Solutions for Financial Accounting 8th Edition by Libby

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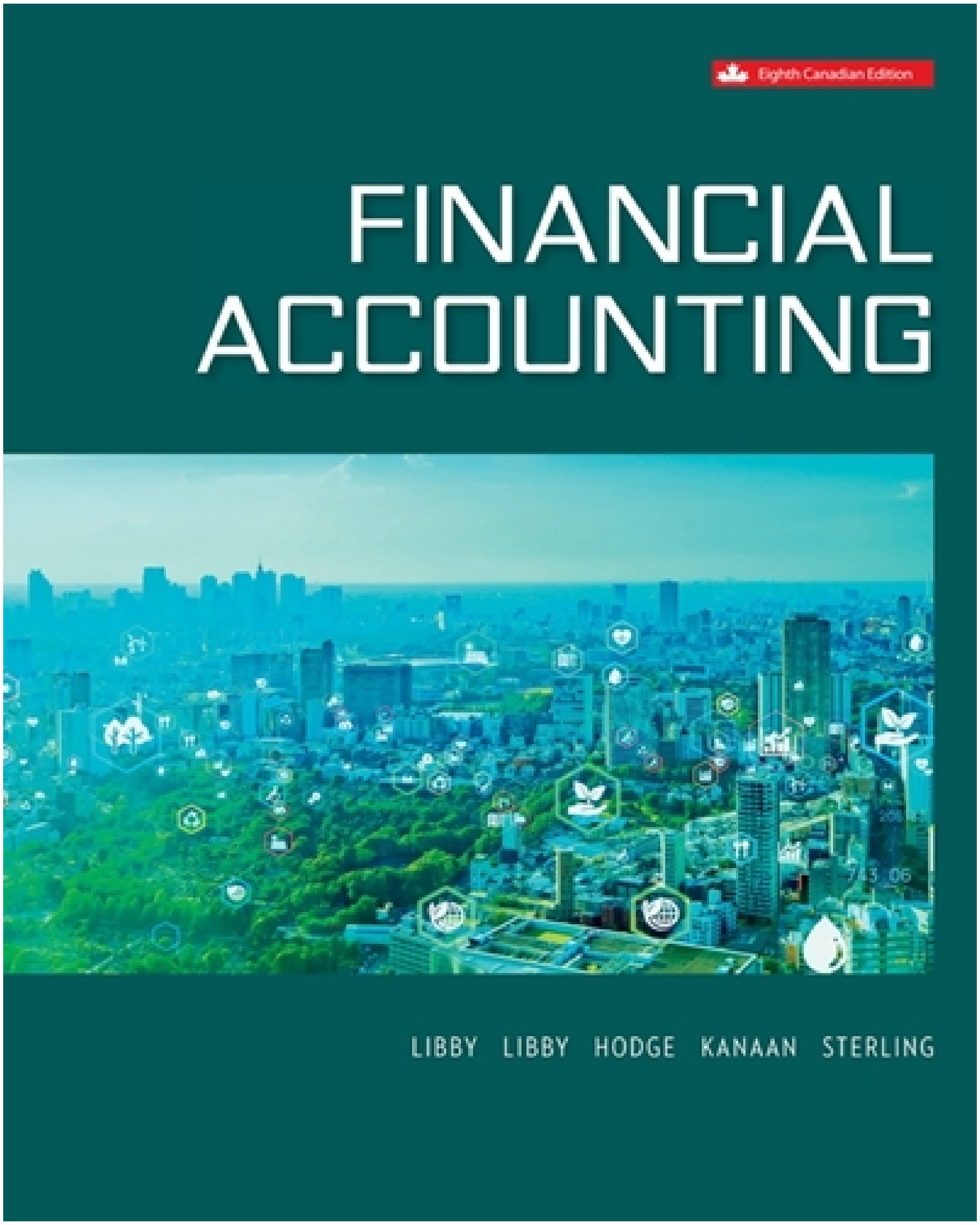

Solutions

CHAPTER 2

INVESTING AND FINANCING DECISIONS AND THE STATEMENT OF FINANCIAL POSITION

CHAPTER OUTLINE

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II OVERVIEW OF ACCOUNTING CONCEPTS
- A. Concepts Emphasized in Chapter 2
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  - iii. Constraint of Accounting Measurement
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- B. Elements of the Classified Statement of Financial Position

III WHAT TYPES OF BUSINESS ACTIVITIES CAUSE CHANGES IN FINANCIAL STATEMENT AMOUNTS?
- A. Nature of Business Transactions
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VI HOW IS THE STATEMENT OF FINANCIAL POSITION PREPARED AND ANALYZED?
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ADDITIONAL TEACHING NOTES
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CHAPTER LEARNING OBJECTIVES

2-1. Define the objective of financial reporting, the qualitative characteristics of accounting information, and the related key accounting assumptions and principles.

2-2. Define the elements of a classified statement of financial position and analyze how the information is relevant to investors and other decision makers.

2-3. Identify what constitutes a business transaction, and recognize common account titles used in business.

2-4. Apply the transaction analysis model routine, simple business transactions in terms of the accounting equation: Assets = Liabilities + Shareholders' Equity.

2-5. Determine the impact of business transactions on the statement of financial position using two basic tools: journal entries and T-accounts.

2-6. Prepare a trial balance and a classified statement of financial position, and analyze the company using the current ratio.

2-7. Identify investing and financing transactions, and demonstrate how they are reported on the statement of cash flows.

CHAPTER LEARNING OBJECTIVES AND THE CPA CANADA TECHNICAL COMPETENCIES

This chapter covers material outlined in **Section 1: Financial Reporting** of the CPA Competency Map.

Chapter LOs	CPA Technical Competencies	
	1.1	**Financial Reporting Needs and Systems**
LO2-1, 2-2	1.1.1	Evaluates financial reporting needs
LO2-1, 2-7	1.1.2	Evaluates the appropriateness of the basis of financial reporting
LO2-2, 2-5	1.1.3	Evaluates reporting systems, data requirements and business processes to support reliable financial reporting
LO2-5	1.1.4	Explains implications of current trends, emerging issues and technologies in financial reporting
	1.2	**Accounting Policies and Transactions**
LO2-2	1.2.1	Develops or evaluates appropriate accounting policies and procedures
LO2-4, 2-6, 2-7	1.2.2	Evaluates treatment for routine transactions
	1.3	**Financial Report Preparation**
LO2-3, 2-4	1.3.1	Prepares financial statements
LO2-5	1.3.2	Prepares routine financial statement note disclosure
	1.4	**Financial Statement Analysis**
LO2-6	1.4.4	Interprets financial reporting results for stakeholders (external or internal)

CHAPTER SUMMARY

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

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

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

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

Transaction Analysis Model

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

T-Account Format

Assets		Liabilities		Equity	
Increase Debit	Decrease Credit	Decrease Debit	Increase Credit	Decrease Debit	Increase Credit
Beg. Bal.			Beg. Bal.		Beg. Bal.
End. Bal.			End. Bal.		End. Bal.

CHAPTER LECTURE NOTES

I INTRODUCTION

Financial statements are intended to communicate the economic facts, measured in monetary units, in a standardized, formal way. Therefore, by applying accounting principles consistently, accountants formally communicate comparable estimates that faithfully represent important economic facts about companies like Gildan and its competitors. Recall from Chapter 1 that financial statements include four components: the statement of financial position, the statement of comprehensive income (and its main component, the statement of earnings), the statement of changes in equity, and the statement of cash flows. In this chapter, we focus on the statement of financial position, and we examine how this financial statement communicates the results, or consequences, of Gilda's strategy by answering the following questions:

- What type of business activities cause changes in amounts reported on the statement of financial position from one period to the next?
- How do specific activities affect each of these amounts?
- How do companies keep track of these amounts?

II OVERVIEW OF ACCOUNTING CONCEPTS

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

A. Concepts Emphasized in Chapter 2

1. The **primary objective of external financial reporting** is to provide financial information about a business to help external parties, primarily investors and creditors, make sound financial decisions in their capacity as capital providers. These decision makers need a reasonable understanding of accounting concepts and procedures. They need to be able to use financial information to help them predict future cash inflows and outflows both in terms of timing and uncertainty, and financial values of assets and liabilities.

2. The qualitative characteristics of accounting information contained in the conceptual framework provide guidance on the essential characteristics that determine the usefulness of accounting information. There are two fundamental qualitative characteristics:
   a. Relevance
      -information is considered to be relevant if it can influence users' decisions
      -relevant information has predictive and/or confirmatory value
   b. Faithful Representation
      -to be useful in decision making, financial statements must be a faithful representation of the economic phenomena it is supposed to represent, thus reflecting the economic substance of a transaction that may differ from the legal form of the transaction

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

a. Comparability

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

b. Verifiability

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

c. Timeliness

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

-usefulness of financial information declines as time passes

d. Understandability

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

B. Constraints of Accounting Measurement

1. The **cost constraint** of accounting measurement suggests that information should be produced only if the perceived benefits of increased decision usefulness exceed the expected costs of providing that information.

