CHAPTER 1

# THE PURPOSE AND USE OF FINANCIAL STATEMENTS

### Summary Of Questions By Study Objectives

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Item** | **SO** | **Item** | **SO** | **Item** | **SO** | **Item** | **SO** | **Item** | **SO** | **Item** | **SO** | **Item** | **SO** |
| True-False Statements | | | | | | | | | | | | | |
| 1. | 1 | 9. | 1 | 17. | 3 | 25. | 4 | 33. | 4 | 41. | 4 |  |  |
| 2. | 1 | 10. | 1 | 18. | 3 | 26. | 4 | 34. | 4 | 42. | 4 |  |  |
| 3. | 1 | 11. | 2 | 19. | 3 | 27. | 4 | 35. | 4 | 43. | 4 |  |  |
| 4. | 1 | 12. | 2 | 20. | 3 | 28. | 4 | 36. | 4 | 44. | 4 |  |  |
| 5. | 1 | 13. | 2 | 21. | 3 | 29. | 4 | 37. | 4 | 45. | 4 |  |  |
| 6. | 1 | 14. | 2 | 22. | 3 | 30. | 4 | 38. | 4 | 46. | 4 |  |  |
| 7. | 1 | 15. | 2 | 23. | 3 | 31. | 4 | 39. | 4 |  |  |  |  |
| 8. | 1 | 16. | 3 | 24. | 3 | 32. | 4 | 40. | 4 |  |  |  |  |
| Multiple Choice Questions | | | | | | | | | | | | | |
| 47. | 1 | 57. | 2 | 67. | 3 | 77. | 3 | 81. | 4 | 91. | 4 | 101. | 4 |
| 48. | 1 | 58. | 2 | 68. | 3 | 78. | 3 | 82. | 4 | 92. | 4 | 102. | 4 |
| 49. | 1 | 59. | 2 | 69. | 3 | 79. | 3 | 83. | 4 | 93. | 4 | 103. | 4 |
| 50. | 1 | 60. | 2 | 70. | 3 | 80. | 3 | 84. | 4 | 94. | 4 | 104. | 4 |
| 51. | 1 | 61. | 2 | 71. | 3 | 81. | 3 | 85. | 4 | 95. | 4 | 105. | 4 |
| 52. | 1 | 62. | 2 | 72. | 3 | 82. | 4 | 86. | 4 | 96. | 4 | 106. | 4 |
| 53. | 1 | 63. | 2 | 73. | 3 | 83. | 4 | 87. | 4 | 97. | 4 | 107. | 4 |
| 54. | 1 | 64. | 2 | 74. | 3 | 84. | 4 | 88. | 4 | 98. | 4 | 108. | 4 |
| 55. | 1 | 65. | 2 | 75. | 3 | 85. | 4 | 89. | 4 | 99. | 4 | 109. | 4 |
| 56. | 1 | 66. | 3 | 76. | 3 | 86. | 4 | 90. | 4 | 100. | 4 | 110. | 4 |
| Exercises | | | | | | | | | | | | | |
| 111. | 3 | 115. | 4 | 119. | 4 | 123. | 4 | 127. | 4 | 131. | 4 |  |  |
| 112. | 3 | 116. | 4 | 120. | 4 | 124. | 4 | 128. | 4 | 132. | 4 |  |  |
| 113. | 4 | 117. | 4 | 121. | 4 | 125. | 4 | 129. | 4 |  |  |  |  |
| 114. | 4 | 118. | 4 | 122. | 4 | 126. | 4 | 130. | 4 |  |  |  |  |
| **Matching** | | | | | | | | | | | | | |
| 133. | 1-4 |  |  |  |  |  |  |  |  |  |  |  |  |
| **Short-Answer Essay** | | | | | | | | | | | | | |
| 134. | 1 | 136. | 4 | 138. | 4 | 140. | 2 |  |  |  |  |  |  |
| 135. | 2 | 137. | 4 | 139. | 4 | 141. | 4 |  |  |  |  |  |  |

### SUMMARY OF STUDY OBJECTIVES BY QUESTION TYPE

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Item** | **Type** | **Item** | **Type** | **Item** | **Type** | **Item** | **Type** | **Item** | **Type** | **Item** | **Type** | **Item** | **Type** |
| **Study Objective 1** | | | | | | | | | | | | | |
| 1. | TF | 7. | TF | 49. | MC | 55. | MC |  |  |  |  |  |  |
| 2. | TF | 8. | TF | 50. | MC | 56. | MC |  |  |  |  |  |  |
| 3. | TF | 9. | TF | 51. | MC | 133. | M |  |  |  |  |  |  |
| 4. | TF | 10. | TF | 52. | MC | 134. | SAE |  |  |  |  |  |  |
| 5. | TF | 47. | MC | 53. | MC |  |  |  |  |  |  |  |  |
| 6. | TF | 48. | MC | 54. | MC |  |  |  |  |  |  |  |  |
| **Study Objective 2** | | | | | | | | | | | | | |
| 11. | TF | 15. | TF | 60. | MC | 64. | MC | 135. | SAE |  |  |  |  |
| 12. | TF | 57. | MC | 61. | MC | 65. | MC | 140. | SAE |  |  |  |  |
| 13. | TF | 58. | MC | 62. | MC | 133. | M |  |  |  |  |  |  |
| 14. | TF | 59. | MC | 63. | MC |  |  |  |  |  |  |  |  |
| **Study Objective 3** | | | | | | | | | | | | | |
| 16. | TF | 21. | TF | 67. | MC | 72. | MC | 77. | MC | 111. | EX |  |  |
| 17. | TF | 22. | TF | 68. | MC | 73. | MC | 78. | MC | 112. | EX |  |  |
| 18. | TF | 23. | TF | 69. | MC | 74. | MC | 79. | MC | 133. | M |  |  |
| 19. | TF | 24. | TF | 70. | MC | 75. | MC | 80. | MC |  |  |  |  |
| 20. | TF | 66. | MC | 71. | MC | 76. | MC | 81. | MC |  |  |  |  |
| **Study Objective 4** | | | | | | | | | | | | | |
| 25. | TF | 38. | TF | 85. | MC | 98. | MC | 114. | EX | 127. | EX |  |  |
| 26. | TF | 39. | TF | 86. | MC | 99. | MC | 115. | EX | 128. | EX |  |  |
| 27. | TF | 40. | TF | 87. | MC | 100. | MC | 116. | EX | 129. | EX |  |  |
| 28. | TF | 41. | TF | 88. | MC | 101. | MC | 117. | EX | 130. | EX |  |  |
| 29. | TF | 42. | TF | 89. | MC | 103. | MC | 118. | EX | 131. | EX |  |  |
| 30. | TF | 43. | TF | 90. | MC | 104. | MC | 119. | EX | 132. | EX |  |  |
| 31. | TF | 44. | TF | 91. | MC | 105. | MC | 120. | EX | 133. | M |  |  |
| 32. | TF | 45. | TF | 92. | MC | 106. | MC | 121. | EX | 136. | SAE |  |  |
| 33. | TF | 46. | TF | 93. | MC | 107. | MC | 122. | EX | 137. | SAE |  |  |
| 34. | TF | 82. | MC | 94. | MC | 108. | MC | 123. | EX | 138. | SAE |  |  |
| 35. | TF | 83. | MC | 95. | MC | 109. | MC | 124. | EX | 139. | SAE |  |  |
| 36. | TF | 83. | MC | 96. | MC | 110. | MC | 125. | EX | 141. | SAE |  |  |
| 37. | TF | 84. | MC | 97. | MC | 113. | EX | 126. | EX |  |  |  |  |

Note: TF = True-False M = Matching

MC = Multiple Choice EX = Exercise SAE = Short-Answer Essay

## CHAPTER STUDY OBJECTIVES

1. ***Identify the users and uses of accounting.*** The purpose of accounting is to provide useful information for decision-making. There are two types of user groups who use accounting information: internal and external users. Internal users work for the business and need accounting information to plan, organize, and run operations. The primary external users are investors, lenders and other creditors. Investors (existing and potential shareholders) use accounting information to help decide whether to buy, hold, or sell shares. Lenders (such as bankers) and other creditors (such as suppliers) use accounting information to evaluate the risk of granting credit or lending money to a business. In order for financial information to have value to its users, both internal and external, it must be prepared by individuals with high standards of ethical behaviour.

