CHAPTER 1

Overview of Corporate Financial Reporting

SOLUTIONS TO DISCUSSION QUESTIONS

DQ1-1 Accounting, as an information system, provides economic information to users to allow them to determine whether the entity is operating effectively and efficiently. In addition, accounting facilitates the making of important decisions in the management of the entity, such as whether new assets should be purchased or leased, or whether equity financing should be used as opposed to debt financing.

DQ1-2 The owner's legal liability is as follows for each form of business:

Proprietorship: The owner (or proprietor) is responsible for the debts of the business. His or her personal assets are at risk in the event of legal action.

Partnership: The owners (or partners) are responsible for the debts of the business. Their personal assets are at risk in event of legal action.

Corporation: The owners (or shareholders) are only responsible for the debts of the corporation to the extent of their investment in the company's shares. Any debts in excess of this amount are not their responsibility.

The taxation of income is as follows for each form of business:

Proprietorship: The income of a proprietorship is taxed in the hands of the owner (i.e. the proprietor).

Partnership: The income of a partnership is taxed in the hands of the owners (i.e. the partners).

DQ1-2 (Continued)

Corporation: The income of a corporation is taxed separately (i.e. the corporation files its own tax return). Any income distributed to the shareholders (i.e. dividends) is then taxed in the hands of the owners (i.e. the shareholders).

DQ 1-3 A private corporation is one whose shares are held by a small number of individuals. This makes the transfer of ownership more difficult, as the shares do not trade on a public stock exchange. A public corporation has shares held by a larger number of individuals or entities and these shares are bought and sold on a public stock exchange (such as the Toronto Stock Exchange).

DQ1-4 **Shareholders –** These users are interested in the performance of their investment in the company. They will use the financial statements to evaluate how well management is handling their investment. Individual shareholders may also use the financial statements in assessing whether to continue to hold the shares, purchases more or sell the shares they have.

Creditors (i.e. Financial Institutions) – These users are interested in evaluating the company to decide whether to lend money to it. They will use the statements to evaluate the risk that will be taken in making the loan. This includes assessing the company's ability to service the debt (i.e. pay interest and repay principal).

Taxing Authorities – These users establish the rules for how taxable income will be measured. They are interested in the fair measurement of the financial performance of the company so that the appropriate tax will be paid. Note, however, that income taxes are not paid based on the net earnings reported in the financial statements; rather, income taxes are based on taxable income. In preparing the tax return, the financial statements' net income is the starting point and is then adjusted to arrive at taxable income.

DQ1-4 (Continued)

Financial Analysts – These users provide investment advice to their customers. They are interested in evaluating the investment potential of various companies. They will want to evaluate not only individual companies, but also make comparisons between companies, likely in the same industry.

(Note: there are other users discussed in the chapter that would be equally acceptable answers to this question.)

DQ1-5 Shareholders invest in the shares of a company. They may expect to receive dividends, which are a distribution of past profits to shareholders. They also expect to eventually sell their shares at a higher price than they paid for them due to capital appreciation.

DQ1-6 Capital appreciation is an increase in the market value of the shares of a company. Investors realize this type of return by purchasing shares in a company, and then later selling the shares at a higher market price than they had originally paid. Capital appreciation often results from a company's growth (i.e. increased revenues and increased profits).

DQ1-7 When creditors loan money to a company, they expect to receive their money back. That is one cash stream, called return of principal. The other cash stream is periodic interest that creditors receive for time they have allowed the company to use their money.

DQ1-8 The three major types of activities in which all companies engage are financing, investing, and operating activities.

Financing refers to the activity of obtaining funds for the company to operate. Two primary sources of funds are owners and creditors. Some typical financing activities are: short- and long-term borrowing, repayment of debt, dividend payments, and the issuance of additional shares.

DQ1-8 (Continued)

Investing refers to the activity of using funds generated by financing activities to acquire assets that will generate profits in the future. Investments include the purchase of property, plant, and equipment and the purchase and sale of investments in other companies.

Operating activities are associated with developing, producing, marketing, and selling the products and/or services of the company. Mainly concerned with the day-to-day activities of the company.

DQ1-9 The three major categories of items that appear in a typical statement of financial position (balance sheet) are assets, liabilities, and shareholders' equity.

Assets are resources owned by a company that will be used or sold for its the future economic benefit. In order to have an asset, the event that gave the company the control of the resource must have already happened. The company is able to perform its activities and thereby generate profits with the help of its assets. This means that they are income earning. Assets may be current or non-current. Current assets will be converted into cash within the next year or operating cycle. Examples include cash, inventory, and accounts receivable. Non-current assets are those assets whose benefits may be realized over a period longer than one year or operating cycle. Examples include property, plant, and equipment, patents, trademarks, etc.

