CHAPTER 1

The Purpose and Use of Financial Statements

ASSIGNMENT CLASSIFICATION TABLE

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Study Objectives |  | Questions |  | Brief Exercises |  | Exercises |  | A Problems |  | B Problems |  | BYP |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| 1. Identify the users and uses of accounting. |  | 1, 2, 3, 4, 5, 6 |  | 1, 5 |  | 1, 4 |  | 1A |  | 1B |  | 3, 4, 5, 7, 9 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| 2. Describe the primary forms of business organization. |  | 7, 8, 9, 10 |  | 2, 5 |  | 2 |  | 2A |  | 2B |  | 4, 6, 9 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| 3. Explain the three main types of business activity. |  | 11, 12, 13, 14 |  | 3, 4, 5 |  | 3, 4 |  | 3A, 4A |  | 3B, 4B |  | 9 |
|  |  |  |  |  |  |  |  |  |  |  |  |  |
| 4. Describe the content and purpose of each of the financial statements. |  | 15, 16, 17, 18, 19, 20, 21, 22 |  | 6, 7, 8, 9, 10, 11, 12 |  | 5, 6, 7, 8, 9, 10, 11, 12, 13 |  | 4A, 5A, 6A, 7A, 8A, 9A, 10A |  | 4B, 5B, 6B, 7B, 8B, 9B, 10B |  | 1, 2, 3, 5, 8 |

ASSIGNMENT CHARACTERISTICS TABLE

| Problem Number |  | Description |  | Difficulty Level |  | Time Allotted (min.) |
| --- | --- | --- | --- | --- | --- | --- |
| 1A |  | Identify users and uses of financial statements. |  | Moderate |  | 30-40 |
|  |  |  |  |  |  |  |
| 2A |  | Determine forms of business organization. |  | Moderate |  | 20-30 |
|  |  |  |  |  |  |  |
| 3A |  | Identify business activities. |  | Simple |  | 25-30 |
|  |  |  |  |  |  |  |
| 4A |  | Classify accounts. |  | Simple |  | 20-30 |
|  |  |  |  |  |  |  |
| 5A |  | Classify accounts. |  | Simple |  | 20-30 |
|  |  |  |  |  |  |  |
| 6A |  | Determine missing amounts; answer questions. |  | Complex |  | 30-40 |
|  |  |  |  |  |  |  |
| 7A |  | Prepare financial statements. |  | Moderate |  | 35-45 |
|  |  |  |  |  |  |  |
| 8A |  | Prepare statement of cash flows; comment on adequacy of cash. |  | Moderate |  | 25-35 |
|  |  |  |  |  |  |  |
| 9A |  | Calculate missing amounts; explain statement interrelationships. |  | Moderate |  | 40-50 |
|  |  |  |  |  |  |  |
| 10A |  | Prepare corrected statement of financial position; identify financial statements for ASPE. |  | Complex |  | 35-45 |
|  |  |  |  |  |  |  |
| 1B |  | Identify users and uses of financial statements. |  | Moderate |  | 30-40 |
|  |  |  |  |  |  |  |
| 2B |  | Determine forms of business organization. |  | Moderate |  | 20-30 |
|  |  |  |  |  |  |  |
| 3B |  | Identify business activities. |  | Simple |  | 25-30 |
|  |  |  |  |  |  |  |
| 4B |  | Classify accounts. |  | Simple |  | 20-30 |
|  |  |  |  |  |  |  |
| 5B |  | Classify accounts |  | Simple |  | 20-30 |
|  |  |  |  |  |  |  |
| 6B |  | Determine missing amounts; answer questions. |  | Complex |  | 30-40 |
|  |  |  |  |  |  |  |
| 7B |  | Prepare financial statements. |  | Moderate |  | 35-45 |
|  |  |  |  |  |  |  |
| 8B |  | Prepare statement of cash flows; comment on adequacy of cash. |  | Moderate |  | 25-35 |
|  |  |  |  |  |  |  |

ASSIGNMENT CHARACTERISTICS TABLE (Continued)

| Problem Number |  | Description |  | Difficulty Level |  | Time Allotted (min.) |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  |  |  |
| 9B |  | Calculate missing amounts; explain statement interrelationships. |  | Moderate |  | 40-50 |
|  |  |  |  |  |  |  |
| 10B |  | Prepare corrected statement of financial position; identify financial statements for ASPE. |  | Complex |  | 35-45 |

**ANSWERS TO QUESTIONS**

1. Accounting is the information system that identifies and records the economic events of an organization, and then communicates them to a wide variety of interested users.

2. Everyone should study accounting since a working knowledge of accounting will be relevant and useful to any user of accounting information, not just an accountant.

3. Internal users of accounting information work for the company and include finance directors, marketing managers, human resource personnel, production supervisors, and company officers.

External users of accounting information do not work for the company. The main external users are investors, lenders, and other creditors. Other external users include labour unions, customers, the Canada Revenue Agency (CRA), and securities commissions.

4. Internal users may want the following questions answered:

* Is there enough cash to purchase a new piece of equipment?
* What price should we sell our product for to cover costs and to maximize profits?
* How many employees can we afford to hire this year?
* Which product line is the most profitable?
* How much of a pay raise can the company afford to give me?

External users may want the following questions answered:

* Is the company earning enough to give me my required return on investment?
* Will the company be able to repay its debts as the debts come due?
* Will the company stay in business long enough to service the products I buy from it?

5. Ethics are important because without the expectation of ethical behaviour, the information presented in the financial statements would have no credibility for the accounting profession. Without credibility, financial statement information would be useless to financial statement users.

6. Answers will vary. Examples of ethical dilemmas follow.

(a) Professor at a university: being asked to give additional marks to a student “because they need it.”

(b) A cashier at a Fast Food Inc.: giving free food to friends.

(c) A chief financial officer: presenting financial information so that it increases a performance bonus.

(d) A supplier of goods to a company: selling goods that are past their due date to boost profits.

Questions (Continued)

7. (a) Proprietorship: Proprietorships are easier to form (and dissolve) than other types of business organizations. They are not taxed as separate entities; rather the proprietor pays personal income tax on the company’s profits. Depending on the circumstances, this may be an advantage or disadvantage. Disadvantages of a proprietorship includes unlimited liability (proprietors are personally liable for all debts of the business) and difficulty in obtaining financing compared to other forms of organization. In addition, the life of the proprietorship is limited as it is dependent on the willingness and capability of the proprietor to continue operations.

(b) Partnership: Partnerships are easier to form (and dissolve) than a corporation; although not as easy as a proprietorship. Similar to a proprietorship, partnerships are not taxed as separate entities. Instead, the partners pay personal income tax on their share of profits. Depending on the circumstances this may be an advantage or disadvantage. Disadvantages of partnerships include unlimited liability (partners are jointly and severally liable for all debts of the business) and difficulty in obtaining financing compared to corporations. In addition, the life of a partnership can be limited depending on the terms of the partnership agreement and actions of the other partners.

(c) Corporation: Advantages of a corporation include limited liability (shareholders not being personally liable for corporate debts), indefinite life, and transferability of ownership. These features make it easier for corporations to raise financing than other forms of business organizations. Disadvantages of a corporation include increased government regulations and paperwork. The fact that corporations are taxed as a separate legal entity may be an advantage or a disadvantage and corporations may receive more favourable tax treatment than other forms of business organizations.

8. The reporting entity concept means that economic activity of the company is kept separate and distinct from the activities of the shareholders. It also means that economic activities of related corporations that are owned or controlled by one corporation are consolidated. The results of these individual companies are also reported separately as separate economic entities.

9. Public corporations are corporations that list their shares for sale to the public on Canadian or other stock exchanges. Private corporations issue shares, but do not make them available to the general public or trade them on public stock exchanges.

Questions (Continued)

10. (a) Public corporations must apply International Financial Reporting Standards (IFRS); private corporations can apply either IFRS or Accounting Standards for Private Enterprises (ASPE).

(b) The information needs of users of public corporations and private corporations are different. Users of financial information of public corporations require more extensive disclosure. They may also be benefit from the enhanced comparability to global companies provided by international standards. Since private corporations tend to be smaller, their users do not require as extensive reporting.

11. (a) Assets are what the company owns such as cash and equipment.

(b) A liability is an amount the company owes such as accounts payable and unearned revenue.

(c) Shareholders’ equity represents the residual interest (assets less liabilities) of a company at a point in time and includes share capital and retained earnings, in addition to other possible components. It is equal to the company’s assets less its liabilities.

