CHAPTER 2

Analyzing Transactions and Their Effects on Financial Statement

ASSESSING YOUR RECALL SOLUTIONS

2-1 An asset is something that you own or that will provide you with future benefit. On the other hand, a liability is an obligation that you owe, and thus is a claim on your resources.

2-2 When transactions are recorded in the accounting system, the equality of the basic accounting equation (or balance sheet equation), Assets = Liabilities + Shareholders' Equity, must be maintained. This implies that all transactions must affect at least two accounts in the financial statements to maintain the equality, although the effects may be within the same category of accounts. For example, the collection of cash from customers on account both increases an asset (cash) and decreases another asset (accounts receivable).

2-3 Dividends are not normal business expenses. They are a return of part of the profits earned by shareholders and not an expense incurred to generate revenues. Dividend payments involve an outflow of cash and are therefore recorded on the cash flow statement.

2-4 Advantages of using the accrual basis:

1. Revenue is recognized when earned. Under the cash system, the revenue is recognized only when the cash is received.
2. Accrual basis is consistent with generally accepted accounting principles.
3. It is a based on three accounting principles, revenue recognition, matching, and time period.
4. It increases the comparability of financial statements from one period to another.

Disadvantages of using the accrual basis:

1. Revenue and expenses must be matched to the time period in which they actually happened, which is not consistent with when the cash was received or used.
2. The uncertainty of the future cash flows is captured by estimates of potential uncollectibility. Indeed, under the accrual system some of the revenues may never be received at all.
3. The accrual basis does not give a clear view of the amount of cash that that an organization has in a given time period.

2-5 The three major sections in the cash flow statement are:

1. **Operating activities**: Includes transactions involved with the buying and selling of goods/services such as business expenditures and revenues, etc.
2. **Investing Activities**: Includes transactions involved with the buying and selling of assets such as long-term investments, property, plant, and equipment, etc.
3. **Financing Activities**: Includes transactions regarding the inflow and outflow of cash necessary for investment plans of the business such as issuance of shares, payment of dividends, acquisition and repayment of loans, etc.

2-6 a. T
b. T
c. F
d. F
e. F
f. F
g. F
h. F

2-7 Under IFRS and GAAP, revenues are recognized on the accrual basis, where the recording of revenues (and expenses) is in the period in which they are earned (incurred) rather than when the cash event occurs. Revenue recognition criteria are criteria used to determine when revenues should be recognized from a sales transaction. The amount recognized must be reasonable and there must also be a high probability that cash will ultimately be collected. The matching concept requires that all expenses associated with the generation of revenues should be matched with the respective revenues.

2-8 Under accrual-basis accounting, a prepaid expense is brought forward as an asset on the balance sheet and expensed as the related benefits are realized. For example, if rent is paid for future months, no expense is recognized immediately even though cash is paid. The prepaid expense is then expensed over the months that benefit from the advance payment.

2-9 Under accrual-basis accounting, an accrued expense is one that is recognized on the income statement as an expense before cash is paid out. In this case, a liability is set up on the balance sheet that will be eliminated once the cash has been paid.

2-10 Depreciation is a method of allocating the cost of a non-current asset to each of the years of its useful life. Using the straight-line method, depreciation is calculated as the total cost of the asset less the estimated residual value divided by the estimated number of years of useful life.

APPLYING YOUR KNOWLEDGE SOLUTIONS

2-11

a. 19,000
b. 7,500
c. 16,000
d. 15,500
e. 5,000
f. 4,000
g. 3,000
h. 25,500
i. 29,000
j. 5,000

2-12 \$125,000 – 85,000 = 40,000 (Ending Equity)

\$110,000 – 80,000 = 30,000 (Beginning Equity)

\$40,000 – 30,000 – 7,000 = 3,000 (Ending Retained Earnings)

\$3,000 + 4,000 = 7,000 (Net Earnings)

2-13 a. \$448,800 + 2,200 + 4,800 = 455,800

b. \$26,400 + 38,800 + 63,300 + 1,200 + 272,000 = 401,700

c. \$455,800 – 401,700 = 54,100

d. \$96,000 + 54,100 – 105,600 = 44,500

2-14 a. sales revenue = $8,000
cost of goods sold = $5,000
total expenses other than cost of goods sold = $2,400
($400 + $100 + $1,900)
net earnings or loss = $600 net earnings

b. cash on hand = $4,900
($10,000 – $4,000 – $500 – [$5,000 x 50%] + [$8,000 x 50%] – $1,900 – $200)
total assets other than cash = $9,000
([$1,000 - $100] + $4,000 + [$500 – $400] + [$8,000 x 50%])
total liabilities = $2,500
([$5,000 x 50%])
share capital = $11,000 ($10,000 + $1,000)
retained earnings = $400 ($600 – $200)

2-15 a. **Cash Basis:**

Cash sales	$115,000
Cash collections on credit sales	30,000
Less:	
Payments to suppliers	(75,000)
Wages paid	(32,500)
Insurance premiums paid	(1,000)
Net receipts over disbursements	$ 36,500

b. **Accrual Basis:**

Cash sales	$115,000
Credit sales	35,000
Less:	
Cost of Goods Sold	(85,000)
Wages expense	(35,000)
Insurance expense	(500)
Net Earnings	$ 29,500

2-16 Cash Basis:

Cash sales	$80,000
Cash collections on credit sales	20,000
Less:	
Payments to suppliers	0
Wages paid	(37,500)
Rent paid	(13,000)
Office supplies paid	(5,500)
Net receipts over disbursements	$44,000

Accrual Basis:

Cash sales	$80,000
Credit sales	20,000
Less:	
Cost of Goods Sold	(60,000)
Wages expense	(38,000)
Rent expense	(12,000)
Office supplies expense	(5,000)
Net Loss	$ (15,000)

2-17 A balance in retained earnings means that the business has been profitable in the past and the profits have been retained within the company. It does not mean that the profits are in the form of cash. More than likely the profits have been invested in other assets such as property, plant, and equipment and inventory. To the extent that these assets can be sold for their carrying values, the statement is somewhat correct—the proceeds could be used to pay off liabilities. If the assets are not worth their carrying values or they are difficult to turn into cash (such as investments in real estate), the statement is not entirely correct. Retained earnings do provide some level of comfort during difficult times as their existence means that assets exceed liabilities.

2-18 A statement of earnings (under IFRS) presents the effects of the operating activities of a company on the shareholders' wealth for a period of time on an accrual basis. A statement of cash flows reports the net cash flows of a company for a period of time. A statement of earnings presents mainly the results of the operating activities while a statement of cash flows reports cash flows relating to operating, investing, and financing activities. A statement of earnings gives the net earnings (or income or profits) of a company whereas a statement of cash flows explains the inflow and outflow of cash for the period. The statement of earnings provides an explanation of the changes in shareholders' wealth during the period, whereas the statement of cash flows provides an explanation of the changes in cash. Because they both explain changes in balance sheet accounts, they are both referred to as flow statements.

