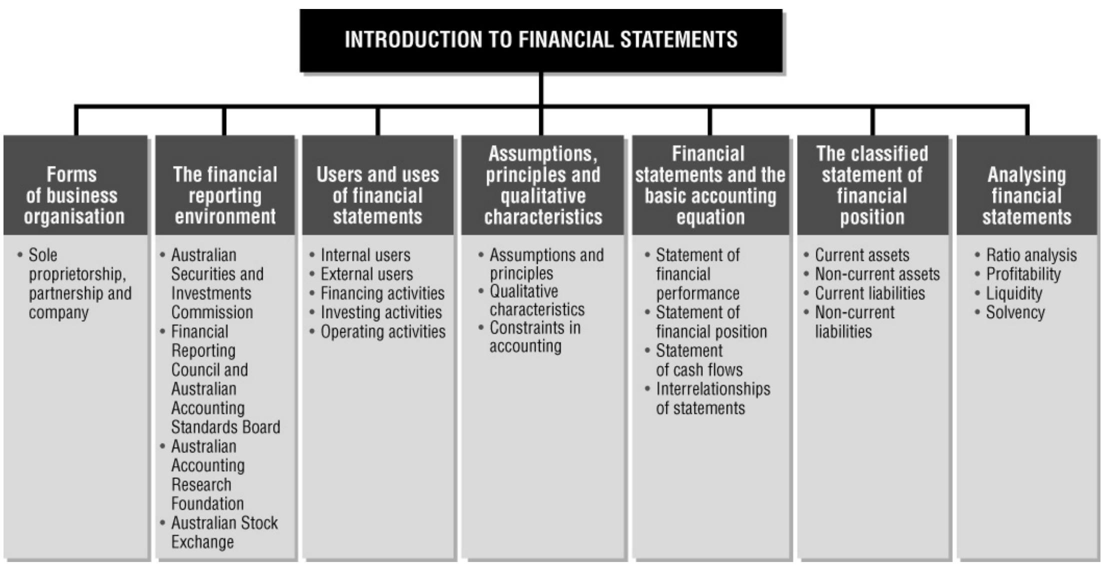
CHAPTER 1

Introduction to financial statements

CHAPTER OVERVIEW

Chapter 1 introduces you to a variety of financial accounting topics. You will learn about the main forms of business organisation, and the financial reporting environment. You will also learn about the types of users of accounting information, and their information needs, and how that information is delivered. You will learn about the basic financial statements and the basic accounting equation relating to the statement of financial position. You will learn about the components of each of the three main financial statements, and the assumptions, principles and qualitative characteristics underlying these statements.



REVIEW OF LEARNING OBJECTIVES

LO1 Describe the main forms of business organisation.

- A **sole proprietorship** is a business owned by one person. It is simple to set up, and the owner has control over the business. Because they are so simple to organise there are many thousands of sole proprietorships operating in the business world.

- A **partnership** is a business owned by more than one person. Although it is not a separate legal entity, it is a separate accounting entity and has to complete a partnership tax return every year. It provides strength in numbers: each partner may bring economic resources or unique talents or skills to the combination.

- A **company** is a separate legal entity owned by shareholders. Advantages include the fact that investors can invest small amounts of money, shares are easy to sell, and the raising of funds is relatively easy. While there are many more sole proprietorships and partnerships than there are companies, companies produce far more revenue.

LO2 Describe the financial reporting environment.

- In Australia registered companies must comply with the Corporations Act which is administered by the **Australian Securities and Investments Commission (ASIC)**, and requires companies to comply with Australian accounting standards which are issued by the **Australian Accounting Standards Board (AASB)**. The AASB is overseen by the **Financial Reporting Council (FRC)**, which comprises key members of the business community, the accounting professional bodies, governments and regulatory agencies.

- The AASB is also developing a conceptual framework which currently comprises four statements of accounting concepts (SACs) which provide guidance to preparers of financial statements and standard setters. These statements, which were issued jointly by the **Australian Accounting Research Foundation (AARF)** and AASB predecessor, deal with the scope of financial reporting, objectives of financial reporting, qualitative characteristics and the elements of financial statements. The AARF is jointly sponsored by the two professional accounting bodies, the **Institute of Chartered Accountants in Australia (ICAA)** and **CPA Australia**.

- Listed public companies must also comply with the listing rules of the **Australian Stock Exchange (ASX)**. These listing rules focus mainly on disclosure of information, for example industry-specific disclosures.

LO3 Identify the types of users of accounting reports and their information needs.