(d) Revenues are an increase in a company’s economic resources from operating activities such as the sale of a product.

(e) Expenses are the cost of assets that are consumed or services that are used in the process of generating revenues. Examples include cost of goods sold, rent expense, and salaries expense.

12. **Operating activities** are the activities that the organization undertakes to earn a profit. They include the day-to-day activities which generate revenues and cause expenses to be incurred. In order to earn profits, a company must first purchase resources they need to operate. The purchase of these resources (assets) are considered to be **investing activities**. Finally, the company must have sufficient funds to purchase assets and to operate. While some of the necessary cash will be generated from operations, often the company has to raise external funds by either issuing shares or borrowing money. **Financing activities** involve the activities undertaken by the company to raise cash externally.

13. (a) Two examples of operating activities are revenue generated from providing auto repair services and the expenses related to paying employee salaries.

(b) Two examples of investing activities are the purchase of property, plant, and equipment, such as a building, and the sale of a long-term investment.

(c) Two examples of financing activities for a corporation are borrowing money (debt) and selling shares (equity).

Questions (Continued)

14. Accounts receivable is classified as an operating activity because receivables are created in conjunction with the generation of revenue which is a day-to-day activity. An account receivable is created when a company earns revenue (e.g., performs a service or delivers a good) but does not collect the cash immediately. The generation of revenue is an operating activity and therefore, the accounts receivable is classified in the same manner. Property, plant, and equipment is purchased so that the company can commence/continue its operations. Thus, its acquisition is classified as an investing activity.

15. A fiscal year is an accounting time period that is one year in length, but does not have to end on December 31. Corporations can select their fiscal year end based on when their operations are low or when inventory is low. Selecting a fiscal year end when operations are low provides more time for accounting staff to complete the year-end reporting requirements. If inventories are low, this simplifies the inventory count and minimizes the business disruption caused by counting the inventory.

16. The internal accounting records do use exact figures. However, for presentation purposes, it is unlikely that the use of rounded figures would change a decision made by the users of the financial statements. As well, presenting the information in this manner makes the statements easier to read and analyze thereby increasing their utility to the users. Rounding the numbers to the nearest thousand does not have a material impact on decision-making using the financial statements.

17. Assets = Liabilities + Shareholders’ Equity

$1,126,975 = $85,796 + $1,041,179 (amounts are in thousands of U.S. dollars)

18. A statement of changes in equity explains the changes in the components of shareholders’ equity, such as share capital and retained earnings. Examples of items that increase the components are issue of shares (increases share capital) and profit (increases retained earnings). Examples of items that decrease the components are repurchases of shares (decreases share capital) and payment of dividends (decrease retained earnings).

19. (a) The primary purpose of the statement of cash flows is to provide financial information about the cash receipts (inflows) and cash payments (outflows) of a company for a specific period of time.

(b) The three categories of the statement of cash flows are operating activities, investing activities, and financing activities. These categories represent the three principal types of business activities.

Questions (Continued)

20. The statement of financial position is prepared *as at a specific point* in time because it shows what the business owns (its assets) and what it owes (its liabilities). These items are constantly changing. It is necessary to select one point in time at which to present them. The other statements (income statement, statement of changes in equity, and statement of cash flows) cover a *period* of time as they report activities and measure performance that takes place over time.

21. (a) The income statement reports profit for the period. The profit figure from the income statement is shown on the statement of changes in equity as an addition to beginning retained earnings. If there is a loss it is deducted from the opening balance of retained earnings.

(b) The statement of changes in equity explains the change in the balances of the components of shareholders’ equity (e.g., common shares and retained earnings) from one period to the next. The ending balances are reported in the shareholders’ equity section of the statement of financial position.

(c) The statement of cash flows explains the change in the cash balance from one period to the next. The ending balance of cash reported in the statement of cash flows agrees with the ending cash balance reported in the current assets section on the statement of financial position.

22. (a) Companies using IFRS must report an income statement, statement of changes in equity, statement of financial position, and statement of cash flows. In addition, companies using IFRS may also need to prepare a statement of comprehensive income.

(b) Companies using ASPE must report an income statement, statement of retained earnings, statement of financial position, and a statement of cash flows.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 1-1

|  |  |  |
| --- | --- | --- |
|  | (a) Type of Evaluation | (b) Type of User |
| Investor | 5 | External |
| Marketing manager | 4 | Internal |
| Creditor | 3 | External |
| Chief financial officer | 6 | Internal |
| Canada Revenue Agency | 1 | External |
| Labour union | 2 | External |

BRIEF EXERCISE 1-2

(a) 1 Proprietorship

(b) 2 Partnership

(c) 3 Public corporation

(d) 4 Private corporation

BRIEF EXERCISE 1-3

(a) O

(b) F\*

(c) F

(d) F

(e) I

(f) O

*Note to instructors:* As we will learn later in Chapter 13, companies reporting under IFRS have a choice in classifying dividends paid as an operating or financing activity. We have chosen to classify dividends paid as financing activities in this textbook.

BRIEF EXERCISE 1-4

|  |  |  |
| --- | --- | --- |
|  | (a) | (b) |
| 1. | O | NE |
| 2. | F | + |
| 3. | O | - |
| 4. | O | + |
| 5. | O | - |
| 6. | I | - |

BRIEF EXERCISE 1-5

(a) 6 Public corporation

(b) 1 Accounts payable

(c) 10 Internal user

(d) 2 Creditor

(e) 3 Financing activities

(f) 9 Fiscal year

(g) 4 Private corporation

(h) 7 Common shares

(i) 8 Accounts receivable

(j) 5 Dividends

BRIEF EXERCISE 1-6

(a) $75,000 – $45,000 = $30,000 (Liabilities)

(b) $35,000 + $45,000 = $80,000 (Assets)

(c) $90,000 – $30,000 = $60,000 (Shareholders’ equity)

BRIEF EXERCISE 1-7

(a) Total assets = Total liabilities + Shareholders’ equity

= $55,000 + $120,000

= $175,000

(b) Total assets = Total liabilities + Shareholders’ equity (share capital + retained earnings)

= $170,000 + ($100,000 + $90,000)

= $360,000

(c) Total liabilities = Total assets – Shareholders’ equity (share capital + retained earnings)

= $150,000 – ($50,000 + $25,000)

= $75,000

(d) Shareholders’ equity = Total assets – Total liabilities

= $500,000 – ($500,000 ÷ 2)

= $250,000

BRIEF EXERCISE 1-8

Beginning of Year: Assets = Liabilities + Shareholders’ equity

Beginning of Year: $800,000 = $500,000 + Shareholders’ equity

Beginning of Year: Shareholders’ equity = $300,000

(a) ($800,000 + $150,000) = ($500,000 – $80,000) + Shareholders’ equity

Shareholders’ equity = $530,000

(b) Assets = ($500,000 – $50,000) + ($300,000 + $50,000 + $75,000)

Assets = $875,000

(c) ($800,000 – $80,000) = Liabilities + ($300,000 + $110,000)

Liabilities = $310,000

BRIEF EXERCISE 1-9

(a) IS

(b) SFP

(c) SCF

(d) SFP

(e) SCF

(f) IS

(g) SCE

BRIEF EXERCISE 1-10

(a) A

(b) L

(c) A

(d) A

(e) SE

(f) L

(g) SE

(h) A

BRIEF EXERCISE 1-11

(a) + RE; + TSE

(b) + SC; + TSE

(c) - SC; - TSE

(d) - RE; - TSE

(e) NE

(f) - RE; - TSE

BRIEF EXERCISE 1-12

The corporation is a private corporation. Public corporations are required to present a statement of changes in equity and show changes in the other components of shareholders’ equity in addition to retained earnings, such as share capital. Private corporations present a statement of retained earnings instead of a statement of changes in equity.

**SOLUTIONS TO EXERCISES**

EXERCISE 1-1

1. Chief Financial Officer – Does Roots generate enough cash to expand its product line?

Human Resource Manager – What is Roots’ annual salary expense?

(b) Creditor – Does Roots have enough cash available to make its monthly debt payments?

Investor – How much did Roots pay in dividends last year?

Other examples are also possible.

