CHAPTER 2

Investing and Financing Decisions and the Accounting System

After studying this chapter, you should be able to do the following:

LEARNING OBJECTIVES

LO2-1 Define the objective of financial reporting, the qualitative characteristics of accounting information, and the related key accounting assumptions and principles.

LO2-2 Define the elements of a classified statement of financial position and analyze how the information is relevant to investors and other decision makers.

LO2-3 Identify what constitutes a business transaction and recognize common account titles used in business.

LO2-4 Apply transaction analysis to routine, simple business transactions in terms of the accounting equation: Assets = Liabilities + Shareholders' Equity.

LO2-5 Determine the impact of business transactions on the statement of financial position by using two basic recording tools: journal entries and T-accounts.

LO2-6 Prepare a trial balance and a classified statement of financial position and analyze the company using the current ratio.

LO2-7 Identify investing and financing transactions, and demonstrate how they are reported on the statement of cash flows.

Courtesy of Gildan Activewear Inc.

Focus Company: **Gildan Activewear Inc.**

EXPANSION STRATEGY IN THE APPAREL INDUSTRY

Casual wear continues to be adopted as appropriate in the workplace. Gildan Activewear Inc. (**www.gildan.com**), based in Montreal, Quebec, is a significant producer and marketer of a wide range of apparel from high-performance sportswear and specialty clothing to T-shirts, socks, and intimate apparel. Gildan is a vertically integrated company that produces, spins, and dyes its own yarn to assemble clothing it designs, produces, distributes, and markets to wholesale businesses and consumers through its e-commerce and online platforms.

The success story of Gildan Activewear began in 1946 when Joseph Chamandy started Harley Inc., a manufacturer of basic children's apparel. As is common in new businesses, the founder, or investor, also functioned as the manager of the business. Later in 1982 to 1984, Joseph's grandsons, Glenn and Greg Chamandy, took over the leadership of the Company, launched Gildan Textiles, and invested in new manufacturing equipment to grow the company's operations. The company became a corporation on May 8, 1984 and its shares are publicly traded on stock exchanges in both Canada and the United States.

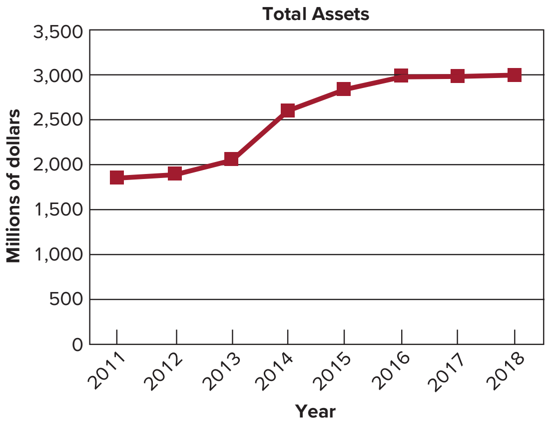
Gildan's competitive strengths include its expertise in building and operating large-scale, vertically integrated, and strategically located manufacturing hubs. It is successful in part because of its ongoing investments in manufacturing, which allow it to operate efficiently to reduce costs and offer competitive pricing, consistent product quality, as well as a reliable supply chain to service replenishment programs with short production/delivery cycle times. Gildan has developed a significant manufacturing infrastructure in two main hubs in Central America (primarily Honduras) and the Caribbean Basin (Dominican Republic). Textiles produced in these two hubs are assembled there as well as in both Nicaragua and Haiti. Activewear is also produced and assembled in Bangladesh.

How did Gildan achieve this growth? It did so through geographic expansion of its manufacturing facilities to meet the growing demand for its products and by acquiring existing apparel manufacturers to complement its own operations. Expanding the company's manufacturing and sales capabilities required the acquisition of productive capacity, which was financed by both shareholders and creditors. The company's growth in recent years is highlighted through the increase in its assets, liabilities, and shareholders' equity from 2011 to 2018, as reported on its statements of financial position. The amounts below and throughout this chapter are in millions of U.S. dollars, except where noted.[1]

	Assets	=	Liabilities	+	Shareholders' Equity
End of 2018	$3,005		$1,069		$1,936
End of 2011	1,859		548		1,311
Change	$1,146		$ 521		$ 625

Year	Total Assets
2011	1,859
2012	1,896
2013	2,044
2014	2,593
2015	2,834
2016	2,990
2017	2,981
2018	3,005

Total Assets



The company's annual growth in total assets since 2011 is plotted on the graph.

UNDERSTANDING THE BUSINESS

Since its formation, Gildan has made significant capital investments in developing its own large-scale, low-cost supply chain, encompassing yarn-spinning facilities, textile and sock manufacturing, and sewing operations. Gildan's manufacturing operations are located in Central America, the Caribbean Basin, North America, and Bangladesh. The everyday family apparel produced in these facilities is sold through strategically located distribution centres that use state-of-the-art technology to best service the company's customers, which include wholesale distributors, screenprinters or embellishers, retailers, and consumers.

The company's financial performance, reported in its audited financial statements, helps users understand how well Gildan has implemented its strategy in the past, and evaluate its growth potential.

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 Gildan'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?

Chapters 2, 3, and 4 build a strong base of knowledge and skills that are important to understanding material in the rest of the chapters. In this chapter, we focus on typical asset acquisition activities (often called *investing activities*) in which Gildan engages, along with the related *financing activities*, such as borrowing funds from creditors and selling shares to investors, to provide the cash necessary to acquire the assets. We examine only those activities that affect amounts reported on the statement of financial position. Operating activities that affect amounts reported on both the statement of earnings and the statement of financial position are covered in Chapters 3 and 4. To begin, let us return to the basic concepts introduced in Chapter 1.

ORGANIZATION OF THE CHAPTER

Overview of Accounting Concepts	What Types of Business Activities Cause Changes in Financial Statement Amounts?	How Do Transactions Affect Accounts?	How Do Companies Keep Track of Account Balances?	How Is the Statement of Financial Position Prepared and Analyzed?
• Concepts Emphasized in Chapter 2 • Elements of the Classified Statement of Financial Position	• Nature of Business Transactions • Accounts	• Principles of Transaction Analysis • Analyzing Gildan's Transactions	• The Direction of Transaction Effects • Analytical Tools • Transaction Analysis Illustrated	• Classified Statement of Financial Position • Ratio Analysis in Decision Making • Some Misconceptions

Supplemental material:
Appendix C: The Formal Recordkeeping System (on *Connect*)

OVERVIEW OF ACCOUNTING CONCEPTS

LO2-1

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

The key accounting terms and concepts we defined in Chapter 1 are part of a theoretical framework developed over many years called the *conceptual framework*. The essential elements and their relationships to one another are embodied in the IASB *Conceptual Framework for Financial Reporting*,[2] which identifies concepts that form the foundation for financial reporting. The framework prescribes the nature, function, and limitations of both financial accounting and financial statements.

This conceptual framework establishes the concepts that underlie the estimates and judgments reported in financial statements. It also provides guidance to accounting standard setters in developing new accounting standards and in revising existing standards. Exhibit 2.1 presents an overview of the key concepts discussed in the next four chapters. An understanding of the accounting concepts will be helpful as you study,

Exhibit 2.1
Conceptual Framework for Financial Reporting

Objective of Financial Reporting to External Users:

To provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

Qualitative Characteristics of Useful Accounting Information:

- Fundamental characteristics: **relevance**, **faithful representation**
- Enhancing characteristics: **comparability (including consistency)**, **verifiability**, **timeliness**, **understandability**

Elements to Be Measured and Reported:

- **Assets**, **liabilities**, **shareholders' equity**, **investments by owners**, **distribution to owners**
- Revenues, expenses, gains and losses
- Comprehensive income

Concepts for Measuring and Reporting Information:

- **Assumptions:** **separate entity**, **stable monetary unit**, **continuity (going concern)**, periodicity
- **Principles:** **mixed-attribute measurement (including historical cost)**, revenue recognition, full disclosure
- **Constraints:** **cost**

Concepts in red are discussed in Chapters 1 and 2. Those not in red type will be discussed in future chapters.

because learning and remembering *how* the accounting process works is much easier if you know *why* it works a certain way. A clear understanding of these concepts will also help you in future chapters as we examine more complex business activities.

Concepts Emphasized in Chapter 2

Objective of Financial Reporting

PRIMARY OBJECTIVE OF EXTERNAL FINANCIAL REPORTING The goal of providing financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

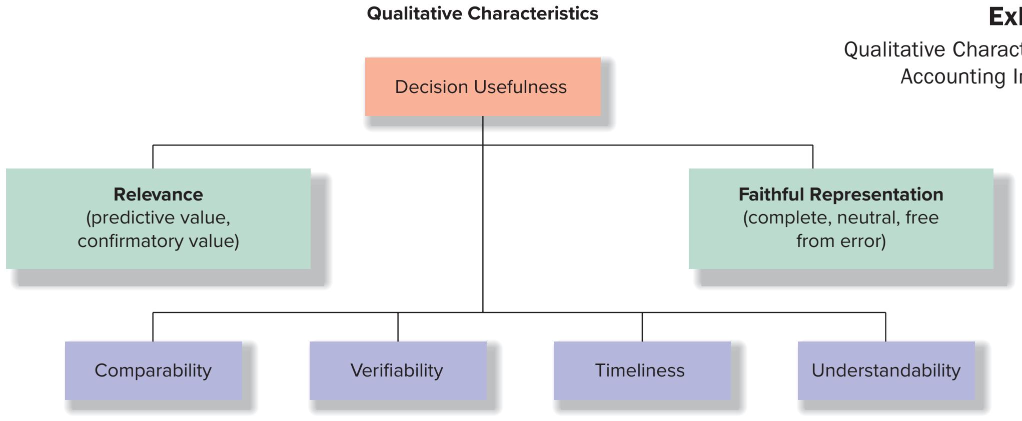
The **primary objective of external financial reporting** is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. To achieve this objective, financial reports must enable *decision makers* not only to assess the amounts, timing, and uncertainty of future cash inflows and outflows but also to understand the financial value of both the assets owned and claims against those assets (liabilities and equity). These decision makers include average investors, creditors, and experts who provide financial advice. All decision makers are expected to have a reasonable understanding of accounting concepts and procedures (this may be one of the reasons you are studying accounting). Of course, as we discussed in Chapter 1, many other groups, such as suppliers and customers, also use financial statements.

Most users are interested in information to assist them in projecting the future cash inflows and outflows of a business. For example, creditors and potential creditors need to assess an entity's ability to pay interest on a loan over time and repay the initial amount borrowed, called the *principal.* Investors and potential investors want to assess the entity's ability to pay dividends in the future. They also want to evaluate how successful the company might be in the future, so that as the share price rises, investors can then sell their shares for more than they paid.

Qualitative Characteristics of Useful Accounting Information

To fulfill the primary objective of providing useful information, the conceptual framework provides guidance on the essential characteristics that determine the usefulness of accounting information. There are two fundamental qualitative characteristics—relevance and faithful representation—supported by four enhancing qualitative characteristics: comparability, verifiability, timeliness, and understandability. Accounting information that embodies the best balance of these characteristics will be of high quality to external decision makers. These six characteristics are presented in Exhibit 2.2 and discussed below, along with an important constraint on accounting measurement.

Exhibit 2.2
Qualitative Characteristics of Accounting Information



Relevance

Information disclosed in financial statements is **relevant information** if it can influence users' decisions by helping them assess the economic effect of past activities and/or predict future events. For example, the various elements of a statement of earnings have predictive value if they help users predict future levels of net earnings or its subcomponents, such as earnings from operations. The *predictive value* of the statement of earnings is enhanced if non-recurring items are presented separately on a multiple-step statement of earnings, because these items are transient in nature. Similarly, information presented on the statement of earnings has *confirmatory value* if it confirms or changes prior expectations based on previous evaluations. Comparison of predicted results with actual results is helpful in improving the quality of the prediction process.

RELEVANT INFORMATION Information that can influence a decision; it has predictive and/or confirmatory value.

Faithful Representation

To be useful for decision making, information provided in financial statements must be a **faithful representation** of the economic phenomena it is supposed to represent, thus reflecting the substance of the underlying transactions. The information must be complete, neutral, and free from error. For example, deferred revenue that is recognized prematurely as revenue for the period overstates the amount of revenue reported on the statement of earnings, causing a lack of faithful representation of current-period revenues.

FAITHFUL REPRESENTATION A characteristic of information provided in financial statements such that it reflects the substance of the underlying transactions.

The usefulness of accounting information is enhanced when it is neutral—that is, free from bias in its measurement and presentation. Bias in measurement occurs when the item being measured is consistently understated or overstated. For example, a consistent understatement of administrative expenses leads to a biased higher amount of net earnings. In this context, the development of accounting standards for measurement and reporting of transaction effects should not result in favouring one group of users over others. The measurement and reporting of liabilities, for example, should not result in consistent understatement of liabilities on the statement of financial position, because this would favour owners over creditors and may influence investment and credit decisions of financial statement users.

Neutrality of information is supported by the exercise of **prudence**, which requires that special care be taken to avoid (1) overstating assets and revenues and (2) understating liabilities and expenses. Users of financial statements often want to know about possible sources of trouble for the company. For example, creditors need to know how secure their investments will be if the company's fortunes deteriorate, but they may not be interested in whether the company might do exceptionally well. They care more about the downside risk than the upside potential. For this reason, financial

PRUDENCE Taking care not to overstate assets and revenues or understate liabilities and expenses.

statements that show assets at historical cost but reduce these amounts when current values are significantly lower help satisfy the needs of creditors. This lower-of-cost-and-market guideline attempts to offset managers' natural optimism about their business operations, which sometimes creeps into the financial reports that they prepare. More companies have perished through excessive optimism than through excessive caution. Prudence may be viewed as a constraint rather than a desirable quality of accounting information, because the prudent reporting of accounting information contradicts the concept of neutrality and is likely to result in bias in the values reported on financial statements.

Information that faithfully represents the underlying transactions must reflect the economic substance of the transactions and how they affect the economic condition of the company rather than their legal form. For example, when a company leases equipment, the monthly or annual payment represents an expense that is reported on the statement of earnings. However, the specific provisions of the lease contract may indicate that it is essentially a purchase of an asset, which is financed by the lessor. Regardless of the legal form of the lease contract, if the underlying substance of the transaction reflects a purchase transaction, then accountants must classify the transaction as a purchase and account for the equipment as an asset and the future lease payments as a liability.

Comparability

COMPARABILITY A characteristic of accounting information across businesses that results when similar accounting methods have been applied.

Comparability of accounting information across businesses is enhanced when similar accounting methods have been applied. It enables users to identify similarities and discrepancies between two sets of financial reports produced by two different companies. This quality is also important when comparing information provided by the same company over time. The comparability of financial reports is enhanced if consistent information is made available by using the same accounting methods over time as well. Changes in accounting methods reduce the comparability of information and necessitate disclosure of the effects of the change in order to maintain comparability.

Verifiability

VERIFIABLE A characteristic of information such that independent accountants can agree on the nature and amount of a transaction.

Information presented in financial statements is **verifiable** if independent accountants can agree on the nature and amount of the transaction. For example, the historical cost of a piece of land that is reported on a company's statement of financial position at year-end is usually highly verifiable. The cost of acquisition is based on the purchase price and related costs that result from actual exchanges with external parties. However, the appraised market value of the land at that date is a subjective estimate that reflects the appraiser's past experience. It is not verifiable because it is not based on an actual exchange transaction. However, if a company is considering the sale of land, its market value would be relevant for that decision even though it is less verifiable than the land's historical cost.[3]

Timeliness

TIMELY A characteristic of information such that it enhances both its predictive and its confirmatory value.

Information that is not available to users in a timely manner loses its relevance because it will not be considered in making decisions. **Timely** information enhances both its predictive and confirmatory values. The relevance of accounting information for decision making declines as time passes. For this reason, companies produce quarterly reports and issue press releases to convey information in a timely way to investors, creditors, and other user groups.

Understandability

UNDERSTANDABILITY The quality of information that enables users to comprehend its meaning.

Information cannot be useful if it is not properly understood. **Understandability** is the quality of information that enables users to comprehend its meaning. It is assumed that users of accounting information have a reasonable knowledge of business and economic activities as these are reflected in financial reports. It is also assumed that users are willing to study the information with reasonable diligence.[4] In this context, the classification and presentation of information within the financial statements and related notes enhance its understandability.

Constraint of Accounting Measurement

Accurate interpretation of financial statements requires that the statements' reader be aware of an important constraint of accounting measurement.

Cost

Companies produce and disseminate accounting information to users with the expectation that the benefits to users of such information exceed the cost of producing it. The **cost constraint** suggests that information should be produced only if the perceived benefits of increased decision usefulness exceed the expected costs of providing that information. Such benefits may be difficult to measure, but the costs of producing additional information can be estimated with reasonable accuracy. When standard setters, such as the Accounting Standards Board, require companies to disclose specific information, known as *mandatory* disclosure, they have determined implicitly that the benefits to users exceed the costs the company will incur to produce the information. For example, the regulation introduced by the Canadian Securities Administrators concerning internal control over financial reporting imposed additional costs on companies to evaluate the effectiveness of internal control procedures put in place to discourage corporate fraud by managers and other employees.[5] The perceived benefits of this regulation include increased verifiability and decision usefulness of the accounting information disclosed in financial statements. While the cost of improving internal control procedures can be estimated, the related benefits to users of financial statements may be difficult to measure.

COST CONSTRAINT A control on information production that suggests it should be produced only if the perceived benefits of decision usefulness exceed the expected costs of providing the information.

In other cases, the company's managers may decide that *voluntary* disclosure of information about specific aspects of the company's operations would be beneficial to users. In such cases, the costs of disclosure should not exceed the expected benefits. In this context, the cost constraint plays an important role in determining whether new information should be produced and communicated to users.

In summary, the usefulness of accounting information depends on many players who contribute their share in the process of preparing and disseminating information that is credible. Credibility of the information conveyed in financial reports depends on those who establish accounting standards, those responsible for the preparation of financial reports, and those responsible for ensuring compliance with the accounting standards. The standard-setting process alone, no matter how meticulous, cannot establish and sustain trust. Compliance in practice; appropriate audit procedures; and professional codes of conduct, oversight, and public disciplinary procedures all work together to enhance the credibility of those who are legally responsible for the periodic production and communication of accounting information to a variety of users.

Recognition and Measurement Concepts

Before we discuss accountants' definitions for elements of the statement of financial position, we should consider three assumptions and a measurement concept that underlie much of our application of these definitions. The **separate-entity assumption** states that the activities of each business must be accounted for separately from the activities of its owners, all other persons, and other entities. Separation of the owners' resources (and obligations) from those of the business entity is necessary for a proper evaluation of the entity's results of operations and its financial position. For example, a building purchased by the owner of a real estate development and management company for personal use should not be mixed with buildings owned by the company. Under the **stable monetary unit assumption**, accounting information should be measured and reported in the national monetary unit (Canadian dollars in Canada, euros in countries that use it, pesos in Mexico, etc.), without any adjustment for changes in purchasing power (e.g., inflation) even if the entity has business operations in many countries.

SEPARATE-ENTITY ASSUMPTION The idea that the activities of a business must be accounted for separately from the activities of its owners.

STABLE MONETARY UNIT ASSUMPTION The idea that accounting information should be measured and reported in the national monetary unit without any adjustment for changes in purchasing power.

The use of a specific unit of measure allows for meaningful aggregation of financial amounts. Furthermore, accountants assume that the unit of measure has a stable value over time, even though the price we pay to purchase a specific item, such as a chocolate bar, tends to increase over time. Gildan's statement of financial position includes many assets purchased in different years and measured in U.S. dollars. The stable monetary unit assumption allows accountants to combine dollar amounts from various years, even though the purchasing power of the monetary unit has changed over time.

For accounting purposes, a business is normally assumed to continue operating long enough to carry out its objectives and to meet contractual commitments. The **continuity (going-concern) assumption** states that businesses are assumed to continue to operate into the foreseeable future. Violation of this assumption means that assets and liabilities should be valued and reported on the statement of financial position as if the company were to be liquidated (i.e., discontinued, with all assets sold and all debts paid). In all future chapters, unless indicated otherwise, we assume that businesses meet the continuity assumption.

CONTINUITY (GOING-CONCERN) ASSUMPTION The idea that businesses are assumed to continue to operate into the foreseeable future.

Finally, accountants measure the elements of the statement of financial position using what is called a **mixed-attribute measurement model**. Most elements of the statement of financial position are recorded at their cash-equivalent value on the date of the transaction. This is called the **historical cost principle or cost principle**. For example, assets are initially recorded at the cash paid plus the monetary value of all non-cash considerations (any assets, privileges, or rights) given on the exchange date. We will discuss the conditions under which these values are adjusted to other amounts, such as their fair value,[6] starting in Chapter 6 of this text. With these assumptions in mind, we are now ready to discuss accountants' precise definitions of the elements of the statement of financial position.

MIXED-ATTRIBUTE MEASUREMENT MODEL A model applied to measuring different assets and liabilities.

HISTORICAL COST PRINCIPLE OR COST PRINCIPLE The principle that requires assets to be recorded at their cash-equivalent value on the date of the transaction, and such value to be reported on the statement of financial position at subsequent dates.

One advantage of this approach is that many assets are acquired according to legal contracts that clearly state the acquisition cost. For example, Gildan owns property that it acquired several years ago and reports it on the statement of financial position at historical cost. Although the market price or economic value of the property has risen over time, its recorded value remains unchanged at its original cost because this amount is a verifiable measure based on an actual exchange that occurred in the past. It would be desirable to show on the statement of financial position the property's fair value—that is, the price at which it could be sold instead of its outdated historical cost. However, Gildan did not acquire the property in order to resell it but rather to use it as sites for manufacturing facilities or distribution centres that would generate revenue. Moreover, the property's fair value may not be reliable if different real estate appraisers produce different values for the same property. Accountants continue, therefore, to rely on historical cost measures for reporting purposes because they are factual, although they may not be useful for specific decision-making purposes. Furthermore, as long as Gildan remains a going concern it is unlikely to sell property at its fair value. Property retains usefulness, often referred to as the asset's *value-in-use*, to Gildan. If Gildan has no intent to sell property, then its fair value is not specifically relevant to understanding the financial health of the company. We will discuss the use of alternative measurement bases for asset valuation and the conditions under which historical cost measures are adjusted to other amounts, such as their fair value, starting in Chapter 6 of this text.

Assets, liabilities, and equity are the key elements of a corporation's statement of financial position, as we learned in Chapter 1. Let us examine the definitions in more detail.

LO2-2

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

Elements of the Classified Statement of Financial Position

Assets are economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained. These are the resources that the entity has and can use in its future operations. When Gildan purchases an asset, it acquires the right for future benefits to be derived from that asset, as well as any future risks and obligations arising from control of the asset. External users of Gildan's financial statements care about its assets because they embody future financial benefits. For lenders, Gildan's assets and their productivity are the basis upon which they can generate forecasts about how readily the company

ASSETS Economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained.

can repay its financial obligations. For Gildan's shareholders, the increase in the value of their investment will depend in large part on the future benefits arising from assets under the company's control.

To make financial statements more useful to investors, creditors, and analysts, specific *classifications* of information are included on the statements. Various classifications are used in practice, and you should not be confused when you notice slightly different formats used by different companies.

