CHAPTER 2

**A FURTHER LOOK AT FINANCIAL STATEMENTS**

1 MINUTE QUESTION

The purpose of these short 1 minute questions is to encourage students to come to class prepared for the lesson, having read the chapter. The question may be given at the beginning of the class and count for ½ to 1 mark.

The primary objective of financial reporting is to provide

a. useful information for making predictions about the future.

b. financial statements.

c. an annual report.

d. useful information to those users making investment and credit decisions.

Answer: d

Vocabulary Quiz

1. Tangible assets that are being used in the business and are not intended for resale.

2. The quality of information that indicates the information makes a difference in a decision.

3. A measure used to evaluate a company’s liquidity and short-term debt-paying ability, calculated by dividing current assets by current liabilities.

4. The basis of accounting that states assets should be recorded at their cost at the time of acquisition.

5. If information is important enough to influence the decision of an investor or creditor then the information is said to be this.

6. Assets not expected to be converted into cash, sold, or consumed in operations within the next year or operating cycle.

7. Obligations reasonably expected to be paid from existing current assets within the next year or operating cycle.

8. The excess of current assets over current liabilities.

9. Measures the ratio of the market price of each common share to its basic earnings per share.

10. Assets that are expected to be realized in cash, sold or consumed in the business within one year or operating cycle.

ANSWERS TO Vocabulary Quiz

1. Property, plant, and equipment

2. Relevance

3. Current ratio

4. Historical cost (basis of accounting)

5. Material

6. Non-current assets

7. Current liabilities

8. Working capital

9. Price-earnings ratio

10. Current assets

Multiple Choice quiz

1. All of the following are current assets *except*

a. accounts receivable.

b. cash.

c. patents.

d. short-term investments.

e. inventory.

2. Current liabilities include

a. obligations to be paid within the year or operating cycle.

b. accounts payable.

c. salaries payable.

d. unearned revenue.

e. all of the above

3. Shareholders’ equity includes

a. share capital.

b. long-term investments.

c. advances from shareholders.

d. goodwill.

e. both a and d

4. Current assets may be listed in the order of

a. liquidity.

b. reverse liquidity.

c. permanency.

d. both a and b

e. a, b, and c

5. Working capital is

a. current assets less current liabilities.

b. current assets divided by current liabilities.

c. net income divided by average assets.

d. net income divided by net sales.

e. current liabilities less current assets.

6. The current ratio is a

a. solvency ratio.

b. profitability ratio.

c. liquidity ratio.

d. none of the above

e. both a and c

7. Under ASPE, the allocation of the cost of assets over their useful lives is known as

a. amortization for both tangible and intangible assets.

b. depreciation for both tangible and intangible assets.

c. amortization for tangible assets and depreciation for intangible assets.

d. depreciation for tangible assets and amortization for intangible assets.

e. none of the above

8. Selected financial information for ACE Corporation has been provided:

|  |  |
| --- | --- |
| Current assets | $100,000 |
| Property, plant, and equipment | 250,000 |
| Current liabilities | 50,000 |
| Non-current liabilities | 200,000 |
| Common shares | 10,000 |

ACE Corporation’s debt to total assets ratio is

a. 14.3%.

b. 50.0%.

c. 69.4%.

d. 71.4%.

e. none of the above

9. Selected financial information for ACE Corporation has been provided:

|  |  |
| --- | --- |
| Current assets | $100,000 |
| Property, plant, and equipment | 250,000 |
| Current liabilities | 50,000 |
| Non-current liabilities | 200,000 |
| Common shares | 10,000 |

ACE Corporation’s current ratio is

a. $50,000.

b. 0.4:1.

c. 0.5:1.

d. 2.0:1.

e. none of the above

10. Basic earnings per share

a. are reported for both public and private companies.

b. are reported only by companies following IFRS.

c. are reported only by companies following ASPE.

d. are optional.

e. are reported by companies following both IFRS and ASPE.