Liabilities are the amounts that the company owes to others and which require a probable future outflow or sacrifice of resources to settle an obligation that exists as a result of a transaction that has already taken place. Liabilities may be classified as current and non-current. Current liabilities include notes payable due within one year, accounts payable, accrued expenses, and dividends payable. Non-current liabilities include long-term debt, long-term warranties payable, and pension liabilities.

DQ1-9 (Continued)

Shareholders' Equity represents the wealth or the ownership interest of the owners. Shareholders' equity may also be defined as the difference between the assets and liabilities of a company:

Shareholders' Equity = Assets – Liabilities

There are two major shareholders' equity accounts: share capital and retained earnings. Share capital represents the amount that investors originally paid for the shares that the company issued. Retained earnings consist of the cumulative earnings of the company less the dividends distributed to shareholders.

DQ1-10 Operating activities relate to the day to day activities of a company. This includes generating revenues and incurring expenses, which are the most crucial activities in relation to the long-term sustainability of a company. Investing activities occur on a more sporadic basis and includes the purchase or disposal of property, plant, and equipment as well as shares in other companies.

DQ1-11 Operating activities relate to the day to day activities of a company. This includes generating revenue and incurring expenses, which are the most crucial to the long-term sustainability of a company. Financing activities are those actions taken by a company to obtain the funding necessary to purchase assets such as buildings and equipment. Financing activities also include the repayment of loan principal and payment of dividends. Financing activities are required in order to start a business. Without financing, most businesses would not be able to begin to engage in operating activities. Financing needs generally continue throughout the life of a company as it grows and expands.

DQ1-12 We would normally expect a company to have an overall inflow of cash from its operating activities. Unless a company is successful at generating positive cash inflows from its operations, it will ultimately run out of cash. Financing sources will dry up because the company will be unable to attract new investors or lenders. Eventually it will have to sell the property, plant, and equipment it uses to generate revenue.

DQ1-13 We would normally expect a company to have an overall cash outflow from its investing activities. These activities include the purchase of property, plant, and equipment that are purchased in order to generate operating revenue. Cash inflows from investing activities require the sale of investments or property, plant and equipment. Companies that are financially healthy and growing typically spend more cash on acquiring new assets than the proceeds they generate from selling the property, plant and equipment they have finished using.

DQ1-14 The statement of income describes the results of the operating activities from the beginning of the current period to its end. Net income is defined as revenues less expenses. Revenues are cash or resources that flow into the company from operating activities. Expenses are cash or resources that flow out of company from operating activities. Investing and financing activities typically depicted on statement of financial position.

DQ1-15 The statement of changes in equity provides details on how each component of shareholders' equity changed during the period. Retained earnings, a component of shareholders' equity, changes each period by the net income reported on the statement of income, less any dividends that were declared by the board of directors during the period.

DQ1-16 The four main financial statements contained in all annual reports are the statement of income, the statement of changes in equity, the statement of financial position, and the statement of cash flows.

Statement of Income: The statement of income records the inflow of revenues and gains and the outflow of expenses and losses over the year. The statement helps investors evaluate the performance of the company during the period and it is useful in forecasting the future results of the company.

Statement of Changes in Equity: The statement of changes in equity provides details on how each component of shareholders' equity changed during the period. This includes any changes in share capital, and any income generated by the company less amounts distributed to shareholders as dividends.

DQ1-16 (Continued)

Statement of Financial Position: The statement of financial position gives the financial status of the company at a particular point in time. Since it presents the details of assets, liabilities, and shareholders' equity, it gives users a fair idea of the riskiness of the mix of assets and liabilities of the company.

Statement of Cash Flows: This statement measures the inflow and outflow of cash during a specific period of time. It is very useful in measuring the performance of the company as well as predicting future cash flows since it gives details about the inflow and outflow of cash broken down into operating, investing, and financing activities. It explains the change in cash between the beginning and the end of the period.

DQ1-17 The notes to the financial statements provide more detailed information on items in the financial statements and are cross-referenced. The first or second note to the financial statements often discusses the Summary of Accounting Policies, which describes the choices made by management from among the possible choices and judgments acceptable under accounting standards. The notes help keep the financial statements free of excessive detail, while providing meaning information to financial statement users.

DQ1-18 The management discussion and analysis (MD&A) section of the annual report provides an overview of the previous year, a discussion of the risks facing the company, and some information about future plans. Many companies use this part of the report to make more extensive, detailed comments on the company and its operating results. Often the information is presented from the company's perspective.

SOLUTIONS TO APPLICATION PROBLEMS

AP1-1 **a**. A one-year insurance policy covering the company's delivery vehicles, paid in advance.

This would be an asset, known as prepaid insurance or prepaid expenses. It meets the definition of an asset in that it is:

i. Controlled by the company (i.e. it is their insurance policy);
ii. The company expects future economic benefits from its use (i.e. insurance is required to operate the delivery vehicles which enable the company to generate revenue); and,
iii. The event giving the company control has already happened (i.e. the company has paid for and has obtained the insurance coverage).

b. Gift cards sold to customers

The gift cards would represent a liability, known as unearned revenue or deferred revenue. They meet the definition of a liability in that:

i. They are a present obligation of the company (i.e. the company must provide goods or services to the holders of these gift cards when they are redeemed);
ii. The company expects to settle the obligation through an outflow of resources (i.e. this will result from providing the goods or services); and,
iii. The obligation results from an event that has already happened (i.e. the obligation arose at the time the gift cards were sold and cash was obtained).