Let us explore Gildan's simplified statement of financial position, presented in Exhibit 2.3. First, notice the title of the statement: Consolidated Statement of Financial Position. *Consolidated* means that the elements of Gildan's statement of financial position are combined with those of other companies under its control (e.g., American Apparel).[7] For convenience, the amounts for the various elements of the statement of financial position are shown in millions of U.S. dollars. Two amounts are shown for each element: one at December 30, 2018, and the other at December 31, 2017, one year earlier. This system allows investors to compare, at a glance, the value of each element from year to year, and then analyze these changes to understand whether the company's financial position has improved or deteriorated over time.

Gildan's statement of financial position is shown in *column*, or *report*, format, with assets listed first, followed by liabilities, and then shareholders' equity. Other companies may choose an account format with the assets listed on the left-hand side and liabilities and shareholders' equity listed on the right. Both formats are standard ways of communicating the same information. We now explain the various elements that appear on Gildan's statement of financial position.

Exhibit 2.3 presents Gildan's statement of financial position, with amounts rounded to the nearest million dollars. Notice that Gildan's 2018 fiscal year ends on December 30. The choice of year-ends will be discussed in Chapter 4.

Typically, the assets of a company include the following:

1. Current assets (short term)
   a. Cash
   b. Short-term investments
   c. Accounts receivable
   d. Inventories
   e. Prepaid expenses (i.e., expenses paid in advance of use)
   f. Other current assets
2. Non-current assets (long term)
   a. Property, plant, and equipment (at historical cost less accumulated depreciation)
   b. Financial assets
   c. Goodwill
   d. Intangible assets
   e. Other (miscellaneous) assets

Gildan lists its assets *in order of liquidity*; meaning, how soon an asset is expected by management to be transformed into cash. Notice that several of Gildan's assets are categorized as current assets. **Current assets** are those economic resources that Gildan will typically transform into cash or use within the next year or the operating business cycle of the company, whichever is longer. Under current assets, *cash* appears first because it is the most liquid asset. *Short-term investments* represent the reported values for shares of other companies, certificates of deposit with banks and other financial assets purchased as investments of excess cash.

CURRENT ASSETS Assets that will be used or turned into cash, normally within one year. Inventory is always considered to be a current asset, regardless of the time needed to produce and sell it.

Any *receivable* represents an amount of money owed to Gildan. *Accounts receivable* consist primarily of *trade receivables*, which are amounts owed by customers who purchased products and services on credit. These amounts are normally collected within one year of the statement's date.

Exhibit 2.3

Gildan's Statement of Financial Position

REAL-WORLD EXCERPT

Gildan Activewear Inc.

GILDAN ACTIVEWEAR INC.
Consolidated Statement of Financial Position
(in millions of U.S. dollars)*

	Assets	**December 30, 2018**	**December 31, 2017**
	Current assets		
Amount of cash in the company's bank accounts	Cash	$ 47	$ 53
Amounts owed by customers from prior sales	Accounts receivable	317	243
Products stored but not sold	Inventories	940	946
Rent, advertising, and insurance paid in advance	Prepaid expenses	77	62
A variety of current assets	Other current assets	2	4
	Total current assets	**1,383**	**1,308**
	Non-current assets		
Land, buildings, and equipment	Property, plant, and equipment	991	1,036
Assets that do not have physical substance but have a long life	Intangible assets	394	402
An asset that results from the acquisition of another business	Goodwill	227	226
A variety of assets that are covered in future chapters	Other non-current assets	10	9
	Total non-current assets	**1,622**	**1,673**
	Total assets	**$3,005**	**$2,981**
	Liabilities and shareholders' equity		
	Current liabilities		
Amounts owed to suppliers for prior purchases	Accounts payable†	$ 250	$ 195
Amounts owed to suppliers of services	Accrued liabilities	97	63
	Total current liabilities	**347**	**258**
	Non-current liabilities		
Amounts owed on written debt contracts after one year	Long-term debt	669	630
A variety of non-current liabilities	Other non-current liabilities	53	41
	Total non-current liabilities	**722**	**671**
	Total liabilities	**1,069**	**929**
	Shareholders' equity		
Amounts invested in the business by shareholders	Contributed capital	192	184
Past earnings not distributed to shareholders	Retained earnings	1,740	1,854
Adjustments to assets and liabilities that are explained in future chapters	Other components	4	14
	Total shareholders' equity	**1,936**	**2,052**
	Total liabilities and shareholders' equity	**$3,005**	**$2,981**

*In reality, Gildan reports its financial statements in thousands of U.S. dollars, but we present them in this book in millions for simplicity.

Note: This statement is an adaptation of Gildan's actual statement of financial position. Some of the elements of the actual statement were combined for illustrative purposes.

†Gildan reported total amounts of $347 and $258 at December 30, 2018 and December 31, 2017, respectively, for both accounts payable and accrued liabilities. Each amount is divided in two separate amounts for illustrative purposes.

Source: Gildan Activewear Inc., Annual Report 2018.

Inventories refers to goods that (1) are held for sale to customers in the normal course of business or (2) are used to produce goods or services for sale. Inventory is always considered to be a current asset, no matter how long it takes to produce and sell. Gildan's inventories would include the cost of raw materials and spare parts held for use in the manufacturing process, the cost of already-completed apparel, and the cost of apparel that is still in the production process at year-end. *Prepaid expenses* (e.g., insurance premiums and rent paid in advance for use of equipment) reflect available benefits (e.g., monthly insurance protection, office space) that the company will use within one year. *Other current assets*, when reported, will include a number of assets with smaller balances that are combined.

ANALYSIS OF CHANGES IN INVENTORY AND ACCOUNTS RECEIVABLE

FINANCIAL **ANALYSIS**

Investors analyze the financial statements of a company to decide whether or not to purchase its shares or to lend it money. One important decision factor is how easily a company can access cash to pay both debts to its creditors and dividends to its shareholders. In a normal business cycle, Gildan would purchase raw materials to produce finished apparel for sale. These products, called *inventories*, are stored in distribution centres until they are sold. The faster these products are sold to customers, the faster these assets are transformed into cash. Let us examine the company's ability to access cash, assuming for simplicity that Gildan's inventories consist of products held for sale.

Notice that the balance of accounts receivable increased from $243* at December 31, 2017 to $317 at December 30, 2018, indicating that the amount of sales on credit exceeded the cash collected from customers. In addition, inventory decreased slightly, from $946 at December 31, 2017 to $940 at December 30, 2018, indicating more inventory was sold and converted to cash. An investor would also observe that cash decreased from $53 at December 31, 2017 to $47 at December 30, 2018. Investors would examine the statement of cash flows to get a clearer insight into how events in the past year resulted in the change in cash (see Chapter 5). For the moment, this brief analysis would reassure an investor that the first three elements reported on the statement of financial position are relevant in answering an important question about how easily Gildan can access cash to pay its debts to creditors and dividends to shareholders.

*We assume, for simplicity, that this amount is the result of trade transactions.

Following the current assets section, Gildan reports a number of non-current assets. **Non-current assets** are considered to be long-term, because they will be used or turned into cash over a period longer than the next year. *Property, plant, and equipment* includes all land, buildings, machinery, and equipment, such as tools, furniture, and other fixtures that will be used for the storage of the many products that Gildan sells. Non-current assets are also called *fixed assets* or *capital assets*—they have a physical form you can touch, and, therefore, each asset is *tangible*.

NON-CURRENT ASSETS Assets considered to be long-term, because they will be used or turned into cash over a period longer than the next year.

Gildan's receivables can be classified as either short-term or long-term assets depending on management's intention in holding these financial assets and how soon they will be converted into cash. *Intangible assets* have no physical substance but have a long life. They are usually not acquired for resale but are directly related to the operations of the business. Intangible assets include such items as franchises, patents, brands, trademarks, copyrights, and computer software. Their values arise from the legal rights and privileges of ownership, which are recognized if they are purchased from external parties or as a result of internal development. Gildan's intangibles include, among other things, customer contracts and relationships, trademarks, and computer software, and they are reported at a net value of $394 at December 30, 2018.

Goodwill is an intangible asset that arises when a company purchases another business to control its operating, investing, and financing decisions. Often, the purchase price of a business exceeds the fair value of all of the identifiable assets owned by the business minus all of the identifiable liabilities owed to others. Goodwill reflects assets that are not easily identifiable or measured, such as customer confidence, quality of products, reputation for good service, and financial standing of the acquired business. The amount of $227 that Gildan reported at December 30, 2018 resulted from the acquisition of Comfort Colors, American Apparel, and other companies, over time. Intangible assets and goodwill are discussed in more detail in Chapter 8.

Other non-current assets, when reported, will include a number of assets that are combined because of their relatively small values.

UNRECORDED BUT VALUABLE ASSETS

FINANCIAL **ANALYSIS**

Many very valuable intangible assets, such as trademarks, patents, and copyrights, that are developed inside a company (not purchased), are not reported on the statement of financial position. For example, Tim Hortons does not report any value for its trademark on its statement of financial position. The trademark was not purchased but developed internally over time through research, development, and marketing. These costs were reported in a timely way as expenses on the statement of earnings as they were incurred. Likewise, the Coca-Cola Company does not report any asset for its patented Coke formulas, although it does report about US$6.7 billion in various trademarks that it has purchased.

LIABILITIES Present debts or obligations of the entity to transfer an economic resource as a result of past events.

Liabilities are present debts or obligations of the entity to transfer an economic resource as a result of past events. They represent future outflows of assets (mainly cash) or services to the *creditors* that provided the corporation with the resources needed to conduct its business. When the corporation borrows money, it signs a formal debt contract with creditors who receive not only full payment of the amount owed to them but also interest on the borrowed amount.

Typically, the liabilities of a company include the following:

1. Current liabilities (short term)
   - *a.* Accounts payable
   - *b.* Short-term debt (or borrowings)
   - *c.* Income taxes payable
   - *d.* Accrued liabilities
   - *e.* Provisions
   - *f.* Other current liabilities
2. Non-current liabilities (long term)
   - *a.* Long-term debt (or borrowings)
   - *b.* Provisions
   - *c.* Other liabilities

CURRENT LIABILITIES Short-term obligations that will be settled within the coming year by providing cash, goods, other current assets, or services.

Just as assets are reported in order of liquidity, liabilities are usually listed by order of time to maturity (how soon an obligation must be paid). **Current liabilities** are short-term obligations that will be settled within the coming year by providing cash, goods, other current assets or services. *Short-term debt (or borrowings)* represents short-term loans from banks. Bank loans are common when the company does not have a sufficient amount of cash to pay its creditors. The liability *income taxes payable* is simply an estimate of the amount of taxes a company is expected to pay to taxation authorities. *Provisions* are estimated liabilities that are expected to be paid within one year, but the exact amount and date of payment are not known with certainty.

Normally, the cash from converting current assets is used to pay current liabilities.

ANALYSIS OF CHANGE IN CURRENT LIABILITIES

FINANCIAL **ANALYSIS**

Using Gildan's current assets and current liabilities, we can improve our analysis of the availability of cash to repay debts to creditors and dividends to shareholders.

Gildan's statement of financial position shows that the company owes $89 more in current liabilities at December 30, 2018 than it did at December 31, 2017. As investors, we would tentatively conclude that the company has increased its reliance on suppliers and other creditors to finance its current assets. However, investors must learn far more about the business cycle for the products marketed by Gildan, its main competitors, and the outlook for the industry sector in which Gildan operates before coming to a firm conclusion.

At the beginning of this chapter, we stated that investors are most interested in relevant information that helps them predict future cash inflows and outflows. From this very preliminary analysis, investors can predict that, because Gildan has increased its current liabilities by $89, a larger amount of cash is needed in the year 2019 to repay the outstanding debt to creditors compared to the amount of $258 that was settled during the year 2018.

Non-current liabilities are all of the entity's obligations not classified as current liabilities. They include *long-term debt (or borrowings)* from banks and other lenders and *other liabilities* which are miscellaneous liabilities identified in the notes to financial statements. These various types of non-current liabilities will be covered in future chapters.

NON-CURRENT LIABILITIES All of an entity's obligations not classified as current liabilities.

THE GREENING OF ACCOUNTING STANDARDS: ENVIRONMENTAL LIABILITIES

A QUESTION **OF ACCOUNTABILITY**

For many years, companies faced growing pressure to estimate and disclose environmental liabilities, such as the cleanup of hazardous waste. IFRS require Canadian publicly accountable enterprises to report their best estimate of probable liabilities, including environmental liabilities, in the notes to the financial statements. For example, Suncor Energy Inc., which mines oil from the tar sands of northern Alberta, reported environmental liabilities of $7,239 million in its 2018 financial statements, representing 15.9 percent of its total liabilities at December 31, 2018. It is estimated, however, that a significant percentage of companies under-report or fail to report such liabilities, often because of the way disclosure rules are applied.

A key economic concern for many Canadian companies is how to manage their resources in an economically sustainable way. Gildan, like many Canadian companies, is subject to environmental regulation, and has disclosed the following information in its annual information form for 2018:*

REAL-WORLD EXCERPT
Gildan Activewear Inc.

> **Environmental Compliance**
> Gildan operates within the guidelines and practices set forth in its Corporate Environmental Policy and in its Restricted Substances Code of Practice. The purpose of our Environmental Management System is to reduce our environmental impact and to preserve the external natural resources the Company utilizes. In 2017, we identified two primary areas of focus that are of top importance to our stakeholders and critical to our Company's long-term operational success: operational water and wastewater management, and climate change. Innovative systems such as the biotop, a biological wastewater treatment system, and our biomass steam generation systems are some of the leading sustainable practices we have put in place. The Company monitors, controls and manages other environmental issues through policies which include, but are not limited to, recycling and creation of measures for waste prevention, minimization and recovery and the treatment at all stages of the production cycle including the off-site disposal of any hazardous waste. While we have achieved great results to date, we remain committed to searching for and investing in new technologies in these areas.

Other companies, such as Suncor Energy Inc. and Bombardier Inc., publish detailed reports on environmental sustainability or corporate social responsibility, which include both financial and non-financial performance indicators that measure their progress in meeting sustainable development targets.

*Source: Gildan Activewear Inc., Annual Information Form, 2018.

SHAREHOLDERS' EQUITY (OWNERS' EQUITY) The financing provided by the owners and the operations of the business.

Shareholders' equity (owners' equity) is the financing provided to the corporation by both its owners and the operations of the business. One key difference between shareholders and creditors is that creditors are entitled to settlement of their legal claims on the corporation's assets before the shareholders receive a penny, even if this consumes all of the corporation's assets. Consequently, shareholders have a residual claim on the corporation's assets.

Shareholders *invest* in a company because they expect to receive two types of cash flow: dividends, which are a distribution of the corporation's earnings (a return on shareholders' investment), and gains from selling their investment in the corporation for more than they paid (known as *capital gains*).

Typically, the shareholders' equity of a corporation includes the following:

1. Contributed capital
2. Retained earnings (accumulated earnings that have not been declared as dividends)
3. Other components

CONTRIBUTED CAPITAL Capital that results from shareholders' providing cash (and sometimes other assets) to the business.

Financing provided by shareholders is referred to as **contributed capital**. Shareholders invest in the business by providing cash and sometimes other assets, and receive shares as evidence of ownership. Investors in the company's shares typically include financial institutions (mutual funds, pension funds, etc.), the company's directors and executive officers, other corporate employees, and the general public. Gildan's contributed capital of $192 at December 30, 2018 has resulted from contributions by shareholders at different points in the company's history.

RETAINED EARNINGS The accumulated earnings of a company that have not been distributed to the shareholders as dividends.

Financing provided by operations is referred to as *earned capital* or **retained earnings**. Most companies that operate profitably retain part of their earnings for reinvestment in their business. The other part is distributed as dividends to shareholders. Earnings that are not distributed to shareholders but instead are reinvested in the business by management are called retained earnings. Gildan's retained earnings equalled $1,740 at December 30, 2018, and represent the amount of earnings that have not been distributed to shareholders since the company was incorporated. Gildan's growth over time has been financed by a substantial reinvestment of retained earnings. In addition to contributed capital and retained earnings, shareholders' equity includes other components that are explained in Chapter 11.

PAUSE FOR **FEEDBACK**

We just learned the elements of the statement of financial position (assets, liabilities, and shareholders' equity) and how assets and liabilities are usually classified (current or non-current). Current assets (including inventory) are expected to be used or transformed into cash within the next 12 months, and current liabilities are expected to be paid or settled within the next 12 months with cash, services, or other current assets.

SELF-STUDY QUIZ 2-1

The following is a list of items from a statement of financial position for Tim Hortons Inc. Indicate on the line provided whether each of the following is categorized on the statement of financial position as a current asset (CA), a non-current asset (NCA), a current liability (CL), a non-current liability (NCL), or shareholders' equity (SE).

_____ Accrued liabilities	_____ Long-term debt	_____ Property, plant, and equipment
_____ Inventories	_____ Retained earnings	_____ Notes receivable (due in five years)
_____ Accounts receivable	_____ Accounts payable	_____ Cash

After you have completed your answers, check them with the solutions at the end of the chapter.

Now that we have reviewed several of the basic accounting concepts and terms, we need to understand the economic activities of a business that result in changes in amounts reported in financial statements and the process used in generating the financial statements.

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

LO2-3

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

Nature of Business Transactions

Accounting focuses on specific events that have an economic impact on the entity. Any event that is recorded as a part of the accounting process is called a **transaction**. The first step in translating the results of business events to financial statement amounts is determining which events to include. As the definitions of assets and liabilities indicate, only economic resources and debts *resulting from past transactions* are recorded on the statement of financial position. Transactions include two types of events:

TRANSACTION (1) An exchange between a business and one or more external parties to a business; (2) a measurable internal event, such as adjustments for the use of assets in operations.

1. *External events.* These are *exchanges* of assets, goods, or services by one party for assets, services, or promises to pay (liabilities) by one or more other parties. Examples include the purchase of a machine from a supplier, the sale of merchandise to customers, borrowing of cash from a bank, and investment of cash in the business by the owners. Transactions that affect elements of the statement of financial position are discussed in this chapter, and those that affect elements of the statement of earnings will be covered in Chapter 3.
2. *Internal events.* These include certain events that are not exchanges between the business and other parties but, nevertheless, have a direct and measurable effect on the accounting entity. Examples include using up insurance paid in advance and using buildings and equipment over several years. Accounting for internal events will be discussed in Chapter 4.

Throughout this textbook, the word "transaction" will be used in the broad sense to include both types of events.

Some important events that have an economic impact on the company, however, are *not* reflected in the financial statements. In most cases, signing a contract is not considered to be a transaction because it involves *the exchange only of promises*, not of assets, such as cash, goods, services, or property. For example, assume that Gildan signs an employment contract with a new regional manager. From an accounting perspective, no transaction has occurred because no exchange of assets, goods, or services has been made. Each party to the contract has exchanged promises; the manager agrees to work and Gildan agrees to pay the manager for work rendered. For each day the new manager works, however, the exchange of services for pay results in a transaction that Gildan must record. Because of their importance, long-term employment contracts, leases, and other commitments may need to be disclosed in notes to the financial statements.

How does the accounting staff at Gildan record external and internal events that cause changes in the amounts reported on the company's statement of financial position? The recording of transactions has evolved over time. Advances in computer hardware and software technology have paved the way for efficient recording of transactions and instantaneous preparation of financial statements. However, the basic system of recording transactions has withstood the test of time and has been in use for more than 500 years. The basic tenets of manual and computerized recording systems are discussed in this chapter and elaborated on in Chapters 3 and 4.

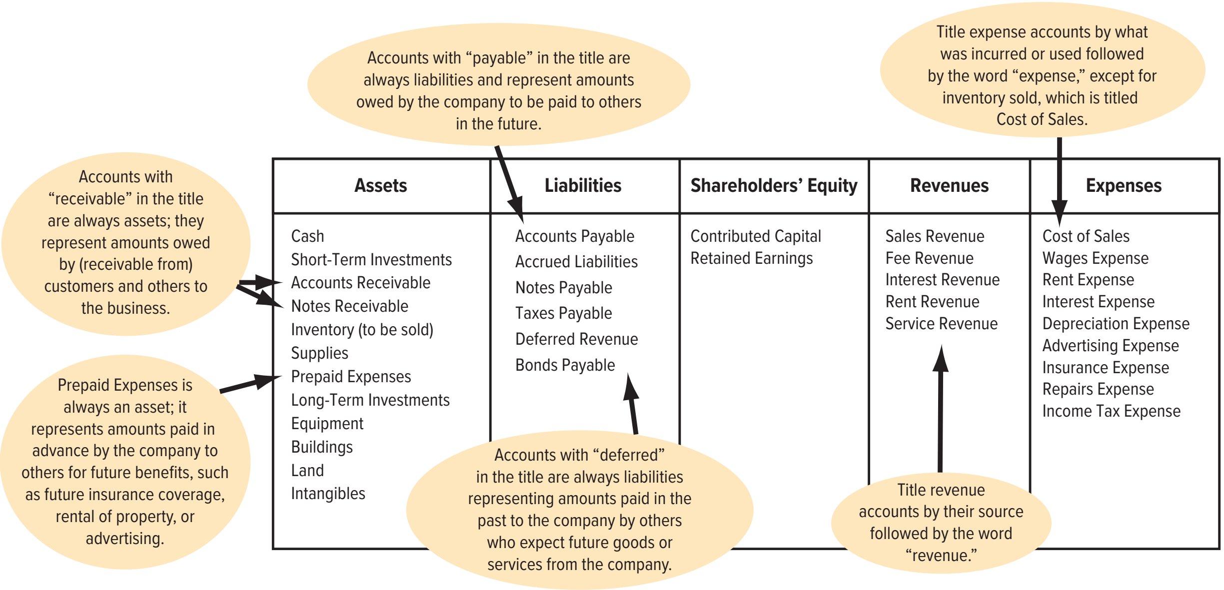
Accounts

ACCOUNT A standardized format that organizations use to accumulate the monetary effects of transactions on each financial statement item.

An **account** is a standardized record that organizations use to accumulate the monetary effects of transactions on each financial statement item. The cumulative result of all transactions that affect a specific account, or its ending balance, is then reported on the appropriate financial statement. To facilitate the recording of transactions, each company establishes a *chart of accounts*—a list of accounts and their unique numeric codes. The chart of accounts is organized by financial statement element, with asset accounts listed first (by order of liquidity), followed by liabilities (by order of time to maturity), shareholders' equity, revenue, and expense accounts, in that order. In formal recordkeeping systems, including computerized accounting systems, use of appropriate account numbers is essential if the monetary effects of similar transactions are to be grouped correctly. Exhibit 2.4 lists account titles that are quite common and used by most companies. This list is helpful when you are completing assignments and are unsure of an account title.

Exhibit 2.4

Typical Account Titles



Every company creates its own chart of accounts to fit the nature of its business activities. For example, a small lawn care service may have an asset account called lawn-mowing equipment, but a large corporation, such as the Royal Bank of Canada, is unlikely to report such an account. These differences will become more apparent as we examine the statements of financial position of various companies. Because every company has a different chart of accounts, you should *not* try to memorize a typical chart of accounts, but you should understand the nature of each typical account. Then when you see a company that uses a slightly different title, you will understand what it means. For example, some companies, like Gildan, use the term "trade accounts receivable" (same as accounts receivable) or "merchandise inventory" (same as inventory). *When you prepare homework problems, you will either be given the company's account names or be expected to select appropriate descriptive names, similar to the ones in Exhibit 2.4.* Once a name is selected for an account, you must use that exact name in all transactions affecting that account.

