

CHAPTER 2

A FURTHER LOOK AT FINANCIAL STATEMENTS

SUMMARY OF QUESTIONS BY STUDY OBJECTIVES

Item	SO	Item	SO	Item	SO	Item	SO	Item	SO	Item	SO	Item	SO
True-False Statements													
1.	1	12.	1	23.	2	34.	2	45.	3	56.	3	67.	3
2.	1	13.	1	24.	2	35.	2	46.	3	57.	3	68.	3
3.	1	14.	1	25.	2	36.	2	47.	3	58.	3	69.	3
4.	1	15.	1	26.	2	37.	2	48.	3	59.	3	70.	3
5.	1	16.	2	27.	2	38.	2	49.	3	60.	3	71.	3
6.	1	17.	2	28.	2	39.	2	50.	3	61.	3	72.	3
7.	1	18.	2	29.	2	40.	3	51.	3	62.	3	73.	3
8.	1	19.	2	30.	2	41.	3	52.	3	63.	3	74.	3
9.	1	20.	2	31.	2	42.	3	53.	3	64.	3	75.	3
10.	1	21.	2	32.	2	43.	3	54.	3	65.	3		
11.	1	22.	2	33.	2	44.	3	55.	3	66.	3		
Multiple Choice Questions													
76.	1	91.	1	105.	2	119.	2	133.	3	147.	3		
77.	1	92.	1	106.	2	120.	2	134.	3	148.	3		
78.	1	93.	1	107.	2	121.	2	135.	3	149.	3		
80.	1	94.	1	108.	2	122.	2	136.	3	150.	3		
81.	1	95.	1	109.	2	123.	2	137.	3				
82.	1	96.	1	110.	2	124.	2	138.	3				
83.	1	97.	1	111.	2	125.	2	139.	3				
84.	1	98.	1	112.	2	126.	2	140.	3				
85.	1	99.	1	113.	2	127.	2	141.	3				
86.	1	100.	1	114.	2	128.	2	142.	3				
87.	1	101.	2	115.	2	129.	2	143.	3				
88.	1	102.	2	116.	2	130.	3	144.	3				
89.	1	103.	2	117.	2	131.	3	145.	3				
90.	1	104.	2	118.	2	132.	3	146.	3				
Exercises													
151.	1	156.	1,2	161.	2	166.	3						
152.	1	157.	1,2	162.	2	167.	3						
153.	1	158.	2	163.	2	168.	3						
154.	1	159.	2	164.	2								
155.	2	160.	2	165.	2								
Matching													
169.	1-3												
Short-Answer Essay													
170.	1,2	171.	2	172.	2	173.	3	174.	3	175.	3		

SUMMARY OF STUDY OBJECTIVES BY QUESTION TYPE

Item	Type	Item	Type	Item	Type	Item	Type	Item	Type	Item	Type	Item	Type
Study Objective 1													
1.	TF	8.	TF	15.	TF	82.	MC	89.	MC	96.	MC	153.	EX
2.	TF	9.	TF	76.	MC	83.	MC	90.	MC	97.	MC	154.	EX
3.	TF	10.	TF	77.	MC	84.	MC	91.	MC	98.	MC	156.	EX
4.	TF	11.	TF	78.	MC	85.	MC	92.	MC	99.	MC	157.	EX
5.	TF	12.	TF	79.	MC	86.	MC	93.	MC	100.	MC	169.	M
6.	TF	13.	TF	80.	MC	87.	MC	94.	MC	151.	EX	170.	SAE
7.	TF	14.	TF	81.	MC	88.	MC	95.	MC	152.	EX		
Study Objective 2													
16.	TF	26.	TF	36.	TF	107.	MC	117.	MC	127.	MC	162.	EX
17.	TF	27.	TF	37.	TF	108.	MC	118.	MC	128.	MC	163.	EX
18.	TF	28.	TF	38.	TF	109.	MC	119.	MC	129.	MC	164.	EX
19.	TF	29.	TF	39.	TF	110.	MC	120.	MC	155.	EX	165.	EX
20.	TF	30.	TF	101.	MC	111.	MC	121.	MC	156.	EX	169.	M
21.	TF	31.	TF	102.	MC	112.	MC	122.	MC	157.	EX	170.	SAE
22.	TF	32.	TF	103.	MC	113.	MC	123.	MC	158.	EX	171.	SAE
23.	TF	34.	TF	104.	MC	114.	MC	124.	MC	159.	EX	172.	SAE
24.	TF	34.	TF	105.	MC	115.	MC	125.	MC	160.	EX		
25.	TF	35.	TF	106.	MC	116.	MC	126.	MC	161.	EX		
Study Objective 3													
40.	TF	51.	TF	62.	TF	73.	TF	138.	MC	149.	MC		
41.	TF	52.	TF	63.	TF	74.	TF	139.	MC	150.	MC		
42.	TF	53.	TF	64.	TF	75.	TF	140.	MC	166.	EX		
43.	TF	54.	TF	65.	TF	130.	MC	141.	MC	167.	EX		
44.	TF	55.	TF	66.	TF	131.	MC	142.	MC	168.	EX		
45.	TF	56.	TF	67.	TF	132.	MC	143.	MC	169.	M		
46.	TF	57.	TF	68.	TF	133.	MC	144.	MC	173.	SAE		
47.	TF	58.	TF	69.	TF	134.	MC	145.	MC	174.	SAE		
48.	TF	59.	TF	70.	TF	135.	MC	146.	MC	175.	SAE		
49.	TF	60.	TF	71.	TF	136.	MC	147.	MC				
50.	TF	61.	TF	72.	TF	137.	MC	148.	MC				

Note: TF = True-False

MC = Multiple Choice

M = Matching

EX = Exercise

SAE = Short-Answer Essay

CHAPTER STUDY OBJECTIVES

1. **Identify the sections of a classified statement of financial position.** In a classified statement of financial position, assets are classified as current or non-current assets. In the non-current asset category, they are further classified as investments; property, plant and equipment; intangible assets and goodwill; and other assets. Liabilities are classified as either current or non-current. There is also a shareholders' equity section, which shows share capital and retained earnings, among other equity items if any exist.
2. **Identify and calculate ratios for analyzing a company's liquidity, solvency, and profitability.** Liquidity ratios, such as working capital and the current ratio, measure a company's short-term ability to pay its maturing obligations and meet unexpected needs for cash. Solvency ratios, such as debt to total assets, measure a company's ability to survive over a long period. Profitability ratios, such as earnings per share and the price-earnings ratio, measure a company's operating success for a specific period of time.
3. **Describe the framework for the preparation and presentation of financial statements.** The key components of the conceptual framework are (1) the objective of financial reporting; (2) qualitative characteristics of useful financial information, which include fundamental and enhancing characteristics and the cost constraint; (3) the going concern assumption underlying the accounting process; (4) elements of the financial statements; and (5) measurement of the elements of financial statements.

TRUE-FALSE STATEMENTS

1. Cash and office supplies are both classified as current assets.
2. Inventories and prepaid expenses are classified as long-term investments.
3. Long-term investments appear in the property, plant, and equipment section of the statement of financial position.
4. Special rights and privileges that provide a future economic benefit to the company are classified as intangible assets.
5. A liability is normally classified as a current liability if it is to be paid within the coming year.
6. Shareholders' equity is divided into at least two parts: share capital and retained earnings.
7. All long-lived assets including land have estimated useful lives over which they are expected to generate revenue.
8. All long-lived assets are depreciated over their estimated useful lives.
9. Mortgages and pension liabilities are examples of non-current liabilities.
10. The investment classification on the statement of financial position normally includes investments that are intended to be held for a short period of time (less than one year).
11. Shareholders' equity consists of two parts: common and preferred shares.
12. The main difference between intangible assets and property, plant, and equipment is the length of the asset's life.
13. Listing assets and liabilities in reverse order of liquidity is not permitted in Canada.
14. The statement of financial position is normally presented as follows, when ordered in order of liquidity: Current assets, current liabilities, non-current assets, non-current liabilities, and shareholders' equity.
15. The statement of financial position is normally presented as follows, when ordered in order of

reverse liquidity: Non-current assets, current assets, shareholders' equity, non-current liabilities, and current liabilities.

