(b) The increase in net income and in the basic earnings per share during the year would indicate that profitability has improved in 2015. In spite of the increase in net income, investors appear to have less confidence in Leon’s future income as indicated by the decrease in the price-earnings ratio in 2015.

LO 2 BT: AN Difficulty: M Time: 10 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

**BRIEF EXERCISE 2-8**

(a) Faithful representation

(b) Verifiability

(c) Understandability

(d) Cost

(e) Going concern

(f) Current value

LO 3 BT: K Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**BRIEF EXERCISE 2-9**

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

LO 3 BT: C Difficulty: C Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

**BRIEF EXERCISE 2-10**

(a) Sosa Ltd. has purchased the land for sale and not for use. The current 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 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.

LO 3 BT: C Difficulty: S Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

**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 Patents

(i) 5 Income and other taxes payable

(j) 1 Income and other taxes receivable

(k) 1 Inventories

(l) 3 Land

(m) 6 Long-term debt

(n) 1 Prepaid expenses

LO 1 BT: K Difficulty: S Time: 10 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**EXERCISE 2-2**

BIG ROCK BREWERY INC.

Statement of Financial Position (partial)

December 31, 2015

(in thousands)

Assets

Current assets

Cash $ 540

Accounts receivable 2,221

Inventories 4,935

Prepaid expenses and other 1,573

Total current assets $ 9,269

Property, plant, and equipment

Land $ 8,377

Buildings $17,692

Less: Accumulated depreciation 1,817 15,875

Machinery and equipment $24,860

Less: Accumulated depreciation 10,122 14,738

Mobile equipment $ 1,054

Less: Accumulated depreciation 434 620

Office furniture and equipment $ 1,286

Less: Accumulated depreciation 516 770

Total property, plant, and equipment 40,380

Intangible assets 456

Total assets $50,105

LO 1 BT: AP Difficulty: M Time: 20 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**EXERCISE 2-3**

SAPUTO INC.

Statement of Financial Position (partial)

March 31, 2016

(in millions)

Liabilities and Shareholders' Equity

Current liabilities

Accounts payable and accrued liabilities $ 896.6

Income taxes payable 37.1

Bank loans payable 423.1

Total current liabilities $ 1,356.8

Non-current liabilities

Long-term debt $1,208.3

Deferred income taxes payable 475.6

Other long-term liabilities 61.8

Total non-current liabilities 1,745.7

Total liabilities 3,102.5

Shareholders' equity

Common shares $ 821.0

Retained earnings 3,180.8

Total shareholders’ equity 4,001.8

Total liabilities and shareholders' equity $7,104.3

LO 1 BT: AP Difficulty: M Time: 20 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**EXERCISE 2-4**

(a) Net income = Revenues – Expenses

= $183,040 – $158,680– $4,550 – $5,200

= $14,610

Retained earnings = Beginning retained earnings + Net income   
 – Dividends declared

= $116,520 + $14,610 – $0

= $131,130

(b) SUMMIT LTD.

Statement of Financial Position

December 31, 2018

Assets

Current assets

Cash $ 24,040

Accounts receivable 20,780

Supplies 1,240

Prepaid insurance 1,420

Total current assets $47,480

Long-term investments 28,970

Property, plant, and equipment

Land $194,000

Buildings $133,800

Less: Accumulated depreciation 50,600 83,200

Equipment $66,100

Less: Accumulated depreciation 21,470 44,630

Total property, plant, and equipment 321,830

Total assets $398,280

Liabilities and Shareholders' Equity

Current liabilities

Accounts payable $21,050

Interest payable 2,100

Current portion of mortgage payable 30,500

Total current liabilities $ 53,650

Mortgage payable ($104,000 – $30,500) 73,500

Total liabilities 127,150

Shareholders' equity

Common shares $140,000

Retained earnings 131,130

Total shareholders’ equity 271,130

Total liabilities and shareholders' equity $398,280

LO 1 BT: AP Difficulty: M Time: 25 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**EXERCISE 2-5**

BATRA CORPORATION

Income Statement

Year Ended July 31, 2018

Revenues

Service revenue $113,600

Rent revenue 18,500

Total revenues 132,100

Expenses

Salaries expense $44,700

Operating expenses 32,500

Rent expense 10,800

Depreciation expense 3,000

Utilities expense 2,600

Interest expense 2,000

Supplies expense 900

Total expenses 96,500

Income before income tax 35,600

Income tax expense 5,000

Net Income $30,600

[Revenues – Expenses = Net income or (loss)]

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| BATRA CORPORATION | | | | |
| Statement of Changes in Equity | | | | |
| Year Ended July 31, 2018 | | | | |
|  |  |  |  | |
|  | Common | Retained |  | |
|  | Shares | Earnings | Total Equity | |
|  |  |  |  | |
| Balance, August 1, 2017 | $ 15,000 | $17,940 | $32,940 |
| Issued common shares | 10,000 |  | 10,000 |
| Net income |  | 30,600 | 30,600 |
| Dividends declared | 000 000 | (12,000) | (12,000) |
| Balance, July 31, 2018 | $25,000 | $36,540 | $61,540 |

[Ending retained earnings = Beginning retained earnings ± Net income or (loss) – dividends declared]