The accounts you see in the financial statements are actually summations (or aggregations) of a number of specific accounts in a company's recordkeeping system. For example, Gildan keeps separate accounts for the products it sells but combines them as *inventories* on the statement of financial position. Equipment, buildings, and land are also combined into an account called *property, plant, and equipment.* Since our aim is to understand financial statements of actual companies, we focus on aggregated accounts.

HOW DO TRANSACTIONS AFFECT ACCOUNTS?

LO2-4

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

Managers make business decisions that often result in transactions affecting financial statements. For example, the decisions to expand the number of stores, advertise a new product, change an employee benefit package, and invest excess cash would all affect the financial statements. Sometimes, these decisions have unintended consequences as well. For example, the decision by a merchandiser to purchase additional inventory for cash in anticipation of a major sales initiative will increase inventory and decrease cash. But, if there is no demand for the additional inventory, the lower cash balance will also reduce the company's ability to pay its other obligations.

Because business decisions often involve an element of risk or uncertainty, business managers should understand how transactions impact the accounts on the financial statements. The process for determining the effects of transactions is called *transaction analysis.* Accountants have specific standards regarding each step in transaction analysis beginning with accounting recognition of a business transaction, identifying and then correctly classifying the accounts affected, recording the transaction accurately, and reporting the balance in each account on the appropriate financial statement at the end of the accounting period.

Principles of Transaction Analysis

TRANSACTION ANALYSIS The process of studying a transaction to determine its economic effect on the entity in terms of the accounting equation.

Transaction analysis is the process of studying each transaction to determine its economic effect on the entity in terms of the accounting equation: A = L + SE (also known as the *fundamental accounting model*). We outline the transaction analysis process in this section of the chapter, and create a visual tool to represent the process. The basic accounting equation and two fundamental concepts are the foundation for this transaction analysis model. Recall from Chapter 1 that the accounting equation for a corporation shows assets on the left side of the equation with both liabilities and shareholders' equity on the right side. Total assets must always equal the sum of liabilities and shareholders' equity:

Assets (A) = Liabilities (L) + Shareholders' Equity (SE)

The two concepts underlying the transaction analysis process follow:

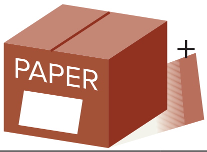
1. Every transaction affects at least two accounts; it is critical to correctly identify and classify these accounts and the direction of the effect (increase or decrease).
2. The accounting equation must remain in balance after each transaction is analyzed, and the affected accounts must be correctly classified.

Success in performing transaction analysis depends on a clear understanding of how the transaction analysis model is constructed, based on these concepts. Study this material well. You should not move on to a new concept until you understand and can apply all prior concepts.

Dual Effects

The idea that every transaction has *at least two effects* on the basic accounting equation is known as the *dual effects* concept.[8] Most transactions with external parties involve an *exchange* by which the business entity both receives something and gives up something in return. For example, suppose that Gildan purchased some office supplies for cash. In this exchange, Gildan would receive supplies (an increase in an asset) and, in return, would give up cash (a decrease in an asset):

Transaction	Gildan Received	Gildan Gave
Purchased paper for cash	Supplies (increased)	Cash (decreased)

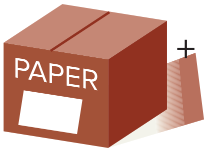


A	=	L	+	SE
+/−				

In analyzing this transaction, we identified and classified the accounts affected, which were office supplies and cash. As we discussed in Chapter 1, however, most supplies are purchased on credit (i.e., money is owed to suppliers). In that case, Gildan would engage in *two* transactions:

1. The purchase of an asset on credit — In the first transaction, Gildan would receive office supplies (an increase in an asset) and would give in return a promise to pay later, called accounts payable (an increase in a liability).
2. The eventual payment — In the second transaction, when Gildan pays the supplier, it would eliminate, or receive back, its promise to pay (a decrease in the accounts payable liability) and would give up cash (a decrease in an asset).

Transaction	Gildan Received	Gildan Gave
1. Purchased paper for credit	Office supplies (increased)	Accounts payable (increased) [a promise to pay]



A	=	L	+	SE
+		+		

Transaction	Gildan Received	Gildan Gave
2. Paid on its accounts payable	Accounts payable (decreased) [a promise was eliminated]	Cash (decreased)

A	=	L	+	SE
−		−		

As noted earlier, not all important business events result in a transaction that affects the financial statements. Most importantly, signing a contract involving *the exchange of promises to perform a future business transaction does not result in a transaction* that is recorded. For example, if Gildan sent an order to its paper supplier for more paper without making any payment, and the supplier accepted the order but did not fill it immediately, then no transaction has taken place for accounting purposes, because Gildan and the paper supplier have exchanged only promises; both the acquisition of an asset and payment for it are uncertain.[9] From the supplier's perspective, the same holds true. No transaction has taken place, so the supplier's financial statements are not affected. As soon as the paper is shipped to Gildan, however, the supplier gives up inventory in exchange for a promise from Gildan to pay for the paper it receives, and Gildan exchanges its promise to pay for the paper it receives. Because a *promise* has been exchanged for *goods*, a transaction has taken place, and the financial statements of both Gildan and the supplier will be affected.

Balancing the Accounting Equation

The accounting equation must remain in balance after each transaction. Total assets (resources) must equal total liabilities plus shareholders' equity (claims to resources). If the correct accounts have been identified and the appropriate direction of the effect on each account has been determined, then the equation will remain in balance.

Systematic transaction analysis for investing and financing activities includes the following steps:

Step 1: **Ask → What was received and what was given?**

- **Identify the accounts affected by their titles** (e.g., cash and accounts payable)**.** Make sure that at least two accounts change.
- **Classify each by type of account.** Was each account an asset (A), a liability (L), or shareholders' equity (SE)?
- **Determine the direction of the effect.** Did the account increase (+) or decrease (–)?

Step 2: **Verify → Is the accounting equation in balance? (A = L + SE)**

Analyzing Gildan's Transactions

To illustrate the use of the transaction analysis process, let us consider typical Gildan transactions that are also common to most businesses. This chapter presents transactions affecting accounts reported on the statement of financial position. Assume that Gildan engaged in the following hypothetical transactions during January 2019, the month following the statement of financial position in Exhibit 2.3. The month ends on January 31. For simplicity, account titles are based on that statement of financial position. Note that monetary amounts are usually preceded by the symbol of the currency used in the exchange transactions (e.g., $ for U.S. dollars, € for euros). In the following illustration, all amounts are in millions of U.S. dollars.

(*a*) Gildan issues shares to new investors in exchange for $53 in cash.

Step 1: **What was received and what was given?** (account name, type of account, amount, and direction of effect)

Received: Cash (+A) $53 **Given:** Additional share certificates; Contributed capital (+SE) $53

Assets	=	Liabilities	+	Shareholders' Equity
Cash				**Contributed capital**
(*a*) +53	=			+53

Step 2: **Is the accounting equation in balance?**

Assets $53 = Liabilities $0 + Shareholders' Equity $53

(*b*) Gildan borrows $45 from its local bank, signing a note to be paid in two years.

Step 1: **What was received and what was given?** (account name, type of account, amount, and direction of effect)

Received: Cash (+A) $45		**Given:** Written promise to bank; Long-term debt (+L) $45		
Assets	=	**Liabilities**	+	**Shareholders' Equity**
Cash		**Long-term debt**		**Contributed capital**
(*a*) +53	=			+53
(*b*) +45	=	+45		

Step 2: **Is the accounting equation in balance?**

Assets $45 = Liabilities $45 + Shareholders' Equity $0

Transactions (*a*) and (*b*) are *financing* transactions. Companies that need cash for *investing* purposes (to buy or build additional facilities as part of their plans for growth) often seek funds by selling shares to investors, as in transaction (*a*), or borrowing from creditors, usually banks, as in transaction (*b*).

(*c*) For expansion, Gildan opened new distribution centres. The company purchased new shelving racks, counters, and other equipment for $22; paid $15 in cash; and signed a note for $7, payable to the supplier in two years.

Step 1: **What was received and what was given?** (account name, type of account, amount, and direction of effect)

Received: Property, plant, and equipment (+A) $22			**Given:** (1) Cash (−A) $15 and a written promise to pay the manufacturer; Long-term debt (+L) $7		
Assets		=	**Liabilities**	+	**Shareholders' Equity**
Cash	**Property, plant, and equipment**		**Long-term debt**		**Contributed capital**
(*a*) +53		=			+53
(*b*) +45		=	+45		
(*c*) −15	+22	=	+7		

Step 2: **Is the accounting equation in balance?**

Assets $7 = Liabilities $7 + Shareholders' Equity $0

Notice that more than two accounts were affected by transaction (*c*).

The analysis of transactions (*d*) through (*f*) follows. The effects are listed in the chart at the end of Self-Study Quiz 2-2. Space is left in the chart for your answers to the quiz, transactions (*g*) and (*h*), which follow transaction (*f*).

(*d*) Gildan lends $80 to a trade supplier in financial difficulty. The trade supplier signs notes (a borrowing contract) agreeing to repay the amount borrowed within six months.

Step 1: **What was received and what was given?** (account name, type of account, amount, and direction of effect)

Received: Written promise from the trade supplier; Notes receivable (+A) $80	**Given:** Cash (−A) $80

Step 2: **Is the accounting equation in balance?**

Assets $0 = Liabilities $0 + Shareholders' Equity $0

(*e*) Gildan purchases shares issued by another company as a long-term investment, paying $18 in cash. The number of shares purchased allows Gildan to exert significant influence over decisions made by that company.

Step 1: **What was received and what was given?** (account name, type of account, amount, and direction of effect)

Received: Share certificates from the other company; Long-term investments (+A) $18	**Given:** Cash (−A) $18

Step 2: **Is the accounting equation in balance?**

Assets $0 = Liabilities $0 + Shareholders' Equity $0

Purchasing and selling property and equipment, and investments in the shares of other corporations are *investing* transactions.

(*f*) Gildan's board of directors declares cash dividends of $20 for shareholders. The dividends are paid immediately.

Step 1: **What was received and what was given?** (account name, type of account, amount, and direction of effect)

Received: Earnings retained in the business distributed to investors; Retained earnings (−SE) $20	**Given:** Cash (−A) $20

Step 2: **Is the accounting equation in balance?**

Assets −$20 = Liabilities $0 + Shareholders' Equity −$20

PAUSE FOR **FEEDBACK**

Transaction analysis involves identifying (by title) accounts affected in a transaction, recognizing that at least two accounts are affected, classifying the accounts (asset, liability, or shareholders' equity), and determining the direction of the effect on the account (increase or decrease). If all accounts and effects are correct, then the fundamental accounting equation (A = L + SE) will remain in balance. *The most effective way to develop your transaction analysis skills is to practise with many transactions.*

SELF-STUDY QUIZ 2-2

Review the analysis in transactions (*a*) through (*f*) and complete the transaction analysis steps in the chart following the transactions (*g*) and (*h*). *Repeat the steps until they become a natural part of your thought process.*

(*g*) Gildan collects $20 cash on notes receivable from the trade supplier. (*Hint:* Think about what is received and what is given.)

Step 1: **Identify and classify accounts and effects.**

Step 2: **Is the accounting equation in balance?**

(*h*) Gildan paid $14 on long-term debt.

Step 1: **Identify and classify accounts and effects.**

Step 2: **Is the accounting equation in balance?**

Include these effects on the following chart.

	Assets				=	Liabilities	+	Shareholders' Equity	
	Cash	Notes receivable	Long-term investments	Property, plant, and equipment		Long-term debt		Contributed capital	Retained earnings
(*a*)	53				=			+53	
(*b*)	+45				=	+45			
(*c*)	−15			+22	=	+7			
(*d*)	−80	+80			=				
(*e*)	−18		+18		=				
(*f*)	−20				=				−20
(*g*)					=				
(*h*)					=				

After you complete your answers, check them with the solutions at the end of the chapter.

(*i*) Gildan's board of directors approved the construction of four new retail stores at a meeting in January 2019 and the borrowing of $4 from the local bank to finance the construction of the new stores in March 2019. (*Hint:* Think about what is received and what is given.)

Unlike transactions (*a*) through (*h*), which reflect exchanges between Gildan and external parties, these two decisions of the board of directors are not transactions, because no exchanges have taken place yet. The company's board of directors made commitments that will likely translate into actions in March 2019. Specific statement of financial position accounts will be affected only when the actual exchanges occur in March 2019. However, to improve on the representational faithfulness of financial statements, such commitments are normally disclosed in a financial statement note.

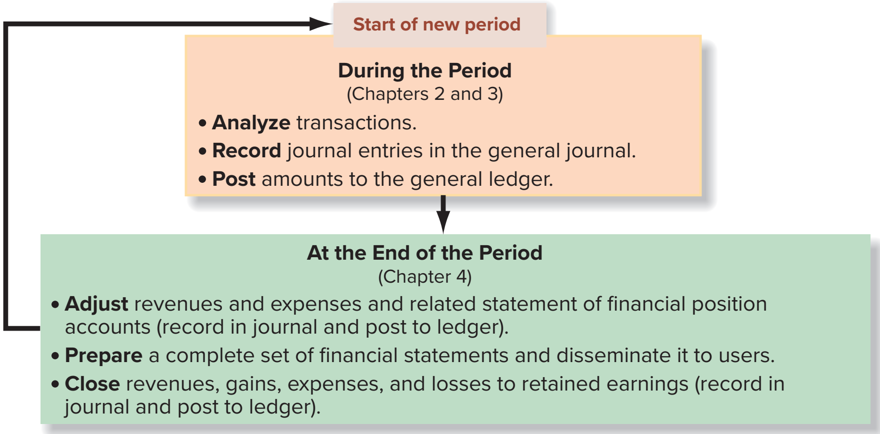
LO2-5

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

HOW DO COMPANIES KEEP TRACK OF ACCOUNT BALANCES?

For most organizations, recording transaction effects and keeping track of account balances in the manner just presented is impractical. Recording is the second step of transaction analysis. It requires the accountant to identify and correctly classify the accounts affected by the transaction and record the increase or decrease to the accounts. To handle the multitude of daily transactions that businesses generate, companies establish accounting systems, usually computerized, that follow a cycle. The accounting cycle, illustrated in Exhibit 2.5, highlights the primary activities performed during the accounting period. In this chapter

EXHIBIT 2.5
The Accounting Cycle



and in Chapter 3, we will illustrate these activities *during the period*. In Chapter 4, we will complete the accounting cycle by discussing and illustrating activities *at the end of the period* to adjust the records, prepare financial statements, and close the accounting records.

During the accounting period, transactions that result in exchanges between the company and other, external parties are analyzed and recorded in the *general journal* in chronological order, and the related accounts are updated in the *general ledger*. These formal records are often referred to as the books of account, or simply the books. The books are based on two very important tools used by accountants: journal entries and T-accounts. From the standpoint of accounting systems design, these analytical tools are more-efficient mechanisms for reflecting the effects of transactions and for determining account balances for financial statement preparation and reporting. *As future business managers, you should develop your understanding and use of these tools in financial analysis. For those studying accounting, this knowledge is the foundation for understanding the accounting system and future accounting coursework.* After we explain how to perform transaction analysis by using these tools, we illustrate their use in financial analysis.

The Direction of Transaction Effects

As we saw earlier, transactions change the balances of assets, liabilities, and shareholders' equity accounts on the statement of financial position. To reflect the transaction effects efficiently, we need to structure the transaction analysis model in a manner that shows the *direction* of the effects. One very useful tool for summarizing the transaction effects and determining the balances for individual accounts is a **T-account**, as shown in Exhibit 2.6. Notice the following:

T-ACCOUNT A tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company's activities.

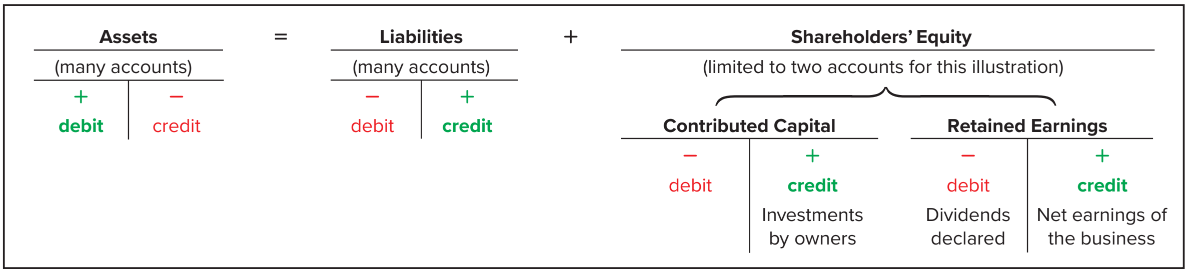
- Each T-account has two sides: a left side, known as the debit side, and a right side, known as the credit side.
- The increase symbol, +, is located on the left side of the T for accounts that appear on the left side of the accounting equation (assets) and report an increase in asset accounts. The + is also located on the right side of the T for accounts that are on the right side of the equation (liabilities and shareholders' equity) and report an increase in these liabilities and shareholders' equity accounts.
- The decrease symbol, –, is located on the right side of the T for accounts that appear on the left side of the accounting equation (assets) and report a decrease in asset accounts. The – is also located on the left side of the T for accounts that are on the right side of the equation (liabilities and shareholders' equity) and report a decrease in liabilities and shareholders' equity accounts. This is why analysis is required to correctly identify not only the accounts but also the direction of change to accounts.
- The term **debit** (dr for short) is always written on the left side of each account, and the term **credit** (cr for short) is always written on the right side irrespective of the location of the account in the accounting equation, but the side of the equation does determine whether the debit increases or decreases an account and whether the credit decreases or increases an account.

DEBIT The left side of an account, abbreviated "dr".

CREDIT The right side of an account, abbreviated "cr".

Exhibit 2.6

Transaction Analysis Model



From this illustration of the transaction analysis model, we can observe the following:

- Asset accounts increase on the left (debit) side of a T-account, and normally have debit balances. It would be highly unusual for an asset account, such as inventories, to have a negative (credit) balance reported on the statement of financial position.
- Liabilities and shareholders' equity accounts increase on the right (credit) side of the T-account and normally have credit balances. It would be highly unusual for a liability account and for a shareholders' equity account to have a negative balance reported on the statement of financial position.

To remember which accounts are increased by debit and which accounts are increased by credit, recall that a debit (left) increases asset accounts, because assets are on the left side of the accounting equation (A = L + SE). Similarly, a credit (right) increases liability and shareholders' equity accounts because they are on the right side of the accounting equation.

In summary,

Assets	=	**Liabilities**	+	**Shareholders' Equity**
+ with Debits		+ with Credits		+ with Credits
Accounts have **debit** balances		Accounts have **credit** balances		Accounts have **credit** balances

In Chapter 3, we will add the effects of transactions on revenue and expense accounts, which are elements of the statement of earnings. Until then, as you are learning to perform transaction analysis, you should refer to this model often until you can construct it on your own without assistance.

Many students have trouble with accounting because they forget that the term "debit" is simply the left side of an account and the term "credit" is simply the right side of an account. Perhaps someone once told you that you were a credit to your school or your family. As a result, you may think that credits are good and debits are bad. Such is not the case. Just remember that *debit is on the left* and *credit is on the right.*

If you have identified the correct accounts and effects through transaction analysis, the accounting equation will remain in balance. Moreover, *the total monetary value of all debits equals the total monetary value of all credits* in a transaction. For an extra measure of assurance, add this equality check (debits = credits) to the transaction analysis process.

PAUSE FOR **FEEDBACK**

From Exhibit 2.6, we learned that each account can increase and decrease as the result of recognizing a transaction. In the transaction analysis model, the effect of a transaction on each element can be represented with a T, with one side increasing and the other side decreasing. The balances of asset accounts that appear on the left side of the accounting equation are increased on the left side of the T. The balances of liability and shareholders' equity accounts that are on the right side of the accounting equation are increased on the right side of the T. In accounting, the left side of the T is called the debit side and the right side is called the credit side. Most accounts have a balance on the positive side.

SELF-STUDY QUIZ 2-3

The following is a list of items from a statement of financial position for Tim Hortons Inc. Indicate on the line provided whether each of the following accounts usually has a debit (dr) or a credit (cr) balance.

_____ Accrued liabilities	_____ Long-term debt	_____ Property, plant, and equipment
_____ Inventories	_____ Retained earnings	_____ Notes receivable (due in five years)
_____ Accounts receivable	_____ Accounts payable	_____ Cash

After you have completed your answers, check them with the solutions at the end of the chapter.

Analytical Tools

The Journal Entry

The **journal entry** is an accounting tool used to express the effects of a transaction in a timely way on various accounts, using the transaction analysis explained previously. In a bookkeeping system, transactions are recorded in chronological order in a *general journal* (see Appendix C for a detailed illustration of formal recordkeeping procedures). After analyzing the business documents (such as purchase invoices, receipts, and cash register tapes) that describe a transaction, its effects on the accounts are entered into the accounting information system through a journal entry. We use Gildan's transaction (*c*) in the previous section to illustrate how a journal entry is prepared.

JOURNAL ENTRY An accounting method for expressing the effects of a transaction on various accounts, using the double-entry bookkeeping system.

Reference: Letter, number, or date

Account Titles: Debited accounts on top Credited accounts on bottom, usually indented

Amounts: Debited amounts on left Credited amounts on right

		Debit	Credit
January 8, 2019	Property, plant, and equipment (+A)	22	
	Cash (−A)		15
	Long-term debt (+L)		7
	Purchased various equipment, paying part in cash and signing a note for the rest.		

Notice the following:

- It is useful to include a date and some other form of unique reference for each transaction to indicate the sequence of transactions. This enables verification of the transaction dates by internal and external auditors. The debited accounts are written first (on top) with the amounts recorded in the left column. The credited accounts are written below the debits and are indented to the right in manual records; the credited amounts are written in the right column. The order of the debited or credited accounts does not matter, as long as the debits are on top and the credits are on the bottom and indented to the right.
- Total debits ($22) equal total credits ($15 + $7). The debit shown in the journal entry is an increase of $22 to the asset account property, plant, and equipment (+A). In exchange for that asset, Gildan paid $15 in cash, shown as a credit in the journal entry to reflect a decrease of an asset account (−A). In addition, Gildan promised to pay the manufacturer the remaining amount of $7, an increase in a liability (+L) shown as a credit in the journal entry.
- The accounting equation is in balance because the net increase in assets, $7 (= $22 – $15) equals the increase in liabilities, $7 with no change to shareholders' equity.
- Three accounts are affected by this transaction, property, plant, and equipment, cash, and long-term debt. Any journal entry that affects more than two accounts is called a *compound entry*. Although this is the only transaction in the preceding illustration that affects more than two accounts, many transactions in subsequent chapters will require compound journal entries.
- As you can see in the illustration of a formal bookkeeping system in Exhibit 2.7, an additional line is written below the journal entry as an explanation of the transaction.

Recording external transactions in the journal is based on documents such as cash register receipts, cheques, or invoices that verify the existence of commitments between Gildan and other parties. Contracts are also important documents but many transactions are recognized even when no contract exists and accountants only

Exhibit 2.7

Posting Transaction Effects from the Journal to the Ledger

General Journal Page G1

Date	Account Titles and Explanations (in millions)	Ref.	Debit	Credit
Jan. 3	Cash	101	53	
	Contributed capital	301		53
	Investment by shareholders.			
Jan. 6	Cash	101	45	
	Long-term debt	201		45
	Borrowed from bank.			
Jan. 8	Property, plant and equipment	140	**22**	
	Cash	101		**15**
	Long-term debt	201		**7**
	Purchased equipment paying part cash			
	and the rest due on a note payable.			

