

CHAPTER 2
Financial Statements: A Window on an Entity

QUESTIONS

Q2-1.

The components of a complete financial statement package include the balance sheet (statement of financial position), the statement of comprehensive income (or income statement), the statement of changes in equity (statement of retained earnings for ASPE), the cash flow statement, and the notes to the financial statements.

Q2-2.

With cash accounting, an economic event is recorded only if cash is involved. Under cash accounting income is just the excess of the cash inflows over the cash outflows during the period. Accrual accounting measures the economic impact of transactions and economic events rather than cash flows. Accrual accounting attempts to measure economic changes rather than simply changes in cash. The exchange of cash isn't crucial to when recording takes place under accrual accounting. If the company provides services to a customer but cash isn't collected, the transaction is recorded under accrual accounting but not under cash accounting.

Q2-3.

Accounting and financial reporting is a means of communication between an entity and its stakeholders so how information is presented in the financial statements (as opposed to what information is presented) reflects what the entity is trying to communicate. It wouldn't be helpful to require all entities to adopt the same format. The specific information items that is most informative for one industry may not be helpful for another industry. Formatting differently permits managers to present the information in a way that allows busy readers to quickly peruse the financial statements to gather the information they need. This is a different issue from whether companies should disclose information. On the other hand, an unfamiliar format might be confusing for some stakeholders and require them to use more time to understand than with a familiar format.

Q2-4.

General purpose statements are prepared for the benefit of all possible stakeholders and haven't been specifically designed to meet the unique information needs of any particular group of stakeholders. For any individual stakeholder, general-purpose statements will usually be less useful than financial statements specifically tailored to their needs. (Managers could tailor general purpose statements to the needs of one particular stakeholder, which would be fine for that stakeholder, but others wouldn't be fully satisfied.)

Q2-5.

Since public companies provide their financial statements for use by any interested stakeholders, those statements are considered general purpose.

Q2-6.

A photograph captures a scene at the instant the photograph is taken. It doesn't show the situation even a second later. Similarly, a balance sheet reports the assets, liabilities, and owners' equity of an entity at a point in time. The entity's financial position may be different before or after the financial statement date.

Q2-7

Net income calculated using the cash basis only includes transactions in which cash has actually changed hands. Under the accrual basis, cash can be exchanged before, after, or at the same time goods or services are provided to customers. For example, a customer may purchase an item but pay at a later date. Under accrual accounting this transaction would be recognized, but under cash accounting it wouldn't be recorded until the cash was received.

Q2-8

Cash is crucial because it's required for an entity to make required payments. If a company doesn't have cash it will be unable to pay its employees, loans, and suppliers. If these payments aren't made, the entity's survival will be in jeopardy. Banks may seize assets, suppliers may stop sending products or may take back products they have delivered, and employees wouldn't continue to work.

Q2-9.

- a. An asset is expected to provide economic benefits in the future by contributing to earning revenues. Examples are trucks, equipment, buildings, furniture, and inventory.
- b. A liability is an obligation to provide goods or services in the future. Examples are accounts payable, wages payable, and loans.
- c. Owners' equity is direct or indirect investment in an entity by its owners. Examples are common shares and preferred shares, and retained earnings.
- d. Dividends are amounts paid to the owners from the earnings of the firm. Examples are common shares dividends and preferred share dividends.
- e. Revenues are economic benefits earned by providing goods or services to customers. Examples are sales and fees earned.
- f. Expenses are costs incurred to earn revenue. Examples include cost of goods sold and wages.

Q2-10.

- a. Working capital is current assets less current liabilities. This amount provides information about the availability of resources (ones that will be consumed or realized in cash in a relatively short time period) for an entity to meet its short-term obligations, or its liquidity.
- b. The current ratio is current assets divided by current liabilities, which is a measure of the amount of current assets relative to current liabilities. It's used as a measure of liquidity.
- c. The debt-to-equity ratio is the ratio of total liabilities to shareholders equity. This ratio is a measure of the risk of the firm.
- d. Gross margin is the excess of sales over cost of goods sold. Gross margin is the amount available to cover the other costs of operating the business and to provide profit to the owners. Since the selling price measures the value that customers place on the firm's products and cost of goods sold measures the price the firm paid for the products, gross margin indicates how good a job the firm is doing at creating value for customers.
- e. Gross margin percentage is the ratio of gross margin to sales. Converting gross margin to a ratio facilitates comparisons across products, product lines, and companies.

Q2-11.

- a. Cash is an economic resource that can be used to pay for needed resources such as inventory and services. An entity has control over its cash – it can spend it however it wishes. Cash is the result of past transactions (sales, borrowing). Cash is easily measured by counting.
- b. The advance payment provides the entity with the future benefit of legal services. The legal services themselves will provide a benefit to the entity. An entity has control as it exclusively has the right to receive these services. It's the result of a past transaction – the exchange of cash. It's also measurable as the amount paid to the lawyer would be backed by an invoice.
- c. An airplane owned by an airline because it will help airlines generate revenue, which is a future benefit. The entity would have documentation proving it has control (owns) the airplane. It's the result of a past transaction – the plane was purchased from the manufacturer. The amount paid can be determined from the invoice.
- d. Shares of another corporation represent ownership of that corporation. The shares can be entitled to dividends declared by the corporation, they can appreciate in value (the market value of the shares can increase), or they can be sold for cash. These represent future benefits from owning the shares.

Q2-12.

- a. The company will have to pay money to the suppliers in the near future as a result of inventory purchased in the past. Cash will be sacrificed to satisfy the suppliers.
- b. The advance from a customer represents an obligation to provide services in the future. The entity will have to sacrifice resources such as employee time, supplies, etc. to satisfy the customers.
- c. The bank loan has an obligation to repay the principal at the maturity date. Cash will be sacrificed to satisfy the bank. The bank loan implies an obligation to pay interest but the interest is recorded as time passes with the loan outstanding.

Q2-13.

Various opinions could be offered on this matter. The essential issue here is the uncertainty about the amount or existence of the future benefits that the research will provide. The cautious or conservative response to this uncertainty is to expense all expenditures on research. The implications for financial statements is that balance sheets don't report research as an asset and income is lower in years when large investments are made in research and higher in other years. Users may underestimate the value of the company's assets if they aren't aware of the value that is being created and that isn't reported. There is little doubt that in principle research represents an asset. However, because of the uncertainty surrounding the future benefit that may or may not emerge from an investment in research, accountants don't record it as an asset. However, it's unlikely that managers would have ongoing research programs if they didn't have an expectation of profit.

Q2-14.

Common shares represents the amount of money (or other assets) that shareholders have invested directly into the corporation in exchange for shares in the corporation. Retained earnings represent indirect investment in the entity by shareholders as a result of profits being left in the entity instead of being distributed as dividends.

Q2-15

Comprehensive income is an extension of net income that captures all transactions and economic events that involve non-owners of the entity and that affect equity. Comprehensive income = Net income + Other comprehensive income.

Q2-16.

Liquidity is the availability of cash or the ability to convert assets to cash quickly. Evaluating liquidity provides information about an entity's ability to meet its obligations as they come due. A firm that can't meet those obligations can suffer significant economic consequences, at worst being put out of business. It's a vital indicator of the riskiness of the firm for creditors and owners.

Q2-17.

Liquidity is the availability of cash or the ability to convert assets to cash quickly. Thus the whiskey inventory can't be considered liquid until it's close to being ready for sale—until it's at least two years old, since it could (and will) not be sold to customers before then (although it could be considered a current asset since the operating cycle of a distiller would be related to the aging period of the whiskey). Regardless of the classification as current or non-current, if the intent is to age the whiskey for at least three years then the entire inventory shouldn't be considered liquid (only the whiskey that's ready for sale should be considered liquid). Notice that the intent of management is important in determining the liquidity of the whiskey. For a stakeholder examining an Irish whiskey distiller's financial statements, it might be very difficult to determine what plans management has for its inventory of whiskey. In a crisis, any whiskey more than three years old could be sold if required. Early sale would likely affect the amount of money the distiller would receive for the whiskey. Whiskey that's less than three years old couldn't be sold.

Q2-18.

Net income is a measure of what is left over for the shareholders after the economic costs or sacrifices incurred by the business are deducted from the economic gains or benefits earned by the business. In other words, net income is a measure of how much the owners made during the period or how much better off they are as a result of economic activity during the period. The owners' equity section of the balance sheet represents the owners' interest in the assets of the entity and is a measure of the owners' investment in the entity. Thus, when an entity reports net income, it means owners' investment has increased and that increase must be reflected with an increase in owners' equity. Another way of looking at this is that net income represents an increase in the net assets of the entity (this increase belongs to the owners). For the balance sheet to balance, if net assets (assets – liabilities) increase, owners' equity must increase.

Q2-19.

Dividends represent a distribution of the assets of an entity to its owners. By paying a dividend, some of the entity's resources are being taken from the entity and being given to its owners. As a result, the owners' interest in the entity, which is represented by the owners' equity section of the balance sheet, must decrease. Since the net assets of the entity have decreased (dividends decrease net assets), there must be a corresponding decrease in owners' equity for the accounting equation to balance. Another way of thinking about this is that when \$1 of dividends is paid to the owner of an entity, the overall wealth of the owner doesn't change. Only the form and location of the wealth changes. The owner's investment in the entity has decreased by \$1, but the personal wealth has increased by \$1, as reflected by the dollar in his or her pocket. The owner has the same wealth, although the entity is \$1 poorer. Given that the entity is \$1 poorer, the owners' equity should be \$1 less.

Q2-20.

Cash and the ability to generate cash are crucial to the survival of an entity. If an entity doesn't have adequate cash flow (or access to cash from lenders or owners) to meet its short term obligations, then it won't survive. Thus, information that helps a stakeholder assess the ability of an entity to generate cash flow (meaning cash flows in the future) is very important for assessing the survival of the entity. Cash flow is also important for the long-term survival of an entity since it must be able to generate cash flow to meet long-term obligations as well.

Q2-21.

The annual cycle is a meaningful period for most companies, especially those that are seasonal. The time period of a year is **relevant**. The year is a relevant time period for investors as it corresponds to the time frame that we often choose for planning. Tax authorities require annual measurement of profit. Secondly, preparing financial statements on annual basis makes financial information **comparable**. Adopting the same time period for all companies facilitates the comparison of one firm's profits to another. Stakeholders want information about an entity from time to time (as opposed to only at the end of its existence) so a periodic reporting is required. One year is probably the maximum reporting period. Many stakeholders would find information prepared much more frequently to be useful. Indeed, public companies provide quarterly reports in addition to their annual statements.

Q2-22.

Showing several years permits comparisons across time to assess trends in a firm's performance. It also discourages a firm from unduly biasing one year since the reader will view several periods. It also allows users to see how a firm has performed over a series of years rather than one isolated period that may not be representative.

Q2-23.

Accounting and financial reporting is a means of communication between an entity and its stakeholders so how information is presented in the financial statements (as opposed to what information is presented) reflects what the entity is trying to communicate. Greater detail in financial statements might be appropriate if the nature of the business was very complex and the preparers believed that the users of the financial statements would benefit from that additional information. Banks, for example, tend to provide more detail than other companies. Companies may also be reluctant to provide details they wouldn't want competitors to learn, such as their most profitable business segments. Some users would be dissuaded from reading financial statements if they were too detailed while others would appreciate having the details provided because they have the time and ability to explore and consider the information.

Q2-24.

It's important for information to be relevant as it must be useful for stakeholders who must be able to assess the impact of past, present or future transactions and economic events, or confirm or correct evaluations they made in the past. There's not much point to information that isn't relevant. Information must also be representationally faithful to be useful as it must reflect the underlying economic activity—it must be complete, neutral, and free from error. Both relevance and faithful representation are important. The absence of either renders information not very useful. Students may state that having representationally faithful information is more appropriate as it prevents managers from making decisions with bias that may mislead other stakeholders. Alternatively, they may argue that relevance is more important as it allows users to make decisions using the most relevant information, even though it isn't necessarily as reliable (for example using market values instead of historical costs).

Q2-25.

The four enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability. Comparability makes information much more relevant because it allows stakeholders to compare information about an entity from year to year or among entities. Verifiability increases representational faithfulness because if information can be confirmed it's more likely to reflect the underlying economic activity of the entity (assuming the information is relevant). Timeliness makes information more relevant because current information will be more useful for decision-making (assuming it's representationally faithful). Understandability makes financial information more relevant because information is useless unless it can be understood. When a stakeholder understands financial information it can influence her decisions.

Q2-26.

The four basic assumptions are:

Unit of measure: The economic activity of an entity is stated in terms of money.

Entity: Accounting systems provide information about only the specific entity.