2-19 a. Increase assets (cash) and increase shareholders' equity (common shares)
b. Decrease assets (cash) and increase assets (land)
c. Increase assets (accounts receivable) and increase shareholders' equity (sales revenue increases, which increases retained earnings)
d. Increase assets (cash) and decrease assets (accounts receivable)
e. Decrease assets (cash) and decrease shareholders' equity (retained earnings)
f. Increase assets (cash) and increase liabilities (bank loan)
g. Decrease assets (cash) and decrease shareholders' equity (interest expense increases, which decreases retained earnings)
h. Increase assets (inventory) and increase liabilities (accounts payable)
i. Decrease assets (cash) and decrease liabilities (accounts payable)
j. Decrease assets (cash) and decrease shareholders' equity (delivery expense increases, which decreases retained earnings)
k. Decrease assets (cash) and increase in assets (prepaid insurance) when payment is made. Once insurance is used decrease in assets (prepaid insurance) and a decrease shareholders' equity (insurance expense increases, which decreases retained earnings)
l. Decrease assets (increases accumulated depreciation, whcih is a contra asset) and decreases shareholders' equity (increases depreciation expense, which decreases retained earnings)

2-20 <u>**Account**</u>	<u>**Increase/Decrease**</u>
a. Cash (A)	Increase
Common Shares (SE)	Increase
b. Cash (A)	Increase
Loan Payable (L)	Increase
c. Equipment (A)	Increase
Accounts Payable (L)	Increase
d. Inventory (A)	Increase
Cash (A)	Decrease
Accounts Payable (L)	Increase
e. Accounts Receivable (A)	Increase
Sales Revenue (SE)	Increase*
Cost of Goods Sold (SE)	Increase**
Inventory (A)	Decrease
f. Accounts Payable (L)	Decrease
Cash (A)	Decrease
g. Cash (A)	Increase
Accounts Receivable (A)	Decrease
h. Office Supplies (A)	Increase
Cash (A)	Decrease
i. Dividends Declared (SE)	Increase**
Cash (A)	Increase
j. Interest Expense (SE)	Increase**
Interest Payable (L)	Increase
k. Accounts Payable (L)	Decrease
Cash (A)	Decrease
l. Office Supplies Expense (SE)	Increase**
Office Supplies (A)	Decrease

* Increase in Shareholders' Equity
** Decrease in Shareholders' Equity

2-21	Income	Cash Flow
	a. No Effect	+$60,000
	b. No Effect	No Effect
	c. +$200	No effect (sold on account, inventory already owned)
	d. No Effect	-$10,000
	e. No Effect	-$1,000
	f. -$300	No Effect
	g. No Effect	+$700
	h. No Effect	No Effect
	i. No Effect	-$2,000
	j. -$500	No Effect

2-22 Assets = Liabilities + Shareholders' Equity

a. +150,000 (cash) = +150,000 (common shares)

b. -25,000 (cash) = +25,000 (accounts payable)
+50,000 (land)

c. +45,000 (inventory) = +45,000 (accounts payable)

d. +52,000 (accounts receivable) = +52,000 [retained earnings (sales revenue)]

-35,000 (inventory) = -35,000 [retained earnings (cost of goods sold)]

e. -1,000 (cash) = -1,000 [retained earnings (taxes expense)]

f. +25,000 (cash) = +25,000 (bank loan)

g. -1,200 (equipment) = -1,200 [retained earnings (depreciation expense)]

h. -750 (cash)
+750 (supplies)

i. -250 (cash) = -250 [retained earnings (utilities expense)]

j. -8,000 (cash) = -8,000 [retained earnings (dividends)]

2-23 Assets = Liabilities + Shareholders' Equity

a. +30,000 (cash) = +50,000 (common shares)
+20,000 (equipment)

b. -1,500 (cash) = -1,500 [retained earnings (rent expense)]

c. +850 (supplies) = +850 (accounts payable)

d. +2,400 (cash) = +2,400 [retained earnings (sales revenue)]

e. -850 (cash) = -850 (accounts payable)

f. +700 (accounts receivable) = +700 [retained earnings (sales revenue)]

g. -350 (supplies) = -350 [retained earnings (supplies expense)]

h. +500 (cash)
-500 (accounts receivable)

i. -75 (cash) = -75 [retained earnings (telephone expense)]

j. = +250 (accounts payable)
-250 [retained earnings (advertising expense)]

k. -3,200 (cash)
+3,200 (prepaid rent)

l. -1,000 (cash) = -1,000 [retained earnings (dividends)]

2-24 Assets = Liabilities + Shareholders' Equity

	Assets		Liabilities + Shareholders' Equity
a.	+15,000 (supplies)	=	+15,000 (accounts payable)
b.	-12,000 (cash)	=	-12,000 (accounts payable)
c.	+20,000 (cash)	=	+25,000 [retained earnings
	+5,000 (accounts receivable)		(service revenue)]
d.	+5,000 (cash)		
	-5,000 (accounts receivable)		
e.	-10,000 (supplies)	=	-10,000 [retained earnings
			(cost of sales)]
f.	+25,000 (cash)	=	+25,000 (common shares)
g.	-500 (cash)	=	+100 (accounts payable)
			-600 [retained earnings
			(utility expense)]
h.	+50,000 (cash)	=	+50,000 (bank loan)
i.	+45,000 (equipment)		
	-45,000 (cash)		
j.	-9,000 (cash)	=	-9,000 [retained earnings
			(wages expense)]
k.		=	+200 (interest payable)
			-200 [retained earnings
			(interest expense)]
l)		=	+500 (warranty payable)
			-500 [retained earnings
			(warranty expense)]

*All transactions except (a) have an immediate effect on statement of earnings or the statement of cash flows.

2-25 a. Selling inventory to customers for cash results in an increase in assets (cash) and a corresponding increase in shareholders' equity (revenue increases) along with a decrease in assets (the inventory account) and a decrease in shareholders' equity (cost of goods sold expense increases).

b. Selling inventory to customers on account results in an increase in assets (accounts receivable) and a corresponding increase in shareholders' equity (revenue increases) along with a decrease in assets (the inventory account) and a decrease in shareholders' equity (cost of goods sold expense increases

c. Collecting cash from customers as payments on their accounts results in an increase in assets (cash) and a corresponding decrease in assets (accounts receivable).

d. Inventory purchased on account will increase the assets (inventory) and liabilities (accounts payable). The inventory will ultimately be sold, and at that time shareholders' equity will decrease (as cost of goods sold expense increases), but will increase as a result of the sale. Assets (inventory) will also decrease. The account payable will be paid with a decrease in the assets (cash) and liabilities (accounts payable).

e. Paying suppliers for goods purchased on account results in an decrease in assets (cash) and a corresponding decrease in liabilities (accounts payable).

f. The purchase of equipment will increase the assets (equipment) and decrease the assets (cash). Over its life, the equipment will have to be depreciated, resulting in a decrease in the carrying amount of the assets (equipment) and a decrease in shareholders' equity (depreciation expense).

2-25 (continued)

g. If the insurance policy is paid in advance (as they usually are), assets (a prepaid insurance account) should be increased along with a decrease in assets (cash). As time passes, the assets (prepaid insurance account) should be reduced and an insurance expense recognized, which will decrease shareholders' equity.

h. Borrowing money from the bank increases assets (cash) and liabilities (a bank loan payable). In the future, interest will accrue on the loan, decreasing shareholders' equity (interest expense) and decreasing assets (cash). The principal of the loan will have to be paid back with a resulting decrease in assets (cash) and a decrease in liabilities (bank loan payable).

i. The purchase of a patent results in an increase in assets (a patent account) and a decrease in assets (cash). Over time, the patent should be depreciated much like plant and equipment. This will result in a decrease in assets (the patent) and a decrease in shareholders' equity (depreciation expense).

j. At the time of signing the warranty agreement the company should recognize a decrease in shareholders' equity (warranty expense increases) and an increase in liabilities (a warranty payable account) based on an estimate of the expense. When the warranty service is actually provided, assets (cash) would be decreased as well as the liability (the warranty payable).