16. Intracompany comparisons are based on comparisons with competitors in the same industry.
17. Calculating financial ratios can give clues to underlying conditions that may not be noticed by examining each financial statement item separately.
18. Liquidity ratios are concerned with the frequency and amounts of dividend payments.
19. Analysis of financial statements is enhanced with the use of comparative data.
20. Solvency ratios measure the entity's ability to survive over a long period.
21. A single ratio by itself is not very meaningful.
22. Profitability means having enough funds on hand to pay debts when they fall due.
23. Working capital is the difference between total assets and current liabilities.
24. The excess of current assets over current liabilities is called working capital.
25. The current ratio is calculated by dividing total assets by total liabilities.
26. The current ratio takes into account the composition of current assets.
27. A current ratio of 1.2 to 1 indicates that a company's current assets exceed its current liabilities.
28. All companies, regardless of size, should have a current ratio of at least 2:1.
29. The most liquid resource is inventory.
30. Solvency ratios measure the short-term ability of the company to pay its maturing obligations.
31. The debt to total assets ratio measures the percentage of assets financed by creditors rather than shareholders.

- 32. From a creditor's point of view, the higher the total debt to total assets ratio, the lower the risk that the company may be unable to pay its obligations.
- 33. Earnings per share is calculated by dividing profit for the period by the dollar value in the common shares account.
- 34. The price-earnings ratio is calculated by dividing the market price per share by the earnings per share.
- 35. The price-earnings ratio is a measure of liquidity.
- 36. Earnings per share is the only ratio that must be presented in the financial statements for publicly traded companies.
- 37. Earnings per share is frequently compared across companies in the same industry.
- 38. The higher the price-earnings ratio, the higher are investors' expectations of the company's future profitability.
- 39. Companies using Accounting Standards for Private Enterprises (ASPE) are not required to present earnings per share information in their financial statements.
- 40. Having a conceptual framework of accounting ensures that standards and practices are clear and consistent.
- 41. Canada has adopted international financial reporting standards for publicly traded companies.
- 42. The conceptual framework is fundamentally similar for both Canadian publicly traded companies and Canadian private companies.
- 43. The objective of financial reporting is to provide financial information about a company that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company.
- 44. The objective of financial reporting is to provide financial information that is useful to all types of internal and external users in making decisions.
- 45. The two fundamental qualitative characteristics are relevance and timeliness.

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46. The two fundamental qualitative characteristics are faithful representation and relevance.
 47. Information is relevant if it will make a difference in a user's decision(s).
 48. Faithful representation means that accounting information must be complete, neutral, and free from material error.
 49. Financial reporting does not have to present the economic substance of a transaction in order to provide a faithful representation of what really happened
 50. Information has predictive value if it helps users confirm or correct their previous predictions.
 51. Materiality and relevance are both defined in terms of what influences or makes a difference to a decision maker.
 52. Enhancing qualitative characteristics include timeliness and comparability.
 53. Accounting information does not have to be understood by the average user with a general business background in order to be useful.
 54. Under the going concern assumption, reporting assets, such as land, at their cost may be more appropriate than reporting land at its fair value.
 55. In order for information to be relevant, it must be reported on a timely basis.
 56. Consistency aids comparability when a company uses the same accounting principles and methods from year to year or when companies with similar circumstances use the same accounting principles.
 57. Comparability in accounting means that a company uses the same generally accepted accounting principles from one accounting period to the next.
 58. In order to compare the financial statements of different companies, it would be desirable to have each company develop its own set of accounting rules and practices.
 59. Comparability and understandability are examples of enhancing qualitative characteristics.
 60. Information has verifiability if the information is comparable.

- 61. The cost constraint ensures that the value of information provided is greater than the cost of providing it.
- 62. The cost constraint ensures that information costs less than budget.
- 63. The going concern assumption states that the business will continue in operation for the foreseeable future.
- 64. If a company is not a going concern, the classification of its assets and liabilities does not matter.
- 65. Using a simplified version of Canadian GAAP for small companies in order to reduce the cost of providing financial information is an example of the application of materiality.
- 66. Elements of financial statements include assets, equity, and expenses, but not liabilities.
- 67. Two measurement principles are historical cost and fair value.
- 68. Two recognition principles are the fair value basis of accounting and the going concern assumption.
- 69. In general, standard setters require that most assets be recorded using historical cost because cost is representationally faithful.
- 70. The fair value basis of accounting states that all assets and liabilities can be reported at fair value.
- 71. Fair values may not always be representationally faithful.
- 72. The cost basis of accounting states that assets and liabilities should be recorded at their cost not only when originally acquired, but also during the time the entity holds them.
- 73. Qualitative characteristics help ensure that the information provided in financial statements is useful.
- 74. The going concern assumption underlies the preparation of financial statements.

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75. A conceptual framework is still under development for companies using International Financial Reporting Standards (IFRS).

ANSWERS TO TRUE-FALSE STATEMENTS

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	T	11.	F	21.	T	31.	T	41.	T	51.	T	61.	T	71.	T
2.	F	12.	F	22.	F	32.	F	42.	T	52.	T	62.	F	72.	T
3.	F	13.	F	23.	F	33.	F	43.	T	53.	F	63.	T	73.	T
4.	T	14.	F	24.	T	34.	T	44.	F	54.	T	64.	T	74.	T
5.	T	15.	T	25.	F	35.	F	45.	F	55.	T	65.	F	75.	T
6.	T	16.	F	26.	F	36.	T	46.	T	56.	T	66.	F		
7.	F	17.	T	27.	T	37.	F	47.	T	57.	F	67.	T		
8.	F	18.	F	28.	F	38.	T	48.	T	58.	F	68.	F		
9.	T	19.	T	29.	F	39.	T	49.	F	59.	T	69.	T		
10.	F	20.	T	30.	F	40.	T	50.	F	60.	F	70.	F		

MULTIPLE CHOICE QUESTIONS

76. On a classified statement of financial position, prepaid expenses are classified as:
- (a) a current liability.
 - (b) property, plant, and equipment.
 - (c) a current asset.
 - (d) a long-term investment.
77. A current asset is:
- (a) the last asset purchased by a business.
 - (b) an asset which is currently being used to produce a product or service.
 - (c) usually found as a separate classification in the income statement.
 - (d) expected to be converted to cash or used in the business within a relatively short period of time.
78. Which of the following is *not* classified as a current asset?
- (a) Supplies
 - (b) Short-term (trading) investments
 - (c) A fund to be used to purchase a building within the next year
 - (d) Equipment with an estimated useful life of five years
79. An intangible asset:
- (a) derives its value from the rights and privileges it provides the company.
 - (b) is worthless because it has no physical substance.
 - (c) is converted into a tangible asset during the year.
 - (d) cannot be classified on the statement of financial position because it lacks physical substance.
80. Which of the following is *not* considered to be an asset?
- (a) Equipment
 - (b) Dividends
 - (c) Accounts receivable
 - (d) Inventory
81. The difference between cost and accumulated depreciation is referred to as:
- (a) net depreciation.
 - (b) carrying amount.
 - (c) fair value.
 - (d) cost value.
82. Trademarks would appear in which section of the statement of financial position?
- (a) Shareholders' equity
 - (b) Investments
 - (c) Intangible assets
 - (d) Current assets

83. Liabilities are generally classified on a statement of financial position as:
- (a) small liabilities and large liabilities.
 - (b) present liabilities and future liabilities.
 - (c) tangible liabilities and intangible liabilities.
 - (d) current liabilities and non-current liabilities.
84. Which of the following would *not* normally be classified as a non-current liability?
- (a) Current maturities of non-current debt
 - (b) Bonds payable
 - (c) Mortgage payable
 - (d) Lease liabilities
85. Which of the following is *not* normally a current liability?
- (a) Salaries payable
 - (b) Accounts payable
 - (c) Income tax payable
 - (d) Bonds payable
86. Office equipment is classified on the statement of financial position as:
- (a) a current asset.
 - (b) property, plant, and equipment.
 - (c) shareholders' equity.
 - (d) a long-term investment.
87. Current liabilities are expected to be:
- (a) converted to cash within one year.
 - (b) paid within one year.
 - (c) used in the business within one year.
 - (d) acquired within one year.
88. On a classified statement of financial position, current assets are often listed:
- (a) in alphabetical order.
 - (b) with the largest dollar amounts first.
 - (c) in the order in which they are expected to be converted into cash.
 - (d) in the order of acquisition.
89. Long-lived assets without physical substance are:
- (a) listed directly under current assets on the statement of financial position.
 - (b) not listed on the statement of financial position because they do not have physical substance.
 - (c) intangible assets.
 - (d) listed as a long-term investment on the statement of financial position.