2. **Prudence** requires that assets and revenues not be overstated, and liabilities and expenses not be understated. This is a cautious and conservative approach.

3. Underlying assumptions of accounting help the decision maker to understand what accounting information purports as well as the inherent limitations of that information. Recall assumptions noted in Chapter 1:
   a. Separate-entity assumption – "business" transactions are separate from “owner” transactions.
   b. Stable monetary unit assumption – accounting information will be measured and reported in the national monetary unit of that company.
   c. Continuity (going concern) assumption – a business is expected to continue operations in the foreseeable future without forced liquidation.

4. The **historical cost principle** provides that amounts shown on the statement of financial position represent the cash-equivalent cost at the date of acquisition. In some instances, fair values are used, in which case a **mixed-attribute measurement model** is being used.

B. Elements of the Classified Statement of Financial Position

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

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

   Current liabilities would include:
      a. Short-term borrowings
      b. Accounts payable
      c. Accrued liabilities and provisions
      d. Income taxes payable
      e. Current portion of long-term debt
      f. Other current liabilities
   Non-current liabilities would include:
      a. Long-term borrowings
      b. Deferred income tax liabilities

c. Provisions
d. Other liabilities

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

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

A. Nature of Business Transactions

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

1. External events: a direct exchange of assets, goods, or services by one party for assets, services, or promises to pay by one or more other parties. Examples include the purchase of equipment, the sales of merchandise, borrowing from a bank, and owner investments.

2. Internal events: a measurable event <u>internal</u> to the business that is not a direct exchange. Examples include losses from casualties and adjustments to record usage of assets previously purchased (depreciation).

Some "events" are external to the business but have not yet given rise to a transaction and are not subject to recording. Examples include signing a lease, taking a customer order, and hiring a new employee. Each of these situations involves future promises but neither assets nor liabilities have yet been established.
A transaction is (1) an exchange between a business and one of more external parties to a business or (2) a measurable internal event, such as adjustments of the use of assets in operations.

B. Accounts

1. An account is a standardized record that organizations use to accumulate the monetary effects of transactions on each financial statement item.
2. A chart of accounts (COA) is a listing of the accounts a company uses to record the transactions of its business operations. Every company creates its own chart of accounts to fit the nature of its business activities. The order of the COA facilitates the financial reporting for a company. For the statement of financial position, assets are listed first in order of liquidity. They are followed by liabilities in order of maturity. Next, equity lists share capital accounts and

retained earnings. Finally, revenue and expense accounts follow. COAs vary widely based on the industry of the company. In formal record keeping systems, unique numbers are used for each account listed in the COA.

3. More detailed listings are kept for several accounts. These are called subsidiary ledgers. Examples include accounts receivable, inventories, equipment, accounts payable, and notes payable. The total of a subsidiary ledger agrees to the related general ledger account balance.

IV HOW DO TRANSACTIONS AFFECT ACCOUNTS?

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

A. Principles of Transaction Analysis

1. **Transaction analysis** involves studying a transaction to determine its economic effect on the entity in terms of the basic accounting equation (fundamental accounting model). This understanding is necessary to determine how transactions affect financial statement accounts.
2. Basic Accounting Equation: A = L + SE
3. Principles of transaction analysis:
   a. Dual effects – each transaction affects at least two accounts. Identification of the appropriate accounts and the direction of the effects (increase or decrease) are key. The fact that every transaction has at least two effects on the basic accounting equation is the essence of the double-entry system of record keeping. Whether a transaction is external (involves an exchange) or internal (involves an adjustment), the duality of effects still holds.
   b. Accounting equation must remain in balance. After each transaction, the accounting equation must be tested for equality. That is, A = L + SE must constantly be considered.
4. Transaction analysis process:
   a. Accounts and effects
      - Identify the accounts affected
      - Classify each account as A, L, or SE
      - Determine the direction of the effect (increase or decrease) for each account
   b. Balancing
      - Prove that A = L+ SE after the transaction

B. Analyzing Gildan's Transactions

V HOW DO COMPANIES KEEP TRACK OF ACCOUNT BALANCES?

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

A. The Direction of Transaction Effects

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

B. Analytical Tools

The Journal Entry

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

The T-account

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

C. Transaction Analysis Illustrated

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

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

1. Account balances for asset, liability, and equity accounts are used to prepare a statement of financial position. Balances from T-accounts are used in this chapter for that purpose.
2. A trial balance is a listing of the T-account names together with their balances. The debits are in the left column and the credits in the right column. The totals must be equal.

A. Classified Statement of Financial Position

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

B. Some Misconceptions

1. Bookkeeping does not equal accounting. Rather, bookkeeping is an important part (a subset) of accounting.

a. Bookkeeping is the routine, clerical function of recording and posting journal entries. A basic knowledge of accounting is necessary to perform these bookkeeping tasks.
b. Accounting involves the design of information systems, analysis of complex transactions, interpretation of financial data, financial reporting, auditing, taxation, and management consulting. A high degree of knowledge, professional judgment, and experience are needed to perform these accounting functions.
c. In Canada, an accountant who is qualified to perform such tasks is commonly referred to as a Chartered Professional Accountant or “CPA.” Accountants who earn their CPA-title are licensed after completing and passing a national common three-day examination called the “CFE” and working in an approved role, typically, for a minimum of 24 months.

2. The results of the accounting processes do not reflect "exact" information.
   a. Many estimates are used that influence account balances.
   b. Generally, the amounts on financial statements do not represent current market values. They typically present historical cost amounts.
   c. It is important to gain an understanding of what financial statements do and do not reflect. The user needs to understand financial statement limitations.
3. Accounting is not inflexible nor is it a “cut and dried” subject. Instead, it is a dynamic and creative area of study that requires considerable judgment. It requires dedicated involvement for the users of financial statements as well as the preparers of those statements. Problem solving and communication skills are ***extremely important*** in accounting.

VII ACCOUNTING STANDARDS FOR PRIVATE ENTERPRISES

1. Under ASPE, assets are reported in decreasing order of liquidity, with cash listed first. Under IFRS, there are two acceptable methods. One method parallels ASPE. The other method shows assets in increasing order of liquidity, with the least-liquid assets listed first. Non-current assets are thus listed first. Equity is listed before liabilities, and liabilities are listed with non-current first before current. The choice depends on which method provides more relevant information.
2. Under ASPE, assets are reported at historical cost. Under IFRS, assets can be reported under the cost model or the revaluation model. As an example, property, plant, and equipment may be reported at fair value. Such a method must be used consistently.

ADDITIONAL TEACHING NOTES

1. Point out that most decision makers are neither ignorant nor superhuman. They often are average investors (or creditors). However, they are expected to have the tools to evaluate what goes on in the business world. Some of your students may already be investors or creditors.

2. Distinguish between "going concern" and "liquidation" valuations.

3. Point out that some companies present amounts on the statement of financial position in dollars, thousands of dollars, etc. The student should be sure to reference the statement of financial position heading for this information.

4. Note that the chart of accounts for assets and liabilities often differs widely for industries and companies.

5. Distinguish between historical costs recorded in the accounts and current fair market values.

6. Owners are "external" to a company because of the separate-entity concept. There should be no commingling of assets or liabilities of owners and companies.

7. Briefly mention how subsidiary ledgers support the details of general ledger accounts such as accounts receivable, accounts payable, and equipment.

8. This chapter presents an excellent experience with several cash transactions that have effects on the cash flow statement. There are references to cash flows throughout the text. Comprehensive coverage of the cash flow statement is in Chapter 5.

9. Emphasize the "misconceptions" at the end of the text materials.

10. T-accounts are great visual learning devices. Encourage students to use them throughout the course.

11. It is quite important that students identify accounts as (A), (L), or (SE) when doing transaction analysis and preparing journal entries. It typically makes the analysis process clearer and the journal entry preparation easier for them at this stage of learning.

CHART OF END-OF-CHAPTER MATERIALS

LEARNING OBJECTIVE	EXERCISES	PROBLEMS	ALTERNATE PROBLEMS	CASES AND PROJECTS	CONTINUING PROBLEM
2-1	1,2,3,5			1,2,5,8	
2-2	1	1	1	1,2,5,8	1
2-3	1,4,5,6	2	2	1,2,3,9,10, 11,12	
2-4	1,7,8,12	2, 3	2	1,2,8,9	
2-5	6,9,10,11,1 4,15,16, 17	1,5,8	1,3,5,8		1
2-6	12, 13, 15	2,3,5,7,8	3,5,7,8	4,5,6,7,8,9	1
2-7	18,19	4,6	4,6	1,2,3,4, 12	1

*NOTE TO INSTRUCTORS: All test bank content available online through Test Builder on Connect can be sorted by learning objective, question type, and level of difficulty.

