CHAPTER 2

A FURTHER LOOK AT FINANCIAL STATEMENTS

LEARNING OBJECTIVES

1. Identify the sections of a classified statement of financial position.
2. Identify and calculate ratios for analyzing a company's liquidity, solvency, and profitability.
3. Describe the framework for the preparation and presentation of financial statements.

SUMMARY OF QUESTIONS BY LEARNING OBJECTIVES AND BLOOM'S TAXONOMY

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

Legend**:** The following abbreviations will appear throughout the solutions manual file.

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

ANSWERS TO QUESTIONS

1. (a) Current assets are assets that are expected to be converted into cash, sold, or used up within one year of the company's financial statement date or its operating cycle, whichever is longer.

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

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

2. The term operating cycle stands for the average time it takes to go from cash to cash in producing revenue. In a merchandising business, this means the time it takes to purchase inventory on account, pay cash to suppliers, sell the inventory on account, and then collect cash from customers. In a service business, it stands for the time it takes to pay employees, provide services on account, and then collect the cash from customers.

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

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

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

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

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

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

(b) Examples of current liabilities include bank indebtedness, accounts payable, accrued liabilities, and current maturities of long-term debt. Current liabilities are listed in the order in which they are expected to be paid in the current liability section of the statement of financial position.

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

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

Difference	Current Liabilities	Non-Current Liabilities
Source of payment	Existing current assets or other current liabilities	Other than existing current assets or other current liabilities
Time of expected payment	Within one year	Beyond one year
Nature of items	Debts pertaining to the operating cycle and other short-term debts	Mortgages, notes, loans, bonds, and other non-current liabilities

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

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

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

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

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

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

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

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

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

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

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

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

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

10. (a) Liquidity ratios measure a company's short-term ability to pay its current liabilities and meet its unexpected needs for cash. Examples of liquidity ratios include working capital and current ratios.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- An increase in the basic earnings per share means that the amount of net income per share is greater than in the previous period.

- An increase in the price-earnings ratio means that the share price has increased at a greater rate than the company’s basic earnings per share, which implies the market believes future net income will continue to increase.

- An increase in the current ratio indicates that the company has more current assets available to settle its current liabilities and is more liquid (assuming the components of current assets (e.g., receivables and inventory) are also liquid.

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

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

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

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

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

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

(b) The main users of financial reporting are investors, lenders, and other creditors.

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

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

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

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

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

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

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

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

24. Materiality is related to relevance in that they are both defined in terms of what influences or makes a difference to the decision-maker. In order to be relevant to a financial statement user, a transaction, a narrative explanation in the notes to the financial statements, or an amount reported for an element must make a difference to the user in the making of a decision. An item is considered to be material if its omission or misstatement could influence the decision.

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

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

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

26. The cost constraint means that information will be presented only when the benefit associated with it exceeds the cost of obtaining and providing it. In attempting to fulfill a completeness objective when obtaining financial information, one could expend considerable resources. The cost of this search may greatly outweigh any benefit in achieving the completeness objective. Consequently, the search for completeness will be restricted by this constraint.

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

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

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

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

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

29. In order to be relevant for decision making, the measurement of elements of financial statements need to reflect amounts that are reliable. For assets that are intended to be sold, the current value of the assets becomes the most relevant measurement as it approximates the current amount of cash that could be obtained on the sale of the asset. On the other hand, for assets held for use by the corporation, the value at resale is not as relevant to the financial statement user. In that case, the historical cost of the assets is the better measurement for reporting the financial statement element. An example of a revenue generating asset is land used for a parking lot. It is relevant to compare the actual cost of the land to the amount of the revenue generated from its use. Using the historical cost basis of accounting gives a faithful representation to the financial statement users.

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

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 2-1

(a)	5	Accounts payable	(i)	8	Dividends declared
(b)	1	Accounts receivable	(j)	5	Income tax payable
(c)	3	Accumulated depreciation	(k)	2	Long-term Investments
(d)	3	Buildings	(l)	3	Land
(e)	1	Cash	(m)	1	Inventory
(f)	7	Common shares	(n)	1	Supplies
(g)	5	Current portion of mortgage Payable	(o)	6	Mortgage payable, due in 20 years
(h)	4	Patents	(p)	1	Prepaid insurance
		(q)	5	Unearned revenue	