2-26

	Assets	=	**Liabilities**	+	**Shareholders' Equity**
a.	+$15,000 (cash)	=	+$15,000 (bank loan)		
b.	-$900 (cash)	=		+	-$900 [retained earnings (interest expense)]
c.	+$10,000 (equipment) -$10,000 (cash)				
d.	-$1,500 (equipment)	=		+	-$1,500 [retained earnings (depreciation expense)]
e.	+$87,500 (inventory)	=	+$87,500 (accounts payable)		
f.	+$17,500 (cash) +130,000 (accounts receivable)	=	+$147,500 [retained earnings (sales revenue)]		
g.	-$85,000 (inventory)	=	- $85,000 [retained earnings (cost of goods sold)]		
h.	-$73,000 (cash)	=	-$73,000 (accounts payable)		

i.	+$116,000 (cash) - $116,000 (accounts receivable)	=		
j.		=	+$48,400 (wages payable)	-$48,400 [retained earnings (wages expense)]
k.	-$1,200 (cash)	=	-$1,200 (wages payable)	
l.	-$1,000 (cash)			-$1,000 (retained earnings)

2-27

	Assets	=	**Liabilities**	+	**Shareholders' Equity**
a.	-$1,000 (supplies)	=		+	$1,000 [retained earnings (supplies expense)]
b.	+$32,000 (inventory)	=	+$32,000 (accounts payable)		
c.	+$24,000 (cash) +$36,000 (accounts receivable)	=		+	$60,000 [retained earnings (sales revenue)]
d.	-$36,000 (cash)	=	-$36,000 (accounts payable)		
e.	+$34,000 (cash) -$34,000 (accounts receivable)				
f.	-$800 (cash) +$800 (prepaid insurance)				
g.	-$39,000 (inventory)	=		-	$39,000 [retained earnings (cost of goods sold)]
h.	-$7,000 (cash)	=		-	$7,000 [retained earnings (operating expenses)]
i.	-$600 (prepaid insurance)	=		-	$600 [retained earnings (insurance expense)]
j.	-$3,600 (property, plant and equipment)	=		-	$3,600 [retained earnings (depreciation expense)]

k.		=	+$1,600 (dividends payable)	- $1,600 [retained earnings (dividends)]
l.	-$1,200 (cash)	=	-$1,200 (dividends payable)	

2-28 a. $95,000
b. $107,000
c. $60,000 (no change)
d. $31,000
e. $59,000

2-29

a.

Sara's Bakery
Statement of Earnings
For the year ended December 31, 2011

Sales		$178,000
Less operating expenses:		
Cost of goods sold	$101,000	
Wages expense	42,000	
Supplies expense	14,000	
Depreciation expense	2,500	
Rent expense	12,000	
Total expenses		171,500
Net Earnings		$ 6,500

b. We did not use the following items on the statement of earnings:

1. **Cash** – This is an asset and belongs on the balance sheet. It is measured at a point in time.

2. **Accounts payable** – This liability item represents an obligation that Sara's Bakery has to its suppliers/creditors. It is also measured at a point in time and belongs on the balance sheet.
3. **Share capital** – This is a component of shareholders' equity on the balance sheet. It represents the amount of capital contributed to the business in exchange for an ownership interest. It does not measure performance of the company's operations, and thus, does not belong on the statement of earnings.

4. **Accounts receivable** – This asset arises when a customer buys goods or services on credit. Sales revenue on the income statement *already includes* this amount (the sales made on credit) because accrual accounting records a transaction (like the sale of goods and services) in the period it occurs, not when cash is paid. Accounts receivable is not part of a company's operating performance. Rather, it tells us the amount of cash that is owed to a company by its customers.

5. **Equipment** – This is a part of the asset section of the balance sheet. Equipment is not part of the statement of earnings.

6. **Retained Earnings** – This is a component of shareholder's equity on the balance sheet. It represents the cumulative net earnings less any net losses over the life of the organization.

7. **Supplies on Hand –** This represents the supplies that Sara's Bakery purchased but have not used in the operations. These supplies are an asset and are a part of the balance sheet.

8. **Prepaid Rent –** Is a component of the balance sheet under the asset section. The prepaid rent has not been used so it is not an expense until it is used.

9. **Wages payable** – This liability item reflects the wages owed by Sara's Bakery to its employees for hours worked but not yet paid. Wages expense, however, already includes the amount of wages payable on the statement of earnings because accrual accounting records an expense in the period that it occurs, not when cash is paid. Wages payable is listed as a liability on the balance sheet.

10. **Accumulated Depreciation** - This is a part of the asset section of the balance sheet. Accumulated depreciation on the equipment is the contra asset account to the equipment asset account. Accumulated depreciation is the cumulative amount of depreciation expensed and is not part of the statement of earnings. Instead, the depreciation expense for the current year is shown in the statement of earnings.

11. **Dividends declared** - The payment of dividends is not recorded as an expense on the statement of earnings because it is not part of the operating performance of Sara's Bakery. Dividends are declared when the company's Board of Directors decides that it does not need to retain all of a company's past profits in the business to fund expansion. If the company has no need for these profits, they are paid out to the owners of the business with the declaration of a dividend.

2-30

a**.**

The Garment Tree Ltd.
Statement of Earnings
For the year ended December 31, 2011

Sales		$110,000
Less expenses:		
Cost of goods sold	$57,000	
Wages expense	32,000	
Rent expense	12,000	
Advertising expense	5,000	
Miscellaneous expense	3,000	

Total expenses	109,000
Net Earnings	$ 1,000

b. We did not use the following items on the statement of earnings:

1. **Wages payable** – This liability item reflects the wages owed by The Garment Tree Ltd. to its employees for hours worked but not yet paid. Wages expense, however, already includes the amount of wages payable on the statement of earnings because accrual accounting records an expense in the period that it occurs, not when cash is paid. Wages payable is listed as a liability on the balance sheet.
2. **Prepaid Rent –** Is a component of the balance sheet under the asset section. The prepaid rent has not been used so it is not an expense until it is used.
3. **Accounts payable** - This liability item represents an obligation that The Garment Tree has to its suppliers/creditors. It is also measured at a point in time and belongs on the balance sheet.
4. **Accounts Receivable -** This asset arises when a customer buys goods or services on credit. Sales revenue on the income statement *already includes* this amount (the sales made on credit) because accrual accounting records a transaction (like the sale of goods and services) in the period it occurs, not when cash is paid. Accounts receivable is not part of a company's operating performance. Rather, it tells us the amount of cash that is owed to a company by its customers.
5. **Inventory** – This asset on the balance sheet is not placed on the statement of earnings because it represents the cost of inventory that is sitting in storage. Once the products are sold to customers, accrual accounting takes the cost of the inventory and records it as cost of goods sold. In the meantime, inventory remains an asset on the balance sheet, representing the cost of products not yet sold.
6. **Retained Earnings** – This is a component of shareholder's equity on the balance sheet. It represents

the cumulative net earnings less any net losses over the life of the organization

7. **Cash** – This is a balance sheet account representing the cash held by the organization at one point in time.
8. **Dividends declared** – The payment of dividends is not recorded as an expense on the statement of earnings because it is not part of the operating performance of The Garment Tree. Dividends declared occurs when the company's Board of Directors decides that it does not need to retain all of a company's past profits in the business to fund expansion. If the company has no need for these profits, they are paid out to the owners of the business with the declaration of a dividend.
9. **Share capital** – This is a component of shareholders' equity on the balance sheet. It represents the amount of capital contributed to the business in exchange for an ownership interest. It does not measure performance of the company's operations, and thus, does not belong on the statement of earnings.