Going concern: The entity's operations are assumed to continue for the foreseeable future.
Periodic reporting: Meaningful financial information can be provided for periods of time that are shorter than the life of the entity, such as annually or quarterly.

Q2-27.

Many of the difficulties in accounting arise because of periodic reporting because it's necessary to measure the income of companies over an arbitrary time period (shorter than the life of the entity). Under accrual accounting, economic events (rather than just cash events) are reflected in financial statements. It isn't always obvious when an economic event occurs so judgement must often be exercised when determining the period in which expenses and revenues are recorded and/or when assets and liabilities are recognized in the balance sheet. This need for judgement sometimes allows managers to time revenues and expenses to their advantage while still remaining within the boundaries of ASPE or IFRS (if it applies).

Q2-28.

Typically the financial statements of Canadian companies are expressed in Canadian dollars, more specifically nominal (not price-level adjusted) dollars. The benefit of expressing all amounts on the balance sheet in the same measure makes it possible to aggregate them to express a total amount that is meaningful to Canadian investors and creditors. A drawback of using only dollars to measure financial statement elements is that information about those financial statement elements is lost (for example quantities), which can be relevant. For example, the bank can't tell by looking at the balance sheet of a clothing store whether the inventory is saleable or out of date. Another drawback is that characteristics that aren't easily measured in terms of dollars won't be reflected in the financial statements. The use of nominal instead of price-level adjusted dollars means that the costs and benefits of changing price levels aren't reflected in the financial statements.

EXERCISES

E2-1.

	Assets	=	Liabilities	+	Owners' Equity
Situation 1	\$680,000		\$385,000		\$295,000
Situation 2	100,000		40,000		60,000
Situation 3	255,000		166,000		89,000
Situation 4	1,050,000		430,000		620,000

E2-2.

	Assets on Dec. 31, 2017	=	Liabilities on Dec. 31, 2017	+	Owners' Equity on Jan. 1, 2017	+	Revenue in 2017	-	Expenses in 2017
Situation 1	\$224,000		\$29,000		\$110,000		\$295,000		\$210,000
Situation 2	648,000		135,000		213,000		550,000		250,000
Situation 3	245,000		220,000		(50,000)		375,000		300,000
Situation 4	32,000		10,000		35,000		65,000		78,000

E2-3.

Current assets are assets that will be used up, sold, or converted to cash within one year or one operating cycle. Current liabilities will be paid or satisfied within one year or one operating cycle. It's assumed below that the period to be applied is one year.

- Current asset, since the inventory is expected to be sold within one year.
- Current liability, since these amounts must be paid within 60 days.
- Current asset, since the amount is expected to be collected in less than one year.
- Non-current asset, since the bins will be used to store inventory for more than one year.
- Non-current asset. The art work will provide benefit for more than a year.
- Current liability, since the bank loan might have to be paid at any time. Even if it's expected that the loan won't have to be repaid within a year, the loan would be classified as current because it might have to be repaid.
- Non-current asset, since we know it won't be collected within one year.
- Non-current liability, since it won't be necessary to settle the loan within one year.

E2-4.

Calculation of Retained Earnings:

Retained Earnings, January 1, 2018	\$ 160,000
Add: Net income for the year 2018	105,000
Less: Dividends paid in 2018	<u>(75,000)</u>
Retained Earnings, December 31, 2018	<u>\$ 190,000</u>

E2-5

Speers Ltd.
Income Statement
For the year ended December 31, 2016

Revenue	\$2,250,000
Expense s	<u>1,875,000</u>
Net Income	<u><u>\$375,000</u></u>

Speers Ltd.
Statement of Comprehensive Income
For the year ended December 31, 2016

Net Income	\$375,000
Other Comprehensive Income	<u>37,500</u>
Comprehensive Income	<u><u>\$412,500</u></u>

E2-6

Vaughn Ltd.
Income Statement
For the year ended August 31, 2017

Revenue	\$25,000,000
Expenses	<u>16,850,000</u>
Net Income	<u><u>8,150,000</u></u>

Vaughn Ltd.
Statement of Comprehensive Income
For the year ended August 31, 2017

Net Income	\$8,150,000
Other Comprehensive Income	<u>(155,000)</u>
Comprehensive Income	<u><u>7,995,000</u></u>

E2-7.

Retained Earnings	August 1, 2015	\$ -	August 1, 2016	\$119,500	August 1, 2017	\$276,500
+	Net Income	119,500	Net Income	212,000	Net Income	291,000
-	Dividends	<u>-</u>	Dividends	<u>(55,000)</u>	Dividends	<u>(175,000)</u>
Retained Earnings	July 31, 2016	<u><u>119,500</u></u>	July 31, 2017	<u><u>276,500</u></u>	July 31, 2018	<u><u>\$392,500</u></u>

E2-8.

- a. Operating
- b. Investing
- c. Operating
- d. Operating
- e. Financing
- f. Investing
- g. Financing
- h. Investing
- i. Operating

E2-9

- a. Operating
- b. Investing
- c. Investing
- d. Investing
- e. Financing
- f. Operating
- g. Operating
- h. Financing (IFRS allows this to be classified as operating)
- i. Operating
- j. Operating

E2-10.

Perkins Outfitters Ltd.
Balance Sheet
As of December 31, 2017

Assets		Liabilities and Shareholders' Equity	
Cash	\$8,000	Bank Loan	\$125,000
Accounts Receivables	20,000	Accounts Payable	95,000
Inventory	175,000	Advances from customers	5,000
Prepaid Rent	8,000	Taxes payable	20,000
		Current portion of long-term debt	20,000
Current assets	<u>211,000</u>	Current liabilities	<u>265,000</u>
Property & equipment	290,000		
Investments in shares of other companies	200,000	Loans from Shareholders	45,000
		Long-term Debt	100,000
		Common Shares	150,000
		Retained Earnings	141,000
Total assets	<u>\$701,000</u>	Total liabilities and equity	<u>\$701,000</u>

E2-11

	2018	2017	2016
Revenues	322,000	\$265,000	\$225,000
Expenses	230,000	190,000	155,000
Net income	92,000	75,000	70,000
Retained earnings at the beginning of the year	98,000	55,000	\$0
Dividends declared during the year	42,000	32,000	15,000
Retained earnings at the end of the year	148,000	98,000	55,000
Common shares at the end of the year	105,000	100,000	95,000
Liabilities at the end of the year	165,000	149,000	125,000
Assets at the end of the year	418,000	347,000	275,000

E2-12

Sparwood Ltd.
Financial Statements
For the Year Ended December 31

	2017	2016	2015
Revenues	102,000	\$95,000	70,000
Expenses	105,500	92,000	50,000
Net income	(3,500)	3,000	20,000
Retained earnings at the beginning of the year	10,000	13,000	0
Dividends declared during the year	6,500	6,000	7,000
Retained earnings at the end of the year	0	10,000	13,000
Capital stock at the end of the year	37,000	35,000	25,000
Liabilities at the end of the year	23,000	20,000	15,000
Assets at the end of the year	60,000	65,000	53,000

E2-13.

- a. Operating cash outflow, since inventory is acquired and sold as a part of regular, day to day operations.
- b. Financing cash outflow, since it's a payment to equity investors. IFRS allows classification of dividends as an operating cash flow so an alternative would be operating cash outflow.
- c. Financing cash inflow, since the proceeds are received from a lender.
- d. Investing cash outflow since a long-term asset increases. (If the furniture were purchased for resale it would be an operating item. However, since it was purchased to decorate an office the amount is an investing activity.)
- e. Investing cash inflow since a long-term asset decreases. This assumes that Argentia isn't a vehicle dealer (in which case the amount would be an operating item). The assumption seems reasonable given the amount received for the four delivery trucks.
- f. Financing cash inflow since common shares increases.
- g. Operating cash inflow since it's a cash receipt from providing services
- h. Operating cash outflow since it's an increase in a current asset for an expense that contributes to revenue

Arcola Ltd.
Statement of Cash Flows
For the year ended December 31, 2017

Operating cash flows	<u>\$184,000</u>
Investing cash flows	
Purchase of investments	(350,000)
Purchase of land	(175,000)
Sale of equipment	<u>25,000</u>
Total investing cash flows	<u>(500,000)</u>
Financing cash flows	<u>260,000</u>
Dividends	(50,000)
Sale of commons shares	<u>310,000</u>
Total financing cash flows	<u>260,000</u>
Decrease in Cash During 2017	(56,000)
Cash on December 31, 2016	<u>75,000</u>
Cash on December 31, 2017	<u><u>\$19,000</u></u>

*Cash from investing activities = Sale of Old equipment: 25,000 - Purchase of investments: 350,000 - Purchase of Land: 175,000

*Cash from financing activities = Sale of common shares: 310,000 - dividends paid: 50,000

*IFRS allows dividends paid to be included as an operating cash flow. Under that assumption CFO would be \$134,000 and Financing activities would be \$310,000

Dugald Ltd.
Statement of Cash Flows
For the year ended December 31, 2018

Operating cash flows	<u>\$245,000</u>
Investing cash flows	
Sale of land	45,000
Purchase of equipment	<u>(210,000)</u>
Total investing cash flows	<u>(165,000)</u>
Financing cash flows	
Issue of long-term debt	150,000
Repayment of bank loan	<u>(85,000)</u>
Total financing cash flows	<u>65,000</u>
Increase in Cash During 2018	145,000
Cash on December 31, 2017	<u>(70,000)</u>
Cash on December 31, 2018	<u><u>75,000</u></u>

*Cash from investing activities = Sale of land: 45,000 – Purchase of equipment: 210,000

*Cash from financing activities = Issue of l-t debt: 150,000 - Repayment of bank loan: 85,000

E2-16.

Balance Sheet (B/S); Income Statement (I/S); Statement of Retained Earnings (R/E); Statement of Cash Flow (C/F)

- a. I/S (Revenue or Sales)
- b. B/S (Assets)
- c. B/S (Assets)
- d. C/F (Cash from financing); B/S (Equity and Cash)
- e. B/S (Equity)
- f. I/S (Expense)
- g. C/F (Cash from operations); B/S (Cash); I/S (Expenses)
- h. B/S (Liabilities)
- i. Statement of Comprehensive Income

E2-17

Balance Sheet (B/S); Income Statement (I/S); Statement of Retained Earnings (R/E); Statement of Cash Flow (C/F)

- a. B/S (Assets)
- b. B/S (Equity)
- c. C/F (Cash from operations) and B/S (Cash, Liability)
- d. I/S (Expense)
- e. B/S (Equity)
- f. B/S (Liabilities)
- g. B/S (Assets)
- h. C/F (Cash from financing); B/S (Cash, Liabilities)
- i. I/S (Sales or Revenue); B/S (Receivables)

E2-18

- a. Working capital is $\$2,250,000 - \$1,750,000 = \$500,000$. This means that Summerside has \$500,000 more current assets than current liabilities.
- b. Current ratio is $\$2,250,000 / \$1,750,000 = 1.29$. This means that for every \$1 of current liabilities, Summerside has \$1.29 in current assets.
- c. Debt-to-equity ratio is $(\$1,750,000 + \$2,500,000) / \$4,250,000 = 1.00$. This means that for every \$1 of debt, Summerside has \$1 of equity.

E2-19.

a.

Sussex Ltd.
Income Statement
For the Year Ended September 30, 2018

Revenue	\$1,525,000	
Cost of Sales	0	
Gross Margin	<u>375,000</u>	1,150,000
Expenses		
Depreciation expense	\$174,000	
Other expenses	0	
Interest expense	75,000	
Rent expense	72,000	
Salaries, wages and benefits expense	110,000	
Selling, general and admin. expenses	280,000	
Income tax expense	<u>201,000</u>	
		951,000
Net Income		<u><u>\$199,000</u></u>

- b. Net income is \$199,000.
- c. Gross margin is \$1,150,000.
- d. Gross margin percentage is 75% ($\$1,150,000/\$1,525,000$)

E2-20.

a. Debt-to-Equity Ratio

$$2018 - (\$259,875 + \$1,656,000)/(\$500,000 + \$1,449,000) = 0.98$$

$$2017 - (\$247,500 + \$1,380,000)/(\$500,000 + \$1,050,000) = 1.05$$

$$2016 - (\$225,000 + \$1,150,000)/(\$500,000 + \$750,000) = 1.10$$

- b. The debt-equity ratio has decreased slightly each year from 2016 - 2018. It fell from 1.10 in 2016 to 0.98 in 2018.
- c. The debt-equity fell from 2016 to 2018 mainly because of the increase in retained earnings which is a component of shareholder's equity was proportionally larger than the increase in liabilities. Current liabilities and non-current liabilities increased each year from 2016 through 2018 but total liabilities didn't increase as much as retained earnings did each year. Because equity increased more than liabilities for each of the three years, the ratio fell each year.
- d. The change in the ratio is a positive thing for the shareholders of Peguis. The debt-equity ratio is often looked upon as a measure of risk for investors. The lower the ratio, the less risky the entity is perceived. The overall increase to net assets (equity) is a positive sign for

shareholders of Peguis and the increase to equity has been brought about by strong net income. The common shares account remains at \$500,000 which means no further share dilution has taken place.