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

BRIEF EXERCISE 2-2

(a)	1	Accounts receivable	(i)	1	Inventory
(b)	2	Accumulated depreciation	(j)	1	Notes receivable, due in six months
(c)	4	Bank indebtedness	(k)	1	Prepaid rent
(d)	5	Bank loan payable, due in three years	(l)	6	Retained earnings
(e)	1	Cash	(m)	4	Salaries payable
(f)	6	Common shares	(n)	1	Supplies
(g)	2	Equipment	(o)	4	Unearned revenue
(h)	3	Goodwill	(p)	1	Prepaid insurance
		(q)	4	Accounts payable	

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

BRIEF EXERCISE 2-3

SHUM CORPORATION
Statement of Financial Position (Partial)

Assets

Current assets		
Cash		$16,400
Accounts receivable		14,500
Inventory		9,000
Supplies		4,200
Prepaid insurance		3,900
Total current assets		48,000
Property, plant, and equipment		
Land		65,000
Buildings	$110,000	
Less: Accumulated depreciation—buildings	33,000	77,000
Equipment	$70,000	
Less: Accumulated depreciation—equipment	25,000	45,000
Total property, plant, and equipment		187,000
Total assets		$235,000

(Assets = Liabilities + Shareholders' equity)

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

BRIEF EXERCISE 2-4

HIRJIKAKA INC.
Statement of Financial Position (Partial)

Current liabilities	
Accounts payable	$22,500
Salaries payable	3,900
Interest payable	5,200
Income tax payable	6,400
Unearned revenue	900
Current portion of mortgage payable	5,000
Total current liabilities	$43,900

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

BRIEF EXERCISE 2-5

(a) ($ in thousands)

2016	2015
Working capital:	Working capital:
$453,254 – $235,400 = $217,854	$421,955 – $223,239 = $198,716

Current Assets – Current Liabilities

2016	2015
Current ratio:	Current ratio:
$\frac{\$453,254}{\$235,400} = 1.9:1$	$\frac{\$421,955}{\$223,239} = 1.9:1$

$\frac{\text{Current Assets}}{\text{Current Liabilities}}$

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

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

BRIEF EXERCISE 2-6

(a) (in US$ millions)

2016	2015
Debt to total assets ratio:	Debt to total assets ratio:
$\frac{(\$2,705.5 + \$4,554.8)}{(\$2,934.8 + \$9,369.1)} = 59.0\%$	$\frac{(\$2,470.3 + \$4,655.1)}{(\$2,742.3 + \$8,286.1)} = 64.6\%$

$\frac{\text{Total Liabilities}}{\text{Total Assets}}$

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

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

BRIEF EXERCISE 2-7

(a) ($ in thousands)

2015	2014
Basic earnings per share:	Basic earnings per share:
$\frac{\$76,629}{71,218}$ = $1.08 per share	$\frac{\$75,524}{70,899}$ = $1.07 per share

$$\frac{\text{Income available to common shareholders}}{\text{Weighted average number of common shares}}$$

2015	2014
Price-earnings ratio:	Price-earnings ratio:
$\frac{\$13.99}{\$\ 1.08}$ = 13.0 times	$\frac{\$17.31}{\$\ 1.07}$ = 16.2 times

$$\frac{\text{Market price per share}}{\text{Basic earnings per share}}$$

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

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

BRIEF EXERCISE 2-8

(a) Faithful representation
(b) Verifiability
(c) Understandability
(d) Cost
(e) Going concern
(f) Current value

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

BRIEF EXERCISE 2-9

(a) 10
(b) 5
(c) 13
(d) 8
(e) 12
(f) 9
(g) 1
(h) 2
(i) 4
(j) 3
(k) 11
(l) 6
(m) 7

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

BRIEF EXERCISE 2-10

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

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

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

SOLUTIONS TO EXERCISES

EXERCISE 2-1

(a)	5	Accounts payable and accrued liabilities
(b)	1	Accounts receivable
(c)	3	Accumulated depreciation
(d)	3	Buildings and leasehold improvements
(e)	7	Common shares
(f)	5	Current maturities of long-term debt
(g)	5	Dividends payable
(h)	4	Patents
(i)	5	Income and other taxes payable
(j)	1	Income and other taxes receivable
(k)	1	Inventories
(l)	3	Land
(m)	6	Long-term debt
(n)	1	Prepaid expenses

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

EXERCISE 2-2

BIG ROCK BREWERY INC.
Statement of Financial Position (partial)
December 31, 2015
(in thousands)