2***. Describe the primary forms of business organizations.*** There are three types of organizations that use accounting information: proprietorships, partnerships, and corporations. A proprietorship is a business owned by one person. A partnership is a business owned by two or more people. A corporation is a separate legal entity whose shares provide evidence of ownership.

3. ***Explain the three main types of business activity.*** Financing activities involve raising the necessary funds (through debt or equity) to support the business. Investing activities involve acquiring the resources (such as property, plant, and equipment) that are needed to run the business. Operating activities involve putting the resources of the business into action to generate a profit.

4. ***Describe the content and purpose of each of the financial statements.*** The income statement presents the revenues and expenses of a company for a specific period of time. The statement of changes in equity summarizes the changes in shareholders’ equity that have occurred for a specific period of time. The statement of financial position reports the assets, liabilities, and shareholders’ equity of a business at a specific date. The statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time. Notes to the financial statements add explanatory detail where required. The financial statements are included in an annual report, along with nonfinancial and other financial information.

## TRUE-FALSE STATEMENTS

1. Accounting identifies and records economic events of a business.
2. High standards of ethics are not required for preparers of financial information.
3. Accounting information is not important to marketing managers.
4. Shareholders and creditors are the only people who need accounting information.
5. Canada Revenue Agency is the major external user of information.
6. External users of accounting information include the managers who plan, organize, and run a business.
7. The information needs and questions of external users vary considerably.
8. Authorities, such as the Canada Revenue Agency, want to know whether a business complies with the tax laws.
9. Accounting communicates financial information about a business to both internal and external users.
10. Two internal users of accounting information are investors and managers.
11. A partnership is a business organized as a separate legal entity.
12. A proprietor has unlimited liability.
13. The liability of corporate shareholders is limited to the amount of their investment.
14. A private corporation is one whose shares are traded on an organized stock exchange, like the Toronto Stock Exchange.
15. A proprietorship is usually operated by the owner.
16. Expenses are the cost of assets consumed or services used in the process of generating revenue.
17. Financing activities for corporations include borrowing money and selling shares.
18. Investing activities involve collecting the necessary funds to operate the business.
19. The purchase of equipment is an example of a financing activity.
20. Assets are resources owned by a business that provide current services or benefits to the business.
21. Economic resources that are owned by a business are called shareholders’ equity.
22. Payments to shareholders are called dividends.
23. Revenues are increases in economic resources that result from a business’s operating activities.
24. Expenses are identified by the type of liability associated with them.
25. Profit for the period is determined by subtracting total expenses and dividends from revenues.
26. Profit is another term for revenue.
27. The issue of shares and distribution of dividends are used in determining profit.
28. Financial statement users are interested in profit because it may be a predictor of future profit.
29. Shareholders’ equity is always equal to the cash on hand at any given date.
30. The primary purpose of the statement of cash flows is to provide information about the cash receipts and cash payments of a business for a specific period of time.
31. The statement of financial position reports assets and claims to those assets at a specific point in time.
32. The statement of changes in equity reflects a different time period than that covered by the income statement.
33. Creditors use the statement of financial position as another source of information to determine the likelihood they will be repaid.
34. The basic accounting equation subdivides liabilities into two categories: claims of creditors and claims of the Canada Revenue Agency.
35. The statement of cash flows shows how cash was used during the period.
36. The accounting equation can be expressed as: Assets – Shareholders’ Equity = Liabilities.
37. The accounting equation can be expressed as: Assets + Liabilities = Shareholders’ Equity.
38. If the assets owned by a business total $100,000 and liabilities total $52,000, shareholders’ equity totals $48,000.
39. Claims of creditors and shareholders on the assets of a business are called liabilities.
40. Shareholder’s equity consists of two parts: share capital and retained earnings.
41. Any deficiency in cash from operating activities must be made up by issuing shares.
42. The statement of changes in equity is not dependent on the results from the income statement.
43. The statement of financial position is always the first statement prepared and presented.
44. Depreciation is the cost of certain long-lived assets allocated to expense for each period.
45. The reasons for a decrease in cash can be determined by examining the income statement.
46. A negative balance in retained earnings is called a deficit.

#### Answers to True-False Statements

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Item** | **Ans.** | **Item** | **Ans.** | **Item** | **Ans.** | **Item** | **Ans.** | **Item** | **Ans.** | **Item** | **Ans.** |
| 1. | T | 9. | T | 17. | T | 25. | F | 33. | T | 41. | F |
| 2. | F | 10. | F | 18. | F | 26. | F | 34. | F | 42. | F |
| 3. | F | 11. | F | 19. | F | 27. | F | 35. | T | 43. | F |
| 4. | F | 12. | T | 20. | F | 28. | T | 36. | T | 44. | T |
| 5. | F | 13. | T | 21. | F | 29. | F | 37. | F | 45. | F |
| 6. | F | 14. | F | 22. | T | 30. | T | 38. | T | 46. | T |
| 7. | T | 15. | T | 23. | T | 31. | T | 39. | F |  |  |
| 8. | T | 16. | T | 24. | F | 32. | F | 40. | T |  |  |

## MULTIPLE CHOICE QUESTIONS

47. The world’s economic systems depend on financial reporting that is:

* 1. highly transparent.
  2. accurate.
  3. reliable.
  4. all of the above.

48. Which of the following is the most appropriate definition of accounting?

1. The information system that identifies, records, and communicates the economic events of an organization to interested users.
2. A means of collecting information.
3. The interconnected network of subsystems necessary to operate a business.
4. Electronic collection, organization, and communication of vast amounts of information.

49. Which of the following would *not* be considered an internal user of accounting data for XYZ Inc.?

1. The company president
2. Production manager
3. Merchandise inventory clerk
4. Receptionist of the employees’ labour union

50. Which of the following groups uses accounting information primarily to ensure the entity is operating within prescribed rules?

1. Taxing authorities
2. Regulatory agencies
3. Labour unions
4. Management

51. Which of the following uses accounting information to determine whether a company can pay its obligations?

1. Shareholders
2. Marketing managers
3. Creditors
4. Chief Financial Officer

52. Which of the following uses accounting information to determine whether a company’s profit will result in a share price increase?