- The purpose of financial information is to provide inputs for decision making. Accounting is the information system that identifies, records, and communicates the economic events of an organisation to interested users. These users can be internal or external to the organisation.

- **Internal users** are people who work for the business, managers who plan, organise, and run a business. Accounting information helps to answer questions such as, ‘Does the business have enough resources to build a new manufacturing plant?’ Internal reports help to provide the required information.

- **External users** are outside of the business and statement of accounting concepts (SAC) 2 identifies resource providers (such as investors and creditors); recipients of goods and services (customers); and parties performing a review or oversight function (regulatory agencies such as the Australian Taxation Office (ATO) and ASIC).

- The accounting system tracks three types of business activity: financing; investing and operating.

- **Financing activities** deal with the ways a business raises funds for operations. The two primary sources of outside funds are borrowing money and issuing (selling) shares.

- A business may borrow money by taking out a loan at a bank, issuing debt securities, or purchasing goods on credit. A **creditor** is a person or entity to which a business owes money, and a **liability** is a debt or other obligation which represents creditors' claims on the business. Examples of liabilities are accounts payable, resulting from purchases on credit; notes payable, resulting from direct borrowing or purchasing on credit; wages payable, representing wages owed to employees; tax payable to governments; and debentures payable, sold to investors and usually due several years in the future. A creditor has a legal right to be paid at an agreed-upon time and must be paid before an owner (shareholder) is paid.

- A company may also sell shares to investors to raise funds. **Share capital** is the term which describes the total amount paid into the company by shareholders for the shares purchased. A shareholder is an owner of the business and receives payments in the form of dividends. (Please note that there are companies which do not pay dividends to shareholders.) As noted above, shareholder claims are secondary to creditor claims.

- **Investing activities** deal with what a company does with the financing it receives. A new business must purchase assets with which to operate. An asset is a resource owned by a business. Examples of assets are property, plant, and equipment, such as buildings and trucks; and accounts receivable, which is someone's or some entity's promise to pay the business money in the future.

- **Operating activities** are just that: operations of the business. Different businesses have different operations, of course. A paper company produces and sells paper while a dairy company produces and sells milk. When a company operates, it earns revenues. Revenues are the increase in assets arising from the sale of a product or service. When a company operates, it also incurs costs or expenses. Expenses are the cost of assets consumed or services used in the process of generating revenues. If revenues exceed expenses (hopefully!), then a business earns net profit. If expenses exceed revenues, then a business incurs a net loss.

LO4 Explain the accounting assumptions, principles and qualitative characteristics underlying financial statements.

- There are various assumptions and principles which underlie financial reporting, and certain qualitative characteristics required of accounting information. Collectively these assumptions, principles, and qualitative characteristics are referred to as **Generally Accepted Accounting Principles (GAAP)**.

The assumptions are:

- The **monetary assumption** which requires that only those things that can be expressed in money are included in the accounting records. Customer satisfaction and a loyal, competent workforce are extremely important but will not appear on a financial statement.

- The **accounting entity assumption** which states that every economic entity can be separately identified and accounted for. If an individual owns a business, then that individual must have two sets of records: one for his/her individual (personal) transactions and one for the business.

- The **period assumption** which states that the life of a business can be divided into discrete, artificial time periods and that useful reports covering those periods can be prepared for the business.

- The **going concern assumption** which states that the business will remain in operation for the foreseeable future. This principle underlies much of what we do in accounting. If it seems likely that a company will go out of business in the near future, then different assumptions will govern preparation of the financial statements, for example assets should be shown at their liquidation value.

The principles are:

- The **historical cost principle** which dictates that assets are recorded at their cost, not only at the time of their acquisition but also for the entire time that they are held. There is much discussion about the relevance of this principle, but accountants adhere to it for various reasons, one of which is that cost is easy to measure, whereas market value is subjective. We will look at alternatives to historical cost later.

- The **full disclosure principle** which requires that all circumstances and events that would make a difference to financial statement users should be disclosed, either in the statements themselves or in the notes that accompany, and are an integral part of, the statements.

- To be useful, information should have the following qualitative characteristics: **relevance**, **reliability**, **comparability**, and **understandability**, and should pass the **materiality test**.

- Accounting information is **relevant** if it makes a difference in a business decision. If relevant, accounting information provides a basis for forecasting, confirms or corrects prior expectations, and is presented on a timely basis.

- Accounting information is **reliable** if it can be depended on. If reliable, accounting information is verifiable (free of error), is a faithful representation of what it purports to be, and is neutral (does not favour one set of users over another).