2-31

Tree Top Restaurant Ltd.
Statement of Financial Position
As at December 31, 2011

ASSETS		
Current assets		
Cash		$ 53,000
Accounts receivable		90,000
Inventory		46,000
Prepaid insurance		8,000
Total current assets		$197,000
Non-current assets		
Furniture and equipment	90,000	
Less: Accumulated Deprec	(10,000)	80,000
Buildings	260,000	
Less: Accumulated Deprec	(30,000)	230,000
Land		100,000
Total non-current assets		$410,000

Total Assets	$607,000
LIABILITIES & SHAREHOLDERS' EQUITY	
Current liabilities	
Accounts payable	$82,000
Taxes payable	5,000
Wages payable	10,000
Total Current Liabilities	97,000
Bank loan	250,000
Total liabilities	347,000
Shareholders' equity	
Share capital	$ 200,000
Retained earnings	60,000
Total Shareholders' equity	260,000
Total Liabilities and Shareholders' Equity	$607,000

2-32 a.

Sales		$69,900
Less expenses:		
Cost of goods sold	$34,900	
Wages expense	26,000	
Rent expense	3,600	
Advertising expense	800	
Electricity expense	300	
Interest expense	100	
Depreciation expense	500	
Other expenses	400	
Total expenses		66,600
Net earnings		$ 3,300

b. Beginning balance $0 + Net earnings $3,300 – Dividends declared $1,200 = Ending balance $2,100 c.

Little Tots Ltd.
Statement of Financial Position
As at December 31, 2011

ASSETS		
Current assets		
Cash		$3,500
Accounts Receivable		2,500
Prepaid rent		300
Inventory		8,000
Total current assets		$14,300
Non-current assets		
Display counters	5,500	
Less: Accumulated depreciation	(500)	5,000
Total Assets		$19,300
LIABILITIES & SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable		$2,000
Wages payable		400
Total current liabilities		$2,400
Non-current liabilities		
Bank Loan		4,800
Total Liabilities		$7,200
Shareholders' equity		
Share capital		$10,000
Retained earnings		2,100
Total Shareholders' equity		$12,100
Total Liabilities and Shareholders' equity		$19,300

2-33 a. To identify the statement of earnings accounts and calculate net earnings, a statement of earnings for Minute Print Company is presented below.

Minute Print Company
Statement of Earnings
For the year ended December 31, 2011

Sales		$486,000
Less expenses:		
Supplies used	$214,500	
Wages	93,000	
Interest charges	2,500	
Rent-equipment	100,000	
Rent-premises	24,000	
Other expenses	9,000	
Total expenses		443,000
Net Earnings		$ 43,000

b.

Net Earnings	$43,000
Less: dividends declared	3,000
Retained earnings at Dec 31, 2011	$40,000

c.

Minute Print Company
Statement of Financial Position
As at December 31, 2011

ASSETS		
Current assets		
Cash	$ 24,000	
Accounts receivable	30,000	
Supplies	68,000	
Prepaid rent	2,000	
Total current assets		$124,000
Total Assets		$124,000
LIABILITIES & SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable		$ 8,000
Wages payable		4,500
Dividends payable		1,500
Non-current liabilities		
Loan payable		40,000
Total liabilities		$54,000
Shareholders' equity		
Share capital	$ 30,000	
Retained earnings	40,000	
Total shareholders' equity		70,000
Total Liabilities and Shareholders' Equity		$124,000

2-34 a.

The Wizard's Corner
Statement of Earnings
For the year ended June 30, 2011

Sales		$160,000
Less expenses:		
Cost of goods sold	$103,000	
Wages expense	36,000	
Rent expense	12,000	
Advertising expense	6,000	
Depreciation expense	2,000	
Total expenses		159,000
Net Earnings		$ 1,000

b. $21,000 + 1,000 – 3,000 = 19,000

c.

The Wizard's Corner
Statement of Financial Position
As at June 30, 2011

ASSETS		
Current assets		
Cash		$ 10,000
Accounts receivable		15,000
Inventory		28,000
Prepaid rent		1,000
Total current assets		$ 54,000
Non-current assets		
Equipment	20,000	
Less: Accumulated deprec.	(9,000)	11,000
Total Assets		$ 65,000

LIABILITIES & SHAREHOLDERS' EQUITY
Current liabilities

Accounts payable	$11,000
Wages payable	2,000
Total Current Liabilities	13,000
Total liabilities	13,000
Shareholders' equity	
Share capital	$ 33,000
Retained earnings	19,000
Total Shareholders' Equity	52,000
Total Liabilities and Shareholders' Equity	$ 65,000

2-35 a.

	Assets	=	Liabilities	+	Shareholders' Equity
1.	+$250,000 (cash)	=		+	+$250,000 (common shares)
2.	+$50,000 (cash)	=	+$50,000 (bank loan)		
3.	+$200,000 [land $60,000 and building $140,000] -$200,000 (cash)				
4.	+$130,000 (inventory)	=	+$130,000 (accounts payable)		
5.	+$205,000 [$30,000 cash and $175,000 accounts receivable]	=			+$205,000 [retained earnings (sales revenue)]
6.	-$120,000 (inventory)	=			-$120,000 [retained earnings (cost of goods sold)]
7.	-$115,000 (cash)	=	-$115,000 (accounts payable)		
8.	+$155,000 (cash) -$155,000 (accounts receivable)				
9.	-$55,000 (cash)	=	+$2,000 (wages payable)	+	-$57,000 [retained earnings (wages expense)]

10.	-$3,000 (cash)	=		+	-$3,000 [retained earnings (interest expense)]
11.	-$4,000 (building - accumulated depreciation)	=		+	-$4,000 [retained earnings (depreciation expense)]
12.		=	+$7,000 (dividends payable)	+	-$7,000 (retained earnings)

b**.**

Singh Company
Statement of Earnings
For the Year Ending December 31, 2011

Revenues		
Sales		$205,000
Expenses		
Cost of Goods Sold	$120,000	
Wages	57,000	
Interest	3,000	
Depreciation	4,000	184,000
Net Earnings		$ 21,000

Singh Company
Statement of Financial Position
As at December 31, 2011

ASSETS	
Cash	$112,000
Accounts Receivable	20,000
Inventory	10,000
Land	60,000
Building, net	136,000
TOTAL ASSETS	$338,000
LIABILITIES	
Accounts Payable	$ 15,000
Wages Payable	2,000
Dividends Payable	7,000
Bank Loan	50,000
TOTAL LIABILITIES	$ 74,000
SHAREHOLDERS' EQUITY	
Common Shares	250,000
Retained Earnings	14,000
TOTAL SHAREHOLDERS' EQUITY	$264,000
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$338,000

Singh Company
Cash Flow Statement
For the Year Ending December 31, 2011

Cash Flow from Operating Activities:	
Cash collections from customers	$185,000
Cash payments to suppliers	(115,000)
Cash payments for salaries	(55,000)
Cash payments for interest	(3,000)
Cash from Operations:	$12,000
Cash Flow from Investing Activities:	
Purchase of Land and Building	(200,000)
Cash used in investing	(200,000)
Cash Flow from Financing Activities:	
Cash proceeds from Issuance of shares	$ 250,000
Cash proceeds from bank loan	50,000
Cash from financing	300,000
TOTAL INCREASE IN CASH	112,000
Cash, beginning of year	0
Cash, end of year	$112,000

2-36

a.