1. Shareholders
2. Marketing managers
3. Creditors
4. Chief Financial Officer

53. Which of the following uses accounting information to determine whether a marketing proposal will be cost effective?

1. Shareholders
2. Marketing managers
3. Creditors
4. Chief Financial Officer

54. Which of the following would *not* be considered an external user of accounting data?

* 1. Canada Revenue Agency
  2. Management
  3. Creditors
  4. Customers

55. Which of the following would *not* be considered an internal user of accounting data?

1. The president of a company
2. The controller of a company
3. A creditor of a company
4. A salesperson of a company

56. External users want answers to all of the following questions except:

1. Is the company earning satisfactory income?
2. Will the company be able to pay its debts as they come due?
3. Will the company be able to afford employee pay raises this year?
4. How does the company compare in profitability with competitors?

57. The proprietorship form of business organization:

1. in most provinces, must have at least two owners.
2. is often chosen for small owner operated businesses.
3. is difficult to set up.
4. is classified as a separate legal entity.

58. A business organized as a corporation:

(a) is not a separate legal entity in most provinces.

(b) requires that shareholders be personally liable for the debts of the business.

1. is owned by its shareholders.
2. has income tax disadvantages over a proprietorship or partnership.

59. The partnership form of business organization:

1. is a separate legal entity.
2. is a common form of organization for service-type businesses.
3. enjoys an unlimited life.
4. has limited liability.

60. Which form of business would have its shares listed on a stock exchange?

1. Proprietorship
2. Partnership
3. Private corporation
4. Public corporation

61. A business organized as a separate legal entity is a:

1. corporation.
2. proprietorship.
3. government unit.
4. partnership.

62. The concept that economic activity which can be identified with a particular company must be kept separate and distinct from the owner(s) and from all other economic entities is known as:

1. the separation concept.
2. the reporting entity concept.
3. the economic concept.
4. the business organization concept.

63. An advantage of the corporate form of business is that:

1. it has limited life.
2. its shareholders’ personal resources are at stake.
3. its ownership is easily transferable via the sale of shares.
4. it is simple to establish.

64. A corporation has which of the following set of characteristics?

1. Shareholder control, income tax disadvantages, increased skills and resources
2. Simple to set up and maintains control with founder
3. Harder to raise funds and gives shareholders control
4. Easier to transfer ownership and raise funds, no personal liability

65. A small neighbourhood barber shop that is operated by its owner would likely be organized as a:

1. public corporation.
2. partnership.
3. private corporation.
4. proprietorship.

66. The liability created by a business when it purchases coffee beans and coffee cups on credit from suppliers is called a(n):

1. account payable.
2. account receivable.
3. revenue.
4. expense.

67. The right to receive money in the future is called a(n):

1. account payable.
2. account receivable.
3. liability.
4. revenue.

68. Which of the following is *not* a principal type of business activity?

1. Operating
2. Investing
3. Financing
4. Marketing

69. Which of the following activities involves raising the necessary funds to support the business?

1. Operating
2. Investing
3. Financing
4. Marketing

70. Buying assets needed to operate a business is an example of a(n):

1. purchasing activity.
2. financing activity.
3. investing activity.
4. operating activity.

71. The purchase of manufacturing equipment for a factory is what type of business activity?

1. Manufacturing
2. Financing
3. Investing
4. Operating

72. Cost of goods sold is a(n):

1. liability.
2. financing activity.
3. asset.
4. expense.

73. Allocating the cost of using long-term assets over their useful lives is called:

1. allocation expense.
2. depreciation expense.
3. a general expense.
4. asset use expense.

74. Buying and selling products are examples of:

1. operating activities.
2. investing activities.
3. financing activities.
4. manufacturing activities.

75. The common characteristic possessed by all assets is:

1. long life.
2. great monetary value.
3. tangible nature.
4. future economic benefit.

76. Expenses are incurred:

1. only on rare occasions.
2. to produce assets.
3. to produce liabilities.
4. to generate revenues.

77. The cost of assets consumed or services used is also known as a(n):

1. revenue.
2. expense.
3. liability.
4. asset.

78. Resources owned by a corporation are referred to as:

1. shareholders’ equity.
2. liabilities.
3. assets.
4. revenues.

79. Debt and obligations of a business are referred to as:

1. assets.
2. equities.
3. liabilities.
4. expenses

80. Liabilities:

1. are future economic benefits.
2. are debts and obligations.
3. possess service potential.
4. are things of value owned by a business.

81. Liabilities of a company are owed to:

1. debtors.
2. owners.
3. creditors.
4. shareholders.

82. Dividends are reported on:

1. the income statement.
2. the statement of changes in equity.
3. the statement of financial position.
4. both the income statement and statement of financial position.

83. Dividends:

1. increase assets.
2. increase expenses.
3. decrease revenues.
4. decrease retained earnings.

84. The financial statement that summarizes the changes in common shares and retained earnings for a specific period of time is the:

1. statement of financial position.
2. income statement.
3. statement of cash flows.
4. statement of changes in equity.

85. Profit results when:

1. Assets > Liabilities.
2. Assets < Liabilities.
3. Revenues > Expenses.
4. Revenues < Expenses.

86. Retained earnings at the end of the period is equal to:

1. retained earnings at the beginning of the period plus profit minus liabilities.
2. retained earnings at the beginning of the period plus profit minus dividends.
3. profit for the period
4. assets plus liabilities.

87. A company’s policy toward dividends and growth could best be determined by examining the:

1. statement of financial position.
2. income statement.
3. statement of changes in equity.
4. statement of cash flows.

88. An income statement:

1. summarizes the changes in retained earnings for a specific period of time.
2. reports the changes in assets, liabilities, and shareholders’ equity over a period of time.
3. reports the assets, liabilities, and shareholders’ equity at a specific date.
4. reports the revenues and expenses for a specific period of time.

89. If the retained earnings account increases from the beginning of the year to the end of the year, then:

* 1. profit is greater than dividends.
  2. a loss is less than dividends.
  3. additional investments are less than reported losses.
  4. no dividends were paid.

90. The statement of changes in equity would *not* show:

1. the beginning retained earnings balance.
2. revenues and expenses.
3. dividends.
4. the ending retained earnings balance.

91. Which financial statement is prepared first?

1. Statement of financial position
2. Income statement
3. Statement of changes in equity
4. Statement of cash flows

92. A statement of financial position shows:

1. revenues, liabilities, and shareholders’ equity.
2. expenses, dividends, and shareholders’ equity.
3. revenues, expenses, and dividends.
4. assets, liabilities, and shareholders’ equity.

93. The accounting equation may be expressed as:

1. Assets = Shareholders’ Equity – Liabilities.
2. Assets = Liabilities + Shareholders’ Equity.
3. Assets + Liabilities = Shareholders’ Equity.
4. Assets + Shareholders’ Equity = Liabilities.

Use the following information for questions 94-95.

Tam’s Car Repair Shop Ltd. started the year with total assets of $70,000 and total liabilities of $40,000. During the year, the business recorded $100,000 in car repair revenues, $65,000 in expenses, and paid dividends of $5,000.

94. Shareholders’ equity at the end of the year was:

1. $60,000.
2. $65,000.
3. $70,000.
4. $75,000.

95. The profit reported for the year was:

1. $30,000.
2. $35,000.
3. $20,000.
4. $100,000.

96. If total liabilities increased by $25,000 and shareholders’ equity increased by $5,000 during a period of time, then total assets must change by what amount and direction (increase or decrease) during that same period?