EXERCISE 1-2

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | Proprietorship | Partnership | Publicly-Traded Corporation |
| 1. | No personal liability | F | F | T |
| 2. | Owner(s) pay personal income tax on company profits | T | T | F |
| 3. | Generally best form of organization to raise capital | F | F | T |
| 4. | Ownership indicated by shares | F | F | T |
| 5. | Required to issue quarterly financial statements | F | F | T |
| 6. | Owned by one person | T | F | F |
| 7. | Limited life | T | T | F |
| 8. | Usually easiest form of organization to set up | T | F | F |

EXERCISE 1-3

|  |  |  |
| --- | --- | --- |
|  | (a) | (b) |
| 1. | O | - |
| 2. | I | - |
| 3. | F | + |
| 4. | I | - |
| 5. | O | + |
| 6. | F | + |
| 7. | I | + |
| 8. | F | - |
| 9. | F | - |
| 10. | O | - |

EXERCISE 1-4

|  |  |  |
| --- | --- | --- |
| 1. |  | O |
| 2. |  | I |
| 3. |  | O |
| 4. |  | F |
| 5. |  | F |
| 6. |  | F |
| 7. |  | O |
| 8. |  | O |
| 9.  10. |  | O  F |

EXERCISE 1-5

1. SFP 9. SFP

2. IS 10. IS

3. IS 11. SCF

4. SFP 12. SCF

5. IS 13. SFP

6. SCE 14. SFP

7. SFP 15. SCF

8. IS

EXERCISE 1-6

[1] Total revenues – Profit = Total expenses

$1,000,000 – $150,000 = $850,000

Note that item [2] cannot be solved until item [3] or [4] has been determined.

[2] Beginning balance in shareholders' equity + Issue of shares + Profit – Dividends = Ending balance in shareholders’ equity

$0 + $100,000 + $150,000 – Dividends = $200,000 (from [3])

Dividends = $50,000

[3] Shareholders’ equity = $200,000 (from [4])

[4] Total Assets – Total liabilities = Shareholders’ equity

$2,000,000 – $1,800,000 = $200,000

[5] Total revenues – Total expenses = Profit

Total revenues – $250,000 = $50,000

Total revenues = $300,000

[6] Beginning balance in shareholders' equity + Issue of shares + Profit – Dividends = Ending balance in shareholders’ equity

$0 + Issue of shares + $50,000 – $20,000 = $100,000

Issue of shares = $70,000

[7] Total assets – Shareholders’ equity = Liabilities

$500,000 – $100,000 (from [8]) = $400,000

[8] Total shareholders' equity = $100,000 (from Statement of changes in equity)

EXERCISE 1-7

[1] Assets – Liabilities = Shareholders’ equity

$105,000 – $80,000 = $25,000

[2] Assets – Liabilities = Shareholders’ equity

$160,000 – $110,000 = $50,000

[3] Total revenues – Total expenses = Profit

$210,000 – $190,000 = $20,000

Beginning balance in shareholders' equity + Issue of shares + Profit – Dividends = Ending balance in shareholders’ equity

$25,000 (from [1]) + Issue of shares + $20,000 – $20,000 = $50,000 (from [2])

Issue of shares = $25,000

[4] Total Assets – Shareholders’ equity = Total liabilities

$120,000 – $80,000 = $40,000

[5] Total Assets – Shareholders’ equity = Total liabilities

$180,000 – $110,000 = $70,000

[6] Total revenues – Total expenses = Profit

$100,000 – $75,000 = $25,000

Beginning balance in shareholders’ equity + Issue of shares + Profit – Dividends = Ending balance in shareholders’ equity

$80,000 + $15,000 + $25,000 – Dividends = $110,000

Dividends = $10,000

[7] Liabilities + Shareholders’ equity = Total assets

$25,000 + $35,000 = $60,000

[8] Liabilities + Shareholders’ equity = Total assets

$65,000 + $40,000 (from [9]) = $105,000

[9] Total revenues – Total expenses = Profit

$54,000 – $40,000 = $14,000

Beginning balance in shareholders' equity + Issue of shares + Profit – Dividends= Ending balance in shareholders' equity

$35,000 + $4,000 + $14,000 – $13,000 = $40,000

EXERCISE 1-8

(a) L Accounts payable and accrued liabilities

A Accounts receivable

L Bank indebtedness

A Capital assets

A Cash

A Goodwill and other intangibles

A Inventory

L Long-term debt

A Other assets

L Other liabilities

SE Other shareholders’ equity items

A Prepaid expenses

SE Retained earnings

SE Share capital

(b) ($ in thousands)

Assets

Cash $ 962

Accounts receivable 71,544

Inventory 316,319

Prepaid expenses 5,092

Capital assets 199,589

Goodwill and other intangibles 95,990

Other assets 12,433

Total assets $701,929

Liabilities

Bank indebtedness $ 27,932

Accounts payable and accrued liabilities 265,007

Long-term debt 49,587

Other liabilities 6,177

Total liabilities $348,703

Shareholders’ equity

Share capital $150,359

Retained earnings 197,063

Other shareholders’ equity items 5,804

Total shareholders’ equity $353,226

Total assets = Total liabilities + Shareholders’ equity

$701,929 = $348,703 + $353,226

EXERCISE 1-9

(a)

L Accounts payable

A Accounts receivable

L Bank loan payable

A Buildings

A Cash

SE Common shares

A Equipment

L Income tax payable

A Land

A Merchandise inventory

L Mortgage payable L Other payables

SE Retained earnings A Supplies

(b) Note: Students may list the accounts in the following statement in any order within the assets, liabilities, and shareholders’ equity classifications as they have not yet learned how to classify/order accounts.

AVENTURA INC.

Statement of Financial Position

November 30, 2012

Assets

Cash $ 20,000

Accounts receivable 19,500

Merchandise inventory 18,000

Supplies 700

Land 50,000

Buildings 100,000

Equipment 30,000

Total assets $238,200

Liabilities and Shareholders’ Equity

Liabilities

Accounts payable $ 26,200

Income tax payable 12,000

Other payables 4,000

Bank loan payable 30,000

Mortgage payable 97,500

Total liabilities 169,700

Shareholders’ equity

Common shares 20,000

Retained earnings 48,500

Total shareholders’ equity 68,500

Total liabilities and shareholders’ equity $238,200

EXERCISE 1-10

(a)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| E | Cost of goods sold |  | NR | Inventory |
| E | Depreciation expense |  | E | Operating expenses |
| NR | Dividends |  | E | Other expenses |
| E | Financing expenses |  | R | Other revenue |
| E | Income tax expense |  | R | Sales |
| NR | Income tax payable |  |  |  |

(b) THE JEAN COUTU GROUP INC.

Income Statement

Year Ended February 27, 2010

(in millions)

Revenues

Sales $2,298.4

Other revenues 251.6

Total revenues 2,550.0

Expenses

Cost of goods sold 2,068.9

Operating expenses 218.1

Other expenses 55.2

Depreciation expense 17.6

Financing expense 2.7

Total expenses 2,362.5

Profit before income tax 187.5

Income tax expense 74.9

Profit $ 112.6

EXERCISE 1-11

KON INC.

Income Statement

Year Ended December 31, 2012

Revenues

Service revenue $61,000

Expenses

Salaries expense $30,000

Rent expense 12,400

Utilities expense 2,400

Advertising expense 1,600

Total expenses 46,400

Profit before income tax 14,600

Income tax expense 3,000

Profit $11,600

KON INC.

Statement of Changes in Equity

Year Ended December 31, 2012

Common Retained Total

Shares Earnings Equity

Balance, January 1 $20,000 $58,000 $78,000

Issued common shares 10,000 10,000

Profit 11,600 11,600

Dividends (5,000) (5,000)

Balance, December 31 $30,000 $64,600 $94,600

EXERCISE 1-12

(a) Camping revenue $168,000

Expenses ($130,000 + $10,000) 140,000

Profit $ 28,000

(b) SEA SURF CAMPGROUND, INC.

Statement of Changes in Equity

Year Ended December 31, 2012

Common Retained Total

Shares Earnings Equity

Balance, January 1 $30,000 $18,000 $48,000

Issued common shares 10,000 10,000

Profit 28,000 28,000

Dividends (12,000) (12,000)

Balance, December 31 $40,000 $34,000 $74,000

Note: Students may list the accounts in the following statement in any order within the assets, liabilities, and shareholders’ equity classifications as they have not yet learned how to classify/order accounts.

SEA SURF CAMPGROUND, INC.