- Accounting information is **comparable** when different companies use the same accounting principle. Complying with accounting standards does not automatically result in comparability as the standards allow for some variation in methods, eg. in measurement of inventory. For this reason companies must disclose accounting methods used. Ability to compare the same company's financial reports over time is an important aspect of comparability for users, although this is referred to as **consistency**.

- Accounting information is **consistent** when one company uses the same accounting principles and methods from year to year. This does not mean that a company must use the same methods forever after making the initial selection. If it changes in order to produce more meaningful information, then it must disclose the change in the notes to the financial statements.

- Please note that **comparability** deals with making comparisons between two or more companies, whereas **consistency** deals with making comparisons within one company over several periods.

- To assist decision making of users accounting information must be **understandable**. This is, of course, dependent on the capability of the individual users, however preparers of financial reports should be mindful of ensuring that financial reports are understandable for those users who have the proficiency to comprehend the significance of accounting practices.

- All relevant and reliable financial information should be included if it passes the **materiality test**. An item is **material** if its omission or misstatement could adversely affect the decision of a user. 'Immaterial' items still need to be recorded, but do not need to be identified separately.

- There are two **constraints** to the above qualitative characteristics recognised by statement of accounting concepts (SAC) 3, and these are **timeliness**: that to be useful financial information must be reported in a timely manner; and **cost vs benefit**: that the benefit of providing financial information exceeds the cost of providing it. These constraints permit a company to modify generally accepted accounting principles without jeopardising the usefulness of the reported information.

LO5 Describe the three main financial statements and the basic accounting equation relating to the statement of financial position.

- Various users desire information to help them make decisions, and this financial information is provided in the form of financial statements, which form the backbone of financial accounting. There are three financial statements: **the statement of financial performance** (formerly called the profit and loss statement), **the statement of financial position** (formerly called the balance sheet), and **the statement of cash flows**.

- The **statement of financial performance** reports the success or failure of the company's operations during the period. Only revenues and expenses appear on the statement of financial performance, along with their difference, either net profit (revenues exceed expenses) or net loss (expenses exceed revenues). Beginning students often want to put the account 'Cash' on the statement of financial performance, but this is incorrect because cash is an asset (a resource owned by a business). So remember: only revenues and expenses appear on the statement of financial performance.

- The **statement of financial position** reports assets and claims to those assets at a specific point in time. There are **two types of claims**: claims of creditors (liabilities) and claims of owners (owners' equity). The statement of financial position is an expanded expression of the basic accounting equation which is:

Assets = Liabilities + Owners' equity

- Please note that this is a mathematical equation and must be in balance at all times. It can be used to answer questions such as: If assets total $100 and liabilities total $20, then what is the total of owners' equity? (Answer: $80 — because $20 plus 'something' must equal $100, so the 'something' must be $80).

- **Owners' equity** consists of two parts: share capital; and retained profits and reserves.

- The **statement of cash flows** provides financial information about the cash receipts and cash payments of a business for a specific period of time. Here a user will find information about the financing, investing, and operating activities of the business.

- Note the interrelationships between statements:

- Net profit or net loss from the statement of financial performance appears on the statement of financial position. It is added to beginning retained profits and used to determine ending retained profits.

- The ending balance of cash must be the same both on the statement of financial position and on the statement of cash flows.

- Companies usually present **comparative statements**, which are statements reporting information for more than one period.

- Please be aware of the following when you prepare financial statements:

- All statements must have a heading. The company name appears on the first line, the name of the document appears on the second line, and the date appears on the third line. With respect to dates, the statement of financial position sheet date is for one point in time, like a still photograph (e.g. 'as at 30 June 2003' or 'as at 31 December 2003'), while the date on the statement of financial performance, and the statement of cash flows are for a period of time ('for the month ended 30 June 2003' or 'for the year ended 31 December 2003').

- The number at the top of a column should have a dollar sign: this indicates that it is the first number in that column. The final number on a statement, such as Net Profit or Total Assets, should have a dollar sign and be double-underlined. This indicates that it is the 'answer'. If there is a negative number, such as Net Loss, then it should be presented in parentheses or brackets. These are part of a type of shorthand used by preparers of statements and understood by users of statements.

LO6 Identify the sections of a classified statement of financial position.

- The **statement of financial position** of a company presents a snapshot of its financial position at a point in time. A **classified statement of financial position** breaks the statement components into several classifications.