**EXERCISE 2-5 (CONTINUED)**

BATRA CORPORATION

Statement of Financial Position

July 31, 2018

Assets

Current assets

Cash $ 5,060

Held for trading investments 20,000

Accounts receivable 17,100

Supplies 1,500

Total current assets $ 43,660

Property, plant, and equipment

Equipment $62,900

Less: Accumulated depreciation 6,000

Total property, plant, and equipment 56,900

Total assets $100,560

Liabilities and Shareholders' Equity

Current liabilities

Accounts payable $ 4,220

Interest payable 1,000

Unearned revenue 12,000

Bank loan payable 21,800

Total liabilities $ 39,020

Shareholders' equity

Common shares $25,000

Retained earnings 36,540

Total shareholders’ equity 61,540

Total liabilities and shareholders' equity $100,560

(Assets = Liabilities + Shareholders’ equity)

LO 1 BT: AP Difficulty: M Time: 45 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**EXERCISE 2-6**

(a) Current ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| $60,000 | = 1.5:1 |  |  |  |
| $40,000 |  |  |
| Current Assets | |
| Current Liabilities | |

(b) Current ratio:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| ($60,000 – $20,000) | = 2:1 |  |  |  |
| ($40,000 – $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 that is meant to show Padilla’s liquidity position has been artificially altered by a simple payment on account.

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

LO 2 BT: E Difficulty: M Time: 15 min. AACSB: Analytic and Ethics CPA: cpa-e001, cpa-t001 and cpa-t005 CM: Reporting

**EXERCISE 2-7**

(a) (in thousands)

2015 2014

Working capital: Working capital:

 $167,816 – $158,120 = $9,696 $63,150 – $193,384 = $(130,234)

Current Assets – Current Liabilities

Current ratio:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| $167,816 | | = 1.1:1 |  | $63,150 | = 0.3:1 |
| $158,120 | |  | $193,384 |
| Current Assets | |
| Current Liabilities | |

Debt to total assets ratio:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| ($158,120 + $2,166,843) | | = 67.0% |  | ($193,384 + $2,036,716) | = 65.3% |
| ($167,816 + 3,304,377) | |  | ($63,150 + $3,350,264) |
|  | |  |  |  |  |
| Total Liabilities | |
| Total Assets | |

(b) Crombie REIT’s liquidity improved dramatically in 2015 when compared to 2014, while at the same its solvency deteriorated slightly.

**EXERCISE 2-7 (CONTINUED)**

(c)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | | 2015 | | | |
|  | Crombie | | CT | Choice | Industry | |
| Working capital (in thousands) | $9,696 | | $(215,889) | $(416,879) | n/a | |
| Current ratio | 1.1:1 | | 0.1:1 | 0.4:1 | 0.3 :1 | |
| Debt to total assets ratio | 67.0% | | 49.1% | 90.5% | 43.8% | |
|  | 2014 | | | | | |
|  | Crombie | | CT | Choice | Industry | |
| Working capital (thousands) | $(130,234) | | $(295,123) | $(142,356) | n/a | |
| Current ratio | 0.3:1 | | 0.0:1 | 0.6:1 | 0.4:1 | |
| Debt to total assets ratio | 65.3% | | 50.2% | 87.3% | 45.9% | |

Based on working capital and the current ratio, Crombie’s liquidity is the best (highest) of the three companies, as the current ratio far exceeds the ratios for CT and Choice as well as the industry average. Compared to 2014, Crombie and CT improved working capital and the current ratio, while both deteriorated for Choice. The industry average current ratio also declined.

Based on the debt to total assets ratio, CT’s solvency is the best of the three companies, but it is not as good as the industry average. Crombie’s solvency deteriorated slightly. Choice’s solvency is the worst of the three companies.

LO 2 BT: AN Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

**EXERCISE 2-8**

(a) (in thousands)

2015 2014

Basic earnings per share: Basic earnings per share:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| $65,286 | = $0.16 per share |  | | $185,234 | = $0.47 per share |
| 395,793 |  | | 395,740 |
| Income available to common shareholders | | | |
| Weighted average number of common shares | | | |

Price-earnings ratio: Price-earnings ratio:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| $17.07 | = 106.7 times | |  | $18.62 | = 39.6 times |
| $0.16 |  | $0.47 |
| Market price per share | | |
| Basic earnings per share | | |

(b) The decrease in the basic earnings per share during the year would indicate that profitability has deteriorated dramatically in 2015. However, investors appear to have some confidence in Cameco's future profitability as its share price has declined by only 8%.

LO 2 BT: AN Difficulty: M Time: 15 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting

**EXERCISE 2-9**

(a) 7 (g) 1

(b) 10 (h) 6

(c) 11 (i) 4

(d) 3 (j) 5

(e) 2 (k) 9

(f) 8 (l) 12

LO 3 BT: K Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

**EXERCISE 2-10**

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

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

2. (a) The current 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.