Assets

Current assets				
Cash		$ 540		
Accounts receivable		2,221		
Inventories		4,935		
Prepaid expenses and other		1,573		
Total current assets				$ 9,269
Property, plant, and equipment				
Land		$ 8,377		
Buildings	$17,692			
Less: Accumulated depreciation	1,817	15,875		
Machinery and equipment	$24,860			
Less: Accumulated depreciation	10,122	14,738		
Mobile equipment	$ 1,054			
Less: Accumulated depreciation	434	620		
Office furniture and equipment	$ 1,286			
Less: Accumulated depreciation	516	770		
Total property, plant, and equipment			40,380	
Intangible assets				456
Total assets				$50,105

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

EXERCISE 2-3

SAPUTO INC.
Statement of Financial Position (partial)
March 31, 2016
(in millions)

Liabilities and Shareholders' Equity

Current liabilities		
Accounts payable and accrued liabilities	$ 896.6	
Income taxes payable	37.1	
Bank loans payable	423.1	
Total current liabilities		$ 1,356.8
Non-current liabilities		
Long-term debt	$1,208.3	
Deferred income taxes payable	475.6	
Other long-term liabilities	61.8	
Total non-current liabilities		1,745.7
Total liabilities		3,102.5
Shareholders' equity		
Common shares	$ 821.0	
Retained earnings	3,180.8	
Total shareholders' equity		4,001.8
Total liabilities and shareholders' equity		$7,104.3

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

EXERCISE 2-4

(a) Net income = Revenues – Expenses
= \$183,040 – \$158,680– \$4,550 – \$5,200
= \$14,610

Retained earnings = Beginning retained earnings + Net income – Dividends declared
= \$116,520 + \$14,610 – \$0
= \$131,130

(b)

SUMMIT LTD.
Statement of Financial Position
December 31, 2018

Assets			
Current assets			
Cash		$ 24,040	
Accounts receivable		20,780	
Supplies		1,240	
Prepaid insurance		1,420	
Total current assets			$47,480
Long-term investments			28,970
Property, plant, and equipment			
Land		$194,000	
Buildings	$133,800		
Less: Accumulated depreciation	50,600	83,200	
Equipment	$66,100		
Less: Accumulated depreciation	21,470	44,630	
Total property, plant, and equipment			321,830
Total assets			$398,280
Liabilities and Shareholders' Equity			
Current liabilities			
Accounts payable		$21,050	
Interest payable		2,100	
Current portion of mortgage payable		30,500	
Total current liabilities			$ 53,650
Mortgage payable ($104,000 – $30,500)			73,500
Total liabilities			127,150
Shareholders' equity			
Common shares		$140,000	
Retained earnings		131,130	
Total shareholders' equity			271,130
Total liabilities and shareholders' equity			$398,280

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

EXERCISE 2-5

BATRA CORPORATION
Income Statement
Year Ended July 31, 2018

Revenues		
Service revenue		$113,600
Rent revenue		18,500
Total revenues		132,100
Expenses		
Salaries expense	$44,700	
Operating expenses	32,500	
Rent expense	10,800	
Depreciation expense	3,000	
Utilities expense	2,600	
Interest expense	2,000	
Supplies expense	900	
Total expenses		96,500
Income before income tax		35,600
Income tax expense		5,000
Net Income		$30,600

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

BATRA CORPORATION
Statement of Changes in Equity
Year Ended July 31, 2018

	Common Shares	Retained Earnings	Total Equity
Balance, August 1, 2017	$ 15,000	$17,940	$32,940
Issued common shares	10,000		10,000
Net income		30,600	30,600
Dividends declared		(12,000)	(12,000)
Balance, July 31, 2018	$25,000	$36,540	$61,540

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

EXERCISE 2-5 (CONTINUED)

BATRA CORPORATION
Statement of Financial Position
July 31, 2018

Assets		
Current assets		
Cash	$ 5,060	
Held for trading investments	20,000	
Accounts receivable	17,100	
Supplies	1,500	
Total current assets		$ 43,660
Property, plant, and equipment		
Equipment	$62,900	
Less: Accumulated depreciation	6,000	
Total property, plant, and equipment		56,900
Total assets		$100,560
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable	$ 4,220	
Interest payable	1,000	
Unearned revenue	12,000	
Bank loan payable	21,800	
Total liabilities		$ 39,020
Shareholders' equity		
Common shares	$25,000	
Retained earnings	36,540	
Total shareholders’ equity		61,540
Total liabilities and shareholders' equity		$100,560