GUIDE TO OTHER CHAPTER FEATURES

Focus Company used for Primary Illustrations/Management Decision Setting
Gildan Activewear Inc. - www.gildan.com

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

Focus on Cash Flows
Investing and Financing Activities

A Question of Accountability
Environmental Liabilities—The Greening of Accounting Standards

International Perspective
Understanding Financial Statements of Foreign Companies

Key Ratio Analysis
The Current Ratio

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

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

Demonstration Case Summary
Set up T-accounts
Analyze transactions, prepare journal entries, and determine account balances
Prepare a classified statement of financial position
Identify investing and financing transactions

Chapter Take Aways
Chapter summary by learning objective

SUPPLEMENTAL ENRICHMENT ACTIVITIES

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

IN THE CLASSROOM

"Who Owns What" Game:

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

"Chart of Accounts" Exercise:

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

"Liquidity" Exercise:

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

"Life as a Balance Sheet" Exercise:

Ask students to work in groups or independently to list, first, all of the assets they own in their personal life – everything from the cash in their bank account to their apartment or home furniture, car, laptop and smartphone. After listing these assets, have students then itemize any obligations or debts they may have which would constitute liabilities – for example: credit card balances, student loans or outstanding cell phone bill. Finally, have students calculate what their personal net worth or equity would be based on all the assets they own less liabilities determined. This exercise should help students better understand that "equity" in a business is no different than their own individual net worth.

OUTSIDE THE CLASSROOM

LIBRARY PROJECTS:

Company Update Project:

Students could locate and read articles about Gildan Activewear Inc. They could prepare written or oral reports on their research.

Literature Reference Project:

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

Chapter 2
Investing and Financing Decisions and the Accounting System

Revised: August 5, 2022

ANSWERS TO QUESTIONS

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

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

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

   (c) A liability is a present debt or obligation of the entity to transfer an economic resource as a result of past events. It represents a future outflow of assets (mainly cash) or services to the *creditors* that provided the corporation with the resources needed to conduct its business.

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

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

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

3. To be useful, information must be relevant; that is, it must be timely and have predictive and/or feedback value. Relevant information is any information that is likely to change an investor’s decision. However, if the information is not a faithful representation of the economic phenomena it is supposed to represent (complete, neutral, and free from material error), it will not be trusted, and thus will not be useful.

4. (a) The separate-entity assumption requires that business transactions are separate from the transactions of the owners. For example, the purchase of a truck by the owner for personal use is not recorded as an asset of the business.

   (b) The stable monetary unit assumption requires information to be reported in the national monetary unit. Each business will account for and report its financial results primarily in terms of the national monetary unit, such as Canadian dollars in Canada, euros in Germany, and Australian dollars in Australia.

   (c) Under the continuity or going-concern assumption, businesses are assumed to operate into the foreseeable future. That is, they are not expected to liquidate.

   (d) The (historical) cost principle requires assets to be recorded at the cash-equivalent cost on the date of the transaction. Cash-equivalent cost is the cash paid plus the dollar value of all non-cash considerations.

5. Accounting assumptions are necessary because they reflect the scope of accounting and the expectations that set certain limits on the way accounting information is reported.

6. The current ratio is calculated as current assets divided by current liabilities. It measures the ability of the company to pay its short-term obligations with current assets. A ratio above 1.0 normally suggests that the company has sufficient current assets to settle short-term obligations. Sophisticated cash management systems allow many companies to minimize funds invested in current assets and have a current ratio below 1.0. However, a ratio that is too high in relation to other competitors in the industry may indicate inefficient use of resources.

7. An account is a standardized format used by organizations to accumulate the dollar effects of transactions on each financial statement item. Accounts are necessary to keep track of all increases and decreases in the fundamental accounting model.

8. Historical cost reflects the market value of an asset at the time of acquisition. However, the continued reporting of historical cost subsequent to acquisition does not reflect any change in fair value. Accountants continue to report historical costs on statements of financial position because they are more verifiable and objective measures than fair values.

9. The fundamental accounting model is provided by the equation:
   Assets = Liabilities + Shareholders' Equity

10. A business transaction is (a) an exchange of resources (assets) and obligations (debts) between a business and one or more outside parties, and (b) certain events that directly affect the entity, such as the use over time of rent that was paid prior to occupying space and the wearing out of equipment used to operate the business. An example of the first situation (a) is the sale of goods or services. An example of the second situation (b) is a loss incurred due to a fire.

11. Debit is the left side of a T-account and credit is the right side of a T-account. Debits increase asset accounts, and decrease liability and shareholders' equity accounts. Credits decrease asset accounts, and increase liability and shareholders' equity accounts.

12. Transaction analysis is the process of studying a transaction to determine its economic effect on the entity in terms of the accounting equation:
Assets = Liabilities + Shareholders' Equity
The two principles underlying the process are:
    * every transaction affects at least two accounts.
    * the accounting equation must remain in balance after each transaction.

The three steps in transaction analysis are:
    (1) ask what was received, then identify the account(s) affected, classify the account(s) by type of element, and determine the direction and amount of the effects.
    (2) ask what was received, then repeat the same process described in (1).
    (3) determine that the accounting equation (A = L + SE) remains in balance.

13. The equalities in accounting are:
(a) Assets = Liabilities + Shareholders' Equity
(b) Debits = Credits

14. A journal entry is a method for expressing the effects of a transaction on accounts in a debits equal credits format. The title of the account(s) to be debited is (are) listed first. The title of the account(s) to be credited is (are) listed underneath the debited account(s), and the account title(s) and amount(s) credited is (are) indented to the right.

15. A T-account is a tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company's activities. It is a simplified representation of a ledger account with a debit column on the left and a credit column on the right.

16. Investing activities on the statement of cash flows include the buying and selling of productive assets and investments. Financing activities include borrowing and repaying debt, issuing and repurchasing shares, and paying dividends.

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

18. Reports produced by companies on their environmental, social, and governance (ESG) activities have not been based so far on standardized reports and are not audited. It is more probable that they are not representationally faithful and therefore are of little relevance to users because they may misrepresent the risk associated with environmental, social, and governance factors. This risk may reduce or even eliminate the expected future return on shareholders' investment. Nevertheless, ESG reports incorporate descriptions of activities that either affected cash flows in previous periods or will more probably affect future cash flows. Consequently, ESG reports are relevant to decisions by investors, creditors, and other stakeholders. The recent establishment of the International Sustainability Standards Board and the issuance of new International Financial Reporting Standards focused on sustainability will enhance the quality and relevance of ESG reports.

Authors' Recommended Solution Time

(Time in minutes)

Mini-Exercises		*Exercises*		*Problems*		*Alternate Problems*		*Cases and Projects*	
No.	*Time*	*No.*	*Time*	*No.*	*Time*	*No.*	*Time*	*No.*	*Time*
1	3 E	1	10 E	1	15 E	1	15 E	1	20 M
2	3 E	2	10 M	2	25 M	2	35 M	2	25 M
3	4 E	3	15 M	3	50 M	3	55 M	3	20 M
4	5 E	4	10 E	4	15 M	4	15 M	4	30 M
5	3 M	5	10 E	5	60 D	5	70 D	5	30 M
6	3 M	6	10 E	6	15 M	6	15 M	6	20 M
7	6 E	7	10 E	7	30 M	7	30 M	7	20 M
8	6 M	8	10 E	8	40 M	8	25 M	8	45 M
9	6 E	9	10 E					9	30 M
		10	10 E			*Continuing Problem*		10	20 M
		11	15 M					11	30 D
		12	20 M			1	40 M	12	*
		13	10 M					13	*
		14	15 E						
		15	20 M						
		16	10 M						
		17	10 M						
		18	10 E						
		19	10 M						

E = Easy M = Moderate D = Difficult

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

MINI–EXERCISES

M2–1

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

M2–2

CL	(1) Accounts payable
CA	(2) Accounts receivable
NCA	(3) Buildings
CA	(4) Cash
SE	(5) Contributed capital
CL	(6) Income taxes payable
NCA	(7) Land
NCA	(8) Long-term investments
CA	(9) Merchandise inventory
NCL	(10) Notes payable (due in three years)
CA	(11) Notes receivable (due in six months)
CA	(12) Prepaid rent
SE	(13) Retained earnings
CA	(14) Supplies
CL	(15) Utilities payable
CL	(16) Wages payable

M2–3

	Assets		Liabilities		Shareholders' Equity	
a.	Cash	+30,000	Notes payable	+30,000		
b.	Cash Notes receivable	–10,000 +10,000				
c.	Cash	+500			Contributed capital	+500
d.	Cash Equipment	–5,000 +15,000	Notes payable	+10,000		
e.			Dividends payable	+2,000	Retained earnings	–2,000

M2–4

	Debit	Credit	Increases	Decreases
Assets	*Increases*	*Decreases*	*Debit*	*Credit*
Liabilities	*Decreases*	*Increases*	*Credit*	*Debit*
Shareholders' equity	*Decreases*	*Increases*	*Credit*	*Debit*