AP1-2 Examples of Canadian Tire's financing transactions:

1. Share issuance to raise capital for purchasing property, plant & equipment
2. Issuance of long-term debt to raise capital

AP1-2 (Continued)

Examples of Canadian Tire's investing transactions:

1. Purchase of buildings to house their retail stores
2. Purchase of shelving racks and other displays

Examples of Canadian Tire's operating transactions:

1. Purchase of inventory from suppliers
2. Sale of goods and services

AP1-3 Examples of Hudson Bay Company's financing transactions:

1. Issuance of shares to investors to raise capital for the purchasing of property, plant and equipment
2. Issuance of long-term debt to raise necessary capital to build new stores or invest in new retail technologies (such as online shopping)

Examples of Hudson Bay Company's investing transactions:

1. Purchase of buildings and equipment for retail operations
2. Purchase of building and vehicles for a distribution network to move inventory between warehouses and retail stores

Examples of Hudson Bay Company's operating transactions:

1. Sale of retail inventory to customers
2. Payment of salaries and wages to employees

AP1-4 Examples of Bank of Nova Scotia's financing transactions:

1. Issuance of shares to investors to raise capital to lend money to customers
2. Issuance of long-term debt to raise necessary capital to have funds available to lend money (provide mortgages and loans) to customers

Examples of Bank of Nova Scotia's investing transactions:

1. Purchase of buildings and equipment for in branch operations
2. Purchase of information technology equipment and software to maintain the banking transactions and provide online access for customers

AP1-4 (Continued)

Examples of Bank of Nova Scotia's operating transactions:

1. Sale of services (interest revenue, service charges, etc.) to customers
2. Payment of salaries and wages to employees

AP1-5 A statement of income presents the results of the operating activities of a company for a period of time. A statement of cash flows reports the net cash flows of a company for a period of time. Both statements cover the same time period.

A statement of income presents mainly the results of the operating activities while a statement of cash flows reports cash flows related to operating, investing, and financing activities.

A statement of income gives the net earnings (net income/profits) of a company whereas a statement of cash flows explains the inflows and outflows of cash for the period.

The statement of income includes some items that are not related to cash, such as depreciation. The statement of cash flows includes items related only to cash.

AP1-6

a. Sales revenue is found on the statement of income and represents the amounts charged to customers for the sale of goods and services.

b. Accounts receivable appears on the statement of financial position and represents claims to cash for the sale of goods and services that have not yet been paid for by the customer. Accounts receivable represents an asset of the company.

c. The connection between these two accounts is that accounts receivable are created when sales have been made on credit.

AP1-7

a. Wages payable is found on the statement of financial position and represents the amount that the company owes to the employees for time worked but not yet paid to the employees.

b. Wages expense is found on the on the statement of income and represents the amount of salaries incurred (earned by the employees) during the period. Wages payable represents a liability of the company and wages expense represents a use of the resources of the company.

c. The connection between these two accounts is that wages payable are created from wages expense for time that has been worked by the employees but has not yet been paid.

AP1-8

a. CL
b. SI
c. CL
d. NCA
e. CA
f. SI
g. SCF
h. SI & SCF
i. SC
j. CA
k. NCL

AP1-9

a. CL
b. CA
c. SI
d. SCF
e. CA
f. SI and SCE
g. SCF
h. SCF
i. SI
j. SI
k. SCE and SCF

AP1-10 **a.** NCA
b. SI
c. SCF
d. SI
e. RE and SCE
f. SI
g. SCE and SCF
h. SCF
i. SI
j. NCA
k. SCE and SCF

AP1-11 **a.** O
b. O
c. F
d. I
e. F
f. I
g. O
h. F

AP1-12 **a**. I
b. O
c. O
d. F
e. O as an adjustment to income for non-cash item
f. I
g. F

AP1-13 **a.** SFP
b. SFP
c. SFP
d. SI
e. SI
f. N
g. SI
h. N
i. N
j. SFP

AP1-14
a. SFP
b. SI
c. SFP
d. SFP
e. SI
f. SI
g. N
h. SFP
i. SI
j. SFP

AP1-15 There were no items that appeared on both the statement of financial position and the statement of income. This is to be expected because revenues (expenses) represent increases (decreases) in economic resources and only appear on a statement of income whereas assets, liabilities and equity represent economic resources owned or obligations owed by the company and only appear on a statement of financial position.

