

Chapter 2

Investing and Financing Decisions and the Statement of Financial Position

Revised: February 23, 2017

ANSWERS TO QUESTIONS

1. The primary objective of financial reporting for external users is to provide useful financial information about a business to help external parties, primarily investors and creditors, make sound financial decisions. These users are expected to have a reasonable understanding of accounting concepts and procedures. Usually, they are interested in information to assist them in projecting future cash inflows and outflows of a business.

2.
 - (a) An asset is an economic resource controlled by an entity as a result of a past transaction or event and from which future economic benefits may be obtained.

 - (b) A current asset is an asset that will be used or turned into cash within one year; inventory is always considered a current asset regardless of how long it takes to produce and sell the inventory.

 - (c) A liability is a probable debt or obligation of the entity as a result of a past transaction, which will be paid with assets or services.

 - (d) A current liability is a liability that will be paid in cash (or other current assets) or satisfied by providing service within the coming year.

 - (e) Contributed capital is cash (and sometimes other assets) provided to the business by owners.

 - (f) Retained earnings are the cumulative net earnings of a company that are not distributed to the owners and are reinvested in the business.

3. To be useful, information must be relevant; that is, it must be timely and have predictive and/or feedback value. Relevant information is any information that is likely to change an investor's decision. However, if the information is not a faithful representation of the economic phenomena it is supposed to represent (complete, neutral and free from material error) it will not be trusted, and thus will not be useful.
4.
 - (a) The separate-entity assumption requires that business transactions are separate from the transactions of the owners. For example, the purchase of a truck by the owner for personal use is not recorded as an asset of the business.
 - (b) The unit-of-measure assumption requires information to be reported in the national monetary unit. That means that each business will account for and report its financial results primarily in terms of the national monetary unit, such as Euros in Germany and Australian dollars in Australia.
 - (c) Under the continuity or going-concern assumption, businesses are assumed to operate into the foreseeable future. That is, they are not expected to liquidate.
 - (d) The (historical) cost principle requires assets to be recorded at the cash-equivalent cost on the date of the transaction. Cash-equivalent cost is the cash paid plus the dollar value of all non-cash considerations.
5. Accounting assumptions are necessary because they reflect the scope of accounting and the expectations that set certain limits on the way accounting information is reported.
6. The current ratio is computed as current assets divided by current liabilities. It measures the ability of the company to pay its short-term obligations with current assets. A high ratio normally suggests good liquidity, but a ratio that is too high may include inefficient use of resources. The general rule was a ratio between 1.0 and 2.0 (twice as many current assets as current liabilities), but sophisticated cash management systems allow many companies to minimize funds invested in current assets and have a current ratio below 1.0.
7. An account is a standardized format used by organizations to accumulate the dollar effects of transactions on each financial statement item. Accounts are necessary to keep track of all increases and decreases in the fundamental accounting model.
8. Historical cost reflects the market value of an asset at the time of acquisition. However, the continued reporting of historical cost subsequent to acquisition does not reflect any change in market value. Accountants continue to report historical costs on statements of financial position because they are more verifiable and objective measures than market values.

9. The fundamental accounting model is provided by the equation:
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$
10. A business transaction is (a) external - an exchange of resources (assets) and obligations (debts) between a business and one or more outside parties, and (b) internal - certain events that have a direct and measurable effect on the business. An example of the first situation (a) is the sale of goods or services. An example of the second situation (b) is a loss incurred due to a fire.
11. Debit is the left side of a T-account and credit is the right side of a T-account. Debits increase asset accounts, and decrease liability and shareholders' equity accounts. Credits decrease asset accounts, and increase liability and shareholders' equity accounts.
12. Transaction analysis is the process of studying a transaction to determine its economic effect on the entity in terms of the accounting equation:
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

The two principles underlying the process are:
- * every transaction affects at least two accounts.
 - * the accounting equation must remain in balance after each transaction.
- The two steps in transaction analysis are:
- (1) identify and classify accounts and effects.
 - (2) determine that the accounting equation ($A = L + SE$) remains in balance.
13. The equalities in accounting are:
- (a) $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$
 - (b) $\text{Debits} = \text{Credits}$
14. The journal entry is a method for expressing the effects of a transaction on accounts in a debits equal credits format. The title of the account(s) to be debited is (are) listed first. The title of the account(s) to be credited is (are) listed underneath the debited account(s), and the account title(s) and amount(s) credited is (are) indented to the right.
15. The T-account is a tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company's activities. It is a simplified representation of a ledger account with a debit column on the left and a credit column on the right.
16. Investing activities on the statement of cash flows include the buying and selling of productive assets and investments. Financing activities include borrowing and repaying debt, issuing and repurchasing shares, and paying dividends.

17. Bookkeeping is only one part of accounting. A bookkeeper records the routine transactions in most businesses and may maintain the records of a small business. An accountant is a highly trained professional, competent in the design of information systems, analysis of complex transactions, interpretation of financial data, financial reporting, auditing, taxation, and management consulting.

**Authors' Recommended Solution Time
(Time in minutes)**

<i>Mini-Exercises</i>		<i>Exercises</i>		<i>Problems</i>		<i>Alternate Problems</i>		<i>Cases and Projects</i>	
<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>	<i>No.</i>	<i>Time</i>
1	3 E	1	10 E	1	15 E	1	15 E	1	20 M
2	3 E	2	10 M	2	25 M	2	35 M	2	25 M
3	4 E	3	15 M	3	50 M	3	55 M	3	20 M
4	4 E	4	10 E	4	15 M	4	15 M	4	30 M
5	5 E	5	10 E	5	60 D	5	70 D	5	30 M
6	3 M	6	10 E	6	15 M	6	15 M	6	20 M
7	3 M	7	10 E	7	30 M	7	30 M	7	45 M
8	6 E	8	10 E	8	40 M	8	25 M	8	30 M
9	6 M	9	10 E					9	30 D
10	6 E	10	15 M					10	*
		11	20 M					<i>Continuing Case</i>	
		12	10 M					1	40 M
		13	15 E						
		14	20 M						
		15	10 M						
		16	10 M						
		17	10 E						
		18	10 M						

E = Easy

M = Moderate

D = Difficult

* Due to the nature of these cases and projects, it is very difficult to estimate the amount of time students will need to complete the assignment. As with any open-ended project, it is possible for students to devote a large amount of time to these assignments. While students often benefit from the extra effort, we find that some become frustrated by the perceived difficulty of the task. You can reduce student frustration and anxiety by making your expectations clear. For example, when our goal is to sharpen research skills, we devote class time discussing research strategies. When we want the students to focus on a real accounting issue, we offer suggestions about possible companies or industries.

MINI-EXERCISES

M2-1

- F (1) Continuity assumption
- H (2) Historical cost principle
- G (3) Credits
- A (4) Assets
- I (5) Account

M2-2

(1) N; (2) N; (3) Y; (4) Y; (5) Y; (6) N;

M2-3

- CL (1) Accounts Payable
- CA (2) Accounts Receivable
- NCA (3) Buildings
- CA (4) Cash
- SE (5) Contributed capital
- NCA (6) Land
- CA (7) Merchandise Inventory
- CL (8) Income Taxes Payable
- NCA (9) Long-Term Investments
- NCL (10) Notes Payable (due in three years)
- CA (11) Notes Receivable (due in six months)
- CA (12) Prepaid Rent
- SE (13) Retained Earnings
- CA (14) Supplies
- CL (15) Utilities Payable
- CL (16) Wages Payable

M2-4

	<u>Assets</u>		=	<u>Liabilities</u>		+	<u>Stockholders' Equity</u>	
a.	Cash	+30,000		Notes payable	+30,000			
b.	Cash	-10,000						
	Notes receivable	+10,000						
c.	Cash	+500					Contributed capital	+500
d.	Cash	-5,000		Notes payable	+10,000			
	Equipment	+15,000						
e.	Cash	-2,000					Retained earnings	-2,000

M2-5

	<u>Debit</u>	<u>Credit</u>	<u>Increase</u>	<u>Decrease</u>
Assets	<i>Increases</i>	<i>Decreases</i>	<i>Debit</i>	<i>Credit</i>
Liabilities	<i>Decreases</i>	<i>Increases</i>	<i>Credit</i>	<i>Debit</i>
Shareholders' equity	<i>Decreases</i>	<i>Increases</i>	<i>Credit</i>	<i>Debit</i>

M2-6

a.	Cash (+A)	30,000	
	Notes Payable (+L)		30,000
b.	Notes Receivable (+A)	10,000	
	Cash (-A)		10,000
c.	Cash (+A)	500	
	Contributed Capital (+SE)		500
d.	Equipment (+A)	15,000	
	Cash (-A)		5,000
	Notes Payable (+L)		10,000
e.	Retained Earnings (-SE)	2,000	
	Cash (-A)		2,000

M2-7

Cash				Notes Receivable		Equipment	
Beg.	900			Beg.	1,000	Beg.	15,100
(a)	30,000	10,000	(b)	(b)	10,000	(d)	15,000
(c)	500	5,000	(d)				
		2,000	(e)				
	<u>14,400</u>				<u>11,000</u>		<u>30,100</u>

Notes Payable	
	3,000 Beg.
	30,000 (a)
	10,000 (d)
	<u>43,000</u>

Contributed Capital		Retained Earnings	
	4,000 Beg.		10,000 Beg.
	500 (c)	(e)	2,000
	<u>4,500</u>		<u>8,000</u>

M2-8

Dennen, Inc. Trial Balance January 31, 2018		
	Debit	Credit
Cash	\$14,400	
Notes receivable	11,000	
Equipment	30,100	
Notes payable		\$43,000
Contributed capital		4,500
Retained earnings		8,000
Totals	\$55,500	\$55,500

M2-9

Dennen Inc.
Statement of Financial Position
At January 31, 2018

Assets		Liabilities	
<i>Current assets:</i>		<i>Current liabilities:</i>	
Cash	\$ 14,400	Notes payable	\$ 43,000
Notes receivable	<u>11,000</u>	Total current liabilities	<u>43,000</u>
Total current assets	25,400	Shareholders' Equity	
Equipment	30,100	Contributed capital	4,500
		Retained earnings	<u>8,000</u>
		Total shareholder	12,500
		Shareholders' equity	<u>12,500</u>
Total Assets	<u>\$55,500</u>	Total Liabilities & Shareholders' Equity	<u>\$55,500</u>

M2-10

- (a) F
- (b) I
- (c) F
- (d) I
- (e) F

EXERCISES

E2-1

- E (1) Transaction
- F (2) Continuity assumption
- B (3) Statement of Financial Position
- O (4) Liabilities
- K (5) $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$
- L (6) Note payable
- H (7) Historical cost principle
- I (8) Account
- P (9) Dual effects
- N (10) Retained earnings
- A (11) Current assets
- C (12) Separate-entity assumption
- D (13) Debits
- J (14) Accounts receivable
- M (15) Stable monetary unit assumption
- Q (16) Shareholders' equity

E2-2

- H (1) Relevance
- C (2) Timeliness
- E (3) Predictive value
- F (4) Confirmatory value
- J (5) Verifiability
- B (6) Faithful representation
- D (7) Neutrality
- G (8) Comparability
- A (9) Consistency

Document Qualitative Characteristics

1. This document is relevant to the decision at hand because it has predictive value. Paula will be concerned if Mak will be able to make future payments and this will depend on future sales and cash flow for Mak. However such expectations may not have faithful representation. The sales did not occur yet, so it is not possible to determine if they are complete or free from material error. Furthermore, the projected sales may not be neutral because Tim Mak may wish to show a favourable image of the company in order to receive credit from Pinnacle.

2. Sales projections are similar to the previous document in that they have some relevance, and they may not have faithful representation as these projections are based on assumptions about the future and not facts. Projecting sales five years into the future is more difficult than projecting sales for one year and therefore would likely have less faithful representation. They are not as relevant as the one-year forecast as Paula will be looking at short term payments not five years.

3. The monthly bank statements have faithful representation. The events that affected the bank balance occurred already and are supported by documents. They should, therefore, be complete and free from material error. They are prepared by a third party and should be neutral. They have some relevance to the decision because they reflect the previous cash position of the company and its ability to meet its obligations in the past. They are relevant to the extent that the past is indicative of the future.

4. The report on Mak's credit history is relevant as it may reveal any difficulties the company may have faced in the past. However, the fact that it was prepared by employees and not an independent source means it has less faithful representation – the information may not be neutral as the employees have a vested interest in having the credit approved.

5. The letter with personal guarantees provided by the four company officers is relevant because they provide assurance that any default on the payable will be covered by the company officers individually and collectively. This may give Paula additional security in terms of amounts owing. However without information on the financial position of the officers the information is incomplete and therefore does not have a high level of representational faithfulness.

E2-3 (continued)

6. The résumés of the four company officers may be of some use in the credit decision and future dealings with the company. For example, the credit manager may be more likely to lend money to a company with qualified officers, including a financial professional. This indicates some relevance to the decision. The information would not have a high level of faithful representation as it is prepared by the company and is not neutral.
7. The letters of reference may provide useful information about the company officers, but they may not be neutral if they are written by their close friends and relatives. Hence, they do not have a high level of faithful representation, and therefore may not be relevant to the decision at hand.

E2-4

(1) Y; (2) N; (3) Y; (4) N; (5) N; (6) Y.

E2-5

Req. 1

	<u>Given</u>	<u>Received</u>	
(a)	Cash	Land	
(b)	Cash and Note payable	Patents	
(c)	Note payable	Computer equipment	
(d)	Cash	Prepayments	<i>Future services</i>
(e)	Cash	Construction in progress	<i>or Building</i>
(f)	Cash	Copyright	
(g)	Cash	Delivery truck	
(h)	Accounts payable	Merchandise inventory	<i>Promise to pay</i>
(i)	Contributed capital	Cash	
(j)	Cash	Investments	
(k)	—	—	<i>No exchange transaction</i>
(l)	Cash	Retained earnings	
(m)	Cash	Note payable	<i>Reduced promise to pay</i>

Req. 2

The land in (a) would be recorded as an asset at \$100,000. The truck in (g) would be recorded as an asset of \$32,000. These are applications of the cost principle.

E2-5 (continued)

Req. 3

The agreement in (k) occurs between the owner and others. There is no effect on the business because of the separate-entity assumption.

E2-6

<i>Account</i>	<i>Statement of Financial Position Classification</i>	<i>Debit or Credit Balance</i>
1.	CL	Credit
2.	CA	Debit
3.	SE	Credit
4.	NCA	Debit
5.	CA	Debit
6.	NCL	Credit
7.	CA	Debit
8.	NCA	Debit
9.	SE	Credit
10.	CL	Credit
11.	CA	Debit

E2-7

<u>Event</u>	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Shareholders' Equity</u>
a.	Cash +32,000				Contributed capital +32,000
b.	Land +18,000		Mortgage note payable +12,000		
	Cash -6,000				
c.	Cash +11,000		Note payable +11,000		
d.	Note receivable +300				
	Cash -300				
e.	Cash -11,000		Note payable -11,000		
f.	Equipment +8,000		Notes payable +4,000		
	Cash -4,000				

E2-8

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Shareholders' Equity</u>
a.	Property and equipment	+186.7			
	Cash	-186.7			
b.	Cash	-225.2			Contributed capital -225.2
c.	Cash	-130.5	Dividends payable	-20.3	Retained earnings -110.2
d.	<i>No effect</i>				
e.	Cash	-7.7	Long-term notes payable	-7.7	
f.	Cash	-175.9			Retained earnings or Income tax payable -175.9

E2-9

a.	Cash (+A)	32,000	
	Contributed capital (+SE)		32,000
b.	Land (+A)	18,000	
	Cash (-A)		6,000
	Mortgage note payable (+L)		12,000
c.	Cash (+A)	11,000	
	Note payable (+L)		11,000
d.	Note receivable (+A)	300	
	Cash (-A)		300
e.	Note payable (-L)	11,000	
	Cash (-A)		11,000
f.	Equipment (+A)	8,000	
	Cash (-A)		4,000
	Note payable (+L)		4,000

E2-10

Req. 1

a.	Cash (+A) Contributed capital (+SE)	63,000	63,000
b.	Equipment (+A) Cash (-A) Short-term note payable (+L)	16,000	4,000 12,000
c.	No journal entry required because no delivery of services has yet occurred.		
d.	Short-term note receivable (+A) Cash (-A)	2,500	2,500
e.	Cash (+A) Land (+A) Contributed capital (+SE)	6,000 15,000	21,000
f.	Short-term note payable (-L) Cash (-A)	12,000	12,000
g.	This transaction occurs between an owner and others, there is no effect on the business due to the separate-entity assumption.		