Use the following information to answer questions 90 to 94:

HONEST RON'S FURNITURE OUTLET LTD.

Statement of Financial Position

December 31, 2012

Cash	\$ 5,000	Accounts payable	\$30,000
Accounts receivable	20,000	Salaries payable	10,000
Supplies	1,000	Mortgage payable	<u>130,000</u>
Inventory	170,000	Total liabilities	\$170,000
Land	100,000	Shareholders' equity	
Building	\$100,000	Common shares	\$140,000
Less: Accum. depreciation	<u>20,000</u>	Retained earnings	<u>96,000</u>
Trademark	\$40,000	Total shareholders' equity	<u>236,000</u>
Less: Accum. amortization	<u>10,000</u>		
	<u>30,000</u>		
Total assets	<u>\$406,000</u>	Total liabilities and shareholders' equity	<u>\$406,000</u>

90. The dollar amount of current liabilities is:

- (a) \$196,000.
- (b) \$170,000.
- (c) \$ 40,000.
- (d) \$ 30,000.

91. The dollar amount of net property, plant and equipment is:

- (a) \$ 80,000.
- (b) \$180,000.
- (c) \$210,000.
- (d) \$350,000.

92. The dollar amount of current assets is:

- (a) \$ 26,000.
- (b) \$ 40,000.
- (c) \$ 25,000.
- (d) \$196,000.

93. The dollar amount of share capital is:

- (a) \$406,000.
- (b) \$236,000.
- (c) \$140,000.
- (d) \$ 96,000.

94. The total obligations that have resulted from past transactions are:

- (a) \$ 20,000.
- (b) \$ 40,000.
- (c) \$ 96,000.
- (d) \$170,000.

Use the following information to answer questions 95-100.

ACE AUTO SUPPLIES LTD.
Statement of Financial Position
December 31, 2012

Cash	\$ 50,000	Accounts payable	\$ 40,000
Prepaid insurance	5,000	Salaries payable	5,000
Accounts receivable	75,000	Bonds payable	<u>190,000</u>
Inventory	110,000	Total liabilities	<u>235,000</u>
Land	90,000		
Building	\$220,000	Common shares	200,000
Less: Accumulated depreciation	<u>60,000</u>	Retained earnings	<u>105,000</u>
	160,000	Total shareholders' equity	<u>305,000</u>
Trademark	\$75,000		
Less: Accumulated amort.	<u>25,000</u>	Total liabilities and shareholders' equity	<u>\$540,000</u>
	50,000		
Total assets	<u>\$540,000</u>		

95. The total dollar amount of assets to be classified as current assets is:
- \$240,000.
 - \$220,000.
 - \$170,000.
 - \$130,000.
96. The total dollar amount of assets to be classified as net property, plant, and equipment is:
- \$300,000.
 - \$250,000.
 - \$240,000.
 - \$160,000.
97. The total dollar amount of assets to be classified as investments is:
- \$ 0.
 - \$ 50,000.
 - \$ 90,000.
 - \$190,000.
98. The total amount in the contra asset accounts is:
- \$ 60,000.
 - \$ 85,000.
 - \$210,000.
 - \$235,000.
99. Non-current liabilities total:
- \$540,000.
 - \$235,000.
 - \$190,000.
 - \$ 45,000.

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100. Profit retained for use in the business are:
- (a) \$540,000.
 - (b) \$305,000.
 - (c) \$200,000.
 - (d) \$105,000.
101. A measure of profitability is the:
- (a) current ratio.
 - (b) debt to total assets ratio.
 - (c) earnings per share.
 - (d) working capital.
102. Earnings per share is calculated by dividing:
- (a) revenue by weighted average shareholders' equity.
 - (b) revenue by the weighted average number of common shares.
 - (c) profit by weighted average shareholders' equity.
 - (d) profit by the weighted average number of common shares.
103. The price-earnings ratio is calculated by dividing:
- (a) the market price per share by earnings per share.
 - (b) earnings per share by the average number of shares.
 - (c) profit by the market price per share.
 - (d) earnings per share by the market price per share.
104. The relationship between current assets and current liabilities is important in evaluating a company's:
- (a) profitability.
 - (b) liquidity.
 - (c) fair value.
 - (d) solvency.
105. The most important information needed to determine if companies can pay their current obligations is the:
- (a) profit for this year.
 - (b) projected profit for next year.
 - (c) relationship between current assets and current liabilities.
 - (d) relationship between current and non-current liabilities.
106. A short-term creditor is primarily interested in the _____ of the borrower.
- (a) liquidity
 - (b) profitability
 - (c) comparability
 - (d) solvency

107. The current ratio is calculated as:
- (a) current assets plus current liabilities.
 - (b) current assets minus current liabilities.
 - (c) current assets divided by current liabilities.
 - (d) current assets times current liabilities.
108. Working capital is calculated as:
- (a) current assets plus current liabilities.
 - (b) current assets minus current liabilities.
 - (c) current assets divided by current liabilities.
 - (d) current assets times current liabilities.
109. Working capital is a measure of:
- (a) comparability.
 - (b) liquidity.
 - (c) profitability.
 - (d) solvency.
110. Long-term creditors are usually most interested in evaluating:
- (a) liquidity and profitability.
 - (b) comparability and profitability.
 - (c) profitability and solvency.
 - (d) consistency and solvency.
111. A liquidity ratio measures the:
- (a) profit or operating success of a company over a period of time.
 - (b) ability of a company to survive over a long period of time.
 - (c) short-term ability of a company to pay its maturing obligations and to meet unexpected needs for cash.
 - (d) percentage of total financing provided by creditors.
112. Working capital is:
- (a) calculated by dividing current assets by current liabilities.
 - (b) used to evaluate a company's liquidity and short-term debt paying ability.
 - (c) used to evaluate a company's solvency and long-term debt paying ability.
 - (d) calculated by subtracting current liabilities from total assets.
113. The ability of a business to pay obligations that are expected to become due within the next year is called:
- (a) leverage.
 - (b) liquidity.
 - (c) profitability.
 - (d) solvency.

Use the following information to answer questions 114-118.

Current assets	\$ 9,000	Net sales	\$20,000
Current liabilities	4,000	Total liabilities	5,000
Average assets	40,000	Shareholders' equity	25,000
Total assets	30,000	Market price of shares	\$2
Profit	9,000	Weighted average number of common shares	18,000

114. What is the total amount of working capital?
- (a) \$2,000
 - (b) \$4,000
 - (c) \$5,000
 - (d) \$7,000
115. What is the current ratio?
- (a) 2.2:1
 - (b) 2.0:1
 - (c) 0.6:1
 - (d) 0.4:1
116. What is the earnings per share?
- (a) \$0.36
 - (b) \$0.50
 - (c) \$0.80
 - (d) \$1.11
117. What is the price-earnings ratio?
- (a) 5.6 times
 - (b) 4.0 times
 - (c) 2.5 times
 - (d) 1.8 times
118. What is the debt to total assets?
- (a) 12.5%
 - (b) 20.0%
 - (c) 75.0%
 - (d) 16.7%
119. The debt to total assets ratio is calculated by dividing:
- (a) non-current liabilities by total assets.
 - (b) non-current liabilities by average assets.
 - (c) total liabilities by total assets.
 - (d) total liabilities by average assets.
120. A useful measure of solvency is the:
- (a) current ratio.
 - (b) price-earnings ratio.