General Ledger — **Cash** — 101

Date	Explanation	Ref.	Debit	Credit	Balance
	Balance				47
Jan. 3	Investment by shareholders.	G1	53		100
Jan. 6	Borrowed from bank.	G1	45		145
Jan. 8	Purchased equipment paying part cash and the rest due on a note payable.	G1		**15**	130

General Ledger — **Property, Plant and Equipment** — 140

Date	Explanation	Ref.	Debit	Credit	Balance
	Balance				991
Jan. 8	Purchased equipment paying part cash and the rest due on a note payable.	G1	**22**		1,013

General Ledger — **Long-Term Debt** — 201

Date	Explanation	Ref.	Debit	Credit	Balance
	Balance				669
Jan. 6	Borrowed from bank.	G1		45	714
Jan. 8	Purchased equipment paying part cash and the rest due on a note payable.	G1		**7**	721

recognize relevant information of benefit to investors and other decision makers. In our example, however, Gildan signed a contract with a supplier to purchase equipment for $22. It issued a cheque for $15 to transfer cash to the manufacturer and promised to pay $7 in two years. Consequently, the effects of this transaction are recognized, classified and recorded in the journal, and reflected in Gildan's financial statements.

The equipment supplier retains legal control of the equipment until it is fully paid after two years. For accounting purposes, however, Gildan has control of and will use this resource to generate revenue over the next two years. This is why the transaction is recognized because there is a low risk to the inflow of benefits to Gildan by using the asset as well as the outflow of obligations owned to the lender. This highlights the focus on the economic substance of a transaction rather than its legal form in reporting information to financial statement users. While recording external transactions in the journal requires formal documents to initiate the procedure, some legal contracts, such as signing a contract to hire a new employee, are not reflected in the financial statements until the employee actually begins to work and risk or uncertainty is removed regarding the existence of the employee.

While you are learning to perform transaction analysis, use the symbol A, L, or SE next to each account title, as in the preceding journal entry, for all homework problems. Specifically identifying accounts as assets (A), liabilities (L), or shareholders' equity (SE) clarifies that it is the statement of financial position which is affected and the necessary accounts considered in the transaction analysis. These two results of a simple notation make journal entries easier to write correctly and to determine the increase or decrease to the account. For example, if cash is to be increased, we will write "Cash (+A)." In subsequent chapters, we include the direction of the effect along with the symbol to help you understand the effects of each transaction on the financial statements.

A note of caution: Many students try to memorize journal entries without understanding or using the transaction analysis model. The task becomes increasingly difficult as more detailed transactions are presented in subsequent chapters, which affect more than one financial statement. In the long run, *understanding, applying, and using the transaction analysis model* presented here will save you time and prevent confusion.

The T-Account

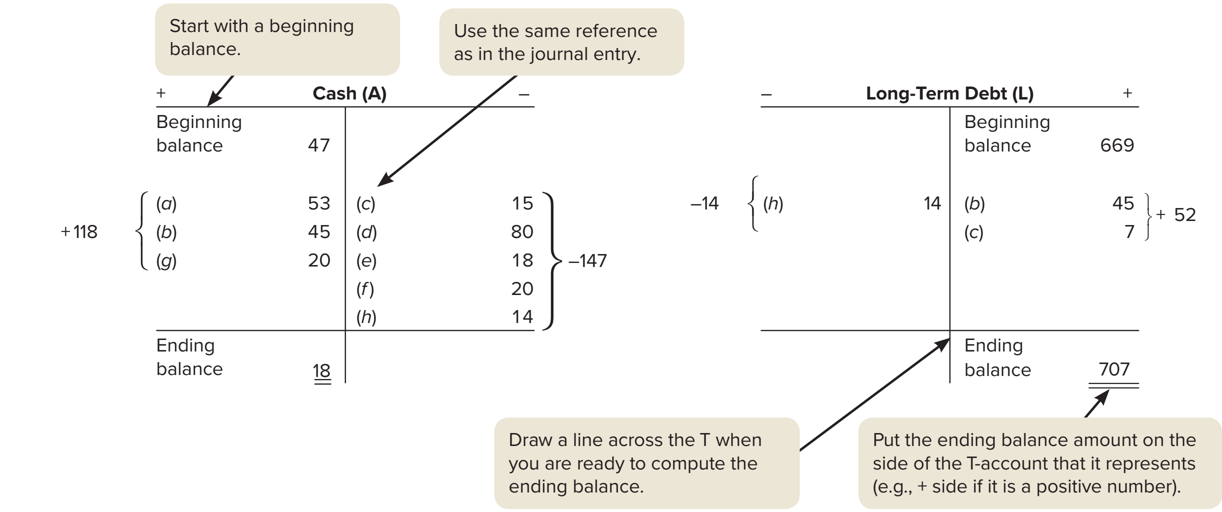
By themselves, journal entries do not provide the ending balances in accounts. After the journal entries have been recorded, the bookkeeper posts (transfers) the monetary values to each account affected by the transaction to determine the new account balances. In most computerized accounting systems, this happens automatically upon recording the journal entry.

The amounts recorded chronologically in all journal entries are collected for each account—for example Cash. All the debited and credited amounts are classified and reported by account in a *general ledger*. In a manual accounting system used by some small organizations, the ledger is often a three-ring binder with a separate page for each account. In a computerized system, accounts are part of a database and securely stored electronically. See Exhibit 2.7 for an illustration of journal entries recorded on a page of the general journal and the related general ledger pages for the three accounts Cash, Property, plant, and equipment, and Long-term debt. Note that the cash effects from the journal entries have been posted to the general ledger page for Cash. The three digits under the "Ref." column in the general journal are examples of account codes used in the chart of accounts.

Exhibit 2.8 shows the T-accounts for the cash and long-term debt accounts for Gildan, based on transactions (*a*) through (*h*). Notice the following:

- For cash, which is an asset, increases are shown on the left side of the T-account and decreases are on the right side. For long-term debt, however, increases are shown on the right and decreases on the left, since notes payable is a liability. This is consistent with recording the same information in either a journal entry or in the general ledger account.
- We added the + and − signs on the appropriate side of each T-account but removed the debit and credit notations. Remember that debit is always on the left side and credit is always on the right side of a T-account.
- Every T-account starts with a beginning balance.

Exhibit 2.8
T-Accounts Illustrated



- It is important to include the reference to the journal entry next to the debit or credit in each T-account. In our illustration, it is (*a*). For companies, it would be a date. This cross-referencing allows the transactions to be traced between the journal entries and T-accounts.
- When all of the transactions have been posted to a T-account, a horizontal line is drawn across it, similar to the line drawn in a mathematical problem, to signify that a balance is to be determined.
- An ending balance is entered on the appropriate side of the T-account.

Some small businesses still use handwritten, or manually maintained, accounts in this T-account format. Computerized systems retain the concept, though not the format, of the T-account; it is handy for accurately recording transactions and their effect on accounts on Excel spreadsheets.

In Exhibit 2.8, notice that the ending balance is indicated on the positive side with a double underline. To find the account balances, we can express the T-accounts as equations:

	Cash	Long-Term Debt
Beginning balance	$ 47	$669
+ "+" side	+118	+ 52
– "–" side	–147	– 14
Ending balance	$ 18	$707

A word on terminology: The words "debit" and "credit" may be used as verbs, nouns, or adjectives. For example, we can say debit (verb) Gildan's cash account $53 when shares were issued to investors, meaning that the amount was entered on the left side of the T-account. Or we can say that a debit (noun) of $53 was entered on the left side of Gildan's cash account. The cash account may be described as a debit account (adjective) because this is the normal state of the ending balance of an asset account. These terms will be used instead of "left" and "right" throughout the rest of the textbook.

The next section illustrates the steps to follow in analyzing the effects of transactions, recording the effects in journal entries, and determining account balances by using T-accounts.

Transaction Analysis Illustrated

In this section, we will use the monthly transactions of Gildan that were presented earlier to demonstrate transaction analysis and the use of journal entries and T-accounts. We analyze each transaction, checking to make sure that the accounting equation remains in balance and that debits equal credits. The amounts from Gildan's statement of financial position at December 30, 2018 have been inserted as the beginning balances in the T-accounts, located together at the end of the illustration. After reviewing or preparing each journal entry, trace the effects to the appropriate T-accounts by using the transaction letters (*a*) to (*h*) as a reference. The first transaction has been highlighted for you.

Study this illustration carefully, including the explanations of transaction analysis. Careful study is *essential* to the understanding of (1) the accounting model, (2) transaction analysis, (3) the dual effects of each transaction, and (4) the dual-balancing system. *The most effective way to learn these critical concepts that affect material throughout the rest of the textbook is to practise, practise, practise.*

(*a*) Gildan issues shares to new investors in exchange for $53 in cash.

Cash (+A)	53	
Contributed capital (+SE)		53
Issued shares for cash.		

Assets		=	Liabilities		+	Shareholders' Equity	
Cash	+53					Contributed capital	+53

These effects have been posted to the appropriate T-accounts at the end of the illustration. To post the amounts, transfer or copy the debit or credit amount on each line to the appropriate T-account indicated in order to accumulate balances for each account. For example, the $53 debit is listed in the debit (increase) column of the cash T-account.

(*b*) Gildan borrows $45 from its local bank, signing a note to be paid in two years.

Cash (+A)	45	
Long-term debt (+L)		45
Borrowed money from the local bank, payable in two years.		

Assets		=	Liabilities		+	Shareholders' Equity
Cash	+45		Long-term debt	+45		

(*c*) For expansion, Gildan opened new distribution centres. The company purchased new shelving racks, counters, and other equipment for $22; paid $15 in cash; and signed a note for $7, payable to the supplier in two years.

Property, plant, and equipment (+A)	22	
Cash (−A)		15
Long-term debt (+L)		7
Purchased various equipment, paying part in cash and signing a note for the rest, payable in two years.		

Assets		=	Liabilities		+	Shareholders' Equity
Property, plant, and equipment	+22		Long-term debt	+7		
Cash	−15					

(*d*) Gildan lends $80 to a trade supplier in financial difficulty. The trade supplier signs notes agreeing to repay the amount borrowed within six months.

Notes receivable (+A)	80	
Cash (−A)		80
Lent money to a trade supplier; to be repaid within six months.		

Assets		=	**Liabilities**	+	**Shareholders' Equity**
Cash	−80				
Notes receivable	+80				

(*e*) Gildan purchases shares issued by another corporation as a long-term investment, paying $18 in cash.

Long-term investments (+A)	18	
Cash (−A)		18
Purchased shares in another corporation as a long-term investment.		

Assets		=	**Liabilities**	+	**Shareholders' Equity**
Cash	−18				
Investments	+18				

(*f*) Gildan's board of directors declares cash dividends of $20 for shareholders. The dividends are paid immediately.

Retained earnings (−SE)	20	
Cash (−A)		20
Declared and paid dividends to shareholders.		

Assets		=	**Liabilities**	+	**Shareholders' Equity**	
Cash	−20				Retained earnings	−20

PAUSE FOR **FEEDBACK**

Accountants record recognized transactions first in the general journal in chronological order in journal entry form. Debited accounts are written on top with amounts in the left column, and credited accounts are written on the bottom with amounts in the right column. Then, the effects are posted in the general ledger. Each page of the ledger represents a different account, which has a debit (left) side and a credit (right) side. To post transaction effects, the amount for each account in a journal entry is recorded in the appropriate debit or credit column on the ledger page, to obtain account balances.

SELF-STUDY QUIZ 2-4

For transactions (*g*) and (*h*), fill in the missing information, including postings to the T-accounts.

(*g*) Gildan collects $20 cash on note receivable from the trade supplier.

Write the journal entry.		[Post to the T-accounts.]
	Collection of note from trade supplier.	

Assets		=	**Liabilities**	+	**Shareholders' Equity**
Cash	+20				
Notes receivable	−20				

(*h*) Gildan paid $14 on long-term debt.

Long-term debt (−L)	14		[Post to the T-accounts.]
Cash (−A)		14	
Partial payment of the amount owed to the local bank.			

Assets	=	**Liabilities**	+	**Shareholders' Equity**

The T-accounts that changed during the period because of these transactions are shown below. The beginning balances are the amounts from Gildan's statement of financial position at December 30, 2018 (Exhibit 2.3). The balances of all other accounts remained the same.

Assets = **Liabilities + Shareholders' Equity**

+	**Cash (A)**		−
Beg. bal.	47		
(*a*)	53	(*c*)	15
(*b*)	45	(*d*)	80
(*g*)		(*e*)	18
		(*f*)	20
		(*h*)	
End. bal.	18		

+	**Property, Plant, and Equipment (A)**		−
Beg. bal.	991		
(*c*)	22		
End. bal.	1,013		

+	**Long-Term Investments (A)**		−
Beg. bal.	0		
(*e*)	18		
End. bal.	18		

+	**Notes Receivable (A)**		−
Beg. bal.	0		
(*d*)	80	(*g*)	
End. bal.	60		

−	**Long-Term Debt (L)**		+
		Beg. bal.	669
		(*b*)	45
(*h*)		(*c*)	7
		End. bal.	707

−	**Contributed Capital (SE)**		+
		Beg. bal.	192
		(*a*)	53
		End. bal.	245

−	**Retained Earnings (SE)**		+
		Beg. bal.	1,740
(*f*)	20		
		End. bal.	

You can verify that you reported the entries properly by adding the increase side and subtracting the decrease side and then comparing your answer to the ending balance for each T-account. Check your answers with the solutions at the end of the chapter.

INFERRING BUSINESS ACTIVITIES FROM T-ACCOUNTS

FINANCIAL **ANALYSIS**

T-accounts are useful primarily for instructional and analytical purposes. In many cases, we will use T-accounts to determine what transactions a company engaged in during a period. For example, the primary transactions affecting accounts payable for a period are purchases of assets on account and cash payments to suppliers. If we know the beginning and ending balances of accounts payable and all of the amounts that were purchased on credit during a period, we can determine the amount of cash paid, *p*. A T-account will include the following:

−	**Accounts Payable (L)**		+
		Beg. bal.	600
Cash payments to suppliers	?	Purchases on account	1,500
		End. bal.	300

Solution:

Beginning balance	+	**Purchases on account**	−	**Cash payments to suppliers**	=	**Ending balance**
$600	+	$1,500	−	*p*	=	$ 300
		$2,100	−	*p*	=	$ 300
				p	=	$1,800

USING BIG DATA ANALYTICS FOR BUSINESS EXPANSION

DATA ANALYTICS

Data Analytics (also called Business Intelligence and Big Data) has exploded in the past several years, but what is it? SAS (a world leader in business analytics software and services) describes it as follows:

> Big data analytics examines large amounts of data to uncover hidden patterns, correlations and other insights. With today's technology, it's possible to analyze your data and get answers from it almost immediately . . . .[10]

By collecting both structured and unstructured data from various sources inside the business in any format, either numbers or text (e.g. information system data, sales invoices, cash register receipts, spreadsheets, bills of lading for goods in transport to or from a business, or contracts from accounting, human resources, supply chain, and legal departments) and data from outside the business (from social media, customers, and weather and traffic patterns), companies worldwide are now making more data-driven business decisions. Analysis is done using statistical methods (called algorithms) to generate relevant information useful to decision makers. Inside a business, these decisions can be aimed at decreasing costs, identifying new business opportunities, launching new products and services, implementing innovative technologies such as data analytics, and transforming business in preparation for the future.

Companies like Gildan are increasing their investments in technological innovations, such as digital/mobile ordering, which provide more information about their customers and their competitors and they use predictive models to project future sales and their needs for raw materials or merchandise purchases to reduce costs and meet the demand for the products they sell. Gildan's leaders understand the importance of creating a reliable data-driven culture to transform the way to think and apply technology to innovate and improve future business results.

What does this shift to a data-driven culture mean for accounting students? Competition for talented individuals with strong analytical skills is exceptionally high. As CPA Canada explains on its website:[11]

Data landscape for the future accountant

Technology keeps changing and so do the value levers of business. Be prepared for what's next and arm yourself with the right skills to play an active role in shaping the future of the profession.

EVENT DETAILS . . .

The future of the profession is evolving, and CPAs must keep up with the pace of change. this includes having a strong understanding of the latest technologies and the growing impact of digital on business, finance and accounting.

In this course, you will learn about big data, the rise of cryptocurrencies, new developments in artificial intelligence and more. Dive into practical case studies that explore some of the most pressing privacy, ethical and legal issues facing technology in business.

LO2-6

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

HOW IS THE STATEMENT OF FINANCIAL POSITION PREPARED AND ANALYZED?

TRIAL BALANCE A list of all accounts with their balances to provide a check on the equality of the debits and credits.

As discussed in Chapter 1, a statement of financial position is one of the financial statements that will be reported to investors and other decision makers, especially those external to the business. Although no operating activities occurred yet (they will be illustrated in Chapter 3), it is possible to prepare a statement of financial position based solely on the investing and financing activities recorded in the previous section. Usually, businesses will create a **trial balance** spreadsheet first for internal purposes before preparing and reporting financial statements for external users. A trial balance lists the titles of the T-accounts in the first column, usually in financial statement order (assets, liabilities, shareholders' equity, revenues, and expenses), with their ending debit or credit balances in the next two columns. Debit balances are indicated in the left column and credit balances are indicated in the right column. Then the two columns are totalled to provide a check on the equality of the debits and credits. Errors in a computer-generated trial balance may exist if wrong accounts, wrong amounts, or wrong direction of change (debit or credit) are used in the journal entries.[12]

Gildan's trial balance follows. The account balances that did not change are taken from Gildan's statement of financial position at December 30, 2018 in Exhibit 2.3. The accounts that did change due to the investing and financing transactions illustrated in this chapter are shaded; their balances are taken from the T-accounts summarized earlier.

GILDAN ACTIVEWEAR INC.
TRIAL BALANCE
As at January 31, 2019

(in millions of U.S. dollars)	Debit	Credit
Cash	$ 18	
Accounts receivable	317	
Notes receivable	60	
Inventories	940	
Prepaid expenses	77	
Other current assets	2	
Long-term investments	18	
Property, plant, and equipment	1,013	
Intangible assets	394	
Goodwill	227	
Other non-current assets	10	
Accounts payable		$ 250
Accrued liabilities		97
Long-term debt		707
Other non-current liabilities		53
Contributed capital		245
Retained earnings		1,720
Other components		4
Total	**$3,076**	**$3,076**

Classified Statement of Financial Position

The statement of financial position in Exhibit 2.9 was prepared from the trial balance above. Notice several additional features:

- The assets and liabilities are classified into two categories: *current* and *non-current*. Current assets are those to be used or transformed into cash within the upcoming 12 months whereas non-current assets are those that will last longer than one year. Current liabilities are those obligations to be paid or settled within the next 12 months with current assets.
- Dollar signs are indicated at the top and bottom of both the asset section and the liabilities and shareholders' equity section.
- The statement includes comparative data. That is, it compares the account balances at January 31, 2019 with those at December 30, 2018. When multiple periods are presented, the most recent statement of financial position amounts are usually listed on the left.

At the beginning of the chapter, we presented the changes in Gildan's total assets from 2011 to 2018. We questioned what made the accounts change and what the process was for reflecting the changes. Now we can see that the assets have changed again in one month, along with liabilities and shareholders' equity, because of the transactions illustrated in this chapter.

	Assets	=	Liabilities	+	Shareholders' Equity
January 31, 2019	3,076		1,107		1,969
December 30, 2018	3,005		1,069		1,936
Change	+ 71		+ 38		+ 33

Exhibit 2.9

Gildan's Statement of Financial Position

GILDAN ACTIVEWEAR INC.
Consolidated Statement of Financial Position
(in millions of U.S. dollars)

Assets	**January 31, 2019**	**December 30, 2018**
Current assets		
Cash	$ 18	$ 47
Accounts receivable	317	317
Notes receivable	60	–
Inventories	940	940
Prepaid expenses	77	77
Other current assets	2	2
Total current assets	**1,414**	**1,383**
Non-current assets		
Long-term investments	18	–
Property, plant, and equipment	1,013	991
Intangible assets	394	394
Goodwill	227	227
Other non-current assets	10	10
Total non-current assets	**1,662**	**1,622**
Total assets	**$3,076**	**$3,005**
Liabilities and Shareholders' equity		
Current liabilities		
Accounts payable	$ 250	$ 250
Accrued liabilities	97	97
Total current liabilities	347	347
Non-current liabilities		
Long-term debt	707	669
Other non-current liabilities	53	53
Total non-current liabilities	760	722
Total liabilities	**1,107**	**1,069**
Shareholders' Equity		
Contributed capital	245	192
Retained earnings	1,720	1,740
Other components	4	4
Total shareholders' equity	**1,969**	**1,936**
Total liabilities and shareholders' equity	**$3,076**	**$3,005**

UNDERSTANDING FINANCIAL STATEMENTS OF FOREIGN COMPANIES

INTERNATIONAL **PERSPECTIVE**

The adoption of IFRS by many countries has made it easier to read foreign companies' financial statements. However, there are still some differences in the structure of the statements and account titles that may cause confusion. A single, consistent format has not been mandated. Consequently, various formats have evolved over time, with those by Canadian and U.S. companies differing from those typically used internationally, particularly by European companies. The formatting differences are shown below:

	Format Typically Used by Canadian Companies	Alternative Format Typically Used by European Companies
Order of Listing Assets, Liabilities, and Shareholders' Equity	**Assets:**	**Assets:**
	Current	Non-current
	Non-current	Current
Similar accounts are shown, but the order of liquidity (for assets) and the order of maturity (for liabilities) differ	**Liabilities:**	**Shareholders' Equity**
	Current	**Liabilities:**
	Non-current	Non-current
	Shareholders' Equity	Current

Canadian companies typically list assets in *decreasing order of liquidity*, but European companies have typically listed their assets in *increasing order of liquidity.* Similarly, companies may emphasize longer-term financing sources by listing equity before liabilities and, within liabilities, by listing non-current liabilities before current liabilities (*decreasing time to maturity*). The key to avoiding confusion is to be sure to *pay attention to the subheadings in the statement.* Any account under the heading "liabilities" must be a liability.

Ratio Analysis in Decision Making

Why do the classifications of current and non-current assets and liabilities matter on the statement of financial position? Users of financial information compute a number of ratios when analyzing a company's past performance and financial condition as input in predicting its future potential. The change in ratios over time and how they compare to the ratios of the company's competitors or industry averages provide valuable information about a company's strategies for its operating, investing, and financing activities.

We introduce here the first of many ratios that will be presented throughout the rest of this textbook, with a final summary of ratio analysis in Chapter 12. In Chapters 2, 3, and 4, we present four ratios that provide information about management's effectiveness at managing short-term debt (current ratio), controlling revenues and expenses (net profit margin), and utilizing assets (total asset turnover ratio and return on assets), all for the purpose of enhancing returns to shareholders. The remaining chapters discuss other ratios that provide valuable information to assess a company's strategies, strengths, and areas of concern.