Req. 2

Cash		Short-Term Note Receivable		Equipment	
Beg.	0	Beg.	0	Beg.	0
(a)	63,000	(d)	2,500	(b)	16,000
(e)	6,000				
	4,000 (b) 2,500 (d) 12,000 (f)				
<u>50,500</u>		<u>2,500</u>		<u>16,000</u>	

Land		Short-Term Note Payable		Contributed Capital	
Beg.	0	0 Beg.	0	0 Beg.	0
(e)	15,000	(f)	12,000	63,000 (a)	63,000
			12,000 (b)	21,000 (e)	21,000
<u>15,000</u>		<u>0</u>		<u>84,000</u>	

Req. 3

Assets = \$50,500 + 2,500 + 16,000 + 15,000 = \$84,000

Assets \$ 84,000 = Liabilities \$ 0 + Shareholders' Equity \$ 84,000.

E2-11

Req. 1

Transaction	Brief Explanation
1	Issued shares to investors for \$15,000 cash. (FastTrack Sports Inc. is a corporation.)
2	Borrowed \$75,000 cash and signed a short-term note for this amount.
3	Purchased land for \$16,000; paid \$5,000 cash and signed a short-term note payable for the balance, \$11,000.
4	Loaned \$4,000 cash; the borrower signed a short-term note for this amount (Note Receivable).
5	Purchased store fixtures for \$9,500 cash.
6	Purchased land for \$4,000, paid for by signing a short-term note.

Req. 2

**FastTrack Sports Inc.
Statement of Financial Position
At January 7, 2017**

Assets		Liabilities	
<i>Current Assets</i>		<i>Current Liabilities</i>	
Cash	\$ 71,500	Note payable	\$ 90,000
Note receivable	<u>4,000</u>	<i>Total Current Liabilities</i>	<u>90,000</u>
<i>Total Current Assets</i>	75,500		
Store fixtures	9,500	Shareholders' Equity	
Land	<u>20,000</u>	Contributed capital	<u>15,000</u>
		<i>Total Shareholders' Equity</i>	<u>15,000</u>
		Total Liabilities and Shareholders' Equity	
Total Assets	<u><u>\$105,000</u></u>		<u><u>\$105,000</u></u>

E2-12

Req. 1

Transaction	Brief Explanation
1	Issued shares to shareholders for \$50,000 cash.
2	Purchased delivery truck for \$25,000; paid \$4,000 cash and gave a \$21,000 note payable for the balance.
3	Loaned \$4,000 cash; borrower signed a short-term interest-bearing note for this amount.
4	Purchased investments for \$6,000 cash.
5	Paid \$3,000 on Note Payable.
6	Sold investments at cost for \$2,000 cash.
7	Issued shares to shareholders for \$4,000 in exchange for computer equipment.

Req. 2

Faye's Fashions, Inc.
Statement of Financial Position
As at March 31, 2018

Assets		Liabilities	
<i>Current Assets</i>		Long-term note payable	\$18,000
Cash	\$35,000	<i>Total Liabilities</i>	<u>18,000</u>
Short-term investments	4,000		
Short-term note receivable	<u>4,000</u>		
<i>Total Current Assets</i>	43,000		
<i>Noncurrent Assets</i>		Shareholders' Equity	
Computer equipment	4,000	Contributed capital	<u>54,000</u>
Delivery truck	<u>25,000</u>	<i>Total Shareholders' Equity</i>	<u>54,000</u>
Total Assets	<u>\$72,000</u>	Total Liabilities and Shareholders' Equity	<u>\$72,000</u>

E2-13

(Amounts are in millions of euros)

a.	Dividends declared (or Retained earnings) (-SE).....	937	
	Dividend payable (+L)		937
b.	Cash (+A)	19	
	Contributed capital (+SE)		19
c.	Dividends payable (-L).....	1,516	
	Cash (-A)		1,516
d.	Cash (+A)	7,977	
	Note payable – long-term (+L).....		7,977
e.	Notes receivable – short term (+A)	27	
	Cash (-A)		27
f.	Equipment (+A)	6,890	
	Cash (-A)		5,236
	Note payable (+L)		1,654
g.	Investments (+A).....	2,073	
	Cash (-A)		2,073

E2-14

Req. 1

Assets \$5,500 = Liabilities \$ 2,500 + Shareholders' Equity \$3,000

Req. 2

Cash		Short-Term Investments		Property and Equipment	
Beg.	1,000	Beg.	2,000	Beg.	2,500
(b)	1,000		1,000 (b)		1,250 (c)
(c)	1,250				
(d)	2,000				
End.	<u>4,600</u>	End.	<u>1,000</u>	End.	<u>1,250</u>

Short-Term Notes Payable		Long-Term Notes Payable	
	2,200 Beg.	(a)	300 Beg.
		150	2,000 (d)
	<u>2,200</u> End.		<u>2,150</u> End.

Contributed Capital		Retained Earnings	
	1,000 Beg.	(e)	2,000 Beg.
		500	
	<u>1,000</u> End.		<u>1,500</u> End.

Req. 3

Assets \$ 6,850 = Liabilities \$ 4,350 + Shareholders' Equity \$ 2,500

E2-14 (continued)

Req. 4

Massimo Company
Statement of Financial Position
As at December 31, 2017

Assets		Liabilities	
<i>Current Assets</i>		Short-term notes payable	\$2,200
Cash	\$4,600	Long-term notes payable	<u>\$2,150</u>
Short-term investments	<u>1,000</u>	<i>Total Liabilities</i>	4,350
<i>Total Current Assets</i>	5,600	Shareholders' Equity	
Property and equipment	<u>1,250</u>	Contributed capital	1,000
		Retained earnings	<u>1,500</u>
		Total Shareholders' Equity	<u>2,500</u>
Total Assets	<u><u>\$6,850</u></u>	Total Liabilities and Shareholders' Equity	<u><u>\$6,850</u></u>

Req. 5

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$5,600}{\$2,200} = 2.55$$

This ratio indicates that, for every \$1 of current liabilities, Massimo has \$2.55 in current assets. Massimo's ratio is much higher than the industry average of 1.50, indicating that Massimo maintains a relatively high level of current assets than does the average firm in the industry. Although Massimo's current ratio is relatively high, and may be able to pay back short-term bank loans, one has to take into consideration its long-term note payable as well. Massimo's liabilities are about twice the size of its equity. As a result, lenders may demand a higher interest rate to compensate for the risk associated with lending to this company. Massimo should consider issuing shares instead.

E2-15

Transaction	Brief Explanation
(a)	Issued shares to shareholders in exchange for \$17,000 in cash and \$3,000 in tools and equipment.
(b)	Purchased a building for \$50,000; paid \$10,000 cash and signed a note for \$40,000 .
(c)	Loaned \$1,500 cash; received a note signed by the borrower.
(d)	Collected \$500 from the note receivable in (c).
(e)	Paid \$1,000 on note payable in (b).
(f)	Sold tools and equipment for their original cost of \$800.

E2-16

Req. 1

	<u>Increases with...</u>	<u>Decreases with...</u>
Equipment	Purchase of equipment	Sale of equipment
Note receivable	Additional loans made to others	Collection of loans made to others
Notes payable	Additional borrowings	Payments of debt

Req. 2

Equipment			Note Receivable			Notes Payable		
1/1	500		1/1	150			100	1/1
	250	650		245	225		90	170
12/31	100		12/31	170			180	12/31

	Beginning balance	+	Increases	-	Decreases	=	Ending balance
Equipment	\$500	+	250	-	X	=	\$100
					X	=	<u>650</u>
Note receivable	150	+	X	-	225	=	170
					X	=	<u>245</u>
Note payable	100	+	170	-	X	=	180
					X	=	<u>90</u>

E2-17

Activity	Type of Activity	Effect on Cash
(a) Issuance of shares	F	+
(b) Purchase of property, plant, and equipment	I	-
(c) Issuance of long-term debt	F	+
(d) Principal repayment of long-term debt	F	-
(e) Purchase of investments	I	-
(f) Repurchase of shares	F	-
(g) Proceeds from disposition of property, plant, and equipment	I	+

E2-18

Hilton Hotels Corporation
Partial Statement of Cash Flows
For the year ended December 31, 2017

Investing Activities

Purchase of investments	\$ (139)
Purchase and renovation of properties	(370)
Sale of property	230
Receipt of payment on a note receivable	125
<i>Cash flow from investing activities</i>	<u>\$ (154)</u>

Financing Activities

Additional borrowing from creditors	\$ 992
Payment of debt principal	(24)
Issuance of shares	60
<i>Cash flow from financing activities</i>	<u>\$ 1,028</u>

PROBLEMS

P2-1

<i>Account</i>	<i>Statement of Financial Position Classification</i>	<i>Debit or Credit Balance</i>
(1)	CA	Debit
(2)	NCL	Credit
(3)	SE	Credit
(4)	CL	Credit
(5)	CA	Debit
(6)	SE	Credit
(7)	NCA	Debit
(8)	CL	Credit
(9)	CL	Credit
(10)	CL	Credit
(11)	NCA	Debit
(12)	NCA	Debit
(13)	CA	Debit
(14)	NCL	Credit

P2-2

Req. 1

East Hill Home Healthcare Services was organized as a corporation. Only a corporation issues shares of capital to its owners in exchange for their investment, as in transaction (a).

Req. 2 (on next page)

Req. 3

The transaction between the two shareholders (event *e*) was not included in the tabulation. Since the transaction in (*e*) occurs between the shareholders, there is no effect on the business due to the separate-entity assumption.

Req. 4

$$(a) \quad \text{Total assets} = \$111,500 + \$18,000 + \$5,000 + \$510,500 + \$160,000 + \$65,000 \\ = \$870,000$$

$$(b) \quad \text{Total liabilities} = \$100,000 + \$180,000 = \$280,000$$

$$(c) \quad \text{Total shareholders' equity} = \text{Total assets} - \text{Total liabilities} \\ = \$870,000 - \$280,000 = \$590,000$$

$$(d) \quad \text{Cash balance} = \$50,000 + \$90,000 - \$9,000 + \$3,500 - \$18,000 - \$5,000 = \$111,500$$

$$(e) \quad \text{Total current assets} = \text{Cash } \$111,500 + \text{Short-Term Investments } \$18,000 \\ + \text{Notes Receivable } \$5,000 = \$134,500$$

Req. 5

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$134,500}{\$100,000} = 1.35$$

This suggests that for every \$1 in current liabilities, East Hill maintains \$1.35 in current assets. The ratio suggests that East Hill is likely maintaining adequate liquidity and using resources efficiently.

P2-2 (continued)

Req. 2

	Assets						=	Liabilities		+	Stockholders' Equity	
	Cash	Short-Term Investments	Notes Receivable	Land	Buildings	Equipment	ST Notes Payable	LT Notes Payable	Contributed Capital	Retained Earnings		
Beg.	50,000			500,000	100,000	50,000	100,000	100,000	100,000	400,000		
(a)	+90,000								+90,000			
(b)	-9,000			+14,000	+60,000	+15,000		+80,000				
(c)	+3,500			-3,500								
(d)	-18,000	+18,000										
(e)	No effect											
(f)	-5,000		+5,000									
	<u>+111,500</u>	<u>+18,000</u>	<u>+5,000</u>	<u>+510,500</u>	<u>+160,000</u>	<u>+65,000</u>	<u>+100,000</u>	<u>+180,000</u>	<u>+190,000</u>	<u>+400,000</u>		
	\$870,000							\$280,000			\$590,000	

P2-3

Req. 1 and 2

Cash				Investments (Short-term)		Accounts Receivable	
Beg.	21,000			Beg.	2,000	Beg.	3,000
(b)	12,000	6,000	(a)	(d)	9,000		
(f)	12,000	7,000	(c)				
(j)	1,000	9,000	(d)	End.	<u>11,000</u>	End.	<u>3,000</u>
		5,000	(e)				
		3,000	(g)				
		9,000	(h)				
End.	<u>7,000</u>			End.	<u>24,000</u>		

Equipment				Factory Building		Intangibles	
Beg.	48,000			Beg.	90,000	Beg.	3,000
(a)	18,000	1,000	(j)	(h)	25,000	(g)	3,000
End.	<u>65,000</u>			End.	<u>115,000</u>	End.	<u>6,000</u>

Accounts Payable				Accrued Liabilities		Short-Term Borrowings	
		15,000	Beg.			2,000	Beg.
		15,000	End.			2,000	End.

Notes Payable (Long-term)				Contributed Capital		Retained Earnings	
		48,000	Beg.			90,000	Beg.
		16,000	(h)			12,000	(b)
		64,000	End.			102,000	End.

Short-Term Borrowings			
		7,000	Beg.
(e)	5,000	12,000	(a)
		12,000	(f)
		26,000	End.

Req. 3

No effect was recorded for (i). The agreement in (i) involves no exchange or receipt of cash, goods, or services and thus is not a transaction.

P2-3 (continued)

Req. 4

Injection Plastics Company		
Trial Balance		
At December 31, 2018		
	Debit	Credit
Cash	\$ 7,000	
Investments (short-term)	11,000	
Accounts receivable	3,000	
Inventory	24,000	
Notes receivable (long-term)	8,000	
Equipment	65,000	
Factory building	115,000	
Intangibles	6,000	
Accounts payable		\$ 15,000
Accrued liabilities		2,000
Short-term borrowings		26,000
Notes payable (long-term)		64,000
Contributed capital		102,000
Retained earnings		30,000
Totals	\$239,000	\$239,000

P2–3 (continued)

Req. 5

Injection Plastics Company
Statement of Financial Position
As at December 31, 2018

Assets		Liabilities	
<i>Current Assets</i>		<i>Current Liabilities</i>	
Cash	\$ 7,000	Accounts payable	\$ 15,000
Investments	11,000	Accrued liabilities	2,000
Accounts receivable	3,000	Short-term Borrowings	26,000
Inventories	24,000	<i>Total Current Liabilities</i>	43,000
<i>Total Current Assets</i>	45,000	<i>Non-current Liabilities</i>	
<i>Non-current Assets</i>		Notes payable	64,000
Notes receivable	8,000	<i>Total Liabilities</i>	107,000
Equipment	65,000	Shareholders' Equity	
Factory building	115,000	Contributed capital	102,000
Intangibles	6,000	Retained earnings	30,000
	Total Assets	<i>Total Shareholders' Equity</i>	132,000
	\$239,000	Total Liabilities and Shareholders' Equity	\$239,000

Req. 6

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$45,000}{\$43,000} = 1.05$$

This suggests that for every \$1 in current liabilities, Injection Plastics Company has \$1.05 in current assets. Analysis of the current assets indicates that inventory makes up about 50 percent of these assets. This may present a potential problem if demand for this inventory drops causing the company to sell it at less than its carrying amount. Otherwise, the company should be able to settle its short-term obligations as they become due.