M2–5

		Debit	Credit
a.	Cash (+A)	30,000	
	Notes payable (+L)		30,000
b.	Notes receivable (+A)	10,000	
	Cash (–A)		10,000
c.	Cash (+A)	500	
	Contributed capital (+SE)		500
d.	Equipment (+A)	15,000	
	Cash (–A)		5,000
	Notes payable (+L)		10,000
e.	Retained earnings (–SE)	2,000	
	Dividends payable (+L)		2,000

M2–6

Cash

	Debit	Credit	
Beg.	900		
(a)	30,000	10,000	(b)
(c)	500	5,000	(d)
	16,400		

Notes Receivable

	Debit	Credit
Beg.	1,000	
(b)	10,000	
	11,000	

Equipment

	Debit	Credit
Beg.	15,100	
(d)	15,000	
	30,100	

Notes Payable

Credit	
3,000	Beg.
30,000	(a)
10,000	(d)
43,000	

Dividends Payable

Credit	
2,000	(e)
2,000	

Contributed Capital

Debit	Credit	
	4,000	Beg.
	500	(c)
	4,500	

Retained Earnings

	Debit	Credit	
		10,000	Beg.
(e)	2,000		
		8,000	

M2-7

Dennen Inc.
Trial Balance
January 31, 2024

	Debit	Credit
Cash	$16,400	
Notes receivable	11,000	
Equipment	30,100	
Dividends payable		$ 2,000
Notes payable		43,000
Contributed capital		4,500
Retained earnings		8,000
Totals	$57,500	$57,500

M2–8

Dennen Inc.
Statement of Financial Position
At January 31, 2024

Assets		***Liabilities***	
Current assets:		*Current liabilities:*	
Cash	$16,400	Dividends payable	$ 2,000
Notes receivable	11,000	Notes payable	43,000
Total current assets	27,400	Total current liabilities	45,000
		Shareholders' Equity	
		Contributed capital	4,500
Equipment	30,100	Retained earnings	8,000
		Total shareholders' equity	12,500
Total Assets	$57,500	***Total Liabilities and Shareholders' Equity***	$57,500

M2–9

(a) F

(b) I

(c) F

(d) I

(e) F in February 2024, but no effect on cash flows in January 2024.

EXERCISES

E2–1

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

E2–2

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

E2–3

Document	Qualitative Characteristics
1.	This document is relevant to the decision at hand because it has predictive value. Paula will be concerned if Mak will be able to make future payments and this will depend on future sales and cash flow for Mak. However, such expectations may not have faithful representation. The sales did not occur yet, so it is not possible to determine if they are complete or free from material error. Furthermore, the projected sales may not be neutral because Tim Mak may wish to show a favourable image of the company in order to receive credit from Pinnacle.
2.	Sales projections are similar to the previous document in that they have some relevance, and they may not have faithful representation as these projections are based on assumptions about the future and not facts. Projecting sales five years into the future is more difficult than projecting sales for one year and therefore would likely have less faithful representation. They are not as relevant as the one-year forecast as Paula will be looking at short-term payments, not five years.
3.	The monthly bank statements have faithful representation. The events that affected the bank balance occurred already and are supported by documents. They should, therefore, be complete and free from material error. They are prepared by a third party and should be neutral. They have some relevance to the decision because they reflect the previous cash position of the company and its ability to meet its obligations in the past. They are relevant to the extent that the past is indicative of the future.
4.	The report on Mak's credit history is relevant as it may reveal any difficulties the company may have faced in the past. However, the fact that it was prepared by employees and not an independent source means it has less faithful representation – the information may not be neutral as the employees have a vested interest in having the credit approved.
5.	The letter with personal guarantees provided by the four company officers is relevant because they provide assurance that any default on the payable will be covered by the company officers individually and collectively. This may give Paula additional security in terms of amounts owing. However, without information on the financial position of the officers, the information is incomplete and therefore does not have a high level of faithful representation.

E2–3 (continued)

6. The résumés of the four company officers may be of some use in the credit decision and future dealings with the company. For example, the credit manager may be more likely to lend money to a company with qualified officers, including a financial professional. This indicates some relevance to the decision. The information would not have a high level of faithful representation as it is prepared by the company and is not neutral.

7. The letters of reference may provide useful information about the company officers, but they may not be neutral if they are written by their close friends and relatives. Hence, they do not have a high level of faithful representation, and therefore may not be relevant to the decision at hand.

E2–4

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

E2–5

Req. 1

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

Req. 2

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

E2–5 (continued)

Req. 3

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

E2–6

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

E2–7

Event	**Assets**		=	**Liabilities**		+	**Shareholders' Equity**	
a.	Cash	+32,000					Contributed capital	+32,000
b.	Land	+18,000		Mortgage notes payable	+12,000			
	Cash	−6,000						
c.	Cash	+11,000		Notes payable	+11,000			
d.	Notes receivable	+300						
	Cash	−300						
e.	Cash	−11,000		Notes payable	−11,000			
f.	Equipment	+8,000		Notes payable	+4,000			
	Cash	−4,000						

E2–8

(Dollars in millions)

Event	Assets		=	Liabilities		+	Shareholders' Equity	
a.	Buildings	+303		Notes payable (long-term)	+1,073			
	Equipment	+1,202						
	Cash	– 432						
b.	Cash	+695					Contributed capital	+695
c.				Dividends payable	+1,159		Retained earnings	–1,159
d.	Short-term investments	+5,928						
	Cash	-5,928						
e.	No effects*							
f.	Cash	+2,423						
	Short-term investments	–2,423						

* The separate-entity assumption states that transactions of the business are separate from transactions of the owners. Since transaction *(e)* occurs between the owners and others in the stock market, there is no effect on the business.

E2-9

		Debit	Credit
a.	Cash (+A)	32,000	
	Contributed capital (+SE)		32,000
b.	Land (+A)	18,000	
	Cash (–A)		6,000
	Mortgage notes payable (+L)		12,000
c.	Cash (+A)	11,000	
	Notes payable (+L)		11,000
d.	Notes receivable (+A)	300	
	Cash (–A)		300
e.	Notes payable (–L)	11,000	
	Cash (–A)		11,000
f.	Equipment (+A)	8,000	
	Cash (–A)		4,000
	Notes payable (+L)		4,000

E2–10

a.	Cash (+A)	30,000	
	Notes payable (+L)		30,000
b.	Cash (+A) *(500 shares x $30 market value per share)*	15,000	
	Contributed capital (+SE)		15.000
c.	Buildings (+A)	115,000	
	Cash (–A)		23,000
	Mortgage notes payable (+L)		92,000
d.	Equipment (+A)	20,000	
	Cash (–A)		4,000
	Accounts payable (+L)		16,000
e.	Notes receivable (+A)	1,000	
	Cash (–A)		1,000
f.	Accounts payable (–L)	2,000	
	Cash (–A)		2,000
g.	Short-term investments (+A)	10,000	
	Cash (–A)		10,000

E2–11

Req. 1

a.	Cash (+A)	63,000	
	Contributed capital (+SE)		63,000
b.	Equipment (+A)	16,000	
	Cash (–A)		4,000
	Notes payable (+L)		12,000
c.	No journal entry required because no delivery of services has yet occurred.		
d.	Notes receivable (+A)	2,500	
	Cash (–A)		2,500
e.	Cash (+A)	6,000	
	Land (+A)	15,000	
	Contributed capital (+SE)		21,000
f.	Notes payable (–L)	12,000	
	Cash (–A)		12,000

g. This transaction occurred between an owner and others, and there is no effect on the business due to the separate-entity assumption.

Req. 2

Cash

	Debit	Credit	
Beg.	0		
(a)	63,000	4,000	(b)
(e)	6,000	2,500	(d)
		12,000	(f)
	50,500		

Notes Receivable

	Debit	Credit
Beg.	0	
(d)	2,500	
	2,500	

Equipment

	Debit	Credit
Beg.	0	
(b)	16,000	
	16,000	

Land

	Debit	Credit
Beg.	0	
(e)	15,000	
	15,000	

Notes Payable

	Debit	Credit	
		0	Beg.
(f)	12,000	12,000	(b)
		0	

Contributed Capital

Debit	Credit	
	0	Beg.
	63,000	(a)
	21,000	(e)
	84,000	

Req. 3

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

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

E2–12

Req. 1

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

Req. 2

FastTrack Sports Ltd.
Statement of Financial Position
At January 7, 2023

Assets		***Liabilities***	
Current assets		*Current liabilities*	
Cash	$ 71,500	Notes payable	$ 90,000
Notes receivable	4,000	*Total current liabilities*	90,000
Total current assets	75,500		
Store fixtures	9,500	***Shareholders' Equity***	
Land	20,000	Contributed capital	15,000
		Total shareholders' equity	15,000
Total assets	$105,000	***Total liabilities and shareholders' equity***	$105,000

E2–13

Req. 1

Transaction	***Brief Explanation***
a	Issued shares to shareholders for $50,000 cash.
b	Purchased delivery truck for $25,000; paid $4,000 cash and gave a $21,000 long-term note payable for the balance.
c	Loaned $4,000 cash; borrower signed a short-term note.
d	Purchased short-term investments for $6,000 cash.
e	Paid $3,000 on long-term note payable.
f	Sold short-term investments at cost for $2,000 cash.
g	Issued shares to shareholders for $4,000 in exchange for computer equipment.