(Assets = Liabilities + Shareholders’ equity)

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

EXERCISE 2-6

(a) Current ratio:

$$\frac{\$60{,}000}{\$40{,}000} = 1.5:1$$

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

(b) Current ratio:

$$\frac{(\$60{,}000 - \$20{,}000)}{(\$40{,}000 - \$20{,}000)} = 2:1$$

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

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

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

EXERCISE 2-7

(a) (in thousands)

2015	2014
Working capital: $167,816 – $158,120 = $9,696	Working capital: $63,150 – $193,384 = $(130,234)

Current Assets – Current Liabilities

Current ratio:

2015	2014
$\frac{\$167,816}{\$158,120} = 1.1:1$	$\frac{\$63,150}{\$193,384} = 0.3:1$

$\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Debt to total assets ratio:

2015	2014
$\frac{(\$158,120 + \$2,166,843)}{(\$167,816 + 3,304,377)} = 67.0\%$	$\frac{(\$193,384 + \$2,036,716)}{(\$63,150 + \$3,350,264)} = 65.3\%$

$\frac{\text{Total Liabilities}}{\text{Total Assets}}$

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

EXERCISE 2-7 (CONTINUED)

(c)

	2015			
	Crombie	CT	Choice	Industry
Working capital (in thousands)	$9,696	$(215,889)	$(416,879)	n/a
Current ratio	1.1:1	0.1:1	0.4:1	0.3 :1
Debt to total assets ratio	67.0%	49.1%	90.5%	43.8%

	2014			
	Crombie	CT	Choice	Industry
Working capital (thousands)	$(130,234)	$(295,123)	$(142,356)	n/a
Current ratio	0.3:1	0.0:1	0.6:1	0.4:1
Debt to total assets ratio	65.3%	50.2%	87.3%	45.9%

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

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

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

EXERCISE 2-8

(a) (in thousands)

2015	2014
Basic earnings per share:	Basic earnings per share:
$\frac{\$65,286}{395,793}$ = \$0.16 per share	$\frac{\$185,234}{395,740}$ = \$0.47 per share

$$\frac{\text{Income available to common shareholders}}{\text{Weighted average number of common shares}}$$

2015	2014
Price-earnings ratio:	Price-earnings ratio:
$\frac{\$17.07}{\$0.16}$ = 106.7 times	$\frac{\$18.62}{\$0.47}$ = 39.6 times

$$\frac{\text{Market price per share}}{\text{Basic earnings per share}}$$

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

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

EXERCISE 2-9

(a)	7	(g)	1
(b)	10	(h)	6
(c)	11	(i)	4
(d)	3	(j)	5
(e)	2	(k)	9
(f)	8	(l)	12

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

EXERCISE 2-10

1. (a) The historical cost basis of accounting is involved in this situation.
   (b) The historical cost basis of accounting has been violated. The land was reported at its current value when it should have remained at its historical cost.

2. (a) The current value basis of accounting is involved in this situation.
   (b) The principle has not been violated since the parcel of land is being held for resale and not for use.

3. (a) The assumption involved in this situation is the going concern assumption.
   (b) The going concern assumption has been violated. The elements on the statement of financial position should have been classified between current and non-current.

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

SOLUTIONS TO PROBLEMS

PROBLEM 2-1A

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

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

PROBLEM 2-2A

(a)

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

PROBLEM 2-2A (CONTINUED)

(b)

WESTJET AIRLINES LTD.
Statement of Financial Position (partial)
December 31, 2015
(in thousands)

Assets

Current assets			
Cash		$1,252,370	
Accounts receivable		82,136	
Inventory		36,018	
Prepaid expenses, deposits, and other		131,747	
Total current assets			$1,502,271
Property, plant, and equipment			
Aircraft	$3,912,617		
Less: Accumulated depreciation	1,170,643	$2,741,974	
Ground and other property and equipment	$ 821,753		
Less: Accumulated depreciation	196,829	624,924	
Buildings	$ 136,783		
Less: Accumulated depreciation	30,419	106,364	
Total property, plant, and equipment			3,473,262
Intangible assets			63,549
Other assets			89,942
Total assets			$5,129,024

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

PROBLEM 2-3A

(a)

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

(b)

WESTJET AIRLINES LTD.
Statement of Financial Position (partial)
Liabilities and Shareholders' Equity
December 31, 2015
(in thousands)