THE CURRENT RATIO

KEY RATIO **ANALYSIS**

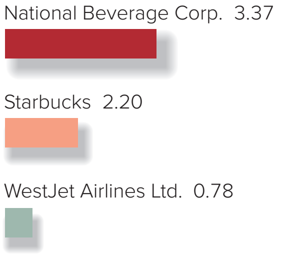
As we discussed earlier in the chapter, companies raise large amounts of money to acquire additional assets by issuing shares to investors and borrowing funds from creditors. These additional assets are used to generate more earnings. However, since debt must be repaid, taking on increasing amounts of debt carries increased risk. Information about current liabilities is very important to managers and analysts because these obligations must be paid in the near future. Analysts say that a company has liquidity if it has the ability to pay its current obligations. Companies that do not settle their current obligations in a timely manner quickly find that suppliers of goods and services may not be prepared to grant them credit for their purchases, potentially forcing them to seek short-term financing through banks. The current ratio provides one measure for analysts to examine the company's financing strategy.

ANALYTICAL QUESTION → Does the company currently have the resources to pay its short-term debt?

RATIO AND COMPARISONS → Analysts use the *current ratio* as an indicator of the amount of current assets available to satisfy current liabilities. It is computed as follows:

$$\text{Current ratio} = \text{Current assets} \div \text{Current liabilities}$$

SELECTED FOCUS COMPANY CURRENT RATIOS—2018



The 2018 ratio for Gildan is

$$\$1,383 \div \$347 = 3.99$$

Comparisons over Time		
Gildan Activewear		
2016	2017	2018
5.68	5.06	3.99

Comparisons with Competitors	
Hanesbrands	Delta Apparel
2018	2018
1.73	2.97

INTERPRETATIONS

In General → The current ratio is a very common ratio. Creditors and financial analysts use the current ratio to measure the ability of the company to pay its short-term obligations with short-term assets. Generally, the higher the ratio, the more cushion a company has to pay its current obligations if future economic conditions take a downturn. Many industries, such as retail companies and manufacturers, historically face difficult times with sustained dips in the economy. They often have a current ratio at 2.0 (twice as many current economic resources as current obligations) or higher to be able to pay employees, suppliers, and other current obligations until the economy recovers.

While a high ratio above 1.0 normally suggests good liquidity, today many strong companies use sophisticated management techniques to minimize funds invested in current assets, and, as a result, have current ratios below 1.0. Likewise, when compared to ratios of other companies in the same industry, too high a ratio suggests inefficient use of resources.

Focus Company Analysis → Gildan's current ratio at December 30, 2018 indicates that the company has $3.99 for each $1 in current liabilities. The decrease in this ratio over the three years is the result of a proportionally larger increase in current liabilities than the increase in current assets. Gildan's ratio is higher than those of its competitors, Hanesbrands and Delta Apparel. Inventories are the largest current asset for all three companies, accounting for more than 55 percent of total current assets, which they need to meet customers' demand for their products, but both Hanesbrands and Delta Apparel have relatively larger amounts of current liabilities than Gildan. Since all three companies have ratios exceeding 1.0, this suggests that they have sufficient liquidity to meet their short-term obligations.

A Few Cautions → The current ratio may be a misleading measure of liquidity if significant funds are tied up in assets that are not easily converted into cash. A company with a high current ratio might still have liquidity problems if the majority of its current assets are slow-moving inventory. Analysts recognize that managers can manipulate the current ratio by engaging in particular types of transactions just before the close of the fiscal year. For example, the current ratio can be improved by paying creditors immediately prior to the preparation of financial statements.

Using the relevant information from financial statements to calculate a single ratio is only the first step toward understanding whether a company is healthy enough to merit your investment money. The real challenges are discovering why the ratios have changed over time, comparing the ratios with competitors' ratios, developing a keen understanding of the industry and businesses, and using all this knowledge to predict the future for a company.

PAUSE FOR **FEEDBACK**

We just learned that the current ratio measures a company's ability to pay short-term obligations with short-term assets, a liquidity measure. It is computed by dividing current assets by current liabilities. A ratio between 1.0 and 2.0 is normally considered good, although some companies may need a higher ratio, while other companies with good cash management systems can have a ratio below 1.0 (i.e., more current liabilities than current assets).

SELF-STUDY QUIZ 2-5

Dollarama Inc. is the leading dollar store operator in Canada, with more than 1,100 locations across the country. The company offers a broad assortment of everyday consumer products, general merchandise, and seasonal items. It reported the following balances on its recent statements of financial position (in millions). Compute Dollarama's current ratio for the three years.

	Current Assets	Current Liabilities	Current Ratio
January 28, 2018	$570	$721	
January 29, 2017	559	513	
January 31, 2016	617	227	

What does this ratio suggest about Dollarama's liquidity in the current year and over time?

After you complete your answers, check them with the solutions at the end of the chapter.

INVESTING AND FINANCING ACTIVITIES

FOCUS ON
CASH FLOWS

LO2-7

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

Recall from Chapter 1 that companies report cash inflows and outflows over a period in their statement of cash flows. This statement divides all transactions that affect cash into three categories:

- Operating activities are covered in Chapter 3.
- Investing activities include buying and selling non-current assets and investments.
- Financing activities include borrowing and repaying debt, including short-term bank loans, issuing and repurchasing shares, and paying dividends.

Only transactions affecting cash are reported on the statement. An important step in constructing and analyzing the statement of cash flows is identifying the various transactions as operating (O), investing (I), or financing (F). Let us analyze the cash T-account for Gildan's transactions in this chapter. Refer to transactions (*a*)–(*h*) illustrated on previous pages, and remember that *cash must be part of the transaction for it to affect the statement of cash flows.*

	+	Cash (A)		–	
	Beg. bal.	47			
From investors + F	(*a*)	53	15	(*c*)	– I For non-current assets
From bank + F	(*b*)	45	80	(*d*)	– I To trade supplier
From trade supplier + I	(*g*)	20	18	(*e*)	– I For investment in other companies
			20	(*f*)	– F To shareholders
			14	(*h*)	– F To bank
	End. bal.	18			

The eight transactions we have analyzed for Gildan are issuing shares, borrowing from a bank, purchasing equipment, lending to a trade supplier, purchasing shares in other companies, declaring and paying dividends, collecting cash on a note receivable, and paying down a bank loan. All of these transactions either increased or decreased the balance in the cash account. Four of the eight transactions relate to investment activities, and the other four relate to financing activities.

PAUSE FOR
FEEDBACK

As we discussed, every transaction affecting cash can be classified as an operating (discussed in Chapter 3), investing, or financing activity. Investing activities relate to purchasing/selling investments or property and equipment, or lending funds to/receiving repayment from others. Financing activities relate to borrowing from or repaying banks, issuing shares to or repurchasing shares from investors, or paying dividends to investors.

SELF-STUDY QUIZ 2-6

Lance Inc. manufactures and sells snack products. Indicate whether the following transactions from a recent statement of cash flows were investing (I) or financing (F) activities, and show the direction of the effect on cash (+ means increases cash; − means decreases cash):

Transaction	Type of Activity (I or F)	Effect on Cash Flows (+ or −)
1. Paid dividends	______	______
2. Sold property	______	______
3. Repaid debt	______	______
4. Purchased vending machines	______	______
5. Issued new shares	______	______

After you complete your answers, check them with the solutions at the end of the chapter.

Some Misconceptions

Some people confuse bookkeeping with accounting. Bookkeeping involves routine data entry, a clerical task that requires only minimal knowledge of accounting. A bookkeeper may record the repetitive and uncomplicated transactions in most businesses and may maintain the simple records of a small business. In contrast, a professional accountant is highly trained in analysis of complex and non-routine transactions, preparation and reporting of financial statements, design of information systems, interpretation of financial data, auditing, taxation, and management consulting.

Another prevalent misconception is that all transactions are subject to precise and objective measurement of their dollar value, and that therefore the accounting results reported in the financial statements are exact. In reality, accounting numbers are influenced by estimates produced according to IFRS, as subsequent chapters will illustrate. One example is accounts receivable, which reports an estimated cash inflow from customers due within the next 12 months. Some people believe that financial statements report the entity's market value (including its assets), but this is inaccurate. More often the reported value of an asset is based on historical cost because it can be verified by existing documents. To understand and interpret financial statements, you must be aware of their limitations as well as their usefulness. You should understand what the financial statements do and do not try to accomplish.

Finally, financial statements are often thought to be inflexible because of their quantitative nature. As you study accounting, you will continue to learn that it requires considerable *professional judgment* on the part of the accountant to capture the economic essence of business transactions. Accountants develop professional judgment after years of experience in analyzing business transactions and in applying accounting principles and financial reporting standards in preparing and auditing financial reports. Accounting is stimulating intellectually; it is not a cut-and-dried subject. It calls on your intelligence, analytical ability, creativity, and judgment. Accounting is a communication process involving an audience (users) with a wide diversity of knowledge, interest, and capabilities; therefore, it will call on your ability as a communicator. The language of accounting uses concisely written phrases and symbols to convey information about the resource flows measured for specific organizations.

To understand financial statements, you must have a minimum level of knowledge of the concepts and the measurement procedures used in the accounting process. You should learn what accounting is really like and appreciate the reasons for using specific procedures. This level of knowledge cannot be gained by reading a list of the concepts and a list of the misconceptions. Neither can a generalized discussion of the subject matter suffice. Considerable practice of accounting tasks and involvement, primarily problem solving (similar to the requirement in mathematics courses), are essential in the successful study of accounting focused on the needs of the user. Therefore, we provide problems aimed at the desirable knowledge level for the user as well as the preparer of financial statements.

ACCOUNTING STANDARDS **FOR PRIVATE ENTERPRISES**

As noted in Chapter 1, the accounting standards applicable for the reporting of financial information by private enterprises may differ from IFRS. This is especially true for small private enterprises, which engage in fewer complex transactions, reducing the extent of detail reported in the notes to the financial statements.

The application of different accounting standards may result in values reported for assets, liabilities, and equity of private enterprises that would have differed had IFRS been applied to measure and report the values of specific elements of their financial statements. A few differences are highlighted below.

Financial Reporting Issue	IFRS	ASPE
Presentation of assets, liabilities, and shareholders' equity	Publicly accountable enterprises have a choice between two ways of presenting their assets and liabilities. The choice depends upon which method provides the most relevant information. Companies may list their assets in increasing order of liquidity, with the least-liquid assets listed at the top of the assets. Hence, non-current assets are presented before current assets. IFRS similarly emphasize longer-term financing sources by listing equity before liabilities and, within liabilities, by listing non-current liabilities before current liabilities (decreasing time to maturity). However, assets should be reported by decreasing order of liquidity and liabilities by increasing time to maturity if such classification provides more relevant information to users of financial statements.	Private enterprises report their assets in a decreasing order of liquidity, with the most-liquid asset (cash) presented first. Similarly, liabilities are reported in order of time to maturity. Current assets are presented before non-current assets, and current liabilities appear before non-current liabilities.
Asset valuation	Publicly accountable enterprises may choose to report their assets using either the cost model or the revaluation model. For example, property, plant, and equipment can be reported at fair value (e.g., net sales price) provided that the company uses this method consistently over time. This allows the company to record increases and decreases in the values of these assets.	Private enterprises are required to report assets at historical cost and are not permitted to record increases in these assets over time.

DEMONSTRATION **CASE**

On April 1, 2020, three ambitious college students started Terrific Lawn Maintenance Corporation. Completed transactions (summarized) through April 7, 2020 for Terrific Lawn Maintenance follow:

a. Issued 1,500 shares in exchange for $9,000 cash. Each investor received 500 shares.

b. Acquired rakes and other hand tools (equipment) for $600 but with a list price of $690; paid the hardware store $200 cash and signed a three-month note for the balance.

c. Ordered three lawn mowers and two edgers from Lawn Supply Inc. for $4,000.

d. Purchased four acres of land as a future site of a storage garage; paid cash, $5,000.

e. Received the mowers and edgers that had been ordered, signing a note to pay Lawn Supply in full, in 18 months.

f. Sold one acre of land to the city for a park. Accepted a note for $1,250 as payment to be received at April 10, 2020.

g. One of the owners borrowed $3,000 from a local bank for personal use.

Required:

1. Set up T-accounts for cash, notes receivable (from the city), equipment (for hand tools and mowing equipment), land, short-term notes payable (to the hardware store), long-term notes payable (to the equipment supply company), and contributed capital. Indicate beginning balances of $0 in the T-accounts. Analyze each transaction by using the process outlined in the chapter. Prepare journal entries in chronological order. Enter the effects of the transactions in the appropriate T-accounts. Identify each amount with its letter in the preceding list. Use the following transaction analysis model:

Assets		=	**Liabilities**		+	**Shareholders' Equity**			
+	−		−	+		**Contributed Capital**		**Retained Earnings**	
debit	credit		debit	**credit**		−	+	−	+
						debit	**credit**	debit	**credit**
							Investment by owners	Dividends declared	Net earnings

2. Use the balances in the T-accounts developed in (1) to prepare a classified statement of financial position for Terrific Lawn Maintenance Corporation at April 7, 2020. Show the account balances for all assets, liabilities, and shareholders' equity.
3. Identify transactions (*a*)–(*g*) as investing or financing activities affecting cash flows and the direction of each effect. Use +I for investing inflow, −I for investing outflow, +F for financing inflow, and −F for financing outflow.

We strongly recommend that you prepare your own answers to these requirements and then check your answers with the following solution.

SUGGESTED **SOLUTION**

1. **Transaction Analysis:**

Received:	**Given:**
a. Cash (+A) $9,000	Contributed capital (+SE) $9,000
b. Equipment (+A) $600	Cash (−A) $200
	Short-term notes payable (+L) $400
c. Not a transaction—a promise to pay for a promise to deliver from the supplier	
d. Land (+A) $5,000	Cash (−A) $5,000
e. Equipment (+A) $4,000	Long-term notes payable (+L) $4,000
f. Notes receivable (+A) $1,250	Land (−A) $1,250 *(one-fourth of cost of the land)*
g. Not a transaction of the business—separate-entity assumption	

Journal Entries:

(*a*) Cash (+A)	9,000	
Contributed capital (+L)		9,000

Assets		=	**Liabilities**		+	**Shareholders' Equity**	
Cash	+9,000					Contributed capital	+9,000

(*b*) Equipment (+A)	600	
Cash (−A)		200
Short-term notes payable (+L)		400

Assets		=	**Liabilities**		+	**Shareholders' Equity**
Equipment	+600		Short-term notes payable	+400		
Cash	−200					

The historical cost principle states that assets should be recorded at the amount paid on the date of the transaction. This is $600, not the list price of $690.

(*c*) This is not a transaction; no exchange has taken place. No accounts are affected.

(*d*) Land (+A)	5,000	
Cash (−A)		5,000

Assets		=	**Liabilities**	+	**Shareholders' Equity**
Land	+5,000				
Cash	−5,000				

(*e*) Equipment (+A)	4,000	
Long-term notes payable (+L)		4,000

Assets		=	**Liabilities**		+	**Shareholders' Equity**
Equipment	+4,000		Long-term notes payable	+4,000		

(*f*) Notes receivable (+A)	1,250	
Land (−A)		1,250

Assets		=	**Liabilities**	+	**Shareholders' Equity**
Notes receivable	+1,250				
Land	−1,250				

(*g*) This is not a transaction that involves the company. The separate-entity assumption states that transactions of the owners are separate from transactions of the business.

T-Accounts:

Assets = Liabilities + Shareholders' Equity

+	Cash (A)		−
Beg. bal.	0		
(*a*)	9,000	(*b*)	200
		(*d*)	5,000
End. bal.	3,800		

+	Notes Receivable (A)		−
Beg. bal.	0		
(*f*)	1,250		
End. bal.	1,250		

−	Short-Term Notes Payable (L)		+
		Beg. bal.	0
		(*b*)	400
		End. bal.	400

−	Long-Term Notes Payable (L)		+
		Beg. bal.	0
		(*e*)	4,000
		End. bal.	4,000

+	Equipment (A)		−
Beg. bal.	0		
(*b*)	600		
(*e*)	4,000		
End. bal.	4,600		

+	Land (A)		−
Beg. bal.	0		
(*d*)	5,000	(*f*)	1,250
End. bal.	3,750		

−	Contributed Capital (SE)		+
		Beg. bal.	0
		(*a*)	9,000
		End. bal.	9,000

2. Statement of financial position:

TERRIFIC LAWN MAINTENANCE CORPORATION
Statement of Financial Position
At April 7, 2020

Assets		**Liabilities**	
Current Assets		*Current Liabilities*	
Cash	$ 3,800	Short-term notes payable	$ 400
Notes receivable	1,250	Total current liabilities	400
Total current assets	5,050	Long-term notes payable	4,000
		Total liabilities	4,400
Equipment	4,600	*Shareholders' Equity*	
Land	3,750	Contributed capital	9,000
Total assets	**$13,400**	**Total liabilities and shareholders' equity**	**$13,400**

Notice that the statement of financial position presented earlier in the text listed assets on the top, and liabilities and shareholders' equity on the bottom. It is also acceptable practice to prepare a statement of financial position with assets on the left side and liabilities and shareholders' equity on the right side, as in the preceding example.

3. Cash Flows:

+	Cash (A)		−
Beg. bal.	0		
(*a*)	9,000	(*b*)	200
		(*d*)	5,000
End. bal.	3,800		

Only transactions (*a*), (*b*), and (*d*) affect cash flows (as shown in the cash T-account).

(*a*) +F for $9,000

(*b*) −I for $200

(*d*) −I for $5,000

CHAPTER TAKE-AWAYS

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

Objective:
- 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.

Qualitative characteristics of useful financial information:
- Relevance that allows users to assess past activities and/or predict future activities
- Faithful representation requires information to be complete, neutral, and free from error
  - To enhance the two fundamental qualitative characteristics, information should be comparable (to other companies and over time), verifiable, timely, and understandable.

Key recognition, measurement, and disclosure concepts:

Assumptions
- Separate-entity assumption—transactions of the business are accounted for separately from transactions of the owner.
- Stable monetary unit assumption—financial information is reported in the national monetary unit without adjustment for changes in purchasing power.
- Continuity (going-concern) assumption—a business is expected to continue to operate into the foreseeable future.

Principles
- Mixed-attribute measurement model—most elements of the statement of financial position are recorded according to the historical cost principle—financial statement elements should be recorded at their cash-equivalent cost on the date of the transaction; however, these values may be adjusted to other amounts, such as fair value depending on certain conditions.

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.

Elements of the statement of financial position are as follows:
- Assets—these are probable future economic benefits owned by the entity as a result of past transactions.
- Liabilities—these are present debts or obligations of the entity to transfer an economic resource as a result of past events.
- Shareholders' equity—residual interest of owners in the assets of the entity after settling liabilities. This is the financing provided by the owners (contributed capital) and the operations of the business (earned capital).

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

A transaction includes the following:
- An exchange of cash, goods, services, or promises between a business and one or more external parties to a business (not the exchange of a promise for a promise)

or
- A measurable internal event, such as adjustments for the use of assets in operations

An account is a standardized format that organizations use to accumulate the dollar effects of transactions of each financial statement item. Typical account titles are:
- *Assets*—cash, accounts receivable, inventory, prepaid expenses, investments, property (buildings and land) and equipment, and intangibles (rights without physical substance).
- *Liabilities*—accounts payable, notes payable, accrued liabilities, deferred revenue, and taxes payable.
- *Shareholders' equity*—contributed capital and retained earnings.

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

To determine the economic effect of a transaction on the entity in terms of its accounting equation, each transaction is analyzed in terms of the accounts (at least two) that are affected. In an exchange, the company receives something and gives something. If the accounts, direction of the effects, and amounts are correctly analyzed, the accounting equation must stay in balance. The transaction analysis model is as follows:

Assets		=	**Liabilities**		+	**Shareholders' Equity**			
(many accounts)			(many accounts)			(limited to two accounts for this illustration)			
						Contributed Capital		**Retained Earnings**	
+	−		−	+		−	+	−	+
debit	credit		debit	**credit**		debit	**credit**	debit	**credit**
							Investments by owners	Dividends declared	Net earnings of the business

Systematic transaction analysis includes (1) determining the accounts that were received and were given in the exchange, including the type of each account (A, L, or SE), amounts, and direction of the effect, and (2) determining that the accounting equation remains in balance.

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

- Journal entries express the effects of a transaction on accounts by using the debit–credit framework. The accounts and amounts to be debited are listed first. Then the accounts and amounts to be credited are listed below the debits and indented, resulting in debits on the left and credits on the right. A brief description of the transaction is then included for future reference:

(date or reference)	Property, plant, and equipment	22	
	Cash (−A)		15
	Long-term debt (+L)		7

- T-accounts summarize transaction effects for each account. These tools can be used to determine balances and draw inferences about a company's activities.

+ **Assets**	−
Beginning balance	
Increases	Decreases
Ending balance	

− **Liabilities and Shareholders' Equity**	+
	Beginning balance
Decreases	Increases
	Ending balance

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

Classified statements of financial position are structured as follows:

- Assets are categorized as current assets (those to be used or turned into cash within the year, with inventory always considered to be a current asset) and non-current assets, such as long-term investments, property, plant, and equipment, and intangible assets.
- Liabilities are categorized as current liabilities (those that will be paid within the next year or the operating cycle, whichever is longer) and non-current liabilities.
- Shareholders' equity accounts are listed as contributed capital first, followed by retained earnings (earnings reinvested in the business) and other components.

The current ratio (current assets ÷ current liabilities) measures a company's liquidity—that is, the ability of the company to pay its short-term obligations with current assets.

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

A statement of cash flows reports the sources and uses of cash for the period by the type of activity that generated the cash flow: operating, investing, or financing. Investing activities are purchasing and selling long-term assets, making loans, and receiving payment from loans to others. Financing activities are borrowing and repaying loans to banks, issuing and repurchasing shares, and paying dividends.

In this chapter, we discussed the fundamental accounting model and transaction analysis. Journal entries and T-accounts were used to record the results of transaction analysis for investing and financing decisions that affect specific accounts. In Chapter 3, we continue our detailed look at financial statements, in particular the statement of earnings. The purpose of Chapter 3 is to build on your knowledge by discussing concepts for the measurement of revenues and expenses and by illustrating transaction analysis for operating decisions.

KEY **RATIOS**

The current ratio measures the ability of the company to pay its short-term obligations with current assets. Although a ratio larger than 1.0 indicates that sufficient current assets are available to meet obligations when they become due, many companies with sophisticated cash management systems have ratios below 1.0. The ratio is computed as follows:

$$\textbf{Current ratio} = \frac{\textbf{Current assets}}{\textbf{Current liabilities}}$$

FINDING **FINANCIAL INFORMATION**

STATEMENT OF FINANCIAL POSITION

Current Assets
- Cash
- Accounts receivable
- Notes receivable
- Inventory
- Prepaid expenses

Non-current Assets
- Investments
- Property, plant, and equipment
- Intangibles
- Goodwill

Current Liabilities
- Bank borrowings
- Accounts payable
- Notes payable
- Accrued liabilities

Non-current Liabilities
- Long-term debt

Shareholders' Equity
- Contributed capital
- Retained earnings

STATEMENT OF CASH FLOWS

Under Investing Activities

\+ Sales of non-current assets for cash
− Purchases of non-current assets for cash
− Loans to others
\+ Receipt of cash on loans to others

Under Financing Activities

\+ Borrowing from banks
− Repayment of loans from banks
\+ Issuance of shares
− Repurchase of shares
− Payment of dividends

STATEMENT OF EARNINGS

To be presented in Chapter 3.

NOTES

To be discussed in future chapters.

QUESTIONS

1. What is the primary objective of financial reporting for external users?
2. Define the following:
   a. Asset
   b. Current asset
   c. Liability
   d. Current liability
   e. Contributed capital
   f. Retained earnings
3. Explain why information must be relevant and have faithful representation to be useful.
4. Explain what the following assumptions and principle mean in accounting:
   a. Separate-entity assumption
   b. Unit-of-measure assumption
   c. Continuity assumption
   d. Cost principle
5. Why is it important to have accounting assumptions?
6. How is the current ratio computed and how is it interpreted?
7. For accounting purposes, what is an account? Explain why accounts are used in an accounting system.