The following are the common asset categories:

- **Current assets** are those expected to be converted into cash or used in the business within a relatively short period of time, usually within one year. Please note that some companies use a period longer than one year because they have a longer operating cycle (the average time that it takes to spend cash to obtain or manufacture a product to sell, then to sell the product, and then to collect cash from the customer). The operating cycle is sometimes called the cash-to-cash cycle. Current assets are listed in the order in which they are expected to be converted into cash and include **cash**; **marketable securities**; **receivables**; **inventories**; and **prepaid expenses**.

- **Non-current assets** are those assets expected to be converted into cash more than one year from **balance date** (the date of the statement of financial position) or used in the business in the long term. They include **receivables**; **long-term investments**; **property**, **plant and equipment**; and **intangible assets**.

- **Property**, **plant**, and **equipment** are assets with relatively long useful lives that are used in the operations of the business. Examples include **land**, **building**, **machinery and equipment**, **delivery equipment**, and **furniture**. These assets depreciate, or wear out with the passage of time, and their cost must be allocated to expense over the useful life of the asset (termed depreciation). On the statement of financial position, they are shown at their cost less total accumulated depreciation. (The one exception is land: instead of depreciating, land normally appreciates.)

- **Intangible assets** are non-current assets which have no physical substance. They are essentially long-lived rights, examples include **franchises**, **patents**, **copyrights**, and **trademarks** or **trade names**.

The following are the common liability categories:

- **Current liabilities** are obligations that are to be paid within one year. Examples include accounts payable, notes payable, salaries payable, interest payable, taxes payable, and current maturities of long-term obligations.

- **Non-current liabilities** are expected to be paid after one year from the date of the statement of financial position. If the statement of financial position date is 31 December 2002, and an obligation is due on 30 June 2005, then the obligation is long-term. Examples include **debentures payable**, **mortgages payable**, **long-term notes payable**, **lease liabilities**, and **provisions for employee entitlements**. There is no particular guidance for listing these long-term obligations, and companies simply choose a way of disclosing them which is most useful for the users of their financial statements.

- **Owners' equity** has two components: share capital; and retained profits and reserves. **Share capital** consists of shareholders' investments of assets in the business, while **retained profits** is just that — earnings, or income, retained for use in the business. (Note that if the company has 'retained losses' this account on the statement of financial position will be called **accumulated losses**.) **Reserves** are the result of either transfers from retained profits or from the application of certain accounting standards, such as revaluation of non-current assets.

LO7 Calculate ratios for analysing a company's profitability, liquidity and solvency.

- Financial statements are used to gauge the strength or weakness of a company. To make numbers in the statements more useful and meaningful, users conduct **ratio analysis**, a technique for expressing relationships among selected financial statement data. Ratios can be expressed in three ways: **percentage** (e.g. current assets are 150% of current liabilities); **rate** (e.g. current assets are 1.5 times as great as current liabilities); and **proportion** (e.g. the relationship of current assets to current liabilities is 1.5:1).

- **Profitability ratios** measure the income or operating success of a company for given period of time. Two such ratios are the **return on assets ratio** and the **profit margin ratio**.

- The **return on assets ratio** is an overall measure of profitability, computed by dividing net profit by average total assets. (To compute average total assets, add together the beginning and ending asset values for the period and then divide by 2.) A high ratio is preferable because the ratio indicates the amount of net profit generated by each dollar invested in assets.

- The **profit margin ratio** measures the percentage of each dollar of sales (revenue) that results in net profit and is computed by dividing net profit by net sales (revenue) for the period. High turnover businesses, such as supermarkets, usually have low profit margins, while low turnover businesses have high profit margins.

- **Liquidity** refers to a company's ability to pay obligations expected to come due within the next year or operating cycle.

- One measure of liquidity is **working capital**, which is the difference between current assets and current liabilities. It is certainly preferable to have a positive number (current assets exceed current liabilities) because this indicates that a company has a good likelihood of being able to pay its liabilities. If current assets are $300 and current liabilities are $100, then working capital is $200.

- Another measure of liquidity is the **current ratio**, computed by dividing current assets by current liabilities. Referring to the numbers just above, dividing $300 by $100 yields a current ratio of 3 (or 3:1), meaning that the company has $3 of current assets for every $1 of current liabilities.

- **Solvency** deals with a company's ability to survive over a long period of time, with its ability to pay its long-term obligations and the interest due on them.