E2-21.

- a. 2018 – $[\$95,095/\$247,000] \times 100\% = 38.5\%$
 2017 – $[\$84,746/\$232,180] \times 100\% = 36.5\%$
 2016 – $[\$77,200/\$220,571] \times 100\% = 35.0\%$
- b. The gross margin has increased each year from 2016 – 2018. The gross margin percentage is the percentage of each dollar of sales that is left to cover other costs and to return a profit to the owners. The increase to the gross margin percentage means there is more money per dollar of sales available. However, it's possible the higher gross margin percentage (which implies the prices Oxdrift charges have increased) may have been achieved at the cost of lower sales volume (Oxdrift sells fewer units of merchandise but the price per unit is higher).
- c. To see what net income would be if gross margin stayed the same in 2016 – 2018, we must solve for the new gross margin using 35.0% as our gross margin percentage.

2017:

$$x = 0.35 \times (\$232,180)$$

$$x = \$81,263$$

Gross margin falls by \$3,483 $[\$84,746 - \$81,263]$

Therefore, net income would fall to \$13,931 $[\$17,414 - \$3,483]$

2018:

$$x = 0.35 \times (\$247,000)$$

$$x = \$86,450$$

Gross margin falls by \$8,645 $[\$95,095 - \$86,450]$

Therefore, net income would fall to \$12,350 $[\$20,995 - \$8,645]$

E2-22.

Cash basis revenue	\$ 8,000
Cash basis expense	<u>4,700</u>
Cash basis net income	<u>\$ 3,300</u>

$$\text{Accrual basis revenue} = \$ 8,000 + 1,200 = \$9,200$$

$$\text{Accrual basis expense} = \$4,700 + 1,100 = \underline{5,800}$$

$$\text{Accrual basis net income} = \underline{3,400}$$

Cash basis accounting recognizes as revenue only cash collected from customers and as expenses only cash paid to suppliers. Accrual accounting recognizes revenue as amounts “earned” during a period and expenses incurred to earn that revenue. It isn’t necessary for cash to be exchanged for recognition in an accrual accounting system. Kedgwick’s cash net income differs from its accrual net income because as of the end of its first year of operations it was owed \$1,200 for work it had done for customers (the amount owed is reported in the accrual system but not the cash system) and it owed suppliers \$1,100 for supplies used during the year (the amount it owed to suppliers wouldn’t be recorded in a cash system but would be recorded in an accrual system). Note that it’s assumed that the amount owed to suppliers was associated with expenses incurred in the period.

E2-23.

Income on a cash basis:

Cash collected from customers	\$413,000
Amounts paid to suppliers	(121,450)
Amount paid to employees = \$61,250 + 3,500	(64,750)
Income taxes	<u>(26,250)</u>
Cash basis net income	<u>\$ 200,550</u>

Income on an accrual basis:

Revenue (\$413,000+39,200)	\$452,200
Cost of Supplies (\$121,450+28,350-9,800)	140,000
Wages expense (\$61,250+7,700)	68,950
Depreciation expense	14,000
Income taxes	<u>26,250</u>
Accrual basis net income	<u>\$203,000</u>

The two bases of accounting provide different results because expenses and revenues are recognized differently. On the cash basis expenses and revenues must reflect the exchange of cash. Under accrual accounting the exchange of cash isn't required.

The calculation of the cost of supplies under the accrual system is tricky. The \$9,800 of supplies on hand isn't expensed because it was on hand (and therefore unused) at the end of the period.

Advances paid to employees aren't reflected in the accrual income statement because it's for work that will be done in the future. Therefore, the amount is classified as an asset until the work is provided. The amount is assumed not to be included in cash paid to employees for work done. (Some student might assume that the amount paid to employees includes the advances. This is a reasonable assumption. However, the assumption must be applied consistently so this would mean for the accrual calculation that the \$3,500 would be ignored.

The solution assumes income taxes paid is the same as the income tax expense (this isn't an assumption students at this stage should be expected to make).

PROBLEMS

P2-1.

Auberndale Ltd.
Balance Sheets
As at December 31
(in thousands of dollars)

	2017	2016	2015
Current Assets			
Cash	\$7,140	\$11,712	\$2,856
Accounts Receivable	22,134	19,992	17,850
Inventory	39,270	31,416	28,560
Prepaid Assets	2,142	714	1,428
Total Current Assets	70,686	63,834	50,694
Land	8,925	8,925	8,925
Plant & Equipment	53,550	49,266	43,554
Accumulated Depreciation	(26,418)	(22,134)	(19,278)
Other Assets	3,285	5,850	7,311
Total Non-Current Assets	39,342	41,907	40,512
Total Assets	\$110,028	\$105,741	\$91,206

Current Liabilities			
Accounts Payable	\$21,420	\$20,703	\$16,422
Bank Loan Payable	2,385	6,168	2,856
Total Current Liabilities	23,805	26,871	19,278
Mortgage Payable	12,138	14,130	15,708
Total Liabilities	35,943	41,001	34,986
Shareholders' Equity			
Common Shares	13,566	12,288	12,138
Retained Earnings	60,519	52,452	44,082
Total Shareholders' Equity	74,085	64,740	56,220
Total Liabilities and Shareholders' Equity	\$110,028	\$105,741	\$91,206

Auburndale Ltd.
Income Statements
For the Year Ended December 31 (in thousands of dollars)

	2017	2016	2015
Sales Revenue	\$178,500	\$160,650	\$146,370
Cost of Goods Sold	124,950	110,670	99,960
Gross Margin	53,550	49,980	46,410
Expenses			
Selling	22,134	19,635	17,850

Administrative	10,710	9,996	9,639
Amortization	4,641	3,570	2,856
Interest	1,785	2,712	2,856
Total Expenses	39,270	35,913	33,201
Income Before Income Taxes	14,280	14,067	13,209
Income Taxes	5,427	4,911	4,113
Net Income	\$8,853	\$9,156	\$9,096

Auburndale Ltd.
Statements of Retained Earnings
As at December 31 (in thousands of dollars)

	2017	2016	2015
Retained Earnings, Beginning of year	\$52,452	\$44,082	\$35,700
Net Income	8,853	9,156	9,096
Dividends	786	786	714
Retained Earnings, End of year	\$60,519	\$52,452	\$44,082

- b. It's difficult to make much of an assessment of a loan application when virtually nothing is known about the prospective borrower, including its industry. The financial statements tell us that Auburndale Ltd. has been profitable over the last three years and the profits have been stable. However, sales have increased significantly over the three years but profits haven't kept up. There is no dramatic proportional change in any of the expenses so a more detailed examination of the individual expenses is needed to understand the decline in profitability. The gross margin percentage has declined slightly over the three years (30% in 2017, 31.1% in 2016, 31.7% in 2015). The liquidity position of Auburndale seems reasonable, with a lot more current assets than liabilities. Inventory is growing faster than sales and this could suggest that sales are expected to grow or poor inventory management. Auburndale Ltd. doesn't appear to have an excessive amount of debt. Ratios such as the current ratio and debt-to-equity ratio could be calculated to support these comments.

Different conclusions are possible. Any conclusion that is drawn should be supported by the explanation provided. At best only a preliminary conclusion can be drawn because there are many unanswered questions.

Additional information includes:

- What business is Auburndale Ltd. in?
- What will the money be used for?
- How long will the loan be for?
- What are projected cash flows for the term of the loan?
- When is the loan to be paid off?
- What assets are available as collateral? What are their market values?
- Are there any changes expected in the near future that will change the nature or performance of the business?
- If cash is needed for investment why are dividends being paid?

- Why has profit decreased somewhat when sales have increased 11.1% from 2016 to 2017?
- Why has the gross margin percentage been decreasing?
- Why has inventory increased by so much? Anticipated growth, expansion, or inventory that can't be used?
- Who are the managers and what is known about them?
- Other points can be raised.

P2-2.

Josselin Ltd.
Income Statement
For the Year Ended October 31, 2017

Revenue		\$5,750,000
Cost of sales		2,800,000
Gross margin		<u>2,950,000</u>
Expenses:		
Depreciation expense	\$224,000	
Selling, general and administrative	650,000	
Interest expense	185,000	
Salaries and wage expense	545,000	
Income tax expense	300,000	
Total Expenses		<u>1,904,000</u>
Net income		1,046,000
Other comprehensive income		<u>(75,000)</u>
Comprehensive income		<u><u>\$971,000</u></u>

Hanmer Limited
Income Statement
For the year ended December 31

	2017	2016
Revenue	\$2,370,000	\$2,138,250
Cost of Inventory Sold	<u>850,000</u>	<u>801,000</u>
Gross Margin	1,520,000	1,337,250
Expenses		
Advertising and promotion	\$250,000	\$187,500
General and Admin	270,000	225,750
Miscellaneous	55,000	48,000
Rent	43,500	41,250
Salaries, wages and commissions	426,600	337,500
Utilities	11,850	11,400
Income taxes	<u>140,625</u>	<u>111,000</u>
Total Expenses	<u>\$1,197,575</u>	<u>\$962,400</u>
Net Income	<u><u>\$322,425</u></u>	<u><u>\$374,850</u></u>

b)	Gross Margin	\$1,520,000	\$1,337,250
	Gross Margin Percentage	64.1%	62.5%

If we base our evaluation on the gross margin percentage, Hanmer appears more successful in 2017 because of the increase in the gross margin percentage of 1.6 %. However, Hanmer saw significant changes in their expenses aside from the cost of goods sold thereby their net income from 2016 by more than \$52,000. Hanmer was less successful in 2017 from a net income standpoint. Note, however, that the increase in some of Hanmer's expenses may have been non-controllable by the entity thereby making it hard to evaluate how successful management was based on net income.

c.

If Hanmer's gross margin percentage was the same in 2017 as it was in 2016, it would be 62.5 %. We can solve for what the gross margin would be by creating an algebraic equation.

$$x / \$2,370,000 = 62.5\%$$

$$x = .625(\$2,370,000)$$

$$x = \$1,481,250$$

With the new gross margin percentage, the gross margin fell \$38,750 [\$1,520,000 - \$1,481,250]. This would result in net income falling by the same amount and would be \$283,675 [\$322,425 - \$38,750]. As we can see, when gross margin decreases there is a negative effect on net income. This makes sense because gross margin decreases when cost of goods sold, an expense, increases.

d.

When we examine the income statement we can see the decrease in net income resulted from the increase of Hanmer's expenses. The gross margin % increased in 2017 so the cost of sales isn't the reason for the decrease to income. Every expense increased from 2016 to 2017. Many expenses had greater increases proportionately relative to the proportionate increase in revenue. Advertising and promotion increased by \$62,500 (33 %); Salaries, wages and commissions also increased by \$89,100 (26 %); General and admin increased by \$44,250 (20 %). Revenue increased by only 11 %. The collective increase in all the expenses was much greater than the increase in revenue. This caused net income to drop significantly from 2016 to 2017.

P2-4.

To qualify as an asset according to IFRS, the following items must satisfy the IFRS criteria

- Provide a future benefit to the entity and it must be probable that the entity will enjoy the benefit.
 - Be controlled by the entity that will obtain the benefits.
 - Be the result of a transaction or event that has already occurred
 - Be measurable.
- a. These are assets. Computers are required to determine the availability of inventory, prices, and delivery times. The amount associated with the computers is measurable – there would be invoices indicating the prices paid for the computers. Leon's has control over the computers as it owns them and can use them how it sees fit. It's also the result of a past transaction – the original purchase of the computers from a supplier.
 - b. The tables and chairs in the stores are an asset. They provide a future benefit as they allow for discussions between salespeople and customers. The table and chairs are measurable as they would have a purchase price and invoice from the supplier. Leon's has control over the tables and chairs as they are the only rightful owner of them. They are the result of a past transaction – the original purchase of the tables and chairs.
 - c. This isn't an asset to Leon's. Leon's doesn't have control over this television promotion and Leon's wasn't involved in the transaction as the product's manufacturer paid for it. There is a benefit to Leon's because the promotion may attract people to the theatre.
 - d. This is an asset. The signage provides a future benefit to Leon's as it helps in the revenue generating process (it makes finding the store easier and provides useful information). The signage is measurable as Leon's would have an invoice detailing the supplies and labour of creating the sign. Leon's has control over the signage as it can choose what to display on it. The sign is the result of a past transaction (purchase of the sign).
 - e. This isn't an asset because there is no future benefit to damaged and presumably unsalable inventory. It will be thrown out eventually.
 - f. This is an asset. It has a future benefit as this receivable will turn into cash when the senior executive pays. The receivable is measurable as is the amount borrowed should be documented. Leon's has control over this receivable assuming Leon's isn't involved in any factoring of receivables. The receivable is the result of a past transaction – the payment to the executive.
 - g. This is an asset. Prepaid rent has a future benefit because it provides use of a building for a specified amount of time (no monthly rent during this time). The amount is measurable as there would be an invoice stating the amount paid and length of prepaid rental period. Leon's has control as it has the right to use the space rented for the specified period. The prepaid rent is a result of a past transaction – the payment of cash to the property owner.