	Assets	=	**Liabilities**	+	**Shareholders' Equity**
1.	+$175,000 (cash)	=		+	+$175,000 (common shares)
2.	+$225,000 (cash)	=	+$225,000 (loan)		
3a.	+$75,000 (prepaid rent) -$75,000 (cash)				
3b.	-$60,000 (prepaid rent)	=		+	-$60,000 [retained earnings (rent expense)]
4.	+$220,000 (equipment) -$220,000 (cash)				
5.	+$90,000 (inventory) -$90,000 (cash)				
6.	+$570,000 (inventory)	=	+$570,000 (accounts payable)		
7.	+$80,000 (cash) +$720,000 (accounts receivable)	=		+	+$800,000 [retained earnings (sales revenue)]
8.	+$650,000 (cash) -$650,000 (accounts receivable)				

9.	-$510,000 (cash)	=	-$510,000 (accounts payable)		
10.	-$560,000 (inventory)	=		+	-$560,000 [retained earnings (cost of goods sold)]
11.	-$82,500 (cash)	=	+$4,000 (accrued expenses)	+	-$86,500 [retained earnings (S&A expense)]
12.	-$47,500 (cash)	=	-$25,000 (loan)	+	-$22,500* [retained earnings (interest expense)]
13.	-$20,000 (equipment – accumulated depreciation)	=		+	-$20,000 [retained earnings (depreciation expense)]
14.	-$12,000 (cash)	=	+$3,300 (income tax payable)	+	-$15,300** [retained earnings (income tax expense)]
15.	-$7,000 (cash)	=		+	-$7,000 [retained earnings (dividends)]

*$225,000 x 10% = $22,500
**Calculation made after statement of earnings was prepared.

b.

Hughes Tools Company
Statement of Earnings
For the year ended September 30, 2012

Sales		$800,000
Expenses		
Cost of goods sold	$560,000	
Rent expense	60,000	
Depreciation expense	20,000	
Interest expense	22,500	
Selling and administrative	86,500	749,000
Earnings before income taxes		51,000
Income taxes ($51,000 x 30%)		15,300
Net earnings		$35,700

Hughes Tools Company
Statement of Financial Position
As at September 30, 2012

Assets	
Cash	$ 86,000
Accounts receivable	70,000
Inventory	100,000
Prepaid rent	15,000
Equipment, net	200,000
Total assets	$471,000
Liabilities	
Accounts payable	$ 60,000
Accrued expenses	4,000
Income tax payable	3,300
Bank loan	200,000
Total liabilities	267,300
Shareholders' equity	
Common shares	175,000
Retained earnings	28,700 *
Total shareholders' equity	203,700
Total liabilities and shareholders' equity	$471,000

*Net earnings – dividend declared = $35,700 – $7,000 = $28,700

Hughes Tools Company
Cash Flow Statement
For the year ended September 30, 2012

Operations		
Cash receipts from customers	$730,000	
Cash paid for inventory	(600,000)	
Cash paid for interest	(22,500)	
Cash paid for selling and administrative expenses	(82,500)	
Cash paid for rent	(75,000)	
Cash paid for income taxes	(12,000)	
Cash used in operations		$(62,000)
Investing		
Purchase of equipment		(220,000)
Financing		
Issuance of shares	175,000	
Issuance of debt	225,000	
Repayment of debt	(25,000)	
Payment of dividends	(7,000)	
Cash from financing		368,000
Increase in cash		$86,000
Cash, beginning of the year		0
Cash, end of the year		$86,000

c. The results of the first year of operations are generally very good. The sales are excellent, with a healthy profit margin ($357,000/$800,000) 4.5%, and a very substantial cash balance. However, cash flow from operations is negative, which may be a cause for concern.

The company's return on assets measures 7.6% ($35,700/$471,000) and their return on equity comes in at 17.5% ($35,700/$203,700). As it is their first year of operations we will want to compare these results to industry averages to have a better understanding of this company's performance.

2-37

a**.**

	Assets	=	**Liabilities**	+	**Shareholders' Equity**
1.	+$300,000 (cash)	=		+	+$300,000 (common shares)
2.	+$57,500 (land) +$172,500 (building) -$80,000 (cash)			+	+$150,000 (common shares)
3.	+$37,500 (cash)	=	+$7,500 (unearned rent)	+	+$30,000 [retained earnings (rental revenue)]
4a.	+$120,000 (equipment) -$60,000 (cash)	=	+$60,000 (notes payable)		
4b.		=	+$3,000 (interest payable)	+	-$3,000* [retained earnings (interest expense)]
5.	+$250,000 (inventory)	=	+$250,000 (accounts payable)		
6.	+$50,000 (cash) +$250,000 (accounts receivable)	=		+	$300,000 [retained earnings (sales revenue)]
7.	-$190,000 (inventory)	=		+	-$190,000 [retained earnings (cost of goods sold)]
8.	-$205,000 (cash)	=	-$205,000 (accounts payable)		

9.	+$200,000 (cash) -$200,000 (accounts receivable)				
10.	-$50,000 (cash)	=		+	-$50,000 [retained earnings (operating expense)]
11.	-$7,125 (building)	=		+	-$7,125** [retained earnings (depreciation expense)]
12.	-$5,750 (equipment)	=		+	-$5,750*** [retained earnings (depreciation expense)]
13.	-$10,000 (cash)	=	+$12,238 (taxes payable)	+	-$22,238**** [retained earnings (inc. tax exp.)]
14.	-$15,000 (cash)	=	+$5,000 (dividends payable)	+	-$20,000 [retained earnings (dividends)]

*$60,000 x 10% x 1/2 = $3,000
**($172,500 – $30,000) ÷ 20 = $7,125
***($120,000 – $5,000) ÷ 10 x 1/2 = $5,750
****See statement of earnings for calculation

b.