LO 3 BT: C Difficulty: M Time: 10 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

**SOLUTIONS TO PROBLEMS**

PROBLEM 2-1A

|  |  |
| --- | --- |
| Item | Statement of Financial  Position Category |
| Accounts payable | Current liabilities |
| Accounts receivable | Current assets |
| Accumulated depreciation | Contra asset to property, plant, and equipment |
| Cash | Current assets |
| Common shares | Share capital |
| Computer equipment | Property, plant, and equipment |
| Current portion of long-term debt | Current liabilities |
| Furniture and equipment | Property, plant, and equipment |
| Goodwill | Goodwill |
| Land, buildings and improvements | Property, plant, and equipment |
| Long-term debt | Non-current liabilities |
| Prepaid expenses | Current assets |
| Unearned revenue | Current liabilities |

LO 1 BT: K Difficulty: S Time: 15 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

PROBLEM 2-2A

|  |  |
| --- | --- |
| (a)  Item | Statement of Financial  Position Category |
| Accounts receivable | Current assets |
| Accumulated depreciation—aircraft | Property, plant, and equipment (contra account) |
| Accumulated depreciation—buildings | Property, plant, and equipment (contra account) |
| Accumulated depreciation—ground, property and equipment | Property, plant, and equipment (contra account) |
| Aircraft | Property, plant, and equipment |
| Buildings | Property, plant, and equipment |
| Cash | Current assets |
| Ground and other property and equipment | Property, plant, and equipment |
| Intangible assets | Intangible assets |
| Inventory | Current assets |
| Other assets | Other assets |
| Prepaid expenses, deposits, and other | Current assets |
|  |  |

**PROBLEM 2-2A (CONTINUED)**

(b)

WESTJET AIRLINES LTD.

Statement of Financial Position (partial)

December 31, 2015

(in thousands)

Assets

Current assets

Cash $1,252,370

Accounts receivable 82,136

Inventory 36,018

Prepaid expenses, deposits, and other 131,747

Total current assets $1,502,271

Property, plant, and equipment

## Aircraft $3,912,617

Less: Accumulated depreciation 1,170,643 $2,741,974

## Ground and other property and equipment $ 821,753

Less: Accumulated depreciation 196,829 624,924

Buildings $ 136,783

Less: Accumulated depreciation 30,419 106,364

Total property, plant, and equipment 3,473,262

Intangible assets 63,549

Other assets 89,942

Total assets $5,129,024

LO 1 BT: AP Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

PROBLEM 2-3A

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

(b) WESTJET AIRLINES LTD.

Statement of Financial Position (partial)

### Liabilities and Shareholders' Equity

December 31, 2015

(in thousands)

Current liabilities

Accounts payable and accrued liabilities $545,438

Advanced ticket sales 620,216

Other current liabilities 158,880

Current portion of long-term debt 227,391

Total current liabilities $1,551,925

Non-current liabilities

Long-term debt $1,276,475

Other long-term liabilities 13,603

Deferred income tax 327,028

Total non-current liabilities 1,617,106

Total liabilities 3,169,031

Shareholders' equity

Share capital $ 582,796

Retained earnings 1,292,581

Other shareholders’ equity items 84,616

Total shareholders’ equity 1.959.993

Total liabilities and shareholders' equity $5,129,024

(c) Yes, these two amounts agree. Assets of $5,129,024 thousand equal total liabilities plus shareholders’ equity of the same amount.

LO 1 BT: AP Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

PROBLEM 2-4A

(a)

MBONG CORPORATION

Income Statement

Year Ended December 31, 2018

Revenues

Service revenue $213,900

Interest revenue 500

Total revenues $214,400

Expenses

Salaries expense $129,800

Operating expense 39,400

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 184,900

Income before income tax 29,500

Income tax expense 6,000

Net income $23,500

[Revenues – Expenses = Net income or (loss)]

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| MBONG CORPORATION | | | | |
| Statement of Changes in Equity | | | | |
| Year Ended December 31, 2018 | | | | |
|  |  |  |  | |
|  | Common | Retained |  | |
|  | Shares | Earnings | Total Equity | |
|  |  |  |  | |
| Balance, January 1 | $30,000 | $221,000 | $251,000 |
| Issued common shares | 4,200 |  | 4,200 |
| Net income |  | 23,500 | 23,500 |
| Dividends declared | \_ \_\_\_\_\_ | (5,000) | (5,000) |
| Balance, December 31 | $34,200 | $239,500 | $273,700 |

(Beginning equity ± Changes to equity = Ending equity)

[Ending retained earnings = Beginning retained earnings ± Net income or (loss) – dividends declared]

**PROBLEM 2-4A (CONTINUED)**

(a) (continued)

MBONG CORPORATION

Statement of Financial Position

December 31, 2018

Assets

Current assets

Cash $ 11,900

Held for trading investments 20,000

Accounts receivable 14,200

Supplies 200

Prepaid insurance 2,000

Total current assets $ 48,300

## Property, plant, and equipment

Land $156,000

Buildings $72,000

Less: Accumulated depreciation—buildings 18,000 54,000

Equipment $66,000

Less: Accumulated depreciation—equipment 17,600 48,400

Total property, plant, and equipment 258,400

Total assets $306,700

Liabilities and Shareholders' Equity

Current liabilities

Accounts payable $15,000

Salaries payable 3,000

Current portion of bank loan payable 1,500

Total current liabilities $ 19,500

Non-current liabilities

Bank loan payable ($15,000 - $1,500) 13,500

Total liabilities 33,000

Shareholders' equity

Common shares $ 34,200

Retained earnings 239,500

Total shareholders’ equity 273,700

Total liabilities and shareholders' equity $306,700

(Assets = Liabilities + Shareholders’ equity)

**PROBLEM 2-4A (CONTINUED)**

(b) The income statement reports the net income or loss for the period. This figure is then used in the statement of changes in equity, along with dividends declared 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.