P2-5

To qualify as an asset according to IFRS, the following items must satisfy the IFRS criteria

- Provide a future benefit to the entity and it must be probable that the entity will enjoy the benefit.
 - Be controlled by the entity that will obtain the benefits.
 - Be the result of a transaction or event that has already occurred
 - Be measurable.
- i. The partially completed vehicle is an asset. It has a future benefit in that when it's completed, it can be sold. The amount spent to build it to date is measurable (the costs incurred can be accumulated; i.e. wages and materials). GM has control over the vehicle as it's in its facility and no one else has a claim on it. It's the result of many past transactions – parts purchased from suppliers, employee labour, etc.
 - ii. These shares are assets. They represent a future benefit as these shares can appreciate in value, they can generate dividends, and they can be converted into cash by being sold. The shares are easily measurable – they would have a known purchase price (and a known market value if they are publicly traded). GM has control over these shares – they would have a share certificate proving they own the shares. These shares are the result of a past transaction – the cash purchase of the shares.
 - iii. This isn't an asset. Before the collision the vehicle would have future benefit as a test vehicle. Once damaged (and assuming it can no longer be used) the vehicle serves no useful purpose for GM and therefore there is no future benefit (it can't help GM make money).
 - iv. These tools are assets. They provide a future benefit to GM because they are used to assemble cars that can then be sold. The purchase price is determinable from invoices. GM has control over the tools as they can use the tools however they please. The tools are also the result of a past transaction – they were purchased from a supplier.
 - v. This is an asset. The computer equipment has a future benefit in that it helps design new cars thereby contributing to the revenue generating process for years to come. It's also measurable as the equipment would have had a purchase price when it was originally purchased. GM has control over the use of the software equipment. The computer equipment is also the result of a past transaction – its original purchase from the supplier.
 - vi. This isn't an asset under IFRS because GM built its brand name, it didn't buy it. The value of the name was built up over the years through advertising and marketing and when the money was spent it wouldn't be possible to know if or what the future benefit associated with an expenditure would be.
 - vii. The amounts owed by dealers—accounts receivable—has a future benefit in that they will turn into cash when the dealership pays. The receivable is easily measurable as it would be known the amount in dollars of the cars purchased that created the receivable. GM has control over the receivable as no one else is entitled to receiving the cash. It's also the result of a past transaction – the purchase of cars by the dealership.
 - viii. This may or may not be considered an asset depending on the circumstances. It would meet all the eligibility criteria except possibly future benefit. As the dealership is going through a bankruptcy, there is question as to whether cash will be collected by GM. Creditors would likely be first in line to be paid so some or all of the amount owing might be collected. If the amount isn't going to be recovered it wouldn't be reported as an asset. If only part will be collected only the collectable part would be reported as an asset.

P2-6.

Liabilities have three characteristics according to IFRS:

- Present obligation involving a future sacrifice of economic resources
 - Result of a past transaction
 - Measurable
- a. This is a liability. Wages owed to employees are a present obligation as GM (the employees worked, they're entitled to be paid). They will result in a future sacrifice of cash by GM. These wages are the result of many past transactions – work performed by the employee. The wages are also measurable as the employee has an hourly rate and it's known how many hours they have worked.
 - b. This is a liability. These amounts are collected on behalf of the government and are owing to it. Cash will have to be paid to the government. It's a present obligation because the amounts pertain to wages earned by employees. The amounts are the result of a past transaction – the employees have earned wages and so must pay income taxes. These amounts are measurable as it can be traced how much income tax was deducted on an employee's pay stub.
 - c. This is a liability as long as it can be estimated. GM has the present obligation to provide a dental plan to retired workers. This will result in a future sacrifice of cash to pay for retired employees dental services. This is the result of a past transaction –the work employees have done over the years to earn this benefit. The issue pertains to measurement. GM would have to be able to make a reasonable estimate of the costs of this dental plan for it to be considered a liability.
 - d. This is a liability. The amounts owed to suppliers represent a present obligation as GM has the legal obligation to pay the suppliers for goods supplied. The obligation will be satisfied with the sacrifice of cash in the future. This is the result of a past transaction – the receipt of goods from the supplier. This amount is measurable as there would be a purchase invoice indicating the total amount of the goods purchased.
 - e. This is a liability. The warranty offered to customers represents a present obligation for GM to fix trucks and cars within the specified warranty period. The obligation arises from the sale of a vehicle to a customer. This will result in a future sacrifice –labour and parts to provide the warranty service that GM must pay for. The warranty costs are the result of a past transaction – the purchase of a car/truck by a customer. Typically, warranty costs are measurable as GM could look at historical data in order to make a reasonable estimate. For any particular vehicle GM won't know the cost to be incurred for warranty service. In most cases it will be likely to estimate the amount related to all sales in a period.
 - f. A lawsuit isn't a liability until something is decided. The issue lies in that it isn't certain that this lawsuit will result in a future sacrifice or resources and its measurement is far from certain. There is no obligation until there is a settlement, decision by the court, or a commitment by GM that it owes something.

P2-7.

a.

**Nathan Reed
Balance Sheet**

Assets		Liabilities and Owners' Equity	
Cash	\$ 844	Accounts Payable	\$ 200
Accounts receivable	750	Bank Loan	2,000
Computer	1,050	Total liabilities	2,200
Car	1,800		
Personal Property	6,000	Owners' Equity	8,244
Total	<u>\$ 10,444</u>	Total Liabilities and Owners' Equity	<u>\$ 10,444</u>

This balance sheet is prepared on the following assumptions and rationale. However, there are other reasonable assumptions that could be made for this statement.

i. Cash can be used to buy things that Nathan needs; thus will be a future benefit to him. The amount of cash increases his assets.

ii. The used car is a benefit for Nathan because he can use it to drive around and do things. He purchased it three years ago and estimates it's going to be useful for another two years. The car is depreciating at \$900 a year ($4500/5$) or Nathan is using up \$900 of the cars cost car each year; thus, the car net value is \$1800 (2 years left).

iii. Nathan has the right to receive \$750 from the social group; this right is a benefit to Nathan.

iv. Nathan has an obligation to pay \$2,000 sometime in the future; this obligation increases Nathan's liabilities.

v. The computer purchased is a benefit to Nathan because he will be able use it for personal use and school and represents an asset. The \$1,200 cost of the computer would be recorded as an asset and the amount he owes to the store, \$200, is a liability. The total debt was \$500 at purchase time six months ago. He has paid \$300 for the six months period. He still has a current obligation to pay \$200 over the next four months. The computer has an estimated life of four years and Nathan has owned the computer for six months so depreciation to date is \$225.

vi. The cost of his personal property was \$6,000 which benefits Nathan in many different ways, thus increase in his assets by that amount. There is no information given to when he has purchased these items or how long these items will be benefit to him or the extent to which they have been used up.

b. One possible response: alternate assumptions and viewpoints are possible. The art school would use the information in the balance sheet to assess whether Nathan requires financial assistance to attend the school, since the amount of the scholarship is based on their perception of his financial need. The balance sheet provides information on his current financial position. The cash inflow from the collection of the account receivable will increase

the cash balance to \$1,594. The computer won't provide cash, but it does probably indicate that Nathan's computing needs are met for the duration of his program. The school may view the car as a luxury and suggest that it be sold to provide cash. The personal possessions really don't provide much relevant information because we don't know their age or condition. One might assume that they couldn't be sold for a significant amount of cash and that the books aren't relevant to the art program.

The response of the art school to Nathan's financial obligations depends on whether they are aware of the repayment arrangements that he has made. Without additional information, it appears that Nathan will be required to pay \$2,200 in the near future. In fact, only the \$200 must be paid before graduation and will be paid off in 4 months. The point illustrates the need to ask questions to avoid being misled.

It's really not helpful to consider that Nathan has \$8,394 in equity, particularly since no adjustment has been made to reflect the fact that the computer is six months old. The value of his personal possessions is questionable. The art school is likely most interested in the resources Nathan has to pay tuition and other expenses. Cash and near cash are most relevant.

- c. The important thing to understand in this question is the balance sheet doesn't tell the whole story and to make informed decisions a user should search or inquire to obtain more information. Many additional items of information would be helpful. The balance sheet only indicates his current financial position, but doesn't indicate expected cash receipts and payments during the time he is a student. The school would want to know what expenses Nathan would incur. They would already be aware of the school-related costs such as tuition, books, and art supplies. They would also need to know his budget for accommodation, food, clothing, transportation, and other expenses. They would also ask about any income that he expects to earn during the duration of the degree, as well as what financial support is expected from other sources such as family members or other scholarships.

P2-8.

a.

Nathan Reed			
Balance Sheet			
Assets		Liabilities and Owners' Equity	
Cash	\$ 844	Accounts Payable	\$ 200
Accounts receivable	750	Bank Loan	2,000
Computer	1,000	Total liabilities	2,200
Car	2,200		
Personal Property	1,000	Owners' Equity	3,594
Total Assets	<u>\$ 5,794</u>	Total Liabilities and Owners' Equity	<u>\$ 5,794</u>

This balance sheet is prepared based on what Nathan believes he could sell all his assets for (Net Realizable Value or Market Value) compared to the previous balance sheet, which was based on historical value.

- b. The second balance sheet is more useful (relevant) for the art school since the asset values are more reflective of the amount of cash that Nathan has available.
- c. The problem with using market values is that they can reflect opinions or incomplete transactions rather than objective evidence of value. The cost is more reliable even though it may be less relevant for decision-making. The question is one of whether the loss of reliability is offset by the increase in relevance. Probably for the art school, the estimates of current values of the assets are sufficiently precise. One way of preparing the balance sheet (market value) isn't better than the other (historical cost); it depends on the user of the information.

P2-9.

a.

Louis Davis			
Balance Sheet			
Assets		Liabilities and Owners' Equity	
Cash	\$ 4,750	Accounts Payable	\$ 12,000
Accounts receivable	19,000	Wages Payable	2,500
Supplies	750	Bank Loan	10,000
Furniture	13,200	Total liabilities	24,500
Equipment	33,333	Owners' Equity	46,533
Total Assets	<u>\$71,033</u>	Total Liabilities and Owners' Equity	<u>\$ 71,033</u>

i. Equipment: This equipment has and is providing a benefit to Louis and his dentist practice. Two thirds of the estimated life of this asset has been used up leaving a current benefit of one third of the life of the assets ($1/3 * 100,000$), thus there is a current benefit value of the asset of \$33,333 not used up.

ii. Furniture: This furniture has and is providing a benefit to Louis and his dentist practice. Forty percent of the estimated life of this asset has been used up leaving a current benefit of sixty percent of the life of the assets ($.6 * 22,000$), thus there is a current benefit value of the asset of \$13,200 not used up.

iii. Accounts receivable: Louis has a right to receive \$19,000, thus it represents an asset.

iv. Accounts payable: This represents an obligation for Louis to pay \$12,000 in cash to suppliers in future.

v. Cash: Cash can be used to buy things that that the dentist practice needs; thus will be a future benefit to the business. The amount of cash in the bank increases Louis' assets.

vi. Wages payable: This represents an obligation for Louis to give up \$2,500 in cash in two weeks thus an increase in liability.

vii. Bank loan: This represents an obligation for Louis to give up \$10,000 in the future thus an increase in liability.

viii. Supplies: These supplies will be used to provide service to patients and thus provide a benefit and asset to the business recorded at \$750.

b. One possible response: alternate assumptions and viewpoints are possible. The judge would use the information in the balance sheet to determine Louis' wealth in the practice. The balance sheet seems to indicate that his equity in the business is worth \$46,533, but that is likely very misleading. The equipment and furniture are likely to be worth a different amount than what is reported on the balance sheet. The value on the balance sheet is the net book

value of the furniture and equipment and represents an amount of how an asset has provided benefit to the business not what the asset can be sold for or value of asset. An appraisal of the equipment and furniture would provide more relevant information to determining value and selling price. Most importantly, missing from the balance sheet would be the patients, which embody the flow of cash that practice will generate.