P2-4

Transaction	Type of Activity	Effect on Cash
(a)	I	-
(b)	F	+
(c)	I	-
(d)	I	-
(e)	F	-
(f)	F	+
(g)	I	-
(h)	I	-
(i)	Not applicable	Not applicable
(j)	I	+

P2-5

(Amounts are in millions of euros)

Req. 1

a.	Cash (+A)	60	
	Contributed capital (+SE)		60
b.	Cash (+A)	615	
	Financial liabilities (+L)		615
c.	Retained earnings (-SE)	560	
	Cash (-A)		560
d.	Intangibles (+A)	64	
	Cash (-A)		64
e.	Property, plant, and equipment (+A)	6,924	
	Cash (-A)		1,514
	Financial liabilities (+L)		5,410
f.	Investments (+A)	623	
	Cash (-A)		623
g.	Receivables (+A)	125	
	Cash (-A)		125
h.	Cash (+A)	461	
	Investments (-A)		461

P2-5 (continued)

Req. 2

Cash and Cash Equivalents

Beg.	1,853		
(a)	60	560	(c)
(b)	615	64	(d)
		1,514	(e)
		623	(f)
		125	(g)
(h)	461		
	<u>103</u>		

Receivables

Beg.	10,585
(g)	125
	<u>10,710</u>

Other Assets (Current)

Beg.	1,311
	<u>1,311</u>

Inventories

Beg.	8,478
	<u>8,478</u>

Investments

Beg.	223	
(f)	623	461 (h)
	<u>385</u>	

Property, Plant and Equipment

Beg.	11,428
(e)	6,924
	<u>18,352</u>

Goodwill

Beg.	16,168
	<u>16,168</u>

Intangible Assets

Beg.	15,653
(d)	64
	<u>15,717</u>

Other Assets

Beg.	4,535
	<u>4,535</u>

Trade Accounts Payable (Current)

	5,363	Beg.
	<u>5,363</u>	

Financial Liabilities (Current)

	3,376	Beg.
	<u>3,376</u>	

Provisions (Short Term)

	4,912	Beg.
	<u>4,912</u>	

Other Current Liabilities

	1,852	Beg.
	<u>1,852</u>	

Provisions (Long-Term)

	14,252	Beg.
	<u>14,252</u>	

Deferred Income Taxes

	689	Beg.
	<u>689</u>	

P2-5 (continued)

Financial Liabilities (Long-term)		Other liabilities (Long-term)		Contributed Capital	
	18,484 Beg.		1,088 Beg.		8,284 Beg.
	615 (b)				
	5,410 (e)				60 (a)
	<u>24,509</u>		<u>1,088</u>		<u>8,344</u>
Retained Earnings					
	11,934 Beg.				
(c)	560				
	<u>11,374</u>				

P2-5 (continued)

Req. 3

BAYER AG
Statement of Financial Position
at December 31, 2015
(in millions of Euros)

ASSETS

<i>Current assets</i>	
Cash and cash equivalents	103
Receivables	10,710
Inventories	8,478
Other assets	<u>1,311</u>
Total current assets	<u>20,602</u>
<i>Non-current assets</i>	
Investments	385
Property, plant, and equipment	18,352
Goodwill	16,168
Intangible assets	15,717
Other assets	<u>4,535</u>
Total non-current assets	<u>55,157</u>
Total assets	<u>75,759</u>

LIABILITIES AND SHAREHOLDERS' EQUITY

<i>Current liabilities</i>	
Trade accounts payable	5,363
Financial liabilities	3,376
Provisions	4,912
Other short-term liabilities	<u>1,852</u>
Total current liabilities	<u>15,503</u>
<i>Non-current liabilities</i>	
Provisions	14,252
Deferred income taxes	689
Financial liabilities	24,509
Other liabilities	<u>1,088</u>
Total non-current liabilities	<u>40,538</u>
Total liabilities	<u>56,041</u>
<i>Shareholders' equity</i>	
Contributed capital	8,344
Retained earnings	<u>11,374</u>
Total shareholders' equity	<u>19,718</u>
Total liabilities and shareholders' equity	<u>75,759</u>

P2-5 (continued)

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$20,602}{\$15,503} = 1.33$$

This suggests that for every \$1 in current liabilities, Bayer has \$1.33 in current assets. The ratio suggests that Bayer is likely maintaining adequate liquidity and using resources efficiently.

P2-6

BAYER AG
Partial Statement of Cash Flows
For the year ended December 31, 2015
(in millions of Euros)

INVESTING ACTIVITIES

Purchase of investments	(623)
Sale of investments	461
Purchase of property, plant, and equipment ¹	(1,514)
Purchase of intangibles	(64)
Loan to associated company	(125)
Cash flow used in investing activities	<u>(1,865)</u>

FINANCING ACTIVITIES

Borrowings from banks	615
Payment of dividends	(560)
Issuance of shares	60
Cash flow used in financing activities	<u>115</u>

Proof:

Ending cash per T-account	€ 103
Less beginning balance	<u>1,853</u>
Decrease	€ <u>1,750</u>
Cash flow used in investing activities	€(1,865)
Cash flow from investing activities	<u>115</u>
Net decrease	<u>€(1,750)</u>

¹ Only the portion of the acquisition financed by cash is disclosed in this statement.

P2-7

Req. 1

Le Château Inc.
Statements of Financial Position
As at January 31
(in thousands of dollars)

	Current Year	Prior Year
Assets	\$	\$
Cash	–	1,195
Accounts receivable	1,180	2,025
Inventories	113,590	115,357
Prepaid expenses and other current assets	<u>1,954</u>	<u>1,698</u>
Total current assets	116,724	120,275
Property and equipment, net	48,332	58,091
Intangible assets	<u>3,434</u>	<u>2,961</u>
Total Assets	<u>168,490</u>	<u>181,327</u>
Liabilities		
Accounts payable and accrued liabilities	<u>17,865</u>	<u>16,133</u>
Short-term debt	<u>14,957</u>	<u>17,422</u>
Deferred revenue	<u>3,216</u>	<u>3,452</u>
Total current liabilities	36,038	37,007
Non-current liabilities		
Long-term debt	<u>61,132</u>	<u>39,510</u>
Other non-current liabilities	<u>10,966</u>	<u>12,827</u>
Total Liabilities	<u>108,136</u>	<u>89,344</u>
Shareholders' Equity		
Contributed capital	56,522	52,406
Retained earnings	<u>3,832</u>	<u>39,577</u>
Total Shareholders' Equity	<u>60,354</u>	<u>91,983</u>
Total Liabilities and Shareholders' Equity	<u>168,490</u>	<u>181,327</u>

Req. 2

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$116,724}{\$36,038} = 3.24$$

This ratio suggests that for every \$1 in current liabilities, Le Château Inc. has \$3.24 in current assets. Analysis of the current assets indicates that they consist mainly of inventories. While this represents a high margin of safety for creditors, it also indicates that the company may not be using its cash resources efficiently to generate income for shareholders.

P2-8

Req. 1

Cash		Short-Term Note Receivable		Land	
Beg.	0	Beg.	0	Beg.	0
(a)	40,000	(d)	4,000	(b)	16,000
	5,000 (c)		4,000 (h)		4,000 (d)
(h)	4,000				
	2,000 (e)				
	6,000 (f)				
	5,000 (i)				
	<u>26,000</u>		<u>0</u>		<u>12,000</u>
Equipment		Short-Term Notes Payable		Long-Term Notes Payable	
Beg.	0		0 Beg.		0 Beg.
(c)	20,000		16,000 (b)	(i)	5,000
(e)	2,000				15,000 (c)
(f)	16,000				
	10,000 (f)				
	<u>28,000</u>		<u>16,000</u>		<u>10,000</u>
Contributed Capital					
	0 Beg.				
	40,000 (a)				
	<u>40,000</u>				

P2–8 (continued)

Req. 2

Lee Delivery Company
Statement of Financial Position
As at December 31, 2017

Assets		Liabilities	
<i>Current Assets</i>		<i>Current Liabilities</i>	
Cash	\$26,000	Short-term notes payable	\$16,000
		<i>Total Current Liabilities</i>	16,000
<i>Total Current Assets</i>	26,000	Long-term notes payable	10,000
<i>Non-current Assets</i>		<i>Total Liabilities</i>	26,000
Land	12,000		
Equipment	28,000	Shareholders' Equity	
		Contributed capital	40,000
		<i>Total Shareholders' Equity</i>	40,000
Total Assets	\$66,000	Total Liabilities and Shareholders' Equity	\$66,000

2017:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$26,000}{\$16,000} = 1.63$$

Req. 3

2018:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$52,000}{\$23,000} = 2.26$$

2019:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$47,000}{\$40,000} = 1.18$$

The current ratio increased in 2018 and then decreased in 2016, suggesting that the company's liquidity is decreasing. Although the company still maintains sufficient current assets to settle the short-term obligations, this steep decline in the ratio may be of concern – it may be indicative of more efficient use of resources or it may suggest the company is having cash flow problems.

Req. 4

The management of Lee Delivery Company has already been financing the company's development through additional short-term debt, from \$16,000 in 2017 to \$40,000 in 2016. This suggests the company is taking on increasing risk. Additional lending, particularly short-term, to the company may be too much risk for the bank to absorb. Based solely on the current ratio, the bank's vice president should consider not providing the loan to the company as it currently stands. Of course, additional analysis would provide better information for making a sound decision.

ALTERNATE PROBLEMS

AP2-1

<i>Account</i>	<i>Statement of Financial Position Classification</i>	<i>Debit or Credit Balance</i>
(1)	CA	Debit
(2)	CL	Credit
(3)	SE	Credit
(4)	NCL	Credit
(5)	CA	Debit
(6)	NCA	Debit
(7)	NCA	Debit
(8)	SE	Credit
(9)	CL	Credit
(10)	CA	Debit
(11)	CL	Credit
(12)	NCL	Credit
(13)	CA	Debit
(14)	CL	Credit

AP2-2

Req. 1 (on next page)

Req. 2

Since the transaction in (i) occurs between the shareholder and other person outside the company, there is no effect on the business due to the separate-entity assumption.

Req. 3

a. Total assets = \$35,000 + \$2,000 + \$85,000 + \$107,000 + \$510,000 = \$739,000

b. Total liabilities = \$169,000 + \$170,000 = \$339,000

c. Total shareholders' equity = Total assets – Total liabilities
= \$739,000 – \$339,000 = \$400,000

d. Cash balance = \$120,000 + \$110,000 – \$3,000 + \$100,000 – \$5,000 – \$2,000
– \$200,000 – \$85,000 = \$35,000

e. Total current assets = \$35,000 + \$2,000 = \$37,000

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$35,000 + \$2,000}{\$169,000} = \frac{\$37,000}{\$169,000} = 0.22$$

This suggests that Adamson may not have sufficient liquidity to cover its current obligations. Adamson should consider increasing its current assets or seeking to convert some of its short-term debt to long-term debt.

AP2-2 (continued)

Req. 1

	Assets					=	Liabilities		+	Shareholders' Equity	
	Cash	Notes Receivable	Long-Term Investments	Equipment	Building		Short-Term Notes Payable	Long-Term Notes Payable		Contributed Capital	Retained Earnings
Beg.	120,000			70,000	310,000	=	140,000	60,000		220,000	80,000
(a)	+110,000					=		+110,000			
(b)	-3,000			+30,000		=	+27,000				
(c)	+100,000					=				+100,000	
(d)	-5,000			+10,000		=	+5,000				
(e)	-2,000	+2,000				=					
(f)	-200,000				+200,000	=					
(g)	-85,000		+85,000			=					
(h)				-3,000		=	-3,000				
(i)	No effect					=					
	+35,000	+2,000	+85,000	+107,000	+510,000	=	+169,000	+170,000		+320,000	+80,000
	\$739,000						\$339,000			\$400,000	

AP2-3

Req. 1 and 2

Cash and Cash Equivalents		
Beg.	50,675	
(a)	630	14,000 (b)
(d)	600	3,400 (c)
(f)	1,500	5,400 (e)
(h)	310	12,450 (g)
		9,000 (i)
	<u>9,465</u>	

Accounts Receivable	
Beg.	306,132
	<u>306,132</u>

Prepaid Expenses	
Beg.	42,934
	<u>42,934</u>

Inventories	
Beg.	851,033
	<u>851,033</u>

Other Current assets	
Beg.	2,840
	<u>2,840</u>

Investments (Non-current)	
(c)	3,400
	<u>3,400</u>

Property, Plant and Equipment, net		
Beg.	1,044,389	
(g)	21,850	600 (d)
	<u>1,065,639</u>	

Intangible Assets		
Beg.	336,753	
(e)	5,400	630 (a)
	<u>341,523</u>	

Goodwill	
Beg.	190,626
	<u>190,626</u>

Other Non-Current Assets	
Beg.	8,898
	310 (h)
	<u>8,588</u>

Accounts Payable and Accrued Liabilities		
		232,268 Beg.
		<u>232,268</u>

Long-Term Debt	
	375,000 Beg.
(b)	14,000
	9,400 (g)
	<u>370,400</u>

Other Long-Term Liabilities	
	38,569 Beg.
	<u>38,569</u>

Contributed Capital	
	164,504 Beg.
	1,500 (f)
	<u>166,004</u>

Retained Earnings	
	2,022,846 Beg.
(i)	9,000
	<u>2,013,846</u>

Other Components of Equity	
	1,093 Beg.
	<u>1,093</u>

AP2-3 (continued)

Req. 3

Gildan Activewear Inc.
Statement of Financial Position
As at March 31, 2016
(in thousands of dollars)

Assets	
Current assets	
Cash and cash equivalents	\$ 9,465
Accounts receivable	306,132
Inventories	851,033
Prepaid expenses	42,934
Other current assets	2,840
Total current assets	<u>1,212,404</u>
Investments	3,400
Property, plant and equipment, net	1,065,639
Intangible assets	341,523
Goodwill	190,626
Other non-current assets	8,588
Total Assets	<u><u>\$2,822,180</u></u>
Liabilities	
Current liabilities	
Accounts payable and accrued liabilities	232,268
Long-term debt	370,400
Other long-term liabilities	38,569
Total Liabilities	<u>641,237</u>
Shareholders' Equity	
Contributed capital	166,004
Retained earnings	2,013,846
Other components of equity	1,093
Total Shareholders' Equity	<u>2,180,943</u>
Total Liabilities and Shareholders' Equity	<u><u>\$2,822,180</u></u>

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$1,212,404}{\$232,268} = 5.22$$

This ratio suggests that for every \$1 in current liabilities, Gildan Activewear Inc. has \$5.22 in current assets. While this represents a high margin of safety for creditors, it also indicates that the company may not be using its current assets efficiently to generate income for shareholders.