A.J. Smith Company
Statement of Earnings
For the year ended December 31, 2011

Sales		$300,000
Rent revenue		30,000
Total revenues		$330,000
Expenses		
Cost of goods sold	$190,000	
Depreciation expense	12,875	
Interest expense	3,000	
Operating	50,000	255,875
Earnings before income taxes		74,125
Income taxes ($74,125 x 30%)		22,238
Net earnings		$ 51,887

A.J. Smith Company
Statement of Financial Position
As at December 31, 2011

Assets	
Cash	$167,500
Accounts receivable	50,000
Inventory	60,000
Land	57,500
Building, net	165,375
Equipment, net	114,250
Total assets	$614,625
Liabilities	
Accounts payable	$ 45,000
Notes payable	60,000
Interest payable	3,000
Unearned rent	7,500
Income tax payable	12,238
Dividend payable	5,000
Total liabilities	132,738

Shareholders' equity		
Common shares	$450,000	
Retained earnings	31,887	*
Total shareholders' equity	481,887	
Total liabilities and shareholders' equity	$614,625	

*Net earnings – Dividend declared = $51,887 – $20,000 = $31,887

A.J. Smith Company
Cash Flow Statement
For the year ended December 31, 2011

Operations		
Cash receipts from customers	$250,000	
Cash from rent revenue	37,500	
Cash paid for inventory	(205,000)	
Cash paid for operating expenses	(50,000)	
Cash paid for income taxes	(10,000)	
Cash from operations		$22,500
Investing		
Purchase of capital assets		(140,000)
Finances		
Issuance of shares	300,000	
Payment of dividends	(15,000)	
Cash from financing		285,000
Increase in cash		$167,500
Beginning cash balance		0
Ending cash balance		$167,500

c. Students should utilize the three performance measures introduced in the chapter:
Profit margin ratio (using total revenues): $51,887/$330,000 = 15.7%
Return on Assets: $51,887/$614,625 = 8.4%
Return on Equity: $51,887/$481,887 = 10.8%
Ideally, they should consider these numbers with respect to industry averages; however, these are not provided.
Students should also identify from the cash flow statement that positive cash flows were generated from operating activities, which is a good sign – especially in the company's first year of operations.

2-38

Moore Repairs
Statement of Earnings
For the month ended January 31, 2012

Repair fees earned		$18,000
Expenses		
Rent expense	$6,000	
Miscellaneous expense	600	
Part & supplies used	2,600	
Salaries expense	5,000	14,200
Net earnings		$ 3,800

Moore Repairs
Statement of Financial Position
As at January 31, 2012

Assets	
Cash	$ 7,000
Accounts receivable	15,500
Inventory of parts and supplies on hand	8,800
Total assets	$31,300
Liabilities	
Accounts payable	$ 3,800
Bank loan	5,500
Total liabilities	9,300
Shareholders' equity	
Share capital	$13,600
Retained earnings	8,400 *
Total shareholders' equity	22,000
Total liabilities and shareholders' equity	$31,300

*Retained Earnings + Net earnings – Dividend declared = $6,600 + $3,800 – $2,000 = $8,400

2-39

Gordon Company
Statement of Cash Flows
For the Year Ended January 31, 2012

Operations		
Cash receipts from customers	$14,000	
Cash payments to suppliers	(9,000)	
Cash payments for salaries	(10,000)	
Cash payments for other expenses	(2,000)	
Cash used in operations		$(7,000)
Investing		
Purchase of equipment	(15,000)	
Purchase of investment	(2,000)	
Proceeds Sale of equipment	1,000	
Cash from investing		(16,000)
Financing		
Issuance of shares	25,000	
Repayment of bank loan	(3,000)	
Payment of dividends	(3,000)	
Cash used in financing		19,000
Decrease in cash		$(4,000)
Cash balance on April 1, 2011		8,000
Cash balance on March 31, 2012		$ 4,000

The first thing to note about the cash flow statement of Gordon Company is that it used more cash than it generated for operating activities. This is not a promising sign. The major uses of cash were to buy new equipment, pay dividends, repay a bank loan, and invest in another company. To pay for these items, the company sold some equipment and issued common shares. One of the implications of issuing shares is that the amount of dividends could increase in the future. Unlike bank debt, however, the cash received from issuing shares does not need to be paid back.

2-40 a. Borrower: increase assets (cash) and increase liabilities (bank loan)

Bank: increase assets (loan receivable) and decrease assets (cash)

b. Buyer: increase assets (inventory) and decrease assets (cash)

Seller: increase assets (cash) and decrease assets (inventory), increase shareholders' equity (sales); and decrease shareholders' equity (cost of goods sold)

c. Company A: increase assets (investment in Company B) and decrease assets (cash)

Company B: increase assets (cash) and increase shareholders' equity (common shares)

d. Company A: increase assets (investment in Company B) and decrease assets (cash)

Company B: no effect because Company B is not a party to the transaction

e. Buyer: increase assets (inventory) and increase liabilities (accounts payable)

Seller: decrease assets (inventory), increase assets (accounts receivable), increase shareholders' equity (sales), and decrease shareholders' equity (cost of goods sold expense increases)

f. Supplier: increase assets (cash) and increase liabilities (unearned revenue)

Customer: decrease assets (cash) and increase assets (prepaid deposit)

USER PERSPECTIVE SOLUTIONS

2-41 As Krave's Candy Company will use the proceeds of the bank loan for expansion, I would want to know details of their future plans:

- Any budgets/forecasts of future periods' net income and/or cash flow
- Details of any contracts signed with customers (e.g. Wal-Mart) to support expanded sales revenue forecasts
- Details of capital equipment to be purchased (costs to acquire, estimated residual/resale values)

I would also review the accounting results of past operations:

- Sales revenue trends in past periods (to assess company growth)
- Net income trends in past periods (to assess company profitability)
- Cash flow from operating activities—I would hope this is positive and increasing
- A list of owned assets (purchase cost listed on the balance sheet) and an estimate of market values since such assets can provide the loan officer with security for a loan (can be offered to the bank in lieu of repayment, or could be sold to provide cash)
- Inventory control policies to ensure inventory levels are sufficient to meet customer needs but not excessive (ties up cash, may lead to spoilage problems)
- Accounts receivable collection policies to ensure credit terms are fair

2-42 Under the cash basis, it is very clear when to recognize revenue and expenses since they are recognized at the time of cash receipt or cash disbursement. Under the accrual basis, management has much more discretion in the recognition of revenues and expenses. The timing of the revenue is determined based on meeting certain revenue recognition criteria that are subject to interpretation and estimation. Expenses are to be matched with revenues, but many expenses are estimated and are therefore somewhat subjective. For example, many computer companies recognize revenue when they ship computers to dealers who can return them. This allows them to recognize revenue very early. The costs of fixing computers under warranties offered to customers must be estimated and expensed when the computers are shipped to dealers (matched to revenues), although the actual costs of warranty claims may not be known for a considerable period of time.

2-43 a**.** From the perspective of a shareholder of the company, treating the cost of a piece of equipment as an expense at the date of purchase is likely to misstate net earnings in the current period as well as in future periods. The current period's earnings are understated because the full cost of the equipment would be deducted in the current period and it would not be matched with the revenue produced from using that equipment since the revenue would come in over a much longer period of time (the useful life of the asset). Future periods' income will be overstated since the revenue shown in those periods will not be offset by the expense of using the equipment.

b. From the perspective of a buyer, the concern would be that no asset would be listed on the balance sheet of the company (since it would already have been expensed). In attempting to value the assets of the company, the buyer would have to recognize that there are some assets that do not appear on the balance sheet, but should be considered in valuing the company.

2-44 The estimation of warranty expense is a difficult process since there are so many uncertainties. Of all of the expenses that the company could recognize and match against revenues, warranty costs are probably the most uncertain. Therefore, as a taxing authority, I would be worried about potential misstatement of warranty expense. As well, allowing early recognition would reduce the income on which taxes were paid. For these reasons, I would recommend that warranty expense only be recognized for tax purposes when the actual cost is incurred.