AP1-16

	A	B	C	D
Current Assets	**$570,000**	$600,000	$180,000	$990,000
Non-current Assets	780,000	**735,000**	390,000	**660,000**
Total Assets	**1,350,000**	1,335,000	**570,000**	1,650,000
Current Liabilities	375,000	345,000	135,000	390,000
Non-current Liabilities	**337,000**	330,000	**105,000**	225,000
Shareholders' Equity	638,000	**660,000**	330,000	**1,035,000**
Total Liabilities and Shareholders' Equity	1,350,000	**1,335,000**	**570,000**	**1,650,000**

AP1-17

	A	B	C	D
Current Assets	$ 650,000	**$420,000**	$150,000	$ 320,000
Non-current Assets	**1,150,000**	380,000	**210,000**	760,000
Total Assets	1,800,000	**800,000**	360,000	**1,080,000**
Current Liabilities	750,000	170,000	50,000	410,000
Non-current Liab.	500,000	**205,000**	120,000	**270,000**
Shareholders' Equity	**550,000**	425,000	**190,000**	400,000
Total Liabilities and Shareholders' Equity	**1,800,000**	800,000	**360,000**	**1,080,000**

AP1-18

	A	B	C	D
Retained Earnings Dec. 31, 2015	$100,000	$420,000	**$1,475,000**	$930,000
Net Earnings	40,000	**160,000**	550,000	290,000
Dividends declared and paid	10,000	50,000	225,000	**140,000**
Retained Earnings Dec. 31, 2016	**130,000**	530,000	1,800,000	1,080,000

AP1-19

a.

A Slice of Life Ltd.
Statement of Income
For the month of November, 2xxx

Sales		$23,870
Cost of goods sold	$7,130	
Wages expense	5,120	
Rent expense	1,200	
Utilities expense	1,090	
Telephone expense	220	
Total expenses		14,760
Net income		$ 9,110

b. Other costs that Jason might have incurred in November not listed above include:

1. Depreciation expense for kitchen facilities and equipment
2. Income tax expense
3. Depreciation expense and operating expenses such as gas and insurance for pizza delivery vehicles
4. Other employee benefit costs such as employer portion of CPP and EI
5. Interest expense on any bank loans owing

AP1-20

a.

Scents Unlimited Ltd.
Statement of Income
For the month of May, 2xxx

Sales		$24,730
Cost of goods sold	$10,733	
Wages expense	7,000	
Telephone expense	160	
Utilities expense	370	
Rent expense	1,500	
Operating expenses	329	
Total expenses		20,092
Net income		$ 4,638

b. Other costs that Lydia might have incurred in May not listed above include:

1. Depreciation expense of vehicles and equipment
2. Income tax expense
3. Cost of any certifications, licences or association memberships
4. Other employee benefit costs such as employer portion of CPP and EI
5. Interest expense on any bank loans owing

AP1-21

a.

Call of the Wild Ltd.
Statement of Income
For the month of July, 2xxx

Service revenue		$ 171,430
Wages expense	$ 49,860	
Advertising expense	14,610	
Supplies expense	25,629	
Operating expenses	3,460	
Utilities expense	1,532	
Total expenses		95,091
Net income		$ 76,339

b. Other costs Michelle might have incurred in July that were not listed above include:

1. Depreciation expense of tents and rafting equipment
2. Income tax expenses
3. Interest expense on any outstanding loans
4. Other employee benefit costs such as employer portion of CPP and EI

AP1-22

a.

Item	Classification
Supply of ingredients	Asset
Wages owed to employees	Liability
Loan owed to the bank	Liability
Cash held in chequing account	Asset
Cost of ovens & refrigerators	Asset
Prepaid rent for December	Asset
Common shares	Shareholders' equity
Retained Earnings	Shareholders' equity

AP1-22 (continued)

b.

A Slice of Life Ltd.
Statement of Financial Position
Nov. 30, 2xxx

Cash	$ 3,490	Wages payable	$ 1,460
Supplies	670	Bank loan	11,000
Prepaid rent	1,200	Common shares	5,000
Equipment	14,300	Retained earnings	2,200
		Total Liabilities and	
Total Assets	$ 19,660	Shareholders' Equity	$19,660

c. It is unlikely that Jason will have an account called 'accounts receivable' since most of his sales will be on a cash basis. If customers purchased pizza and other food items on credit, then Jason would have accounts receivable on his statement of financial position that would represent the amount that he is owed from his customers. However, pizza parlours sell products that are relatively inexpensive, therefore most customers, if not all, will have enough funds to pay cash for their purchase, which is why it is unlikely that Jason will have an account called "accounts receivable". It may be necessary for him to have an accounts receivable account if he has customers that purchase frequently and/or in large quantities, such as a school. In that case, it would be appropriate to ship a large order of pizzas along with an invoice. Until the invoice is paid (by the school for example), the amount owing would be "accounts receivable".

AP1-23

a.

Item	Classification
Inventory	Asset
Wages owed to employees	Liability
Loan owed to the bank	Liability
Cash held in chequing account	Asset
Cost of refrigerator	Asset
Prepaid rent for June	Asset
Common shares	Shareholders' equity
Retained Earnings	Shareholders' equity

b.