LO 1 BT: AP Difficulty: M Time: 45 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

PROBLEM 2-5A

(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. | Basic earnings per share | |  | Income available to common shareholders | | | | | |
|  | Weighted average number of common shares | | | | | |
|  |  | |  | $160,000 | = | $4.00 |  |  |  |
|  |  | |  | 40,000 |  |  |  |
|  |  | |  |  |  |  |  |  |  |
| 5. | Price-earnings ratio |  | | Market price per share | | |  |  |  | |
|  | | Basic earnings per share | | |  |  |  | |
|  |  |  | | $35.00 | = | 8.8 times |  |  |  | |
| $4.00 |  |  | |

(b) Johanssen’s liquidity has improved dramatically as the working capital is greater in 2018 and the current ratio is almost double that of 2017. On the other hand, the solvency has deteriorated as the debt to total assets ratio is higher in 2018. Johanssen’s profitability has improved as the basic earnings per share ratio has increased in 2018, as has investors’ expectations for future profitability as indicated by the increasing price-earnings ratio.

LO 2 BT: AN Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance.

PROBLEM 2-6A

(a)

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

|  |  |  |
| --- | --- | --- |
| Current ratio | = | Current assets |
| Current liabilities |

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 | = | Total liabilities |
| 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 2-6A (CONTINUED)**

(c)

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  | | --- | --- | --- | --- | |  | Chen |  | Caissie | | Service revenue | $1,800,000 |  | $620,000 | | Operating expenses | 1,458,000 |  | 438,000 | | Interest expense | 10,000 |  | 4,000 | | Income tax expense | 85,000 |  | 35,400 | | Total expenses | 1,553,000 |  | 477,400 | | Net income | $ 247,000 |  | $142,600 | | |  |  | |  |
|  |  | | |
| Basic earnings per share = | Income 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 | = | Market price per share |
| Basic earnings per share |

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 not meaningful to compare basic earnings per share between companies.

LO 2 BT: AN Difficulty: M Time: 40 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

PROBLEM 2-7A

1. (in thousands)

## Le Château Reitmans

1. Working capital $116,724 – $36,038 $319,362 – $121,172

= $80,686 = $198,190

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| 2. | Current ratio | $116,724 | = 3.2:1 | $319,362 | = 2.6:1 |
|  |  | $36,038 |  | $121,172 |  |
|  |  |  |  |  |  |
| 3. | Debt to total assets | $108,136 | = 64.2% | $160,915 | = 29.7% |
|  |  | $168,490 |  | $542,083 |  |
|  |  |  |  |  |  |
| 4. | Basic earnings per share | $(35,745) | = $(1.19) | $(24,703) | = $(0.39) |
|  |  | 29,964 |  | 64,079 |  |
|  |  |  |  |  |  |
| 5. | Price-earnings ratio |  | = N/A |  | = N/A |
|  |  |  |  |  |  |

(b) Liquidity

With a current ratio of 3.2:1, Le Château is more liquid than Reitmans and both companies have stronger ratios than the industry average of 1.8:1.

Solvency

Reitmans is more solvent than Le Château as evidenced by its lower debt to total assets ratio, which is better than the industry average of 57%.

Profitability

Although the basic earnings per share ratio does not provide a basis for comparison by investors, both companies have net losses for the year and therefore negative earnings per share. Consequently, no price-earnings ratio can be calculated to compare to each other or to the industry average.

LO 2 BT: AN Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

PROBLEM 2-8A

1. The higher the amount of working capital, the better a company’ liquidity. From 2016 to 2018 Pitka Corporation’s working capital deteriorated and showed a constant downward trend over the three-year period.

A higher current ratio is evidence of better liquidity for a company (assuming the components of the current assets are also liquid). Although the current ratio stayed the same from 2016 to 2017, it deteriorated 2017 to 2018 and is low.

A smaller (lower) debt to total assets ratio shows evidence of better solvency. The percentage of total liabilities to total assets increased from 2016 to 2017, showing deterioration in the solvency for Pitka. On the other hand, the ratio improved substantially from 2017 to 2018.

The higher the basic earnings per share, the better the profitability. Profitability decreased from 2016 to 2017, but improved from 2017 to 2018.

The investors appeared to have less confidence in the future net income of Pitka as evidenced by Pitka's price-earnings ratio, which declined from 2016 to 2017. This view changed as demonstrated by the climb in the price-earnings ratio from 2017 to 2018.

(b) Liquidity

Pitka’s current ratio, although steady in 2016 and 2017, declined slightly in 2018. This trend is of concern given the low level of liquidity 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 2016.

Profitability

Pitka’s profitability declined and then recovered as is demonstrated by the basic earnings per share ratio. The price-earnings ratio in 2018 indicates expectations of improving profitability.

LO 2 BT: AN Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

PROBLEM 2-9A

1. The objective of financial reporting is to provide information that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company. In this case, the information will be used by the team’s bank. Bucky’s suggestions concerning how elements should be reported on the financial statements do not meet the objective of financial reporting. His suggestions would lead to a violation of the fundamental basis on which financial statements are prepared: accrual accounting. The suggested changes to the financial statements would not portray economic reality and would not faithfully represent the performance of the business and its financial position at December 31, 2018. Bucky’s suggestions show bias and an attempt to portray a financial picture that would be perceived as more favourable than it is in reality.