- (c) earnings per share.
- (d) debt to total assets.

121. Which of the following is *not* considered a measure of liquidity?
- (a) Current ratio
 - (b) Working capital
 - (c) Both current ratio and working capital
 - (d) Debt to total assets
122. Investors are usually most interested in evaluating:
- (a) liquidity and solvency.
 - (b) solvency and marketability.
 - (c) liquidity and profitability.
 - (d) profitability and solvency.
123. Shareholders are most interested in evaluating:
- (a) liquidity and solvency.
 - (b) profitability and solvency.
 - (c) liquidity and profitability.
 - (d) marketability and solvency.
124. The current assets of Key Corporation are \$360,000. The current liabilities are \$240,000. The current ratio expressed as a ratio is:
- (a) 150%
 - (b) 1.5:1
 - (c) 0.7:1
 - (d) $\$360,000 \div \$240,000$
125. A weakness of the current ratio is:
- (a) the difficulty of the calculation.
 - (b) that it doesn't take into account the composition of the current assets.
 - (c) that it is rarely used by sophisticated analysts.
 - (d) that it can be expressed as a percentage, as a rate, or as a proportion.
126. A supplier to a company would probably be most interested in the:
- (a) debt to total assets.
 - (b) price-earnings ratio.
 - (c) current ratio.
 - (d) earnings per share.

Use the following information for questions 127-128.

Sweeney Corporation had \$250,000 in current assets and \$90,000 in current liabilities before borrowing \$50,000 from the bank for a 3-month period.

-
127. What effect did the borrowing transaction have on the amount of Sweeney's working capital?
- (a) No effect
 - (b) \$50,000 increase
 - (c) \$90,000 increase
 - (d) \$50,000 decrease
128. What effect did the borrowing transaction have on Sweeney's current ratio?
- (a) The ratio remained unchanged
 - (b) The change in the current ratio cannot be determined
 - (c) The ratio decreased
 - (d) The ratio increased
129. City Recycling Inc. has \$120,000 in current assets and \$100,000 in current liabilities. When the company pays \$20,000 owed to employees (salaries payable), what effect does this have on their current ratio?
- (a) The ratio increases
 - (b) The ratio decreases
 - (c) The ratio stays the same
 - (d) Cannot be determined
130. The conceptual framework of accounting helps to ensure that:
- (a) users with no accounting or business knowledge will understand financial statements.
 - (b) a rule will be in place for every possible situation.
 - (c) there are consistent standards prescribing the nature, functions and limits of financial statements.
 - (d) all countries have their own unique accounting standards.
131. The objective of financial reporting is to:
- (a) provide information to the Canada Revenue Agency.
 - (b) provide financial information that is useful to existing and potential investors, lenders and other creditors.
 - (c) comply with Accounting Standards for Private Enterprises.
 - (d) comply with International Financial Reporting Standards.
132. The conceptual framework of accounting begins with:
- (a) qualitative characteristics.
 - (b) the going concern assumption.
 - (c) the objective of financing reporting.
 - (d) elements of financial statements.
133. Which one of the following is *not* a qualitative characteristic of useful accounting information?
- (a) Relevance
 - (b) Verifiability
 - (c) Going concern
 - (d) Comparability

134. Which one of the following is a fundamental qualitative characteristic?
- (a) Relevance
 - (b) Timeliness
 - (c) Understandability
 - (d) Comparability
135. In order for accounting information to be relevant, it must:
- (a) have very little cost.
 - (b) help predict future events or confirm prior expectations.
 - (c) be verifiable.
 - (d) be used by a lot of different organizations.
136. If accounting information has relevance, it:
- (a) is not required to be complete
 - (b) will not have predictive value.
 - (c) will only make a difference for internal stakeholders.
 - (d) will make a difference in users' decisions.
137. The two qualitative characteristics that are defined in terms of what influences or makes a difference to a decision maker are:
- (a) faithful representation and materiality.
 - (b) comparability and timeliness
 - (c) materiality and relevance.
 - (d) relevance and understandability
138. Which of the following is *not* an enhancing qualitative characteristic?
- (a) Verifiability
 - (b) Faithful representation
 - (c) Comparability
 - (d) Timeliness
139. Accounting information should be neutral in order to enhance:
- (a) faithful representation.
 - (b) materiality.
 - (c) comparability.
 - (d) understandability.
140. Which of the following is *not* a main section of the conceptual framework of accounting?
- (a) The objective of financial reporting
 - (b) The going concern assumption
 - (c) Financial analysis
 - (d) The elements of financial statements
141. Which of the following statements is *not* true?
- (a) Comparability means using different accounting principles from year to year within a company.

- (b) Faithful representation means information must be neutral, complete, and free from material error.
 - (c) Relevant accounting information must be capable of making a difference in a user's decision.
 - (d) For accounting information to be relevant, it must have timeliness.
142. A company can change to a new accounting principle if management can justify that the change will result in:
- (a) less likelihood of clerical errors.
 - (b) higher profit.
 - (c) lower profit for tax purposes.
 - (d) more relevant information for decision-making.
143. If accounting information has predictive value, it will help users:
- (a) prepare for future Canada Revenue Agency audits.
 - (b) make predictions about future events.
 - (c) make predictions about foreign currency exchange rates.
 - (d) confirm or correct previous predictions or expectations.
144. The going concern assumption assumes that the business:
- (a) will be liquidated in the near future.
 - (b) will be purchased by another business.
 - (c) is in a growth industry.
 - (d) will remain in operation for the foreseeable future.
145. The going concern assumption is inappropriate when:
- (a) the business is just starting up.
 - (b) liquidation appears likely.
 - (c) fair values are higher than costs.
 - (d) the business is organized as a proprietorship.
146. Which of the following is a constraint in accounting?
- (a) Comparability
 - (b) Cost
 - (c) Faithful representation
 - (d) Timeliness
147. In general, standard setters require that most assets be recorded using historical cost because:
- (a) fair values may overstate assets and equity.
 - (b) fair values may not always be representationally faithful.
 - (c) cost often cannot be verified.
 - (d) cost values may or may not be relevant.
148. Which of the following is *not* a financial statement element?
- (a) Liabilities
 - (b) Equity

- (c) Expenses
- (d) Fair value

149. The qualitative characteristic that says the value of information should exceed the cost of preparing it is called:
- (a) relevance.
 - (b) understandability.
 - (c) cost constraint.
 - (d) verifiability.
150. The measurement principle that says assets are reported at the price that would be received if the item were sold is called:
- (a) fair value.
 - (b) historical cost.
 - (c) materiality.
 - (d) going concern.

ANSWERS TO MULTIPLE CHOICE QUESTIONS

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
76.	c	90.	c	104.	b	118.	d	132.	c	146.	b
77.	d	91.	c	105.	c	119.	c	133.	c	147.	b
78.	d	92.	d	106.	a	120.	d	134.	a	148.	d
79.	a	93.	c	107.	c	121.	d	135.	b	149.	c
80.	b	94.	d	108.	b	122.	d	136.	d	150.	a
81.	b	95.	a	109.	b	123.	b	137.	c	.	
82.	c	96.	b	110.	c	124.	b	138.	b		
83.	d	97.	a	111.	c	125.	b	139.	a		
84.	a	98.	b	112.	b	126.	c	140.	c		
85.	d	99.	c	113.	b	127.	a	141.	a		
86.	b	100.	d	114.	c	128.	c	142.	d		
87.	b	101.	c	115.	a	129.	a	143.	b		
88.	c	102.	d	116.	b	130.	c	144.	d		
89.	c	103.	a	117.	b	131.	b	145.	b		

EXERCISES

Ex. 151

Identify the errors, corrections required, and corrected subtotals required in the following classified statement of financial position. Then prepare a corrected statement of financial position.