- The **debt to total assets ratio** is one source of information about a company's solvency and measures the percentage of assets financed by creditors rather than by shareholders. It is computed by dividing total debt (both current and non-current) by total assets. The higher the percentage of debt financing, the greater the risk that the company may be unable to pay its debts as they mature. If total debt is $3 000 000 and total assets are $5 000 000, then the ratio is 60%, meaning that of every dollar invested in company assets, $0.60 has been provided by creditors. A creditor does not like to see a high debt to total assets ratio for a company.

- The **statement of cash flows** provides financial information about the sources and uses of a company's cash. As shown in chapter 1 there are three sections to the statement: operating activities, investing activities, and financing activities.

- A company's source of cash is very important. There are two sources: operating activities and financing activities. When a company is well-established it should be able to generate most of its cash from operations, not from financing activities (issuing shares or borrowing money).

- The statement of cash flows can be used to calculate measures of liquidity and solvency. The **current cash debt coverage ratio** is a measure of **liquidity** and is computed by dividing cash provided by operating activities by average current liabilities. The **cash debt coverage ratio** is a measure of **solvency** and is computed by dividing cash provided by operating activities by average total liabilities.

- Please note that one ratio by itself doesn't convey very much. The ratio must be compared with something, either with the ratios from prior years of the company, or with the ratios of other companies in the same industry, or with the particular industry's averages.

RATIOS TO KNOW

The **return on assets ratio** is an overall measure of profitability, computed by dividing net profit by average total assets.

The **profit margin ratio** measures the percentage of each dollar of sales (revenue) that results in net profit and is computed by dividing net profit by net sales (revenue) for the period.

Working capital is a measure of liquidity and is the difference between current assets and current liabilities.

The **current ratio** gives an indication of liquidity and is computed by dividing current assets by current liabilities.

The **debt to total assets ratio** measures the percentage of assets financed by creditors rather than by shareholders. It is computed by dividing total debt (both current and non-current) by total assets.

The **current cash debt coverage ratio** is a measure of liquidity and is computed by dividing cash provided by operating activities by average current liabilities.

The **cash debt coverage ratio** is a measure of solvency and is computed by dividing cash provided by operating activities by average total liabilities.

CHAPTER SELF-TEST

DECISION TOOLKIT — A SUMMARY

Decision checkpoints	Info needed for decision	Tool to use for decision	How to evaluate results
Are the business's operations profitable?	Statement of financial performance	The statement of financial performance reports on the success or failure of the business's operations by reporting its revenues and expenses.	If the business's revenues exceed its expenses, it will report net profit; otherwise it will report a net loss.
Does the business rely mainly on debt or shareholders' equity to finance its assets?	Statement of financial position	The statement of financial position reports the business's resources and claims to those resources. There are two types of claims: liabilities and owners' (shareholders') equity.	Compare the amount of debt versus the amount of owners' (shareholders') equity to determine whether the business relies more on creditors or owners for its financing.
Does the business generate sufficient cash from operations to fund its investing activities?	Statement of cash flows	The statement of cash flows shows the amount of cash provided or used by operating activities, investing activities and financing activities.	Compare the amount of cash provided by operating activities with the amount of cash used by investing activities. Any deficiency in cash from operating activities must be made up with cash from financing activities.
Is the company using its assets effectively?	Net profit and average assets	$\text{Return on assets ratio} = \dfrac{\text{Net profit}}{\text{Average total assets}}$	Higher value suggests favourable efficiency (use of assets).
Is the company maintaining an adequate margin between sales and expenses?	Net profit and net sales	$\text{Profit margin ratio} = \dfrac{\text{Net profit}}{\text{Net sales}}$	Higher value suggests favourable return on each dollar of sales.
Can the company meet its short-term obligations?	Current assets and current liabilities	$\text{Current ratio} = \dfrac{\text{Current assets}}{\text{Current liabilities}}$	Higher ratio suggests favourable liquidity.
Can the company meet its short-term obligations?	Current liabilities and cash provided by operating activities	$\text{Current cash debt coverage ratio} = \dfrac{\text{Cash provided by operations}}{\text{Average current liabilities}}$	A higher value indicates liquidity.
Can the company meet its long-term obligations?	Total liabilities and total assets	$\text{Debt to assets ratio} = \dfrac{\text{Total liabilities}}{\text{Total assets}}$	A higher ratio indicates solvency risk because the company has fewer assets available for creditors.
Can the company meet its long-term obligations?	Total liabilities and cash provided by operating activities	$\text{Cash debt coverage ratio} = \dfrac{\text{Cash provided by operations}}{\text{Average total liabilities}}$	A higher ratio indicates better solvency, that the company is generating cash sufficient to meet its long-term needs.