Req. 2

Faye's Fashions Limited
Statement of Financial Position
As at March 31, 2024

Assets		***Liabilities***	
Current assets		Long-term note payable	$18,000
Cash	$35,000	*Total liabilities*	18,000
Short-term investments	4,000		
Short-term notes receivable	4,000		
Total current assets	43,000		
Non-current assets		***Shareholders' Equity***	
Computer equipment	4,000	Contributed capital	54,000
Delivery truck	25,000	*Total shareholders' equity*	54,000
Total assets	$72,000	***Total liabilities and shareholders' equity***	$72,000

E2–14

(Amounts are in millions of euros)

a.	Dividends declared (or Retained earnings) (–SE)	1,253	
	Dividends payable (+L)		1,253
b.	No transaction has occurred because the equipment has not been received and cash has not been paid yet.		
c.	Dividends payable (–L)	1,671	
	Cash (–A)		1,671
d.	Notes payable (–L)	2,172	
	Cash (–A)		2,172
e.	Cash (+A)	34	
	Equipment (–A)		34
f.	Equipment (+A)	7,410	
	Cash (–A)		6,150
	Notes payable (+L)		1,260
g.	Investments (+A)	925	
	Cash (–A)		925

E2–15

Req. 1

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

Req. 2

Cash

Beg.	1,000		
(b)	1,000	150	(a)
(c)	1,250		
(d)	2,000	500	(e)
End.	4,600		

Short-Term Investments

Beg.	2,000		
		1,000	(b)
End.	1,000		

Property and Equipment

Beg.	2,500		
		1,250	(c)
End.	1,250		

Short-Term Notes Payable

		2,200	Beg.
		2,200	End.

Long-Term Notes Payable

		300	Beg.
(a)	150	2,000	(d)
		2,150	End.

Contributed Capital

		1,000	Beg.
		1,000	End.

Retained Earnings

		2,000	Beg.
(e)	500		
		1,500	End.

Req. 3

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

E2–15 (continued)

Req. 4

Massimo Company
Statement of Financial Position
As at December 31, 2023

Assets		***Liabilities***	
Current assets		Short-term notes payable	$2,200
Cash	$4,600	Long-term notes payable	2,150
Short-term investments	1,000	*Total liabilities*	4,350
Total current assets	5,600	***Shareholders' Equity***	
Property and equipment	1,250	Contributed capital	1,000
		Retained earnings	1,500
		Total shareholders' equity	2,500
Total assets	$6,850	***Total liabilities and shareholders' equity***	$6,850

Req. 5

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

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

E2–16

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

E2–17

Req. 1

	Increases with…	**Decreases with…**
Equipment	Purchase of equipment	Sale of equipment
Notes receivable	Additional loans made to others	Collection of loans made to others
Notes payable	Additional borrowings	Payments of debt

Req. 2

Equipment

	Debit	Credit
1/1	500	
	250	$\boxed{650}$
12/31	100	

Note Receivable

	Debit	Credit
1/1	150	
	$\boxed{245}$	225
12/31	170	

Notes Payable

Debit	Credit	
	100	1/1
$\boxed{90}$	170	
	180	12/31

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

E2–18

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

E2–19

Hilton Hotels Corporation
Partial Statement of Cash Flows
For the Year Ended December 31, Current Year

Investing Activities	
Purchase of investments	$ (139)
Purchase and renovation of properties	(370)
Sale of property	230
Receipt of principal on a note receivable	125
Cash flow from investing activities	$ (154)
Financing Activities	
Additional borrowing from banks	$ 992
Payment of debt principal	(24)
Issuance of shares	60
Cash flow from financing activities	$1,028

PROBLEMS

P2–1

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

P2–2

Req. 1

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

Req. 2 (on next page)

Req. 3

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

Req. 4

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

(b) Total liabilities = \$100,000 + \$180,000 = \$280,000

(c) Total shareholders' equity = Total assets – Total liabilities
= \$870,000 – \$280,000 = \$590,000

(d) Cash balance = \$50,000 + \$90,000 – \$9,000 + \$3,500 – \$18,000 – \$5,000 = \$111,500

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

Req. 5

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

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

P2–2 (continued)

Req. 2

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

P2–3

Req. 1 and 2

Cash

	Debit	Credit	
Beg.	21,000		
(b)	12,000	6,000	(a)
(f)	12,000	7,000	(c)
(j)	1,000	9,000	(d)
		5,000	(e)
		3,000	(g)
		9,000	(h)
End.	7,000		

Investments (Short-term)

	Debit	Credit	
Beg.	2,000		
(d)	9,000		
End.	11,000		

Accounts Receivable

	Debit	Credit	
Beg.	3,000		
End.	3,000		

Inventories

	Debit	Credit	
Beg.	24,000		
End.	24,000		

Notes Receivable (Long-term)

	Debit	Credit	
Beg.	1,000		
(c)	7,000		
End.	8,000		

Equipment

	Debit	Credit	
Beg.	48,000		
(a)	18,000	1,000	(j)
End.	65,000		

Factory Building

	Debit	Credit	
Beg.	90,000		
(h)	25,000		
End.	115,000		

Intangibles

	Debit	Credit	
Beg.	3,000		
(g)	3,000		
End.	6,000		

Accounts Payable

	Debit	Credit	
		15,000	Beg.
		15,000	End.

Accrued Liabilities

	Debit	Credit	
		2,000	Beg.
		2,000	End.

Short-Term Borrowings

	Debit	Credit	
		7,000	Beg.
(e)	5,000	12,000	(a)
		12,000	(f)
		26,000	End.

Notes Payable (Long-term)

	Debit	Credit	
		48,000	Beg.
		16,000	(h)
		64,000	End.

Contributed Capital

	Debit	Credit	
		90,000	Beg.
		12,000	(b)
		102,000	End.

Retained Earnings

	Debit	Credit	
		30,000	Beg.
		30,000	End.

Req. 3

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

P2–3 (continued)

Req. 4

Injection Plastics Company Trial Balance At December 31, 2024		
	Debit	**Credit**
Cash	$ 7,000	
Investments (short term)	11,000	
Accounts receivable	3,000	
Inventories	24,000	
Notes receivable (long term)	8,000	
Equipment	65,000	
Factory building	115,000	
Intangibles	6,000	
Accounts payable		$ 15,000
Accrued liabilities		2,000
Short-term borrowings		26,000
Notes payable (long term)		64,000
Contributed capital		102,000
Retained earnings		30,000
Totals	**$239,000**	**$239,000**

P2–3 (continued)

Req. 5

Injection Plastics Company
Statement of Financial Position
As at December 31, 2024

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

Req. 6

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

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

P2–4

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

P2–5

(Amounts are in millions of U.S. dollars)

Req. 1

a.	Cash and cash equivalents (+A)	20,393	
	Long-term debt (+L)		20,393
b.	Long-term investments (+A)	18,910	
	Short-term investments (+A)	75,640	
	Cash and cash equivalents (–A)		94,550
c.	Property, plant, and equipment (+A)	11,085	
	Cash and cash equivalents (–A)		5,675
	Short-term notes payable (+L)		5,410
d.	Cash and cash equivalents (+A)	1,105	
	Contributed capital (+SE)		1,105
e.	Cash and cash equivalents (+A)	47,460	
	Short-term investments (–A)		47,460
f.	Dividends declared (or Retained earnings) (–SE)	4,431	
	Dividends payable (+L)		4,431

P2–5 (continued)

Req. 2

Cash and Cash Equivalents

Beg.	34,940		
(a)	20,393	94,550	(b)
(d)	1,105	5,675	(c)
(e)	47,460		
	3,673		

Short-Term Investments

Beg.	27,699		
(b)	75,640	47,460	(e)
	55,879		

Accounts Receivable

Beg.	26,278		
	26,278		

Inventories

Beg.	6,580		
	6,580		

Other Current Assets

Beg.	39,339		
	39,339		

Long-Term Investments

Beg.	127,877		
(b)	18,910		
	146,787		

Property, Plant, and Equipment

Beg.	39,440		
(c)	11,085		
	50,525		

Other Non-current Assets

Beg.	48,849		
	48,849		

Accounts Payable

		54,763	Beg.
		54,763	

Short-Term Notes Payable

		6,000	Beg.
		5,410	(c)
		11,410	

Deferred Revenue

		7,612	Beg.
		7,612	

Other Current Liabilities

		57,106	
		57,106	

Dividends Payable

		0	Beg.
		4,431	(f)
		4,431	

Long-Term Debt

		109,106	Beg.
		20,393	(a)
		129,499	

Other Non-current Liabilities

		53,325	Beg.
		53,325	

Contributed Capital

		57,365	Beg.
		1,105	(d)
		58,470	

Retained Earnings

		5,725	Beg.
(f)	4,431		
		1,294	

P2–5 (continued)