Current liabilities		
Accounts payable and accrued liabilities	$545,438	
Advanced ticket sales	620,216	
Other current liabilities	158,880	
Current portion of long-term debt	227,391	
Total current liabilities		$1,551,925
Non-current liabilities		
Long-term debt	$1,276,475	
Other long-term liabilities	13,603	
Deferred income tax	327,028	
Total non-current liabilities		1,617,106
Total liabilities		3,169,031
Shareholders' equity		
Share capital	$ 582,796	
Retained earnings	1,292,581	
Other shareholders' equity items	84,616	
Total shareholders' equity		1.959.993
Total liabilities and shareholders' equity		$5,129,024

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

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

PROBLEM 2-4A

(a)

MBONG CORPORATION
Income Statement
Year Ended December 31, 2018

Revenues		
Service revenue	$213,900	
Interest revenue	500	
Total revenues		$214,400
Expenses		
Salaries expense	$129,800	
Operating expense	39,400	
Depreciation expense	6,200	
Repair and maintenance expense	2,800	
Insurance expense	2,200	
Utilities expense	2,000	
Interest expense	1,500	
Supplies expense	1,000	
Total expenses		184,900
Income before income tax		29,500
Income tax expense		6,000
Net income		$23,500

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

MBONG CORPORATION
Statement of Changes in Equity
Year Ended December 31, 2018

	Common Shares	Retained Earnings	Total Equity
Balance, January 1	$30,000	$221,000	$251,000
Issued common shares	4,200		4,200
Net income		23,500	23,500
Dividends declared		(5,000)	(5,000)
Balance, December 31	$34,200	$239,500	$273,700

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

PROBLEM 2-4A (CONTINUED)

(a) (continued)

MBONG CORPORATION
Statement of Financial Position
December 31, 2018

Assets				
Current assets				
Cash		$ 11,900		
Held for trading investments		20,000		
Accounts receivable		14,200		
Supplies		200		
Prepaid insurance		2,000		
Total current assets				$ 48,300
Property, plant, and equipment				
Land		$156,000		
Buildings	$72,000			
Less: Accumulated depreciation—buildings	18,000	54,000		
Equipment	$66,000			
Less: Accumulated depreciation—equipment	17,600	48,400		
Total property, plant, and equipment				258,400
Total assets				$306,700
Liabilities and Shareholders' Equity				
Current liabilities				
Accounts payable		$15,000		
Salaries payable		3,000		
Current portion of bank loan payable		1,500		
Total current liabilities				$ 19,500
Non-current liabilities				
Bank loan payable ($15,000 - $1,500)				13,500
Total liabilities				33,000
Shareholders' equity				
Common shares		$ 34,200		
Retained earnings		239,500		
Total shareholders' equity				273,700
Total liabilities and shareholders' equity			$306,700	

(Assets = Liabilities + Shareholders' equity)

PROBLEM 2-4A (CONTINUED)

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

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

PROBLEM 2-5A

(a)

1. Working capital

Current assets – Current liabilities

$ 446,900 – $142,500 = $304,400

2. Current ratio

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\frac{\$446,900}{\$142,500} = 3.1 :1$$

3. Debt to total assets

$$\frac{\text{Total liabilities}}{\text{Total assets}}$$

$$\frac{\$452,500}{\$1,072,200} = 42.2\%$$

4. Basic earnings per share

$$\frac{\text{Income available to common shareholders}}{\text{Weighted average number of common shares}}$$

$$\frac{\$160,000}{40,000} = \$4.00$$

5. Price-earnings ratio

$$\frac{\text{Market price per share}}{\text{Basic earnings per share}}$$

$$\frac{\$35.00}{\$4.00} = 8.8 \text{ times}$$

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

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

PROBLEM 2-6A

(a)

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

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Chen		Caissie	
$\frac{\$407,200}{\$166,325}$ = 2.4 :1		$\frac{\$190,400}{\$133,700}$ = 1.4 :1	

Chen is significantly more liquid than Caissie. It has a higher current ratio and more current assets available to pay current liabilities as they come due.