1. Decision Checkpoints: At this point you ask a question.

2. Info needed for Decision: You make a choice regarding the information needed to answer the question.

3. Tool to Use for Decision: At this point you review just what the information chosen in step 2 does for the decision-making process.

4. How to Evaluate Results: You perform evaluation of information for answering the question.

Note: The notation (LO1) means that the question was drawn from learning objective number one.

Completion activity

Please write in the word or words which will complete the sentence.

1. (LO1) A _______________ is a separate legal entity owned by shareholders.

2. (LO3) An example of a(n) _______________ activity is a company's sale of shares to investors.

3. (LO5) The purpose of the _______________ is to report the success or failure of the company's operations during the period.

4. (LO5) Claims of creditors on the assets of the business are called _______________, and claims of owners are called _______________.

5. (LO5) If liabilities total $6000 and owners' equity totals $10 000, then assets must total _______________.

6. (LO4) The _______________ assumption requires that only those things that can be expressed in money are included in the accounting records.

7. (LO4) An asset was purchased for $5000 and is now worth $7000. The _______________ dictates that the asset continue to be recorded on the books at $5000.

8. (LO6) Obligations to be paid within the next year or operating cycle, whichever is longer are called _______________.

9. (LO4) _______________ are resources expected to be realised in cash or sold or consumed within one year or one operating cycle, whichever is longer.

10. (LO4) Assets that do not have physical substance are called _______________ assets.

Multiple choice

Please circle the correct answer.

1. (LO1) Which of the following statements is correct?
   a. A sole proprietor has no personal liability for debts of his business.
   b. There are far more corporations than there are sole proprietorships and partnerships.
   c. Revenue produced by corporations is much greater than that produced by proprietorships and partnerships.
   d. It is very difficult for a corporation to raise capital.

2. (LO3) Which of the following is an investing activity?
   a. Borrowing money from a bank
   b. Earning revenue from the sale of products
   c. Payment of employees' salaries
   d. Purchase of a delivery truck

3. (LO3) A business's earning of revenue is considered to be a(n):
   a. operating activity.
   b. investing activity.
   c. financing activity.
   d. statement of financial position activity.

4. (LO3) Borrowing money from a bank or purchasing goods on credit is considered to be a(n):
   a. operating activity.
   b. investing activity.
   c. financing activity.
   d. statement of financial position activity.

5. (LO5) Which of the following is an appropriate date for a statement of financial position?
   a. As at 31 December 2003
   b. For the month ending 31 December 2003
   c. For the quarter ending 31 December 2003
   d. For the year ending 31 December 2003

6. (LO5) Which of the following is the correct expression of the basic accounting equation?
   a. Liabilities = Assets + Owners' equity
   b. Owners' equity = Assets + Liabilities
   c. Assets = Liabilities + Owners' equity
   d. Assets = Liabilities - Owners' equity

7. (LO5) Assets total $14 000, owners' equity totals $9000, and revenues total $6000. What is the dollar amount of liabilities?
   a. $23 000
   b. $17 000
   c. $11 000
   d. $5000

8. (LO4) Which of the following assumptions states that every business must be separately identified and accounted for?
   a. Monetary assumption
   b. Accounting entity assumption
   c. Period assumption
   d. Going concern assumption

9. (LO4) Which of the following assumes that a business will remain in operation for the foreseeable future?
   a. Monetary assumption
   b. Accounting entity assumption
   c. Period assumption
   d. Going concern assumption

10. (LO4) The _______________ assumption states that the life of a business can be divided into artificial time periods and that useful reports covering those periods can be prepared for the business.
    a. monetary
    b. going concern
    c. period
    d. accounting entity

11. (LO4) Accounting rules having substantial authoritative support and recognised as a general guide for financial reporting purposes are called:
    a. general accounting principles.
    b. generally accepted auditing principles.
    c. generally accepted accounting standards.
    d. generally accepted accounting principles.

12. (LO4) _______________ results when different companies use the same accounting principles.
    a. Relevance
    b. Consistency
    c. Comparability
    d. Reliability

13. (LO7) Net profit is \$100 000, average assets are \$800 000, and net sales are \$1 000 000. The return on assets ratio is:
    a. 10 times.
    b. 8 times.
    c. 10.0%.
    d. 12.5%.

14. (LO6) Which of the following is considered a current asset on a classified statement of financial position?
    a. Marketable securities
    b. Land
    c. Building
    d. Patent

15. (LO7) 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.