1. $20,000 decrease
2. $20,000 increase
3. $25,000 increase
4. $30,000 increase

97. If total liabilities decreased by $14,000 during a period of time and shareholders’ equity increased by $6,000 during the same period, then the amount and direction (increase or decrease) of the period’s change in total assets is a(n):

1. $14,000 increase.
2. $20,000 increase.
3. $8,000 decrease.
4. $8,000 increase.

98. The statement of financial position:

1. summarizes the changes in shareholders’ equity for a specific period of time.
2. reports the changes in assets, liabilities, and shareholders’ equity over a period of time.
3. reports the assets, liabilities, and shareholders’ equity at a specific date.
4. presents the revenues and expenses for a specific period of time.

99. Which of the following financial statements is concerned with the company at a point in time?

1. Statement of financial position
2. Income statement
3. Statement of changes in equity
4. Statement of cash flows

100. Shareholders’ equity can be described as claims of:

1. creditors on total assets.
2. owners on total assets.
3. customers on total assets.
4. debtors on total assets.

101. Payments to shareholders are called:

1. expenses.
2. liabilities.
3. dividends.
4. shares.

102. Common shares are reported on:

1. the statement of financial position.
2. the statement of changes in equity.
3. both the statement of financial position and the income statement.
4. both the statement of changes in equity and the statement of financial position.

103. Shareholders’ equity is comprised of:

1. common shares and dividends.
2. common shares and retained earnings.
3. dividends and retained earnings.
4. profit and retained earnings.

104. Common shares represent:

1. the creditors’ claims on the company.
2. the total profit of the company to date.
3. the amount paid by investors for ownership in the company.
4. the owners’ claims on the company.

105. Retained earnings are:

1. the shareholders’ claim on total assets.
2. equal to cash.
3. equal to revenues.
4. the amount of profit kept in the corporation for future use.

106. Which financial statement would indicate whether the company relies more on debt or shareholders’ equity to finance its assets?

1. Statement of cash flows
2. Statement of changes in equity
3. Income statement
4. Statement of financial position

107. The primary purpose of the statement of cash flows is to report:

1. a company'sinvestingtransactions.
2. a company's financing transactions.
3. information about cash receipts and cash payments of a company.
4. the net increase or decrease in cash.

108. The statement of changes in equity is dependent on the results from:

1. the statement of cash flows.
2. the statement of financial position.
3. the income statement.
4. a company's share capital.

109. The statement of financial position and statement of changes in equity are related because:

1. the total assets on the statement of financial position is reported on the statement of changes in equity.
2. the ending amount on the statement of changes in equity is reported on the statement of financial position.
3. the ending amount on each statement is transferred to the statement of cash flows.
4. both contain information for the corporation.

110. The statement of cash flows and the statement of financial position are interrelated because:

1. the ending amount of cash on the statement of cash flows must agree with the amount on the income statement.
2. the ending amount of cash on the statement of cash flows must agree with the amount in the statement of changes in equity.
3. the ending amount of cash on the statement of cash flows must agree with the amount in the statement of financial position.
4. both disclose the corporation's profit.

#### Answers to Multiple Choice Questions

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| **Item** | **Ans.** | **Item** | **Ans.** | **Item** | **Ans.** | **Item** | **Ans.** | **Item** | **Ans.** | **Item** | **Ans.** |
| 47. | d | 59. | b | 71. | c | 83. | d | 95. | b | 107. | c |
| 48. | a | 60. | d | 72. | d | 84. | d | 96. | d | 108. | c |
| 49. | d | 61. | a | 73. | b | 85. | c | 97. | c | 109. | b |
| 50. | b | 62. | b | 74. | a | 86. | b | 98. | c | 110. | c |
| 51. | c | 63. | c | 75. | d | 87. | c | 99. | a |  |  |
| 52. | a | 64. | d | 76. | d | 88. | d | 100. | b |  |  |
| 53. | b | 65. | d | 77. | b | 89. | a | 101. | c |  |  |
| 54. | b | 66. | a | 78. | c | 90. | b | 102. | d |  |  |
| 55. | c | 67. | b | 79. | c | 91. | b | 103. | b |  |  |
| 56. | c | 68. | d | 80. | b | 92. | d | 104. | c |  |  |
| 57. | b | 69. | c | 81. | c | 93. | b | 105. | d |  |  |
| 58. | c | 70. | c | 82. | b | 94. | a | 106. | d |  |  |

## Exercises

##### Ex. 111

Classify each of the following items as investing, financing, or operating activity and indicate which financial statement(s) it will appear on.

(a) Cash sale of merchandise

(b) Repayment of bank loan

(c) Purchase of inventory

(d) Sale of equipment for cash

(e) Payment of commission to a salesperson

(f) Payment of dividends

(g) Receipt of interest on accounts receivable

(h) Payment for insurance for the current year

(i) Purchase of shares in another company as a long-term investment

(j) Issue of debt

##### Solution 111 (6 min.)

(a) Operating, Income statement, Statement of cash flows

(b) Financing, Statement of cash flows

(c) Operating, Statement of cash flows

(d) Investing, Statement of cash flows

(e) Operating, Income statement, Statement of cash flows

(f) Financing, Statement of changes in equity, Statement of cash flows

(g) Operating, Income statement, Statement of cash flows

(h) Operating, Income statement, Statement of cash flows

(i) Investing, Statement of financial position, Statement of cash flows

(j) Financing, Statement of financial position, Statement of cash flows

##### Ex. 112

Indicate in the space provided by each item whether it would appear on the statement of cash flows as a(n): (O) operating activity, (I) investing activity, or (F) financing activity.

\_\_\_\_\_ (a) Cash receipts from customers

\_\_\_\_\_ (b) Issue of common shares for cash

\_\_\_\_\_ (c) Payment of cash dividends

\_\_\_\_\_ (d) Cash purchase of equipment

\_\_\_\_\_ (e) Cash payments to suppliers

\_\_\_\_\_ (f) Sale of old machine for cash

##### Solution 112 (5 min.)

O (a) I (d)

F (b) O (e).

F (c) I (f)

##### Ex. 113

The following questions are unrelated. If the amount cannot be determined from the information provided, state “Not determinable.”

1. You know that profit is $50,000, opening retained earnings $25,000, dividends $20,000, common shares $2,000, current assets $26,000 and total liabilities are $33,000.

(a) What is the amount of total assets?

(b) What is the cash balance?

2. Cash provided by operating activities is $25,000, cash used in investing activities is $20,000 and cash used in financing activities is $2,000. The ending cash balance is $10,000.

(a) What is the amount of profit?

(b) What is the beginning cash balance?

##### Solution 113 (10 min.)

1. (a) Opening retained earnings $25,000

Profit 50,000

Less: dividends (20,000)

Ending retained earnings $55,000

Retained earnings $55,000

Common shares 2,000

Total liabilities 33,000

Total liabilities and shareholders’ equity $90,000

Total assets $90,000

(b) Not determinable

2. (a) Not determinable

(b) Cash provided by operating activities $25,000

Cash used in investing (20,000)

Cash used in financing (2,000)

Net change in cash 3,000

Cash beginning X

Cash ending $10,000

Solving for X, cash beginning is $7,000

##### Ex. 114

Prepare an income statement, a statement of changes in equity, and a statement of financial position for Norman Rae Ltd., a service business, from the items listed below for the month of October, 2012.