8. What are the limitations of using the historical cost principle as a basis for valuation of assets subsequent to acquisition?
9. What is the fundamental accounting model?
10. Define a business transaction in the broad sense and give examples of the two different kinds of transactions.
11. Explain what *debit* and *credit* mean.
12. Briefly explain what is meant by transaction analysis. What are the two steps in transaction analysis?
13. What two equalities in accounting must be maintained in transaction analysis?
14. What is a journal entry?
15. What is a T-account? What is its purpose?
16. What transactions are classified as investing activities in a statement of cash flows? What transactions are classified as financing activities?
17. What is the difference between a bookkeeper and an accountant?

MINI-EXERCISES

LO2-1,2-5

M2-1 Matching Definitions with Terms

Match each definition with its related term by entering the appropriate letter in the space provided. There should be only one definition per term (there are more definitions than terms).

Term		Definition
_____ (1)	Continuity assumption	A. = Liabilities + Shareholders' Equity
_____ (2)	Historical cost principle	B. Reports assets, liabilities, and shareholders' equity
_____ (3)	Credits	C. Accounts for a business separately from its owners
_____ (4)	Assets	D. Increase assets; decrease liabilities and shareholders' equity
_____ (5)	Account	E. An exchange between an entity and other parties
		F. The concept that businesses will operate into the foreseeable future
		G. Decrease assets; increase liabilities and shareholders' equity
		H. The concept that assets should be recorded at the amount paid on the date of the transaction
		I. A standardized format used to accumulate data about each item reported on financial statements

LO2-3

M2-2 Identifying Events as Accounting Transactions

Which of the following events result in an exchange transaction for Dittman Company (Y for yes and N for no)?

_____ (1) Six investors in Dittman Company sold their shares to another investor.
_____ (2) The founding owner, Megan Dittman, purchased additional shares in another company.
_____ (3) The company borrowed $2,500,000 from a local bank.
_____ (4) Dittman Company purchased a machine and signed a note, payable in one year.
_____ (5) The company lent $300,000 to a supplier.
_____ (6) Dittman Company ordered supplies from Staples to be delivered next week.

LO2-3

M2-3 Classifying Accounts on a Statement of Financial Position

The following are accounts of Rosa-Perez Company:

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

In the space provided, classify each as it would be reported on a statement of financial position. Use the following symbols:

CA for current asset	CL for current liability	SE for shareholders' equity
NCA for non-current asset	NCL for non-current liability	

■ LO2-3 **M2-4 Determining Financial Statement Effects of Several Transactions**

For each of the following transactions of Dennen Inc. for the month of January 2021, indicate the accounts, amounts, and direction of the effects on the accounting equation. A sample solution is provided.

a. *(Sample)* Borrowed $30,000 from a local bank by signing a short-term note.
b. Lent $10,000 to an affiliate; accepted a note due in one year.
c. Sold 100 additional shares to investors for $500 cash.
d. Purchased $15,000 of equipment, paying $5,000 cash and signing a note for the rest due in one year.
e. Declared $2,000 in dividends to shareholders, to be paid in February.

Assets		=	Liabilities		+	Shareholders' Equity
a. Sample: Cash	+30,000		Notes payable	+30,000		

■ LO2-4 **M2-5 Identifying Effects on Elements of the Statement of Financial Position**

Complete the following table by entering either "increases" or "decreases" in columns (1) and (2), and either "debit" or "credit" in columns (3) and (4).

	(1) Debit	(2) Credit	(3) Increases	(4) Decreases
Assets	________	________	________	________
Liabilities	________	________	________	________
Shareholders' equity	________	________	________	________

■ LO2-5 **M2-6 Recording Simple Transactions**

For each transaction in M2-4 (including the sample), write the journal entry in proper form.

■ LO2-5 **M2-7 Completing T-Accounts**

For each transaction in M2-4 (including the sample), post the effects to the appropriate T-accounts and determine ending account balances. Beginning balances are provided.

Cash	
Beg. bal. 900	

Accounts Receivable	
Beg. bal. 1,000	

Equipment	
Beg. bal. 15,100	

Notes Payable (Current)	
	Beg. bal. 3,000

Contributed Capital	
	Beg. bal. 4,000

Retained Earnings	
	Beg. bal. 10,000

■ LO2-6 **M2-8 Preparing a Trial Balance**

Complete M2-7, and then prepare a trial balance for Dennen Inc. as at January 31, 2021.

■ LO2-6 **M2-9 Preparing a Simple Classified Statement of Financial Position**

Starting with the beginning balances in M2-7 and given the transactions in M2-4 (including the sample), prepare a statement of financial position for Dennen Inc. as at January 31, 2021, with a classification of the assets and liabilities into current and non-current categories.

■ LO2-7 **M2-10 Identifying Transactions as Investing or Financing Activities on the Statement of Cash Flows**

For the transactions in M2-4 (including the sample), identify each as an investing (I) activity or financing (F) activity on the statement of cash flows.

EXERCISES

■ LO2-1,2-2,2-3,2-4

E2-1 **Matching Definitions with Terms**

Match each definition with its related term by entering the appropriate letter in the space provided. There should be only one definition per term (there are more definitions than terms).

Term

_____ (1) Transaction
_____ (2) Continuity assumption
_____ (3) Statement of financial position
_____ (4) Liabilities
_____ (5) Assets = Liabilities + Shareholders' Equity
_____ (6) Note payable
_____ (7) Historical cost principle
_____ (8) Account
_____ (9) Dual effects
_____ (10) Retained earnings
_____ (11) Current assets
_____ (12) Separate-entity assumption
_____ (13) Debits
_____ (14) Accounts receivable
_____ (15) Stable monetary unit assumption
_____ (16) Shareholders' equity

Definition

A. Economic resources to be used or turned into cash within one year.
B. Reports assets, liabilities, and shareholders' equity.
C. Business transactions are separate from the transactions of the owners.
D. Increase assets; decrease liabilities and shareholders' equity.
E. An exchange between an entity and other parties.
F. The concept that businesses will operate into the foreseeable future.
G. Decrease assets; increase liabilities and shareholders' equity.
H. The concept that assets should be recorded at the amount paid on the exchange date.
I. A standardized format used to accumulate data about each item reported on financial statements.
J. Amounts owed from customers.
K. The fundamental accounting model.
L. The account that is credited when money is borrowed from a bank.
M. The concept that states that accounting information should be measured and reported in the national monetary unit.
N. Cumulative earnings of a company that are not distributed to the owners.
O. Present obligation to transfer an economic resource as a result of a past event.
P. Every transaction has at least two effects.
Q. Financing provided by owners and by business operations.
R. Economic resources expected to be used or turned into cash beyond the next 12 months.

■ LO2-1

E2-2 **Qualitative Characteristics of Accounting Information**

Match each qualitative characteristic of useful accounting information with the related definition by entering the appropriate letter in the space provided. There should be only one definition per term (there are more definitions than terms).

Qualitative Characteristics

_____ (1) Relevance
_____ (2) Timeliness
_____ (3) Predictive value
_____ (4) Confirmatory value
_____ (5) Verifiability
_____ (6) Faithful representation
_____ (7) Neutrality
_____ (8) Comparability
_____ (9) Consistency

Definitions

A. Application of the same accounting methods over time.
B. Agreement between what really happened and the disclosed information.
C. The information is available prior to the decision.
D. The accounting information does not favour a particular group.
E. The information helps reduce uncertainty in the future.
F. The information provides input to evaluate previous expectations.
G. The information allows the evaluation of one alternative against another.
H. The information has a bearing on a specific decision.
I. The information can be depended upon.
J. Implies that qualified persons working independently arrive at similar conclusions.

LO2-1

E2-3 Assessing the Relevance and Faithful Representation of Information

Paula Romanov is the credit manager of Pinnacle Inc. She is considering whether to extend credit to Mak Inc., a new customer. Pinnacle sells most of its goods on credit but is very careful in extending credit to new customers. Tim Mak, the owner of Mak Inc., provided the following documents to Paula to assist her in her evaluation:

1. A detailed analysis of the sales revenue and earnings that Mak Inc. expects to achieve within the next 12 months
2. Projections of the company's sales during the next five years
3. The company's monthly bank statements for the past three years
4. A report of the company's credit history prepared by Mak's employees
5. A letter signed by all four company officers indicating that they are prepared to personally guarantee the amount of credit that Pinnacle approves
6. Brief résumés of the four company officers along with descriptions of the functions they perform in the company
7. Eight letters of reference from close friends and relatives of the four company officers

Required:

Analyze each of the items above with respect to the characteristics of relevance (predictive value and confirmatory value) and faithful representation (complete, neutral, and free from error). Explain whether or not each item possesses these characteristics.

LO2-3

E2-4 Identifying Events as Accounting Transactions

Which of the following events results in an exchange transaction for O'Brien Company (Y for yes and N for no)?

_____ (1) O'Brien purchased a machine and signed a note, payable in six months.
_____ (2) Six investors in O'Brien Company sold their shares to another investor.
_____ (3) The company lent $150,000 to a member of the board of directors.
_____ (4) O'Brien Company ordered supplies from Office Max to be delivered next week.
_____ (5) The founding owner, Meaghan O'Brien, purchased additional shares in another company.
_____ (6) The company borrowed $1,000,000 from a local bank.

LO2-1,2-3

E2-5 Identifying Account Titles

The following are independent situations.

a. A company purchases a piece of land for $100,000 cash. An appraiser for the buyer valued the land at $105,000.
b. A telecommunications company purchases the patent (an intangible asset) on a software application for its wireless communication system. The company paid $250,000 cash and signed a note for $550,000, payable in one year at an annual interest rate of 5 percent.
c. A company orders and receives five laptops for office use for which it signs a note promising to pay $12,000 within three months.
d. A company makes a cash payment of $5,400 for prepaid services.
e. A manufacturing company signs a contract for the construction of a new warehouse for $500,000. At the signing, the company writes a cheque for $50,000 as a deposit on the future construction.
f. A publishing firm purchases the copyright (an intangible asset) to a manuscript for an introductory accounting text from the author for $40,000.
g. A company purchases a new delivery truck that has a list, or sticker, price of $35,000 for $32,000 cash.
h. A company purchases on account women's clothing for sale to customers. The supplier's invoice of $2,430 is payable within 30 days.
i. A new company is formed and sells 2,000 shares for $22 per share to investors.
j. A company purchases 100 shares of Canadian Tire Corporation for $14,000 cash.
k. A local company is a sole proprietorship (one owner); its owner buys a car for $10,000 for personal use. Answer from the company's point of view.
l. A manufacturing firm pays dividends of $100,000 to shareholders in cash.
m. A company pays $1,500 principal on its note payable.

Required:

1. Indicate the appropriate elements on the classified statement of financial position (use account titles), if any, that are affected in each of the preceding events. Consider what is given and what is received.
2. At what amount would you record the land in (*a*)? The truck in (*g*)? What measurement principle are you applying?
3. What accounting concept did you apply for situation (*k*)?

■ LO2-3,2-5
WestJet Airlines

E2-6 Classifying Accounts and Their Usual Balances

As described in a recent annual report, WestJet Airlines provides quality travel services to many destinations in North America.

Required:

For each of the following accounts from WestJet's recent statement of financial position, complete the following chart by indicating whether the account is classified as a current asset (CA), a non-current asset (NCA), a current liability (CL), a non-current liability (NCL), or shareholders' equity (SE), and whether the account usually has a debit or a credit balance.

Account	Statement of Financial Position Classification	Debit or Credit Balance
1. Advance ticket sales (defer redrevenue)	________	________
2. Cash and cash equivalents	________	________
3. Contributed capital	________	________
4. Intangible assets	________	________
5. Inventory	________	________
6. Long-term borrowings	________	________
7. Prepaid expenses	________	________
8. Property and equipment	________	________
9. Retained earnings	________	________
10. Accounts payable	________	________
11. Accounts receivable	________	________

■ LO2-4

E2-7 Determining Financial Statement Effects of Several Transactions

The following events occurred for Mitka Ltd.:

a. Received investment of $32,000 cash by organizers.
b. Purchased land for $18,000; paid $6,000 in cash and signed a mortgage note with a local bank for the balance (due in five years).
c. Borrowed cash from a bank and signed a note for $11,000.
d. Lent $300 to an employee who signed a note due in three months.
e. Paid the bank the amount borrowed in (*c*).
f. Purchased $8,000 of equipment, paying $4,000 in cash and signing a note due to the manufacturer.

Required:

For each of the events (*a*) through (*f*), perform transaction analysis and indicate the account, amount, and direction of the effects (+ for increase and – for decrease) on the accounting equation. Check that the accounting equation remains in balance after each transaction. Use the following headings:

Event	Assets	=	Liabilities	+	Shareholders' Equity

■ LO2-4
Nike Inc.

E2-8 Determining Financial Statement Effects of Several Transactions

Nike, Inc., with headquarters in Beaverton, Oregon, is one of the world's leading manufacturers of athletic shoes and sports apparel. The following activities occurred during a recent year. The amounts are rounded to millions.

a. Purchased additional buildings for $303 and equipment for $1,202; paid $432 in cash and signed a long-term note for the rest.
b. Issued 10 million shares for a total of $695 cash.
c. Declared $1,159 in dividends to be paid in the following year.
d. Purchased additional short-term investments for $5,928 cash.
e. Several Nike investors sold their own shares to other investors on the stock exchange for $7,150.
f. Sold $2,423 in short-term investments for $2,423 in cash.

Required:
For each of these events, perform transaction analysis and indicate the account, amount, and direction of the effects on the accounting equation. Check that the accounting equation remains in balance after each transaction. Use the following headings:

Event	Assets	=	Liabilities	+	Shareholders' Equity

LO2-5 **E2-9 Recording Investing and Financing Activities**
Refer to E2-7.

Required:
For each of the events in E2-7, prepare journal entries, checking that debits equal credits.

LO2-5 **E2-10 Recording Investing and Financing Activities**
Kelsey Baker founded GolfDeals.com at the beginning of February. GolfDeals.com sells new and used golf equipment online. The following events occurred in February.

a. Borrowed $30,000 cash from a bank, signing a note due in three years.
b. Received investment of cash by organizers and distributed to them 500 shares with a market price of $30 per share.
c. Purchased a warehouse for $115,000, paying $23,000 in cash and signing a note payable for the balance on a 10-year mortgage.
d. Purchased computer and office equipment for $20,000, paying $4,000 in cash and owing the rest on accounts payable to the manufacturers.
e. Loaned $1,000 to an employee who signed a note due in three months.
f. Paid $2,000 to the manufacturers in (*d*) above.
g. Purchased short-term investments for $10,000 cash.

Required:
For each of the events (*a*) through (*g*), prepare journal entries, checking that debits equal credits.

LO2-5 **E2-11 Analyzing the Effects of Transactions in T-Accounts**
Grady Service Company Inc. was organized by Chris Grady and five other investors. The following events occurred during the year:

a. Received $63,000 cash from the investors; each was issued 1,400 shares.
b. Purchased equipment for use in the business at a cost of $16,000; one-fourth was paid in cash, and the company signed a note for the balance, payable in six months.
c. Signed an agreement with a cleaning service to pay it $200 per week for cleaning the corporate offices.
d. Lent $2,500 to one of the investors, who signed a note due in six months.
e. Issued shares to additional investors, who contributed $6,000 in cash and a lot of land valued at $15,000.
f. Paid the amount of the note payable in (*b*).
g. Chris Grady borrowed $10,000 for personal use from a local bank and signed a note payable in one year.

Required:
1. Prepare journal entries for each transaction. If an event does not require a journal entry, explain the reason. Use the account titles listed in (2).
2. Create T-accounts for the following accounts: cash, note receivable, equipment, land, note payable, and contributed capital. Beginning balances are zero. For each of the preceding transactions, record the effects of the transaction in the appropriate T-accounts. Include good referencing and totals for each T-account.
3. Using the balances in the T-accounts, fill in the following amounts for the accounting equation:

   Assets $_____ = Liabilities $_____ + Shareholders' Equity $_____

LO2-4,2-6 **E2-12 Inferring Investing and Financing Transactions, and Preparing a Statement of Financial Position**
During its first week of operations ended January 7, 2020, FastTrack Sports Inc. completed six transactions with the dollar effects indicated in the following schedule:

Accounts	Dollar Effect of Each of the Six Transactions						Ending Balance
	1	2	3	4	5	6	
Cash	$15,000	$75,000	$(5,000)	$(4,000)	$(9,500)		
Note receivable (short term)				4,000			
Store fixtures					9,500		
Land			16,000			$4,000	
Note payable (due in three months)		75,000	11,000			4,000	
Contributed capital	15,000						

Required:

1. Write a brief explanation of each transaction. Explain any assumptions that you made.
2. Compute the ending balance in each account and prepare a classified statement of financial position for FastTrack Sports Inc. on January 7, 2020.

■ LO2-6

E2-13 Inferring Investing and Financing Transactions, and Preparing a Statement of Financial Position

During its first month of operations, March 2021, Faye's Fashions Limited completed seven transactions with the dollar effects indicated in the following T-accounts:

Cash

(*a*)	50,000	4,000	(*b*)
(*f*)	2,000	4,000	(*c*)
		6,000	(*d*)
		3,000	(*e*)

Short-Term Investments

(*d*)	6,000	2,000	(*f*)

Short-Term Note Receivable

(*c*)	4,000		

Computer Equipment

(*g*)	4,000		

Delivery Truck

(*b*)	25,000		

Long-Term Note Payable

(*e*)	3,000	21,000	(*b*)

Contributed Capital

		50,000	(*a*)
		4,000	(*g*)

Required:

1. Write a brief explanation of transactions (*a*) through (*g*). Explain any assumptions that you made.
2. Compute the ending balance in each account and prepare a classified statement of financial position for Faye's Fashions Limited at the end of March 2021.

■ LO2-5

BMW Group

E2-14 Recording Journal Entries

BMW Group, headquartered in Munich, Germany, manufactures several automotive brands, including BMW, MINI, and Rolls-Royce. Financial information is reported in euros (€), using IFRS as applicable to the European Union. The following transactions were adapted from the annual report of the BMW Group; amounts are in millions of euros:

a. Declared €2,106 in dividends to be paid next month.

b. Ordered €8,410 of equipment.

c. Paid €2,212 in dividends declared in a prior month.

d. Borrowed €8,952 in cash from banks.

e. Sold equipment at its cost of €753 for cash.

f. Received the equipment ordered in event (*b*), paying €5,823 in cash and signing a note for the balance.

g. Purchased investments for €3,592 cash.

Required:

Prepare journal entries for each transaction. Be sure to use good referencing, and categorize each account as an asset (A), a liability (L), or shareholders' equity (SE). If a transaction does not require a journal entry, explain the reason.

■ LO2-5,2-6

E2-15 Analyzing the Effects of Transactions by Using T-Accounts, Preparing a Statement of Financial Position, and Interpreting the Current Ratio as a Manager of the Company

Massimo Company has been operating for one year (2019). You are a member of the management team investigating expansion ideas, all of which will require borrowing funds from banks. At the start of 2020, Massimo's T-account balances were as follows:

Assets:

Cash	
1,000	

Short-Term Investments	
2,000	

Property and Equipment	
	2,500

Liabilities:

Short-Term Notes Payable	
	2,200

Long-Term Notes Payable	
	300

Shareholders' Equity:

Contributed Capital	
	1,000

Retained Earnings	
	2,000

Required:

1. Using the data from these T-accounts, complete the accounting equation on January 1, 2020:

   Assets $_____ = Liabilities $_____ + Shareholders' Equity $_____

2. Enter in the T-accounts the following transactions that occurred in 2020:

   a. Paid one-half of the principal on the long-term note payable.

   b. Sold $1,000 of the investments for $1,000 cash.

   c. Sold one-half of the property and equipment for $1,250 cash.

   d. Borrowed $2,000 from the bank and signed a note promising to pay the principal and interest at an annual rate of 5 percent in three years.

   e. Paid $500 in dividends to shareholders.

3. Compute ending balances in the T-accounts to complete the statement of financial position on December 31, 2020:

   Assets $_____ = Liabilities $_____ + Shareholders' Equity $_____

4. Using the ending balances in the T-accounts, prepare a classified statement of financial position at December 31, 2020, in good form.
5. Calculate the current ratio at December 31, 2020. If the industry average for the current ratio is 1.50, what does your computation suggest to you about Massimo Company? Would you support expansion by borrowing? Why or why not?

■ LO2-5

E2-16 Explaining the Effects of Transactions on Specific Accounts by Using T-Accounts

Heavey and Lovas Furniture Repair Service, a company with two shareholders, began operations on June 1, 2020. The following T-accounts indicate the activities for the month of June.

Cash (A)			
(*a*)	17,000	(*b*)	10,000
(*d*)	500	(*c*)	1,500
(*f*)	800	(*e*)	1,000

Notes Receivable (A)			
(*c*)	1,500	(*d*)	500

Tools and Equipment (A)			
(*a*)	3,000	(*f*)	800

Building (A)			
(*b*)	50,000		

Notes Payable (L)			
(*e*)	1,000	(*b*)	40,000

Contributed Capital (SE)			
		(*a*)	20,000

Required:

Explain transactions (*a*) through (*f*), which resulted in the entries in the T-accounts; that is, what activity made the accounts increase or decrease?

■ LO2-5

E2-17 Inferring Typical Investing and Financing Activities in Accounts

The following T-accounts indicate the effects of normal business transactions:

Equipment		
1/1	500	
	250	?
31/12	100	

Note Receivable		
1/1	150	
	?	225
31/12	170	

Notes Payable		
	100	1/1
?	170	
	180	31/12

Required:

1. Describe the typical investing and financing transactions that affect each T-account. That is, what economic events made these accounts increase or decrease?
2. For each T-account, compute the missing amounts.

■ LO2-7 **E2-18**
Performance Sports Group Ltd.

Identifying Investing and Financing Activities Affecting Cash Flows

Performance Sports Group Ltd. is a leading developer and manufacturer of ice hockey, roller hockey, and lacrosse equipment, and related apparel. The company holds the top market share position in both ice and roller hockey. Its products are marketed under the Bauer Hockey, Mission Roller Hockey, Maverik Lacrosse, and Cascade Sports brand names. The following are several of the company's investing and financing activities that were reflected in a recent annual statement of cash flows:

a. Issuance of shares
b. Purchase of property, plant, and equipment
c. Issuance of long-term debt
d. Principal repayment of long-term debt
e. Purchase of investments
f. Repurchase of shares
g. Proceeds from disposition of property, plant, and equipment

Required:

For each of these, indicate whether the activity is investing (I) or financing (F), and indicate the direction of the effect on cash flows (+ = increases cash; − = decreases cash).

■ LO2-7 **E2-19**
Hilton Hotels Corporation

Preparing the Investing and Financing Section of the Statement of Cash Flows

Hilton Hotels Corporation constructs, operates, and franchises domestic and international hotel and hotel-casino properties. Information from the company's annual statement of cash flows indicates the following investing and financing activities during that year (simplified):

Payment of debt principal	$ 24
Purchase of investments	139
Sale of property (assume sold at cost)	230
Issuance of shares	60
Purchase and renovation of properties	370
Additional borrowing from banks	992
Receipt of principal payment on a note receivable	125

Required:

Prepare the investing and financing sections of the statement of cash flows for Hilton Hotels. Assume that the company's year-end is December 31, 2019.