(b) 1. Failing to include the estimated expenses for utilities and the corresponding liability for the utilities already consumed by December 31, 2018 violates accrual accounting. The expense was incurred and a liability exists, and although the exact amount is not known, a reasonable estimate can be made as this type of expense occurs often. The definitions of the elements have been met. Failing to include the expense would represent an error of omission done on purpose to increase the profitability and reduce the liabilities of the company at December 31, 2018.

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

3. The signing bonus paid to Wayne Crosby does not represent an asset at December 31, 2018. No future benefit can be derived from this payment as it was not conditional upon the occurrence of a future event. Consequently, the expenditure does not fit the definition of an asset.

LO 3 BT: E Difficulty: C Time: 30 min. AACSB: None CPA: cpa-t001 CM: Reporting

PROBLEM 2-10A

1. The advantage of the current value basis of accounting is that it represents a more up-to-date measurement of the value of the asset reported. Consequently, the amounts reported are more relevant to the financial statement users. The disadvantage of the current 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 current value basis of accounting for real estate is that assets reported on the statement of financial position will have higher values than they would using the historical cost basis. It is inherent in the nature of real estate that the land will increase in value over time. Creditors will find the current 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 historical cost basis of accounting for real estate is that assets reported on the statement of financial position will have more faithful representation because it reports the actual cost of the asset when it was acquired and this measurement can be easily verified and it is neutral. There is also a significant cost to obtaining reliable current 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 current value for real estate for the company using the historical cost basis of accounting. In fact, this information is required to be disclosed for real estate companies even if they adopted the historical cost basis of accounting to improve comparability and disclosure. Otherwise, trying to compare businesses that use different bases of accounting would be very difficult.

LO 3 BT: E Difficulty: C Time: 30 min. AACSB: None CPA: cpa-t001 CM: Reporting

PROBLEM 2-1B

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

LO 1 BT: K Difficulty: S Time: 15 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

PROBLEM 2-2B

(a)

|  |  |
| --- | --- |
| Item | Statement of FinancialPosition Category |
|  |  |
| Accounts receivable | Current assets |
| Accumulated depreciation—buildings | Property, plant, and equipment (contra account) |
| Accumulated depreciation—equipment | Property, plant, and equipment (contra account) |
| Buildings | Property, plant, and equipment |
| Cash | Current assets |
| Equipment | Property, plant, and equipment |
| Goodwill | Goodwill (after intangibles) |
| Held for trading investments | Current assets |
| Inventory | Current assets |
| Land | Property, plant, and equipment |
| Patent | Intangible assets |
| Prepaid expenses | Current assets |

(b)

DEVON LIMITED

Statement of Financial Position (partial)

December 31, 2018

Assets

Current assets

Cash $100,460

Held for trading investments 52,520

Accounts receivable 13,345

Inventory 105,320

Prepaid expenses 13,950

Total current assets $285,595

## Property, plant, and equipment

Land $207,290

Buildings $ 58,275

Less: Accumulated depreciation 27,595 30,680

Equipment $287,400

Less: Accumulated depreciation 146,550 140,850

Total property, plant, and equipment 378,820

Intangible assets

Patent 20,225

Goodwill 39,590

Total assets $724,230

LO 1 BT: AP Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

PROBLEM 2-3B

(a)

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

(b)

DEVON LIMITED

Statement of Financial Position (partial)

December 31, 2018

Liabilities and Shareholders' Equity

Current liabilities

Accounts payable $ 13,100

Unearned revenue 14,180

Current portion of mortgage payable 29,000

Total current liabilities $ 56,280

Non-current liabilities

Mortgage payable 231,255

Total liabilities 287,535

Shareholders' equity

Common shares $115,400

Retained earnings 321,295

Total shareholders’ equity 436,695

Total liabilities and shareholders' equity $724,230

(c) Yes, the total assets of $724,230 matches the total liabilities and shareholders’ equity.

LO 1 BT: AP Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

PROBLEM 2-4B

(a)

BEAULIEU LIMITED

Income Statement

Year Ended December 31, 2018

Revenues

Service revenue $193,100

Interest revenue 500

Total revenues $193,600

Expenses

Salaries expense $145,600

Interest expense 8,000

Depreciation expense 5,400

Utilities expense 3,700

Insurance expense 2,400

Total expenses 165,100

Income before income tax 28,500

Income tax expense 5,000

Net Income $23,500

[Revenues – Expenses = Net income or (loss)]

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| BEAULIEU LIMITED | | | | |
| Statement of Changes in Equity | | | | |
| Year Ended December 31, 2018 | | | | |
|  |  |  |  | |
|  | Common | Retained |  | |
|  | Shares | Earnings | Total Equity | |
|  |  |  |  | |
| Balance, January 1 | $25,000 | $34,000 | $59,000 |
| Issued common shares | 20,000 |  | 20,000 |
| Net income |  | 23,500 | 23,500 |
| Dividends declared | \_ \_\_\_\_\_ | (3,500) | (3,500) |
| Balance, December 31 | $45,000 | $54,000 | $99,000 |

(Beginning retained earnings ± Changes in retained earnings = Ending retained earnings)