Retained earnings, October 1 $15,000

Common shares 28,000

Accounts payable 10,000

Office equipment 30,000

Service revenue 28,500

Dividends paid 6,000

Office supplies expense 3,500

Cash 10,000

Utilities expense 700

Office supplies 2,800

Salaries expense 7,000

Accounts receivable 14,000

Rent expense 3,000

Income tax expense 4,500

NORMAN RAE LTD.

Income Statement

Month Ended October 31, 2012

Revenues $

Expenses $

Total expenses \_\_\_\_\_\_\_\_\_

Profit before income tax

Income tax expense

Profit $

NORMAN RAE LTD.

Statement of Changes in Equity

Month Ended October 31, 2012

Common Shares Retained Earnings Total Equity

Balances, October 1 $

Profit

Dividends

Balances, October 31 $

NORMAN RAE LTD.

Statement of Financial Position

October 31, 2012

Assets

$

Assets

Total assets $

$

Liabilities and Shareholders’ Equity

Liabilities $

Shareholders’ equity

Total shareholders’ equity $

Total liabilities and shareholders’ equity $

**Solution 114** (30 min.)

NORMAN RAE LTD.

Income Statement

Month Ended October 31, 2012

Revenues

Service revenue $28,500

Expenses

Salaries expense $7,000

Office supplies expense 3,500

Rent expense 3,000

Utilities expense 700

Total expenses 14,200

Profit before income tax 14,300

Income tax expense 4,500

Profit $ 9,800

NORMAN RAE LTD.

Statement of Changes in Equity

Month Ended October 31, 2012

Common Shares Retained Earnings Total Equity

Balances, October 1 $28,000 $15,000 $43,000

Profit 9,800 9,800

Dividends \_\_\_\_\_\_ (6,000) (6,000)

Balances, October 31 $28,000 $18,800 $46,800

NORMAN RAE LTD.

Statement of Financial Position

October 31, 2012

Assets

Cash $10,000

Accounts receivable 14,000

Office supplies 2,800

Office equipment 30,000

Total assets $56,800

Liabilities and Shareholders’ Equity

Liabilities

Accounts payable $10,000

Shareholders’ equity

Common shares $28,000

Retained earnings 18,800

Total shareholders’ equity 46,800

Total liabilities and shareholders’ equity $56,800

##### Ex. 115

Use the following information to calculate for the year ended December 31, 2012: (a) profit, (b) ending retained earnings, and (c) total assets.

Supplies $ 1,500 Revenues $18,500

Operating expenses 10,000 Cash 20,000

Accounts payable 11,000 Dividends 3,000

Accounts receivable 6,000 Bank loan payable 2,000

Common shares 10,000 Office equipment 3,500

Retained earnings (beginning) 4,000 Income tax expense 1,500

##### Solution 115 (5 min.)

(a) $7,000 ($18,500 - $10,000 - $1,500)

(b) $8,000 ($4,000 + $7,000 - $3,000)

(c) $31,000 ($1,500 + $20,000 + $6,000 + $3,500)

##### Ex. 116

Use the following information to prepare, in good form, an income statement, a statement of changes in equity, and a statement of financial position for Technical Industries Ltd. for the month ended July 31, 2012.

Accounts payable $ 5,100 Dividends $ 2,000

Accounts receivable 1,400 Insurance expense 2,200

Office building 60,000 Supplies 400

Cash 28,600 Bank loan payable 3,300

Revenues 21,100 Common shares 52,000

Salaries expense 10,000 Income tax expense 2,800

Retained earnings (beginning) 25,900

TECHNICAL INDUSTRIES LTD.

Income Statement

Month Ended July 31, 2012

Revenues

$

Expenses

$

Total expenses

Profit before income tax

Income tax expense

Profit $

TECHNICAL INDUSTRIES LTD.

Statement of Changes in Equity

Month Ended July 31, 2012

Common Shares Retained Earnings Total Equity

Balances, July 1 $ $ $

Profit

Dividends

Balances, July 31 $ $

TECHNICAL INDUSTRIES LTD.

Statement of Financial Position

July 31, 2012

Assets

$

Total assets

$

Liabilities and Shareholders’ Equity

Liabilities $

Total liabilities

Shareholders’ equity

Total shareholders’ equity

Total liabilities and shareholders’ equity $ t

##### Solution 116 (30 min.)

TECHNICAL INDUSTRIES LTD.

Income Statement

Month Ended July 31, 2012

Revenues

Service revenue $21,100

Expenses

Salaries expense $10,000

Insurance expense 2,200

Total expenses 12,200

Profit before income tax 8,900

Income tax expense 2,800

Profit $ 6,100

TECHNICAL INDUSTRIES LTD.

Statement of Changes in Equity

Month Ended July 31, 2012

Common Shares Retained Earnings Total Equity

Balances, July 1 $52,000 $25,900 $77,900

Profit 6,100 6,100

Dividends \_\_\_\_\_\_ \_(2,000) (2,000)

Balances, July 31 $52,000 $30,000 $82,000

TECHNICAL INDUSTRIES LTD.

Statement of Financial Position

July 31, 2012

Assets

Cash $28,600

Accounts receivable 1,400

Supplies 400

Office building 60,000

Total assets $90,400

Liabilities and Shareholders’ Equity

Liabilities

Accounts payable $5,100

Bank loan payable 3,300

Total liabilities $ 8,400

Shareholders’ equity

Common shares $52,000

Retained earnings 30,000 82,000

Total liabilities and shareholders’ equity $90,400

##### Ex. 117

Listed below in alphabetical order is accounting information for Ching Corp. at December 31, 2012. Prepare a statement of financial position in good format.

Accounts payable $ 19,000

Accounts receivable 32,000

Building 100,000

Cash 42,000

Common shares 160,000

Land 60,000

Office equipment 40,000

Retained earnings 95,000

##### Solution 117 (10 min.)

CHING CORP

Statement of Financial Position

December 31, 2012

Assets

Cash $ 42,000

Accounts receivable 32,000

Land 60,000

Building 100,000

Office equipment 40,000

Total assets $274,000

Liabilities and Shareholders’ Equity

Liabilities

Accounts payable $ 19,000

Shareholders’ equity

Common shares $160,000

Retained earnings 95,000 255,000

Total liabilities and shareholders’ equity $274,000

##### Ex. 118

Indicate in the space provided by each item whether it would appear on the Income statement (IS), Statement of financial position (SFP), and/or Statement of changes in equity (SCE):

(a) Service Revenue (g) Accounts Receivable

(b) Utilities Expense (h) Common Shares

(c) Cash (i) Equipment

(d) Accounts Payable (j) Advertising Expense

(e) Office Supplies (k) Dividends

(f) Salaries Expense (l) Notes Payable

##### Solution 118 (5 min.)

(a) IS (g) SFP

(b) IS (h) SCE and SFP

(c) SFP (i) SFP

(d) SFP (j) IS

(e) SFP (k) SCE

(f) IS (l) SFP

##### Ex. 119

Battu Inc. was reviewing its business activities at the end of its fiscal year (November 30, 2012) and decided to prepare a statement of changes in equity. At the beginning of the year, its assets were $600,000, liabilities were $150,000, and common shares were $200,000. The profit for the year was $220,000. Dividends of $120,000 were paid during the year.