DUMBOW INC.
Statement of Financial Position
Year Ended December 31, 2012

Assets		
Current assets		
Accounts receivable (net of accounts payable of \$2,000)		\$ 6,000
Prepaid expenses		120
Goodwill		<u>1,200</u>
		<u>7,320</u>
Property, plant and equipment	\$4,300	
Less: Accounted depreciation	1,100	
Other assets (non-current)	<u>420</u>	<u>3,620</u>
Total assets		<u><u>\$10,940</u></u>
Liabilities		
Bank loan payable (due in 6 months)	\$2,000	
Non-current debt	<u>5,300</u>	
Total liabilities		7,300
Shareholders' equity		
Retained earnings	\$6,000	
Less: Dividends	3,000	
Common shares	<u>640</u>	<u>3,640</u>
Total		<u><u>\$10,940</u></u>

Solution 151 (15 min.)

- The date is not properly identified in the heading—it should be December 31, 2012, not year ended.
- The accounts payable should not be netted against the receivables—accounts receivable should be \$8,000 and accounts payable shown as a current liability of \$2,000.
- Goodwill should not be a current asset. Goodwill is a type of intangible asset, shown separately. Current assets should be \$8,120.
- Other (non-current) assets should not be included with property, plant and equipment subtotal. The subtotal should be \$3,200.
- Accounted depreciation should be accumulated depreciation.
- A heading “Liabilities and Shareholders' Equity” should replace the “Liabilities” heading.
- Liabilities should be classified as current and non-current.
- Current liabilities should include accounts payable of \$2,000 and note payable (due in 6 months) of \$2,000—for total current liabilities of \$4,000.
- Common shares should be listed first under the shareholders' equity heading.
- Dividends should not be shown on the statement of financial position—only the ending amount of retained earnings of \$3,000 (\$6,000 – \$3,000) should be shown.

Corrected statement of financial position.

DUMBOW INC.
Statement of Financial Position
December 31, 2012

Assets

Current assets		
Accounts receivable		\$ 8,000
Prepaid expenses		<u>120</u>
Total current assets		8,120
Property, plant and equipment	\$4,300	
Less: Accumulated depreciation	<u>1,100</u>	3,200
Goodwill		1,200
Other assets (non-current)		<u>420</u>
Total assets		<u>\$12,940</u>

Liabilities and Shareholders' Equity

Liabilities		
Current liabilities		
Accounts payable	\$2,000	
Bank loan payable (due in 6 months)	<u>2,000</u>	
Total current liabilities		
Non-current liabilities		\$ 4,000
Long term debt		<u>5,300</u>
Total liabilities		9,300
Shareholders' equity		
Common shares	\$ 640	
Retained earnings	<u>3,000</u>	
Total shareholders' equity		<u>3,640</u>
Total liabilities and shareholders' equity		<u>\$12,940</u>

Ex 152

The following information is available for Hardeep Ltd at December 31, 2012:

Accounts payable	\$ 4,200
Building not currently used, held for sale	9,500
Accumulated depreciation, equipment	4,000
Retained earnings	15,000
Common shares	6,300
Patents	10,000
Accumulated amortization, patents	7,500
Notes payable (due in 5 years)	6,500
Accounts receivable	1,500
Cash	5,600
Short-term (trading) investments	1,000
Land	8,000
Equipment	7,500
Long-term investments	400

Instructions

Use the above information to prepare a classified statement of financial position at December 31, 2012.

Solution 152 (20 min.)

HARDEEP LTD.
Statement of Financial Position
December 31, 2012

<u>Assets</u>		
Current assets		
Cash.....	\$ 5,600	
Short-term (trading) investments.....	1,000	
Accounts receivable.....	<u>1,500</u>	
Total current assets.....		8,100
Investments		
Building held for sale.....	9,500	
Long-term investments.....	<u>400</u>	
Total investments.....		9,900
Property, plant, and equipment		
Land.....		8,000
Equipment.....	\$7,500	
Less Accumulated depreciation, equipment.....	<u>4,000</u>	3,500
Intangible assets		
Patents.....	\$10,000	
Less: Accumulated amortization, patents.....	<u>7,500</u>	<u>2,500</u>
Total assets.....		<u>\$32,000</u>

<u>Liabilities and Shareholders' Equity</u>		
Current liabilities		
Accounts payable		\$ 4,200
Total current liabilities.....		4,200
Non-current liabilities		
Notes payable.....		<u>6,500</u>
Total liabilities		10,700
Shareholders' equity		
Common shares.....	\$ 6,300	
Retained earnings.....	<u>15,000</u>	
Total shareholders' equity.....		<u>21,300</u>
Total liabilities and shareholders' equity.....		<u>\$32,000</u>

Ex. 153

Cuppa Sales Ltd. has just completed *its first year of operations*. Presented below are its income statement and statement of financial position. No dividends were paid during the year.

CUPPA SALES LTD.
Income Statement
Year Ended July 31, 2012

Sales	\$ A
Operating expenses	31,000
Depreciation expense	<u> B</u>
Profit before income tax expense	C
Income tax	<u>1,000</u>
Profit	<u>\$ D</u>

CUPPA SALES LTD.
Statement of Financial Position

E

Assets

Cash		\$ F
Accounts receivable		200
Inventory		5,500
Prepaid rent		600
Equipment	\$13,000	
Accumulated depreciation	<u>G</u>	<u>11,000</u>
Total assets		<u>\$ H</u>

Liabilities and Shareholders' Equity

Accounts payable	\$5,500	
Bank loan payable	<u>I</u>	<u>\$ 7,500</u>
Shareholders' equity		
Common shares (5,000 shares issued)	\$9,300	
Retained earnings	<u>J</u>	
Total shareholders' equity		<u>K</u>
Total liabilities and shareholders' equity		<u>\$19,800</u>

Instructions

Solve for the missing amounts.

Hint: It is not always best to start at the beginning and do things in alphabetical order.

A _____	F _____
B _____	G _____
C _____	H _____
D _____	I _____
E _____	J _____
K _____	

Solution 153 (15 min.)

CUPPA SALES LTD.
Income Statement
Year Ended July 31, 2012

Sales.....	\$37,000
Operating expenses.....	31,000
Depreciation expense.....	<u>2,000</u>
Profit before income tax expense.....	4,000
Income tax.....	<u>1,000</u>
Profit.....	<u>\$ 3,000</u>

CUPPA SALES LTD.
Statement of Financial Position
July 31, 2012

Assets

Current assets		
Cash.....	\$ 2,500	
Accounts receivable.....	200	
Inventory.....	5,500	
Prepaid rent.....	<u>600</u>	\$ 8,800
Equipment.....	\$13,000	
Accumulated depreciation.....	<u>2,000</u>	<u>11,000</u>
Total assets.....		<u>\$19,800</u>

Liabilities and Shareholders' Equity

Current liabilities		
Accounts payable.....	\$5,500	
Bank loan payable.....	<u>2,000</u>	\$ 7,500
Shareholders' equity		
Common shares (5,000 shares issued).....	\$9,300	
Retained earnings.....	<u>3,000</u>	<u>12,300</u>
Total liabilities and shareholders' equity.....		<u>\$19,800</u>

A \$37,000	G \$2,000
B \$2,000	H \$19,800
C \$4,000	I \$2,000
D \$3,000	J \$3,000
E July 31, 2012	K \$12,300
F \$2,500	

Ex. 154

Alberta Springs Limited presents the following condensed data for the year ended December 31, 2012:

Income tax expense	\$ 8,000
Cost of goods sold	1,684,000
Net sales	2,260,000
Operating expenses	517,000
Interest expense	58,000
Dividend revenue	55,000

Instructions

Prepare an income statement for the year ended December 31, 2012.

Solution 154 (15 min.)