READING AND INTERPRETING PUBLISHED FINANCIAL STATEMENTS SOLUTIONS

2-45 H&M AB

a. Growth from 2008 to 2009.

i.	Sales (excluding VAT)	+15%	((101,393 – 88,532) / 88,532)
ii.	Profit for the year	+8%	((16,384 – 15,294) / 15,294)
iii.	Total assets	+6%	((54,363 – 51,243) / 51,243)
iv.	Total equity	+ 10%	((40,613 – 36,950) / 36,950)

We would not generally expect all of these accounts to grow at the same rate for a variety of reasons. For example:

- Sales can increase as a result of a more aggressive pricing policy or as a result of increased spending on advertising, which would each lead to a lower profit as a percentage of sales.
- An investment in assets may not immediately lead to an increase in sales.
- Equity balances are affected by new investments in the company, by the rate of profitability, and by the dividend policy, among other things. Any of these can affect the fine balance among financial statement items and will cause growth rates to be uneven.

It appears that H & M is in a phase of healthy growth, and that investments in the firm and its assets are leading to increased sales. Additional information, especially in the Management Discussion and Analysis section of the annual report, should help to clarify the meaning of these changes and the prospects for further growth.

b. The equity investors finance more of the company in 2009 than they did in 2008, as the rate of increase in equity financing is higher than the rate of increase in total assets, indicating that the proportion of the company financed by equity investors has increased.

c. (Note: ratios are computed using ending equity and assets, and interest expense is not added back to income for the ROA calculation, as that idea has not been introduced in the text).

	2009	2008
Profit margin	16384/101393 = 17%	15294/88532 = 18%
ROA	16384/54363 = 31%	15294/51243 = 30%
ROE	16384/40613 = 41%	15294/36950 = 42%

These ratios each indicate little change in performance, with two improving and one declining. That is an indicator of a relatively stable company. Comments could include:

- The decline in profit margin is consistent with the growth in profitability having been greater than the growth in sales.
- Performance relative to investment in total assets suggests assets are being used more efficiently.
- The increase in equity between the years has not yet led to an increased return.

2-46 Research in Motion Limited (RIM)

a. The $2,207,609 in common shares represent the net proceeds received from shareholders at the time the shares were issued.

b. The $5,274,365 in retained earnings represents the cumulative lifetime income that the company has earned, less all dividends paid out during that period.

c. Shareholders' equity is significantly higher than liabilities during both years.

d. Total assets grew to $10,204,409,000 in 2010 from $8,101,372,000 in 2009? This increase of $2.1 Billion (26%) comes largely from four accounts, cash and cash equivalents, accounts receivable, property, plant and equipment and intangible assets.

e. If RIM were to pay the income taxes payable, both assets and liabilities would decrease, but the basic accounting equation would remain in balance.

f. Gross margin from the Statement of Operations, two lines of business:

	2010	2009
Devices	$4,556,835 (37%)	$3,692,714 (40%)
Services/software	$2,027,431 (84%)	$1,404,584 (85%)

As a percent, both lines have declined in profitability since 2009, although the dollar increase has been significant between the years. "Devices and other" contribute more to the bottom line, but "services and software" earn more profit as a proportion of revenue generated.

2-47 Magnotta Winery Corporation

a. Cash collected from customers, fiscal 2010 =
opening accounts receivable + sales – ending accounts receivable
$560,800 + 24,172,809 – 590,322 = $24,143,287

b. Purchases, fiscal 2010
ending inventory + cost of goods sold – opening inventory
$29,878,758 + 13,935,458 – 27,847,603 = $15,966,613

Cash paid to suppliers, fiscal 2010 =
opening accounts payable + purchases – ending accounts payable
$1,437,033 + 15,966,613 – 1,568,495 = $15,835,151

c. Cash at end of fiscal 2010 = 0 (nil).
Note that the company has significant bank indebtedness, which probably includes an operating line of credit, permitting operation with an insignificant amount of cash.

d. Retained earnings, end of fiscal 2010: $29,574,427.

e. No dividends were declared during fiscal 2010. No amounts are shown on either the statement of cash flows or the statement of earnings, comprehensive earnings and retained earnings.

f. The amounts reported for amortization of property, plant, and equipment have been segregated between production and non-production. The activities are significantly different and the segregation may help with the preparation of more detailed analysis and comparison within the industry group.

g. (Note: ratios are computed using ending equity and assets, and interest expense is not added back to income for the ROA calculation, as that idea has not been introduced in the text).

	2010	2009
Profit margin	1590114/24172809 = 7%	2643929/24046671 = 11%
ROA	1590114/51678268 = 3%	2643929/50469920 = 6%
ROE	1590114/36629794 = 5%	2643929/34923430 = 8%

h. These ratios indicate significant declines in the margins and returns realized, and would be a cause for real concern.

2-48 WestJet Airlines Ltd.

(Amounts in thousands of Canadian dollars)

a. Cash collected from customers, 2009 =
opening accounts receivable + sales – ending accounts receivable
$16,837 + 2,281,120 – 27,654 = $2,270,303

b. WestJet does not report a cost of goods sold account on their statement of earnings because the nature of the business does not involve the sale of goods. It is possible that a "cost of services sold" amount could be computed, but there is no standard definition as to how this would be done and so it would not necessarily provide useful information.

c. *Advance ticket sales,* among the current liabilities, represents the selling price of tickets that had been purchased by the balance sheet date relating to travel after that date. This liability decreases when the tickets are used for completed air travel or refunded to the customer.

d. WestJet raised $172,463 in 2009 by issuing shares. This would have the effect of increasing cash and increasing the share capital account by that amount.

e. WestJet spent $118,686 on acquiring new aircraft in 2009. If these acquisitions were financed with long-term debt, the accounts "property and equipment" and "long term debt" would both go up by that amount.

2-49 WestJet Airlines Ltd.

a. (Note: ratios are computed using ending equity and assets, and interest expense is not added back to income for the ROA calculation, as that idea has not been introduced in the text).

	2009	2008
Profit margin	98178/2281120 = 4.3%	178506/2549506 = 7.0%
ROA	98178/3493702 = 2.8%	178506/3268702 = 5.5%
ROE	98178/1388928 = 7.0%	178506/1075990 =16.6%

b. WestJet's profitability declined in 2009 relative to 2008, as shown by any of these ratios. The company would provide an explanation for the reasons for the decline in the management report. In this case, there was an overall decline in air passenger traffic associated with the adverse economic conditions of 2009.

2-50 Domino's Pizza Enterprises Limited

a. The amount of dividends *declared* during fiscal 2009, as shown in Note 25, Retained Earnings, was $7,470,000.

b. The declaration of dividends affect the accounting equation by reducing shareholders equity and increasing liabilities by the amount of the dividend declared.

c. The amount of dividends actually *paid* during fiscal 2009 was $4,246,000, as shown on the Cash Flow Statement.

d. The payment of dividends affect the accounting equation by reducing cash by the amount paid and the dividends payable liability by the same amount.

e. The percentage of total assets invested in inventories is relatively small at 2.4%. This would be expected as Domino's would deal mostly in perishable items which are generally sourced locally and could be purchased as frequently as on a daily basis. This may be contrasted with the high level of inventory at H&M, which designs and sources unique products in many countries and distributes them over a broad geographical area.

f. The account "Borrowings" appears in two places on the balance sheet as there are both short term (less than one year) and longer term borrowings. The user of the financial statements needs to know roughly when liabilities are due in order to have a better understanding of the financial position and cash flows of the firm.

g. The largest two expenses on Domino's income statement are Food and Paper at $82 million and Employee benefits (including wages) at $60 million.