Req. 3

Apple Inc.
Trial Balance
At September 24, 2022
(in millions of U.S. dollars)

	Debit	**Credit**
Cash and cash equivalents	$ 3,673	
Short-term investments	55,879	
Accounts receivable	26,278	
Inventories	6,580	
Other current assets	39,339	
Long-term investments	146,787	
Property, plant, and equipment	50,525	
Other non-current assets	48,849	
Accounts payable		$ 54,763
Other current liabilities		57,106
Deferred revenue		7,612
Short-term notes payable		11,410
Dividends payable		4,431
Long-term debt		129,499
Other non-current liabilities		53,325
Contributed capital		58,470
Retained earnings		1,294
Totals	**$377,910**	**$377,910**

P2–5 (continued)

Req. 4

Apple Inc.
Statement of Financial Position
At September 24, 2022
(in millions of U.S. dollars)

ASSETS	
Current assets:	
Cash and cash equivalents	$ 3,673
Short-term investments	55,879
Accounts receivable	26,278
Inventories	6,580
Other current assets	39,339
Total current assets	131,749
Long-term investments	146,787
Property, plant, and equipment	50,525
Other non-current assets	48,849
Total non-current assets	246,161
Total assets	$377,910
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$54,763
Short-term notes payable	11,410
Deferred revenue	7,612
Dividends payable	4,431
Other current liabilities	57,106
Total current liabilities	135,322
Long-term debt	129,499
Other non-current liabilities	53,325
Total non-current liabilities	182,824
Total liabilities	318,146
Shareholders' Equity:	
Contributed capital	58,470
Retained earnings	1,294
Total shareholders' equity	59,764
Total liabilities and shareholders' equity	$377,910

P2–5 (continued)

Req. 5

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$131{,}749}{\$135{,}322} = 0.97$$

For every $1 of short-term liabilities, Apple Inc. has approximately $0.97 of current assets. Although Apple’s current assets are lower than its current liabilities, this may not be a cause for concern. Apple has a very efficient cash management system and keeps its current resources at lower levels to maximize investment opportunities.

P2–6

	Activity	Type of Activity	Effect on Cash
(a)	Borrowed from banks	F	+ 20,393
(b)	Purchased investments	I	– 94,550
(c)	Purchased property, plant, and equipment	I	– 5,675
(d)	Issued additional shares	F	+ 1,105
(e)	Sold short-term investments	I	+ 47,460
(f)	Declared dividends (does not affect cash flows)	NE	NE

P2–7

Req. 1

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

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

Req. 2

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

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

P2–8

Req. 1

Cash

	Debit	Credit	
Beg.	0		
(a)	40,000	5,000	(c)
(h)	4,000	2,000	(e)
		6,000	(f)
		5,000	(i)
	26,000		

Short-Term Notes Receivable

	Debit	Credit	
Beg.	0		
(d)	4,000	4,000	(h)
	0		

Land

	Debit	Credit	
Beg.	0		
(b)	16,000	4,000	(d)
	12,000		

Equipment

	Debit	Credit	
Beg.	0		
(c)	20,000		
(e)	2,000		
(f)	16,000	10,000	(f)
	28,000		

Short-Term Notes Payable

	Debit	Credit	
		0	Beg.
		16,000	(b)
		16,000	

Long-Term Notes Payable

	Debit	Credit	
		0	Beg.
(i)	5,000	15,000	(c)
		10,000	

Contributed Capital

	Debit	Credit	
		0	Beg.
		40,000	(a)
		40,000	

P2–8 *(continued)*

Req. 2

Lee Delivery Company
Statement of Financial Position
As at December 31, Year 1

Assets		***Liabilities***	
Current assets		*Current liabilities*	
Cash	$26,000	Short-term notes payable	$16,000
Total current assets	26,000	*Total current liabilities*	16,000
Non-current assets		Long-term notes payable	10,000
Land	12,000	*Total liabilities*	26,000
Equipment	28,000		
		Shareholders' Equity	
		Contributed capital	40,000
		Total shareholders' equity	40,000
Total assets	$66,000	***Total liabilities and shareholders' equity***	$66,000

Req. 3

Year 1:

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

Year 2:

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

Year 3:

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

The current ratio increased in Year 2 and then decreased in Year 3, suggesting that the company's liquidity is decreasing. Although the company still maintains sufficient current assets to settle the short-term obligations, this steep decline in the ratio may be of concern – it may be indicative of the need for more efficient use of resources or it may suggest the company is having cash flow problems.

P2–8 *(continued)*

Req. 4

The management of Lee Delivery Company has already been financing the company's development through additional short-term debt, from $16,000 in Year 1 to $40,000 in Year 3. This suggests the company is taking on increasing risk. Additional lending, particularly short-term, to the company may be too much risk for the bank to absorb. Based solely on the current ratio, the bank's vice-president should consider not providing the loan to the company as it currently stands. Of course, additional analysis would provide better information for making a sound decision.

ALTERNATE PROBLEMS

AP2–1

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

AP2–2

Req. 1 (on next page)

Req. 2

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

Req. 3

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

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

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

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

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

Req. 4

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

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

AP2–2 (continued)

Req. 1

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

AP2–3

Req. 1 and 2

Cash and Cash Equivalents

	Debit	Credit	
Beg.	104,596		
(a)	1,020	3,400	(b)
(d)	4,020	2,980	(e)
(g)	310	1,830	(f)
	101,736		

Accounts Receivable

	Debit	Credit	
Beg.	9,026		
	9,026		

Inventories

	Debit	Credit	
Beg.	143,978		
(e)			
	143,978		

Prepaid Expenses and Other Current Assets

	Debit	Credit	
Beg.	37,679		
	37,679		

Property, Plant, and Equipment

	Debit	Credit	
Beg.	231,446		
(f)	11,230	4,020	(d)
	238,656		

Intangible Assets

	Debit	Credit	
Beg.	45,128		
(b)	3,400		
	48,528		

Long-Term Investments

	Debit	Credit	
Beg.	108,730		
(e)	2,980		
	111,710		

Other Non-current Assets

	Debit	Credit	
Beg.	2,662		
		310	(g)
	2,352		

Accounts Payable and Accrued Liabilities

	Debit	Credit	
		37,786	Beg.
		37,786	

Deferred Revenue

	Debit	Credit	
		130,635	Beg.
		130,635	

Other Current Liabilities

	Debit	Credit	
		55,481	Beg.
		55,481	

Dividends Payable

	Debit	Credit	
		0	Beg.
		300	(h)
		300	

Long-Term Debt
(current portion is $2,731)

	Debit	Credit	
		97,911	Beg.
		9,400	(f)
		107,311	

Other Non-current Liabilities

	Debit	Credit	
		10,014	Beg.
		10,014	

Contributed Capital

	Debit	Credit	
		43,051	Beg.
		1,020	(a)
		44,071	

Retained Earnings

	Debit	Credit	
		308,367	Beg.
(h)	300		
		308,067	

AP2–3 (continued)

Req. 3

No effect was recorded for *(c)*. Ordering goods involves no exchange or receipt of cash, goods, or services and thus is not a transaction.

Req. 4

Modern Interiors Inc.
Trial Balance
At September 30
(in thousands of dollars)

	Debit	**Credit**
Cash and cash equivalents	$101,736	
Accounts receivable	9,026	
Inventories	143,978	
Prepaid expenses and other current assets	37,679	
Property, plant, and equipment	238,656	
Intangible assets	48,528	
Long-term investments	111,710	
Other non-current assets	2,352	
Accounts payable and accrued liabilities		$ 37,786
Deferred revenue		130,635
Other current liabilities		55,481
Dividends payable		300
Long-term debt (current portion, $2,731)		107,311
Other non-current liabilities		10,014
Contributed capital		44,071
Retained earnings		308,067
Totals	**$693,665**	**$ 693,665**

AP2–3 (continued)

Req. 5

Modern Interiors Inc.
Statement of Financial Position
At September 30
(in thousands of dollars)

Assets	
Current assets	
Cash and cash equivalents	$101,736
Accounts receivable	9,026
Inventories	143,978
Prepaid expenses and other current assets	37,679
Total current assets	292,419
Property, plant, and equipment	238,656
Intangible assets	48,528
Long-term investments	111,710
Other non-current assets	2,352
Total assets	$693,665
Liabilities	
Current liabilities	
Accounts payable and accrued liabilities	$ 37,786
Deferred revenue	130,635
Other current liabilities	55,481
Dividends payable	300
Current portion of long-term debt	2,731
Total current liabilities	226,933
Long-term debt	104,580
Other non-current liabilities	10,014
Total liabilities	341,527
Shareholders' Equity	
Contributed capital	44,071
Retained earnings	308,067
Total shareholders' equity	352,138
Total liabilities and shareholders' equity	$693,665

Req. 6

$$\text{Current Ratio} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}} = \frac{\$292,419}{\$226,933} = 1.29$$

Modern Interiors has $1.29 in current assets to pay each dollar of current obligations. Even though the company has a significant amount of inventories that will take some time to be converted to cash, the current liabilities include a sizable amount in deferred revenue that will not require cash to be settled, but is settled through the delivery of the goods and services paid for in advance.