**Instructions**

Prepare a statement of changes in equity for the year ended November 30, 2012.

##### Solution 119 (10 min.)

BATTU INC.

Statement of Changes in Equity

Year Ended November 30, 2012

Common Shares Retained Earnings Total Equity

Balances, Dec 1, 2011 $200,000 $250,000 $450,000

Profit 220,000 220,000

Dividends \_\_\_\_\_\_ (120,000) (120,000)

Balances, Nov 30, 2012 $200,000 $350,000 $550,000

(opening R/E = $600,000 – 150,000 – 200,000 = $250,000)

##### Ex. 120

At September 1, the statement of financial position accounts for GoodFood Restaurant Ltd. were as follows:

Accounts payable $ 3,800 Land $33,000

Accounts receivable 1,600 Common shares ?

Building 68,000 Notes payable 46,000

Cash 5,000 Supplies 4,600

Furniture 18,700 Retained earnings 43,200

The following transactions occurred during the next two days:

Shareholders invested an additional $32,000 cash in the business. The accounts payable were paid in full. (No payment was made on the notes payable.)

**Instructions**

Prepare a statement of financial position at September 3, 2012.

##### Solution 120 (10 min.)

GOODFOOD RESTAURANT LTD.

Statement of Financial Position

September 3, 2012

Assets

Cash $ 33,200

Accounts receivable 1,600

Supplies 4,600

Land 33,000

Building 68,000

Furniture 18,700

Total assets $159,100

Liabilities and Shareholders’ Equity

Liabilities

Notes payable $ 46,000

Shareholders’ equity

Common shares $69,900

Retained earnings 43,200 113,100

Total liabilities and shareholders’ equity $159,100

Cash ($5,000 + $32,000 – $3,800) = $33,200

Accounts Payable ($3,800 – $3,800) = $0

Shareholders’ Equity: Beginning balance ($130,900 – $49,800) $ 81,100

Additional investment 32,000

Ending balance $113,100

Common Shares ($113,100 – $43,200) = $69,900

##### Ex. 121

From the following list of selected accounts taken from the records of Smiles Unlimited Clinic Inc., identify those that would appear on the statement of financial position.

(a) Common Shares (f) Accounts Payable

(b) Patient Revenue (g) Cash

(c) Land (h) Medical Supplies Expense

(d) Wages Expense (i) Medical Supplies

(e) Notes Payable (j) Utilities Expense

##### Solution 121 (5 min.)

(a), (c), (e), (f), (g), (i)

##### Ex. 122

One item is omitted in each of the following summaries of statement of financial position and income statement data for three different corporations, X, Y, and Z.

**Instructions**

Determine the amounts of the missing items, identifying each corporation by letter.

Corporation

X Y Z

Beginning of the Year:

Assets $400,000 $150,000 $199,000

Liabilities 250,000 105,000 168,000

End of the Year:

Assets 450,000 195,000 195,000

Liabilities 280,000 95,000 169,000

During the Year:

Common shares issued by shareholders ? 79,000 78,000

Dividends 70,000 83,000 ?

Revenue 195,000 ? 187,000

Expenses including income tax expense 155,000 113,000 185,000

##### Solution 122 (30 min.)

Corporation X ($50,000)

Beginning shareholders’ equity ($400,000 – $250,000) $150,000

Common shares issued ($170,000 + $70,000 – $150,000 – $40,000) 50,000

Profit for year ($195,000 – $155,000) 40,000

240,000

Less dividends 70,000

Ending shareholders’ equity ($450,000 – $280,000) $170,000

Corporation Y ($172,000)

Beginning shareholders’ equity ($150,000 – $105,000) $ 45,000

Common shares issued 79,000

Profit for year ($183,000 – $45,000 – $79,000) 59,000

[Revenues = $172,000 ($113,000 + $59,000)] 183,000

Less dividends 83,000

Ending shareholders’ equity ($195,000 – $95,000) $100,000

Corporation Z ($85,000)

Beginning shareholders’ equity ($199,000 – $168,000) $ 31,000

Common shares issued 78,000

Profit for year ($187,000 – $185,000) 2,000

111,000

Less dividends ($111,000 – $26,000) 85,000

Ending shareholders’ equity ($195,000 – $169,000) $ 26,000

##### Ex. 123

Calculate the missing items.

**Assets = Liabilities + Shareholders’ Equity**

$80,000 = $32,000 + (a)

(b) = $28,000 + $90,000

$84,000 = (c) + $65,000

##### Solution 123 (5 min.)

(a) $48,000 (b) $118,000 (c) $19,000

##### Ex. 124

Identify which of the following accounts appear on a statement of financial position.

1. Service revenue
2. Cash
3. Common shares
4. Accounts payable
5. Rent expense
6. Supplies
7. Land

##### Solution 124 (5 min.)

(b), (c), (d), (f), (g)

##### Ex. 125

For the items listed below, fill in the appropriate code letter to indicate whether the item is an asset, liability, or shareholders’ equity item.

Code

Asset A

Liability L

Shareholders’ Equity SE

1. Rent expense 7. Accounts receivable

2. Office equipment 8. Retained earnings

3. Accounts payable 9. Service revenue

4. Common shares 10. Bank loan payable

5. Insurance expense 11. Dividends

6. Cash 12. Unearned revenue

##### Solution 125 (5 min.)

1. SE 7. A

2. A 8. SE

3. L 9. SE

4. SE 10. L

5. SE 11. SE

6. A 12. L

##### Ex. 126

Classify each of these items as an asset (A), liability (L), or shareholders’ equity (SE).

\_\_\_\_\_ 1. Rent receivable \_\_\_\_\_ 6. Cash

\_\_\_\_\_ 2. Salaries payable \_\_\_\_\_ 7. Mortgage payable

\_\_\_\_\_ 3. Preferred shares \_\_\_\_\_ 8. Land

\_\_\_\_\_ 4. Office supplies \_\_\_\_\_ 9. Dividends

\_\_\_\_\_ 5. Retained earnings \_\_\_\_\_ 10. Office supplies expense

##### Solution 126 (5 min.)

1. A 6. A

2. L 7. L

3. SE 8. A

4. A 9. SE

5. SE 10. SE

##### Ex. 127

At the beginning of the year, Hanover Limited had total assets of $600,000 and total liabilities of $300,000. Answer the following questions, viewing each situation as being independent of the others.

1. If total assets increased $225,000 during the year, and total liabilities decreased $100,000, what is the amount of shareholders’ equity at the end of the year?

2. During the year, total liabilities increased $315,000 and shareholders’ equity decreased $130,000. What is the amount of total assets at the end of the year?

3. If total assets decreased $60,000 and shareholders’ equity increased $180,000 during the year, what is the amount of total liabilities at the end of the year?