AP2-4

Transaction	Type of Activity	Effect on Cash
(a)	I	+
(b)	F	-
(c)	I	-
(d)	I	+
(e)	I	-
(f)	F	+
(g)	I	-
(h)	I	+
(i)	F	-

AP2-5

(Amounts are in millions)

Req. 1

a.	Cash (+A)	200	
	Contributed capital (+SE)		200
b.	Cash (+A)	6,300	
	Long-term liabilities (+L)		6,300
c.	Short-term investments (+A)	1,200	
	Investments (+A)	300	
	Cash (-A)		1,500
d.	Property, plant, and equipment (+A)	5,500	
	Cash (-A)		4,650
	Long-term liabilities (+L)		850
e.	Receivables (+A)	250	
	Cash (-A)		250
f.	Cash (+A)	200	
	Short-term Investments (-A)		200

AP2-5 (continued)

Req. 2

Cash and Cash Equivalents	
Beg.	613
(a)	200
(b)	6,300
	1,500 (c)
	4,650 (d)
	250 (e)
(f)	200
	<u>913</u>

Short-Term Investments	
(c)	1,200
	200 (f)
	<u>1,000</u>

Receivables	
Beg.	3,009
(e)	250
	<u>3,259</u>

Inventories	
Beg.	416
	<u>416</u>

Prepaid Expenses	
Beg.	393
	<u>393</u>

Other Assets – Current	
Beg.	377
	<u>377</u>

Property, Plant and Equipment, net	
Beg.	21,630
(d)	5,500
	<u>27,130</u>

Long-Term Investments	
Beg.	1,119
(c)	300
	<u>1,419</u>

Intangible Assets	
Beg.	11,176
	<u>11,176</u>

Goodwill	
Beg.	8,377
	<u>8,377</u>

Other Non-current Assets	
Beg.	883
	<u>883</u>

Trade Payables and Accrued Liabilities	
	4,287 Beg.
	<u>4,287</u>

Income Taxes Payable	
	148 Beg.
	<u>148</u>

Dividends Payable	
	576 Beg.
	<u>576</u>

Debt Due within One Year	
	4,895 Beg.
	<u>4,895</u>

Other Liabilities (Current)	
	86 Beg.
	<u>86</u>

Long-term Debt	
	15,390 Beg.
	6,300 (b)
	850 (d)
	<u>22,540</u>

Other Liabilities (Non-current)	
	5,282 Beg.
	<u>5,282</u>

Shareholders' Equity	
	17,329 Beg.
	200 (a)
	<u>17,529</u>

AP2-5 (continued)

Req.3

BCE Inc. Trial Balance At December 31, 2016 (in millions of dollars)		
	Debit	Credit
Cash and cash equivalents	\$ 913	
Short-term investments	1,000	
Receivables	3,259	
Inventories	416	
Prepaid expenses	393	
Other current assets	377	
Property, plant, and equipment, net	27,130	
Long-term investments	1,419	
Intangible assets	11,176	
Goodwill	8,377	
Other non-current assets	883	
Trade payables and accrued liabilities		\$ 4,287
Income taxes payable		148
Dividends payable		576
Debt due within one year		4,895
Other current liabilities		86
Long-term debt		22,540
Other non-current liabilities		5,282
Shareholders' Equity		17,529
Totals	<u>\$55,343</u>	<u>\$55,343</u>

AP2–5 (continued)

Req. 4

BCE Inc.
Statement of Financial Position
As at December 31, 2016
(in millions of Canadian dollars)

	Current Year
Assets	
<i>Current assets</i>	
Cash and cash equivalents	\$ 913
Short-term investments	1,000
Receivables	3,259
Inventories	416
Prepaid expenses	393
Other assets	377
<i>Total current assets</i>	6,358
Property, plant, and equipment, net	27,130
Long-term investments	1,419
Intangible assets	11,176
Goodwill	8,377
Other non-current assets	883
Total Assets	\$55,343
Liabilities and Shareholders' Equity	
<i>Current liabilities</i>	
Trade payables and accrued liabilities	\$ 4,287
Income taxes payable	148
Dividends payable	576
Debt due within one year	4,895
Other current liabilities	86
<i>Total current liabilities</i>	9,992
Long-term debt	22,540
Other liabilities	5,282
Total Liabilities	37,814
Shareholders' Equity	17,519
Total Liabilities and Shareholders' Equity	\$55,343

AP2–5 (continued)

Req. 5

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$6,358}{\$9,992} = 0.64$$

This ratio suggests that for every \$1 in current liabilities, BCE Inc. has \$0.64 in current assets. While this represents a low margin of safety for creditors, BCE has about \$5,172 million in cash and cash equivalents, short-term investments and receivables that can be converted into cash quickly to settle trade payables and accrued liabilities, income taxes payable and dividends payable that total \$5,011 million.

AP2–6 (Refer to AP2-5)

BCE Inc.
Partial Statement of Cash Flows
For the Year Ended December 31, 2016
(in millions of Canadian dollars)

INVESTING ACTIVITIES

Purchase of investments	(1,500)
Purchase of property, plant, and equipment	(4,650)
Loan to affiliate	(250)
Sale of investments	<u>200</u>
Cash flow used in investing activities	<u>(6,200)</u>

FINANCING ACTIVITIES

Borrowings from creditors	6,300
Issuance of shares	<u>200</u>
Cash flow from financing activities	<u>6,500</u>

Proof:

Ending balance of cash per T account	\$913
Less: beginning balance	<u>613</u>
Increase	\$300

Cash flow used in investing activities	\$(6,400)
Cash provided by investing activities	<u>200</u>
Net decrease	<u>\$(6,200)</u>

AP2-7

Req. 1

Big Burgers Inc.
Statements of Financial Position
As at December 31
(in thousands of dollars)

	Current Year	Prior Year
Assets		
Cash and equivalents	4,260.4	1,379.8
Accounts and notes receivable	795.9	745.5
Inventories	147.0	147.5
Prepaid expenses and other current assets	646.4	585.0
Total current assets	5,849.7	2,857.8
Property and equipment, net	20,108.0	20,903.1
Intangible assets, net	1,950.7	1,828.3
Long-term investments	1,035.4	1,109.9
Other non-current assets	1,245.0	1,338.4
Total Assets	<u>30,188.8</u>	<u>28,037.5</u>
Liabilities		
Accounts payable	689.4	714.3
Accrued liabilities	2,344.2	2,144.0
Notes payable	544.0	-
Current maturities of long-term debt	658.7	862.2
Total current liabilities	4,236.3	3,720.5
Long-term debt	8,937.4	8,357.3
Other long-term liabilities	1,869.0	1,758.2
Total Liabilities	<u>15,042.7</u>	<u>13,836.0</u>
Shareholders' Equity		
Contributed capital	2,814.2	2,202.6
Retained earnings	12,331.9	11,998.9
Total Shareholders' Equity	<u>15,146.1</u>	<u>14,201.5</u>
Total Liabilities and Shareholders' Equity	<u>30,188.8</u>	<u>28,037.5</u>

Req. 2

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$5,849.7}{\$4,236.3} = 1.38$$

This ratio suggests that for every \$1 in current liabilities, Big Burgers Inc. has \$1.38 in current assets. This low current ratio suggests that Big Burgers is using its resources efficiently and has sufficient liquidity. Its cash resources alone are sufficient to pay the current liabilities.

AP2-8

Req. 1

Cash	Note Receivable	Land
(a) 40,000	(d) 3,000	(b) 12,000
		3,000 (d)
35,000	3,000	9,000
(c) 20,000	Note Payable (Short-term)	Note Payable (Long-term)
(e) 1,000		
21,000	12,000 (b)	16,000 (c)
16,000	12,000	16,000
Contributed Capital		
40,000 (a)		
40,000		

Req. 2

**Chu Delivery Company Inc.
Statement of Financial Position
As at December 31, 2018**

Assets	
Current assets	
Cash	\$ 35,000
Note receivable	3,000
Total current assets	38,000
Land	9,000
Equipment	21,000
Total Assets	\$ 68,000
Liabilities	
Current liabilities	
Note payable	\$ 12,000
Total current liabilities	12,000
Long-term note payable	16,000
Total Liabilities	28,000
Shareholders' Equity	
Contributed capital	40,000
Total Liabilities and Shareholders' Equity	\$ 68,000

AP2-8 (continued)

Req. 2

2018:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$38,000}{\$12,000} = 3.17$$

Req. 3

2019:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$42,000}{\$23,000} = 1.83$$

2020:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$47,000}{\$40,000} = 1.18$$

The current ratio has decreased over the years, suggesting that the company's liquidity is decreasing. Although the company still maintains sufficient current assets to settle the short-term obligations, this steep decline in the ratio may be of concern – it may be indicative of more efficient use of resources or it may suggest the company is having cash flow problems.

Req. 4

The management of Chu Delivery Company has already been financing the company's development through additional short-term debt, from \$12,000 in 2018 to \$40,000 in 2020. This suggests the company is taking on increasing risk. Additional lending, particularly short-term, to the company may be too much risk for the bank to absorb. Based solely on the current ratio, the bank's vice president should consider not providing the loan to the company as it currently stands. Of course, additional analysis would provide better information for making a sound decision.

CASES AND PROJECTS

FINDING AND INTERPRETING ACCOUNTING INFORMATION

CP2-1

The answers below are based on Canadian Tire Corporation's annual report for the fiscal year 2015.

Req. 1

The company is a corporation since it maintains contributed capital and its owners are referred to as "shareholders".

Req. 2 (amounts in millions)

$$\begin{array}{rclcl} \text{Assets} & = & \text{Liabilities} & + & \text{Shareholders' Equity} \\ \$14,987.8 & = & \$9,198.1 & + & \$5,789.7 \end{array}$$

Req. 3

The amount listed on the statement of financial position for inventories does not necessarily represent the expected selling price. It likely represents the historical cost of acquiring the inventory, in accordance with the cost principle. We discuss this issue further in chapter 7.

Req. 4

The company's year-end is January 2, 2016. This can be read from the heading of the financial statements. The notes to the Company's financial statements indicate that its fiscal year consists of a 52- or 53-week period ending on the Saturday closest to December 31.

Req. 5

The company's non-current liabilities consist of long-term provisions, long-term debt, long-term deposits, deferred income taxes, and other long-term liabilities, as disclosed on the statement of financial position.

Req. 6 (amounts in millions)

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$8,692.3}{\$3,883.8} = 2.24$$

This ratio suggests that for every \$1 in current liabilities, Canadian Tire has \$2.24 in current assets. It provides a good margin of safety for short-term creditors. The Company has a large amount of inventory which may have to be marked down if the Company is strapped for cash. The Company will likely increase its short-term borrowings from banks to meet its obligations to other short-term creditors, except in the case of an economic recession that depresses the market value of the Company's inventory which may limit its ability to borrow additional funds from banks.

CP2-1 (continued)

Req. 7

The company spent \$515.9 million on property, plant and equipment during 2015 and \$538.6 million during 2014. This information is shown in the investing activities section of the statement of cash flows.

CP2-2

The answers below are based on Sears Canada's annual report for the fiscal year 2015.

Req. 1 (amounts in millions)

$$\begin{array}{rclcl} \text{Assets} & = & \text{Liabilities} & + & \text{Shareholders' Equity} \\ \$1,633.1 & = & \$1,079.1 & + & \$554.2 \end{array}$$

Req. 2

No – shareholders' equity is a residual balance, meaning that the shareholders will receive what remains in cash and assets after the creditors have been satisfied. Most of the assets on the statement of financial position are not stated at market value, only at their historical cost. Shareholders would receive more than \$554.2 million if the market value of the net assets (assets – liabilities) exceeds their book value.

Req. 3

The Company's non-current liabilities include long-term obligations, deferred revenue, retirement benefit liability, deferred tax liabilities and other long-term liabilities.

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$1,133.7}{\$590.7} = 1.92$$

Req. 5

The company had a net cash inflow from investing activities of \$258.9, primarily from the sale of its portfolio of credit card accounts and related receivables (174.0), and sale of some of its properties (130.0). The company also purchased property, plant and equipment and intangible assets for \$45.4.

CP2-3

Req.1

Canadian Tire had total assets of \$14,987.8 million compared to \$1,633.1 million for Sears Canada.

Req. 2

Current year	Industry Average	Canadian Tire Corporation	Sears Canada
Current ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$	2.11	$\frac{\$8,692.3}{\$3,883.8} = 2.24$	$\frac{\$1,133.7}{\$590.7} = 1.92$

(Dollar amounts are in millions)

Canadian Tire's current ratio of 2.24, which is higher than both Sears Canada's ratio of 1.92 and the industry average of 2.11. Canadian Tire's ratio provides a comfortable safety margin for short-term creditors, particularly that it has a sizeable portfolio of loans receivable that can be converted into cash to pay off current liabilities on a short-term notice.

Req. 3

Canadian Tire paid \$434.6 million to repurchase its own common shares during 2015, but Sears Canada did not repurchase any shares during that year.

Req. 4

Canadian Tire paid \$152.2 million in dividends during 2015 as disclosed in the Financing Activities section of its statement of cash flows, but Sears Canada did not pay any dividends to its shareholders during the same year.

Req. 5

Canadian Tire uses two titles: Investment property, and Property and Equipment, whereas Sears Canada uses the titles Property, plant, and equipment, and Investment properties.

CP2-4

The answers below are based on the Company's Interim Report for the three months ended March 31, 2016, released on April 28, 2016.

Req. 1

- (a) Thomson Reuters Corporation's total assets for the first quarter ending March 31, 2016 were US\$29,048 million.
- (b) Long-term debt decreased during the quarter from US\$6,829 million to US\$6,379 million as shown on the statements of financial position at March 31, 2016 and December 31, 2015, respectively.

(c) Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$4,841}{\$6,221} = 0.78$

(Dollar amounts above are in millions of US dollars.)

Thomson Reuters Corporation's current ratio indicates that it has \$0.78 for every \$1 of current liabilities. Although a current ratio that exceeds 1.0 is desirable, the Company's ratio has been below 1.0 for some time. This relatively low level of this ratio does not seem to be a major concern for creditors given that the Company has managed to meet its short-term obligations.

Req. 2

- (a) For the first quarter, the statement of cash flows reveals that Thomson Reuters Corporation spent US\$231 million on capital expenditures, net of proceeds from disposal of property, plant and equipment.
- (b) The net cash flows used for financing activities were US\$248 million for the quarter ended March 31, 2016 as reported on the statement of cash flows.

CP2-5

Req. 1

The major deficiency in this statement of financial position is the inclusion of the owner's personal residence as a business asset. Under the separate-entity assumption, each business must be accounted for as an individual organization, separate and apart from its owners. The improper inclusion of this asset as part of Betsey Jordan's business overstates total assets by \$300,000; total assets should be \$105,000 rather than \$405,000, and shareholder's equity should be only \$5,000, rather than \$305,000. There is also a reference to monthly payments after the personal residence. This seems to indicate there is a mortgage on this property. While exclusion of the liability (mortgage) is appropriate it is inconsistent with the inclusion of the asset (personal residence).

Req. 2

The company's liabilities are relatively high relative to the owner's equity in the business. This indicates that Betsey Jordan's business is far riskier than suggested by the incorrect statement of financial position. As a bank manager, I would not lend money to this company. This decision is based both on the high debt relative to equity and the error in the financial statements which raised questions as to their reliability.

CP2-6

Req. 1

Normally investment and credit decisions are not based on the information on statements of financial positions alone. Nevertheless, one could focus on the relationships among various elements of the statements of financial position to compare these two companies.

Smiley Corp. has \$63,000 in current assets, about one-third of its total assets. In contrast, Tsang Inc. has \$29,200 in current assets, representing about one-ninth of its total assets. Tsang Inc. is larger in size than Smiley, but it seems to me more efficient in managing its inventory and accounts receivable. On the surface, this may reflect good relations with both its suppliers of merchandise that provide it with merchandise when needed and its customers who pay on time.

On the other hand, Tsang's current liabilities amount to \$98,400 and exceed by far the company's current assets. It appears that Tsang Inc. has a liquidity problem as most of its assets are tied into property, plant and equipment and cannot be easily converted into cash in the short term to meet the company's current obligations. In contrast, Smiley Corp. has \$33,000 in current liabilities, representing about 50 percent of the company's current assets. Hence, it appears to have a relatively strong liquidity position.

	Smiley Corp.	Tsang Inc.
Current ratio	$\$63,000 \div \$33,000 = 1.91$	$\$29,200 \div \$98,400 = 0.30$

Based on the above considerations, Smiley Corp. appears to be a better investment than Tsang Inc. As indicated earlier, investors would consider additional information related to the companies' profitability before deciding to purchase their shares.

Req. 2

Smiley Corp. has sufficient current assets to allow the company to repay the loan in four months. That also depends on its ability to generate revenues and net cash flows from operations. In contrast, Tsang Inc. needs to manage its property, plant and equipment in an efficient way so that they generate revenues and net cash flows that would be sufficient to repay the bank loan. Given that Tsang Inc. has \$98,400 in current liabilities and only \$29,200 in current assets, it may very well use the \$20,000 to pay off part of its current obligations.

As a bank loan officer, I would ask both companies to provide me with a cash flow budget or report showing how they plan to use the money and ensure that they will generate a sufficient amount of cash during the next four months to allow them to pay the loan and interest. I would be inclined to approve a loan of \$20,000 for Smiley Corp., but have severe reservations about lending money to Tsang Inc. without a clear plan and specific guarantees for the repayment of the loan. One thing that they may be considering or that I could suggest is that they obtain some long-term financing as they have long-lived assets and this would match the financing with the assets.