- c. The important thing to understand in this question is that the balance sheet doesn't tell the whole story and to make informed decisions a user should search or inquire to obtain more information. Many additional pieces of information would be helpful. If the balance sheet is to be used to determine the cash value of assets then the selling prices of the assets is important; cost wouldn't be. As it stands the balance sheet indicates the current financial position of the business (based on the measurement conventions used), but doesn't reflect the value that has been created by building a reputation. There are ways of estimating the value of what is called goodwill, such as some multiple of revenues or annual income. We would also like to know how much cash has been taken out of the business this year, since Louis might have anticipated the purpose of the information request and skimmed off assets to reduce his wealth and obtain a smaller settlement. We might wonder if he expects to collect 100% of the accounts receivable, whether he has done work for anyone that he hasn't included in accounts receivable because they haven't been billed, or if he accepted cash from patients and didn't record the amounts.

P2-10.

a.

Louis Davis			
Balance Sheet			
Assets		Liabilities and Owners' Equity	
Cash	\$ 4,750	Accounts Payable	\$ 12,000
Accounts receivable	19,000	Wages Payable	2,500
Supplies	750	Bank Loan	10,000
Patient list	125,000	Total liabilities	24,500
Equipment	25,000	Owners' Equity	150,000
Total Assets	<u>\$174,500</u>	Total Liabilities and Owners' Equity	<u>\$174,500</u>

This balance sheet is prepared based on what Louis believes he could sell all his assets for (Net Realizable Value or Market Value) compared to the previous balance sheet, which was based on historical value). This basis is useful if a stakeholder wants to know the cash value of the practice's net assets.

- b. The second balance sheet is significantly more useful for the judge since the asset values are more reflective of the equity that Louis actually has in the practice. The \$150,000 equity is a much better indicator of the price that Louis would be likely to obtain if he sold the practice and paid off all the liabilities. The judge presumably is trying to estimate that number without actually forcing Louis to sell the business, which is the only way to determine with certainty the value of the business. If the practice continues to operate it would be relevant to consider the cash flow and income that it would generate in the future, which would require examination of an income statement.
- c. The problem with using market values is that they are often subjective and difficult to determine. We might be very suspicious of Louis' estimate of the value of the patient list since a lower value will reduce the amount he would have to pay his wife in any settlement. Yet this is the most significant asset. We would want to see the calculations and draw our own conclusions as to its reasonableness. Similar doubt might be expressed regarding the other information given. Does dental equipment really become obsolete that quickly? Using cost requires Louis to provide evidence of the amount paid, so the concerns about bias in the information is lessened, but in this case the relevance would seem to be very strongly in favour of the market values. The judge may feel comfortable forming a conclusion about the reasonableness of Louis' estimates or ask him enough questions about how they were derived to accept them or make some adjustment. In this case, market values are more useful, since relevance is more important than reliability.

**Income Statements
For Joe Krasman's Business**

	Cash		Accrual	
Revenue	\$3,500 + \$500	\$4,000	\$3,500 + \$400	\$3,900
Cost of Sales (Court time)	\$1,000	<u>1,000</u>	\$1,000 - \$350	<u>650</u>
Gross Margin		3,000		3,250
Expenses				
Wages	\$250	250	\$250 + \$50	300
Supplies*	150	150	150	150
Advertising	0	<u>0</u>		<u>75</u>
		400		525
Net Income		<u><u>\$2,600</u></u>		<u><u>\$2,725</u></u>

Differences between the cash and accrual method are a result of:

- Credit sales which are included under the accrual method, but not under the cash method
- Cash collected for services to be provided in the future are included under the cash method but not the accrual method
- Wages not paid but owed for work in May are included under the accrual method but not the cash method
- The ads were run in May so should be expensed. They won't be paid for until June so there is no cash effect

Joe's business looks like it's done fairly well. He has an accrual profit and positive cash flow for the first month of a student run business. If things continue this way he'll earn about \$11,000 for the summer. Things could get better since he may find more clients as people become more aware of his service and when schools are out for the summer and parents are looking for activities for their children. The business is simple and there aren't a lot of costs that he has to incur so the most important thing is to make sure he's able to fill as much of his time as he wants.

* This assumes all supplies were used in May – there may be some carried over to June which should increase net income on an accrual basis.

**Income Statements
For Mr. Sulu's Business**

	Cash		Accrual	
Revenue	\$8,500+3,500+2,150	\$14,150	\$10,800	\$10,800
Expenses				
Wages	2,000	2,000	[2,000-200+700]	2,500
Supplies	2,000	2,000	1,500	1,500
Other	1,600	1,600	1,600	1,600
Depreciation			500	500
		<u>5,600</u>		<u>6,100</u>
Net Income		<u><u>\$8,550</u></u>		<u><u>\$4,700</u></u>

Differences between the cash and accrual method are a result of:

- Revenue under the cash method includes cash collected on current month's sales, prior months sales and deposits for services yet to be provided
- Revenue under the accrual method includes only the amounts related to services actually provided in May
- Depreciation is included under the accrual method but not the under cash method
- Wages under the cash method include amounts paid to employees, regardless of when they worked
- Wages under the accrual method includes only the amount owed to employees for work done in May
- Supplies under the cash method include only supplies that have been paid for while the accrual method counts supplies used in May, regardless of when they are paid for
- Other expenses are the same under both

It isn't possible to say which method is better all the time. The two approaches provide different perspectives on the performance of the company. The cash statement is straightforward and indicates how much more cash Mr. Sulu had at the end of the period than the beginning. The cash approach provides a straightforward indicator of liquidity. The accrual approach is more comprehensive, reflecting the broader concept of economic performance, so it captures receivables and payables, which the cash approach doesn't. Net income under the accrual approach is less concrete than the cash measure. The cash method could be a bit misleading if Mr. Sulu believes the net income for a period is always available for him to spend, which may not be the case, since spending all the cash may not leave enough to pay outstanding obligations.

Under both methods the business performed well. The accrual approach is likely a better indication of ongoing performance since it ties together the economic benefits and the economic costs. The cash approach shows a significant increase in the amount of cash at the end of the month.

P2-13

Balance Sheet as of September 30			
Assets		Liabilities and Shareholder's Equity	
Cash	\$8,000	Bank loan	\$16,000
Accounts receivable	2,400	Accounts payable	4,200
Inventory	10,000	Customer deposits	2,000
Equipment	18,000	Common shares	8,000
		Retained Earnings	8,200
	38,400		38,400

Asset Side:

-Add equipment

-Remove accounts payable

-Add accounts receivable

-Remove dividend paid

Liability and Shareholder's Equity Side

-Remove accounts receivable

-Subtract dividends from net income
and label that retained earnings

-Add accounts payable

-Add customer deposit

P2-14.

a.

Ferintosh Pharmacies Ltd
Income Statement – **Existing Strategy**
For the year ended December 31, 2017

Revenue (\$475,000 * 1.03)	\$489,250
Cost of Sales (\$296,875 * 1.03)	<u>305,781</u>
Gross Margin	183,469
Salaries and wages (64,125*1.03)	66,049
General and admin (66,975*1.03)	68,984
Advertising and promotion (19,000*1.03)	19,570
Depreciation (19,475*1.03)	20,059
Interest	<u>7,125</u>
Income before taxes	1,682
Income tax expense (256*1.03)	<u>264</u>
Net Income	<u><u>\$1,418</u></u>

Ferintosh Pharmacies Ltd
Income Statement – **New Strategy**
For the year ended December 31, 2017

Revenue (\$475,000 * 1.10)	\$522,500
Cost of Sales**	<u>342,238</u>
Gross Margin	180,262
Salaries and wages (64,125*1.02)	65,408
General and admin (66,975*1.015)	67,980
Advertising and promotion	19,000
Depreciation (19,475*1.03)	20,059
Interest	<u>7,125</u>
Income before taxes	690
Income tax expense (690*18%)	124
Net Income	<u><u>\$566</u></u>

** Gross Margin previous year = 37.5% (\$178,125/\$475,000)

Gross margin is predicted to fall 3% to 34.5%.

$GM/\$522,500 = 34.5\%$

$GM = \$522,500(0.345)$

$= \$180,263$

Therefore, cost of sales = \$522,500 - \$180,262 = \$342,238

b. When we compare the two strategies, it looks as if Ferintosh should continue with its existing strategy. This new strategy actually earns about 60% less profit than the existing strategy. There is also the risk that the new strategy won't turn out as expected, thereby increasing the risk of implementing the new strategy. Even though sales increases by 10% under the new strategy, this isn't enough to make up for the 3 % overall decrease to gross margin (37.5 % down to 34.5 %).

However, neither strategy is very successful. Ferintosh isn't making much money in either case. Management needs to consider which strategy offers more potential in the longer term.

c. By lowering the gross margin percentage Ferintosh increases sales because it offers lower prices to customers. The expectation is that the increase in sales volume will compensate for the decrease in the gross margin percentage. In 2017 under the stated assumptions things won't work out this way as the gross margin under the new strategy would be \$3,207 lower than the old. For the gross margins to be the same it would be necessary for sales to increase to \$531,793 ($\$183,469 \div 34.5\%$) or by almost 12 percent from 2016 ($\$531,793 \div \$475,000$).

P2-15.

Report to Lenore Ryerson, President of Nipawin Shoes Ltd.

The following report discusses why Nipawin's profit has been falling from 2015 to 2017 despite having increasing sales. A calculation of Nipawin's gross margin percentage for years 2015 – 2017 is a good starting point:

2015 gross margin percentage = $\$599,046 / 900,821 = 66.5\%$

2016 gross margin percentage = $\$609,931 / 938,355 = 65.0\%$

2017 gross margin percentage = $\$618,915 / 998,250 = 62.0\%$

These numbers definitely tell a story. In each of these years, Nipawin's gross margin percentage has been falling. It has fallen 4.5 % from 2015 to 2017. A gross margin percentage that is in decline means that an entity has less per dollar of sales to cover other expenses and return a profit to the entity's owners. To make this even clearer, a declining gross margin can have a very detrimental effect on net income.

The declining gross margins should make sense to Nipawin. Competition is fierce so Nipawin has been forced to offer a lot of sales to clients. A sale means lowering prices, which shrinks the gross margin percentage, because cost of goods sold stay the same. Even though Nipawin has been selling more every year, it is making less and on each sale because the cost of the goods sold is a greater percentage of the selling price.

Something interesting to consider is to imagine if Nipawin had the same gross margin it did in 2015 (66.5 % as opposed to 62.0 %):

GM / Sales = Gross Margin %

GM / $\$998,250 = 66.5\%$

GM = $\$998,250(.665)$

GM = $\$663,836$

Therefore, if GM % was still 66.5 %, Nipawin's overall gross margin would increase by $(\$663,836 - 618,915)$ **\$44,921**. If all other expenses stayed the same, net income would increase by this amount!

I hope this report proved useful to you in assessing your company's declining profitability.

P2-16.

- a. Company A – Current Ratio: $[\$90+375+200]/[\$225+170+60] = 1.46$
Working Capital: $\$665 - \$455 = \$210$
Company B – Current Ratio: $[\$15+410+255]/[\$170+195+60] = 1.60$
Working Capital: $\$680 - \$425 = \$255$
- b. It's hard to conclude which company has a better liquidity position by just knowing working capital and the current ratio. In just examining these things, it would appear that Company B has the better liquidity position because it has more working capital and a higher current ratio. However, it's good to examine the composition of Company A and B's current assets. Company B only has \$15 of cash compared to \$90 for Company A (cash is an entity's most liquid asset) Company B also has more inventory, a less liquid current asset. One positive for Company B is they have \$55 less in short term bank loans. In sum, we really need more information about certain accounts for Company A and B. It would help to know different ratios, such as the accounts receivable turnover ratio and inventory turnover ratio so as to find out how liquid those assets really are.

P2-17.

- a. Current Ratio = Current Assets / Current Liabilities
2015 – $\$2,267,350 / 1,898,115 = 1.19$
2016 - $\$2,418,434 / 1,663,353 = 1.45$
2017 - $\$2,497,436 / 1,477,784 = 1.69$
- b. When looking at the current ratio, it definitely appears that Ignace's liquidity position is improving. The current ratio has increased each year from 2015 to 2017 and has increased by from 1.19 to 1.69. The amount of cash on hand in 2017 has increased by about 76 percent compared with 2015 and bank loans have decreased in that period by over 57 percent.
- c. Current assets rose each year and current liabilities declined each year from 2015 to 2017. Ignace saw a \$441,805 decrease in their short-term bank loans (\$778,646 in 2015 and \$336,841 in 2017 a decrease of over 57 percent). That decrease mostly explains the decline in current liabilities. Cash nearly doubled from 2015 to 2017, which is good news because cash is the most liquid asset. One possible negative is that Ignace's inventories rose by over \$214,000 or over 12 percent. Inventories are listed as current assets, but are sometimes not all that liquid as you will find out in later chapters. When inventory balances continue to rise from year to year, it may mean some inventory is getting very old and may be in need of a write-down. Further information is needed to draw a conclusion on the inventory.