##### Solution 127 (5 min.)

Total Assets Total Liabilities Shareholders’ Equity

Beginning $600,000 $300,000

Change 225,000 (100,000)

Ending $825,000 – $200,000 = $625,000 (1)

Total Assets Total Liabilities Shareholders’ Equity

Beginning $600,000 $300,000 $300,000

Change 185,000 315,000 (130,000)

Ending $785,000 (2) = $615,000 + $170,000

Total Assets Total Liabilities Shareholders’ Equity

Beginning $600,000 $300,000 $300,000

Change (60,000) 180,000

Ending $540,000 = $ 60,000 (3) + $480,000

##### Ex. 128

Brookfield Carpet Cleaning Ltd. has the following statement of financial position items:

Van Bank Loan Payable Common Shares

Accounts Payable Cleaning Supplies Retained Earnings

Cash Accounts Receivable Equipment

**Instructions**

Identify which items are 1. Assets

2. Liabilities

3. Shareholders’ Equity

##### Solution 128 (5 min.)

1. Assets—Van; Cash; Cleaning Supplies; Accounts Receivable; Equipment

2. Liabilities—Accounts Payable; Bank Loan Payable

3. Shareholders’ Equity—Common Shares; Retained Earnings

##### Ex. 129

On June 1, Carmelo Ltd. prepared a statement of financial position that shows the following:

Assets (no cash) $125,000

Liabilities 75,000

Shareholders’ Equity 50,000

Shortly thereafter, all of the assets were sold for cash.

**Instructions**

How would the statement of financial position appear immediately after the sale of the assets for cash for each of the following cases?

Cash Received for Balances Immediately After Sale

the Assets Assets – Liabilities = Shareholders’ Equity

Case A $135,000 $\_\_\_\_\_\_\_\_ $\_\_\_\_\_\_\_\_ $\_\_\_\_\_\_\_\_

Case B 125,000 \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_

Case C 110,000 \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_

##### Solution 129 (5 min.)

Cash Received for Balances Immediately After Sale

the Assets Assets – Liabilities = Shareholders’ Equity

Case A $135,000 $135,000 $75,000 $60,000

Case B 125,000 125,000 75,000 50,000

Case C 110,000 110,000 75,000 35,000

##### Ex. 130

Calculate the missing amount in each category of the accounting equation.

Assets Liabilities Shareholders’ Equity

(a) $360,000 $ ? $ 98,000

(b) $178,000 $ 73,000 $ ?

(c) $ ? $302,000 $310,000

##### Solution 130 (5 min.)

(a) $262,000 ($360,000 – $98,000 = $262,000).

(b) $105,000 ($178,000 – $73,000 = $105,000).

(c) $612,000 ($302,000 + $310,000 = $612,000).

##### Ex. 131

Use the following information to prepare the statement of cash flows for Venice Corporation for the year ended December 31, 2012:

Cash received from customers $25,000

Cash dividends paid 3,000

Cash paid to suppliers 10,000

Cash paid for new equipment 30,000

Cash received from lenders 7,000

Cash, January 1, 2012 25,000

Cash, December 31, 2012 14,000

##### Solution 131 (10 min.)

VENICE CORPORATION

Statement of Cash Flows

Year Ended December 31, 2012

Operating activities

Cash received from customers $25,000

Cash paid to suppliers (10,000)

Net cash provided by operating activities $15,000

Investing activities

Cash paid for new equipment (30,000)

Financing activities

Cash received from lenders $ 7,000

Cash dividends paid (3,000)

Net cash provided by financing activities 4,000

Net increase (decrease) in cash (11,000)

Cash, January 1 25,000

Cash, December 31 $14,000

##### Ex 132

Speedway Corporation’s shareholders’ equity equals one-fifth of the company’s total assets. The company’s liabilities are $125,000. What is the amount of the company’s shareholders’ equity?

##### Solution 132

$31,250 (X= 1/5X + $125,000)

Where X = total assets

Solving for X

X – 1/5X = $125,000 Shareholder’s equity = (1/5) × $156,250 = $31,250

4/5X = $125,000

X = $125,000 × 5/4

X = $156,250 Proof: $31,250 + $125,000 = $156,250

## MATCHING

133. Match the items below by entering the appropriate code letter in the space provided.

(a) Internal users (f) Assets

(b) Proprietorship (g) Liabilities

(c) Expenses (h) Private corporation

(d) Investing activities (i) Loss

(e) Fiscal year (j) Dividends

\_\_\_\_\_ 1. Consumed assets or services.

\_\_\_\_\_ 2. Ownership is limited to one person.

\_\_\_\_\_ 3. Distributions to shareholders.

\_\_\_\_\_ 4. Officers and others who manage the business.

\_\_\_\_\_ 5. Creditor claims against the assets of the business.

\_\_\_\_\_ 6. An accounting period that is one year long.

\_\_\_\_\_ 7. A separate legal entity that issues shares that are not publicly traded.

\_\_\_\_\_ 8. Amount by which expenses exceed revenues.

\_\_\_\_\_ 9. Future economic benefits.

\_\_\_\_\_ 10. Involve acquiring the resources necessary to run the business.

#### Answers to Matching

1. (c) 6. (e)

2. (b) 7. (h)

3. (j) 8. (i)

4. (a) 9. (f)

5. (g) 10. (d)

## SHORT-ANSWER ESSAY QUESTIONS

##### S-A E 134

The information that a specific user of financial information needs depends upon the kinds of decisions that a user makes. Identify the major users of accounting information and discuss what questions financial information answers for each group of users.

##### Solution 134

The major users of accounting information are internal and external users. Internal users are those who manage the business. External users are those outside the business who have either a present or potential financial interest.

Financial information may answer the following questions for internal users:

1. Is cash sufficient to pay our debts?

2. Can we afford to give our employees a raise this year?

3. What is the cost of manufacturing each unit of product?

4. Which product line is the most profitable?

Questions answered by financial information for external users include:

1. Is the company earning satisfactory profit?

2. How does the company compare in size and profitability with competitors?

3. Will the company be able to pay its debts as they come due?

##### S-A E 135

Why would it be “safer” for a wealthy individual to set up his or her business as a corporation rather than as a proprietorship or partnership?

##### Solution 135

With a proprietorship or partnership, the owner(s) have unlimited liability. That is, they may be required to use personal assets to satisfy business debts. The liability of a corporate shareholder, however, is limited to his or her investment in the business.

##### S-A E 136

Which three types of transactions affect shareholders’ equity, and how do they affect it?

##### Solution 136

Shareholders’ equity consists generally of share capital and retained earnings. Share capital is increased by issues of common or preferred shares, for example. Retained earnings are increased by revenues, and decreased by expenses and dividends.

**S-A E 137**

In what order should the four financial statements be prepared? Explain why it is necessary to prepare the financial statements in the proper order.

**Solution 137**

Order of financial statement preparation: 1. income statement; 2. statement of changes in equity; 3. statement of financial position; and 4. statement of cash flows.

It is necessary to prepare the financial statements in proper order because they are interrelated. The statement of changes in equity cannot be prepared without knowing the results from the income statement. Thus the income statement must be prepared first. The statement of financial position cannot be prepared without knowing the ending balance for retained earnings, which is taken from the statement of changes in equity. Finally, the statement of cash flows shows how the cash account changed during the period. The ending cash balance shown on the statement of cash flows must agree with the cash balance shown on the statement of financial position.

##### S-A E 138

The framework used to record and summarize the economic activities of a company is referred to as the accounting equation. (a) State the basic accounting equation and define its major components. (b) How are business transactions and financial statements related to the accounting equation?

##### Solution 138

(a) The basic accounting equation is expressed as follows:

Assets = Liabilities + Shareholders’ Equity

Assets are defined as resources owned by the business. Liabilities are creditors’ claims against the assets of the business; in other words, existing debts and obligations. Shareholders’ equity is the ownership claim on the total assets of the business; it is equal to total assets minus total liabilities.