[Ending retained earnings = Beginning retained earnings ± Net income or (loss) – dividends declared]

**PROBLEM 2-4B (CONTINUED)**

(a) (continued)

BEAULIEU LIMITED

Statement of Financial Position

December 31, 2018

Assets

Current assets

Cash $11,170

Accounts receivable 7,500

Prepaid insurance 250

Total current assets $ 18,920

Long-term investments 20,000

Property, plant, and equipment

Land $145,800

Buildings $105,000

Less: Accumulated depreciation—buildings 12,000 93,000

Equipment $ 32,000

Less: Accumulated depreciation—equipment 19,200 12,800

Total property, plant, and equipment 251,600

Total assets $290,520

Liabilities and Shareholders' Equity

Current liabilities

Accounts payable $ 9,550

Salaries payable 6,170

Current portion of mortgage payable 35,100

Total current liabilities $ 50,820

Non-current liabilities

Mortgage payable ($175,800 - $35,100) 140,700

Total liabilities 191,520

Shareholders' equity

Common shares $45,000

Retained earnings 54,000

Total shareholders’ equity 99,000

Total liabilities and shareholders' equity $290,520

(b) The income statement reports the net income or loss for the period. This figure is then used in the statement of changes in equity, along with dividends declared 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.

LO 1 BT: AP Difficulty: M Time: 45 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

PROBLEM 2-5B

(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. | Basic earnings per share |  | Income available to common shareholders | | | | | |
|  | Weighted average number of common shares | | | | | |
|  |  |  | $96,600 | = | $2.42 |  |  |  |
|  |  |  | 40,000 |  |  |  |

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

(b) Fast’s liquidity has improved as the working capital is larger in 2018 and the current ratio is greater than that of 2017. The solvency has improved as the debt to total assets ratio is a smaller percentage in 2018 than in 2017. Fast’s profitability has improved dramatically as the basic earnings per share ratio has increased by a large amount in 2018, as has the price-earnings ratio, suggesting that investors are excited about the company’s future prospects.

LO 2 BT: AN Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

PROBLEM 2-6B

(a)

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

|  |  |  |
| --- | --- | --- |
| Current ratio | = | Current assets |
| Current liabilities |

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.

(b)

|  |  |  |
| --- | --- | --- |
| Debt to total assets | = | Total liabilities |
| Total assets |

Belliveau Shields

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

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

**PROBLEM 2-6B (CONTINUED)**

(c)

|  |  |  |  |
| --- | --- | --- | --- |
|  | Belliveau |  | Shields |
| Service revenue | $450,000 |  | $890,000 |
| Operating expenses | 390,000 |  | 679,000 |
| Interest expense | 6,000 |  | 10,000 |
| Income tax expense | 10,000 |  | 65,000 |
| Total expenses | 406,000 |  | 754,000 |
| Net income | $ 44,000 |  | $136,000 |

|  |  |
| --- | --- |
| Basic earnings per share = | Income 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 | = | Market price per share |
| Basic earnings per share |

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 impractical to compare basic earnings per share between companies.

LO 2 BT: AN Difficulty: M Time: 40 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

PROBLEM 2-7B

(a) (in US$ millions)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | Walmart | | | Costco | |
|  |  |  |  | |  |  |
| 1. | Working capital | $60,239 – $64,619 | | | $17 ,299 – $16,540 | |
|  |  | = $(4,380) | | | = $759 | |
|  |  |  | |  |  |  |
| 2. | Current ratio | $60,239 | | = 0.9:1 | $17,299 | = 1.0:1 |
|  |  | $64,619 | |  | $16,540 |  |
|  |  |  | |  |  |  |
| 3. | Debt to total assets | $115,970 | | = 58.1% | $22,597 | = 67.6% |
|  |  | $199,581 | |  | $33,440 |  |
|  |  |  | |  |  |  |
| 4. | Basic earnings per share | $14,694 | | = $4.58 | $2,377 | = $5.41 |
|  |  | 3,207 | |  | 439 |  |
|  |  |  | |  |  |  |
| 5. | Price-earnings ratio | $65.39 | | = 14.3 times | $133.58 | = 24.7 times |
|  |  | $4.58 | |  | $5.41 |  |

(b) Liquidity

Both companies are not very liquid, with Walmart having a working capital deficiency. Both Walmart and Costco have current ratios that are lower (worse) than the industry average.

Solvency

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

Profitability

Although the basic earnings per share ratio does not provide a basis for comparison, investors appear to have more confidence in the future net income of Costco as evidenced by Costco’s price-earnings ratio. Both Costco and Walmart have lower price-earnings ratios than the industry.

LO 2 BT: AN Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

PROBLEM 2-8B

(a) The higher the amount of working capital, the better a business’ liquidity. From 2016 to 2017, Giasson Corporation’s working capital improved. It then deteriorated from 2017 to 2018, decreasing by $17,000.

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 2016 to 2018. The corporation remains liquid, as its current ratio was 1.5:1 in 2018.

A smaller debt to total assets ratio shows evidence of better solvency. The percentage of total liabilities to total assets increased from 2016 to 2017, showing deterioration in the solvency for Giasson. On the other hand, this ratio improved from 2017 to 2018. Less than half of the company’s assets have been financed using debt.

The higher the basic earnings per share, the better evidence of improved profitability. Profitability increased from 2016 to 2017 but declined significantly from 2017 to 2018 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 2016 to 2018.

