ACCT2111H Introductory Financial Accounting

2021-2022 2nd Term

Suggested Solution

Question 1

A.

Eurasia Travel Equipment
Statement of Cash Flows
Year ended December 31, 2015

	€	€
Cash flows from operating activities		
Net income		76000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation expense	25000	
Decrease in accounts receivable	15000	
Decrease in inventory	60000	
Increase in prepaid expenses	(900)	
Increase in accounts payable	13000	
Decrease in accrued liabilities	(81000)	
Net cash provided by operating activities		31100
Cash flows from investing activities		
Acquisition of PPE	(170000)	
Sale of land	25000	
Net cash used in investing activities		(145000)
Cash flows from financing activities		
Issuance of shares	90000	
Payment of long-term note payable	(17000)	
Payment of dividends	(12000)	
Net cash provided by operating activities		61000
Net increase in cash		23100
Cash at December 31, 2014		6900
Cash at December 31, 2015		€30000

B.

Free cash flow

= 31100 – 170000

= -€138900

Cash realization ratio

$= \frac{31100}{76000}$

= 0.41

Cash flows from operating activities:

The cash realization ratio is 0.41, which is lower than 1. The company may have a problem in realizing cash from profit.

Cash flows from investing activities:

The company has a negative cash flow for this category due to purchase of PPE. This may result in increase in future cash flow.

Cash flows from financing activities:

The cash flow from issuance of shares can cover up the repayment of notes payable and payment of cash dividend. The company has a good ability to raise funds from issuing shares.

The company has an overall positive cash flow but has a rather poor ability to generate cash from operating activities.

C.

Information about the historic cash flows of the company can be used to project of future cash flows. In addition, statement of cash flows provides useful information about the cash-generating abilities of the company's core activity and helps in analyzing the operating, investing and solvency of the company.

Due to its emphasis on profit, the company may have boosted its sales, resulting in holding a large amount of accounts receivable. As debtors have not made the payment yet, the company does not have enough money to repay the loans.

However, the amount of accounts receivable and inventory have reduced, while the company may have delayed payments to accounts payable which has caused an increase in accounts payable. These all led to an improvement in cash flow from 2014 to 2015 with increased cash in hand.

Question 2

A.

Journal

Account Titles and Explanation	Dr.	Cr.
	$	$
Cash (450000 * 0.3)	135000	
Notes receivable (450000 * 0.7)	315000	
Sales revenue		450000
To record the sales revenue.		
Warranty expense	29000	
Provision for warranty repairs		29000
To accrue the warranty expense.		
Provision for warranty repairs	20000	
Cash		20000
To record the warranty payments.		

B.

Provision for Warranty Repairs

	$		$
Cash	20000	Beginning balance	11000
		Warranty expense	29000
		Ending balance	20000

Therefore, the company still owes $20000 to its customers.

C.

The amount of warranty expense is $29000.

Matching concept is applied.

Matching concept matches the warranty expense against sales within the same period. An estimated amount of warranty expense is recorded in the Income Statement in the year of sales, while the warranty payment is an actual amount that customers claim in current year. Therefore, warranty expense for the year does not equal to the year's cash payments for the warranties.

Question 2 (Cont'd)

D.

The cost of the contingent liabilities cannot be estimated, or the probability of not needing to pay is high.

E.

(a) The company needs to follow business law and other relevant requirements such as IAS 37 regarding the disclosure of the contingent liabilities.

(b) The company is responsible for letting shareholders, investors and other stakeholders know the latest financial position of the company.

(c) The share price may be adversely affected due to the negative market's expectation of the company.

Question 3

A.

When the proceeds of the sale of old PPE was greater than the net book value of the old PPE, the company had a gain on the sale of old PPE.

When the proceeds of the sale of old PPE was smaller than the net book value of the old PPE, the company had a loss on the sale of old PPE.

There is a loss on the sale of old PPE of €0.3 billion (0.3-(1.1-0.5)).

B.

European Great Wall
Balance Sheet
Year ended December 31, 2016

	€ '000000000	€ '000000000
Non-current Assets		
Property, Plant and Equipment		
Cost (5-1.1+1.6)	5.5	
Less: Accumulated Depreciation (3.5+2-0.5)	(5)	
		0.5

Therefore, the book value of PPE is €0.5 billion.

C.

Goodwill = P-(A-L)

P represents the purchase price of the company, A represents the fair market value of assets of the company, L represents the fair market value of liabilities of the company.

Goodwill that has indefinite life will be recorded in the balance sheet and is subject to impairment test. Goodwill that has definite life will be amortized every year until its net book value equals 0. An amortization expense will be recorded in the Income Statement.

Question 4

A.

The proportionate ownership remains unchanged since the share dividend is distributed according to the proportion of the ownership of shares.

B.

Cash dividends that were received last year

= 10000 * 0.825

= €8250

Cash dividends that will be received

= 10000 * 1.1 * 0.75

= €8250

C.

Loss in the decrease in share price

= 10000 * (61.05-55.5)

= €55500

Gain in dividends

= 10000 * 0.1 * 55.5 + 8250

= €63750

Since the gain in dividends (both share dividends and cash dividends) is greater than the loss in the decrease in share price, the decrease in share price does not represent a loss.

Question 5

A.

All answers are corrected to 3 decimal places.

	2016	2015
1. Current Ratio	$\frac{537000}{280000}$ = 1.918	$\frac{496000}{290000}$ = 1.710
2. Inventory turnover	$\frac{370000}{(290000+280000)/2}$ = 1.298 times	$\frac{270000}{(280000+180000)/2}$ = 1.174 times
3. Times-interest-earned ratio	$\frac{170000}{30000}$ = 566.667%	$\frac{160000}{50000}$ = 320%
4. Return on ordinary shareholder's equity	$\frac{105000-65000*0.03}{(242000+195000)/2}$ = 47.162%	$\frac{70000-65000*0.03}{(195000+198000)/2}$ = 34.631%
5. Earnings per ordinary share	$\frac{105000-65000*0.03}{20000}$ = 5.153	$\frac{70000-65000*0.03}{18000}$ = 3.781
6. Price/earnings ratio	$\frac{75}{5.153}$ = 14.556	$\frac{55}{3.781}$ = 14.548

B.

(a). The company's financial position improved due to improvements in profitability, liquidity and management efficiency.

(b). Price/earnings ratio increased in 2016 compared to 2015. It implies that the market's overall expectation of the company's performance become more optimistic. Therefore, the investment attractiveness of the ordinary shares appears to have increased.

Question 5 (Cont’d)

C.

We can make use of ratios in financial statement analysis to investment decisions.

Inventory turnover can measure the efficiency of a company’s operations.

Current ratio and times-interest-earned ratio can measure financial strengths of the company in both short term and long term.

Return on ordinary shareholders’ equity can measure the profitability of the company.

Earnings per ordinary share and price/earnings ratio can analyze shares as potential investment.