CRITICAL THINKING CASES

CP2-7

Req. 1

Dewey, Cheetum and Howe, Inc.
Statement of Financial Position
As at December 31, 2018

Assets	
Cash	\$ 1,000
Accounts receivable	8,000
Inventory	8,000
Total current assets	<u>17,000</u>
Furniture and fixtures	52,000
Delivery truck (net)	12,000
Buildings (net)	60,000
Total assets	<u><u>\$141,000</u></u>
Liabilities	
Accounts payable	\$ 16,000
Payroll taxes payable	13,000
Total current liabilities	<u>29,000</u>
Long-term notes payable	15,000
Mortgage payable	50,000
Total liabilities	<u>94,000</u>
Shareholders' Equity	
Contributed capital	80,000
Accumulated deficit ¹	(33,000)
Total shareholders' equity	<u>47,000</u>
Total liabilities and shareholders' equity	<u><u>\$141,000</u></u>

¹ Retained earnings as presented \$5,000 – (98,000, building at market – 60,000, building at cost) = \$5,000 – 38,000 = \$(33,000)

CP2-7 (continued)

Req. 2

Dear _____,

I corrected the statement of financial position for Dewey, Cheetum and Howe, Inc. Primarily, I reduced the amount reported for buildings to \$60,000 which is the historical cost less accumulated amortization. The \$38,000 difference (\$98,000 – \$60,000) reduces total assets and reduces retained earnings. In fact, retained earnings becomes negative suggesting that there may have been several years of operating losses.

Before making a final decision on investing in this company, you should examine the past three years of *audited* statement of earnings and the past two years of *audited* statements of financial position to identify positive and negative trends for this company. You can also compare this company's current ratio to that of the industry to assess trends in liquidity, and compare how this company's long-term debt as a proportion of shareholders' equity has changed over time. You should also learn as much about the industry as you can by reviewing recent articles on economic and technological trends which may have an impact on this company.

CP2-8

Proposal 1

Reclassification of the debt as equity is not supported in this case by an exchange transaction that results in issuing shares by the company and an equivalent reduction in debt. It is simply a manipulation of the statement of financial position information that is unethical. Furthermore, auditors would not approve of such distortions of the information presented on the statement of financial position in the absence of a proper underlying transaction that would result in splitting the \$20 million debt into equal amounts of debt and equity.

Proposal 2

The market value of the land is relevant as far as showing an updated value of the land on the statement of financial position. However, the market value of \$8 million has not resulted from an external transaction with another party. Rather it is an estimate based on an appraisal (formal or informal) of its value. The company's management would do well to disclose such information in a note to the statement of financial position in order to draw attention to the outdated value of the land on the company's books. The bank loan officer would look favourably at the additional disclosure and may request that the land be used as collateral for a bank loan.

Proposal 3

The nature of the relationship between the company and FirstRate Software is that of a supplier of software products. Suppliers of goods and services are typically paid within 30 to 90 days. In some cases, arrangements can be made to delay the payment of the debt if the buyer faces financial difficulties. Accounts payable may be converted into Notes payable having a stated interest rate to be paid at the maturity date of the note. Such a transaction may not seem unusual. In this particular case, it is not clear whether the chief financial officer of FirstRate Software would accept what is being proposed. Furthermore, we do not know whether the interest rate that will be paid is a fair market rate. It is quite possible that the company may end up agreeing to pay a higher interest rate in order to improve on its liquidity position, and secure the bank loans.

While the conversion of the account payable of \$2 million into a one-year note seems like an acceptable business transaction, the motive behind such a transaction, which is essentially a window-dressing exercise, raises some concerns about the behaviour of the company's executive officers.

CP2-9

Req. 1

The people most harmed by the fraud were those who invested in the company based on fraudulent financial information and those who failed to sell their shares prior to the disclosure of the fraud. The net income is a central piece of information that investors use to calculate the potential future return on their investment. Since Nortel had overstated its net income by a quarter of a billion dollars, investors could have purchased other investments and ultimately realized a gain when they sold these investments, instead of the loss they incurred on their investment in Nortel.

Investors will again be penalized if the SEC investigation results in the imposition of substantial fines on the company. The SEC is also pursuing the officers and executives of the company individually and may yet lay criminal charges.

Creditors who relied on the debt as a proportion of equity as the basis to lend money to Nortel were looking at an understated debt amount which would have misled them into believing that Nortel was less reliant on debt than was actually the case – in fact debt was understated by almost \$1 billion. The information disclosed in the financial statements may have led them to lend money at a relatively lower interest rate than what they should have charged the company to compensate them for the higher risk associated with the debt.

People benefiting most from the fraud were the executives who received additional compensation in the form of stock options and cash bonuses based on inflated earnings. As share prices rose in response to overstated net income, executives would have been able to sell their stock options and realize a far higher gain on sale than they would have if they disclosed accurate and far lower net income amounts.

Req. 2

The magnitude of annual financial incentives in the hundreds of millions of dollars is evidence that greed for money plays a large part in this fraud. It is clear that there is a huge financial incentive for executives to delay reporting bad financial news, and a concerted effort must be made to report misinformation.

Req. 3

In many cases of fraudulent activity, auditors are named in lawsuits along with the company. If the auditors are found to be negligent in performing their audit, then they are liable. However, in many frauds, the management at multiple levels of the organization are so involved in covering the fraud that it becomes nearly impossible for the auditors to detect the fraudulent activity. It appears that Deloitte & Touche LLP filed charges against Nortel's management because the auditors believed that senior management must have known about the fraud given the way the unrealistic budgets were set and expected to be met. The auditors were sending a strong signal to those pointing fingers at them that they believe the blame rests solely with company officials.

FINANCIAL REPORTING AND ANALYSIS TEAM PROJECT

CP2-10

The solution to this case will depend on the company and/or accounting period selected for analysis.

CC2-1

Req. 1

	<u>Debit</u>	<u>Credit</u>
a. Cash (+A)	25,000	
Equipment (+A)	36,000	
Contributed capital (+SE).....		61,000
b. Land (+A).....	18,000	
Building (+A).....	72,000	
Cash (-A).....		10,000
Mortgage notes payable (+L).....		80,000
c. Equipment (+A).....	6,500	
Cash (-A).....		2,500
Short-term notes payable (+L).....		4,000
d. No transaction		
e. Mortgage notes payable (-L).....	1,000	
Cash (-A).....		1,000
f. Short-term investments (+A).....	5,000	
Cash (-A).....		5,000
g. No transaction		

CC2-1 (continued)

Req. 2

Cash		
Beg.	0	
(a)	25,000	10,000 (b)
		2,500 (c)
		1,000 (e)
		5,000 (f)
	<u>6,500</u>	

Short-term Investments	
Beg.	0
(f)	5,000
	<u>5,000</u>

Equipment	
Beg.	0
(a)	36,000
(c)	6,500
	<u>42,500</u>

Land	
Beg.	0
(b)	18,000
	<u>18,000</u>

Buildings	
Beg.	0
(b)	72,000
	<u>72,000</u>

Short-term Notes Payable	
	0 Beg.
	4,000 (c)
	<u>4,000</u>

Mortgage Notes Payable	
	0 Beg.
(e)	1,000
	80,000 (b)
	<u>79,000</u>

Contributed Capital	
	0 Beg.
	61,000 (a)
	<u>61,000</u>

Req. 3

Penny's Pool Service and Supply, Inc.		
Trial Balance		
March 31, 2016		
	Debit	Credit
Cash	\$ 6,500	
Short-term investments	5,000	
Equipment	42,500	
Land	18,000	
Buildings	72,000	
Short-term notes payable		\$ 4,000
Mortgage notes payable		79,000
Contributed capital		61,000
Totals	<u>\$144,000</u>	<u>\$144,000</u>

CC2–1 (continued)

Req. 4

Penny’s Pool Service and Supply, Inc.
Statement of Financial Position
On March 31, 2016

Assets

Current Assets:

Cash	\$ 6,500
Short-term investments	5,000
Total current assets	11,500
Equipment	42,500
Land	18,000
Buildings	72,000
Total assets	\$144,000

Liabilities and Shareholder’s Equity

Current Liabilities:

Short-term notes payable	\$ 4,000
Total current liabilities	4,000
Mortgage notes payable	79,000
Total liabilities	83,000

Stockholder’s Equity:

Contributed capital	61,000
Total shareholder’s equity	61,000
Total liabilities and shareholder’s equity	\$144,000

Req. 5

	Type of Activity (I, F, or NE)	Effect on Cash Flows (+ or – and amount)
(a)	F	+ 25,000
(b)	I	– 10,000
(c)	I	– 2,500
(d)	NE	NE
(e)	F	–1,000
(f)	I	– 5,000
(g)	NE	NE

CC2-1 (continued)

Req. 6

	<u>Current Assets</u>	÷	<u>Current Liabilities</u>	=	<u>Current Ratio</u>
March 31, 2016	\$11,500	÷	\$4,000	=	2.875

With a current ratio of 2.875, PPSS has liquidity with sufficient current assets to settle short-term obligations. However, this may change as the inventory is received in April and operations begin requiring paying cash for inventory purchases from suppliers, advertising, utilities, employee salary, and other operating needs, and paying notes payable when due. One of the most significant problems for new small businesses is generating sufficient cash from operations to pay obligations and maintain liquidity.

CHAPTER 2

INVESTING AND FINANCING DECISIONS AND THE STATEMENT OF FINANCIAL POSITION

CHAPTER OUTLINE

- I UNDERSTANDING THE BUSINESS
- II OVERVIEW OF ACCOUNTING CONCEPTS
 - A. Concepts Emphasized in Chapter 2
 - i. Objective of Financial Reporting
 - ii. Qualitative Characteristics of Accounting Information
 - iii. Accounting Assumptions
 - iv. Basic Accounting Principle
 - B. Elements of the Classified Statement of Financial Position
- III WHAT TYPES OF BUSINESS ACTIVITIES CAUSE CHANGES IN FINANCIAL STATEMENT AMOUNTS?
 - A. Nature of Business Transactions
 - B. Accounts
- IV HOW DO TRANSACTIONS AFFECT ACCOUNTS?
 - A. Principles of Transaction Analysis
 - i. Dual Effects
 - ii. Balancing the Accounting Equation
 - B. Analyzing Sun-Rype's Transactions
- V HOW DO COMPANIES KEEP TRACK OF ACCOUNT BALANCES?
 - A. The Direction of Transaction Effects
 - B. Analytical Tools
 - i. The Journal Entry
 - ii. The T-Account
 - C. Transaction Analysis Illustrated
- VI HOW IS THE STATEMENT OF FINANCIAL POSITION PREPARED AND ANALYZED?
 - A. Classified Statement of Financial Position
 - B. Some Misconceptions
- VII ACCOUNTING STANDARDS FOR PRIVATE ENTERPRISES

ADDITIONAL RESOURCES

ADDITIONAL TEACHING NOTES
CHART OF END-OF-CHAPTER MATERIALS
GUIDE TO OTHER CHAPTER FEATURES
SUPPLEMENTAL ENRICHMENT ACTIVITIES

CHAPTER LEARNING OBJECTIVES

- 2-1. Define the objective of financial reporting, the qualitative characteristics of accounting information, and the related key accounting assumptions and principles.
- 2-2. Define the elements of a classified statement of financial position.
- 2-3. Identify what constitutes a business transaction, and recognize common account titles used in business.
- 2-4. Apply transaction analysis to simple business transactions in terms of the accounting model: $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$.
- 2-5. Determine the impact of business transactions on the statement of financial position using two basic tools: journal entries and T-accounts.
- 2-6. Prepare a trial balance and a classified statement of financial position, and analyze the company using the current ratio.
- 2-7. Identify investing and financing transactions and demonstrate how they impact cash flows.

CHAPTER SUMMARY

The text materials contain many useful exhibits for this chapter. In addition, other chapter features useful in the teaching of this text are contained in this manual.

This chapter reviews the parts of the conceptual framework relevant to the statement of financial position (the objective of external financial reporting, definitions of the elements of the statement of financial position, and the cost principle). The chapter discusses the accounting model and illustrates its application in the accounting system for a business. For accounting purposes, transactions are defined as (a) exchanges of assets and liabilities between the business and other individuals and organizations, and (b) certain events that do not occur between the business and other parties but exert a direct effect on the entity (such as, recording adjustments to reflect the use of equipment in operations).

Application of the accounting model ---- Assets = Liabilities + Shareholders' Equity ---- is illustrated for Canadian Tire (www.canadiantire.ca). The application involves (1) transaction analysis, (2) journal entries, and (3) the accounts (T-account format). Each transaction causes at least two different accounts to be affected in terms of the accounting model. The model often is referred to as a double-entry system because each transaction has a dual effect. The process used in transaction analysis involves (a) identifying the accounts affected and classifying each as an asset, liability, or shareholders' equity account and (b) determining that the accounting equation remains in balance.

The transaction analysis model (built on the accounting model) and the mechanics of the debit-credit concepts in T-account format can be summarized as follows:

Transaction Analysis Model

Assets (A)		=	Liabilities (L)		+	Equity (E)	
Increase Debit	Decrease Credit		Decrease Debit	Increase Credit		Decrease Debit	Increase Credit

T-Account Format

Assets		Liabilities		Equity	
Increase Debit	Decrease Credit	Decrease Debit	Increase Credit	Decrease Debit	Increase Credit
Beg. Bal.			Beg. Bal.		Beg. Bal.
<u>End. Bal.</u>			<u>End. Bal.</u>		<u>End. Bal.</u>

CHAPTER LECTURE NOTES

I UNDERSTANDING THE BUSINESS

1. An understanding of a company's financial statements requires knowledge of business activities and their effects on account balances.
2. Financial statement analysis will allow the decision maker to arrive at decisions about a company. This evaluation can be used to compare one company to other companies.
3. Financial statements for Canadian companies contain estimates of financial value that are developed in accordance with generally accepted accounting principles (GAAP which can be IFRS or ASPE).
4. Financial statements are intended to communicate the economic facts, measured in monetary units in a standardized manner incorporating rules (standards) consistently without bias (faithful representation).
5. Analysis of investing (asset acquisition activities) activities and financing (activities around borrowing and equity transactions) activities of a business should be explored.
6. Financial statements communicate results or consequences of strategy by answering the following questions:
 - i what type of business activities cause changes in the statement of financial position amounts from one period to the next?
 - ii how do specific activities affect each of the statement of financial position amounts?
 - iii how do companies keep track of these amounts?
7. Once we have answered these questions, we will be able to use the information to
 - i. Analyze and predict the effects of business decisions on the company's financial statements.
 - ii. Identify and evaluate the financial activities that managers engaged in during the past period. This is a key task in financial statement analysis.

II OVERVIEW OF ACCOUNTING CONCEPTS

The concepts presented in Exhibit 2.1 are the key concepts in the financial reporting framework of objectives, elements, qualitative characteristics, assumptions, principles, and constraints.

A. Concepts Emphasized in Chapter 2

1. The **primary objective of external financial reporting** is to provide financial information about a business to help external parties, primarily investors and creditors, make sound financial decisions in their capacity as capital providers. These decision makers need a reasonable understanding of

accounting concepts and procedures. They need to be able to use financial information to help them predict future cash inflows and outflows both in terms of timing and uncertainty, and financial values of assets and liabilities.

2. The qualitative characteristics of accounting information contained in the conceptual framework provide guidance on the essential characteristics that determine the usefulness of accounting information. There are two fundamental qualitative characteristics:

- a. Relevance

- information is considered to be relevant if it can influence users' decisions

- relevant information has predictive and/or confirmatory value

- b. Faithful Representation

- to be useful in decision making, financial statements must be a faithful representation of the economic phenomena it is supposed to represent, thus reflecting the economic substance of a transaction that may differ from the legal form of the transaction

The fundamental qualitative characteristics are supported by four enhancing qualitative characteristics:

- a. Comparability

- the usefulness of accounting information is enhanced when similar accounting methods have been applied on a consistent basis

- b. Verifiability

- assumes that accountants acting independent of each other can agree on the nature and amount of a transaction

- c. Timeliness

- information should be provided in a timeframe that enables users to make decisions

- usefulness of financial information declines as time passes

- d. Understandability

- users of financial information are expected to have a reasonable understanding of business and economic activities and be willing to analyze the information in a diligent manner

B. Constraints of Accounting Measurement

1. The **cost constraint** of accounting measurement suggests that information should be produced only if the perceived benefits of increased decision usefulness exceed the expected costs of providing that information.
2. **Prudence** requires that assets and revenues not be overstated, and liabilities and expenses not be understated. This is a cautious and conservative approach.