Scents Unlimited
Statement of financial position
May 31, 2xxx

Cash	$ 8,361	Wages payable	$ 950
Inventory	1,100	Bank loan	8,000
Prepaid rent	1,500		
		Common shares	18,000
Equipment	18,695	Retained earnings	2,706
Total Assets	$ 29,656	Total Liabilities and Shareholders' Equity	$29,656

c. It is unlikely that Lydia will have an account called 'accounts receivable' since most of her sales will be on a cash basis. If customers purchased flowers and other items on credit, then Lydia would have accounts receivable on her statement of financial position that would represent the amount that she is owed from her customers. However, florist shops sell products that are relatively inexpensive, therefore most customers, if not all, will have enough funds to pay cash for their purchase, which is why it is unlikely that Lydia will have an account called "accounts receivable". It may be necessary for her to have an accounts receivable account if she has customers that purchase frequently and/or in large quantities, such as an event planner. In that case, it would be appropriate to ship a large order of flowers along with an invoice. Until the invoice is paid (by the event planner for example), the amount owing would be "accounts receivable".

AP1-24

a.

Item	Classification
Loan owed to bank	Liability
Supplies on hand	Asset
Cash in bank accounts	Asset
Common shares	Shareholders' equity
Cost of tents and rafts	Asset
Retained earnings	Shareholders' equity
Amount prepaid by customers for August trips	Liability
Vehicles	Asset

b.

Call of the Wild Ltd.
Statement of Financial Position
As at July 31, 2xxx

Cash	$33,670	Unearned revenue	$19,140
Supplies	13,420	Bank loan	24,000
Equipment	34,100	Common shares	20,000
Vehicles	38,400	Retained earnings	56,450
	$ 119,590		$ 119,590

c. Inventory refers to products that have been purchased for resale to customers. Michelle's business does not have any products for resale to customers, but instead it provides a service, rafting excursions. Thus, the real product is not inventory but a service.

d. Michelle's business does not produce a product for which customers would be extended credit. Michelle would want her customers to pay in advance. Unlike a car dealership where the company can repossess the car if the customer does not pay, it would not be possible for Michelle to repossess a rafting excursion once it is complete. Furthermore, the cost for the service is likely not too high for customers to pay right away. Thus, Michelle's business is not likely to have an accounts receivable account. If Michelle provided rafting excursions to a company for a large number of persons, it is possible that she would invoice the customer and allow them to pay after the event. In this case, Michelle would have an account receivable.

AP1-25

a. *Bombardier Inc.*

Assets

- Inventories
- Aerospace program tooling

Liabilities

- Advances on aerospace programs

b. *Sobeys Inc.*

Assets

- Inventory (groceries, pharmaceutical products)
- Shelving - equipment

Liabilities

- Wages payable

c. *McCain Foods Limited*

Assets

- Processing and packaging equipment
- Inventory of ingredients and finished food products

Liabilities

- Accounts payable

d. *Royal Bank*

Assets

- Loans Receivable
- Cash

Liabilities

- Deposits from Customers

e. *Suncor Energy Inc.*

Assets

- Cash
- Oil and gas properties and drilling and extraction equipment

Liabilities

- Bonds payable or loans payable

AP1-25 (Continued)

f. *Westjet Airlines*
Assets
- Airplanes
- Airport terminal licensing contracts and agreements (intangible asset)

Liabilities
- Deposits from customers for future flights (unearned revenue)

g. *Danier Leather Inc.*
Assets
- Inventory for sale
- Raw materials and supplies to manufacture clothing

Liabilities
- Wages payable

AP1-26

a. *Bombardier Inc.*
Statement of income
- Research and development expense
- Income tax expense

b. *Sobeys Inc.*
Statement of income
- Cost of goods sold (grocery items)
- General & administrative expenses

c. *McCain Foods Limited*
Statement of income
- Sales revenue
- Cost of goods sold (processed and packaged food)

d. *Royal Bank*
Statement of income
- Interest revenue (from customer loans)
- Interest expense (on customer deposits)

AP1-26 (Continued)

e. *Suncor Energy Inc.*
Statement of income
- Sales revenue
- Research and exploration expenses

f. *Westjet Airlines*
Statement of income
- Sales revenue
- Fuel expense

g. *Danier Leather Inc.*
Statement of income
- Sales revenue
- Cost of goods sold

AP1-27

a. *Bombardier Inc.*
Statement of Cash Flows
- Net proceeds from sale of business
- Purchase of manufacturing equipment

b. *Sobeys Inc.*
Statement of Cash Flows
- Increase/decrease in inventory
- Issuance of common shares

c. *McCain Foods Limited*
Statement of Cash Flows
- Proceeds from debt issuance
- Purchase of freezers

d. *Royal Bank*
Statement of Cash Flows
- Purchase of investments
- Increase/decrease in customer deposits