Statement of Financial Position

December 31, 2012

Assets

Cash $ 7,500

Supplies 2,500

Equipment 119,000

Total assets $129,000

Liabilities and Shareholders’ Equity

Liabilities

Accounts payable $ 5,000

Bank loan payable 50,000

Total liabilities 55,000

Shareholders’ equity

Common shares 40,000

Retained earnings 34,000

Total shareholders’ equity 74,000

Total liabilities and shareholders’ equity $129,000

EXERCISE 1-13

1. Yu Corporation is distributing nearly all of this year's profit as dividends. This suggests that Yu is not pursuing rapid growth. Companies that are pursuing opportunities for growth normally retain its profit and pay low, or no, dividends.

2. Surya Corporation is not generating sufficient cash from operating activities to fund its investing activities. The company is borrowing to finance its investing activities. This is common for companies in their early years of existence. It could also be in an expansion stage.

3. Naguib Ltd. is financing its assets in a slightly higher proportion through equity than through debt. The company has $450,000 ($200,000 + $250,000) of total assets, which are funded 44.4% ($250,000 ÷ $450,000) by liabilities and 55.6% ($250,000 ÷ $450,000) by equity. Since equity does not have to be repaid and does not require interest payments, the company appears to be in a healthy financial position.

4. Rijo Inc. does not have any liabilities and its assets are completely financed by equity. This places it in a very strong financial position since there are no outside claims on the company’s assets. This also means that the company is using its own funds to finance assets. While this reduces risk, it may also reduce return if borrowed funds can be employed to generate an internal return higher than the cost of borrowing.

**SOLUTIONS TO PROBLEMS**

PROBLEM 1-1A

(a) 1. The South Face Inc. is an external user of accounting information in assessing the credit-worthiness of their customer.

2. An investor purchasing common shares of Music Online, Inc. is an external user.

3. In deciding whether to extend a loan, the Caisse d’Économie Base Montréal is an external user.

4. As an employee of Tech Toy Limited, the CEO is an internal user.

1. 1. In deciding to extend credit, South Face would focus its attention on the statement of financial position of the new customer. The terms of credit they are extending require repayment in a short period of time. Funds to repay the credit would come from cash on hand and other current assets. The statement of financial position of the new customer will show if the company has enough current assets to meet its current obligations.

2. Since the investor intends to hold the shares for a long period of time (at least five years), s(he) should focus on the company’s income statement. The income statement reports the company’s past performance in terms of revenues, expenses, and profit. This is generally regarded as a good indicator of the company’s future performance.

3. The Caisse is interested in two things—the ability of the company to make interest payments on a monthly basis for the next three years and the ability to repay the principal amount at the end of the three years. In order to evaluate both of these factors, the focus should be on the statement of cash flows. This statement provides information on the cash the company generates from its operations on an ongoing basis. It also tells you whether the company is borrowing or repaying debt currently.

PROBLEM 1-1A (Continued)

(b) (Continued)

4. The CEO should focus on the statement of cash flows as this statement clearly sets out the cash generated from operating activities and the amount the company has spent in the past on purchasing equipment and paying dividends.

Note to instructor: Other answers may be valid provided they are properly supported.

PROBLEM 1-2A

1. The professors should incorporate their business as a private corporation because of their concerns about legal liabilities. A corporation is the only form of business that provides limited liability. Since the professors do not need access to large amounts of investment capital, a private corporation provides the limited liability advantage the professors need.

2. Joseph should run his bait shop as a proprietorship because this is the simplest and least costly form of business organization to establish and eventually dissolve. It is also the least expensive. He is the only person involved in the business and is planning to operate for a limited time.

3. Robert and Tom should form a public corporation when they combine their operations. This is the best form of business for them to choose because they expect to raise funds in the coming year. A public corporation will enable them to raise significant amounts of funds for their manufacturing company. A corporation may also receive more favourable income tax treatment.

4. A partnership would be the most likely form of business for Darcy, Ellen, and Meg to choose. It is simpler to form than a corporation and less costly.

5. Hervé is most likely to select to operate his business as a private corporation. This will assist him with the liability of storing goods for others. He will also be able to raise funds to purchase equipment, rent space in airports, and hire employees. It is easier to raise funds through a private corporation rather than a proprietorship or partnership.

PROBLEM 1-3A

(a)

|  |  |  |  |
| --- | --- | --- | --- |
|  | Operating | Investing | Financing |
| Indigo Books & Music | Sale of books | Purchase of store equipment | Issue of shares |
| High Liner Foods Incorporated | Payment for fish | Purchase of production equipment | Borrowing money from a bank |
| Mountain Equipment Co-op | Payment for inventory | Purchase of store fixtures | Borrowing money from a bank |
| Ganong Bros. Limited | Payment of salaries and benefits | Purchase of production equipment | Payment of dividends to shareholders |
| Royal Bank | Payment of interest on savings accounts | Purchase office equipment | Issue of bonds |

PROBLEM 1-3A (Continued)

(b) Financing

Issuing shares is common to all corporations. Issuing debt is common to all corporations. Borrowing from a bank is common to all businesses. Payment of dividends is common to all corporations. Issuing bonds is common to large public corporations.

Investing

Purchasing and selling property, plant, and equipment is common to all businesses—the types of assets would vary according to the nature of the business. Some types of businesses require a larger investment in long-lived assets. A new business or expanding business would be more apt to be acquiring assets.

Operating

The general activities identified above would be common to most businesses with the exception of the payment of interest on savings accounts. The source of the cash receipt (e.g., sale of books) and cash payment (e.g., payment for fish) would vary by the nature of the business.

PROBLEM 1-4A

|  |  |  |
| --- | --- | --- |
|  | (a) | (b) |
| Accounts payable and accrued charges | L | O |
| Accounts receivable | A | O |
| Cash | A | NE\* |
| Common shares | SE | F |
| Cost of goods sold | E | O |
| Interest expense | E | O |
| Inventories | A | O |
| Long-term debt | L | F |
| Property and equipment | A | I |
| Sales | R | O |
| Selling, general, and administrative expenses | E | O |

\* Each of the activities – operating, financing, and investing – explains the change in cash. Cash is not classified by itself, but rather is the result of the changes in all the activities.

PROBLEM 1-5A

|  |  |  |
| --- | --- | --- |
|  | (a) | (b) |
| Accounts payable | L | SFP |
| Accounts receivable | A | SFP |
| Cash | A | SFP |
| Common shares | SE | SFP, SCE |
| Dividends | SE | SCE |
| Equipment | A | SFP |
| Income tax expense | E | IS |
| Income tax payable | L | SFP |
| Insurance expense | E | IS |
| Interest expense | E | IS |
| Notes payable | L | SFP |
| Other payables | L | SFP |
| Preferred shares | SE | SFP, SCE |
| Prepaid insurance | A | SFP |
| Rent expense | E | IS |
| Repairs and maintenance expense | E | IS |
| Retained earnings | SE | SCE,SFP |
| Salaries payable | L | SFP |
| Service revenue | R | IS |
| Travel expense | E | IS |
| Vehicles | A | SFP |

PROBLEM 1-6A

(a) (Note: amounts are in millions of dollars)

[1] Total assets = Total liabilities + Total shareholders’ equity

Total assets = $1,754 + $1,483

Total assets = $3,237

[2] Total liabilities = Total assets – Total shareholders’ equity

Total liabilities = $3,405 – $1,658

Total liabilities = $1,747

[3] Ending balance – Beginning balance = Change in shareholders’ equity

$1,658 – $1,483 = $175

Change in shareholders' equity during year - Issue of shares + Dividends + Other decreases in shareholders’ equity = Profit

Profit = $175 – $0 + $0 + $60

Profit = $235

Total expenses = Total revenues – Profit

Total expenses = $5,201– $235

Total expenses = $4,966

[4] Total liabilities = Total assets – Total shareholders’ equity

Total liabilities = $7,784 – $3,565

Total liabilities = $4,219

[5] Total assets = Total liabilities + Total shareholders’ equity

Total assets = $5,102 + $3,688 [6]

Total assets = $8,790

PROBLEM 1-6A (Continued)

(a) (Continued)

[6] Ending balance = Beginning balance + Issue of shares – Dividends + Profit – Other decreases in shareholders’ equity

Ending balance = $3,565 + $5 – $69 + $335\* - $148

Ending balance = $3,688

\*Profit = Total revenues – Total expenses

Profit = $8,687 – $8,352

Profit = $335

(b) At the end of the most recent fiscal year, Canadian Tire has a higher proportion of debt financing and Sears has a higher proportion of equity financing. Canadian Tire financed 42.0% ($3,688 million ÷ $8,790 million) of its assets with equity and 58.0% of its assets with debt ($5,102 million ÷ $8,790 million). For the same period, 48.7% ($1,658 million ÷ $3,405 million) of Sears assets were financed by equity and 51.3% ($1,747 million ÷ $3,405 million) by debt. Canadian Tire is slightly more risky because more of its assets are financed by debt.