(b) Liquidity

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

Solvency

Giasson’s debt to total assets ratio, although deteriorating from 2016 to 2018, 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 basic earnings per share ratio and the price-earnings ratio.

LO 2 BT: AN Difficulty: M Time: 30 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

PROBLEM 2-9B

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

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

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

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

LO 3 BT: E Difficulty: C Time: 30 min. AACSB: None CPA: cpa-t001 CM: Reporting

PROBLEM 2-10B

1. The advantage of the current value basis of accounting is that it represents a more up-to-date measurement of the value of the asset reported. Consequently, the amounts reported are more relevant to the financial statement users. The disadvantage of the current 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 basis of measurement that should be used for the following purchases:
3. Due the nature of the asset, a textbook purchase should be recorded at the historical cost basis of accounting because of its intended use. The objective of owning the asset is to use it and not to immediately resell it at a profit.
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 historical 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 historical 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 historical cost basis of accounting should be used. On the other hand, if the purchase is for resale, the current value basis of accounting should be used.
7. 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 historical 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 current value basis of accounting used for investments, assuming the current value is readily available.

LO 3 BT: E Difficulty: C Time: 30 min. AACSB: None CPA: cpa-t001 CM: Reporting

CT2-1 FINANCIAL REPORTING CASE

(a) Total current assets were $335,581,000 at January 31, 2016, and $315,840,000 at January 31, 2015.

Total assets were $793,795,000 at January 31, 2016, and $724,299,000 at January 31, 2015.

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

(c) The current liabilities total $155,501,000 at January 31, 2016, and $146,275,000 at January 31, 2015. The total liabilities at January 31,   
2016 and January 31, 2015 were $436,183,000 and $395,016,000, respectively.

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

LO 1 BT: K Difficulty: S Time: 15 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

CT2-2 FINANCIAL ANALYSIS CASE

(a)

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | North West  (in thousands) | | | | Sobeys  (in millions) | | | |
|  |  |  |  |  |  |  |  |  |
| 1. Working capital |  | $335,581 – $155,501 | = | $180,080 |  | $2,581.4 – $2,707.4 | = | $(126.0) |
|  |  |
|  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| 2. Current ratio |  | $335,581 | = | 2.2:1 |  | $2,581.4 | = | 1.0:1 |
|  |  | $155,501 |  |  |  | $2,707.4 |  |  |
|  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |
| 3. Debt to |  | $436,183 | = | 54.9% |  | $5,230.9 | = | 65.7% |
| total assets |  | $793,795 |  |  |  | $7,960.6 |  |  |
|  |  |  |  |  |  |  |  |  |

(b) Liquidity: Working capital is not comparable, because of the differing sizes of the two companies involved. However, using the current ratio to assess liquidity, we can determine that North West is significantly more liquid than Sobeys and well ahead of the industry average. Sobeys is in a difficult position of having a working capital deficiency.

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. North West has a better ratio than the industry while Sobeys has a worse ratio.

LO 2 BT: C Difficulty: S Time: 25 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

(a) McCain’s multinational structure means that accounting personnel from various countries are involved with preparing financial statements. Since IFRS is a global standard, most of the accounting personnel would be familiar with IFRS. Also, by using one standard across all subsidiaries, there is no need to make adjustments for various GAAP differences (this was often the case for Canadian multinationals prior to the adoption of IFRS). For McCain, it means that the company will reduce cost as well as the chance for errors.

CT2-3 FINANCIAL REPORTING CASE

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

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

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

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

Understandability – When different accounting standards are used by various companies within a corporate group they are less understandable. Furthermore, when users are not resident in the country where the head office of the company is located, they often have a difficult time understanding financial statements that are presented using standards that they are not familiar with. For instance, a McCain manager in a United States subsidiary that follows U.S. GAAP may have difficulty understanding the statements of a McCain subsidiary located in the U.K. (that follows IFRS).

**CT2-3 (CONTINUED)**

(c) The assumption that small companies would avoid IFRS can relate to many things like:

1. Not planning to take their company public in the future;
2. They like the simplicity and familiarity of ASPE;
3. They have many competitors, customers, and suppliers that use ASPE which makes their financial statements comparable and understandable.

Examples of why private companies may adopt IFRS:

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

LO 3 BT: S Difficulty: M Time: 25 min. AACSB: None CPA: cpa-t001 CM: Reporting

CT2-4 FINANCIAL ANALYSIS CASE

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

1. Sheila paid $25,000 for 10,000 common shares of Kenmare Architects Ltd. (or $2.50 per share) when the company was formed. This amount is reported as the balance in the Common Shares account on the statement of financial position of December 31, 2017.

Sheila’s mother paid $10,000 for 1,000 common shares (or $10.00 per share) in early 2018. This amount paid can be determined by calculating the increase of $10,000 ($35,000 less $25,000) in the Common Shares account on the statement of financial position of December 31, 2018.

1. By December 31, 2017, Uncle Harry wanted $8,000 of the loan paid off in 2018. This amount is classified as the current portion of the loan due at December 31, 2017. The actual amount of principal paid in 2018 was $30,000. This amount paid can be determined by calculating the total decrease in the loan payable from December 31, 2017 to December 31, 2018: [($52,000 + $8,000) less ($26,000 + $4,000)]. During 2017 Uncle Harry received interest only in the amount of $3,600 as indicated in the statement of income for interest expense. In 2018, Uncle Harry received $32,700. This amount is equal to the principal repayment of $30,000 and the interest of $2,700.