AP2–4 (dollars in thousands)

Transaction	Type of Activity	Effect on Cash
(a)	F	+1,020
(b)	I	–3,400
(c)	NE	NE
(d)	I	+4,020
(e)	I	–2,980
(f)	I	–1,830
(g)	I	+310
(h)	NE	NE

AP2–5

(Amounts are in millions)

Req. 1

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

AP2–5 (continued)

Req. 2

Cash

	Debit	Credit	
Beg.	224		
(a)	200		
(b)	6,300		
		1,500	(c)
		4,650	(d)
		250	(e)
(f)	200		
	524		

Short-Term Investments

	Debit	Credit	
(c)	1,200		
		200	(f)
	1,000		

Trade and Other Receivables

	Debit	Credit
Beg.	3,528	
(e)	250	
	3,778	

Inventory

	Debit	Credit
Beg.	439	
	439	

Prepaid Expenses

	Debit	Credit
Beg.	209	
	209	

Other Current Assets

	Debit	Credit
Beg.	1,288	
	1,288	

Property, Plant and Equipment, net

	Debit	Credit
Beg.	27,513	
(d)	5,500	
	33,013	

Long-Term Investments

	Debit	Credit
Beg.	756	
(c)	300	
	1,056	

Intangible Assets

	Debit	Credit
Beg.	13,102	
	13,102	

Goodwill

	Debit	Credit
Beg.	10,604	
	10,604	

Other Non-current Assets

	Debit	Credit
Beg.	3,002	
	3,002	

Trade Payables and Other Liabilities

Debit	Credit	
	3,935	Beg.
	3,935	

Interest Payable

Debit	Credit	
	222	Beg.
	222	

Current Tax Liabilities

Debit	Credit	
	214	Beg.
	214	

Dividends Payable

Debit	Credit	
	766	Beg.
	766	

Debt Due within One Year

Debit	Credit	
	2,417	Beg.
	2,417	

Other Current Liabilities

Debit	Credit	
	717	Beg.
	717	

Long-term Debt

Debit	Credit	
	23,906	Beg.
	6,300	(b)
	850	(d)
	31,056	

Other Non-current Liabilities

Debit	Credit	
	7,159	Beg.
	7,159	

Shareholders' Equity

Debit	Credit	
	21,329	Beg.
	200	(a)
	21,529	

AP2–5 (continued)

Req.3

BCE Inc. Trial Balance At December 31, 2021 (in millions of dollars)		
	Debit	**Credit**
Cash	$ 524	
Short-term investments	1,000	
Trade and other receivables	3,778	
Inventory	439	
Prepaid expenses	209	
Other current assets	1,288	
Property, plant, and equipment, net	33,013	
Long-term investments	1,056	
Intangible assets	13,102	
Goodwill	10,604	
Other non-current assets	3,002	
Trade payables and other liabilities		$ 3,935
Interest payable		222
Current tax liabilities		214
Dividends payable		766
Debt due within one year		2,417
Other current liabilities		717
Long-term debt		31,056
Other non-current liabilities		7,159
Shareholders’ equity		21,529
Totals	$68,015	$68,015

AP2–5 (continued)

Req. 4

BCE Inc.
Statement of Financial Position
As at December 31, 2021
(in millions of Canadian dollars)

Assets	
Current assets	
Cash	$ 524
Short-term investments	1,000
Trade and other receivables	3,778
Inventory	439
Prepaid expenses	209
Other current assets	1,288
Total current assets	7,238
Property, plant, and equipment, net	33,013
Long-term investments	1,056
Intangible assets	13,102
Goodwill	10,604
Other non-current assets	3,002
Total assets	$68,015
Liabilities and Shareholders' Equity	
Current liabilities	
Trade payables and other liabilities	$ 3,935
Interest payable	222
Current tax liabilities	214
Dividends payable	766
Debt due within one year	2,417
Other current liabilities	717
Total current liabilities	8,271
Long-term debt	31,056
Other non-current liabilities	7,159
Total liabilities	46,486
Shareholders' equity	21,529
Total liabilities and shareholders' equity	$68,015

AP2–5 (continued)

Req. 5

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$7{,}238}{\$8{,}271} = 0.88$$

This ratio suggests that for every $1 in current liabilities, BCE Inc. has $0.88 in current assets. While this represents a lower margin of safety than the level desired by creditors, BCE has $5,302 million in cash, short-term investments, and receivables that can be converted into cash quickly to settle trade payables and other liabilities, interest payable, current tax payable, and dividends payable that total $5,137 million.

AP2–6 (Refer to AP2-5) (dollars in millions)

Transaction	Type of Activity	Effect on Cash
(a)	F	+200
(b)	F	+6,300
(c)	I	–1,500
(d)	I	–4,650
(e)	I	–250
(f)	I	+200

AP2-7

Req. 1

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

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

Req. 2

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

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

AP2–8

Req. 1

Cash

(a)	40,000	4,000	(c)
		1,000	(e)
	35,000		

Notes Receivable (Short-term)

(d)	3,000		
	3,000		

Land

(b)	12,000	3,000	(d)
	9,000		

Equipment

(c)	20,000		
(e)	1,000		
	21,000		

Notes Payable (Short-term)

		12,000	(b)
		12,000	

Notes Payable (Long-term)

		16,000	(c)
		16,000	

Contributed Capital

		40,000	(a)
		40,000	

Req. 2

Chu Delivery Company
Statement of Financial Position
As at December 31, 2024

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

AP2–8 *(continued)*

Req. 2

2024:

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

Req. 3

2025:

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

2026:

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

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

Req. 4

The management of Chu Delivery Company has already been financing the company's development through additional short-term debt, from $12,000 in 2024 to $40,000 in 2026. This suggests the company is taking on increasing risk. Additional lending, particularly short-term, to the company may be too much risk for the bank to absorb. Based solely on the current ratio, the bank's vice-president should consider not providing the loan to the company as it currently stands. Of course, additional analysis would provide better information for making a sound decision.

CONTINUING PROBLEM

CON2-1

Req. 1

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

CON2–1 (continued)

Req. 2

Cash

	Debit	Credit	
Beg.	0		
(a)	25,000	10,000	(b)
		2,500	(c)
		1,000	(e)
		5,000	(f)
	6,500		

Short-term Investments

	Debit	Credit	
Beg.	0		
(f)	5,000		
	5,000		

Equipment

	Debit	Credit	
Beg.	0		
(a)	36,000		
(c)	6,500		
	42,500		

Land

	Debit	Credit	
Beg.	0		
(b)	18,000		
	18,000		

Buildings

	Debit	Credit	
Beg.	0		
(b)	72,000		
	72,000		

Short-term Note Payable

	Debit	Credit	
		0	Beg.
		4,000	(c)
		4,000	

Mortgage Note Payable

	Debit	Credit	
		0	Beg.
(e)	1,000	80,000	(b)
		79,000	

Contributed Capital

	Debit	Credit	
		0	Beg.
		61,000	(a)
		61,000	

Req. 3

Penny's Pool Service and Supply Inc.
Trial Balance
March 31, 2022

	Debit	Credit
Cash	$ 6,500	
Short-term investments	5,000	
Equipment	42,500	
Land	18,000	
Buildings	72,000	
Short-term notes payable		$ 4,000
Mortgage notes payable		79,000
Contributed capital		61,000
Totals	$144,000	$144,000

CON2–1 (continued)

Req. 4

Penny's Pool Service and Supply Inc.
Statement of Financial Position
At March 31, 2022

Assets	
Current assets	
Cash	$ 6,500
Short-term investments	5,000
Total current assets	11,500
Equipment	42,500
Land	18,000
Buildings	72,000
Total assets	$144,000
Liabilities and Shareholder's Equity	
Current liabilities	
Short-term notes payable	$ 4,000
Total current liabilities	4,000
Mortgage notes payable	79,000
Total liabilities	83,000
Shareholder's equity	
Contributed capital	61,000
Total shareholders' equity	61,000
Total liabilities and shareholders' equity	$144,000

Req. 5

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

CON2–1 (continued)

Req. 6

	Current Assets	÷	Current Liabilities	=	Current Ratio
March 31, 2022	$11,500	÷	$4,000	=	2.88

With a current ratio of 2.88, PPSS has liquidity with sufficient current assets to settle short-term obligations. However, this may change as the inventory is received in April and operations begin requiring paying cash for inventory purchases from suppliers, advertising, utilities, employee salary, and other operating needs, and paying notes payable when due. One of the most significant problems for new small businesses is generating sufficient cash from operations to pay obligations and maintain liquidity.