16. (LO7) Current assets are $60 000, total assets are $180 000, current liabilities are $30 000, and total liabilities are $50 000. The current ratio is:
    a. 2 to 1.
    b. 1.2 to 1.
    c. 0.5 to 1.
    d. 0.33 to 1.

17. (LO7) Which ratio measures the percentage of assets financed by creditors rather than by shareholders?
    a. Current ratio
    b. Debt to total assets ratio
    c. Current cash debt coverage ratio
    d. Profit margin ratio

18. (LO5) Which of the following statements provides information about the operating, investing, and financing activities of a company?
    a. Statement of cash flows
    b. Statement of financial position
    c. Statement of financial performance
    d. Statement of owners' equity

19. (LO7) Which of the following is a measure of liquidity calculated as cash provided by operating activities divided by average current liabilities?
    a. Current ratio
    b. Cash debt coverage ratio
    c. Current cash debt coverage ratio
    d. Profit margin ratio

Problems

1. From the appropriate accounts given below, please prepare a statement of financial position for Jerome Corporation on 30 September 2003 (LO6):

Accumulated Depreciation	$ 3 000
Share Capital	15 000
Service Revenue	20 000
Note Payable	5 000
Salaries Expense	10 000
Accounts Receivable	7 000
Dividends	2 000
Unearned Revenue	3 000
Retained Profit	24 000
Supplies	2 000
Insurance Expense	1 500
Prepaid Insurance	3 000
Utilities Expense	4 000
Office Equipment	17 000
Accounts Payable	1 000
Cash	22 000

Jerome Corporation
Statement of Financial Position
as at 30 September 2003

Current assets		
Total current assets		
Non-current assets		
Total non-current assets		
Total assets		
Current liabilities		
Total current liabilities		
Non-current liabilities		
Total non-current liabilities		
Total liabilities		
Net assets		
Equity		
Total equity		

2. Please refer to the Colorado Group Limited consolidated financial statements at the end of this study guide for information for answering the following questions. Don't forget to use the Decision Toolkit approach for help in the problem-solving.

   a. What is the total dollar amount of the company's assets in 2002? What are the asset classes and their dollar amount, again in 2002? (LO6)

   b. Which class of liabilities has the largest total dollar amount in 2002? (LO6)

   c. Was the company profitable in the financial year ended 26 January 2002? What has been the trend in company income over the three years shown? (LO5)

   d. What was the biggest expense in the financial year ended 26 January 2002? (LO5)

   e. What was the company's income tax expense for the financial year ended 26 January 2002? (LO5)

3. Consider the following data from Meadows Corporation:

	2004	2003
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	39 000	28 000

After computing the following, please explain what the results mean:

a. Working capital for 2004 and 2003 (LO7).

b. Current ratio for 2004 and 2003 (LO7).

c. Debt to total assets ratio for 2004 and 2003 (LO7).

d. Return on assets ratio for 2004 (LO7).

e. Profit margin ratio for 2004 and 2003 (LO7).

CHAPTER SELF-TEST SOLUTIONS

Completion

1. company
2. financing
3. statement of financial performance
4. liabilities; owners' equity
5. $16 000
6. monetary
7. historical cost principle
8. current liabilities
9. current assets
10. intangible

Multiple choice

1. c Sole proprietors are liable for debts of their businesses, there are more proprietorships and partnerships than there are companies, and companies easily raise capital through selling of shares.
2. d Borrowing money is a financing activity, and earning revenue and incurring expense are operating activities.
3. a Investing activities deal with the purchase of assets, and financing activities deal with the borrowing of money and selling of shares.
4. c Operating activities deal with the day to day operations of the business, the earning of revenue, i.e. the provision of goods and services and incurring of expenses; whilst investing activities deal with the purchase and sale of non-current assets, i.e. the assets the business uses to operate. There are no such things as 'statement of financial position activities'.
5. a The statement of financial position shows balances on a specific date, not for a period of time.
6. c The basic accounting equation is Assets = Liabilities + Owners' Equity. This can be expressed in a number of other ways, e.g. Assets – Liabilities = Owners' Equity, and Assets – Owners' Equity = Liabilities
7. d \$14 000 – \$9000 (Assets – Owners' equity = Liabilities)
8. b The monetary assumption requires that only those things which can be expressed in money are included in the accounting records; the period assumption states that the life of a business can be divided into artificial time periods; and the going concern assumption assumes that a business will remain in operation for the foreseeable future.
9. d The monetary assumption requires that only those things which can be expressed in money are included in the accounting records; The accounting entity assumption requires that each economic entity is separately identified and accounted for; and the period assumption states that the life of a business can be divided into artificial time periods.
10. c The monetary assumption requires that only those things which can be expressed in money are included in the accounting records; the accounting entity assumption requires that each economic entity is separately identified and accounted for; and the going concern assumption assumes that a business will remain in operation for the foreseeable future.
11. d These are known as generally accepted accounting principles as they have general widespread acceptance within the accounting profession.
12. c Accounting information is relevant if it makes a difference in a business decision, consistency is when the company uses the same accounting principles and methods from year to year; and reliability is when accounting information can be depended upon, i.e. it is free from error, neutral and is a faithful representation of what it purports to be.
13. d \$100 000 ÷ \$800 000
14. a Land, Building, and Patent are all non-current assets.