ALBERTA SPRINGS LIMITED
Income Statement
Year Ended December 31, 2012

Revenues	
Net sales.....	\$2,260,000
Dividend revenue.....	55,000
Total revenues.....	<u>2,315,000</u>
Expenses	
Cost of goods sold.....	\$1,684,000
Operating expenses.....	517,000
Interest expense.....	<u>58,000</u>
Total expenses.....	<u>2,259,000</u>
Profit before income tax.....	56,000
Income tax expense.....	8,000
Profit.....	<u>\$ 48,000</u>

Ex. 155

Presented below is information on XBRL Ltd.

	<u>2012</u>	<u>2011</u>
Current assets	\$ 85,000	\$ 75,000
Long term assets	125,000	110,000
Current liabilities	60,000	45,000
Total liabilities	110,000	95,000
Common shares	30,000	30,000
Retained earnings	60,000	40,000
Dividends paid on common shares	11,000	15,000
Price-earnings ratio	12	14
Cash	15,000	12,000
Cash provided by financing activities	20,000	0
Cash used in investing activities	18,000	7,000
Weighted average number of shares issued	1,000	1,000

Instructions

Calculate the following for 2012:

- Earnings per share
- Market price per common share
- Working capital
- Current ratio
- Debt to total assets

Solution 155 (15 - 20 min.)

- Earnings per share

Calculate profit

Retained earnings 2011	\$40,000
Less: Dividends paid on common shares	<u>11,000</u>
Subtotal	29,000
Profit	<u>X</u>
Retained earnings 2012	<u>\$60,000</u>

Solving for X, profit = \$31,000

Earnings per share = profit ÷ weighted average number of common shares
= \$31,000 ÷ 1,000 = \$31

- Market price per common share

$$\text{Price-earnings ratio} = \text{Market price per share} \div \text{EPS}$$

Therefore Market price per share = Price-earnings ratio $\times$ EPS = 12 $\times$ \$31 = \$372

- (c) Working capital = current assets – current liabilities
= \$85,000 – \$60,000 = \$25,000
- (d) Current ratio = current assets ÷ current liabilities
= \$85,000 ÷ \$60,000 = 1.4:1
- (e) Debt to total assets = Total liabilities ÷ Total assets
= \$110,000 ÷ (\$85,000 + \$125,000) = 52%

Ex. 156

The following items are taken from the financial statements of La Brea Ltd. for the fiscal year ended December 31, 2012. Note they are in alphabetical order.

Accounts payable	\$ 15,500
Accounts receivable	18,000
Accumulated depreciation—video equipment	30,500
Advertising expense	21,000
Cash	15,000
Common shares (10,000 shares)	90,000
Depreciation expense	12,000
Dividends	5,000
Insurance expense	3,000
Note payable	70,000
Prepaid insurance	6,000
Rent expense	22,000
Retained earnings, January 1, 2012	12,000
Salaries expense	32,000
Salaries payable	3,000
Service revenue	143,000
Supplies	4,000
Supplies expense	6,000
Video equipment	210,000
Income tax expense	10,000

Instructions

- Calculate the profit for the year.
- Calculate the balance of Retained Earnings that would appear on the statement of financial position at December 31, 2012.
- Prepare a classified statement of financial position for La Brea Ltd. at December 31, 2012, assuming the note payable is a non-current liability.
- Calculate the current ratio, debt to total assets, and earnings per share. Assets at the beginning of 2012 totalled \$183,000. No shares were issued or redeemed during the year.

Solution 156 (20 min.)

- (a) Profit is $\$143,000 - \$21,000 - \$12,000 - \$3,000 - \$22,000 - 32,000 - \$6,000 - \$10,000 = \$37,000$
- (b) Retained earnings, January 1 \$12,000

Add: Profit	<u>37,000</u>
	49,000
Less: Dividends	<u>5,000</u>
Retained earnings, December 31	<u>\$44,000</u>

(c)

LA BREA LTD.
Statement of Financial Position
December 31, 2012

<u>Assets</u>	
Current assets	
Cash	\$ 15,000
Accounts receivable	18,000
Supplies	4,000
Prepaid insurance	<u>6,000</u>
Total current assets	43,000
Property, plant and equipment	
Video equipment	\$210,000
Less: Accumulated depreciation—video equipment	<u>30,500</u>
Total assets	<u>\$222,500</u>
<u>Liabilities and Shareholders' Equity</u>	
Current liabilities	
Accounts payable	\$ 15,500
Salaries payable	<u>3,000</u>
Total current liabilities	18,500
Non-current liabilities	
Note payable	<u>70,000</u>
Total liabilities	88,500
Shareholders' equity	
Common shares.....	\$90,000
Retained earnings	<u>44,000</u>
Total liabilities and shareholders' equity	<u>\$222,500</u>

- (d) Current ratio: $\$43,000 \div \$18,500 = 2.3:1$
Debt to total assets: $\$88,500 \div \$222,500 = 39.8\%$
Earnings per share: $\$37,000 \div 10,000 = \3.70

Ex. 157

The following items are taken from the financial statements of Columbia Ltd. for the year ended December 31, 2012:

Income tax expense	\$ 1,000
Accounts payable	19,500
Accounts receivable	4,000
Accumulated depreciation – equipment	4,800
Bonds payable	18,000
Cash	22,000
Common shares (2,500 shares issued)	25,000
Cost of goods sold	12,000
Depreciation expense	4,800

Dividends	300
Equipment	48,000
Goodwill	7,500
Interest expense	3,500
Retained earnings, beginning	16,000
Salaries expense	8,200
Sales revenue	32,500
Supplies	4,500
Market price per common share	\$4.50

Instructions

(a) Prepare an income statement and a classified statement of financial position for Columbia for 2012.

(b) Calculate the following ratios:

1. Current ratio
2. Debt to total assets
3. Earnings per share
4. Price-earnings ratio

Solution 157 (25 min.)

(a)

COLUMBIA LTD.
Income Statement
Year Ended December 31, 2012

Sales revenue		\$32,500
Operating expenses		
Cost of goods sold	\$12,000	
Salaries expense	8,200	
Depreciation expense	4,800	
Interest expense	<u>3,500</u>	<u>28,500</u>
Profit before income tax		4,000
Income tax expense		<u>1,000</u>
Profit		<u>\$ 3,000</u>

COLUMBIA LTD.
Statement of Financial Position
December 31, 2012

Assets

Current assets		
Cash		\$22,000
Accounts receivable		4,000
Supplies		<u>4,500</u>
Total current assets		30,500
Property, plant, and equipment		
Equipment	\$48,000	
Less: Accumulated depreciation—equipment	<u>4,800</u>	43,200
Goodwill.....		<u>7,500</u>
Total assets		<u>\$81,200</u>

Liabilities and Shareholders' Equity

Current liabilities	
Accounts payable	\$19,500

*Retained earnings = \$18,700 (\$16,000 + \$3,000 – \$300)

- ### Ex. 158

Accounts payable	\$28,000	Market price per share	\$ 12.75
Accounts receivable	56,000	Profit	44,000
Weighted average number of common shares	10,000	Other current liabilities	17,000
Cash	54,000	Wages payable	5,000
Dividends	10,000		

(a) Current ratio
(b) Working capital
(c) Earnings per share
(d) Price-earnings ratio

$$\text{Current liabilities} = \$28,000 + \$17,000 + \$5,000 = \$50,000$$

- Current ratio = Current assets $\div$ Current liabilities = \$110,000 $\div$ \$50,000 = 2.2:1
- Working capital = Current assets – Current liabilities = \$110,000 – \$50,000 = \$60,000
- Earnings per share = Profit $\div$ Weighted average number of common shares
= \$44,000 $\div$ 10,000 = \$4.40
- Price-earnings ratio = Market price $\div$ Earnings per share = \$12.75 $\div$ \$4.40 = 2.9

The following data are taken from the financial statements of Estevan Inc.

Weighted average number of common shares	5,000	Market price per share	\$ 5
Average shareholders' equity	\$140,000	Profit	21,000
Dividends	5,000	Net capital expenditures	10,000
Average total assets	210,000	Net sales	150,000
Current assets	150,000	Total liabilities	105,000
Current liabilities	100,000	Total assets	175,000

Instructions

Calculate the following ratios:

- (a) Current ratio
- (b) Working capital
- (c) Earnings per share
- (d) Price-earnings ratio
- (e) Debt to total assets

Solution 159 (15 min.)