11. Materiality in accounting implies

a. that everything is important.

b. the value of information must exceed the cost of producing it.

c. GAAP does not always have to be followed.

d. investors should not be influenced by financial statements.

e. none of the above

12. The following are fundamental qualitative characteristics:

a. relevance and verifiability.

b. relevance and faithful representation.

c. faithful representation and verifiability.

d. relevance, verifiability, and faithful representation.

e. none of the above

13. The following are enhancing qualitative characteristics:

a. comparability and faithful representation.

b. verifiability and relevance.

c. comparability, timeliness, verifiability, and understandability.

d. relevance, verifiability, comparability, and faithful representation.

e. none of the above

14. Which of the following characteristics is *not* necessary in order for accounting information to be a faithful representation?

a. complete

b. neutral

c. cost constraint

d. free from error

e. none of the above

15. The elements of financial statements include

a. assets, liabilities, and equity.

b. income and expenses.

c. the going concern assumption.

d. both a and b

e. a, b, and c

ANSWERS to Multiple Choice quiz

1. c

2. e

3. a

1. d

5. a

6. c

7. b

8. d

9. d

10. b

11. c

12. b

13. c

14. c

15. d

chapters 1 & 2 Multiple Choice quiz

1. The objective of financial reporting is met in large part by a set of financial statements. Of the following, which is *not* one of these statements?

a. Income tax return

b. Income statement

c. Statement of financial position

d. Statement of cash flows

e. both a and b

2. The system that guides decisions about what to present in financial statements, alternative ways of reporting economic events, and appropriate ways of communicating this information is called

a. the conceptual framework.

b. accounting standards for private enterprises.

c. the statement of financial accounting concepts.

d. Canadian standards for public accountants.

e. generally accepted accounting principles.

3. A statement of financial position is designed to show the financial position of a business

a. at a single point in time.

b. over a period of time such as a year or a quarter.

c. at December 31 of the current year.

d. at January 1 of the coming year.

e. none of the above

4. Which financial statement is prepared first?

a. Statement of financial position

b. Income statement

c. Statement of changes in equity

d. Statement of cash flow

e. The order does not matter

5. The Sun and Snow Shop Ltd. started the year with total assets of $60,000 and total liabilities of $40,000. During the year the business recorded $100,000 in car repair revenues, $65,000 in expenses, and dividends of $10,000. The net income reported by The Sun and Snow Shop Ltd. for the year is

a. $20,000.

b. $35,000.

c. $45,000.

d. $90,000.

e. $100,000.

6. Which financial statement reports the cash effects of the company’s operating, investing and financing activities for a period of time?

a. Income statement

b. Statement of changes in equity

c. Statement of financial position

d. Statement of cash flows

e. Both a and d

7. The ability to pay obligations that are expected to become due within the next year or operating cycle is called

a. working capital.

b. profitability.

c. solvency.

d. liquidity.

e. both a and d

8. Which of the following is considered an intangible asset on a statement of financial position?

a. accounts receivable

b. cash

c. goodwill

d. short-term investments

e. inventory

9. Assets total $16,000 and shareholders’ equity totals $11,000. What is the dollar amount of liabilities?

a. $23,000

b. $17,000

c. $11,000

d. $5,000

e. none of the above

10. Borrowing money from a bank is considered to be a(n)

a. merchandising activity.

b. financing activity.

c. operating activity.

d. investing activity.

e. both c and d

11. Buying a cash register for a fast food business is an example of a(n)

a. merchandising activity.

b. financing activity.

c. operating activity.

d. investing activity.

e. both c and d

12. Relevant information is considered

a. timely.

b. predictive and material.

c. predictive, confirmatory, and material.

d. confirmatory and timely.

e. timely and predictive.

13. Faithful representation is considered

a. complete and neutral.

b. complete and free from errors.

c. neutral and free from errors.

d. complete, neutral, and free from errors.

e. none of the above

14. The basic earnings per share ratio is a

a. solvency ratio.

b. profitability ratio.

c. liquidity ratio.

d. none of the above

e. a, b, and c are correct

15. Selected financial information from ACE Corporation has been provided:

|  |  |
| --- | --- |
| Common shares | $10,000 |
| Net income | $80,000 |
| Market price per share | $25 |
| Weighted average number of common shares | 100,000 |

ACE Corporation’s basic earnings per share is

a. $0.80.

b. $8.00.

c. $10.00.

d. $25.00.

e. none of the above

ANSWERs to chapters 1 & 2 Multiple Choice quiz

1. a

2. a

1. a
2. b

5. b

6. d

7. d

8. c

9. d

10. b

11. d

12. c

13. d

14. b

15. a

20-MINUTE QUIZ #1

Circle the correct answer.