CASES AND PROJECTS

FINDING AND INTERPRETING ACCOUNTING INFORMATION

CP2–1

The answers below are based on Metro's annual report for the fiscal year 2021.

Req. 1
The company is a corporation since it maintains contributed capital and its owners are referred to as "shareholders."

Req. 2 (amounts in millions)

Assets	=	Liabilities	+	Shareholders' Equity
$13,592.1	=	$7,179.3	+	$6,412.8

Req. 3
The amount listed on the statement of financial position for inventories does not necessarily represent the expected selling price. It likely represents the historical cost of acquiring the inventory, in accordance with the cost principle. We discuss this issue further in Chapter 6.

Req. 4
The company's year-end is September 25, 2021. This can be read from the heading of the financial statements. The notes to the financial statements indicate that its fiscal year ends on the last Saturday of September and that fiscal year 2021 included 52 weeks of operations.

Req. 5
The company's non-current liabilities consist of debt, lease liabilities, defined benefit liabilities, provisions, deferred taxes, and other liabilities, as disclosed on the statement of financial position.

Req. 6 (amounts in millions)

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$2,466.8}{\$2,198.2} = 1.12$$

This ratio suggests that for every $1 in current liabilities, Metro has $1.12 in current assets. It provides a good margin of safety for short-term creditors. The company has a large amount of inventory that may have to be marked down if the Company is strapped for cash. The company will likely increase its short-term borrowings from banks to meet its obligations to other short-term creditors, except in the case of an economic recession that depresses the market value of the company's inventory, which may limit its ability to borrow additional funds from banks.

CP2–1 (continued)

Req. 7

The company spent $463.3 million on property and equipment (fixed assets and investment properties) during 2020 and $520.0 million during 2021. This information is shown in the investing activities section of the statement of cash flows as additions to fixed assets and investment properties.

CP2–2

The answers below are based on Empire Company Limited's annual report for the fiscal year 2021.

Req. 1 (amounts in millions)

Assets	=	Liabilities	+	Shareholders' Equity
$15,173.9	=	$10,675.9	+	$4,498.0

Req. 2

No – shareholders' equity is a residual balance, meaning that the shareholders will receive what remains in cash and assets after the creditors have been satisfied. Most of the assets on the statement of financial position are not stated at fair value, only at their historical cost. Shareholders would receive more than $4,498.0 million if the fair value of the net assets (assets – liabilities) exceeds their book value.

Req. 3

The Company's non-current liabilities include provisions, long-term debt, long-term lease liabilities, other long-term liabilities, employee future benefits, and deferred tax liabilities.

Req. 4

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$3,193.5}{\$3,488.2} = 0.92$$

Req. 5

The company had a net cash outflow of $502.3 million for investing activities.

CP2–3

Req.1

Metro had total assets of $13,592.1 million compared to $15,173.9 million for Empire Company Limited.

Req. 2

Current year	Industry Average	Metro Inc.	Empire Company Limited
Current ratio = Current Assets / Current Liabilities	1.20	$2,466.8 / $2,198.2 = 1.12	$3,193.5 / $3,488.2 = 0.92

(Dollar amounts are in millions)

Metro's current ratio of 1.12 is higher than Empire Company Limited's ratio of 0.92, but both ratios are lower than the industry average of 1.20.

Req. 3

Metro paid $456.3 million to repurchase its own common shares during 2021, and Empire Company Limited paid $153.6 million to repurchase its own shares in fiscal year 2021. The information is reported on the statements of cash flows of both companies with details in the notes to the financial statements.

Req. 4

Metro paid $240.1 million in dividends during 2021 as disclosed in the financing activities section of its statement of cash flows. Empire Company Limited paid $139.4 million to its shareholders during 2021.

Req. 5

Metro uses three titles: Fixed assets, Right-of-use assets, and Investment properties, whereas Empire Company Limited uses the titles Property and equipment, Right-of-use assets, and Investment property.

CP2–4

The answers below are based on the Company's Interim Report for the three months ended October 3, 2021, released on November 4, 2021.

Req. 1

(a) Gildan's total assets at the end of the third quarter ended October 3, 2021 were $3,075.7 million.

(b) Long-term debt decreased during the quarter from $1,000 million to $600 million as shown on the statements of financial position at October 3, 2021 and January 3, 2021, respectively.

(c)

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$1{,}607.8}{\$489.4} = 3.29$$

Gildan's current ratio indicates that it has $3.29 for every $1 of current liabilities. The company has a sizable amount of cash resources that covers most of its current liabilities. It appears that Gildan may not be utilizing its cash resources efficiently by investing in short-term investments, or is looking for investment opportunities and keeping its cash resources for this purpose.

Req. 2

(a) For the third quarter, the statement of cash flows reveals that Gildan spent $48.1 million on capital expenditures.

(b) The net cash flows used for financing activities were $153.3 million for the third quarter as reported on the statement of cash flows.

FINANCIAL REPORTING AND ANALYSIS CASES

CP2–5

Req. 1

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

Req. 2

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

CP2–6

Req. 1

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

Smiley Corp. has $63,000 in current assets, about one-third of its total assets. In contrast, Tsang Inc. has $29,200 in current assets, representing about 10% of its total assets. Tsang Inc. is larger in size than Smiley, but it seems to be more efficient in managing its inventory and accounts receivable. On the surface, this may reflect good relations with both its trade suppliers that provide it with merchandise when needed and its customers who pay on time.

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

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

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

Req. 2

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

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

CRITICAL THINKING CASES

CP2–7

Dollars are in U.S. millions:

1. The company is a corporation because its owners are referred to as stockholders.

2.

Assets	=	Liabilities	+	Stockholders' Equity
$13,379	=	$5,409	+	$7,970

3.

	Current Assets	÷	Current Liabilities	=	Current Ratio
2020	$7,620		$ 832		9.16
2021	8,637		1,953		4.42

In 2020, for every $1 of current liabilities, Twitter maintained $9.16 of current assets, suggesting that Twitter is highly liquid and has the ability to pay its short-term obligations with current assets in the upcoming year. The current ratio decreased during 2021. The interpretation of this ratio would be more useful if we could compare the company's current ratio to the current ratio for the industry and/or competitors and additional years of data to observe trends.

4.

	Debit	Credit
Accounts payable (–L)...................................	194	
Cash (–A)...		194

5. Over its years in business, it appears that Twitter has been unprofitable, based on a negative amount in Accumulated Deficit of $1,126 at December 31, 2020. The Accumulated Deficit account represents the cumulative losses of the firm since the business began, assuming no dividends were declared (unlikely given its deficit position).

It is possible to determine the amount of the net loss by using the following equation, assuming no dividends were declared (amounts in millions):

Beginning Retained Earnings	+	For the Year: Net Income (Loss)	–	For the Year: Dividends declared	=	Ending Retained Earnings
$12	+	?	–	$ 0	=	($1,126)

Thus, net loss for the most recent year was ($1,126) – $12 = ($1,138).

CP2–8

Req. 1

Lettucedothis.Com Inc.
Statement of Financial Position
As at December 31, 2024

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

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

CP2–8 *(continued)*

Req. 2

Dear ___________,

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

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

CP2-9

Proposal 1

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

Proposal 2

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

Proposal 3

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

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

CP2–10

Req. 1

The most obvious parties harmed by the fraud at Biovail Corporation were the shareholders and creditors. Shareholders were purchasing shares that were inflated due to the fraud. Creditors were lending funds to the company based on inaccurate information reported on the statement of earnings and the statement of financial position. When the fraud was discovered, the stock price dropped, causing the shareholders to lose money on their investments. In addition, the creditors had a lower probability of receiving full payment on their loans. The vendors who assisted in verifying false promotional allowances were also investigated.

Those who were helped by the fraud included the former executives who were able to receive substantial bonuses based on the inflated results of operations.

Req. 2

Biovail set certain financial goals and tied the former executives' bonuses to meeting the goals. Adopting targets is a good tool for monitoring progress toward goals and identifying problem areas, such as rising costs or sagging sales. Better decision making can result by heading off potential problems before they grow too large. However, setting unrealistic financial targets, especially in poor economic times, can result in circumventing appropriate procedures and policies by those responsible for meeting the targets for their own benefit.

CP2–11

Req. 1

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

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

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

Req. 2

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

Req. 3

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

FINANCIAL REPORTING AND ANALYSIS PROJECT

CP2–12

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

CP2–13

The project is open-ended and can be focused on a specific sustainability area. Hence, the solution will depend on the ESG area selected for analysis.