- (a) Current ratio = Current assets ÷ Current liabilities = \$150,000 ÷ \$100,000 = 1.5:1
- (b) Working capital = Current assets – Current liabilities = \$150,000 – \$100,000 = \$50,000
- (c) Earnings per share = Profit ÷ Weighted average number of common shares
= \$21,000 ÷ 5,000 = \$4.20
- (d) Price-earnings ratio = Market price per share ÷ Earnings per share
= \$5 ÷ \$4.20 = 1.2
- (e) Debt to total assets = Total debt ÷ Total assets = \$105,000 ÷ \$175,000 = 60%

Ex. 160

The following selected data are taken from the financial statements of Rosco Inc. The data are in alphabetical order.

Accounts payable	\$ 28,000	Net sales	\$500,000
Accounts receivable	65,000	Weighted average number of common shares	5,000
Average assets	320,000	Other current liabilities	15,000
Cash	70,000	Salaries payable	7,000
Market price/share	21.25	Shareholders' equity	169,000
Profit	60,000	Total assets	345,000

Instructions

Calculate the following ratios:

- (a) Current ratio
- (b) Working capital
- (c) Earnings per share
- (d) Price-earnings ratio
- (e) Debt to total assets

Solution 160 (10 min.)

- (a) Current ratio = Current assets ÷ Current liabilities
= \$135,000 ÷ \$50,000 = 2.7:1
- (b) Working capital = Current assets – Current liabilities
= \$135,000 – \$50,000 = \$85,000
- (c) Earnings per share = Profit ÷ Weighted avg. number of common shares
= \$60,000 ÷ 5,000 = \$12

- (d) Price-earnings ratio = Market price per share ÷ Earnings per share
 = \$21.25 ÷ \$12.00 = 1.8
- (e) Debt to total assets = Total liabilities ÷ Total assets
 = \$176,000 ÷ \$345,000 = 51%
 (Total debt = Total assets – Shareholders' equity = \$345,000 – \$169,000 = \$176,000)

Ex. 161

For each of the ratios listed below, indicate by the appropriate code letter, whether it is a liquidity ratio, a profitability ratio, or a solvency ratio.

Code:

- L = Liquidity ratio
 P = Profitability ratio
 S = Solvency ratio

- _____ 1. Earnings per share
 _____ 2. Debt to total assets
 _____ 3. Price-earnings ratio
 _____ 4. Current ratio

Solution 161 (5 min.)

- P 1. Earnings per share
 S 2. Debt to total assets
 P 3. Price-earnings ratio
 L 4. Current ratio

Ex. 162

The following information is available from the 2012 financial statements of Hubble Corp and Bubble Inc.

(amounts in millions, except share price)

	<u>Hubble</u>	<u>Bubble</u>
Sales	\$26,510	\$34,512
Profit	565	1,271
Current assets	11,712	28,447
Beginning total assets	17,102	33,130
Ending total assets	22,088	36,167
Current liabilities	7,966	14,950
Total liabilities	16,136	31,222
Weighted average number of common shares	22	39
Share price	\$79	\$112

Instructions

- (a) For each company, calculate the following ratios:
1. Current ratio
 2. Debt to total assets
 3. Earnings per share
 4. Price-earnings ratio
- (b) Based on your calculations, discuss the relative liquidity, solvency, and profitability of the two companies.

Solution 162 (15 min.)

- (a)
- | | Hubble | Bubble |
|-------------------------|-----------------------------|-----------------------------|
| 1. Current ratio | 1.5:1 (\$11,712 ÷ \$7,966) | 1.9:1 (\$28,447 ÷ \$14,950) |
| 2. Debt to total assets | 73.1% (\$16,136 ÷ \$22,088) | 86.3% (\$31,222 ÷ \$36,167) |
| 3. Earnings per share | \$25.68 (\$565 ÷ 22) | \$32.59 (\$1,271 ÷ 39) |
| 4. Price-earnings ratio | 3.1 (\$79 ÷ \$25.68) | 3.4 (\$112 ÷ \$32.59) |
- (b) Based on the current ratio, Bubble is more liquid than Hubble since its current ratio (1.9:1) is 27% higher than Hubble's ratio (1.5:1). However, Hubble would be considered more solvent than Bubble since its debt to total assets (73.1%) is lower than Bubble's debt to total assets ratio (86.3%). A lower debt to total assets ratio indicates a company is more solvent and better able to survive over a long period of time.

Bubble has a higher earnings per share and price-earnings ratio than Hubble. Bubble's earnings per share (\$32.59) is 26.9% higher than Hubble's earnings per share (\$25.68); as well, Bubble's price-earnings ratio (3.4) is 9.7% higher than Hubble's ratio (3:1).

Ex. 163

Selected information from the comparative financial statements of Scotia River Inc. for the year ended December 31 appears below:

	2012	2011
Cash	\$ 30,000	\$ 20,000
Accounts receivable	150,000	190,000
Inventory	140,000	160,000
Total assets	1,200,000	800,000
Current liabilities	140,000	110,000
Bonds payable	400,000	300,000
Total revenues	1,710,000	700,000
Cost of goods sold	600,000	530,000
Interest expense	50,000	25,000
Income tax expense	60,000	29,000
Profit	150,000	85,000
Cash provided by operating activities	100,000	120,000
Weighted average number of common shares	10,000	8,000

Instructions

Calculate the following ratios for 2012:

- Current ratio.
- Working capital.
- Debt to total assets.
- Earnings per share.

Solution 163 (12 min.)

- Current ratio is 2.3:1.

$$\frac{\$30,000 + \$150,000 + \$140,000}{\$140,000} = 2.3:1$$

- Working capital is \$180,000.

$$(\$30,000 + \$150,000 + \$140,000) - \$140,000 = \$180,000$$

3. Debt to total assets is 45%.

$$\frac{\$140,000 + \$400,000}{\$1,200,000} = 45\%$$

4. Earnings per share is \$15.

$$\frac{\$150,000}{10,000} = \$15$$

Ex. 164

Oldminster Corporation reported the following current assets and current liabilities:

	<u>Dec. 31, 2012</u>	<u>Dec. 31, 2011</u>
Current assets		
Cash	\$ 40,000	\$ 30,000
Short-term investments	40,000	10,000
Accounts receivable	55,000	95,000
Inventory	110,000	90,000
Prepaid expenses	<u>35,000</u>	<u>20,000</u>
Total current assets	<u>\$280,000</u>	<u>\$245,000</u>
Current liabilities		
Accounts payable	\$120,000	\$110,000
Salaries payable	40,000	30,000
Income tax payable	<u>20,000</u>	<u>15,000</u>
Total current liabilities	<u>\$180,000</u>	<u>\$155,000</u>

Instructions

- (a) Calculate the following ratios for 2012:

1. Current ratio.
2. Working capital.

- (b) Explain the purpose of each ratio.

Solution 164 (10-15 min.)

- (a)

1. Current ratio = Current assets ÷ Current liabilities
 $= \$280,000 \div \$180,000$
 $= 1.56:1$
2. Working capital = \$280,000 – \$180,000
 $= \$100,000$

- (b) The purpose of each ratio:

1. The current ratio is a measure of liquidity. For example, for every dollar of current liabilities, the corporation has \$1.56 of current assets.
2. Working capital is a measure of liquidity. When working capital is positive, there is a greater likelihood that the company can pay its liabilities.

Ex. 165

Selected data from O'Shaughnessy Ltd. are presented below:

Weighted average number of common shares	190,000
Share price	\$ 15.48
Profit	245,000
Net sales	1,400,000

Instructions

- Based on the above information, calculate two profitability ratios.
- Explain the purpose of each ratio.

Solution 165 (10-15 min.)