(b) Business transactions are economic events and activities that affect the elements of the basic accounting equation; that is, transactions cause increases or decreases in assets, liabilities, and shareholders’ equity. Financial statements report the results and effects of transactions on the business' assets, liabilities, and shareholders’ equity. The statement of financial position is a summary expression of the basic accounting equation.

##### S-A E 139

Identify each of the four financial statements. For each statement, explain the primary purpose and identify the primary users and their uses. Answer in point form.

##### Solution 139

Income statement

• Primary purpose – report the success or failure of the company for a specific period of time

• Primary users and uses

1. Shareholders/investors – to decide whether to invest or sell their investment

2. Creditors/lenders – to decide whether to loan the company money and assess whether it will be able to repay any debt.

Statement of changes in equity

• Primary purpose – to show the amounts and causes of changes in each component of shareholders’ equity during a specific period of time (same period as income statement)

• Primary users and uses

1. Shareholders/investors – to evaluate dividend policy

2. Creditors/lenders – to monitor dividend policy as it affects the ability to repay debt

Statement of financial position

• Primary purpose – to report assets and claims to assets at a particular point in time

• Primary users and uses

1. Creditors/lenders – to assess the likelihood that they will be repaid

2. Managers – to determine if they have the best mix of debt and equity financing

Statement of cash flows

• Primary purpose – to provide information about cash receipts and payments of a business for a specific period of time (same period as income statement)

• Primary users and uses

1. Shareholders/investors – to decide whether to invest or sell their investment

2. Creditors/lenders – to decide whether to lend the business money and assess whether it will be able to repay its debts.

**S-A E 140**

Joey Carbonara, an old friend of yours from high school, started a small business about a year ago, which is organized as a private corporation. Joey is currently in the process of applying for a bank loan to expand his business. He shows you the most recent statement of financial position that he has prepared for the bank, which is as follows:

CARBONARA CORPORATION

Statement of Financial Position

September 30, 2012

Assets

Cash $ 40,000

Accounts receivable 25,000

Equipment 100,000

Total assets $165,000

Liabilities and Shareholders’ Equity

Accounts payable $ 25,000

Shareholders’ equity 140,000

Total liabilities and shareholders’ equity $165,000

Since Joey knows that you are studying accounting at college, he asks your opinion. “What do you think?” he says. “Do you think the bank will be impressed and lend me the $50,000 I’m asking for?”

You study the statement for a few minutes. You are pretty sure Joey doesn’t have anywhere near $100,000 worth of equipment belonging to the business, so you ask where all this equipment is. “Well,” explains Joey, “in order to increase my assets, I included my personal vehicle, computer and camera equipment, and some of my furniture. They’re worth about $60,000. That should be OK, since they belong to me and I am the only shareholder anyway.” On further questioning, Joey admits that he added his personal savings account of $30,000 in with the company cash to “make it look better.”

**Instructions**

(a) Who are the stakeholders here?

(b) Is Joey’s “creative accounting” acceptable? Why or why not?

(c) What would you recommend be done here?

**Solution 140**

(a) The stakeholders in this situation are Joey, the bank, and any other external users who may rely on Joey’s financial statements.

(b) No, it is not acceptable. Joey is ignoring the reporting entity concept, which requires the separation of business and personal records. It is unethical to include personal assets in with the business assets, as it distorts the overall financial picture and will mislead the bank.

(c) You should recommend that Joey revise the statement so that it correctly reflects his true financial position. It should then be as follows:

CARBONARA CORPORATION

Statement of Financial Position

September 30, 2012

Assets

Cash ($40,000 - $30,000) $10,000

Accounts receivable 25,000

Equipment ($100,000 - $60,000) 40,000

Total assets $75,000

Liabilities and Shareholders’ Equity

Accounts payable $25,000

Shareholders’ equity ($140,000 - $30,000 - $60,000) 50,000

Total liabilities and shareholders’ equity $75,000

It may be that Joey will still be able to obtain the loan, but even if the bank turns him down, at least he can rest easy, knowing that he has acted ethically and presented a true picture of his business.

##### S-A E 141

Lisa Brunet is a friend of yours from high school. She decided to become a beautician after leaving high school, rather than to attend college. She recently opened her own shop on September 1, 2012 and has contracted her services to a local hospital. She is paid a fee for her services from the hospital, and receives a small gratuity (tip) from each patient. She has invested $1,000 of her own money into the company, which is a private corporation, as she plans to expand by providing services to hospitals in other nearby cities. She is the sole shareholder.

She has just received her first set of financial statements from her accountant. She is quite upset. Since the income statement reports profit of $1,075 and she put $1,000 into the company, she is surprised to see her cash account only has $925 in it.

She has written you a letter, asking you how this is possible. She does not understand why her cash balance isn’t $2,075 (her profit plus the $1,000 she invested). Along with her letter she has included her financial statements.

BRUNET BEAUTICIAN LTD

Income Statement

Month Ended September 30, 2012

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Revenues

Contract revenue $2,500

Gratuities………………………………………………………………... 75

Total revenues…………………………………………………….. 2,575

Operating expenses 1,200

Profit before income tax 1,375

Income tax expense 300

Profit $1,075

BRUNET BEAUTICIAN LTD.

Statement of Changes in Equity

Month Ended September 30, 2012

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Common Shares Retained Earnings Total Equity

Balances, Sept. 1 $ 0 $ 0 $ 0

Issued common shares 1,000 1,000

Profit 1,075 1,075

Balances, Sept. 30 $1,000 $1,075 $2,075

BRUNET BEAUTICIAN LTD.

Statement of Financial Position

September 30, 2012

———————————————————————————————————————————

Assets

Cash $ 925

Accounts receivable 1,500

Total assets $2,425

Liabilities and Shareholders’ Equity

Liabilities

Accounts payable $ 50

Income tax payable 300

Total liabilities $ 350

Shareholders’ equity

Common shares $1,000

Retained earnings 1,075 2,075

Total liabilities and shareholders’ equity $2,425

**Instructions**

Using proper form, write a short letter to Lisa, answer her question completely, but briefly.

**Solution 141**

Answers will vary. The instructor's requirements concerning proper form should be followed. The letter may be either business or personal. At a minimum, the letter should be in a recognizable form, and proper grammar and spelling should be used. A suggested personal letter follows:

1010 Carlsen Avenue

Ottawa, Ontario K2P 1G0

(Date)

Dear Lisa,

The reason that your cash balance is not $2,075 is because some of the revenue you have earned has not been paid to you yet. This is the balance in the Accounts Receivable account which shows what your customer, the hospital, still owes you for the services you have provided.

There are also expenses that you have incurred that you have not paid yet. The Accounts Payable account shows the money you still owe to your suppliers and the Income Tax Payable account shows the amount of money you still have to pay for income tax expense.

When your customer has paid to you what they owe and when you pay off your liabilities, your cash balance will be $2,0775, as the following calculation shows:

Cash balance $ 925

Add: Cash to be received from the hospital (Accounts Receivable) 1,500

Less: Cash paid to your suppliers (Accounts Payable) (50)

Less: Cash paid for income tax (Income Tax Payable) (300)

Cash balance $2,075

The amount of cash reported on your statement of financial position is correct. A statement of cash flows will provide information on the cash receipts and payments for your business and will help to explain the cash balance that appears on your statement of financial position.

Sincerely,

(signature)