P2-18.

a. Current Ratio = Current Assets / Current Liabilities

$$2015 - \$1,752,562 / \$1,345,522 = 1.30$$

$$2016 - 1,839,815 / 1,597,064 = 1.15$$

$$2017 - 2,093,587 / 2,025,352 = 1.03$$

Working Capital = Current Assets – Current Liabilities

$$2015 - \$407,040$$

$$2016 - 242,751$$

$$2017 - 68,235$$

- b. The liquidity position of Moyie appears to be weakening according to our analysis of current ratio. The current ratio has declined each year from 2015 – 2017 and has declined by 0.27 (from 1.30 to 1.03) which is a noteworthy drop. There are some concerns about Moyie's liquidity as its cash balance has declined significantly.
- c. There are many changes to individual accounts that aren't worth noting. Despite current assets rising each year, current liabilities have increased greater (proportionately) thereby causing the ratio to drop. Especially alarming is the cash balance decreasing from \$66,567 in 2015 to just \$3,558 in 2017. Inventory has increased by almost 27 percent and it isn't always very liquid. On the current liabilities side, short-term bank loans have increased dramatically from \$515,426 to \$868,951 and the company is still short on cash. There is also much more long-term debt that has become current (due in less than one year). Accounts payable has climbed by almost \$215,000 from 2015 to 2017.

P2-19.

a.

		2017		2016
i. Working capital	\$474,200 – \$342,000	\$132,200	\$410,000 – \$260,000	\$150,000
ii. Current ratio	\$474,200/\$342,000	1.39	\$410,000/\$260,000	1.58
iii. Debt to equity	\$592,000/\$737,200	0.80	\$410,000/\$690,000	0.59
iv. Gross margin	\$2,475,000 – \$1,350,000	\$1,125,000	\$1,925,000 – \$1,098,000	\$827,000
v. Gross margin percentage	\$1,125,000/\$2,475,000	45%	\$827,000/\$1,925,000	43%

b.

- i. Working capital decreased because the increase in current liabilities exceeded the increase in current assets.
- ii. The current ratio decreased because the increase in current liabilities exceeded the increase in current assets.
- iii. The debt-to-equity ratio increased because the company increased long-term debt by \$100,000, accounts payable by \$50,000, and bank loan by \$25,000 while the components of shareholders equity didn't increase as much.
- iv. The gross margin increased primarily because the total sales increased and partially because the gross margin percentage increased.
- v. The gross margin percentage increased either because the cost of goods sold decreased or the company marked up the selling price more than in 2016.

- c. On the surface Penticton's liquidity seems reasonable. Its current ratio is ok and it has a reasonable reserve of working capital. However, the liquidity position declined since last year with both the current ratio and the amount of working capital having decreased. Perhaps of greatest concern is the small amount of cash the company has on hand, only \$5,000. The company seems to have fared alright in the last year with a small amount of cash (\$10,000), but even that small amount has decreased by 50%. Of concern is that if the collectability of receivables is impaired (or collection slows down) Penticton may not have the cash it needs to meet its obligations. Concerns about Penticton's liquidity position include collectability problems with receivables and saleability of inventory. The current ratio assumes that receivables and inventory will ultimately be realized in cash. This may not be the case (although there is no information that there is a problem). As economic conditions change it can become more difficult to collect receivables and more difficult to sell inventory. A lender would also be interested in the bank loan. When is the loan due to be paid back and what are its terms? Some bank loans are classified as current because the bank can demand payment at any time. However, in practice the loan can effectively be outstanding for a long time. In addition, the amount of bank loan has increased significantly in the last year, which puts added stress on the cash requirements of the entity (higher interest costs). Similarly,

Penticton's long-term debt has increased by \$100,000 (apparently invested in new property and equipment), which will also commit cash flow to support the loan. It's important to note that assessing liquidity without information of the entity's business is very difficult. It's necessary to have benchmarks such as industry standards and competitor information to do a more complete analysis. An analysis could determine that the company is too liquid or not liquid enough relative to industry norms.

- d. While Penticton's liquidity is reasonably good there are ways in which it could be improved. By improving the time it takes to collect receivables and the time it takes to sell inventory the company would tend to have more cash and less inventory and receivables. These steps wouldn't change working capital or the current ratio, but it would make the current assets more liquid by increasing the proportion of cash on hand. The company appears to be growing quite quickly and growth is costly in terms of liquidity. By slowing its growth it can protect its liquidity position. Penticton could also try to increase the amount of business it conducts on a cash basis (rather than on credit) to increase the amount of cash the company has. It appears Penticton paid dividends in 2017 because retained earnings didn't increase by the amount of net income so liquidity could be improved by not paying dividends (the dividend was \$158,280).

P2-20.

	Transaction	Effect on the current ratio	Effect on the debt-to-equity ratio
1	Furniture is sold to customers for cash.	Increase	Decrease
2	Leon's borrows \$10 million. The loan must be repaid in ten years.	Increase	Increase
3	Cash is paid to settle an account payable	Increase	Decrease
4	Inventory is purchased on credit.	Decrease	Increase
5	New display cases are purchased on credit. Payment is due 30 days.	Decrease	Increase
6	Display cases are purchased for cash	Decrease	No effect
7	Employee wages are paid in cash.	Decrease	Increase
8	A cash dividend is paid.	Decrease	Increase
9	Common shares are sold to investors for cash.	Increase	Decrease

P2-21.

Transaction	Revised current ratio	Effect on the current ratio	Revised debt-to-equity ratio	Effect on the debt-to-equity ratio	CA \$700,000	CL \$350,000	TL \$900,000	TE \$600,000
1. \$10,000 owed by a customer is collected in cash.	2.00	No Effect	1.50	No effect	\$700,000	\$350,000	\$900,000	\$600,000
2. Sale of common shares to investors for \$100,000 cash.	2.29	Increase	1.29	Decrease	\$800,000	\$350,000	\$900,000	\$700,000
3. Dividends of \$100,000 are declared and paid in cash	1.71	Decrease	1.80	Increase	\$600,000	\$350,000	\$900,000	\$500,000
4. A loan of \$100,000 from a bank is arranged and the cash received. The loan must be repaid in 18 months.	2.29	Increase	1.67	Increase	\$800,000	\$350,000	\$1,000,000	\$600,000
5. A \$50,000 short-term bank loan is repaid.	2.17	Increase	1.42	Decrease	\$650,000	\$300,000	\$850,000	\$600,000
6. Merchandise is sold to a customer for \$50,000. The customer must pay in two years. The inventory sold cost \$20,000.	1.94	Decrease	1.43	Decrease	\$680,000	\$350,000	\$900,000	\$630,000

P2-22.

Sudbury Ltd.
Balance Sheet
As of December 31, 2017

Current Assets:		Current Liabilities:	
Cash	\$35,000	Bank Loan	\$27,500
Accounts receivable	38,000	Accounts payable	31,000
Inventory	52,000	Accrued liabilities	8,000
Prepaid assets	3,500	Salaries and wages payable	5,500
Investments in shares	130,000	Income taxes payable	4,500
Total current assets	<u>258,500</u>	Deposits from customers	9,200
		Current portion of long-term debt	25,000
		Total Current Liabilities	<u>110,700</u>
Non-Current Assets:		Non-Current Liabilities	
Property, plant and equipment	260,000		
Accumulated depreciation	(51,000)	Long-term debt	100,000
Long-term accounts receivable	15,000	Total non-current liabilities	<u>100,000</u>
Other non-current assets	18,800	Accumulated OCI	45,000
Total non-current assets	<u>242,800</u>	Common shares	111,000
Total assets	<u>\$501,300</u>	Retained Earnings	134,600
		Total Owner's Equity	<u>290,600</u>
		Total liabilities and equity	<u>\$501,300</u>

Sudbury, Ltd.
Income Statement

For the period ending December 31, 2017

Sales (\$85,000 + 343,800)	\$428,800
Interest revenue	<u>1,500</u>
Total revenue	<u>430,300</u>

Expenses:	
Cost of goods sold	120,000
Advertising expense	43,000
Depreciation expense	21,700
Tax expense	21,000
Interest expense	11,200
Salaries and wages expense	84,000
Charitable donations	10,000
Other expenses	22,000

Sudbury Ltd.
Statement of Retained Earnings
For the period ending December 31, 2017

Retained earnings January 1, 2017	\$89,000
Net income	78,600
Less dividends	<u>33,000</u>
Retained earnings December 31, 2017	<u>\$134,600</u>

Research expense	<u>18,800</u>
Total expenses	<u>351,700</u>
Net Income (loss)	<u><u>\$78,600</u></u>

Sudbury, Ltd.
Statement of Other Comprehensive Income
For the period ending December 31, 2017

Net Income	\$78,600
Other Comprehensive Income	<u>25,000</u>
Comprehensive Income	<u><u>103,600</u></u>

P2-23.

Thaxted Ltd.
Balance Sheet
As of December 31, 2017

Current Assets:		Current Liabilities:	
Cash	\$5,000	Accounts payable	\$26,250
Accounts receivable	27,500	Accrued liabilities	5,000
Inventory	42,500	Wages payable	1,750
Prepaid assets	1,000	Income taxes payable	3,750
Income taxes recoverable	2,250	Customer deposits	1,250
Advances to employees	<u>1,250</u>	Current portion of long-term debt	<u>27,500</u>
Total current assets	79,500	Total Current Liabilities	<u>65,500</u>
Non-Current Assets:		Non-Current Liabilities	
Property, plant, and equipment	1,800,000	Long-term debt	<u>700,000</u>
Accumulated amortization	(375,000)	Total Liabilities	<u>700,000</u>
Intangible Assets	100,000	Common shares	500,000
Other non-current assets	25,000	Retained Earnings	414,000
Investments in the shares of other corporations	<u>60,000</u>	Accumulated OCI	<u>10,000</u>
Total non-current assets	<u>1,610,000</u>	Total Owner's Equity	<u>924,000</u>
Total assets	<u><u>\$1,689,500</u></u>	Total liabilities and equity	<u><u>\$1,689,500</u></u>

Thaxted, Ltd.
Income Statement
For the period ending December 31, 2017

Sales (Credit and Cash)	\$837,500
Interest revenue	<u>500</u>
Total revenue	<u>838,000</u>
Expenses:	
Cost of sales	187,500
Advertising expense	47,500
Depreciation expense	115,000
Interest expense	70,000
Selling expenses	67,500
Charitable donations	50,000
Wages expense	110,000
Loss on lawsuit	45,000
Other expenses	10,000

Income tax expense	<u>75,000</u>
Total expenses	<u>777,500</u>
Net income (loss)	<u><u>\$60,500</u></u>

Thaxted, Ltd.
Statement of Retained Earnings
For the period ending December 31, 2017

Retained earnings December 31, 2016	\$366,000
Net income	60,500
Less dividends	<u>(12,500)</u>
Retained earnings December 31, 2017	<u><u>\$414,000</u></u>

Thaxted, Ltd.
Statement of Other Comprehensive Income
For the period ending December 31, 2017

Net Income	\$60,500
Other Comprehensive Income	<u>3,250</u>
Comprehensive Income	<u><u>\$63,750</u></u>

P2-24.

Edleun Group, Inc.

Consolidated Statements of Financial Position

(CDN \$000's)	Note	December 31, 2011	December 31, 2010	January 1, 2010
Assets				
Current assets				
Cash and cash equivalents		1,911	8,662	-
Accounts receivable	7	1,589	603	-
Prepaid and other expenses	8	3,606	243	-
Short term investments	9	39	204	-
		7,145	9,712	-
Non-current assets				
Property and equipment	5	\$ 33,434	\$ 18,717	\$ -
Goodwill	6	22,940	9,183	-
Definite life intangible assets	6	340	-	-
		56,714	27,900	-
Total Assets		\$ 63,859	\$ 37,612	\$ -
Liabilities				
Current liabilities				
Accounts payable and accrued liabilities	11	2,877	1,369	75
Deferred revenue		399	80	-
		3,276	1,449	75
Non-current liabilities				
Loans payable	10	\$ 2,260	\$ -	\$ -
Deferred tax liability	13	42	34	-
		2,302	34	-
Shareholders' Equity				
Share capital	12	62,931	38,463	-
Equity settled share based compensation	12	1,330	1,089	-
Accumulated deficit		(3,980)	(3,423)	(75)
Total Shareholders' Equity		58,281	36,129	(75)
Total Liabilities and Shareholders' Equity		\$ 63,859	\$ 37,612	\$ -

Edleun Group's balance sheet is simply reorganized into the more traditional Canadian format. On the asset side, non-current assets are on the top and current assets on the bottom. The more common arrangement in Canada is to have more liquid assets at the top. By placing these assets on top, users may focus on the more significant component of the asset pool. The liabilities side places current liabilities first instead of non-current liabilities as in the original statement. This format is used in Europe. It's hard to make a case that format makes a difference. A stakeholder with even a small amount of sophistication will be able to adapt to this somewhat unusual format. There is certainly no more information in the revised statement than in the one presented by the company. Different formats may cause users to focus on different aspects of the statement.