3. Underlying assumptions of accounting help the decision maker to understand what accounting information purports as well as the inherent limitations of that information. Recall assumptions noted in Chapter 1:
 - a. Separate-entity assumption – "business" transactions are separate from "owner" transactions.
 - b. Stable monetary unit assumption – accounting information will be measured and reported in the national monetary unit of that company.
 - c. Continuity (going concern) assumption – a business is expected to continue operations in the foreseeable future without forced liquidation.
4. The **historical cost principle** provides that amounts shown on the statement of financial position represent the cash-equivalent cost at the date of acquisition. In some instances, fair values are used, in which case a **mixed-attribute measurement model** is being used.

B. Elements of the Classified Statement of Financial Position

1. "Classified", means sections of the statement of financial position are broken down into Assets, Liabilities, and Shareholders' Equity. Within each section, further classifications are reflected. "Consolidated" means that the classified elements of the parent company statement of financial position are *combined* with those of other companies under the parent's control (referred to as subsidiaries)
2. Statement of Financial Position (SFP) elements present the basic accounting equation ($A = L + SE$).
 - a. Assets are economic resources controlled by an entity as a result of past transactions or events and from which economic benefits may be obtained. Assets on the SFP are listed in the order of liquidity between "current" (those economic resources that the entity will typically transform into cash or use within the next year or the operating business cycle of the entity, whichever is longer) and "non-current."
Current assets (short term) would include:
 - a. Cash and cash equivalents
 - b. Short-term investments
 - c. Accounts receivable
 - d. Inventories
 - e. Prepaid expenses
 - f. Other current assetsNon-current (long-term) assets would include:
 - a. Financial assets
 - b. Property, plant, and equipment (at cost less accumulated depreciation)
 - c. Goodwill
 - d. Intangible assets
 - e. Other (miscellaneous) assets

- b. Liabilities (L) are debts or obligations of the entity that result from past transactions that will require the outflow of assets or services to the creditors in the future. Liabilities are listed on the SFP in the order of maturity dates between current (expected to be repaid in one year or operating cycle whichever is longer) and non-current (maturities that extend beyond one year from the statement of financial position date).

Current liabilities would include:

- a. Short-term borrowings
- b. Accounts payable
- c. Accrued liabilities and provisions
- d. Income taxes payable
- e. Current portion of long-term debt
- f. Other current liabilities

Non-current liabilities would include:

- a. Long-term borrowings
- b. Deferred income tax liabilities
- c. Provisions
- d. Other liabilities

- c. **Shareholders' equity** (SE) is the residual interest in the net assets of the entity. It can be the result of financing provided to the corporation by both its owners and the operations of the business. There are three categories of shareholders' equity:
- Contributed capital results from owners providing assets to the company in exchange for shares (evidence of ownership). These are the investments of the owners.
 - Retained earnings (RE) result from undistributed earnings generated by the operations of the company. RE are reduced by declared dividends to date.
 - Other components of SE are discussed in Chapter 11.

III WHAT TYPES OF BUSINESS ACTIVITIES CAUSE CHANGES IN FINANCIAL STATEMENT AMOUNTS?

A. Nature of Business Transactions

Transactions are certain recorded economic "events" that impact an entity. Transactions include two types of events:

1. External events: a direct exchange of assets, goods, or services by one party for assets, services, or promises to pay by one or more other parties. Examples include the purchase of equipment, the sales of merchandise, borrowing from a bank, and owner investments.
2. Internal events: a measurable event internal to the business that is not a direct exchange. Examples include losses from casualties and adjustments to record usage of assets previously purchased (depreciation).

Some "events" are external to the business but have not yet given rise to a transaction and are not subject to recording. Examples include signing a lease, taking a customer order, and hiring a new employee. Each of these situations involves future promises but neither assets nor liabilities have yet been established.

A transaction is (1) an exchange between a business and one of more external parties to a business or (2) a measurable internal event, such as adjustments of the use of assets in operations.

B. Accounts

1. An account is a standardized record that organizations use to accumulate the monetary effects of transactions on each financial statement item.
2. A chart of accounts (COA) is a listing of the accounts a company uses to record the transactions of its business operations. Every company creates its own chart of accounts to fit the nature of its business activities. The order of the COA facilitates the financial reporting for a company. For the statement of financial position, assets are listed first in order of liquidity. They are followed by liabilities in order of maturity. Next, equity lists share capital accounts and retained earnings. Finally, revenue and expense accounts follow. COAs vary widely based on the industry of the company. In formal record keeping systems, unique numbers are used for each account listed in the COA.
3. More detailed listings are kept for several accounts. These are called subsidiary ledgers. Examples include accounts receivable, inventories, equipment, accounts payable, and notes payable. The total of a subsidiary ledger agrees to the related general ledger account balance.

IV HOW DO TRANSACTIONS AFFECT ACCOUNTS?

1. Keeping historical records affecting accounts provides information to managers in order to evaluate the effects of past decisions and to plan for the future. Therefore, it is important for managers to understand how past transactions affect financial statement items (accounts) and how future events may impact those accounts. The process for determining the effects of transactions is called transaction analysis.

A. Principles of Transaction Analysis

1. **Transaction analysis** involves studying a transaction to determine its economic effect on the entity in terms of the basic accounting equation (fundamental accounting model). This understanding is necessary to determine how transactions affect financial statement accounts.
2. Basic Accounting Equation: $A = L + SE$
3. Principles of transaction analysis:

- a. Dual effects – each transaction affects at least two accounts. Identification of the appropriate accounts and the direction of the effects (increase or decrease) are key. The fact that every transaction has at least two effects on the basic accounting equation is the essence of the double-entry system of record keeping. Whether a transaction is external (involves an exchange) or internal (involves an adjustment), the duality of effects still holds.
 - b. Accounting equation must remain in balance. After each transaction, the accounting equation must be tested for equality. That is, $A = L + SE$ must constantly be considered.
4. Transaction analysis process:
- a. Accounts and effects
 - Identify the accounts affected
 - Classify each account as A, L, or SE
 - Determine the direction of the effect (increase or decrease) for each account
 - b. Balancing
 - Prove that $A = L + SE$ after the transaction

B. Analyzing Canadian Tire's Transactions

V HOW DO COMPANIES KEEP TRACK OF ACCOUNT BALANCES?

1. The two tools to aid in reflecting the results of transaction analysis are journal entries and T-accounts (a simplified visual substitute for general ledger accounts).

A. The Direction of Transaction Effects

1. It is important to understand which accounts increase and decrease because of a transaction.
2. By referencing T-accounts, increases are on the left for assets (which are on the left side of the T-account) and increases are on the right for liabilities and equity (which are on the right side of the T-account). Decreases work just the opposite.
3. Debit means the left side of an account while credit means the right side of an account.
4. By referencing the accounting equation, debits increase asset accounts, and credits increase liability and shareholders' equity accounts. Credits decrease asset accounts, and debits decrease liability and shareholders' equity accounts.
5. The normal balance of an account is on the increase side. Therefore, asset accounts have debit balances while liability and equity accounts have credit balances.
6. Total debits must equal total credits in a transaction. This is necessary to keep the accounting equation in balance at all times.

B. Analytical Tools

The Journal Entry

1. A general journal is part of the bookkeeping system of a company. It contains a chronological listing of journal entries. It is referred to as the "original" book of entry.
2. A journal entry expresses the effects of a transaction on accounts in a "debit=credit" format. Its source is a business document. A journal entry should include a transaction date.
3. A simple entry affects two accounts. A compound entry affects more than two accounts.
4. In a journal entry, debit accounts and amounts should be listed first followed by credits. Credit accounts and amounts are indented below the debit portion(s) of the journal entry.

The T-account

1. Journal entries, per se, do not provide account balances. Account balances are found in the general ledger (a group of accounts). The general ledger is referred to as the "final" book of entry.
2. Posting is the act of transferring journal entry amounts to the appropriate accounts in the general ledger.
3. A T-account is a simplified version of a ledger account. This tool allows for summarization of journal entry effects on an account. The balance of the account can be determined with T-accounts.

C. Transaction Analysis Illustrated

1. Use transaction analysis as well as the journal entry and T-account tools to process typical monthly transactions.
2. There are beginning balances in most statement of financial position accounts since the ending balances carry over to the new period.
3. It is essential to understand:
 - a. the accounting model
 - b. the transaction analysis process
 - c. recording the dual effects of each transaction
 - d. the dual-balancing system

Note: Practice is important in order to grasp these critical concepts.

VI HOW IS THE STATEMENT OF FINANCIAL POSITION PREPARED AND ANALYZED?

1. Account balances for asset, liability, and equity accounts are used to prepare a statement of financial position. Balances from T-accounts are used in this chapter for that purpose.

2. A trial balance is a listing of the T-account names together with their balances. The debits are in the left column and the credits in the right column. The totals must be equal.

A. Classified Statement of Financial Position

1. Assets and liabilities are classified into current and non-current categories. Current assets are to be transformed into cash within a year, and non-current assets are those that will last longer than a year. Current liabilities are to be paid or settled within a year with current assets.
2. The statement of financial position includes comparative data with the most recent data typically shown on the left.

B. Some Misconceptions

1. Bookkeeping does not equal accounting. Rather, bookkeeping is an important part (a subset) of accounting.
 - a. Bookkeeping is the routine, clerical function of recording and posting journal entries. A basic knowledge of accounting is necessary to perform these bookkeeping tasks.
 - b. Accounting involves the design of information systems, analysis of complex transactions, interpretation of financial data, financial reporting, auditing, taxation, and management consulting. A high degree of knowledge, professional judgment, and experience are needed to perform these accounting functions.
2. The results of the accounting processes do not reflect "exact" information.
 - a. Many estimates are used that influence account balances.
 - b. Generally, the amounts on financial statements do not represent current market values. They typically present historical cost amounts.
 - c. It is important to gain an understanding of what financial statements do and do not reflect. The user needs to understand financial statement limitations.
3. Accounting is not inflexible nor is it a "cut and dried" subject. Instead, it is a dynamic and creative area of study that requires considerable judgment. It requires dedicated involvement for the users of financial statements as well as the preparers of those statements. Problem solving and communication skills are **extremely important** in accounting.

VII ACCOUNTING STANDARDS FOR PRIVATE ENTERPRISES

1. Under ASPE, assets are reported in decreasing order of liquidity, with cash listed first. Under IFRS, there are two acceptable methods. One method parallels ASPE. The other method shows assets in increasing order of liquidity, with the least-liquid assets listed first. Non-current assets are thus listed first. Equity is listed before liabilities, and liabilities are listed with non-current first before current. The choice depends on which method provides more relevant information.

2. Under ASPE, assets are reported at historical cost. Under IFRS, assets can be reported under the cost model or the revaluation model. As an example, property, plant, and equipment may be reported at fair value. Such a method must be used consistently.

ADDITIONAL TEACHING NOTES

1. Point out that most decision makers are neither ignorant nor superhuman. They often are average investors (or creditors). However, they are expected to have the tools to evaluate what goes on in the business world. Some of your students may already be investors or creditors.
2. Distinguish between "going concern" and "liquidation" valuations.
3. Point out that some companies present amounts on the statement of financial position in dollars, thousands of dollars, etc. The student should be sure to reference the statement of financial position heading for this information.
4. Note that the chart of accounts for assets and liabilities often differs widely for industries and companies.
5. Distinguish between historical costs recorded in the accounts and current fair market values.
6. Owners are "external" to a company because of the separate-entity concept. There should be no commingling of assets or liabilities of owners and companies.
7. Briefly mention how subsidiary ledgers support the details of general ledger accounts such as accounts receivable, accounts payable, and equipment.
8. This chapter presents an excellent experience with several cash transactions that have effects on the cash flow statement. There are references to cash flows throughout the text. Comprehensive coverage of the cash flow statement is in Chapter 5.
9. Emphasize the "misconceptions" at the end of the text materials.
10. T-accounts are great visual learning devices. Encourage students to use them throughout the course.
11. It is quite important that students identify accounts as (A), (L), or (SE) when doing transaction analysis and preparing journal entries. It typically makes the analysis process clearer and the journal entry preparation easier for them at this stage of learning.

CHART OF END-OF-CHAPTER MATERIALS

LEARNING OBJECTIVE	EXERCISES	PROBLEMS	ALTERNATE PROBLEMS	CASES AND PROJECTS
2-1	2,3,5			1,2,5,7
2-2	1	1	1	1,2,5,7
2-3	1,4,5,6	2	2	1,2,3,8,9,10
2-4	1,6,7,8,11	2	2	1,2,8
2-5	6,9,10,13,14,15,16	1,5,8	1,3,5,8	
2-6	11,12,14	2,3,5,7,8	3,5,7,8	4,5,6,7,8
2-7	17,18	4,6	4,6	1,2,3,4,10

*NOTE TO INSTRUCTORS: ALL TEST BANK CONTENT AVAILABLE ONLINE THROUGH EZ-TEST AND ON CONNECT CAN BE SORTED BY LEARNING OBJECTIVE, QUESTION TYPE, AND LEVEL OF DIFFICULTY.

GUIDE TO OTHER CHAPTER FEATURES

Focus Company used for Primary Illustrations/Management Decision Setting
Canadian Tire Corporation <http://www.canadiantire.ca>

Financial Analysis

Analysis of Changes in Inventory and Accounts Receivable
Unrecorded but Valuable Assets
Analysis of Change in Current Liabilities
Inferring Business Activities from T-Accounts

Focus on Cash Flows

Investing and Financing Activities

A Question of Accountability

Environmental Liabilities—The Greening of Accounting Standards

International Perspective

Understanding Financial Statements of Foreign Companies

Key Ratio Analysis

The Current Ratio

Pause for Feedback

1. Determine the classification of assets and liabilities as current or non-current
2. Complete the transaction analysis
3. Determine the normal balance for the given accounts as either debit (dr) or credit (cr)
4. Complete the missing information
5. Compute current ratio and discuss results

6. Classify transactions as either financing or investing activity and whether the transaction will increase or decrease cash flow

Demonstration Case Summary

Set up T-accounts

Analyze transactions, prepare journal entries, and determine account balances

Prepare a classified statement of financial position

Identify investing and financing transactions

Chapter Take Aways

Chapter summary by learning objective

SUPPLEMENTAL ENRICHMENT ACTIVITIES

Note: Many of these activities would be suitable for individual or group applications.

IN THE CLASSROOM

"Who Owns What" Game:

Some of your students may work (or have worked) in financial institutions. Explain that there are two sides to every transaction. Working in groups for this game would probably get the best results. Have some students be depositors and others be bank tellers. Use playing cards or "play" money for the transactions. Have each "side" determine if the deposits are assets or liabilities to them. The same thing can be done with borrowing from the bank for a car or home loan. This will reinforce the definition of assets and liabilities for all parties to a transaction. These transactions will "hit close-to-home" for many students.

"Chart of Accounts" Exercise:

It would be beneficial for students to see a variety of charts of accounts (COA) for various industries. You may have had consulting experience with particular industries not presented in the text. Some examples for consideration could be newspapers, banks, pet stores, or other companies that students may find interesting. Have the students "develop" a COA for a company you select for them. They can compare and contrast their account selections with other groups orally in class or in a written report.

"Liquidity" Exercise:

Start with either listings of COAs or those that students developed in the "Chart of Accounts" Exercise above. Have the students develop the order of liquidity for assets and the order of maturity for liabilities. This should reinforce the order of accounts in an accounting system's general ledger.