(b)

$$\text{Debt to total assets} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

Chen	Caissie
$\frac{(\$166,325 + \$108,500)}{(\$407,200 + \$532,000)}$ = 29.3%	$\frac{(\$133,700 + \$40,700)}{(\$190,400 + \$139,700)}$ = 52.8%

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

PROBLEM 2-6A (CONTINUED)

(c)

	Chen	Caissie
Service revenue	$1,800,000	$620,000
Operating expenses	1,458,000	438,000
Interest expense	10,000	4,000
Income tax expense	85,000	35,400
Total expenses	1,553,000	477,400
Net income	$ 247,000	$142,600

$$\text{Basic earnings per share} = \frac{\text{Income available to common shareholders}}{\text{Weighted average number of common shares}}$$

Chen

$$\frac{\$247,000}{76,000} = \$3.25$$

Caissie

$$\frac{\$142,600}{62,000} = \$2.30$$

$$\text{Price-earnings ratio} = \frac{\text{Market price per share}}{\text{Basic earnings per share}}$$

Chen

$$\frac{\$25.00}{\$3.25} = 7.7 \text{ times}$$

Caissie

$$\frac{\$15.00}{\$2.30} = 6.5 \text{ times}$$

Based on the price-earnings ratio, investors believe that Chen will be more profitable than Caissie in the future. It is not meaningful to compare basic earnings per share between companies.

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

PROBLEM 2-7A

(a) (in thousands)

		Le Château		Reitmans	
1.	Working capital	\$116,724 – \$36,038 = \$80,686		\$319,362 – \$121,172 = \$198,190	
2.	Current ratio	\$116,724 / \$36,038	= 3.2:1	\$319,362 / \$121,172	= 2.6:1
3.	Debt to total assets	\$108,136 / \$168,490	= 64.2%	\$160,915 / \$542,083	= 29.7%
4.	Basic earnings per share	\$(35,745) / 29,964	= \$(1.19)	\$(24,703) / 64,079	= \$(0.39)
5.	Price-earnings ratio		= N/A		= N/A

(b) Liquidity

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

Solvency

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

Profitability

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

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

PROBLEM 2-8A

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

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

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

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

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

(b) Liquidity

Pitka's current ratio, although steady in 2016 and 2017, declined slightly in 2018. This trend is of concern given the low level of liquidity the company has with a current ratio of 1.1:1.

Solvency

Pitka's debt to total assets ratio improved in the last year. It appears to be reasonable in size, as does the solvency of the company in 2016.

Profitability

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

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

PROBLEM 2-9A

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

(b)

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

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

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

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

PROBLEM 2-10A

(a) The advantage of the current value basis of accounting is that it represents a more up-to-date measurement of the value of the asset reported. Consequently, the amounts reported are more relevant to the financial statement users. The disadvantage of the current value basis of accounting and corresponding advantage of historical cost is that historical cost is more reliable and shows the amount paid for the asset. The historical cost might provide a more faithful representation because it can be easily verified and is neutral.

(b) The reason a company might choose to adopt the current value basis of accounting for real estate is that assets reported on the statement of financial position will have higher values than they would using the historical cost basis. It is inherent in the nature of real estate that the land will increase in value over time. Creditors will find the current value a more relevant basis for making lending decisions. The increase in the assets will have a corresponding increase in equity.

(c) The reason a company might choose to adopt the historical cost basis of accounting for real estate is that assets reported on the statement of financial position will have more faithful representation because it reports the actual cost of the asset when it was acquired and this measurement can be easily verified and it is neutral. There is also a significant cost to obtaining reliable current value information on a regular basis to be reported in the financial statements.

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

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

PROBLEM 2-1B

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

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

PROBLEM 2-2B

(a)

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

(b)

DEVON LIMITED
Statement of Financial Position (partial)
December 31, 2018

Assets

Current assets				
Cash $100,460				
Held for trading investments		52,520		
Accounts receivable		13,345		
Inventory		105,320		
Prepaid expenses		13,950		
Total current assets				$285,595
Property, plant, and equipment				
Land	$207,290			
Buildings	$ 58,275			
Less: Accumulated depreciation	27,595	30,680		
Equipment	$287,400			
Less: Accumulated depreciation	146,550	140,850		
Total property, plant, and equipment				378,820
Intangible assets				
Patent			20,225	
Goodwill			39,590	
Total assets			$724,230	

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

PROBLEM 2-3B

(a)

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

(b)

DEVON LIMITED
Statement of Financial Position (partial)
December 31, 2018

Liabilities and Shareholders' Equity

Current liabilities			
Accounts payable	$ 13,100		
Unearned revenue	14,180		
Current portion of mortgage payable	29,000		
Total current liabilities			$ 56,280
Non-current liabilities			
Mortgage payable			231,255
Total liabilities			287,535
Shareholders' equity			
Common shares	$115,400		
Retained earnings	321,295		
Total shareholders' equity		436,695	
Total liabilities and shareholders' equity		$724,230	