**True/False**

1. The operating cycle of a company is the average True False

period of time it takes for a business to pay cash

to obtain products or services and then receive

cash from customers for these products or services.

2. Bonds payable is a current liability. True False

3. The basic objective of financial reporting is to True False

provide useful information to investors and

lenders to make decisions about providing

resources to the company.

4. Solvency ratios measure a company’s ability to True False

survive over a long period of time by having

enough assets to settle its liability as they fall due.

5. According to the cost constraint, assets should True False

be reported at their historical cost.

6. Accounting information has faithful representation True False

if knowledge of it will influence a user’s decision.

7. Unearned revenue represents cash received in True False

advance from a customer before revenue is earned.

8. Working capital is a liquidity ratio. True False

9. Liabilities represent the ownership claim on True False

total assets.

10. The going concern assumption assumes that True False

a company will liquidate in the near future.

**Multiple Choice**

11. Which of the following is considered a current asset on a classified statement of financial position?

a. marketable securities

b. notes receivable, due in three years

c. building

d. patent

e. goodwill

12. Which of the following is *not* an enhancing qualitative characteristic of useful information?

a. comparability

b. completeness

c. verifiability

d. timeliness

e. both a and b

13. Net income available to common shareholders is $140,000 and weighted average number of common shares during the year is 80,000. The market price of each common share is $8.75. The price-earnings ratio is

a. 5.

b. 4.

c. 4.375.

d. 16.

e. 1.75

14. Which ratio measures the percentage of assets financed by creditors rather than by shareholders?

a. Current ratio

b. Basic earnings per share ratio

c. Debt to total assets ratio

d. Price-earnings ratio

e. Working capital

15. Accounting information should be neutral in order to be

a. complete.

b. relevant.

c. understandable.

d. a faithful representation of what really exists or happened.

e. reliable.

ANSWERS TO 20-MINUTE QUIZ #1

**True/False**

1. True

2. False

3. True

4. True

5. False

6. False

7. True

8. True

9. False

10. False

**Multiple Choice**

11. a

12. b

13. a

14. c

15. d

20-MINUTE QUIZ #2

1. Selected components of the conceptual framework are shown below:

1. Going concern
2. Predictive value
3. Neutral
4. Understandability
5. Verifiability
6. Timeliness
7. Faithful representation
8. Comparability
9. Confirmatory value
10. Cost constraint
11. Materiality

Match each of the following statements with one of the items on the above list.

a. Information has this quality if different knowledgeable and independent users can reach consensus that the information is faithfully represented.

b. Accounting information that is not biased toward one group of users or another.

c. Information that is presented must portray what really exists or happened.

d. Information has this quality if it is classified, characterized, and presented clearly and concisely.

e. Relevant information helps users make predictions about future events.

f. Accounting information must be available to decision makers before it loses its ability to influence their decisions.

g. The company will remain in operation for the foreseeable future.

h. Information has this quality if users can identify and understand similarities in, and differences among, items.

i. Information has this quality if it provides users with feedback regarding their previous predictions or expectations.

j. The value of the information provided in financial reporting information should justify the cost of providing it.

k. This is an important component of relevance, which requires accountants to consider whether omission or misstatement of the information could influence the decisions of users.