- With the information provided, the profitability ratios that can be calculated are as follows:

- Earnings per share = Profit ÷ Weighted average number of shares
= \$245,000 ÷ 190,000 = \$1.29
- Price-earnings = Market price per share ÷ Earnings per share
= \$15.48 ÷ \$1.29 = 12

- The purpose of each ratio:

- Earnings per share measures the profit for each common share.
- The price-earnings ratio measures the ratio of the market price of each common share to its earnings per share. It reflects the investors' assessment of the company's future profit expectations.

Ex. 166

Insert the characteristics listed below that are associated with relevance and faithful representation.

Confirmatory value	Materiality
Completeness	Free from material errors
Neutral	Predictive value
<u>RELEVANCE</u>	<u>FAITHFUL REPRESENTATION</u>
1. _____	1. _____
2. _____	2. _____
3. _____	3. _____

Solution 166 (5 min.)

<u>RELEVANCE</u>	<u>FAITHFUL REPRESENTATION</u>
1. Confirmatory value	1. Free from material errors
2. Predictive value	2. Completeness
3. Materiality	3. Neutral

Ex. 167

The following terms relate to the characteristics of useful information. Match the key letter of the correct term with the descriptive statement below.

(a) Confirmatory value

(e) Faithful representation

- | | |
|----------------------|-------------------|
| (b) Neutral | (f) Timeliness |
| (c) Predictive value | (g) Verifiability |
| (d) Relevance | |

- _____ 1. Accounting information cannot be selected, prepared, or presented to favour one set of interested users over another.
- _____ 2. Providing information in time to make decisions.
- _____ 3. Providing information that can be confirmed or duplicated by independent parties.
- _____ 4. Providing information that would make a difference in a business decision.
- _____ 5. Providing information that represents economic reality.
- _____ 6. Helping evaluate prior decisions.

Solution 167 (5 min.)

- | | |
|--------|--------|
| 1. (b) | 4. (d) |
| 2. (f) | 5. (e) |
| 3. (g) | 6. (a) |

Ex. 168

For each of the independent situations described below, list the fundamental or enhancing qualitative characteristic that has been violated, if any. List only one term for each case.

- (a) Brunswick Corporation is in its third year of operations and has yet to issue financial statements.
- (b) Ontario Corporation has used different methods for recording the cost of inventory. In the current year, the cost of goods sold is calculated based on the average cost of inventory. Last year, the cost of inventory was calculated based on the actual cost of each item sold. Next year, the company plans to change back to average cost.
- (c) Manitoba Inc. is carrying inventory at its current cost of \$110,000. The inventory has a fair value of \$135,000.
- (d) Saskatchewan Corporation expenses some inexpensive office equipment even though it has a useful life of more than one year.

Solution 168 (5 min.)

- (a) Timeliness
- (b) Comparability (consistency)
- (c) No violation
- (d) No violation (materiality)

MATCHING

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

- | | |
|----------------------|-------------------------|
| A. Relevance | G. Working capital |
| B. Liquidity ratios | H. Current ratio |
| C. Comparability | I. Earnings per share |
| D. Liabilities | J. Solvency ratios |
| E. Intangible assets | K. Price-earnings ratio |
| F. Timeliness | L. Materiality |

- | | |
|-------|---|
| _____ | 1. Measures of the ability of an entity to survive over a long period of time. |
| _____ | 2. Current assets divided by current liabilities. |
| _____ | 3. Information that will make a difference in users' decisions. |
| _____ | 4. Market price per share divided by earnings per share. |
| _____ | 5. An item important enough to influence a prudent investor. |
| _____ | 6. Obligations that result from past transactions. |
| _____ | 7. Noncurrent assets that do not have physical substance. |
| _____ | 8. Profit divided by the weighted average number of common shares. |
| _____ | 9. Different companies using the same accounting principles. |
| _____ | 10. Measures of the short-term ability of the company to pay its maturing obligations. |
| _____ | 11. The excess of current assets over current liabilities. |
| _____ | 12. Information is available to stakeholders before it loses its ability to influence decisions |

ANSWERS TO MATCHING

1. J
2. H
3. A
4. K
5. L
6. D
7. E
8. I
9. C
10. B
11. G
12. F

SHORT-ANSWER ESSAY QUESTIONS

S-A E 170

Give the definition of current assets, current liabilities and the current ratio.

Solution 170

Current assets are cash or other resources that are reasonably expected to be realized in cash or sold or consumed in the business within one year or the operating cycle, if longer. Current liabilities are obligations reasonably expected to be paid from the existing current assets or through the creation of other current liabilities within the next year, or the operating cycle. The current ratio is a measure used to evaluate a company's liquidity and short-term debt paying ability, calculated by dividing current assets by current liabilities.

S-A E 171

Fast Express specializes in overnight transportation of medical equipment and laboratory specimens. The company has selected the following information from its most recent annual report to be the subject of an immediate press release.

- The financial statements are being released.
- Profit this year was \$2.1 million. Last year's, profit was \$1.8 million.
- The current ratio has changed to 2:1 from last year's 1.5:1.
- The debt to total assets ratio has changed to 4:5 from last year's 3:5.
- The company expanded its truck fleet substantially by purchasing ten new delivery vans.
- The company already had twelve delivery vans. The company is now the largest medical courier in the Northern Ontario region.

Instructions

Prepare a brief press release incorporating the information above. Include all information. Think carefully which information (if any) is good news for the company, and which (if any) is bad news.

Solution 171

Fast Express released its financial statements today, disclosing a 17% increase in profit, to \$2.1 million from \$1.8 million last year. The company also improved its short-term liquidity. Its current ratio improved to 2:1 from last year's 1.5:1. Part of the improved performance is no doubt due to the addition of ten new delivery vans to its fleet, allowing it to become the largest medical courier in the Northern Ontario region. The purchase of the vans, however, caused the debt to total assets ratio to increase. There are now \$4 of debt for every \$5 in assets, while last year, there were only \$3 of debt to \$5 in assets.

S-A E 172

Many bonus plans are based upon the attainment of some specified short-term goal. For example, sales personnel at Metal Crafters Limited are given a bonus of 5% of the amount by which their sales exceed \$100,000. Sometimes the attainment of these goals is achieved by methods detrimental to the long-term needs of the company. Sales representative Lisa Allen, for example, finds herself tempted to court certain customers that place large orders, even though she knows they may not be able to pay. She complains that the bonus system itself is unethical.

Instructions

Is a bonus system like the one at Metal Crafters unethical? Explain.

Solution 172

The bonus system described is not necessarily unethical, but it may be short-sighted. When employees are able to identify and address larger concerns (such as Lisa's identification of the problem regarding the ability of a customer to pay) then such issues should probably become part of the system of bonuses. It is very difficult to set a bonus plan that allows for all contingencies, however. Since sales representatives are hired to generate sales, their rewards are most often based on generating sales. Some of the future events, such as customers defaulting on payments, may not be the fault of the sales representative. For Lisa Allen to create sales by soliciting customers with a poor payment record would be unethical on her part. She is required to use integrity, even when the possibility exists of her not using it, and even when she might gain by not using it.

SA-E 173

Comparability is an enhancing qualitative characteristic that makes accounting information useful for decision-making purposes. Briefly explain how comparability affects financial reporting.

Solution 173

Comparability results when a specific company, and similar companies, use the same accounting principles and methods, so that users can identify and understand similarities and differences among items on the financial reports.

S-A E 174

List four enhancing characteristics of useful decision-making information.

Solution 174

To be useful for decision-making, information should have verifiability, timeliness, comparability, and understandability.

S-A E 175

Identify *and describe* the three characteristics information must have in order to provide a faithful representation of economic reality.

Solution 175

In order to achieve faithful representation, information must be complete, neutral and free from material error. Neutral information is free of bias and does not intentionally favour one set of stakeholders over another. Completeness means that all the information that is needed to faithfully represent economic reality must be included, and nothing important is omitted. The statements should be, as far as possible, free from material error. However, this does not mean that there is necessarily 100% accuracy at all times. This is basically impossible given the fact that accounting estimates are frequently necessary.