15. d Working capital is the difference between current assets and current liabilities, profitability refers to the operating success of an enterprise during a period, and solvency is the ability of a company to pay interest as it comes due and to repay the face value of the debt at maturity.

16. a $60 000 ÷ $30 000

17. b The current ratio measures the ability of a company to pay its short-term obligations, the current cash debt coverage ratio measures liquidity on a cash basis, and the profit margin ratio measures the percentage of each dollar of sales that results in net income.

18. a The statement of financial position reports assets, liabilities, and owners' equity items; the statement of financial performance reports revenues and expenses; and the statement of owners' equity is part of the statement of financial position and reports changes in all owners' equity accounts.

19. c The cash debt coverage ratio is a measure of solvency calculated as cash provided by operating activities divided by average <u>total</u> liabilities.

Problems

1.

Jerome Corporation
Statement of Financial Position
as at 30 September 2003

Current assets		
Cash		$22 000
Accounts receivable		7 000
Supplies		2 000
Prepaid insurance		3 000
Total current assets		$34 000
Non-current assets		
Office equipment	$17 000	
Less: Accumulated depreciation	3 000	14 000
Total assets		$48 000
Liabilities and Owners' equity		
Current Liabilities		
Note payable		$5 000
Accounts payable		1 000
Unearned revenue		3 000
Total liabilities		$9 000
Owners' equity		
Share capital		$15 000
Retained earnings		24 000
Total owners' equity		39 000
Total liabilities and owners' equity		$48 000

2. All numbers are presented in thousands ($'000).

   a. Total assets $134 564

      The asset classes:
      Current assets $81 962
      Non-current assets $52 602

   b. Payables: $18 239

   c. To determine whether a company is profitable, you must look at the statement of financial performance. Colorado certainly was profitable in the financial year ended 26 January 2002: Net Profit after income tax was $17 146.

      The trend in the Colorado Annual Report shows profit increasing over the past three years from $11 526 in 2000, to $14 474 in 2001 and $17 146 in 2002. This is an increase of 25.6% from 2000 to 2001, and an increase of 18.5% from 2001 to 2002.

   d. Cost of goods sold: $198 067

   e. Income tax expense relating to ordinary activities: $7571

3. a. Current assets - current liabilities = working capital

      2004: $61 000 – $47 000 = $14 000
      2003: $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 liabilities when they fall due.

   b. Current assets ÷ current liabilities = current ratio

      2004: $61 000 ÷ $47 000 = 1.30
      2003: $50 000 ÷ $39 000 = 1.28

      The current ratio is another measure of liquidity. In 2004 the company had $1.30 of current assets for every dollar of current liabilities. In 2003 it had $1.28 of current assets for every dollar of current liabilities.

   c. Total debt ÷ total assets = debt to total assets ratio

      2004: $80 000 ÷ $108 000 = 74.1%
      2003: $62 000 ÷ $85 000 = 72.9%

      This ratio measures the percentage of assets financed by creditors rather than by shareholders. In 2004, $0.74 of every dollar invested in assets was provided by creditors. In 2003 $0.73 of every dollar was provided by creditors. The higher the percentage of debt financing, the riskier the company.

d. Net income ÷ average assets = return on assets ratio

2004: $39 000 ÷ ($108 000 + $85 000)/2 = 40.4%

This ratio is a measure of profitability. It indicates the amount of net profit generated by each dollar invested in assets. For every dollar invested in assets, this company generated approximately $0.40 of net profit. The higher the return on assets, the more profitable the company.

e. Net income ÷ net sales = profit margin ratio

2004: $39 000 ÷ $200 000 = 19.5%
2003: $28 000 ÷ $180 000 = 15.5%

This ratio measures the percentage of each dollar of sales that results in net profit. In 2004 each dollar of sales generated $0.195 of net income; in 2003 each dollar of sales generated $0.155 of net income.