1. Both retailers typically have low inventories at the end of December and at the end of January as a result of the Christmas sales, with little or no new inventory purchased during the month of January so no major differences in financial position at the end of December compared to January would be anticipated. As long as there were no significant economic events that affected one company more than the other in the intervening period (January), it is unlikely that the different year-end dates would affect the comparison in (b).

PROBLEM 1-7A

(a)

ONE PLANET COSMETICS CORP.

Income Statement

Month Ended June 30, 2012

Revenues

Service revenue $12,000

Expenses

Salaries expense $3,000

Advertising expense 1,500

Utilities expense 1,300

Supplies expense 1,200

Fuel expense 800

Total expenses 7,800

Profit before income tax 4,200

Income tax expense 1,100

Profit $ 3,100

ONE PLANET COSMETICS CORP.

Statement of Changes in Equity

Month Ended June 30, 2012

Common Retained Total

Shares Earnings Equity

Balance, June 1 $ 0 $ 0 $ 0

Issued common shares 25,000 25,000

Profit 3,100 3,100

Dividends (1,000) (1,000)

Balance, June 30 $25,000 $ 2,100 $27,100

PROBLEM 1-7A (Continued)

(a) (Continued)

Note: Students may list the accounts in the following statement in any order within the assets, liabilities, and shareholders’ equity classifications as they have not yet learned how to classify/order accounts.

ONE PLANET COSMETICS CORP.

Statement of Financial Position

June 30, 2012

Assets

Cash $ 6,000

Accounts receivable 4,000

Supplies 1,400

Equipment 32,000

Total assets $43,400

Liabilities and Shareholders’ Equity

Liabilities

Accounts payable $ 2,300

Notes payable 14,000

Total liabilities 16,300

Shareholders’ equity

Common shares 25,000

Retained earnings 0 2,100

Total shareholders’ equity 27,100

Total liabilities and shareholders’ equity $43,400

PROBLEM 1-7A (Continued)

1. The financial statements must be prepared in the order of (1) income statement, (2) statement of changes in equity, and (3) statement of financial position. This is because each financial statement depends on information contained in another statement. The profit from the income statement flows to the retained earnings account on the statement of changes in equity. The shareholders’ equity totals in the statement of changes in equity (e.g., for common shares and retained earnings) then flow to the shareholders’ equity section of the statement of financial position.

PROBLEM 1-8A

(a) MAISON CORPORATION

Statement of Cash Flows

Year Ended December 31, 2012

Operating activities

Cash received from customers $140,000

Cash paid to suppliers (120,000)

Cash provided by operating activities $20,000

Investing activities

Purchase of equipment $(35,000)

Cash used by investing activities (35,000)

Financing activities

Issue of long-term debt $ 20,000

Issue of shares 20,000

Payment of dividends (10,000)

Cash provided by financing activities 30,000

Net increase in cash 15,000

Cash, January 1 12,000

Cash, December 31 $27,000

1. The company is generating less cash from operating activities (+$20,000) than it is using in total for its investing activities (–$35,000) and the payment of dividends (–$10,000). The company, however, is making up the deficiency by generating cash from financing activities. Cash from financing activities is not a renewable source of cash and usually entails future cash payments in the form of interest on debt, principal repayment, and dividend payments for shares.

PROBLEM 1-9A

(a)

[1] Land = Total assets (from [2]) – Cash – Accounts receivable –

Building – Equipment

Land = $110,000 – $5,000 – $10,000 – $60,000 – $25,000

Land = $10,000

[2] Total assets = Total liabilities + Shareholders' equity

Total Assets = $110,000

[3] Accounts payable = Total liabilities – Notes payable

Accounts payable = $84,000 – $50,000

Accounts payable = $34,000

[4] Common shares = $12,000 (from the Statement of changes in

equity)

[5] Retained earnings = $14,000 (from [10])

[6] Shareholders’ equity = Total liabilities and shareholders' equity – Total liabilities

Total shareholders' equity = $110,000 – $84,000

Total shareholders' equity = $26,000

[7] Operating expenses = Revenue – Profit before income tax

Operating expenses = $90,000 – $30,000

Operating expenses = $60,000

[8] Profit = Profit before income tax – Income tax expense

Profit = $30,000 – $6,000

Profit = $24,000

[9] Profit (from [8]) = $24,000

PROBLEM 1-9A (Continued)

(a) (Continued)

[10] Ending retained earnings = Beginning retained earnings + Profit – Dividends

Ending retained earnings = $0 + $24,000 (from [8]) –

$10,000

Ending retained earnings = $14,000

[11] Total issued common shares = $12,000

[12] Total profit = $24,000 (from [9])

[13] Total equity = Beginning balance + Issued common shares + Profit –

Dividends

Total equity = $0 + $12,000 (from [11]) + $24,000 (from [12]) –

$10,000

Total equity = $26,000

(b) (1) In preparing the financial statements, the first statement to be prepared is the income statement, followed by the statement of changes in equity, and then the statement of financial position. While the statements must be prepared in this sequence, these statements can be presented in a variety of orders. Often the statement of financial position is presented first, as the most “permanent” statement.

(2) The reason the statements must be prepared in a certain order as indicated above, is that each statement depends on information in the previously prepared statement. For example, the profit figure from the income statement is used in the statement of changes in equity to calculate the ending balance of retained earnings. The shareholders’ equity section of the statement of financial position is then completed using the ending balances of common shares and retained earnings as calculated in the statement of changes in equity.

PROBLEM 1-10A

(a)

1. Remove the boat from the listing of assets since it does not belong to the corporation. Remove the boat loan payable from the listing of liabilities since this is a personal loan of Guy Gélinas.

2. Remove the $10,000 outstanding receivable from Guy’s brother. This is not a company receivable and should not be listed on the company’s statement of financial position.

3. Provide totals for total liabilities and shareholders’ equity as the two components financing the assets of the company.

(b) GG CORPORATION

Statement of Financial Position

July 31, 2012

Assets

Cash $20,000

Accounts receivable 40,000

Merchandise inventory 36,000

Total assets $96,000

Liabilities and Shareholders’ Equity

Liabilities

Accounts payable $25,000

Total liabilities 25,000

Shareholders’ equity

Common shares (3) 45,000

Retained earnings 0 26,000

Total shareholders’ equity (2) 71,000

Total liabilities and shareholders’ equity (1) $96,000

PROBLEM 1-10A (Continued)

(b) (Continued)

1. Total liabilities and shareholders’ equity = Total assets

Total liabilities and shareholders’ equity = $96,000

1. Total shareholders ‘ equity = Total liabilities and shareholders’ equity – Total liabilities

Total shareholders’ equity = $96,000 (from (1)) – $25,000

Total shareholders’ equity = $71,000

1. Common shares = Total shareholders’ equity – Retained earnings

Common shares = $71,000 (from (2)) – $26,000

Common shares = $45,000

(c) As a private company, GG Corporation should also prepare an income statement, a statement of retained earnings, and a statement of cash flows.

PROBLEM 1-1B

(a) 1. An investor purchasing common shares of Fight Fat Ltd. is an external user.

2. As a potential creditor, Comeau Ltée is an external user.

3. The chief financial officer is an internal user.

4. As a potential creditor, Drummond Bank is an external user.

(b) 1. In making an investment in common shares, the Ontario investor is becoming a partial owner (shareholder) of the company. In this case, the investment will be held for at least three years. The information that will be most relevant to him/her will be on the income statement. The income statement reports the past performance of the company in terms of its revenue, expenses and profit. This is the best indicator of the company’s future potential.

2. In deciding to extend credit to a new customer, Comeau would focus its attention on the new customer's statement of financial position. The terms of credit they are extending require repayment in a short period of time. Funds to repay the credit would come from current assets. The statement of financial position of the new customer will show if the company has enough current assets to meet its current obligations.

3. In order to determine whether the company is generating enough cash to increase the amount of dividends paid to investors, the CEO of Private Label needs information on the amount of cash generated and used in various activities of the business. The statement of cash flows is the most useful statement for this purpose. This statement presents the amount of cash at the beginning and end of the period as well as the details of the amount of cash generated by operating activities and the amount spent on expanding operations (investing activities).