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

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

PROBLEM 2-4B

(a)

BEAULIEU LIMITED
Income Statement
Year Ended December 31, 2018

Revenues		
Service revenue	$193,100	
Interest revenue	500	
Total revenues		$193,600
Expenses		
Salaries expense	$145,600	
Interest expense	8,000	
Depreciation expense	5,400	
Utilities expense	3,700	
Insurance expense	2,400	
Total expenses		165,100
Income before income tax		28,500
Income tax expense		5,000
Net Income		$23,500

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

BEAULIEU LIMITED
Statement of Changes in Equity
Year Ended December 31, 2018

	Common Shares	Retained Earnings	Total Equity
Balance, January 1	$25,000	$34,000	$59,000
Issued common shares	20,000		20,000
Net income		23,500	23,500
Dividends declared		(3,500)	(3,500)
Balance, December 31	$45,000	$54,000	$99,000

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

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

PROBLEM 2-4B (CONTINUED)

(a) (continued)

BEAULIEU LIMITED
Statement of Financial Position
December 31, 2018

Assets					
Current assets					
Cash	$11,170				
Accounts receivable			7,500		
Prepaid insurance			250		
Total current assets					$ 18,920
Long-term investments					20,000
Property, plant, and equipment					
Land			$145,800		
Buildings		$105,000			
Less: Accumulated depreciation—buildings		12,000	93,000		
Equipment		$ 32,000			
Less: Accumulated depreciation—equipment		19,200		12,800	
Total property, plant, and equipment					251,600
Total assets				$290,520	
Liabilities and Shareholders' Equity					
Current liabilities					
Accounts payable			$ 9,550		
Salaries payable			6,170		
Current portion of mortgage payable			35,100		
Total current liabilities				$ 50,820	
Non-current liabilities					
Mortgage payable ($175,800 - $35,100)					140,700
Total liabilities					191,520
Shareholders' equity					
Common shares			$45,000		
Retained earnings			54,000		
Total shareholders' equity					99,000
Total liabilities and shareholders' equity					$290,520

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

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

PROBLEM 2-5B

(a)

1. Working capital

$$\text{Current assets} - \text{Current liabilities}$$
$$\$253{,}850 - \$156{,}550 = \$97{,}300$$

2. Current ratio

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$
$$\frac{\$253{,}850}{\$156{,}550} = 1.6 :1$$

3. Debt to total assets

$$\frac{\text{Total liabilities}}{\text{Total assets}}$$
$$\frac{\$288{,}550}{\$719{,}150} = 40.1\%$$

4. Basic earnings per share

$$\frac{\text{Income available to common shareholders}}{\text{Weighted average number of common shares}}$$
$$\frac{\$96{,}600}{40{,}000} = \$2.42$$

5. Price-earnings ratio

$$\frac{\text{Market price per share}}{\text{Basic earnings per share}}$$
$$\frac{\$30.00}{\$2.42} = 12.4 \text{ times}$$

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

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

PROBLEM 2-6B

(a)

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

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Belliveau	Shields
$\frac{\$180,000}{\$75,000} = 2.4 :1$	$\frac{\$700,000}{\$300,000} = 2.3 :1$

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

(b)

$$\text{Debt to total assets} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

Belliveau	Shields
$\frac{(\$75,000 + \$190,000)}{(\$180,000 + \$600,000)} = 34.0\%$	$\frac{(\$300,000 + \$200,000)}{(\$700,000 + \$800,000)} = 33.3\%$

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

PROBLEM 2-6B (CONTINUED)

(c)

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

$$\text{Basic earnings per share} = \frac{\text{Income available to common shareholders}}{\text{Weighted average number of common shares}}$$

Belliveau	Shields
$\frac{\$44,000}{200,000} = \$0.22$	$\frac{\$136,000}{200,000} = \$0.68$

$$\text{Price-earnings ratio} = \frac{\text{Market price per share}}{\text{Basic earnings per share}}$$

Belliveau	Shields
$\frac{\$2.50}{\$0.22} = 11.4$ times	$\frac{\$6.00}{\$0.68} = 8.8$ times

Investors have higher expectations for Belliveau’s future profitability, as evidenced by the price-earnings ratio. It is impractical to compare basic earnings per share between companies.