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | 2018 |  |  |  | 2017 |  |  |
| Current ratio |  | $46,000 | = | 1.4:1 |  | $31,000 | = | 1.4:1 |
|  |  | $33,580 |  |  |  | $22,490 |  |  |

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

**CT2-4 (CONTINUED)**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | 2018 |  |  |  | 2017 |  |  |
| Debt to total assets |  | $59,580 | = | 56.2% |  | $74,490 | = | 72.3% |
|  | $106,000 |  |  |  | $103,000 |  |  |

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

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | 2018 |  |  |  | 2017 |  |  |
| Basic earnings per share |  | $7,910 | = | $0.72 |  | $3,510 | = | $0.35 |
|  | 11,000 |  |  |  | 10,000 |  |  |

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

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

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | 2018 |  |  |  | 2017 |  |  |
| Price-earnings ratio |  | $10.00 | = | 13.9 times |  | $2.50 | = | 7.1 times |
|  | $0.72 |  |  |  | $0.35 |  |  |

The service revenue increased 20% from 2017 to 2018 [($120,000 – $100,000) ÷ $100,000]. The net income increased by 125% from 2017 to 2018 [($7,910 – $3,510) ÷ $3,510]. Sheila’s salary increased by 25% from 2017 to 2018 [($74,000 – $59,000) ÷ $59,000].

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

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

**CT2-4 (CONTINUED)**

1. The likely reason for the sale in shares in 2018 was to obtain $10,000, which was used to repay the debt to Uncle Harry earlier than originally scheduled.

LO 1,2 BT: AN Difficulty: C Time: 40 min. AACSB: Analytic CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

CT2-5 ETHICS CASE

(a) The stakeholders in this case are:

Kathy Onishi, controller

Redondo’s vice-president of finance

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

(b) The ethical consideration in this situation is whether or not switching from ASPE to IFRS would affect the decisions of the users of the financial statements. Because Redondo Corporation is a private corporation, the use of IFRS is not required. It is ethically preferable to disclose the most financially relevant information to the users of the financial statements so that they can make informed decisions. One should question the reasoning of Redondo’s vice-president of finance who is focusing on the effect of the implementation on the net income for the year.

(c) As the controller, by supporting the conversion from ASPE to IFRS, Kathy could gain the trust and respect of the board of directors and the shareholders in general. The users of the company’s financial statements will find the information provided under IFRS to be more useful in making comparisons with Redondo’s competitors. This in turn will lead to better decisions being made by users of the financial statements.

LO 3 BT: E Difficulty: M Time: 15 min. AACSB: Ethics CPA: cpa-t001 and cpa-t005 CM: Reporting and Finance

CT2-6 SERIAL CASE

(a) Software Solutions’ financial statements will include the statement of financial position, income statement, statement of changes in equity, and statement of cash flows. It may also include a statement of comprehensive income. It will also include the notes to the financial statements.

The statement of financial position reports the assets, liabilities, and shareholders’ equity at a specific date. The income statement presents the revenues and expenses and resulting net income or loss 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 provided or used for operating, investing, and financing activities for a specific period of time.

(b) Because Software Solutions is public company, it is required to have its financial statements audited. The auditor’s report provides users with assurance that the financial statements are fairly presented. As a public company, Software Solutions is also required to file financial statements on a timely basis with the regulator of the stock exchange on which its share trade.

(c) By looking at the statement of financial position and determining the composition of Software Solutions’ current assets and current liabilities, we can assess its ability to pay its short-term obligations. We can also calculate liquidity ratios, such as working capital and the current ratio, for the current and prior periods to help determine its ability to meet its current obligations. This will not guarantee that Software Solutions is able to pay ABC’s invoices in the future, but it will provide some assurance with respect to how it has performed in the past. The statement of cash flows also provides information to determine if Software Solutions generates positive cash flows from its operating activities.

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

**CT2-6 (CONTINUED)**

(e) By looking at the statement of financial position, we can determine Software Solutions’ total liabilities, and the mix of current and non-current debt. We can also calculate solvency ratios, such as the debt to total assets ratio, to determine whether Software Solutions has the ability to repay its total 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 helps in determining whether Software Solutions 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 obligations.

(f) Be aware that the financial statements of Software Solutions provide a historical perspective of what has already taken place. The financial statements may not prove to be the best indicator of what will happen in the future. Consumer tastes change and as a result the demand for Software Solutions’ products may also change.

As well, consider this business opportunity from your perspective. Ask yourself if the price obtained for the hours worked is reasonable considering some of the risks involved. There is a risk that, by taking on this obligation, additional opportunities cannot be pursued. Does Anthony Business Company have the ability to meet the demands of Software Solutions? Is it able to commit to providing 500 hours of service per month? Does it have enough staff to enable the company to do so? Does it have enough cash to pay for the staff that will be required, along with other operating expenses, and wait 30 days from the date of the invoice to collect from Software Solutions?

LO 2,3 BT: E Difficulty: M ime: 40 min. AACSB: Analytic CPA: cpa-t001 CM: Reporting

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