PROBLEM 1-1B (Continued)

(b) (Continued)

4. In deciding whether to extend a loan, the Drummond Bank is interested in two things: the ability of the company to make its monthly interest payments for the next five years and the ability to repay the principal amount at the end of five years. In order to evaluate both of these factors the focus should be on the statement of cash flows. This statement provides information on the cash the company generates from its operating activities on an ongoing basis. This will be the most important factor in determining if the company will survive and be able to repay the principal and interest on the loan.

Note to instructor: Other answers may be valid provided they are properly supported.

PROBLEM 1-2B

1. Dawn will likely operate her vegetable stand as a proprietorship because she is planning on operating it for a short time period. A proprietorship is the simplest and least costly business organization to form and dissolve.

2. Joseph and Sabra should form a private corporation when they combine their operations. A private corporation will be easier and less expensive to form than a public corporation. It will also be an easier type of organization in which to raise funds than a proprietorship or partnership. A corporation may also receive more favourable income tax treatment.

3. The professors should incorporate their business as a private corporation because of their concerns about the legal liabilities. A corporation is the only form of business that provides limited liability to the shareholders.

4. Abdur would likely form a public corporation because he needs to raise funds to invest in inventories and property, plant, and equipment. He has no savings or personal assets and it is normally easier to raise funds through a corporation than through a proprietorship or partnership. A public corporation will allow Abdur to raise larger amounts of funds by selling shares to the public.

5. A partnership would be the most likely form of business for Mary, Richard and Jigme to choose. It is simpler to form than a corporation and less costly.

PROBLEM 1-3B

(a)

|  |  |  |  |
| --- | --- | --- | --- |
|  | Operating | Investing | Financing |
| WestJet Airlines Ltd. | Payment for jet fuel | Purchase of airplanes | Issue of shares |
| University of Calgary Students’ Union | Payment of salaries and benefits | Purchase of office equipment | Borrowing money from a bank |
| Biovail Corporation | Payment of research expenses | Purchase of other companies | Issue of bonds |
| Maple Leaf Sports & Entertainment Ltd. | Payment for court rentals | Purchase of basketball equipment | Payment of dividends to shareholders |
| Grant Thornton LLP | Billing of clients for professional services | Purchase of computers | Distribution of profit to partners |

(b) Financing

Issuing shares is common to all corporations. Borrowing from a bank is common to all businesses. Payment of dividends is common to all corporations. Issuing bonds is common to large corporations. Distributing profit to partners is common to all partnerships.

Investing

Purchasing and selling property, plant, and equipment would be common to all businesses—the types of assets would vary according to the type of business. Some types of businesses require a larger investment in long-lived assets. A new business or expanding business would be more likely to engage in investing activities (e.g., acquiring assets). The purchase of other companies would not be common to all businesses.

Operating

The general activities identified above (sales and expenditures) would be common to most businesses, although the service or product might change.

PROBLEM 1-4B

|  |  |  |
| --- | --- | --- |
|  | (a) | (b) |
| Accounts payable | L | O |
| Accounts receivable | A | O |
| Cash | A | NE\* |
| Common shares | SE | F |
| Cost of sales | E | O |
| Income tax expense | E | O |
| Interest income | R | O |
| Inventories | A | O |
| Property, plant, and equipment | A | I |
| Research and development expenses | E | O |
| Sales | R | O |
| Selling, general, and administrative expenses | E | O |
| Short-term (trading) investments | A | I |

\* Each of the activities – operating, financing, and investing – explains the change in cash. Cash is not classified by itself, but rather is the result of the changes in all the activities.

PROBLEM 1-5B

|  |  |  |  |
| --- | --- | --- | --- |
|  | (a) | | (b) |
| Accounts payable | L | SFP | | |
| Accounts receivable | A | SFP | | |
| Buildings | A | SFP | | |
| Cash | A | SFP | | |
| Common shares | SE | SFP, SCE | | |
| Cost of goods sold | E | IS | | |
| Dividends | SE | SCE | | |
| Equipment | A | SFP | | |
| Income tax expense | E | IS | | |
| Income tax payable | L | SFP | | |
| Interest expense | E | IS | | |
| Land | A | SFP | | |
| Merchandise inventory | A | SFP | | |
| Mortgage payable | L | SFP | | |
| Notes payable | L | SFP | | |
| Operating expenses | E | IS | | |
| Other payables | L | SFP | | |
| Other revenue | R | IS | | |
| Preferred shares | SE | SFP, SCE | | |
| Prepaid insurance | A | SFP | | |
| Retained earnings | SE | SFP, SCE | | |
| Salaries payable | L | SFP | | |
| Sales | R | IS | | |

PROBLEM 1-6B

(a) (Note: amounts are in millions of dollars)

[1] Total liabilities = Total assets – Total shareholders’ equity

Total liabilities = $1,993 – $1,142

Total liabilities = $851

[2] Total shareholders' equity = Total assets – Total liabilities

Total shareholders' equity = $1,997 – $826

Total shareholders' equity = $1,171

[3] Ending balance – Beginning balance = Change in shareholders’ equity

$1,171 – $1,142 = $29

Dividends = Profit – Repurchase of shares – Change in shareholders' equity – Other decreases in shareholders’ equity

Dividends = $296\* – $27 – $29 – $177

Dividends = $63

\*Profit = Total revenues – Total expenses

Profit = $2,242 – $1,946

Profit = $296

[4] Total assets = Total liabilities + Total shareholders’ equity

Total assets = $3,182 + $2,491

Total assets = $5,673

[5] Total assets = Total liabilities + Total shareholders’ equity

Total assets = $2,531 + $3,046 (from [6])

Total assets = $5,577

PROBLEM 1-6B (Continued)

(a) (Continued)

[6] End of year, total shareholders' equity = Beginning of year, total shareholders' equity + Issue of shares during year + Profit – Dividends + Other increases in shareholders’ equity

End of year, total shareholder's equity

= $2,491 + $0 + $391\* – $0 + $164

End of year, total shareholder's equity = $3,046

\* Profit = Total revenues – Total expenses

Profit = $9,775 – $9,384

Profit = $391

(b) At the end of the most recent fiscal year, Starbucks has a higher proportion of debt financing and Tim Hortons has a higher proportion of equity financing. Starbucks financed 54.6% (U.S. $3,046 million ÷ U.S. $5,577 million) of its assets with equity and 45.4% of its assets with debt (U.S. $2,531 million ÷ U.S. $5,577 million). For the same period, 58.6% ($1,171 million ÷ $1,997 million) of Tim Hortons’s assets were financed by equity and 41.4% ($826 million ÷ $1,997 million) by debt. Starbucks is slightly more risky because more of its assets are financed by debt.

1. As long as there are no unusual transactions or economic events that affect one company differently than another during the intervening period of time (October through December), or at each company’s year-end date, the differing year ends should not have a significant impact on the assessment of the financial position and performance for the two companies.

If there are significant currency fluctuations between U.S. and Canadian dollars, it will not be possible to compare absolute amounts unless they are converted to the same currency. However, if the amounts were converted into percentages, such as was done in (b) above, percentages can be compared despite different currencies or sizes of the two companies.

PROBLEM 1-7B

(a) AERO FLYING SCHOOL LTD.

Income Statement

Month Ended May 31, 2012

Revenues

Service revenue $12,600

Expenses

Fuel expense $3,300

Rent expense 2,200

Insurance expense 1,400

Salaries expense 1,000

Advertising expense 900

Repair and maintenance expense 700

Interest expense 100 9,600

Profit before income tax 3,000

Income tax expense 600

Profit $ 2,400

AERO FLYING SCHOOL LTD.

Statement of Changes in Equity

Month Ended May 31, 2012

Common Retained Total

Shares Earnings Equity

Balance, May 1 $ 0 $ 0 $ 0

Issued common shares 50,000 50,000

Profit 2,400 2,400

Dividends (800) (800)

Balance, May 31 $50,000 $1,600 $51,600

PROBLEM 1-7B (Continued)

(a) (Continued)

Note: Students may list the accounts in the following statement in any order within the assets, liabilities, and shareholders’ equity classifications as they have not yet learned how to classify/order accounts.

AERO FLYING SCHOOL LTD.