OUTSIDE THE CLASSROOM

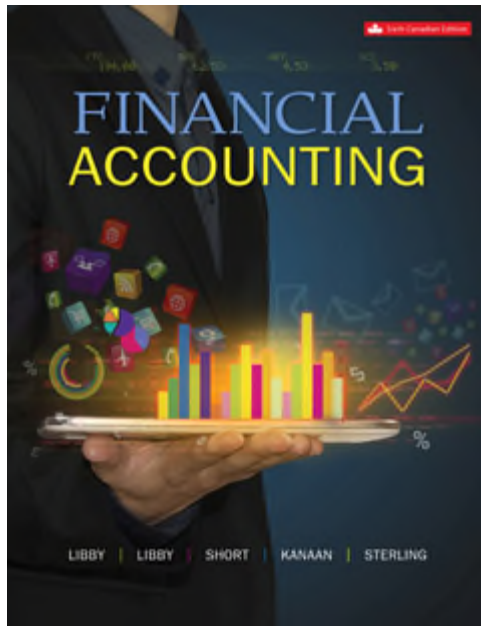
LIBRARY PROJECTS:

Company Update Project:

Students could locate and read articles about Canadian Tire. They could prepare written or oral reports on their research.

Literature Reference Project:

Students could read the articles footnoted in the chapter in their entirety. Students could report additional insights they derived about the companies or subject matter.



FINANCIAL ACCOUNTING

Sixth Canadian Edition

LIBBY, LIBBY, SHORT, KANAAN, STERLING

Investing and Financing Decisions and the Statement of Financial Position

Chapter 2

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Understanding the Business

To understand amounts appearing on a company's statement of financial position we need to answer these questions:

What business activities cause changes in the statement of financial position?

How do specific activities affect each balance?

How do companies keep track of the amounts in the statement of financial position?

The Conceptual Framework

- ▶ Objective of External Financial Reporting
 - ▶ To provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.
- ▶ Qualitative Characteristics of Useful Accounting Information:
 - ▶ **Fundamental characteristics:** relevance, faithful representation
 - ▶ **Enhancing characteristics:** comparability, verifiability, timeliness, understandability
- ▶ Elements to Be Measured and Reported:
 - ▶ Assets, liabilities, shareholders' equity, investments by owners, distribution to owners
 - ▶ Revenues, expenses, gains and losses
 - ▶ Comprehensive income
- ▶ Concepts for Measuring and Reporting Information:
 - ▶ **Assumptions:** separate entity, stable monetary unit, continuity (going concern), periodicity
 - ▶ **Principles:** mixed-attribute measurement, revenue recognition, full disclosure
 - ▶ **Constraints:** cost

The Conceptual Framework

Objective of Financial Reporting

To provide useful economic information to external users for decision making and for assessing future cash flows.

Qualitative Characteristics

Relevance

Faithful Representation

Comparability

Verifiability

Timeliness

Understandability

Elements of Statements

Asset

Liability

Shareholders' Equity

Revenue

Expense

Gain

Loss

The Conceptual Framework

Objective of Financial Reporting

To provide useful economic information to external users for decision making and for assessing future cash flows.

Qualitative Characteristics

Relevance

Faithful Representation

Comparability

Verifiability

Timeliness

Understandability

Fundamental (to be useful)

- **Relevance:** makes a difference in a decision, predictive value, feedback/confirmatory value
- **Faithful representation:** complete, neutral, reasonably free from error or bias.

Enhancing (degrees of usefulness)

- **Comparability:** across companies.
- **Verifiability:** similar results under independent measures.
- **Timeliness:** information must be available before it loses its usefulness.
- **Understandability:** allows reasonably informed users to see the significance of the information.

The Conceptual Framework

Assumptions

Separate entity: Activities of the business are separate from activities of owners.

Continuity (going concern): The business is assumed to continue to operate into the foreseeable future.

Stable monetary unit: Accounting measurements will be in the national monetary unit (i.e., \$ in Canada) without any adjustments for changes in purchasing power (i.e., inflation).

Principle

Historical cost: Cash equivalent cost given up is the basis for the initial recording of elements.

The Conceptual Framework

Objective of Financial Reporting

To provide useful economic information to external users for decision making and for assessing future cash flows.

Asset: economic resource with probable future benefits.

Liability: probable future sacrifices of economic resources.

Shareholders' Equity: financing provided by owners and business operations.

Revenue: increase in assets or settlement of liabilities from ongoing operations.

Expense: decrease in assets or increase in liabilities from ongoing operations.

Gain: increase in assets or settlement of liabilities from peripheral activities.

Loss: decrease in assets or increase in liabilities from peripheral activities.

Qualitative Characteristics

Relevance

Faithful representation

Comparability

Verifiability

Timeliness

Understandability

Elements of Statements

Asset

Liability

Shareholders' Equity

Revenue

Expense

Gain

Loss

Exhibit 2.3 – Canadian Tire Corporation

*The information has been adapted from actual statements and simplified for this chapter.

CANADIAN TIRE CORPORATION

Consolidated Statement of Financial Position* January 2, 2016 (in thousands of dollars, except per share data)

ASSETS		
Current assets		
}	Cash	\$ 901
	Short-term investments	96
	Accounts receivable	5,790
	Inventories	1,765
	Prepaid expenses & other	<u>140</u>
	Total current assets	<u>8,692</u>
Non-current assets		
}	Long-term receivables	731
	Long-term investments	154
	Property and equipment	4,116
	Goodwill	437
	Intangible assets	810
	Other non-current assets	<u>48</u>
	Total non-current assets	<u>6,296</u>
	Total assets	<u>\$14,988</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
}	Accounts payable	\$ 920
	Accrued liabilities	1,037
	Provisions	262
	Short-term borrowings	89
	Income taxes payable	62
	Current portion of long-term debt	24
	Other current liabilities	<u>1,536</u>
	Total current liabilities	3,930
Non-current liabilities		
}	Long-term debt	2,971
	Other non-current liabilities	<u>2,297</u>
	Total liabilities	<u>5,268</u>
Shareholders' equity		
}	Contributed capital	674
	Retained earnings	4,172
	Other components	<u>944</u>
	Total shareholders' equity	<u>5,790</u>
	Total liabilities and shareholders' equity	<u>\$14,988</u>

EXPLANATIONS

"Consolidated" means all subsidiaries are combined
Point in time for which the balance sheet was prepared

Amount of cash in the company's bank accounts
Investments in highly liquid assets
Amounts owed by customers from prior sales
Products stored but not yet sold
Rent, advertising, and insurance paid in advance, and other assets

Amounts owed on loans receivable after one year
Ownership of other companies' shares and bonds
Land, stores, and sales equipment
An intangible asset that results from the acquisition of another business
Assets that do not have physical substance but have a long life
A variety of assets that are covered in future chapters

Amount owed to suppliers for prior purchases
Amounts owed to suppliers of services
Estimated liabilities whose amounts and timing are uncertain
Amounts owed to lenders within one year
Amount of taxes owed to the government
Amounts owed on written debt contracts within one year
A variety of current liabilities

Amounts owed on written debt contracts after one year
A variety of non-current liabilities

Amounts invested in the business by shareholders
Past earnings not distributed to shareholders
Adjustments to assets and liabilities (explained in future chapters)

Elements of the Classified Statement of Financial Position

Current Assets are assets that will be used or turned into cash, normally within one year. Inventory is always considered to be a current asset, regardless of the time needed to produce and sell it.

Non-current Assets are considered to be long-term because they will be used or turned into cash over a period longer than the next year.

Elements of the Classified Statement of Financial Position

Typically, the assets of a company include:

1. Current assets (short-term)

- a. Cash
- b. Short-term investments
- c. Accounts receivable
- d. Inventories
- e. Prepaid expenses (i.e. expenses paid in advance of use)
- f. Other current assets

2. Non-current assets (long-term)

- a. Property and equipment (at cost less accumulated depreciation)
- b. Financial assets
- c. Goodwill
- d. Intangible assets
- e. Other (miscellaneous) assets

Elements of the Classified Statement of Financial Position

Current Liabilities are present debts or obligations of the entity that result from past transactions, which will be paid in cash (or other current assets) or satisfied by providing service for the coming year.

Non-current Liabilities are a company's debts or obligations that have maturities that extend beyond one year from the statement of financial position date.

Elements of the Classified Statement of Financial Position

Typically, the liabilities of a company include:

**1. Current Liabilities
(short-term)**

- a. Accounts payable
- b. Short-term borrowings
- c. Income taxes payable
- d. Accrued liabilities
- e. Provisions
- f. Other current liabilities

**2. Non-current liabilities
(long-term)**

- a. Long-term debt (or borrowings)
- b. Provisions
- c. Other liabilities

Elements of the Classified Statement of Financial Position

Shareholders' equity (owners' equity or stockholders' equity) is the financing provided by the owners and the operations of the business.

Typically the shareholders' equity of a corporation includes the following:

1. Contributed capital
2. Retained earnings (accumulated earnings that have not been declared as dividends)
3. Other components.

A Question of Accountability

ENVIRONMENTAL LIABILITIES — THE GREENING OF ACCOUNTING STANDARDS

- ▶ For many years, companies faced growing pressure to estimate and disclose environmental liabilities, such as the cleanup of hazardous waste. IFRS require Canadian publicly accountable enterprises to report their best estimate of probable liabilities, including environmental liabilities, in the notes to the financial statements. For example, Suncor Energy Inc., which mines oil from the tar sands of northern Alberta, reported environmental liabilities exceeding \$5,505 million in its 2015 financial statements, representing approximately 14.3 percent of its total liabilities at December 31, 2015. It is estimated, however, that a significant percentage of companies under report or fail to report such liabilities, often because of the way disclosure rules are applied.
- ▶ A key economic concern for many Canadian companies is how to manage their resources in an economically sustainable way.

Nature of Business Transactions / Duality of Effects

Most transactions with external parties involve an **exchange** where the business entity **gives up** something but **receives** something in return.

Nature of Business Transactions

External events: exchanges of assets and liabilities between the business and one or more other parties.
(example: borrowing money from the bank)

Internal events: not an exchange between the business and other parties, but have a direct effect on the accounting entity.
(example: loss due to fire damage)

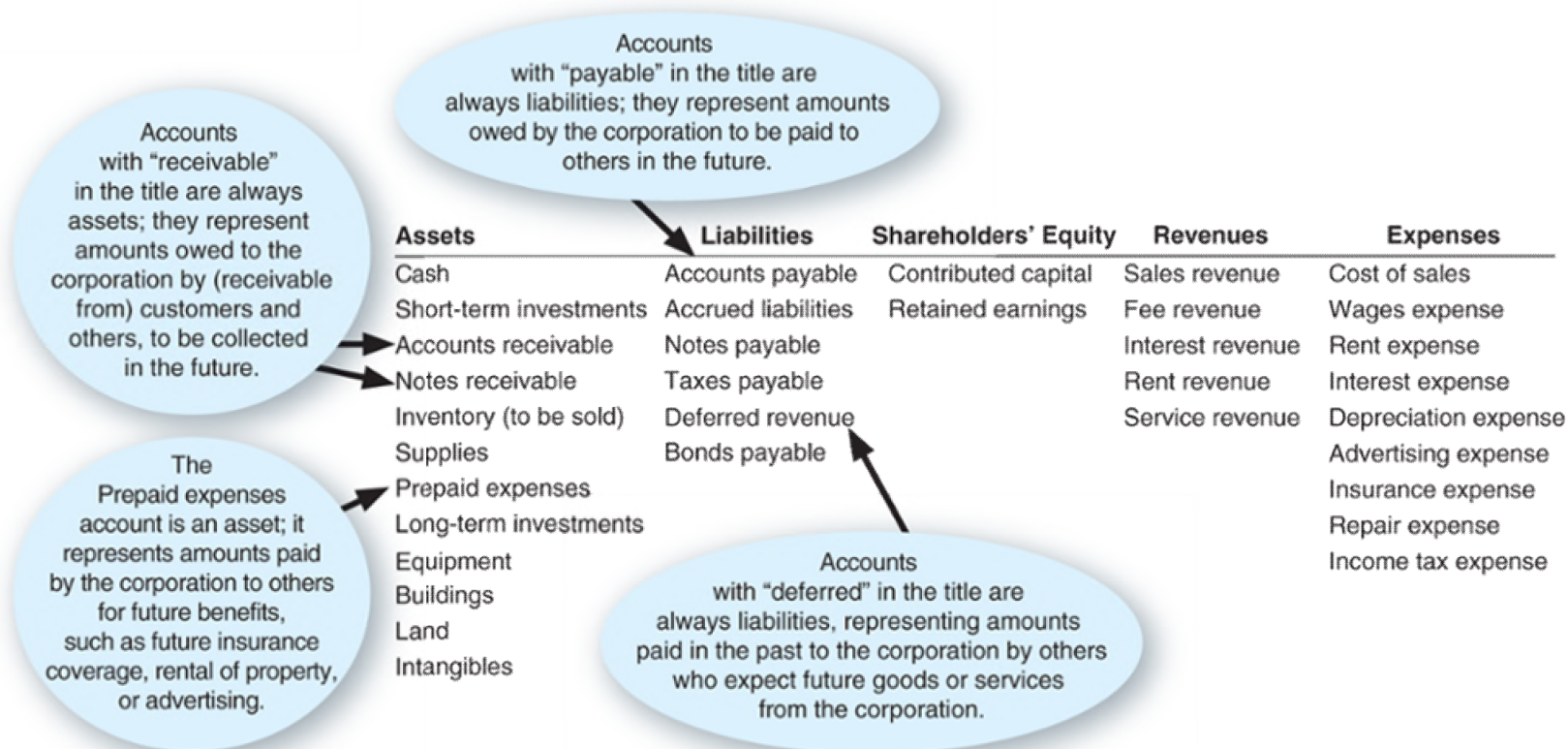
Accounts

ACCOUNTS are an organized format used by companies to accumulate the dollar effects of transactions.

These transactions can be both external, events with parties outside of the business, or internal, that is events that take place within the business organization.

Chart of Accounts

A chart of accounts lists all account titles and their unique numbers.



Typical Account Titles

The Statement of Financial Position

Assets

Cash
Short-Term Investments
Accounts Receivable
Notes Receivable
Inventory (to be sold)
Supplies
Prepaid expenses
Long-Term Investments
Equipment
Buildings
Land
Intangibles

Liabilities

Accounts Payable
Accrued Liabilities
Notes Payable
Taxes Payable
Deferred Revenue
Bonds Payable

Shareholders' Equity

Contributed Capital
Retained Earnings

Typical Account Titles

The Income Statement

Revenues

Sales Revenue
Fee Revenue
Interest Revenue
Rent Revenue
Service Revenue

Expenses

Cost of Sales
Wages Expense
Rent Expense
Interest Expense
Depreciation Expense
Advertising Expense
Insurance Expense
Repair Expense
Income Tax Expense

International Perspective

Understanding Financial Statements of Foreign Companies

The adoption of IFRS by many countries has made it easier to read foreign companies' financial statements. However, there are still some differences in the structure of the statements and account titles that may cause confusion. **A single, consistent format has not been mandated.** Consequently, various formats have evolved over time, with those by Canadian and U.S. companies differing from those typically used internationally, particularly by European companies.

Canadian companies typically list assets in decreasing order of liquidity, but European companies have typically listed their assets in increasing order of liquidity. Similarly, companies may emphasize longer-term financing sources by listing equity before liabilities and, within liabilities, by listing non-current liabilities before current liabilities (decreasing time to maturity). The key to avoiding confusion is to be sure to **pay attention to the subheadings** in the statement. Any account under the heading “liabilities” must be a liability.

Elements of the Statement of Financial Position

A

(Assets)

=

L

(Liabilities)

+

SE

(Shareholders' Equity)

Economic resources with probable future benefits owned or controlled by the entity. Measured by the historical cost principle.

Probable debts or obligations (claims to a company's resources) that result from a company's past transactions and will be paid with assets or services. Entities that a company owes money to are called creditors.

The financing provided by the owners and by business operations. Often referred to as contributed capital.

Principles of Transaction Analysis

- ◆ Every transaction affects at least **two** accounts (duality of effects).
- ◆ The accounting equation must remain in balance after each transaction.

$$\begin{array}{ccccc} \mathbf{A} & = & \mathbf{L} & + & \mathbf{SE} \\ \text{(Assets)} & & \text{(Liabilities)} & & \text{(Shareholders' Equity)} \end{array}$$

Balancing the Accounting Equation

Step 1: Identify and classify accounts and effects

- Identify the accounts (by title) affected and make sure at least two accounts change.
- Classify them by type of account. Was each account an asset (A), a liability (L), or a shareholders' equity (SE)?
- Determine the direction of the effect. Did the account increase [+] or decrease [-]?