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

PROBLEM 2-7B

(a) (in US$ millions)

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

(b) Liquidity

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

Solvency

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

Profitability

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

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

PROBLEM 2-8B

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

A higher current ratio is evidence of better liquidity for a business, assuming all components of current assets are also liquid. The current ratio for Giasson has been deteriorating steadily from 2016 to 2018. The corporation remains liquid, as its current ratio was 1.5:1 in 2018.

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

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

The investors appear to have less confidence in the future profitability of Giasson as evidenced by Giasson's price-earnings ratio which declined from 2016 to 2018.

(b) <u>Liquidity</u>
Giasson's current ratio, although declining over the past two years, demonstrates adequate liquidity. There is $1.50 of current assets available to cover each $1 of current liabilities.

<u>Solvency</u>
Giasson's debt to total assets ratio, although deteriorating from 2016 to 2018, remains modest in size and so the solvency of the company continues to be good.

<u>Profitability</u>
Giasson's profitability is declining steadily as is demonstrated by the basic earnings per share ratio and the price-earnings ratio.

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

PROBLEM 2-9B

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

(b)

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

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

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

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

PROBLEM 2-10B

(a) The advantage of the current value basis of accounting is that it represents a more up-to-date measurement of the value of the asset reported. Consequently, the amounts reported are more relevant to the financial statement users. The disadvantage of the current value basis of accounting and corresponding advantage of historical cost is that historical cost is more reliable and shows the amount paid for the asset. The historical cost might provide a more faithful representation because it can be easily verified and is neutral.

(b) The following is the recommended basis of measurement that should be used for the following purchases:

1. Due the nature of the asset, a textbook purchase should be recorded at the historical cost basis of accounting because of its intended use. The objective of owning the asset is to use it and not to immediately resell it at a profit.

2. In the case of an iPad, the use of the asset will be limited due to technological obsolescence. Because of this obsolescence, the iPad purchase should be recorded and reported using the historical cost basis of accounting.

3. Software is very similar to the iPad of item 2 above in that it becomes technologically obsolete very quickly. On the other hand, the manufacturer has recognized this problem and has included in the sale of the software, automatic upgrades to attempt to deal with the future needs and demands of the purchaser. This asset is purchased for use and not for resale at a gain and consequently the historical cost basis of accounting should be used for its recording and reporting.

4. If the purchase of the used car is for use in the business, the historical cost basis of accounting should be used. On the other hand, if the purchase is for resale, the current value basis of accounting should be used.

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

CT2-1 FINANCIAL REPORTING CASE

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

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

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

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

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

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

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

CT2-2 FINANCIAL ANALYSIS CASE

(a)

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

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

Solvency: The higher a company's percentage of debt to total assets is, the greater the risk that this company may be unable to meet its maturing obligations. North West has a better ratio than the industry while Sobeys has a worse ratio.

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

CT2-3 FINANCIAL REPORTING CASE

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

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

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

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

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

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

CT2-3 (CONTINUED)

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

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

Examples of why private companies may adopt IFRS:

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

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

CT2-4 FINANCIAL ANALYSIS CASE

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

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

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

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

(c)

	2018		2017	
Current ratio	$\frac{\$46,000}{\$33,580}$	= 1.4:1	$\frac{\$31,000}{\$22,490}$	= 1.4:1

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

CT2-4 (CONTINUED)

(d)

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

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

(e)

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

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

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

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

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

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

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

CT2-4 (CONTINUED)

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

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

CT2-5 ETHICS CASE

(a) The stakeholders in this case are:

Kathy Onishi, controller
Redondo's vice-president of finance
Users of the company's financial statements, including shareholders and creditors

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

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

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

CT2-6 SERIAL CASE

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

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

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

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

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

CT2-6 (CONTINUED)

(e) By looking at the statement of financial position, we can determine Software Solutions' total liabilities, and the mix of current and non-current debt. We can also calculate solvency ratios, such as the debt to total assets ratio, to determine whether Software Solutions has the ability to repay its total debt. Solvency ratios help measure a company's ability to survive over a long period of time.

Reviewing the company's income statement and statement of cash flows helps in determining whether Software Solutions is able to pay its interest expense. The more profitable the company, the better able it is to make the interest payments on its debt and generate sufficient cash to repay its obligations.

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

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

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

Legal Notice

Copyright

(MMXVI xi FI)