Statement of Financial Position

May 31, 2012

Assets

Cash $ 5,300

Accounts receivable 10,200

Equipment 60,300

Total assets $75,800

Liabilities and Shareholders’ Equity

Liabilities

Accounts payable $ 2,200

Bank loan payable 22,000

Total liabilities 24,200

Shareholders’ equity

Common shares 50,000

Retained earnings 1,600

Total shareholders’ equity 51,600

Total liabilities and shareholders’ equity $75,800

PROBLEM 1-7B (Continued)

(b) The financial statements must be prepared in the order of (1) income statement, (2) statement of changes in equity, and (3) statement of financial position. This is because each financial statement depends on information contained in another statement. The profit from the income statement flows to the retained earnings in the statement of changes in equity. The shareholders’ equity totals (e.g., for common shares and retained earnings) in the statement of changes in equity then flow to the shareholders’ equity section of the statement of financial position.

PROBLEM 1-8B

(a) FURLOTTE CORPORATION

Statement of Cash Flows

Year Ended June 30, 2012

Operating activities

Cash received from customers $158,000

Cash paid to suppliers (89,000)

Cash paid for income tax (20,000)

Cash provided by operating activities $49,000

Investing activities

Cash paid to purchase equipment $(40,000)

Cash used by investing activities (40,000)

Financing activities

Repayment of long-term debt $(15,000)

Cash dividends paid (13,000)

Cash used by financing activities (28,000)

Decrease in cash (19,000)

Cash, July 1, 2011 40,000

Cash, June 30, 2012 $21,000

1. The company is not generating sufficient cash from its operating activities ($49,000) to pay for the total of its investing activities ($40,000) and dividend payments ($13,000). If the company expects to continue to use cash for investing activities and dividend payments in future years, it will either have to generate more cash from its operating activities or from its financing activities (e.g., borrow money) as its ending cash balance will not sustain this cash outflow on its own.

PROBLEM 1-9B

(a)

[1] Cash = Total assets – (Accounts receivable + Land + Building + Equipment)

Cash = $85,000 (from [2]) – ($15,000 + $20,000 + $40,000 + $5,000)

Cash = $5,000

[2] Total assets = Total liabilities and shareholders’ equity

Total assets = $85,000

[3] Common shares = Total liabilities and shareholders’ equity – (Liabilities + Retained earnings)

Common shares = $85,000 – ($19,000 + $31,000)

Common shares = $35,000

[4] Retained earnings = $31,000 (as per statement of changes in equity)

[5] Operating expenses = Service revenue – Profit before income tax

Operating expenses = $85,000 – $35,000

Operating expenses = $50,000

[6] Profit = Profit before income tax – Income tax expense

Profit = $35,000 – $9,000

Profit = $26,000

[7] Profit = $26,000 (same as [6])

[8] Dividends = Beginning retained earnings + Profit – Ending retained earnings

Dividends = $20,000 + $26,000 – $31,000

Dividends = $15,000

PROBLEM 1-9B (Continued)

(a) (Continued)

[9] Beginning total equity = Beginning common shares + Beginning

retained earnings

Beginning total equity = $25,000 + $20,000

Beginning total equity = $45,000

[10] Total common shares issued = $10,000

[11] Profit = $26,000 (same as [6])

[12] Dividends = $15,000 (same as [8])

[13] Ending total equity = Ending common shares + Ending

retained earnings

Ending total equity = $35,000 + $31,000

Ending total equity = $66,000

(b) (1) In preparing the financial statements, the first statement to be prepared is the income statement, followed by the statement of changes in equity, and then the statement of financial position. While the statements must be prepared in this sequence, these statements can be presented in a variety of orders. Often the statement of financial position is presented first, as the most “permanent” statement.

(2) The reason the statements must be prepared in a certain order as indicated above, is that each statement depends on information in the previously prepared statement. For example, the profit figure in the income statement is used in the statement of changes in equity to calculate the ending balance of retained earnings. The shareholders’ equity section of the statement of financial position is then completed using the ending balances of the shareholders’ equity components (e.g., common shares and retained earnings) as calculated in the statement of changes in equity.

PROBLEM 1-10B

(a)

1. Remove accounts receivable from the revenues since it is a current asset and does not belong on the income statement.

2. Remove the $12,000 rent expense. This is not an actual transaction and cannot be listed on the company’s income statement.

3. Remove the $4,000 vacation expense. This is not a business expense but rather a personal expense of the business owner.

(b) INDEPENDENT BOOK SHOP LTD.

Income Statement

Month Ended April 30, 2012

Revenues

Service revenue $38,000

Expenses

Insurance expense 5,000

Profit before income tax 33,000

Income tax expense 10,000

Profit $23,000

(c) As a private company, Independent Book Shop should also prepare a statement of financial position, a statement of retained earnings, and a statement of cash flows.

BYP 1-1 FINANCIAL REPORTING

(a) There are 46 pages in Eastplats’s financial statements.

(b) The five financial statements, in order of appearance, are the income statement, the statement of comprehensive income, the statement of financial position, the statement of changes in equity, and the statement of cash flows. The financial statements are presented on a consolidated basis. All of them were discussed in the chapter. The income statement, the statement of financial position, the statement of changes in equity, and the statement of cash flows were covered in detail, whereas the statement of comprehensive income was mentioned briefly.

(c) (USD thousands) 2010 2009

Total assets $1,126,975 $706,850

Total liabilities 85,796 77,338

Total shareholders’ equity 1,041,179 629,512

(d) (USD thousands) 2010 2009

Cash $107,846 $7,249

This information can be obtained on the statement of financial position or on the statement of cash flows.

(e) (USD thousands) 2010 2009

Revenue $155,000 $111,365

Profit 9,777 1,222

From 2009 to 2010, Eastplats’s revenue increased. Its profit also increased during that same period. Both revenue and profit increased and moved in the same direction.

(f) (USD thousands) 2010 2009

Net operating cash flows $ 31,974 $(9,287)

Net investing cash flows (257,238) (5,685)

In 2009, Eastplats used U.S. $9,287 thousand in cash for its operating activities. During 2009, cash was used in both operating and investing activities, so cash used by (rather than generated from) operating activities was insufficient to cover investing activities.

In 2010, the company generated U.S. $31,974 thousand from its operating activities. This amount was not enough to cover the amount of cash used in investing activities, U.S. $257,239 thousand.

BYP 1-2 COMPARATIVE ANALYSIS

(a) and (b) Eastern Platinum Limited (Eastplats) (USD thousands)

|  |  |  |  |
| --- | --- | --- | --- |
| 1. | 2010 | 2009 | % change |
| Assets | $1,126,975 | $706,850 | 59.4% |
| Liabilities | 85,796 | 77,338 | 10.9% |
| Shareholders’ equity | 1,041,179 | 629,512 | 65.4% |
|  |  |  |  |
| 2. | 2010 | 2009 | % change |
| Revenue | $155,000 | $111,365 | 39.2% |
| Profit | 9,777 | 1,222 | 700.1% |

Anglo American Platinum Limited (Amplats) (R millions)

|  |  |  |  |
| --- | --- | --- | --- |
| 1. | 2010 | 2009 | % change |
| Assets | 83,801 | 75,821 | 10.5% |
| Liabilities\* | 28,783 | 43,188 | (33.4)% |
| Shareholders’ equity | 55,018 | 32,633 | 68.6% |
|  |  |  |  |
| 2. | 2010 | 2009 | % change |
| Net sales revenue | 46,025 | 36,687 | 25.5% |
| Profit | 10,116 | 3,128 | 223.4% |

Liabilities were calculated as the total of current and non-current liabilities.

2010: 9,009 + 19,774 = 28,783; 2009: 8,358 + 34,830 = 43,188.

(b) Eastplats experienced growth in assets, liabilities, and shareholders’ equity. The increase in shareholders’ equity was largely related to the increase in assets. This is borne out by an examination of the statement of cash flows that shows that the increase in cash during the year was generated predominantly by the issue of common shares. Revenues increased substantially during the year. This increase was magnified by a decrease in expenses to yield a very large increase in profit.

Amplats experienced a similar growth in shareholders’ equity to Eastplats. Amplats’s growth in shareholders’ equity was generated by a modest growth in assets and a significant decrease in liabilities. Its revenues also increased substantially. The increase in revenues of Amplats was magnified by gains from disposals of investments rather than a decrease in expenses, to yield a large increase in profit.

BYP 1-3 INTERPRETING FINANCIAL INFORMATION

(a) External users include investors, lenders, and other creditors, amongst others. Investors (shareholders) use accounting information to make decisions to buy, hold, or sell their shares. Creditors and lenders, such as suppliers and bankers, use accounting information to evaluate the risks of being repaid when granting credit or lending money.

(b) Basic decision-making is unlikely to change from country to country as investors and creditors are making the same types of decisions – whether to invest or whether to lend money.