BEYOND THE BOOK SOLUTIONS

2-51 Answers to this question will depend on the company selected.

2-52 Answers to this question will depend on the company selected.

CASE SOLUTIONS

2-53 a.

Wroad Wrunner
Statement of Earnings
For the four months ending
August 31, 2XXX

Revenue		$ 9,600
Expenses:		
Interest – Note	$ 44	
Interest – Car	123	
Salary	6,000	
Other	1,200	
		$ 7,367
Net Earnings		$ 2,233

Wroad Wrunner
Statement of Financial Position
As At August 31, 2XXX

Assets:	
Cash	$ 3,827
Accounts Receivable	300
Car	4,000
Total Assets	$ 8,127

Liabilities:		
Accounts Payable	$ 100	
Note Payable	2,200	
Interest Payable	44	
		$ 2,344
Loan Payable – Car		2,750
Total Liabilities		$ 5,094

Shareholder's Equity:		
Common Shares	$ 800	
Retained Earnings	2,233	
Total Shareholder's Equity		3,033
Total Liabilities and Shareholder's Equity		$ 8,127

b.
Profit Margin = Net earnings / Total revenues
Profit margin = $2,233 / $9,600 = 23.3%

Nola made $2,233 in the first four months of operation, which is quite impressive – especially in light of the small amount she invested in the business.

c. Nola presently owes $5,094 as of August 31. If she sells the car for $3,500 and uses the existing cash of $3,827, Nola would have more than enough money to pay off all her liabilities.

2-54 Daisy-Fresh Dry Cleaning

1. The payment of the insurance policy should have been recorded as a prepaid expense when it was purchased. A prepaid expense is a current asset because there is a future benefit associated with the policy. As the year progresses, the benefits of the policy are used up because the company has been provided with insurance coverage for that time period. As the benefits of the policy expire, the related costs should be expensed. At December 31, 2011, one-third of the three-year policy has expired, so therefore, one-third of the policy costs should be expensed. The remaining two-thirds should be recorded as a prepaid expense on the asset side of the balance sheet.
2. The new dry-cleaning machine should be recorded as an asset when it was purchased. As time passes and the machine is used, it should be depreciated as an expense on the statement of earnings which would reduce the net book value of the machine on the statement of financial position by increasing the account Accumulated Depreciation which is a contra-asset account. The machine's depreciation expense should be reported in the same period as the benefits (i.e., revenues) received from the use of the machine.
3. The company should report all future claims on its assets even when those claims don't become due for four years. The loan should be recorded as a long-term liability until the fourth year, at which point it becomes a current liability, payable within the normal operating year of the company. Recording the loan on the books now provides a complete listing of total liabilities owed by the organization.

4. The interest on the loan to the bank should be recorded and matched against the revenues generated during the period. Even though the owner did not yet pay any of the interest, there is an obligation to pay the interest in the near future, thus there is a claim on the assets of the company that should be recorded in the financial statements. The company should

report an interest expense on the statement of earnings and an interest payable on the statement of financial position.

5. Dividends represent a distribution of profits to the shareholders and must be authorized by the board of directors. Dividends are not recorded as an expense but rather directly reduce the retained earnings of the business. Because dividends are a distribution of profit and not an expense, their payment should not be reported on the statement of earnings. The payment of dividends appears on the statement of retained earnings and also as a financing activity on the cash flow statement.

2-55 Mega Manufacturing

Mega Manufacturing appears to be improving its financial position to be more in-line with the performance of other companies in the same industry.

Profit margin has decreased in the past year, which indicates that the level of profit generated by each dollar of sales revenue declined. The company is slightly above the industry average.

Currently the company is able to generate a return of 10% on its assets. This means that for every $100 invested in assets the company is able to generate profits of $10. The company appears to be performing slightly below the average companies in the industry, and has improved again over the prior year.

Finally, the return on equity ratio compares the profits earned in the business to the amount invested by shareholders. Shareholders will use this ratio to evaluate the ability of the business to provide them with an acceptable return on their investment. Investors will often compare the return on equity for businesses of similar risk to make decisions about buying new shares or selling their existing shares. With a return on shareholders' equity of 12%, Mega Manufacturing is providing investors with a return that is slightly below the industry average. The 2% increase over the past year should make this company an attractive investment, especially if it continues to increase and it becomes closer to the industry average.

CRITICAL THINKING SOLUTION

2-56 a. Calculation of cash on hand at end of year:

Cash received:		
Bank loan	$ 30,000	
Shareholders' contribution	30,000	
Sale of products	98,000	$158,000
Cash paid out:		
Purchase of baking supplies		
($42,000 – $5,000)	$ 37,000	
Rent payments on ovens	12,000	
Payment on bank loan	10,000	
Payment of salaries		
($30,000 – $3,000)	27,000	
Payment of other expenses	13,500	
Purchase of ovens	46,000	(145,500)
		$ 12,500

Calculation of net earnings for the year:

Sales		$98,000
Cost of goods sold		
($42,000 x 80%)	$33,600	
Wages expense	30,000	
Oven rental expense	12,000	
Interest expense	1,600	
Other expenses	15,000	(92,200)
Net Earnings		$ 5,800

b.

Assets:	
Cash	$ 12,500
Baking supplies ($42,000 x 20%)	8,400
Ovens	46,000
Liabilities:	
Payable for baking supplies	$5,000
Payable for income taxes withheld	3,000
Payable for other expenses	1,500
Payable for accrued interest	1,600
Bank loan payable ($30,000 – $10,000)	20,000

Shareholders' Equity:	
Total Assets ($12,500 + 8,400 + 46,000)	$ 66,900
Total Liabilities ($5,000+3,000+1,500+1,600+20,000)	(31,100)
Total Shareholders' Equity	$ 35,800

Or

Contributed Capital + Beginning Retained Earnings + Net Earnings – Dividends: $30,000 + 0 + 5,800 – 0 = $35,800

The Canadian Cookie and Cake Shop
Statement of Financial Position
December 31, 20xx

Cash	$12,500	Payable for baking supplies	$ 5,000	
		Payable for other Expenses	1,500	
Baking supplies	8,400	Payable for income tax withheld	3,000	
		Payable for interest	1,600	
Baking ovens	46,000	Bank loan payable	20,000	
		Total Liabilities		$31,100
		Share Capital	$30,000	
		Retained Earnings	5,800	
		Shareholders' equity		35,800
Total assets	$66,900	Total liabilities and shareholders' equity		$66,900

c. The shareholder's proportionate claim on the reported net assets (assets less liabilities) is $11,933 ($35,800 x 33.33%). In light of the profitable operations during the first year of operations, the company should be worth more than its book value and the shareholder should be able to sell her shares for more than this. On the other hand, if she is desperate to sell she may be willing to take less than the book value of her share of the company and accept something less than $11,933.

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