P2-25.

a.

Transaction	Amount	Classification
Cash from shareholders	\$1,000,000	Financing
Mortgage	600,000	Financing
Purchase warehouse	1,200,000	Investing
Cash from customers	425,000	Operating
Cash paid for operating expenses	270,000	Operating
Dividends paid*	60,000	Financing
Shares of other corporations	300,000	Investing
*IFRS allows companies to classify dividends paid as financing or operating cash flows		

b.

The Pas Ltd.
Statement of Cash Flows
For the year ended July 31, 2017

Operating cash flows

Cash collected from customers	\$425,000
Cash paid for operating expenses	(270,000)
	<u>155,000</u>

Investing cash flows

Investments in shares of other corporations	(300,000)
Purchase of warehouse	(1,200,000)
	<u>(1,500,000)</u>

Financing cash flows

Investment by shareholders	1,000,000
Borrowed from lender	600,000
Dividends paid	(60,000)
	<u>1,540,000</u>

Increase in cash during the year	195,000
Cash at the beginning of the year	<u>0</u>
Cash at the end of the year	<u><u>\$195,000</u></u>

- c. The income statement and the statement of cash flows provide very different information. For example, it's impossible to determine from the information in the cash flow statement whether The Pas earned a profit in the year. However, we do know that the operating activities of the company generated a positive cash flow, which is a positive sign. This means

that The Pas' regular business activities generate cash that can be used for investment and financing (dividends, repayment of debt) purposes. What we don't know is whether that was accomplished because selling price was much higher than cost or because the company increased current liabilities and decreased current assets. We can also see that the financing of the investment in the warehouse was accomplished by an investment by the owners and a large loan. While it's possible to see some of this information from the balance sheet, the key attribute of the cash flow statement is its focus on cash instead of on accrual accounting.

a.

Transaction	Amount	Classification
Cash from shareholders	\$1,500,000	Financing
Long-term loan	1,100,000	Financing
Purchase office building	2,100,000	Investing
Cash from customers	500,000	Operating
Cash paid for operating expenses	170,000	Operating
Dividends paid	20,000	Financing/Operating*
*IFRS allows companies to classify dividends paid as financing or operating cash flows		

b.

Prelate Ltd.
Statement of Cash Flows
For the year ended August 31, 2018

Operating cash flows

Cash collected from customers	\$500,000
Cash paid for operating expenses	(170,000)
	330,000

Investing cash flows

Purchase of office building	(2,100,000)
-----------------------------	-------------

Financing cash flows

Investment by shareholders	1,500,000
Borrowed from lender	1,100,000
Dividends paid	(20,000)
	2,580,000

Increase in cash during the year 810,000

Cash at the beginning of the year 0

Cash at the end of the year \$810,000

- c. The income statement and the statement of cash flows provide very different information. For example, it's impossible to determine from the information given whether the company earned a profit in this period. The cash flow statement provides information on cash inflows and outflows; it doesn't provide a measure of economic performance. However, we do know that the operating activities of the company generated a positive cash flow, which is a positive sign. This means that Prelate's regular business activities generate cash which can be used for investment and financing (dividends, repayment of debt) purposes. What we don't

know is whether that was accomplished because selling price was much higher than cost or because the company increased current liabilities and decreased current assets. We can also see that the financing of the investment in the building was accomplished by an investment by the owners and a large loan. While it's possible to see some of this information from the balance sheet, the key attribute of the cash flow statement is its focus on cash instead of on accrual accounting.

P2-27

The purpose of this question is to get students thinking about what gets reported on balance sheets as assets. What can be classified as an asset under IFRS may not be considered that way intuitively. The responses from the intuitive or non-accountant are quite wide open since each student's intuition may be different.

	By Non-Accountant (possible response)	According to IFRS
i.	The land is an asset because you own it. However, it can't be used for anything and probably can't be sold so that would argue for not being an asset.	The land is not an asset because it doesn't provide a future benefit. It has been deemed toxic and not suitable for construction so there isn't benefit the builder will receive from the piece of land. (A liability could be required if the company is responsible for a cleanup.
ii.	An asset because you own the expanded piece of the building. It will likely help earn the company more income from year to year.	The expansion to the store is an asset. There is a future benefit as the expansion will likely contribute to greater store sales and profits. The entity has control over the use of the space. The expansion is measurable as there would be invoices for supplies purchased and employee labour receipts for building the expansion. It's the result of many past transactions, including the purchase of building materials or payments to a contractor, etc.
iii.	The customer list is an asset because without this list the business would lose out on a lot of revenue in the future.	Customer lists never qualify as an intangible asset under IAS 38. This is because such expenditure cannot be distinguished from expenditure to develop the business as a whole. However, students applying the criteria for an asset could conclude that customer lists are assets. There is definitely a future benefit associated with a list, there is a past transaction, the cost could be measureable, although it might be difficult to attribute expenditures to the list if it's internally developed.
iv.	The logo is an asset because a company's brand name and everything surrounding the brand name (logo,	Internally generated goodwill, such as brand equity, doesn't qualify for recognition as an asset. IAS 38

	etc.) helps to generate sales. Brand equity is said to allow a company to demand a higher selling price for its products.	specifically deals with this issue and states exactly this. The problem with internally generated goodwill is that it's very difficult to measure and this could lead to companies intentionally overstating the value of their brand equity to have a stronger balance sheet. Purchased brands can be recognized as assets.
v.	The education is an asset because it will increase the earning power of the student.	The education isn't an asset because the future benefits are very uncertain and aren't measurable. The economic benefit may be very low if the student doesn't graduate or chooses another career.
vi	A well-trained staff is valuable because the employees will be able to do their jobs better, so investing in education could be considered an asset. Another response: Training isn't an asset because it can't be sold separately.	The training isn't recognized as an asset because the future benefit is uncertain and the entity doesn't control the education and the employee (employees can easily change jobs).

Economic Event	Net income on the cash basis	Net income on the accrual basis
a. Leon's sells furniture to a franchise store. Payment will be made in January 2017.	No No cash involved	Yes Leon's has earned the revenue
b. Dividends are declared and paid to shareholders in December 2016.	No Cash paid out but dividends wouldn't be included in net income. However, they can be included in cash from operations.	No Dividends aren't an expense
c. During 2016 Leon's sells inventory for cash. Leon's hasn't yet paid for the inventory that has been sold.	Yes Cash for sale of goods is recorded. Sale of inventory (cost of goods sold) not recorded	Yes The revenue is recorded. Also, the cost of the inventory sold is recorded.
d. A customer pays a deposit in December 2016 goods that will be delivered in February 2017.	Yes Cash has been received	No Goods haven't been sold (revenue hasn't been earned).
e. Leon's purchases and pays for stoves in December 2016. The inventory is unsold as of the year-end.	Yes Cash paid out	No Inventory is an asset until sold
f. Leon's depreciates its stores in 2016.	No No cash involved	Yes Matching expense to revenue earned
g. Leon's pays employees in December 2016 for their work in November.	Yes Cash paid out during 2016. (The cash expense would be recorded in December when the employees were paid.)	Yes The wages are an expense in 2016. (They would be expensed in November when the work was done.)

P2-29.

Economic Event	Net income on the cash basis	Net income on the accrual basis
a. An entity receives a deposit for services that will be provided next year	Yes Cash is collected	No No service hasn't been provided
b. Service provided that were previously paid for	No No cash involved	Yes Services have now been performed (earned).
c. Inventory paid for last year is sold to a customer this year	No No cash was paid this year for the inventory (only revenue is recorded).	Yes Inventory has been sold so now it becomes an expense (cost of goods sold)
d. Inventory paid for this year is sold this year	Yes Cash was paid out	Yes Inventory has been sold so its becomes an expense (Cost of goods sold)
e. Inventory is purchased on credit this year but is sold by the end of the year	No Cash hasn't been paid out yet	Yes Inventory has been sold so it becomes an expense (cost of goods sold)
f. Inventory is purchased on credit this year but hasn't been sold by the end of the year	No No cash paid out in the year	No Inventory remains an asset until it's sold

P2-30.

a.

Personal Balance Sheets

	Cost	Replacement Cost	Selling Price
Assets:			
Cash	\$ 1,200	\$ 1,200	\$ 1,200
Owed by employer	700	700	700
Television	1,100	925	400
Laptop	800	900	300
Furniture	4,225	4,525	2,300
Books	750	875	300
Clothes	1,600	1,950	300
iPhone	175	600	275
Jewelry	500	625	300
Appliances	2,600	3,300	1,800
Art	300	500	500
Other	1,000	1,200	750
Total assets	<u>\$14,950</u>	<u>\$17,300</u>	<u>\$9,125</u>
Liabilities:			
Student loans	\$ 27,500	\$ 27,500	\$ 27,500
Loans from parents	<u>5,000</u>	<u>5,000</u>	<u>5,000</u>
Total Liabilities	<u>\$32,500</u>	<u>\$32,500</u>	<u>\$32,500</u>
My Equity	<u>(\$17,550)</u>	<u>(\$15,200)</u>	<u>(\$23,375)</u>
Total liabilities and equity	<u>\$14,950</u>	<u>\$17,300</u>	<u>\$9,125</u>

- b. Each balance sheet gives different information and serves different purposes. The cost based balance sheet tells a reader the amount of money the student has “invested” in his or her personal life. The investment is simply the dollar amount spent. By deducting liabilities from the amount invested the student can get an idea of his or her interest in the personal assets. In this case the student has negative equity. Other than this type of analysis, it’s difficult to identify a specific use for this cost-based information for assets. The liabilities do provide useful information (give an indication of the amount of money the student owes, which might help a lender assess how much additional borrowing the student could support). The cash and amount due from the employer give information about the liquidity of the student—the amount of cash and near cash the student has to meet his or her needs. Note that the information about liquid assets (cash and amounts owed) and liabilities is common to all the statements. An attractive attribute of the information in this balance sheet is that it’s reasonably objective—it can be verified.

The second balance sheet, based on replacement cost, gives an indication of what it would cost to replace the assets owned by the student. The asset side of the balance sheet will be useful for determining the amount of insurance the student would require for his or her belongings. A problem with replacement cost measures is the difficulty with finding

replacement costs for items that are no longer available. For example, what is the replacement cost for a 15 year old TV?

The third balance sheet, based on selling price, gives a measure of the financial position of the student should he or she decide to sell off all the assets. In that case, the student would actually still owe money to creditors because selling off the assets would generate \$9,125 in cash whereas the student owes \$32,500 for student loans and to parents. This is why the equity of the student is negative. A major difficulty with this statement is determining the actual amount that could be obtained by selling the assets. The amounts shown (except for cash and amount owed by employers) are estimates. The actual amount could deviate significantly because actual prices will depend on the condition of the goods, market conditions, alternatives available to buyers, and the urgency of the seller. A lender might have an interest in this form of balance sheet.

Note that the appliances are included in the balance sheets. However, if the appliances are owned by the landlord, they shouldn't be included in any of the balance sheets. However, information about the appliances might be relevant for some uses, like determining the amount of insurance you need.

- c. Actually, none of these balance sheets exactly fit the requirements of IFRS. The statements based on cost and selling price would both be workable under IFRS. As noted in the chapter, the basis for recording under IFRS is the transaction value, in the case of the assets listed above, the cost or amount paid for them but there is considerable scope under IFRS for use of fair values. Cash is recorded at its nominal amount and the amount owed by the employer is stated at the owed amount. The liabilities would be stated at the amounts owed. However, according to IFRS, most of these assets should be depreciated to reflect their usage. Depreciation isn't reflected in any of the balance sheets.
- d. It's rarely possible with accounting information to make a statement about which information is best. Best must be assessed in relation to the purpose of the information. Different information is required for different decisions.

P2-31

Students' responses will vary. This could serve as an interesting class discussion question to find out what students included in their statements and why, and the values that were assigned to the items included. The essential issues are:

- A student's equity in assets is the excess of assets over liabilities. For some students, this may be negative.
- The student will need to choose a basis of valuation such as cost, net realizable value, or expected selling price. Students should consider the effect on equity of alternative valuation bases.
- Most students probably wouldn't, since at the time they are taking this course, they have just begun their university education. While they have undoubtedly increased their earning power, the criteria of IFRS for an asset wouldn't be satisfied, given the uncertainty of future benefits.