Step 2: Verify account equation is in balance.

- Verify that the accounting equation ($A = L + SE$) remains in balance.

Analyzing Transactions

(a) Canadian Tire issues shares to new investors in exchange for \$13 in cash.

Step 1: Identify and classify accounts and effects

1. Cash (+A) \$13. 2. Contributed Capital (+SE) \$13.

Step 2: Is the accounting equation in balance?

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Investments	Equip.	Notes Receivable		Notes Payable		Contributed Capital	Retained Earnings
13							13	
Effect				=				
13				=	13			

A = L + SE

Analyzing Transactions

(b) The company borrows \$10 from its local bank, signing a note to be paid in two-years.

Step 1: Identify and classify accounts and effects

1. Cash (+A) \$10. 2. Notes Payable (+L) \$10.

Step 2: Is the accounting equation in balance?

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Investments	Equip.	Notes Receivable		Notes Payable		Contributed Capital	Retained Earnings
(a) 13							13	
(b) 10					10			
Effect 23				=	23			

A = L + SE

Analyzing Transactions

(c) For expansion, Canadian Tire opened a new store. The company purchased new shelving racks, counters, and other equipment for \$22; paid \$15 in cash; and signed a note for \$7, payable to the supplier in two years.

Step 1: Identify and classify accounts and effects

1. Equipment (+A) \$22. 2. Cash (-A) \$15
 Notes Payable (+L) \$7.

Step 2: Is the accounting equation in balance?

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Investments	Equip.	Notes Receivable		Notes Payable		Contributed Capital	Retained Earnings
(a) 13							13	
(b) 10					10			
(c) (15)		22			7			
Effect 30				=	30			

$$A = L + SE$$

Analyzing Transactions

(d) Canadian Tire lends \$100 to a trade supplier in financial difficulty. The trade supplier signs notes agreeing to repay the amount borrowed in six months.

Step 1: Identify and classify accounts and effects

1. Notes Receivable (+A) \$100. 2. Cash (-A) \$100.

Step 2: Is the accounting equation in balance?

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Investments	Equip.	Notes Receivable		Notes Payable		Contributed Capital	Retained Earnings
(a) 13							13	
(b) 10					10			
(c) (15)		22			7			
(d) (100)			100					
Effect				=				
30				=	30			

$$A = L + SE$$

Analyzing Transactions

(e) Canadian Tire purchases the shares of another company as a long-term investment, paying \$30 in cash.

Step 1: Identify and classify accounts and effects

1. Investments (+A) \$30. 2. Cash (-A) \$30.

Step 2: Is the accounting equation in balance?

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Investments	Equip.	Notes Receivable		Notes Payable		Contributed Capital	Retained Earnings
(a) 13							13	
(b) 10					10			
(c) (15)		22			7			
(d) (100)			100					
(e) (30)	30							
Effect	30			=	30			

$$A = L + SE$$

Analyzing Transactions

(f) Canadian Tire's board of directors declares cash dividends of \$20 for shareholders. The dividends are paid immediately.

Step 1: Identify and classify accounts and effects

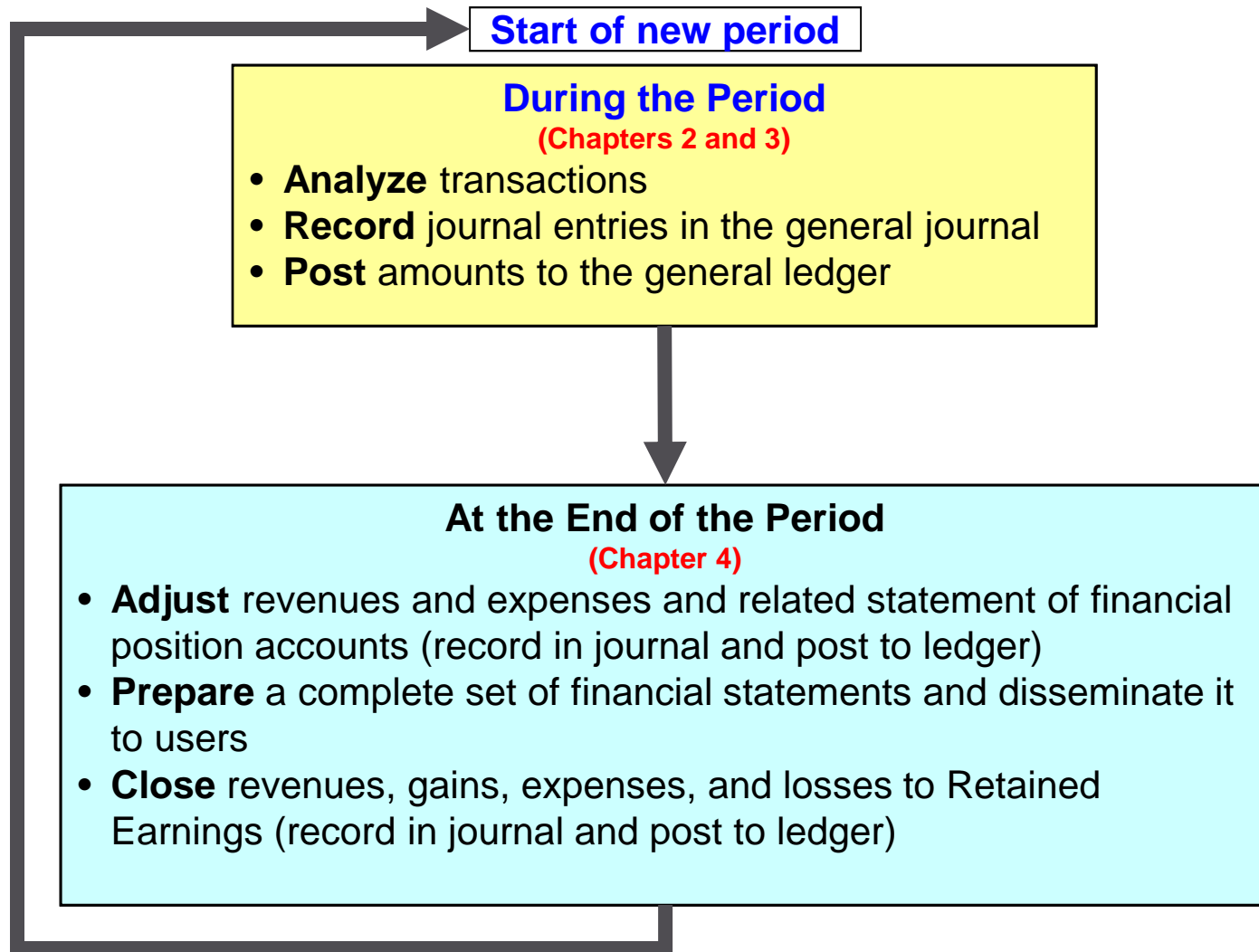
1. Retained Earnings (-SE) \$20. 2. Dividends Payable (+L) \$20.

Step 2: Is the accounting equation in balance?

Assets				=	Liabilities	+	Shareholders' Equity	
Cash	Investments	Equip.	Notes Receivable		Notes Payable		Contributed Capital	Retained Earnings
(a) 13							13	
(b) 10					10			
(c) (15)		22			7			
(d) (100)			100					
(e) (30)	30							
(f) (20)								(20)
Effect	10			=	10			

$$A = L + SE$$

The Accounting Cycle



How Do Companies Keep Track of Account Balances?



General Journal

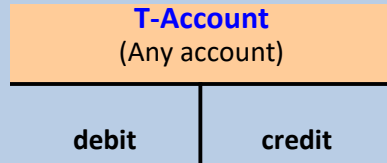


General Ledger



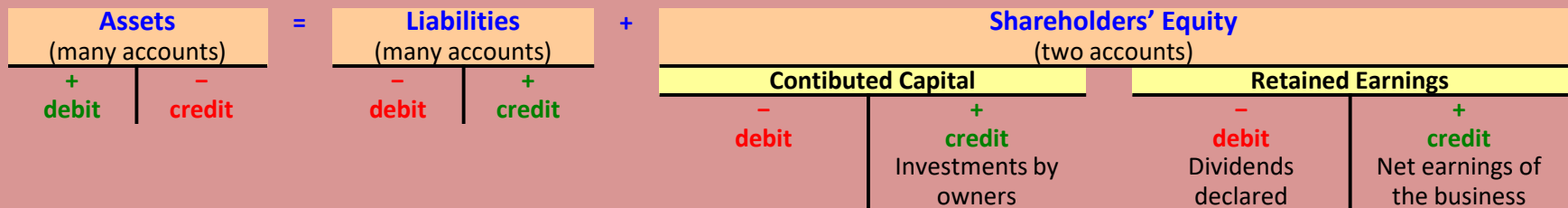
T-accounts

The Direction of Transaction Effects



“T-account” is merely a shorthand term for the entire ledger account. The T-account has a left side, called the debit side, and a right side, called the credit side.

Debits and credits affect the Statement of Financial Position Model as follows:



The Direction of Transaction Effects: Summary

Assets	=	Liabilities	+	Shareholders' Equity
↑ with Debits		↑ with Credits		↑ with Credits
Accounts have debit balances		Accounts have credit balances		Accounts have credit balances

Analytical Tool: The Journal Entry

A journal **entry** might look like this:

		Debit	Credit
(c)	Property and Equipment (+A)	22	
	Cash (-A)		15
	Notes Payable (+L)		7

Reference:
Letter,
number, or
date.

Account Titles:
Debited accounts on top.
Credited accounts on bottom
usually indented.

Amounts:
Debited amounts on left.
Credited amounts on right.

The T-Account

After journal entries are prepared, the accountant posts (transfers) the dollar amounts to each account affected by the transaction.

		Debit	Credit
(c)	Property and Equipment (+A)	22	
	Cash (-A)		15
	Notes Payable (+L)		7

Post → **Ledger**

Canadian Tire issues \$13 of additional common shares to new investors for cash.

GENERAL JOURNAL					
Date		Account Titles and Explanation	Posted Ref.	Debit	Credit
(a)		Cash (+A)		13	
		Contributed Capital (+SE)			13

Cash	
Beg. Bal.	901
(a)	13
<div style="display: flex; justify-content: space-between;"> 914 </div>	

Contributed Capital	
	100 Beg. Bal.
	13 (a)
<div style="display: flex; justify-content: space-between;"> 113 </div>	

The company borrows \$10 from the local bank, signing a two-year note.

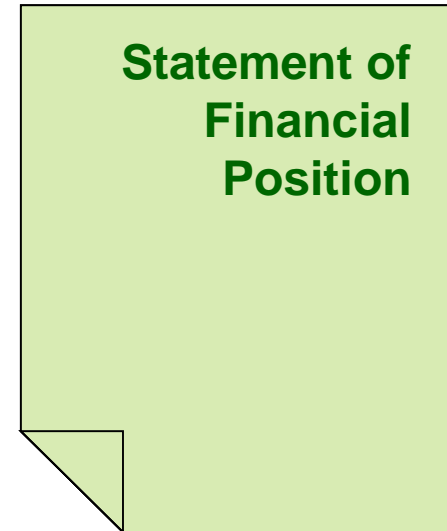
		Debit	Credit
(b)	Cash (+A)	10	
	Notes Payable (+L)		10

Cash	
Beg. Bal.	901
(a)	13
(b)	10
	924

Notes Payable	
	2,971 Beg. Bal.
	10 (b)
	2,981

Statement of Financial Position Preparation

It is possible to prepare a statement of financial position at any point in time from the balances in the accounts.



Classified Statement of Financial Position

In a classified statement of financial position assets and liabilities are classified into two categories – **current** and **non-current**.

Current assets are those to be used or turned into cash within the upcoming year, whereas non-current assets are those that will last longer than one year.

Current liabilities are those obligations to be paid or settled within the next 12 months with current assets.

The Asset Section of a Classified Statement of Financial Position

CANADIAN TIRE CORPORATION Consolidated Statement of Financial Position (in thousands of Canadian dollars)

ASSETS	January 31, 2016	January 2, 2016
Current assets		
Cash	\$ 765	\$ 901
Short-term investments	96	96
Accounts receivable	5,790	5,790
Notes receivable	90	-
Inventories	1,765	1,765
Prepaid expenses	96	96
Other current assets	44	44
Total current assets	<u>8,646</u>	<u>8,692</u>
Non-current assets		
Long-term receivables	731	731
Long-term investments	184	154
Property and equipment	4,138	4,116
Goodwill	437	437
Intangible assets	810	810
Other non-current assets	48	48
Total non-current assets	<u>6,348</u>	<u>6,296</u>
Total assets	<u>\$ 14,994</u>	<u>\$ 14,988</u>

Liabilities and Shareholders' Equity Section of a Classified Statement of Financial Position

CANADIAN TIRE CORPORATION
Consolidated Statement of Financial Position
(in thousands of Canadian dollars)

	January 31, 2016	January 2, 2016
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 920	\$ 920
Accrued liabilities	1,037	1,037
Provisions	262	262
Short-term borrowings	89	89
Income taxes payable	62	62
Current portion of long-term debt	24	24
Other current liabilities	1,536	1,536
Total current liabilities	3,930	3,930
Non-current liabilities		
Long-term debt	2,984	2,971
Deferred tax liabilities	2,297	2,297
Total non-current liabilities	5,281	5,268
Total liabilities	9,211	9,198
Shareholders' equity		
Contributed capital	687	674
Retained earnings	4,152	4,172
Other components	944	944
Total shareholders' equity	5,783	5,790
Total liabilities and shareholders' equity	\$ 14,994	\$ 14,988

Current Ratio

An important indicator of a company's ability to meet its current obligations.

$$\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$$

Canadian Tire has current assets of \$8,692 and current liabilities of \$3,930.

$$\begin{array}{rclcl} \text{Current} & = & \text{Current} & \div & \text{Current} \\ \text{Ratio} & & \text{Assets} & & \text{Liabilities} \\ \\ 2.21 & = & \$ 8,692 & \div & \$ 3,930 \end{array}$$

Comparisons over Time		
2013	2014	2015
1.85	1.84	2.21

2015 Current Ratios		
Canadian Tire	Hudson's Bay	Sears Canada
2.21	1.36	1.92

Focus on Cash Flows

Companies report cash inflows and outflows over a period in their statement of cash flows.

Operating activities

(Covered in the next chapter.)

Investing Activities

Purchasing long-term assets and investments for cash —

Selling long-term assets and investments for cash +

Lending cash to others —

Receiving principal payments on loans made to others +

Financing Activities

Borrowing cash from banks +

Repaying the principal on borrowings from banks —

Issuing shares for cash +

Repurchasing shares with cash —

Paying cash dividends —

Investing and Financing Activities

CANADIAN TIRE CORPORATION	
Consolidated Statement of Cash Flows	
For the Month Ended January 31, 2016	
(in thousands of Canadian dollars)	
Operating activities	
(none in this chapter)	
Investing Activities	
Purchased equipment	\$ (15)
Purchased long-term investments	(30)
Lent funds to trade supplier	(100)
Received payment on loans to trade supplier	10
Net cash used in investing activities	<u>(135)</u>
Financing Activities	
Issued shares	13
Borrowed from banks	10
Repaid loan from bank	(4)
Paid dividends	(20)
Net cash provided by financing activities	<u>(1)</u>
Net decrease in cash	(136)
Cash at beginning of month	901
Cash at end of month	<u>\$ 765</u>

© Agrees with the amount of the statement of financial position.

Some Misconceptions

Don't confuse bookkeeping with accounting.
Bookkeeping involves the routine, clerical part of accounting and requires only minimal knowledge of accounting, but . . .

An **accountant** is a trained professional who can design information systems, analyze complex transactions, and interpret financial data.

Are all transactions subject to precise and objective measurement?

Almost all accounting numbers are influenced by **estimates**.

Some people believe that financial statements report the market value of the company.

Financial statements really report the **cost** of assets, liabilities and shareholders' equity.