(c) Zachary will likely not be able to find such information in the financial statements themselves. However, non-financial information such as this may be available in the annual report, on the company's website, or in trade publications.

(d) Zachary will still be able to compare the two sets of statements. It really doesn’t matter what order the items are presented in—items on the statement of financial position will be similar and the same line items and the same subtotals (e.g., total assets, total liabilities, total shareholders’ equity) will be on each statement of financial position.

Michelin’s financial statements are prepared under IFRS. As we will learn in the next chapter, under IFRS, companies can order their statement of financial position in reverse order of liquidity (as Michelin did) or in order of liquidity. Goodyear’s statement of financial position will be presented in the order of liquidity.

BYP 1-4 COMPARING IFRS AND ASPE

(a) Both public and private companies are separate legal entities owned by shareholders. One of the key differences between the two types of companies is the availability of the shares. Shares of public companies are traded on organized stock exchanges and are available to the general public. In contrast, shares of a private company are not made available to the general public nor are they traded on a public stock exchange.

Another difference is access to capital. Since public companies are traded on organized stock exchanges, they generally have more access to capital than private companies. Private companies tend to rely upon bank financing for capital.

Public and private companies also differ in terms of the amount of information they disclose publicly. Public companies are required to file financial statements with the regulators of the stock exchange. This makes their statements widely available. In contrast, private companies do not have any requirement to make their financial statements publicly available.

(b) The key users of public company financial statements are shareholders, lenders and other creditors, regulators, analysts, and the general public. In contrast, the key users of private company financial statements are generally lenders and other creditors as well as private shareholders.

(c) The key difference between the users of users of public and private financial statements is the different areas of emphasis of the users’ objectives and needs when reviewing the financial statements. Users of public company financial statements can represent a wide range with varying levels of understanding about the company and its operations. They tend to be a broad group of users who benefit from detailed disclosure that will help them make the appropriate financial decision to invest or to lend, etc. On the other hand, users of private company financial statements tend to be a small group, who usually have a high degree of understanding of the company and its operations. They consist mostly of lenders and other creditors and a small group of shareholders. These users tend to place a greater emphasis on liquidity, solvency, and short-term cash flow planning.

(d) One of the main reasons that Canada’s Accounting Standards Board (AcSB) adopted IFRS is that these global set of standards will be beneficial to investors, lenders, other creditors, and other financial statement users by increasing the comparability and quality of financial statements. In other words, users will be able to make a “apples to apples” comparison. If Canadian public companies had a choice of which GAAP to use then it would entirely defeat the purpose of increasing comparability among public companies.

BYP 1-4 (Continued)

(e) Since most private companies in Canada are small to medium-sized businesses, the AcSB decided that IFRS, with its extensive disclosure reporting requirements and sophisticated reporting, was not appropriate for most of these companies. However, since private companies can represent a wide range of companies – from large multinationals to small local restaurants, the AcSB decided it was best if private companies have a choice of which standard to adopt. Companies’ choice of which GAAP to adopt is generally driven by users’ objectives and needs.

BYP 1-5 COLLABORATIVE LEARNING ACTIVITY

1. Information contained in the company’s financial statements that is important to a regional sales manager’s position might include the following:

* The health and stability of the company as a potential vendor can be determined from the financial statements, and would be of interest to the sales manager’s customers.
* Events occurring at the corporate level (corporate takeovers, brand recalls, bad press from fraudulent or socially irresponsible activities, information about the board’s directions and priorities) may affect sales.
* Students can list many accounts and relationships that are affected by the sales function. The important point is that this is aggregate information, available to the public, and not detailed enough for the manager to control day to day activities or analyze success or failure of particular products, regions, or sales force activities.

1. Students can produce a long list of more detailed, shorter-term data specific to the region that the sales manager controls. These might include budget data, non-financial volume data, customer growth and retention data, and external benchmarking data.

BYP 1-6 COMMUNICATION ACTIVITY

(a) Student answers will vary.

(b) Answers will vary but should include the following factors: Advantages of a corporation are limited liability (shareholders not being personally liable for corporate debts), indefinite life, and transferability of ownership. Disadvantages of a corporation are increased government regulations and the fact that corporations are taxed as a separate legal entity. Corporations may receive more favourable tax treatment than other forms of business organizations.

Partnerships and proprietorships are easier to form (and dissolve) than corporations. Proprietorships and partnerships are not taxed as separate entities. The partners and proprietors pay personal income tax on their share of profits. Depending on the circumstances this may be an advantage or disadvantage. Disadvantages of proprietorships and partnerships are unlimited liability (proprietors/partners are personally liable for all debts of the business) and difficulty in obtaining financing compared to corporations.

(c) Student answers will vary.

BYP 1-7 ETHICS CASE

(a) The stakeholders in this situation are the new CEO and CFO, and the creditors and investors who rely on the financial statements to make business decisions.

(b) The CEO and CFO should not sign the certification until they have taken steps to assure themselves that the most recent reports accurately and completely reflect the activities of the business. However, as the current management of the company, they cannot refuse to sign the certification just because they are new. They are the management team now and must assume the responsibilities that go with these positions.

(c) The CEO and CFO have no alternative other than to take the steps necessary to assure themselves of the accuracy and completeness of the financial information, and, if accurate, sign the certification. If the information is not accurate or complete, they need to make the required corrections to the financial information.

BYP 1-8 “ALL ABOUT YOU”

(a) You may want to be working as

* An accountant working towards an accounting designation
* A financial analyst
* A financial advisor
* A manager

(b) The basic elements of a resume include:

* An objective (your goals)
* A summary of your qualifications/accomplishments
* Experience highlights
* Employment history
* Education and training
* Other matters such as continuous education, languages, awards, memberships, affiliations and community involvement, as applicable

(c) You can provide references which can substantiate the information on your resume and evidence of education (diplomas and transcripts).

BYP 1-9 SERIAL CASE

(a) Cookie Creations is a proprietorship. A proprietorship has a lower administrative burden than a corporation—fewer regulations and procedures to adhere to. She may also have more flexibility in working for herself (or less depending on the demands of the business). In addition, as a separate proprietorship, all of the profits of the business belong to Natalie. However, she also has personal and unlimited liability for the debts of the business. She may also have difficulty in raising capital to grow the business.

Koebel’s Family Bakery Ltd. is a private corporation. It would have limited liability for the shareholders’ investments in the business compared to a proprietorship. However, this feature may be negated by a demand from creditors (e.g., the bank) for a personal guarantee by the shareholders. Profits would be shared with the other shareholders by way of dividends. More regulations and paperwork would be required as a corporation compared to that of a proprietorship, however, more opportunities would also exist to share the administrative burdens and to grow the business.

(b) Cookie Creations may use a simple form of accounting, possibly even the cash basis of accounting. Given its current size, it likely has no requirements to produce financial statements to external creditors. It could also choose to follow Accounting Standards for Private Enterprises (ASPE) if it was required to produce financial statements for external users.

Koebel’s Family Bakery Ltd. would most likely use Accounting Standards for Private Enterprises (ASPE).

(c) Natalie will need information on the revenues and cost of the cupcake services and supplies so she can determine if the new contract is profitable. She will need this information more often initially (for example, on a weekly basis) so she can monitor the results of the contract and its impact on the operations of the bakery. She will also need forecasts of cupcake orders to plan the work, determine staffing and delivery schedules, and purchases of supplies. If the cupcake contract requires a loan to expand to meet demand, she will need financial statements so lenders can assess the financial health of the business. Natalie would also find financial statements useful to better understand her business and identify financial issues as early as possible. Monthly financial statements would be best because they are more timely.

BYP 1-9 (Continued)

(d) The users of Koebel’s Family Bakery would include the existing shareholders (Natalie’s parents), potential shareholders such as Natalie, creditors such as the bank, taxing authorities, such as CRA, and major customers such as the national coffee shop.

Natalie’s parents are internal users and they need information to plan, organize and run the company and determine if they can obtain the financing to meet the increase demand. Natalie needs information to determine if her parents’ business is a sound investment for her and what her responsibilities as administrator would be. The national coffee shop needs information to determine if Koebel’s Family Bakery is able to deliver the quantities of cupcakes needed, The users would need all four financial statements—income statement, statement of retained earnings (since it is assumed that Koebel's Family bakery follows ASPE, however, if it follows IFRS then it would be required to prepare a statement of changes in equity), statement of financial position, and statement of cash flows—to assess the financial health of the company.

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