Chapter 2
Accounting and Financial Statements

REVIEW QUESTIONS

1. What are financial statements and what do they include?

   These are financial reports and include the dual statement of income and statement of comprehensive income, the statement of changes in equity, the statement of financial position and the statement of cash flows. These financial statements are included in a company's annual report. The *statement of income* presents a company's revenue and expenses. The *statement of comprehensive income* shows items of income and expense that are not recognized in the statement of income. The *statement of changes in equity* represents the interest of shareholders of a business which shows the cumulative net results in equity with respect to share capital, contributed surplus, retained earnings, and accumulated other comprehensive income/(loss). The *statement of financial position* presents a company's assets, equity and liabilities. The *statement of cash flows* shows the cash flow of a business in terms of its sources (operating activities and financing activities) and uses (investing activities).

2. What activities are involved in bookkeeping?

   Bookkeeping involves activities related to collecting, classifying, and recording information that arises from the transactions that take place in a business. They are first recorded in journals and then in ledgers. This information is than used to prepare the trial balance.

3. Explain the accounting equation.

   The accounting equation describes the relationship between the assets, equity and liabilities: Assets = Equity + Liabilities. The equation must always be in balance.

4. What are journals and ledgers?

   A *journal* is the book in which business transactions are first recorded, in chronological order. *Ledgers* are the books of final entry in which transactions recorded in journals are transferred to individual ledger accounts.

5. What is the purpose of a trial balance?

   The trial balance is prepared in order to be sure that the total of debit balances in the accounts equals the total of credit balances before financial statements are prepared.

6. Explain the different sections of the statement of income.

   The statement of income includes two sections: operating and the non-operating. There are two profit levels included in the operating section: (1) *gross profit* which is the difference between revenue and the cost sales, and (2) *profit before taxes* which is the difference between gross profit, other income, distribution costs, administrative expenses and finance costs. The non-operating section shows the (3) *profit for the year,* which is the result when income tax expense is subtracted from profit before taxes.

7. What does the statement of changes in equity show?

   The statement of changes in equity shows the beginning of the year and end of the year balances for four equity accounts: share capital, contributed surplus, retained earnings, and other comprehensive income/(loss). In the retained earnings section of the statement, for example, it shows (1) the amount of profit retained in a business since it was started, (2) the profit earned and dividends paid during a current operating year, and (3) ends with the amount of earnings remaining in the business at the end of the fiscal period.

8. What is the connection between the retained earnings amount shown in the statement of changes in equity and the statement of financial position?

   The link between these two statements is *retained earnings*. The retained earnings amount shown in the statement of changes in equity indicates the amount of profit that was earned by a business during an operating period. This number is drawn from the statement of income. If a business pays dividends during the current operating period, it will be deducted from the company's profit for the year, which represents the amount retained in the business during the current operating year. This amount is than added to the company's beginning retained earnings which gives the ending retained earnings; this amount is subsequently brought forward to the statement of financial position under the heading "equity".

9. Is there a difference between the book value of accounts shown on the statement of financial position and market value? Explain.

   Answers should recognize that depreciation is a method of spreading the cost of an asset over the periods during which it will be used to generate revenue; therefore, the book value of an asset (original cost minus accumulated depreciation) does not necessarily reflect what an asset can be sold for at any particular time.

10. What is the basic structure of the statement of financial position?

    The basic structure of the statement of financial position is assets on the left side, equity and liabilities on the right side.

11. Differentiate between non-current assets and current assets.

    Non-current assets are not so liquid and are used by the business over an extended period of time while *current assets* are relatively liquid or can be converted into cash quickly.

12. What are the four sections included in the statement of cash flows?

    The sections of a statement of cash flows are: (1) operating activities, (2) financing activities, (3) investing activities, and (4) cash balance.

13. What is the purpose of the auditor’s report?

    An auditor's report gives the auditors' opinion on the financial statements, verifies that the financial statements are prepared in accordance with generally accepted accounting principles, and describes the scope of the audit.

14. Why do you think auditors write in a company’s annual report the following statement: “These consolidated financial statements are the responsibility of the company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits”?

    Answers should reflect the point that an auditor's statement is "qualified," that is, it assigns ultimate responsibility for the financial statements to the company's management, while stating that as far as possible, they have been checked by the auditing team and found to be appropriate. It places the ultimate responsibility for the accuracy of the statements to the management team. Within this context, it might be interesting to raise the Enron and WorldCom accounting and reporting fiasco.