Mc Graw Hill connect PROBLEMS

■ LO2-2,2-5 **P2-1**
Saputo Inc.

Identifying Accounts on a Classified Statement of Financial Position and Their Normal Debit or Credit Balances (AP2-1)

Saputo Inc. is Canada's leading processor of dairy products. The company produces, markets, and distributes a wide array of products of the utmost quality, including cheese, fluid milk, yogurt, dairy ingredients, and snack cakes. Saputo's products are distributed in many countries, primarily in Canada, the United States, and Argentina. The following are several of the accounts that appeared on the company's recent statement of financial position:

Account	Statement of Financial Position Classification	Debit or Credit Balance
1. Cash and cash equivalents	________	________
2. Deferred income tax liabilities	________	________
3. Retained earnings	________	________
4. Income taxes payable	________	________
5. Prepaid expenses	________	________
6. Contributed capital	________	________

Account	Statement of Financial Position Classification	Debit or Credit Balance
7. Trademarks and other intangibles	______	______
8. Accounts payable	______	______
9. Accrued liabilities	______	______
10. Bank loans (short term)	______	______
11. Property, plant, and equipment	______	______
12. Long-term investments	______	______
13. Accounts receivable	______	______
14. Long-term debt	______	______

Required:
For each account, indicate how it normally should be categorized on a classified statement of financial position. Use CA for current asset, NCA for non-current asset, CL for current liability, NCL for non-current liability, and SE for shareholders' equity. Also indicate whether the account normally has a debit or a credit balance.

■ LO2-3,2-4,2-6 eXcel

P2-2 Determining Financial Statement Effects of Various Transactions, and Interpreting the Current Ratio (AP2-2)

East Hill Home Healthcare Services was organized on January 1, 2019 by four friends. Each organizer invested $2,500 in the company and, in turn, was issued 500 shares. To date, they are the only shareholders. At the end of 2020, the accounting records reflected total assets of $700,000 ($50,000 cash, $500,000 land, $50,000 equipment, and $100,000 buildings), total liabilities of $200,000 (short-term notes payable of $100,000 and long-term notes payable of $100,000), and shareholders' equity of $500,000 ($100,000 contributed capital and $400,000 retained earnings). The following summarized events occurred during January 2021:

a. Sold 9,000 additional shares to the original organizers for a total of $90,000 cash.

b. Purchased a building for $60,000, equipment for $15,000, and four acres of land for $14,000; paid $9,000 in cash and signed a note for the balance (due in 15 years). (*Hint:* Five different accounts are affected.)

c. Sold one acre of land acquired in (*b*) for $3,500 cash to another company.

d. Purchased short-term investments for $18,000 cash.

e. One shareholder reported to the company that he sold 300 East Hill shares to another shareholder for $3,000 cash.

f. Lent $5,000 to one of the shareholders for moving costs, receiving a signed six-month note from the shareholder.

Required:

1. Was East Hill Home Healthcare Services organized as a sole proprietorship, a partnership, or a corporation? Explain the basis for your answer.
2. During January 2021, the records of the company were inadequate. You were asked to prepare the summary of the preceding transactions. To develop a quick assessment of their economic effects on East Hill Home Healthcare Services, you have decided to complete the tabulation that follows and to use plus (+) for increases and minus (−) for decreases for each account. The first event is used as an example.

	Assets						=	Liabilities		+	Shareholders' Equity	
	Cash	Short-term investments	Notes receivable	Land	Building	Equipment		Short-term notes payable	Long-term 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	

3. Did you include the transaction between the two shareholders, event (*e*), in the tabulation? Why or why not?
4. Based only on the completed tabulation, provide the following amounts at January 31, 2021 (show computations):
   a. Total assets
   b. Total liabilities

c. Total shareholders' equity
d. Cash balance
e. Total current assets

5. Compute the current ratio at January 31, 2021. What does this suggest about the company?

■ LO2-4,2-6

eXcel

P2-3 Recording Transactions in T-Accounts, Preparing a Statement of Financial Position from a Trial Balance, and Evaluating the Current Ratio (AP2-3)

Injection Plastics Company has been operating for three years. At December 31, 2020, the accounting records reflected the following:

Cash	$21,000	Intangibles	$ 3,000
Investments (short term)	2,000	Accounts payable	15,000
Accounts receivable	3,000	Accrued liabilities	2,000
Inventories	24,000	Short-term borrowings	7,000
Notes receivable (long term)	1,000	Notes payable (long-term)	48,000
Equipment	48,000	Contributed capital	90,000
Factory building	90,000	Retained earnings	30,000

During the year 2021, the following summarized transactions were completed:

a. Purchased equipment that cost $18,000; paid $6,000 cash and signed a one-year note for the balance.
b. Issued 2,000 additional shares for $12,000 cash.
c. Lent $7,000 to a manager, who signed a two-year note.
d. Purchased short-term investments for $9,000 in cash.
e. Paid $5,000 on the note in transaction (*a*).
f. Borrowed $12,000 cash on December 31, 2021, from the bank and signed a note, payable June 30, 2022.
g. Purchased a patent (an intangible asset) for $3,000 cash.
h. Built an addition to the factory for $25,000; paid $9,000 in cash and signed a three-year note for the balance.
i. Hired a new president at the end of the year. The contract was for $85,000 per year plus options to purchase company shares at a set price based on company performance.
j. Returned defective equipment to the manufacturer, receiving a cash refund of $1,000.

Required:

1. Create a T-account for each of the accounts on the statement of financial position and enter the balances at the end of 2020 as beginning balances for 2021.
2. Record each of the transactions for 2021 in the T-account (including referencing) and determine the ending balances.
3. Explain your response to transaction (*i*).
4. Prepare a trial balance at December 31, 2021.
5. Prepare a classified statement of financial position at December 31, 2021.
6. Compute the current ratio at December 31, 2021. What does this ratio suggest about Injection Plastics Company?

■ LO2-7

P2-4 Identifying Effects of Transactions on the Statement of Cash Flows (AP2-4)

Refer to P2-3.

Required:

Using transactions (*a*) through (*j*) in P2-3, indicate whether each transaction is an investing (I) or a financing (F) activity for the year and the direction of the effect on cash flows (+ for increase and – for decrease). If there is no effect on cash flows, write NE.

■ LO2-5,2-6

eXcel

Apple Inc.

P2-5 Recording Transactions, Preparing Journal Entries, Posting to T-Accounts, Preparing a Statement of Financial Position, and Evaluating the Current Ratio (AP2-5)

Apple Inc., headquartered in Cupertino, California, designs, manufactures, and markets mobile communication and media devices, personal computers, and portable digital music players, and sells a variety of related software and services. The following is Apple's (simplified) statement of financial position from a recent year (fiscal year ended on the last Saturday of September).

APPLE INC.
Statement of Financial Position
At September 29, 2018 (in millions of U.S. dollars)

ASSETS	
Current assets	
Cash and cash equivalents	$ 25,913
Short-term investments	40,388
Accounts receivable	23,186
Inventories	3,956
Other current assets	37,896
Total current assets	**131,339**
Non-current assets	
Long-term investments	170.799
Property, plant, and equipment	41,304
Other non-current assets	22,283
Total non-current assets	**234,386**
Total assets	**$365,725**
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities	
Accounts payable	$ 55,888
Short-term notes payable	20,748
Deferred revenue	7,543
Other current liabilities	32,687
Total current liabilities	**116,866**
Non-current liabilities	
Long-term debt	93,735
Other non-current liabilities	47,977
Total non-current liabilities	**141,712**
Shareholders' equity	
Contributed capital	36,747
Retained earnings	70,400
Total shareholders' equity	**107,147**
Total liabilities and shareholders' equity	**$365,725**

Source: Apple Inc., Annual Report 2018.

Assume that the following transactions (in millions) occurred during the next fiscal year (ended on September 28, 2019):

a. Borrowed $6,266 from banks due in two years.

b. Purchased additional investments for $71,000 cash; one-fifth were long-term and the rest were short-term.

c. Purchased property, plant, and equipment; paid $13,571 in cash and signed a short-term note for $5,410.

d. Issued additional shares for $469 in cash.

e. Sold short-term investments costing $55,810 for $55,810 cash.

f. Declared $13,735 in dividends to be paid at the beginning of the next fiscal year.

Required:

1. Prepare a journal entry for each transaction. Use the account titles in Apple's statement of financial position and show answers in millions of dollars.
2. Create T-accounts for each account and include the September 29, 2018, balances; create a new account, Dividends Payable, with a beginning balance of $0. Post each journal entry to the appropriate T-accounts.
3. Prepare a trial balance at September 28, 2019.

4. Prepare a classified statement of financial position for Apple at September 28, 2019 based on these transactions.
5. Compute Apple's current ratio for the year ending on September 28, 2019. Round your answer to two decimal places. What does this suggest about the company?

■ LO2-7
Apple Inc.

P2-6 Identifying the Investing and Financing Activities Affecting the Statement of Cash Flows (AP2-6)

Refer to P2-5.

Required:

For each of the transactions (*a*) to (*f*), indicate whether the activity is (1) investing (I) or financing (F) and (2) the direction and amount of the effect on cash flows (+ for increases; – for decreases). If the activity does not affect the statement of cash flows, indicate no effect (NE).

■ LO2-6
The Castle Inc.

P2-7 Using Financial Reports: Preparing a Classified Statement of Financial Position, and Analyzing the Current Ratio (AP2-7)

The accounts below, in alphabetical order, are adapted from The Castle Inc.'s statement of financial position (amounts in thousands of dollars):

	Current Year	Prior Year		Current Year	Prior Year
Accounts payable and accrued liabilities	$17,865	$16,133	Inventories	$113,590	$115,357
Accounts receivable	1,180	2,025	Long-term debt	61,132	39,510
Cash	–	1,195	Other non-current liabilities	10,966	12,827
Contributed capital	56,522	52,406	Prepaid expenses and other current assets	1,954	1,698
Deferred revenue	3,216	3,452	Property and equipment, net	48,332	58,091
Intangible assets	3,434	2,961	Retained earnings	3,832	39,577
			Short-term debt	14,957	17,422

Required:

1. Prepare, in good form, a classified statement of financial position (with two years reported) for The Castle Inc. Assume a fiscal year-end of January 31.
2. Compute the company's current ratio for the current year. How would you interpret this ratio for The Castle?

■ LO2-5,2-6

P2-8 Analyzing the Effects of Transactions Using T-Accounts, Preparing a Statement of Financial Position, and Interpreting the Current Ratio over Time as a Bank Loan Officer (AP2-8)

Lee Delivery Company was organized at the beginning of 2020. The following transactions occurred during 2020 (the company's first year of operations):

a. Received $40,000 cash from the organizers in exchange for shares in the new company.
b. Purchased land for $16,000 and signed a one-year note (at a 6 percent annual interest rate).
c. Bought two used delivery trucks for operating purposes at the start of the year at a cost of $10,000 each; paid $5,000 cash and signed a promissory note for the balance, payable over the next three years (at an annual interest rate of 7 percent).
d. Sold one-fourth of the land for $4,000 to Birkins Moving, which promised to pay in six months.
e. Paid $2,000 cash to a truck repair shop for a new motor for one of the trucks. (*Hint:* Increase the account you used to record the purchase of the trucks since the usefulness of the truck has been improved.)
f. Traded the other truck and $6,000 cash for a new one. The old truck's fair value is $10,000.
g. Shareholder Jonah Lee paid $27,500 cash for a vacant lot (land) for his personal use.
h. Collected the amount of the note due from Birkins Moving in (*d*).
i. Paid one-third of the principal of the note due for the delivery trucks in (*c*).

Required:

1. Set up appropriate T-accounts with beginning balances of $0 for cash, short-term notes receivable, land, equipment, short-term notes payable, long-term notes payable, and contributed capital. Using the T-accounts, record the effects of these transactions on Lee Delivery Company.

2. Prepare a classified statement of financial position for Lee Delivery Company at the end of 2020.
3. At the end of the next two years, Lee Delivery Company reported the following amounts on its statements of financial position:

	December 31, 2021	December 31, 2022
Current assets	$52,000	$ 47,000
Non-current assets	38,000	73,000
Total assets	**90,000**	**120,000**
Short-term notes payable	23,000	40,000
Long-term notes payable	17,000	20,000
Total liabilities	**40,000**	**60,000**
Shareholders' equity	**50,000**	**60,000**

Compute the company's current ratio for 2020, 2021, and 2022. What is the trend and what does this suggest about the company?

4. At the beginning of 2023, Lee Delivery Company applied to your bank for a $50,000 short-term loan to expand the business. The vice-president of the bank asked you to review the information and make a recommendation on lending the funds based solely on the results of the current ratio. What recommendation would you make to the bank's vice-president about lending the money to Lee Delivery Company?

ALTERNATE PROBLEMS

■ LO2-2,2-5

CGI Inc.

AP2-1 Identifying Accounts on a Classified Statement of Financial Position and Their Normal Debit or Credit Balances (P2-1)

CGI Inc. is a Canadian corporation that provides information technology and business process services to organizations in many countries. Its services include the management of information technology and business functions, sale of software solutions, and systems integration and consulting. The following are several of the accounts from a recent statement of financial position:

(1) Accounts receivable
(2) Long-term provisions
(3) Contributed capital
(4) Long-term debt
(5) Prepaid expenses and other assets
(6) Intangible assets
(7) Property, plant, and equipment
(8) Retained earnings
(9) Accounts payable and accrued liabilities
(10) Cash and cash equivalents
(11) Goodwill
(12) Other long-term liabilities
(13) Income taxes payable

Required:

Indicate how each account normally should be categorized on a classified statement of financial position. Use CA for current asset, NCA for non-current asset, CL for current liability, NCL for non-current liability, and SE for shareholders' equity. Also indicate whether the account normally has a debit or a credit balance.

■ LO2-3,2-4

AP2-2 Determining Financial Statement Effects of Various Transactions, and Interpreting the Current Ratio (P2-2)

Adamson Inc. is a small manufacturing company that makes model trains to sell to toy stores. It has a small service department that repairs customers' trains for a fee. The company has been in business for five years. At December 31, 2019 (the company's fiscal year-end), the accounting records reflected total assets of $500,000 (cash, $120,000; equipment, $70,000; buildings, $310,000), total liabilities of $200,000 (short-term notes payable, $140,000; long-term notes payable, $60,000), and total shareholders' equity of $300,000 (contributed capital, $220,000; retained earnings, $80,000). During the current year, 2020, the following events (summarized) occurred:

a. Borrowed $110,000 cash from the bank and signed a 10-year note.

b. Purchased equipment for $30,000, paying $3,000 in cash and signing a note due in six months for the balance.

c. Issued 10,000 shares for $100,000 cash.

d. Purchased a delivery truck (equipment) for $10,000; paid $5,000 cash and signed a short-term note payable for the remainder.

e. Lent $2,000 cash to the company president, Clark Adamson, who signed a note promising to pay the amount and annual interest at the rate of 10 percent in one year.

f. Built an addition on the factory for $200,000 and paid cash to the contractor.

g. Purchased $85,000 in long-term investments.

h. Returned a $3,000 piece of equipment purchased in (*b*) because it proved to be defective; received a reduction of the note payable equal to the value of the defective equipment.

i. A shareholder sold $5,000 of her shares in Adamson Inc. to her neighbour for $6,400.

Required:

1. Prepare a summary of the preceding transactions. To develop a quick assessment of the transaction effects on Adamson Inc., you have decided to complete the tabulation that follows and to use plus (+) for increases and minus (−) for decreases for each account. The first transaction is used as an example.

	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			

2. Did you include all transactions in the tabulation? If not, which one did you exclude and why?
3. Based on beginning balances plus the completed tabulation, calculate the following amounts at the end of 2020 (show computations):
   a. Total assets
   b. Total liabilities
   c. Total shareholders' equity
   d. Cash balance
   e. Total current assets
4. Compute the company's current ratio at the end of the year. What does this ratio suggest to you about Adamson Inc.?

■ LO2-5,2-6

AP2-3 Recording Transactions in T-Accounts, Preparing a Statement of Financial Position, and Evaluating the Current Ratio (P2-3)

Modern Interiors Inc. is a leading interior design company and manufacturer and retailer of home furnishings. The following is adapted from Modern Interiors's recent annual financial statements for fiscal year ended on June 30. Dollar amounts are in thousands.

Cash and cash equivalents	$ 57,701	Accounts payable	$ 16,961
Accounts receivable	12,293	Accrued liabilities	43,793
Inventories	149,483	Deferred revenue	62,960
Prepaid expenses and other current assets	23,621	Long-term debt	14,339
Property, plant, and equipment	270,198	Other non-current liabilities	29,273
Intangible assets	45,128	Contributed capital	43,051
Long-term investments	7,330	Retained earnings	357,845
Other non-current assets	2,468		

Assume that the following transactions ($ in thousands) occurred in the first quarter ended September 30 of the fiscal year:

a. Issued 1,600 additional shares for $1,020 in cash.

b. Purchased $3,400 in additional intangibles for cash.

c. Ordered $43,500 in wood and other raw materials for the manufacturing plants.

d. Sold equipment at its cost for $4,020 cash.

e. Purchased $2,980 in long-term investments for cash.

f. Purchased property, plant, and equipment; paid $1,830 in cash and signed additional long-term notes for $9,400.

g. Sold at cost other assets for $310 cash.

h. Declared $300 in dividends, payable in October.

Required:

1. Create T-accounts for each of the accounts listed above, including a new account Dividends Payable. Enter the balances at June 30 as the beginning balances for the quarter (in thousands of dollars).
2. Record each of the transactions for the first quarter ended September 30 in the T-accounts (including referencing) and determine the ending balances.
3. Explain your response to event (*c*).
4. Prepare a trial balance at September 30.
5. Prepare a classified statement of financial position at September 30. The company's accountant determined that $2,731 of long-term debt must be paid during the next fiscal year.
6. Compute the current ratio at September 30. Round your answer to two decimal places. What does this suggest about Modern Interiors Inc.?

■ LO2-7

AP2-4 Identifying Effects of Transactions on the Statement of Cash Flows (P2-4)

Refer to AP2-3.

Required:

Using transactions (*a*) through (*i*) in AP2-3, indicate whether each transaction is an investing (I) or financing (F) activity for the year and the direction of the effect on cash flows (+ for increase and – for decrease). If there is no effect on cash flows related to investing or financing, write NE.

■ LO2-5,2-6

excel

BCE Inc.

AP2-5 Recording Transactions, Preparing Journal Entries, Posting to T-Accounts, Preparing a Statement of Financial Position, and Evaluating the Current Ratio (P2-5)

BCE Inc., Canada's largest communications company, provides a comprehensive and innovative suite of broadband communications and content services to consumer, residential, business, and government customers in Canada. The following is BCE's (simplified) statement of financial position from a recent year:

BCE INC.
Statement of Financial Position
At December 31, 2018
(in millions of Canadian dollars)

ASSETS	
Current assets	
Cash	$ 425
Trade and other receivables	3,006
Inventory	432
Prepaid expenses	244
Other current assets	1,686
Total current assets	**5,793**
Non-current assets	
Property, plant, and equipment, net	24,844
Long-term investments	798
Intangible assets	13,205
Goodwill	10,658
Other non-current assets	1,802
Total assets	**$57,100**
LIABILITIES AND SHAREHOLDERS' EQUITY	
Current liabilities	
Trade payables and other liabilities	$ 3,941
Interest payable	196
Current tax liabilities	253
Dividends payable	691
Debt due within one year	4,645
Other current liabilities	703
Total current liabilities	**10,429**

BCE INC. **Statement of Financial Position** **At December 31, 2018** **(in millions of Canadian dollars)**	
Non-current liabilities	
Long-term debt	19,760
Other non-current liabilities	6,222
Total liabilities	**36,411**
Shareholders' equity	**20,689**
Total liabilities and shareholders' equity	**$57,100**

Source: BCE Inc., Annual Report 2018.

Assume that the following transactions (in millions of dollars) occurred in fiscal year 2019 (ended on December 31, 2019):

a. Issued additional shares for $200 in cash.
b. Borrowed 6,300 from creditors; due in 10 years.
c. Purchased additional investments for $1,500 cash; one-fifth were long-term and the rest were short-term.
d. Purchased property, plant, and equipment; paid $4,650 in cash and $850 with additional long-term bank loans.
e. Lent $250 to associated companies that signed a six-month note.
f. Sold short-term investments costing $200 for $200 cash.

Required:

1. Prepare a journal entry for each transaction.
2. Create a T-account for each item on the statement of financial position and include the December 31, 2019 balances. Post each journal entry to the appropriate T-account.
3. Prepare a trial balance as at December 31, 2019.
4. Prepare a statement of financial position for BCE based on the T-account ending balances at December 31, 2019.
5. Compute BCE's current ratio for fiscal year 2019. What does this suggest about the company?

■ LO2-7

BCE Inc.

AP2-6 Preparing the Investing and Financing Sections of a Statement of Cash Flows (P2-6)
Refer to AP2-5.

Required:
For each of the transactions (*a*) to (*f*), indicate whether the activity is (1) investing (I) or financing (F) and (2) the direction and amount of the effect on cash flows (+ for increases; – for decreases). If the activity does not affect the statement of cash flows, indicate no effect (NE).

■ LO2-6

AP2-7 Using Financial Reports: Preparing a Classified Statement of Financial Position, and Analyzing the Current Ratio (P2-7)
The accounts below, in alphabetical order, are adapted from a recent statement of financial position for Big Burgers Inc. (amounts are in thousands of dollars):

	Current Year	**Prior Year**		**Current Year**	**Prior Year**
Accounts and notes receivable	$ 795.9	$ 745.5	Long-term debt	$ 8,937.4	$ 8,357.3
Accrued liabilities	2,344.2	2,144.0	Notes payable (short term)	544.0	–
Cash and cash equivalents	4,260.4	1,379.8	Other long-term liabilities	1,869.0	1,758.2
Contributed capital	2,814.2	2,202.6	Other non-current assets	1,245.0	1,338.4
Current maturities of long-term debt	658.7	862.2	Prepaid expenses and other current assets	646.4	585.0
Intangible assets, net	1,950.7	1,828.3	Property and equipment, net	20,108.0	20,903.1
Inventories	147.0	147.5	Retained earnings	12,331.9	11,998.9
Long-term investments	1,035.4	1,109.9	Accounts payable	689.4	714.3

Required:

1. Construct, in good form, a classified statement of financial position (with two years reported) for Big Burgers Inc.
2. Compute the company's current ratio at the end of the current year. How do you interpret this ratio for Big Burgers?

■ LO2-5,2-6

AP2-8 **Analyzing the Effects of Transactions by Using T-Accounts, Preparing a Statement of Financial Position, and Interpreting the Current Ratio as a Bank Loan Officer (P2-8)**

Chu Delivery Company was organized in 2021. The following transactions occurred during 2021:

a. Received $40,000 cash from organizers in exchange for shares in the new company.

b. Purchased land for $12,000, signing a one-year note.

c. Bought two used delivery trucks for operating purposes at the start of the year at a cost of $10,000 each; paid $4,000 cash and signed a note due in three years for the rest (ignore interest).

d. Sold one-fourth of the land for $3,000 to Pablo Moving, which signed a six-month note.

e. Paid $1,000 cash to a truck repair shop for a new motor for one of the trucks. (*Hint:* Increase the account you used to record the purchase of the trucks since the productive life of the truck has been improved.)

f. Shareholder Jingbi Chu paid $27,600 from her personal savings to purchase a vacant lot (land) for her personal use.