2. Consider the following data from Meadows Corporation:

|  |  |  |
| --- | --- | --- |
|  | 2018 | 2017 |
| Current assets | $ 61,000 | $ 50,000 |
| Total assets | 108,000 | 85,000 |
| Current liabilities | 47,000 | 39,000 |
| Total liabilities | 80,000 | 62,000 |
| Net sales | 200,000 | 180,000 |
| Net income available to common shareholders | 30,000 | 20,000 |
| Market price per common share | 9.00 | 6.40 |
| Weighted average number of common shares | 30,000 | 25,000 |

Calculate the following and explain what the results mean:

1. Working capital for 2018 and 2017
2. Current ratio for 2018 and 2017
3. Debt to total assets for 2018 and 2017
4. Basic earnings per share for 2018 and 2017
5. Price-earnings ratio for 2018 and 2017

3. The following presents December 31, 2018, year-end balances for the Variety Corporation:

|  |  |
| --- | --- |
| Cash | $ 5,900 |
| Accounts payable | 3,300 |
| Accumulated depreciation—equipment | 13,500 |
| Prepaid insurance | 1,400 |
| Common shares | 25,000 |
| Intangible assets | 5,500 |
| Accounts receivable | 13,600 |
| Retained earnings | 49,300 |
| Equipment | 63,000 |
| Land | 10,500 |
| Inventory | 14,400 |
| Long-term loan payable | 20,000 |
| Salaries payable | 3,200 |

Prepare a classified statement of financial position in order of liquidity.

ANSWERS TO 20-MINUTE QUIZ #2

1. a. 5

b. 3

c. 7

d. 4

e. 2

f. 6

g. 1

h. 8

i. 9

j. 10

k. 11

2.

a. Working Capital = Current Assets – Current Liabilities

2018: $61,000 – $47,000 = $14,000

2017: $50,000 – $39,000 = $11,000

Working capital is a measure of liquidity. Since this company’s working capital is positive, there is a greater likelihood that it will be able to pay its current liabilities.

b. Current Ratio = Current Assets ÷ Current Liabilities

2018: $61,000 ÷ $47,000 = 1.30:1

2017: $50,000 ÷ $39,000 = 1.28:1

The current ratio is another measure of liquidity. In 2018, the company had $1.30 of current assets for every dollar of current liabilities. In 2017, it had $1.28 of current assets for every dollar of current liabilities; therefore, the company’s current ratio improved slightly.

c. Debt to Total Assets = Total Debt ÷ Total Assets

2018: $80,000 ÷ $108,000 = 74%

2017: $62,000 ÷ $85,000 = 73%

This ratio measures the percentage of assets that is financed by creditors rather than by shareholders. In 2018, $0.74 of every dollar invested in assets was provided by creditors. In 2017, $0.73 of every dollar invested in assets was provided by creditors. In general, a higher percentage of debt to total assets means there is greater risk that the company will be unable to pay its debts as they come due.

d. Basic Earnings per Share = Net Income Available to Common Shareholders ÷ Weighted

Average Number of Common Shares

2018: $30,000 ÷ 30,000 = $1.00

2017: $20,000 ÷ 25,000 = $0.80

This ratio is a measure of profitability. It measures the net income earned for each common share, and provides a useful perspective of shareholder investment return.

e. Price-Earnings Ratio = Market Price per Share ÷ Basic Earnings per Share

2018: $9.00 ÷ $1.00 = 9 times

2017: $6.40 ÷ $0.80 = 8 times

This ratio reflects investors’ assessment of the company’s future profitability. This ratio will be higher if investors think that the company’s current net income level will persist or increase in the future.

3.

**VARIETY CORPORATION**

**Statement of Financial Position**

**December 31, 2018**

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**Assets**

**Current assets**

Cash $ 5,900

Accounts receivable 13,600

Inventory 14,400

Prepaid insurance 1,400

Total current assets $ 35,300

**Non-current assets**

Property, plant, and equipment

Land $10,500

Equipment $63,000

Less: accumulated depreciation—equipment 13,500 49,500

Total property, plant, and equipment 60,000

Intangible assets 5,500

Total assets $100,800

**Liabilities and Shareholders’ equity**

**Current liabilities**

Accounts payable $ 3,300

Salaries payable 3,200

Total current liabilities $ 6,500

**Non-current liabilities**

Loan payable 20,000

Total non-current liabilities 20,000

Total liabilities $26,500

**Shareholders’ equity**

Common shares $25,000

Retained earnings 49,300

Total shareholders’ equity 74,300

Total liabilities and shareholders’ equity $100,800