15. Differentiate between cash accounting and accrual accounting.

    The *cash method* records transactions when cash is received from sales and paid for expenses, but the *accrual method* records revenue when goods are sold or services rendered, regardless of when the cash is actually received and records expenses when they are incurred, regardless of when cash is actually paid for them.

16. What are future income taxes payable?

    Future income taxes payable are a tax liability postponed to the future due to differences in methods of calculating depreciation and capital cost allowance.

17. What is the difference between depreciation and capital cost allowance?

    Depreciation is an accounting entry allocating the cost of a non-current asset (property, plant and equipment) against revenue over an asset’s life and an estimated decrease in the value of non-current assets due to wear and tear and/or obsolescence. This amount appears on the statement of income as a non-cash expense. *Capital cost allowance* is a tax-deductible expense that Canadian laws allow a business to claim for the loss in value of non-current assets due to wear and tear and/or obsolescence. The CCA amount does not appear anywhere on a company’s financial statements but used by accountants to determine the amount of taxes to be paid.

18. What is a not-for-profit organization?

    Not-for-profit organizations are entities, normally without transferable ownership interests, organized and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purpose. A not-for-profit organization's members, contributors and other resource providers do not, in such capacity, receive any financial return directly from the organization.

19. Name the financial statements prepared by not-for-profit organizations?

    The financial statements are (1) the statement of financial position, (2) the statement of operations, (3) the statement of changes in net assets, and (4) the statement of cash flows.

LEARNING EXERCISES

The Bead Shop

Exercise 1

Question 1: Journal entries

		Debits	Credits
1.	Cash	$100,000	
	Equity		$100,000
2.	Equipment	$ 50,000	
	Bank loan		$ 50,000
3.	Inventories	$ 60,000	
	Cash		$ 30,000
	Trade and other payables		30,000
4.	Advertising	$ 5,000	
	Cash		$ 5,000
5.	Trade receivables	$ 20,000	
	Revenue		$ 20,000
6.	Salaries	$ 15,000	
	Cash		$ 15,000
7.	Bank loan	$ 10,000	
	Cash		$ 10,000

8. Trade and other payables	$ 5,000	
Cash		$ 5,000
9. Trade and other payables	$ 13,000	
Cash		$ 13,000
10. Salaries	$ 3,000	
Cash		$ 3,000

Question 2: Ledgers

Transaction 1

Cash	
$100,000	

Equity	
	$100,000

Transaction 2

Equipment	
$50,000	

Bank loan	
	$50,000

Transaction 3

Inventories	
$60,000	

Cash	
$100,000	$30,000

Account and tr. payables	
	$30,000

Transaction 4

Advertising	
$5,000	

Cash	
$10,000	$30,000
	5,000

Transaction 5

Trade receivables		Revenue	
$20,000			$20,000

Transaction 6

Salaries		Cash	
$15,000		$100,000	$30,000
			5,000
			15,000

Transaction 7

Bank loan		Cash	
$10,000	$50,000	$100,000	$30,000
			5,000
			15,000
			10,000

Transaction 8

Trade and other payables		Cash	
$5,000	$30,000	$100,000	$30,000
			5,000
			15,000
			10,000
			5,000

Transaction 9

Trade and other payables		Cash	
$ 5,000	$30,000	$100,000	$30,000
13,000			5,000
			15,000
			10,000
			5,000
			13,000

Transaction 10

Salaries	
$15,000	
3,000	

Cash	
$100,000	$30,000
	5,000
	15,000
	10,000
	5,000
	13,000
	3,000

Question 3: Trial balance

The Bead Shop
Trial Balance
In $

Cash	19,000	
Trade receivables	20,000	
Trade and other payables		12,000
Bank loan		40,000
Inventories	60,000	
Equipment	50,000	
Equity		100,000
Revenue		20,000
Advertising	5,000	
Salaries	18,000	
Total	172,000	172,000

Exercise 2

Cougar Inc.'s statement of income for the year ended December 31, 2010 is as follows:

Cougar Inc.
Statement of Income
For the year ended December 31, 2010
In $

Gross revenue		520,000
Sales discounts		(20,000)
Net revenue		500,000
Cost of sales		(300,000)
Gross profit		200,000
Interest income		6,000
Distribution costs		
Sales salaries	(40,000)	
Advertising	(10,000)	
Promotional expenses	(2,000)	
Travel expenses	(3,000)	
Total distribution costs		(55,000)
Administrative expenses		
Office salaries	(30,000)	
Lease	(3,000)	
Depreciation (administration)	(2,000)	
Rental charges	(5,000)	
Total administrative expenses		(40,000)
Finance costs		(3,000)
Total		(92,000)
Profit before taxes		108,000
Income tax expense		(35,000)
Profit for the year		73,000

Exercise 3

The amount of depreciation and capital cost allowance for the non-current assets, buildings, equipment and machinery are as follows:

Buildings

Years	Beginning balance	Depreciation @ 5%	Ending balance	Beginning balance	CCA @ 7%	Ending balance
1	$700,000	$35,000	$665,000	$700,000	$24,500	$675,500
2	665,000	35,000	630,000	675,500	47,285	628,215
3	630,000	35,000	595,000	628,215	43,975	584,240
4	595,000	35,000	560,000	584,240	40,897	543,343
5	560,000	35,000	525,000	543,343	38,034	505,309

Equipment

Years	Beginning balance	Depreciation @ 20%	Ending balance	Beginning balance	CCA @ 25%	Ending balance
1	$350,000	$70,000	$280,000	$350,000	$43,750	$306,250
2	280,000	70,000	210,000	306,250	76,562	229,688
3	210,000	70,000	140,000	229,688	57,422	172,266
4	140,000	70,000	70,000	172,266	43,066	129,200
5	70,000	70,000	----	129,200	32,300	96,900

Machinery

Years	Beginning balance	Depreciation @ 15%	Ending balance	Beginning balance	CCA @ 30%	Ending balance
1	$170,000	$25,500	$144,500	$ 170,000	$25,500	$144,500
2	144,500	25,500	119,000	144,500	43,350	101,150
3	119,000	25,500	93,500	101,150	30,345	70,805
4	93,500	25,500	68,000	70,805	21,241	49,564
5	68,000	25,500	42,500	49,564	14,869	34,695

Exercise 4

Question 1: The company's future income taxes payable during the first five years.

Years	CCA @ 30%	Internal depreciation 15%	Difference between CCA and depreciation	Difference in annual future taxes payable (tax rate 50%)	Difference cumulative future taxes payable
1	$15,000	$15,000	---	---	---
2	25,500	15,000	$10,500	$5,250	$5,250
3	17,850	15,000	2,850	1,425	6,675
4	12,495	15,000	- 2,505	- 1,252	5,423
5	8,746	15,000	- 6,254	- 3,127	2,296

Question 2: Statement of income and profit and loss statement using CCA and depreciation rates for year 2.

	Accountants' Worksheet	Statement of Income	P & L Statement
Revenue	$500,000	$500,000	$500,000
Cost of sales	(300,000)	(300,000)	(300,000)
Gross profit	200,000	200,000	200,000
Operating expenses	(100,000)	(100,000)	(100,000)
CCA/depreciation	(25,500)	(15,000)	(15,000)
Total	(125,500)	(115,000)	(115,000)
Profit before taxes	74,500	85,000	85,000
Taxes - Current (50%)	(37,250)	(37,250)	(42,500)
- Future	(5,250)	(5,250)	
	(42,500)	(42,500)	(42,500)
Profit for the year	$ 32,000	$ 43,500	$ 43,500

Exercise 5

Cougar Inc.'s statement of financial position as at December 31, 2010 is as follows:

Cougar Inc.
Statement of Financial Position
as at December 31, 2010
in $

Assets		
Non-current assets (at cost)	300,000	
Accumulated depreciation	(100,000)	
Non-current assets (net)		200,000
Intangible assets		20,000
Current assets		
Inventories	90,000	
Trade receivables	60,000	
Prepaid expenses	10,000	
Cash and cash equivalents	25,000	
Total current assets		185,000
Total assets		405,000
Equity and liabilities		
Owners' equity		
Share capital	100,000	
Retained earnings	80,000	
Total equity		180,000
Non-current liabilities		
Mortgage	130,000	
Long term borrowings	25,000	
Future income taxes payable	5,000	
Total non-current liabilities		160,000
Current liabilities		
Trade and other payables	40,000	
Short-term borrowing	10,000	
Accrued expenses	10,000	
Current income taxes payable	5,000	
Total current liabilities		65,000
Total liabilities		225,000
Total equity and liabilities		405,000