Required:

1. Set up appropriate T-accounts with beginning balances of zero for cash, short-term notes receivable, land, equipment, short-term notes payable, long-term notes payable, and contributed capital. Using the T-accounts, record the effects of these transactions by Chu Delivery Company.
2. Prepare a classified statement of financial position for Chu Delivery Company at December 31, 2021.
3. At the end of the next two years, Chu Delivery Company reported the following amounts on its statements of financial position:

	December 31, 2022	December 31, 2023
Current assets	$42,000	$ 47,000
Non-current assets	38,000	53,000
Total assets	**80,000**	**100,000**
Short-term notes payable	23,000	40,000
Long-term notes payable	17,000	10,000
Total liabilities	**40,000**	**50,000**
Shareholders' equity	**40,000**	**50,000**

   Compute the company's current ratio for 2021, 2022, and 2023. What is the trend and what does this suggest about the company?

4. At the beginning of 2024, Chu Delivery Company applied to your bank for a $100,000 loan to expand the business. The vice-president of the bank asked you to review the information and make a recommendation on lending the funds based solely on the results of the current ratio. What recommendation would you make to the bank's vice-president about lending the money to Chu Delivery Company?

CONTINUING PROBLEM

■ LO2-5,2-6,2-7

CON2-1 **Accounting for the Establishment of a New Business (the Accounting Cycle)**

Penny Cassidy has decided to start a business called Penny's Pool Service & Supply Inc. (PPSS). Here are some of PPSs's transactions that occurred in March 2019.

a. Received $25,000 cash and a large delivery van with a value of $36,000 from Penny, who was given 4,000 shares in exchange.

b. Purchased land with a small office and warehouse by paying $10,000 cash and signing a 10-year mortgage note payable to the local bank for $80,000. The land has a value of $18,000 and the building's value is $72,000. Use separate accounts for land and buildings.

c. Purchased a new computer from Dell for $2,500 cash and office furniture for $4,000, signing a short-term note payable in six months.

d. Hired a receptionist for the office at a salary of $2,500 per month, starting in April 2019.

e. Paid $1,000 on the note payable to the bank at the end of March 2019 (ignore interest).

f. Purchased short-term investments in shares of other companies for $5,000 cash.

g. Ordered $10,000 in inventory from Pool Corporation, a pool supply wholesaler, to be received in April 2019.

Required:

1. For each of the events, prepare journal entries if a transaction of the business exists, checking that debits equal credits. If a transaction does not exist, explain why there is no transaction for the business.
2. Create T-accounts, and post each of the transactions to determine balances at March 31, 2019. Because this is a new business, beginning balances are $0.
3. Prepare a trial balance on March 31, 2019, to check that debits equal credits after the transactions are posted to the T-accounts.
4. From the trial balance, prepare a classified statement of financial position (with current assets and current liabilities sections) at March 31, 2019 (before the beginning of operations in April).
5. For each of the events, indicate if it is an investing activity (I) or financing activity (F), and the direction (+ for increases; – for decreases) and amount of the effect on cash flows using the following structure. Write NE if there is no effect on cash flows.

	Type of Activity (I, F, or NE)	Effect on Cash Flows (+ or – and amount)
(*a*)		
(*b*) etc.		

6. Calculate the current ratio at March 31, 2019. What does this ratio indicate about the ability of PPSS to pay its current liabilities?

CASES AND PROJECTS

FINDING AND INTERPRETING FINANCIAL INFORMATION

■ LO2-1,2-2,2-3,2-4,2-7

CP2-1

METRO Inc.

Finding Financial Information

Refer to the financial statements and the accompanying notes of METRO Inc. in Appendix A at the end of this book.

Required:

1. Is the company a corporation, a partnership, or a proprietorship? How do you know?
2. Use the company's statement of financial position to determine the amounts in the accounting equation (A = L + SE).
3. The company shows on the statement of financial position that merchandise inventories are reported at $1,099.1 million. Does this amount represent the expected selling price? Why or why not?
4. What is the company's fiscal year-end? Where did you find the exact date?
5. What are the company's non-current liabilities?
6. Compute the company's current ratio, and explain its meaning.
7. How much cash did the company spend on purchasing property and equipment in fiscal years 2017 and 2018 (capital expenditures)? Where did you find the information?

■ LO2-1,2-2,2-3,2-4,2-7

CP2-2

Empire Company Limited

Finding Financial Information

Go to *Connect* for the financial statements of Empire Company Limited and related notes.

Required:

1. Use the company's statement of financial position to determine the amounts in the accounting equation (A = L + SE) as at May 5, 2018.
2. If the company were liquidated at the end of the current year (May 5, 2018), are the shareholders guaranteed to receive $3,769.8 million?
3. What are the company's non-current liabilities?
4. What is the company's current ratio? Round your answer to two decimal places.
5. Did the company have a cash inflow or outflow from investing activities? How much?

■ LO2-3,2-7

CP2-3

METRO Inc. vs. Empire Company Limited

Comparing Companies within an Industry

Refer to the financial statements and the accompanying notes of METRO Inc. (Appendix A) and Empire Company Limited (*Connect*) and the Industry Ratio Report (Appendix B) on *Connect*.

Required:

1. Which company is larger in terms of total assets?
2. Compute the current ratio for both companies. Compared to the industry average (from the Industry Ratio Report), are these two companies more or less able to satisfy short-term obligations with current assets? Explain.
3. In the most recent year, how much cash, if any, was spent buying back (repurchasing) each company's own common shares?
4. How much did each company pay in dividends for the most recent year?
5. What account title does each company use to report any land, buildings, and equipment it may have?

FINANCIAL REPORTING AND ANALYSIS CASES

■ LO2-6,2-7

CP2-4

Broadening Financial Research Skills: Locating Financial Information on the SEDAR Database

The Securities Commissions regulate companies that issue shares on the stock market. They receive financial reports from public companies electronically under a system called SEDAR (System for Electronic Document Analysis and Retrieval). Using the Internet, anyone may search the database for the reports that have been filed.

Using your Web browser, access the SEDAR database at **www.sedar.com**. To search the database, select English, then Issuer Profiles; click on the letter T under Companies to get a list of all company names that start with T. Select Thomson Reuters Corporation (TRC), then click on "View this company's documents" at the lower left corner of the next screen.

Required:

1. To look at SEDAR filings, click on the most recent Interim financial statements/report—English. Then locate the consolidated statement of financial position.
   a. What was the amount of TRC's total assets at the end of the most recent quarter reported?
   b. Did long-term debt increase or decrease for the quarter?
   c. Compute the current ratio. What does this suggest about the company?
2. Look at the consolidated statement of cash flow in the interim report.
   a. What amount did TRC spend on capital expenditures for the most recent quarter reported?
   b. What was the total amount of cash flows from (used in) financing activities for the most recent quarter reported?

■ LO2-1,2-2,2-6

CP2-5

Using Financial Reports: Evaluating the Reliability of a Statement of Financial Position

Betsey Jordan asked a local bank for a $50,000 loan to expand her small company. The bank asked Betsey to submit a financial statement of the business to supplement the loan application. Betsey prepared the following statement of financial position:

Statement of Financial Position
At June 30, 2020

Assets	
Cash and investments	$ 9,000
Inventory	30,000
Equipment	46,000
Personal residence (monthly payments, $2,800)	300,000
Other assets	20,000
Total assets	**$405,000**
Liabilities	
Short-term debt to suppliers	$ 62,000
Long-term debt on equipment	38,000
Total debt	100,000
Shareholders' equity	**305,000**
Total liabilities and shareholders' equity	**$405,000**

Required:

1. The statement of financial position has several flaws. However, there is at least one major deficiency. Identify it and explain its significance.
2. As a bank manager, would you lend the company money? Explain.

■ LO2-6

CP2-6 **Using Financial Reports: Analyzing the Statement of Financial Position**

Smiley Corp. and Tsang Inc. were organized in 2005. Both companies operate in the same line of business. The statements of financial position of the two companies at December 31, 2020, are as follows:

SMILEY CORP.
Statement of Financial Position
December 31, 2020

Assets	
Cash	$ 17,000
Accounts receivable	30,000
Inventory	16,000
Property, plant, and equipment	117,600
Total	$180,600
Liabilities and Shareholders' Equity	
Liabilities:	
Notes payable (short-term)	$ 18,600
Accounts payable	14,400
Total liabilities	33,000
Shareholders' equity:	
Contributed capital	90,000
Retained earnings	57,600
Total shareholders' equity	147,600
Total	$180,600

TSANG INC.
Statement of Financial Position
December 31, 2020

Assets	
Cash	$ 7,200
Accounts receivable	14,400
Inventory	7,600
Property, plant, and equipment	244,400
Total	$273,600
Liabilities and Shareholders' Equity	
Liabilities:	
Notes payable (short-term)	$ 33,600
Accounts payable	64,800
Total liabilities	98,400
Shareholders' equity:	
Contributed capital	108,000
Retained earnings	67,200
Total shareholders' equity	175,200
Total	$273,600

Required:

1. Eric Frechette wants to invest in one of these two companies by purchasing all of its shares. As a financial adviser to Mr. Frechette, which company would you select as an investment? Provide justification for your selection.
2. Each company applied to Development Bank for a loan of $20,000, payable in four months. As a bank loan officer, would you lend each company the requested amount? Explain.

■ LO2-6

CP2-7 **Using Financial Reports: Analyzing the Statement of Financial Position**

Recent balance sheets are provided for Twitter, Inc., a global platform for real-time public self-expression and conversation. Show your answers in millions of dollars.

TWITTER, INC.
Consolidated Balance Sheets*
(in millions of U.S. dollars)

	December 31, 2017	December 31, 2016
ASSETS		
Current assets		
Cash and cash equivalents	$1,638	$ 988
Short-term investments	2,765	2,786
Accounts receivable	664	651
Prepaid expenses and other current assets	255	227
Total current assets	5,322	4,652
Property and equipment, net	774	784
Intangible assets, net	1,239	1,280
Other non-current assets	78	154
Total assets	$7,412	$6,870

TWITTER, INC.
Consolidated Balance Sheets*
(in millions of U.S. dollars)

	December 31, 2017	December 31, 2016
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 171	$ 122
Accrued and other current liabilities	327	381
Capital leases, short-term	85	81
Total current liabilities	583	584
Notes payable	1,628	1,539
Capital leases, long-term	81	67
Other long-term liabilities	73	75
Total liabilities	2,365	2,265
Stockholders' equity		
Contributed capital	7,750	7,225
Accumulated deficit	(2,703)	(2,620)
Total stockholders' equity	5,047	4,605
Total liabilities and stockholders' equity	$7,412	$6.870

*These statements have been simplified for instructional purposes.
Source: Twitter, Inc.

Required:

1. Is Twitter a corporation, sole proprietorship, or partnership? Explain the basis of your answer.
2. Use the company's balance sheet (statement of financial position) to determine the amounts in the accounting equation (A = L + SE) at the end of the most recent year.
3. Calculate the company's current ratio on December 31, 2017 and on December 31, 2016 (round your answers to two decimal places). Interpret the ratios that you calculated. What other information would make your interpretation more useful?
4. Prepare the journal entry the company will make in 2018 assuming it pays its December 31, 2017 accounts payable balance in full.
5. Does the company appear to have been profitable over its years in business? On what account are you basing your answer? Assuming no dividends were paid, how much was net earnings (or net loss) in millions of dollars in the most recent year? If it is impossible to determine without a statement of earnings, state so.

CRITICAL THINKING CASES

■ LO2-1,2-2,2-6 **CP2-8** **Making a Decision as a Financial Analyst: Preparing and Analyzing a Statement of Financial Position**

excel

Your best friend from home writes you a letter about an investment opportunity that has come her way. A company is raising money by issuing shares and wants her to invest $20,000 (her recent inheritance from her great-aunt's estate). Your friend has never invested in a company before and, knowing that you are a financial analyst, asks that you look over the statement of financial position and send her some advice. An *unaudited* statement of financial position, in only moderately good form, is enclosed with the letter:

DEWEY, CHEETUM, AND HOWE INC.
Statement of Financial Position
For the Year Ending December 31, 2021

Accounts receivable	$ 8,000
Cash	1,000
Inventory	8,000
Furniture and fixtures	52,000
Delivery truck	12,000
Buildings (estimated market value)	98,000
Total assets	$179,000

DEWEY, CHEETUM, AND HOWE INC. Statement of Financial Position For the Year Ending December 31, 2021	
Accounts payable	$ 16,000
Payroll taxes payable	13,000
Long-term notes payable	15,000
Mortgage payable	50,000
Total liabilities	94,000
Contributed capital	80,000
Retained earnings	5,000
Total shareholders' equity	85,000
Total liabilities and shareholders' equity	$179,000

There is only one footnote, and it states that the building was purchased for $65,000, has been depreciated by $5,000 on the books, and still carries a mortgage (shown in the liability section). The footnote further states that, in the opinion of the company president, the building is "easily worth $98,000."

Required:

1. Draft a new statement of financial position for your friend, correcting any errors you note. (If any of the account balances need to be corrected, you may need to adjust the balance of retained earnings accordingly.) If no errors or omissions exist, say so.
2. Write a letter to your friend explaining the changes you made to the statement of financial position, if any, and offer your comments on the company's apparent financial condition based only on this information. Suggest other information your friend might want to review before coming to a final decision on whether to invest.

■ LO2-3,2-4,2-6 **CP2-9** **Manipulating Financial Statements: Ethical Considerations**

Technology N Motion is a publicly traded company that is facing financial difficulties. To survive, the company needs large new bank loans. As the chief financial officer of the company, you approached several banks, but each has asked for your audited financial statements for 2017, the most recent fiscal year. You called for a meeting with other corporate officers to discuss how the financial statements could be improved. The suggestions made by your colleagues include the following:

a. "We owe $20 million to our suppliers. We could show half this amount as a liability on our statement of financial position and report the other half as contributed capital. This will improve our financial position."

b. "We own land that is worth at least $8 million in today's market, but it cost us only $3 million when we bought it. Why not show the land at $8 million on the company's statement of financial position, which increases both the total assets and shareholders' equity by $5 million?"

c. "We owe FirstRate Software $2 million, due in 30 days. I can ask their chief financial officer to let us delay the payment of this debt for a year, and our company could sign him a note that pays 8 percent interest."

Required:

Evaluate each of these three proposals to improve Technology N Motion's financial statements by considering both accounting and ethical issues.

■ LO2-3 **CP2-10** **Evaluating an Ethical Dilemma: Analyzing Management Incentives**

Biovail Corporation

In March 2008, the Securities and Exchange Commission (SEC) sued Canadian pharmaceutical company Biovail Corporation and some of its former officers for accounting fraud. The SEC alleged that "present and former senior Biovail executives, obsessed with meeting quarterly and annual earnings guidance, repeatedly overstated earnings and hid losses in order to deceive investors and create the appearance of achieving earnings goals. When it ultimately became impossible to continue concealing the company's inability to meet its own earnings guidance, Biovail actively misled investors and analysts about the reasons for the company's poor performance" (Source: www.sec.gov/news/press/2008/2008-50.htm). Biovail settled for $10 million; in 2009, Biovail Corporation merged with Valeant Pharmaceuticals International, Inc. that has its corporate headquarters in Laval, Quebec.

Required:

1. Describe the parties who were harmed or helped by this fraud.
2. Explain how greed may have contributed to the fraud.

■ LO2-3 **CP2-11** **Evaluating an Ethical Dilemma: Analyzing Management Incentives**

Nortel Networks Corporation

Nortel Networks Corporation (Nortel), based in Brampton, Ontario, is a global supplier of networking solutions and services. In 2005, the company released the findings of an independent review as a result of continuing problems with its accounting. The review revealed that three former company executives, the chief executive officer, the chief financial officer, and the controller, used accounting practices that increased reported earnings from late 2002 to mid-2003. Through Nortel's internal investigation, several problems had become known, not the least of which was $900 million of inappropriately reported liabilities and approximately $250 million of overstated net earnings. This mattered to the executives who received a bonus if earnings before tax exceeded specific levels.

In April 2004, Nortel issued a news release announcing the appointment of its new chief executive officer (CEO), Mr. William Owens, and the termination of its previous CEO for cause. The previous CEO left his position on April 28 and left the company's board of directors on May 21, 2004. Neither the chair of the board of directors nor the new CEO would comment on the termination. A month earlier, the chief financial officer and the controller had been put on paid leave of absence and they too were fired. A day later, the U.S. Securities and Exchange Commission announced that it was investigating Nortel. Then the Ontario Securities Commission launched its own investigation. But the worst was yet to come.

In May 2004, a U.S. federal grand jury subpoenaed Nortel for accounting records and other documents prepared for the previous four years during which the previous CEO, an accountant, had served as chief financial officer. A few days later, the Ontario Public Service Employees Union Pension Trust filed a class action lawsuit to recover losses arising from its investment in Nortel shares between April 2003 and April 2004, based on fraudulent financial information. By August 2004, the Royal Canadian Mounted Police began a Canadian criminal investigation into the former CEO's activities. The cost to Nortel has been over $2.4 billion in cash awarded to the Ontario pension fund in April 2005, and the company sued the former CEO to recover this money from him personally. Pursuant to the independent review, 12 senior executives agreed to repay a total of $8.6 million in bonuses they received from the company in the past.

Required:

1. Describe the parties that were harmed or helped by this fraud.
2. Explain how greed may have contributed to this fraud.
3. Why do you think the independent auditors failed to catch the fraud?

FINANCIAL REPORTING AND ANALYSIS TEAM PROJECT

■ LO2-3,2-7 **CP2-12** **Team Project: Analyzing the Statement of Financial Position and Ratios**

As a team, select an industry to analyze. A list of companies classified by industry can be obtained by accessing **www.fpinfomart.ca** through the library services at your college or university and then selecting Industry Reports on the left-hand side. Each industry includes a list of companies within that industry. You can also find a list of industries and companies within each industry via **ca.finance.yahoo.com**. A list of industries can be obtained by clicking on Industry News.

Each group member should acquire the annual report for a different publicly traded company in the industry. (Library files, the SEDAR service at **www.sedar.com**, and the company's website are good sources.)

Required:

Each team member should write a short report answering the following questions about the selected company. Discuss any patterns that you as a team observe. Then, as a team, write a short report comparing and contrasting your companies.

1. For the most recent year, what are the top three asset accounts by size? What percentage is each account of the total assets (calculated as Asset A ÷ Total Assets)?
2. What are the major investing and financing activities (by dollar size) for the most recent year? (Look at the statement of cash flows.)

3. Perform a ratio analysis.
   a. What does the current ratio measure in general?
   b. Compute the current ratio for the past three years. (You may find prior years' information in the section in the annual report called "Selected Financial Information," or search for prior years' annual reports.)
   c. What do your results suggest about the company?
   d. If available, find the industry ratio for the most recent year, compare it to your results, and discuss why you believe your company differs from or is similar to the industry ratio.

SOLUTIONS TO SELF-STUDY QUIZZES

Self-Study Quiz 2-1
Column 1: CL, CA, CA. Column 2: NCL, SE, CL. Column 3: NCA, NCA, CA.

Self-Study Quiz 2-2
(*g*) Cash (A) is received +20. The trade supplier's written promise to pay is "given back" (paid off); Notes receivable (A) −20. The equation remains the same because assets increase and decrease by the same amount.

(*h*) Cash (A) is given −14. Gildan's written promise to the bank is "given back" (paid); Long-term debt −14. There is a $14 decrease on the left side of the equation and a $14 decrease on the right side.

If your answers did not agree with these, go back and make sure that you have completed each of the steps for each transaction.

Self-Study Quiz 2-3
Column 1: cr, dr, dr. Column 2: cr, cr, cr. Column 3: dr, dr, dr.

Self-Study Quiz 2-4
(*g*) Journal entry:

Cash (+A)	20	
Notes receivable (−A)		20

(*h*) Effects on the accounting equation:

Assets		=	Liabilities		+	Shareholders' Equity
Cash	−14		Long-term debt	−14		

Posting to ledger accounts:

Cash: (*g*) 20; (*h*) 14 Notes receivable: (*g*) 20 Long-term debt: (*h*) 14

Ending balance of Retained earnings = $1,720

Self-Study Quiz 2-5
Current ratio:

January 28, 2018	$570 ÷ $721 = 0.79
January 29, 2017	$559 ÷ $513 = 1.09
January 31, 2016	$617 ÷ $227 = 2.72

Dollarama's current ratio decreased from 2.72 to 0.79 within two years. Its liquidity appears to be deteriorating due to the significant increase in its current liabilities. While this may be a cause of concern, a careful examination of the current liabilities is essential to identify the main sources of the increase. The decrease of the ratio to 0.79 at January 28, 2018 may be temporary if Dollarama has debt obligations that must be paid in the short term. This is a typical scenario when a company has long-term debt that is reclassified to short-term as time passes, causing an increase in current liabilities.

Self-Study Quiz 2-6
1. F −, 2. I +, 3. F −, 4. I −, 5. F +

ENDNOTES

1. Gildan reports its financial information in U.S. dollars instead of Canadian dollars because most of its dealings with other parties are in U.S dollars.
2. International Accounting Standards Committee (2018). Conceptual Framework for Financial Reporting. Adopted by the International Accounting Standards Board.
3. In the original conceptual frameworks produced by the FASB and the IASB, verifiability was considered a component of reliability, which also encompassed accuracy and freedom from bias. In the revised conceptual framework, reliability has been replaced with faithful representation as the second fundamental qualitative characteristic. A critical review of the primary qualitative characteristics and their relative significance for performance evaluation and investment and credit decisions is provided in Patricia C. O'Brien, "Changing the Concepts to Justify the Standards," *Accounting Perspectives* 8, No. 4 (2009): 263–275, and in Patricia C. O'Brien and William R. Scott, "Contracting Theory," *CA Magazine* 145, No. 3 (2012): 44–46.
4. To help users better understand the contents of its financial reports, IBM, for example, includes on its website (**www.ibm.com**) a glossary of terms and provides basic explanations of the information contained in financial statements.
5. Canadian Securities Administrators, "National Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings (NI 52-109)" (October 2008). Accessed February 2019, from the OSC website, www.osc.gov.on.ca/en/home.htm.
6. Fair value is the price that would be received to sell an asset in an orderly transaction between the entity and an external party at the measurement date.
7. The basic rules for consolidation of financial statements are covered in Chapter 13.
8. From this concept, accountants have developed what is known as the *double-entry system* of recordkeeping.
9. Contracts of this nature that are likely to result in significant future liabilities must be noted in the financial statements as commitments.
10. Source: www.sas.com/en_us/insights/analytics/big-data-analytics.html#.
11. CPA Canada's website at **www.cpacanada.ca/en/career-and-professional-development/webinars/core-areas/management-accounting/management-reporting-needs-and-systems/data-landscape-of-the-future**. Accessed September 2, 2019.
12. In homework assignments, if you have an error in your trial balance (the two column totals are not equal), errors can be traced and should be corrected. To find errors, reverse your steps. Check that:
    - You copied the ending balances in all of the T-accounts (both the amount and whether it is a debit or a credit) correctly to the trial balance.
    - You computed the ending balances in the T-accounts correctly.
    - You posted the transaction effects correctly from the journal entries to the T-accounts (amount, account, and whether a debit or credit).
    - You prepared the journal entries correctly (amount, account, and whether a debit or credit).