AP1-27 (Continued)

***e**. Suncor Energy Inc.*

Statement of Cash Flows

- Cash proceeds from the sale of unsuccessful properties explored (dry wells)
- Purchases of exploration equipment

f. *Westjet Airlines*

Statement of Cash Flows

- Purchases of aircraft
- Repayment of principal on long-term debt

g. *Danier Leather Inc.*

Statement of Cash Flows

- Purchases of store display fixtures
- Increase or decrease in inventory

USER PERSPECTIVE SOLUTIONS

UP1-1

- Selling price of each model of laptop computer
- Cost of each model of laptop computer
- Selling price of assembly services
- Cost of assembly services
- Salaries and wages paid to any employees
- Costs of parts inventory that would be required
- Information on customers, as in name, model purchased, account balance
- Information on suppliers such as time to delivery and payment policy
- Warranty information on laptops sold
- Return policy for products sold

An accounting software package could reliably keep track of the above information, as well as other relevant information for running the business.

A bank would want assurance that the loan will be repaid. This might include information about past sales and further sales prospects, as well as the cost of goods and services provided. A bank would also want to know about other current financial obligations of the business, and what the loan would be used for. It would be of particular interest whether the loan would be used to cover operating expenses or used for expansion. The bank would also be interested in any other assets you may have that could be used as security for the loan.

UP1-2

a. The loan officer would be interested in your company's ability to repay the loan and thus would look at net income and cash flows. The loan officer would also need to consider a backup plan in the event your company does not make the required loan payments. For example, which assets of your company could be given to the bank in lieu of repayment, or sold to provide cash for repayment? The loan officer would also look at your statement of financial position to identify the assets owned by your company, but would prefer up-to-date market values for these assets rather than the historical

UP1-2 (Continued)

costs listed on the statement of financial position. Any other current or non-current liabilities would be of interest to the loan officer, as they may indicate previous obligations that could compromise the ability to repay a new loan.

b.

1. Is your net income sufficient to repay a loan?
2. Is your net income sustainable?
3. Do you have assets that could be liquidated if your cash flows are insufficient?
4. Do you have currently existing debt that will make it difficult to repay new loans?

*Other answers may also be accepted.

UP1-3

a. The advantages of operating the business as a proprietorship are that it is simple and inexpensive to establish and maintain.

b. The advantages of operating the business as a corporation are that Taylor's personal assets would not be at risk in the event that the company was unsuccessful. This form of business would also enable the company to raise funds by issuing shares, which is not an option if the business operated as a proprietorship. If the business proves to be success, there can be tax advantages from operating it as a corporation.

c. Customers would likely prefer that he operates as a corporation. This gives the appearance that the business is more than a single individual.

d. Creditors would likely prefer that he operate as a proprietorship as they would be able to access any personal assets Taylor might have in the event that the business is not successful. They may be able to do this anyway, by requiring personal guarantees from Taylor for any debts.

UP1-3 (Continued)

e. The corporate form of business would be the most advantageous if Taylor expects the business to grow rapidly. Rapid growth would require additional financing and this is easier to obtain as a corporation. As the company grew Taylor would see a related increase in the value of his shares in the company. Taylor would also have the option of selling some of his shares (for personal gain) or having the company issue additional shares to raise additional capital to fund the company's growth. There may also be tax advantages associated with company being organized as a corporation in the event that profits increase as a result of the growth.

UP1-4 Funds can be raised from several sources, but the two primary sources are from lenders and shareholders.

The advantage of borrowing from a lender is that your friend would retain complete ownership of the business and would not be required to share the decision-making and the profit of the company with anyone else. Bringing in another shareholder may result in a loss of control over the company and would also mean giving up some share of the future profits.

The disadvantage of borrowing from a lender is that loan contracts require repayment of the amount on a set schedule. This increases the risk to the company that it will not be able to make payments on a timely basis. There could be significant consequences for not making payments, including losing ownership of the company. A new shareholder would not have this same type of contractual arrangement and would be at risk in the same way as your friend. However, the new shareholder would probably expect a higher return from her/his investment than would a lender. Your friend would be giving up more potential profit to a new shareholder than lender.

Another disadvantage to borrowing is that interest must be paid on the loan. It is not optional but is tax deductible. Dividends, on the other hand, are optional and would normally only be declared by the company's board if the company was profitable.

UP1-5 The board should consider the number of shares outstanding and the proposed dividend per share, which will determine the total cash requirements. They must also consider whether the available cash in the company is sufficient to make the dividend payment without disturbing the overall liquidity of the business in its day to day operations. If not, they may have to delay payment of the dividend, or look for ways to generate additional cash.

The dividend declaration will reduce retained earnings, so the retained earnings amount must be larger than the proposed dividend. The board should also consider the company's future plans. The retained earnings account represents the cumulative profits of the business that are kept within the company to fund future expansion plans. Dividends are declared and paid when the company has no plans to use the accumulated profits to fund future expansion. Thus, the declaration and payment of dividends only makes sense if the company does not need the cash for future expansion plans.