Exercise 6

Question 1: Company's financial statements

a) Statement of income

Zimmerman Electronics Inc.
Statement of Income
for the year ended December 31, 2010
In $

Gross revenue		650,000
Sales returns		(50,000)
Net revenue		600,000
Cost of sales		(300,000)
Gross profit		300,000
Interest income		15,000
Distribution costs		
Sales salaries	(100,000)	
Advertising	(50,000)	
Total distribution costs		(150,000)
Administrative expenses		
Office salaries	(70,000)	
Lease	(20,000)	
Insurance	(10,000)	
Depreciation	(20,000)	
Total administrative expenses		(120,000)
Finance costs		(10,000)
Total		(265,000)
Profit before taxes		35,000
Income tax expense		(10,000)
Profit for the year		25,000

b) Retained Earnings (statement of changes in equity)

Zimmerman Electronics Inc
Statement of Changes in Equity
as at December 31, 2010
In $

Retained earnings: December 31, 2009		40,000
Profit for the year	25,000	
Dividends	(10,000)	15,000
Retained earnings: December 31, 20010		55,000

c) Statement of Financial Position

Zimmerman Electronics Inc
Statement of Financial Position
at December 31, 2010+
In $

Non-current assets		Equity	
Land	25,000	Share capital	15,000
Buildings (net)	100,000	Retained earnings	55,000
		Total equity	70,000
Total non-current assets	125,000		
		Mortgage	80,000
Current assets		Current liabilities	
Inventories	20,000	Trade and other payables	12,000
Trade receivables	15,000	Notes payable	10,000
Prepaid insurance	2,000		
Marketable securities	5,000	Total current liabilities	22,000
Cash and cash equivalents	5,000		
Total current assets	47,000	Total liabilities	102,000
Total assets	172,000	Total equity and liabilities	172,000

Question 2: Company's cash flow for the year

Profit for the year	$25,000
Depreciation	20,000
Cash flow	$45,000

Exercise 7

The italic figures denotes the numbers that need to be plugged in (either by addition or subtraction, or a figure drawn from another financial statement) to complete the financial statements.

a) Statement of Income

Linden International Inc.
Statement of Income
For the year ended December 31, 2010
In $

Revenue		*11,000,000*
Cost of sales		(7,500,000)
Gross profit		3,500,000
Other income		40,000
Distribution costs	(900,000)	
Administrative expenses	(800,000)	*(1,700,000)*
Finance costs		(90,000)
Total		*(1,750,000)*
Profit before taxes		1,750,000
Income tax expense		(600,000)
Profit for the year		*1,150,000*

b) Statement of Comprehensive Income

Linden International Inc.
Statement of Comprehensive Income
For the year ended December 31, 2010
In $

Profit for the year	*1,150,000*
Other comprehensive income/(loss)	
Change in currency translation adjustment	40,000
Change in property revaluation	(35,000)
Total other comprehensive income/(loss) for the year	*5,000*
Total comprehensive income	*1,155,000*

c) Statement of Changes in Equity

Linden International Inc.
Statement of Changes in Equity
For the year ended December 31, 2010
In $

Share capital		
Balance at beginning of year		*2,500,000*
Common shares issued		895,000
Balance at end of year		3,395,000
Contributed surplus		
Balance at beginning of year		60,000
Stock-option compensation		40,000
Balance at end of year		*100,000*
Retained earnings		
Balance at beginning of year		4,000,000
Profit for the year	*1,150,000*	
Dividends paid	150,000	1,000,000
Balance at end of the year		5,000,000
Accumulated Other Comprehensive Income/(Loss)		
Balance at beginning of period		000
Other comprehensive income/(loss)		*5,000*
Balance at end of year		*5,000*
Total equity		*8,500,000*

d) Statement of Financial Position

Linden International Inc.
Statement of Financial Position
For the year ended December 31, 2010
In $

Assets		
Non-current assets	*10,000,000*	
Current assets	6,500,000	
Total assets		16,500,000
Equity and liabilities		
Equity		
Share capital	*3,395,000*	
Contributed surplus	*100,000*	
Retained earnings	*5,000,000*	
Other comprehensive income	*5,000*	
Total equity		*8,500,000*
Liabilities		
Non-current liabilities	5,000,000	
Current liabilities	*3,000,000*	
Total liabilities		8,000,000
Total equity and liabilities		*16,500,000*