USING FINANCIAL STATEMENTS

FS2-1.

Year	Asset =	Liability		Owners Equity
2009	6,777,066	3,065,182	+	3,711,884
		L + OE	=	6,777,066
2010	\$7,044,197	\$2,941,562	+	\$4,102,635
		L + OE	=	7,044,197
2011	7,300,310	3,032,480	+	4,267,830
		L + OE	=	7,300,310

FS2-2.

Shoppers' year-ends were December 31, 2011, January 1, 2011 and January 3, 2010. The dates are different because the year end is on the Saturday closest to December 31st (see note 1 to the financial statements). This causes a problem for stakeholders because the fiscal years are different in length from year-to-year, making comparisons more difficult. For the 2011 and 2010 fiscal year it is not a problem because both year ends have 52 weeks.

FS2-3

Shoppers prepares its financial statements according to the International Financial Reporting Standards (IFRS). Shoppers provides more than one fiscal year because it is required under IFRS for comparability.

FS2-4.

Year ended or on

	December 31, 2011 (000's)
a Sales	\$10,458,652
b Operating and Administration Expense	3,131,539
c Total assets	7,300,310
Long-term Debt	
d (249,971+695,675+520,188)	1,465,834
e Inventory	2,042,302
f Dividends paid - common	211,479
g Dividends declared - common	215,671
h Additions to PP&E (53,931+339,287)	393,218
i Comprehensive Income	592,363
j Accumulated other comprehensive loss	30,214
k Retained earnings	2,806,078

FS2-5.

	Year ended or on December 31, 2011 (000's)
a Net Income	\$613,934
b Cost of Sales	6,416,208
c Other Comprehensive Income	592,363
d Cash	118,566
e Share Capital	1,486,455
f Total Liabilities	3,032,480
g Total Current Assets	2,695,647
h Cash from Operations	973,838
i Cash on purchase of business	10,496
j Repurchase of own shares	206,779

FS2-6.

All dollar amounts are in thousands

- The amount paid to wages and salaries was \$1,391,430
- The finance expense on long-term debt was \$52,626
- The carrying amount of buildings was \$189,718
- The amount of depreciation expense on equipment, fixtures and computer equipment was \$140,537
- The carrying amount of customer relationships was \$37,045
- The number common shares was 212,475,597
- The interest rate on the Series 4 medium-term notes was 5.19% with an outstanding amount of \$249,081.

FS2-7.

All dollar amounts are in thousands

a.	Working Capital =	CA	–	CL	Answer
Dec 31/11		2,695,647		1,776,238	919,409
Jan 1/11		2,542,820		1,527,567	1,015,253
Jan 3/10		2,441,973		1,706,541	735,432

b.	Current Ratio	CA	÷	CL	Answer
Dec 31/11		2,695,647		1,776,238	1.52
Jan 1/11		2,542,820		1,527,567	1.66
Jan 3/10		2,441,973		1,706,541	1.43

c.	Change in WC	919,409	–	1,015,253	(95,844)
-----------	---------------------	----------------	----------	------------------	-----------------

d. Shoppers' liquidity has declined slightly. There were more current assets available in 2011 compared with 2010, however current liabilities increased by a higher percentage. The entity is in a worse position to meet its current obligations. However, the change is very small and probably not an indication of any liquidity problems. Overall working capital and liquidity has improved if using the 2009 year end as a bench mark.

FS2-8.

Debt-to-equity ratio

a.	Total Debt	÷	Total Equity	Answer
Dec				
31/11	3,032,480		4,267,830	0.71
Jan 1/11	2,941,562		4,102,635	0.72
Jan 3/10	3,065,182		3,711,884	0.83

b. The debt to equity ratio has decreased for two reasons from 2009 to 2011 1) Liabilities have decreased over all despite the increase from 2010 fiscal year to the 2011 year end and 2) Equity, has increased year over year from improvements in earnings without debt increasing at the same rate. Looking at the 2010 and 2011 year end alone liabilities have increased along with equity but liabilities increased at a slower rate.

c. The most notable changes from the beginning of 2010 to the end of 2011 is in the long-term liabilities decreasing by almost \$100,000,000 although much was eroded by the increase current liabilities in the form of increased accounts payables. Over the significant reduction in the debt to equity ratio came the increase in equity by over \$500,000,000 over the same period.

d. The debt to equity ratio tells us that from the beginning of 2010 to the end of 2011 Shoppers is more financed by equity and is reducing its reliance on debt. Because Shoppers ratio is relatively low it can be considered as a less risky firm. The company's actual borrowing has decreased,

with reductions in bank indebtedness, commercial paper, and long-term debt. Increases in liabilities came on the operational side.

This isn't necessarily positive for investors; debt can be beneficial to an entity if the return the entity earns on the borrowed money is higher than the interest rate on the loan. Debt is risky though because the interest and principal must be paid regardless of whether the entity is successful. In the case of Shoppers it doesn't appear they will have a problem getting more debt to fund growth. It would be useful to see a long time series of ratios to get an idea of any trends. Also, comparing Shoppers' ratio with comparable companies would give some insights into the debt load carried. Many questions can be asked and many arguments can be made.

FS2-9.

	2011	2010
Sales	\$10,458,652	\$10,192,714
Cost of sales	6,416,208	6,283,634
a) Gross margin (gross profit)	4,042,444	3,909,080
b) Gross margin percentage (gross margin/sales)	38.65%	38.35%

c. For every dollar in revenue Shoppers earns it has to pay approximately \$0.61 for the products it sells. As a result this leaves about \$0.39 to apply to other costs. There has been a slight increase in gross margin between 2010 and 2011, which means a slight improvement in performance. This is good news for the company, but whether it is an indication of permanent improvement is difficult to tell. The small amount may be the result of changes in the mix of products sold or simply some random factors causing the slight variation. To get better insight it would be useful to see a more detailed breakdown of cost of goods sold, a longer time series of gross margin information, and information about similar companies.

FS2-10.

The information in Note 10 represents a legal settlement. From a stakeholders perspective this can be regarded from two sides. 1) This is a onetime legal settlement and that the costs aren't likely to recur in future periods. Therefore operationally the company performed better than what the figures represent. 2) A settlement of over \$10,000,000 is a serious lawsuit. What is the nature of the suit and will others follow? Therefore while it helps the stakeholder better understand some details of the cost, it leaves room for question since the note doesn't provide any information about the suit.

FS2-11.

- a. The different categories of property, plant, and equipment are:
 1. Properties under development: Land and buildings being built but not opened
 2. Land – Property the company owns on which stores are built on
 3. Buildings – Physical stores or clinics
 4. Equipment, fixtures and computer equipment – The capitalized components inside the stores used to run the business
 5. Leasehold improvements – Upgrades to leased stores

6. Assets under financing lease – leased assets

b. The different categories of intangible assets are:

1. Prescription files – This is the listing of prescription records of customers
2. Customer Relationships – Information as it relates to Shoppers loyalty programs
3. Computer Software – computer software Shoppers has purchased and developed
4. Computer Software under development – Software that Shoppers is developing to help run its business
5. Other – other unspecified intangibles.

c. Property plant and equipment are physical assets that you can see and touch that contribute to the company's earnings. Intangible assets don't have physical substance but are identifiable and developed over time.

d. Shoppers disposed of \$14,687 worth of land.

e. Shoppers expensed \$249,467 worth of depreciation for plant property and equipment.

f. Shoppers amortized \$47,165 for intangible assets of which \$14,697 was for prescription files.

FS2-12.

a. Shoppers had \$948,350 of long-term debt of which \$249,971 was current. It's valuable to have this information because the current portion is debt that is due within the year, which is important for assessing liquidity.

b. Series 2 medium-term notes had an outstanding balance of \$449,298 on December 31, 2011. It carries an interest rate of 4.99% and matures in June 2013.

c. Shoppers revolving revolving term facility has a limit of \$725,000. The unused portion on December 31, 2011 was \$715,402 (\$725,000 - \$9,598). The company utilized \$9,598 of the credit facility. This amount differs from the amount reflected in the financial statements because the credit facility was used to secure letters of credit and trade finance guarantees. This is a guarantee, not an actual borrowing of money, but it reduces the amount of credit available.

d. The information in the note helps determine existing funding and cost of finance along with maturity dates. They also explain lines of credits that the company can't use because it has been used to secure other forms of financing. The information is important for assessing liquidity, predicting future cash flows (amounts that will have to be paid in the future), and predicting earnings.

FS2-13.

The prescription files are considered as an asset because:

- 1) It provides a future benefit – When customers have a relationship with a pharmacy they will typically return to the pharmacy for future prescriptions. When Shoppers buys a pharmacy it

pays for these relationships, valuing them by estimating the future cash flows they will generate. Thus the benefit is the cash flows associated with the prescription files of the customers.

- 2) It is under the control of Shoppers – The files (and the relationships) are in Shoppers' possession and can make money from them. They may even choose to sell this information.
- 3) It is a result of a past transaction – Files were purchased when pharmacies were purchased.
- 4) Be measurable – The prescription files asset arises when a pharmacy is purchased. An amount is assigned to the files on purchase.

FS2-14.

Many different questions are possible. The key is to recognize that the information you are requesting is relevant to your decision. Questions could include (others are possible):

- What are Shoppers' future investment plans and how does it intend to finance those investments?
- How much more debt would you be planning on taking on? This would help assess the company's risk.
- Does the company intend to raise more equity or buy back more shares?
- What are your future predictions on sales revenue, to assist in predicting profitability?
- What assets are currently available as security for loans and what has already been secured against existing loans?
- Can you provide cash flow forecasts for the next few years?
- What major short-term cash requirements are needed to replace existing capital assets?
- What are the terms of existing debt?

FS2-15.

Both Leon's and Shoppers are primarily retailers however they sell different product lines. Therefore while there are similarities there are some differences. A comparison of the two companies' assets are as follows:

Leon's	As of December 31, 2011	Percentage of Total Assets
Cash and cash equivalents	\$72,505	12.18%
Available-for-sale financial assets	149,318	25.08%
Trade receivables	28,937	4.86%
Income taxes receivable	5,182	0.87%
Inventories	87,830	14.75%
Total current assets	343,772	57.74%
Other assets	1,431	0.24%
Property, plant and equipment, net	214,158	35.97%
Investment properties	8,366	1.41%
Intangible assets, net	3,958	0.66%
Goodwill	11,282	1.90%
Deferred income tax assets	12,372	2.08%

Total non-current assets	251,567	42.26%
Total assets	\$595,339	100.00%

Shoppers	As of December 31, 2011	Percentag e of Total Assets
Cash	\$118,566	1.62%
Accounts receivable	493,338	6.76%
Inventory	2,042,302	27.98%
Income taxes recoverable	—	0.00%
Prepaid expenses and deposits	41,441	0.57%
Total current assets	2,695,647	36.93%
Property and equipment	1,767,543	24.21%
Investment property	16,372	0.22%
Goodwill	2,499,722	34.24%
Intangible assets	281,737	3.86%
Other assets	18,214	0.25%
Deferred tax assets	21,075	0.29%
Total non-current assets	4,604,663	63.07%
Total assets	\$7,300,310	100.00%

Overall Shoppers is a much larger company than Leon's. Some notable differences are as follows:

Cash – Cash represents a smaller portion of total assets for Shoppers than Leon's. The companies would have very different cash cycles, requirements, and obligations requiring repayment. Leon's also has a considerable amount of marketable securities (Available for sale assets) which when examined in combination with the cash balance and their debt-to-equity position seems to indicate that Leon's payment obligations are relatively low, therefore allowing them to retain more cash. Leon's liquidity position is very strong when compared to Shoppers when looking at current assets relative to total assets (57.74% vs. 36.93%). It's not clear why Leon's is holding so much cash; perhaps it has plans to expand in the near future or is just being very conservative.

Accounts Receivable – Leon's and Shoppers has similar receivables balances and quite low which is reflective of the retail industry. Shoppers maybe higher as a result of it franchise operations comprising of the majority of its stores.

Inventories – Both companies carries a lot of inventory however Shoppers inventory value is much higher than that of Leon's; this could be due to the product mix each company carries. Medication while taking up very little space can carry very high inventory costs at times more than what a piece of furniture can cost. As a result Shoppers inventory represents a higher percentage. The proportion is much smaller for Leon's because cash and securities is large for Leon's but small for Shoppers.

Plant Property and Equipment – Represents major balance sheet items however as a percentage Shoppers' network of locations comprise primarily of franchise store while Leon's stores are mostly company owned.

Goodwill – Goodwill results from acquisitions and it looks Shoppers has been more aggressively acquiring companies which may help explain a weaker cash ratio than Leon's.

Overall the difference in percentages makes sense.