READING AND INTERPRETING PUBLISHED FINANCIAL STATEMENTS SOLUTIONS

RI1-1

a. Dividends declared in 2014 are $40,141. This amount is included in the consolidated statement of changes in shareholders' equity. The actual amount of dividends paid ($38,418) is shown on the consolidated statement of cash flows.

b. All amounts are in thousands of Canadian dollars.

i. Revenues from the sale of merchandise in 2014 are $2,064,676.
ii. Cost of sales, and general, administrative and store operating expenses, in 2014 are respectively, $1,299,092 and $363,182.
iii. Net financing costs in 2014 $11,673.
iv. Income tax expense in 2014 $92,737.
v. Net earnings in 2013 $220,985.
vi. Merchandise inventories at the end of 2013 $338,385.
vii. Accounts payable and accrued liabilities at the beginning of 2014 fiscal year were $101,286.
viii. Retained earnings at the end of 2014 $346,478 (from the consolidated statement of changes in shareholders' equity or the statement of financial position).
ix. Long-term debt at the beginning of 2014 $262,071
x. Cash flows generated from operating activities in 2014 $308,378
xi. Cash payments to acquire property, plant, and equipment in 2014 ($96,303).
xii. Cash proceeds from the issuance of common shares in 2014 $1,430.
xiii. Cash flows used for financing activities in 2013 ($197,213).
xiv. Cash payments to reduce long-term debt in 2014 ($264,420).

c. The largest sources of cash are $400,000 from proceeds from senior unsecured notes, and $308,378 from operating activities.

The largest uses of cash are ($277,438) for repurchase and cancellation of shares and ($264,420) for disbursements on long-term debt.

RI1-1 (Continued)

d. To compute cash flow from operations, net earnings are increased by the non-cash items including depreciation and amortization expense, and further adjusted by changes in working capital items such as inventory and accounts payable.

e. Cost of goods sold increased by $135,113. General, administrative and store operating expenses increased by $23,520. Depreciation and amortization increased by $ 8,614. Together these help explain "where the additional sales revenue went."

RA1-2

a. The use of the term "consolidated" means that the company has, at a minimum, a parent company and a subsidiary – a company that is controlled by the parent company generally through holding voting shares.

b. Amounts are in thousands of Canadian dollars

Year	Current assets	Current liabilities	Working capital
2014	$137,173	$62,284	$74,889
2013	132,223	47,382	84,841
Decrease in working capital			$ 9,952

The working capital did not improve from 2013 to 2014, it decreased by $9,952,000. This represents a decrease of approximately 12% in the ability to cover current liabilities with current assets.

c. All amounts are in thousands of Canadian dollars.

i. Sales revenues in 2014 $274,840.
ii. Cost of sales in 2014 $101,770.
iii. Finance cost (cost of debt) in 2013 $3,063
iv. Income tax expense (recovery) in 2014 ($5,722)
v. Net income (loss) in 2013 ($8,717).

RA1-2 (Continued)

vi. Intangible assets at the end of 2014 $3,815
vii. Trade receivables (accounts receivable) at the beginning of 2014 $1,906.
viii. Share capital at the end of 2014 $42,960.
ix. Property, plant, and equipment at the end of 2014 $69,870.
x. Cash flows used in operating activities in 2014 ($3,356).
xi. Cash payments to acquire intangibles and property and equipment and intangible assets in 2013 ($9,237).
xii. Cash used for the payment of dividends in 2013 ($ nil).
xiii. Cash produced for financing activities in 2014 $9,337.

d. In 2014, 40.7% ($85,759/$210,858) of LeChateau's assets were financed with debt, while 59.3% ($125,099/$210,858) were financed by equity.

e. The two largest sources of cash were an increase in bank indebtedness of $17,482 and the issuance of shares of $159. The two largest uses of cash were the repayment of long-term debt ($8,304) and the addition to property and equipment and intangible assets of ($6,318).

f. The loss of ($15,986) included non-cash depreciation and amortization of $18,723. This is the most significant difference between the net loss on the consolidated statement of loss and the cash flows from operations.

RI1-3

a. All amounts in thousands of Canadian dollars:

i. Total sales revenue in 2013: $53,873.
ii. Cost of sales in 2013: $47,662.
iii. Sales and marketing expense in 2012: $1,292.
iv. Finance expense in 2013: $149
iiv. Income tax expense in 2013: $498.
vi. Net income in 2013: $1,654.
vii. Inventories at the end of 2013: $6,463
viii. Accounts payable at the beginning of 2013: $1,559.
ix. Shareholders' equity at the end of 2013: $22,509.
x. Deficit at the beginning of 2013: $2,213.
xi. Cash provided from operating activities in 2013: $5,739.
xii. Cash payments to acquire plant and equipment in 2013: $370.
xiii. Cash used in the repayment of debt in 2013: $2,512.
xiv. Cash used to pay dividends in 2013: $1,669.

b. At December 31, 2013, Ten Peaks' total assets of $30,968 were financed by liabilities of $8,459 and equity of $22,509. Approximately 72.7% of Peaks' assets were financed by shareholders, while 27.3% were financed using debt.

c. In 2013, Ten Peaks had a net cash outflow of $4,181 from financing activities (the company paid dividends and repaid debt principal) and a net cash outflow of $370 for investing activities (the company purchased plant and equipment).

d. A classified statement of financial position presents information in order of liquidity. This is how Ten Peaks structures its consolidated statement of financial position, by separating current from non-current assets and liabilities. Current assets are reported according to liquidity, with least liquid first and most liquid last.

RI-4

a. All amounts are in thousands of U.S. dollars

i. Net sales in 2013 - $2,184,303

ii. Total selling, general, and administrative expenses in 2013 – $282,563

iii. Income tax (recovery) in 2012 - ($4,337)

iv. Net income (earnings) in 2013 - $320,178

v. Inventories in the beginning of 2013 - $553,068

vi. Trade accounts receivable at the end of 2012 - $257,595

vii. Retained earnings at the end of 2013 - $1,583,346

viii. Long-term debt at the end of 2012 - $181,000

ix. Cash flows from operating activities in 2013 - $427,156

x. Cash payments to acquire property, plant, and equipment in 2013 - $162,643

xi. Dividends paid in 2013 - $43,723

xii. Cash (used) for investing activities in 2013 - ($172,136).

b. At September 29, 2013, Gildan's total assets of $2,043,651 were financed by liabilities of $324,225 and equity of $1,719,426. Approximately 84.1% of Gildan's assets were financed by shareholders, while only 15.9% were financed using debt.

c. The two largest sources of cash in 2013 were cash flows from operating activities of $427,156 and proceeds from issuance of shares of $6,014. The two largest uses of cash in 2013 were additions to property, plant, and equipment of $162,643 and principal repayments of a revolving long-term bank credit facility, of $181,000.

d. Gildan Activewear prepared a classified statement of financial position presents information in order of liquidity. The presence of sub-totals for current assets and current liabilities show that the statement is a classified statement of financial position. Gildan separates current from non-current assets and liabilities. Current assets are reported according to liquidity, with most liquid first and least liquid last.

RI-4 (Continued)

e.

Year	Current assets	Current liabilities	Working capital
2013	980,712	289,414	691,298
2012	912,600	256,442	656,158
		Increase in working capital	35,140

Gildan's working capital increased by $35,140,000 in 2013. This is approximately 5% higher than working capital in 2012.

RI1-5 Answers to this question will depend on the company selected.

RI1-6 Answers to this question will depend on the company selected.

CASE SOLUTIONS

C1-1 Enticing Fashions Ltd.

Memorandum

To: CEO, Enticing Fashions Ltd.
From: Accountant
Re: Bank's Use of Financial Statements

As the company is seeking financing from its bank to support its expansion plans, it is understandable that the bank will be taking a greater interest in the company's financial reporting. Prior to approving any loan, the bank will use Enticing's financial statements to assess the following:

(i) The company's ability to service a loan

The bank will use the financial statements to determine if Enticing has the earnings and cash flow to service the loan (i.e. pay interest on the loan and repay the loan principal).

Specifically, the bank will review the statement of income to assess the profitability of the company's operations. If the company does not have a track record of profits, then it unlikely a loan will be granted. If the company is not profitable, it will not be able to pay interest or repay loan principal.

The bank will use the statement of cash flows to evaluate the amount of cash the company is generating from its operating activities. It will be these cash flows that Enticing will use to pay interest and repay principal. While it will look at the company's financing and investing cash flows, the bank's primary focus will be on those generated from operations.

C1-1 (Continued)

(ii) The extent of assets that the company has available that could be provided as security in the event of loan default

The bank will also want to ensure that it has adequate loan security. This will normally involve them taking a charge over some of the borrower's assets. For example, they may want a charge over the Enticing's accounts receivable and inventory, meaning these assets would revert to the bank for collection or sale to repay the loan in the event that Enticing defaulted. They may also wish to use the property, plant and equipment of the company as security. This would involve the bank having a charge over Enticing's equipment, buildings, land, etc. The bank could then seize and sell these assets to repay the loan in the event of default.

The bank will use the statement of financial position to determine what assets the company could provide as security. The bank would be aware of the fact that, for many assets, the values on the statement of financial position represent their historic cost rather than their fair values. As such, the bank may ask Enticing to obtain appraisals for these assets prior to agreeing to accept the assets as loan security.

I hope that this enhances your understanding of how the bank may use Enticing's financial statements in the context of approving the company's loan application. Please don't hesitate to contact me if you wish to discuss this matter in greater detail.

Sincerely,

Accountant

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