1 Accounting and the Business Environment

Key Questions are questions about the important concepts in the chapter expressed in everyday language.

Learning Objectives are a "roadmap" showing what will be covered and what is especially important in each chapter.

KEY QUESTIONS		LEARNING OBJECTIVES
Why is accounting important, and who uses the information?	1	Define accounting, and describe the users of accounting information
Why is it important for accountants to be ethical?	2	Explain why ethics and rules of conduct are crucial in accounting and business
In what form can we set up a company?	3	Describe and discuss the forms of business organizations
What are the rules of accounting, and why do we need them?	4	Explain the development of accounting standards, and describe the concepts and principles
How do business transactions affect the accounting records of a company?	5	Describe and use the accounting equation to analyze business transactions
What financial statements are prepared by a company, and how do we create them?	6	Prepare and evaluate the financial statements

Lisa Hunter graduated from university with a degree in environmental studies. She then went to work with an environmental consulting company and gained extensive experience in the area of environmental sustainability. Lisa soon came to realize that many businesses were starting to recognize the benefits of advancing their environmental performance and were seeing increasing opportunities to participate in the green economy. For these companies, the financial implications of "going green" were significant.

Lisa decided to go back to university to pursue an accounting designation. Within three years, she had successfully completed all the requirements and became designated as a professional accountant.

Lisa started her own consulting firm to combine her passion for environmental sustainability with her recently developed accounting skills. She named her new company "Hunter Environmental Consulting." She was now an entrepreneur! She realized she needed to develop a business plan, secure clients, set up an office, and hire staff.

Lisa's first year in business was stressful and successful. Her work in the first year was primarily in the area of energy efficiency and how her clients could reduce their energy consumption and their energy costs.

"My previous training and experience gave me the confidence to know that I could be successful in this field. However, I did not realize how carefully you have to watch the books—costs can get out control in a hurry if you are not careful!"

A **chapter-opening story** shows why the topics in the chapter are important to real companies and business people. We refer to this story throughout the chapter.

CONNECTING CHAPTER 1

1	2	3	4	5	6
Define accounting, and describe the users of accounting information	Explain why ethics and rules of conduct are crucial in accounting and business	Describe and discuss the forms of business organizations	Explain the development of accounting standards, and describe the concepts and principles	Describe and use the accounting equation to analyze business transaction	Prepare and evaluate the financial statements
Why is accounting important, and who uses the information? page 5	*Why is it important for accountants to be ethical? page 7*	*In what form can we set up a company? page 9*	*What are the rules of accounting, and why do we need them? page 11*	*How do business transactions affect the accounting records of a company? page 16*	*What financial statements are prepared by a company, and how do we create them? page 23*
Accounting: The Language of Business, page 5	Ethical Considerations in Accounting and Business, page 7	Forms of Business Organizations, page 9	Accounting Concepts, page 11	The Accounting Equation, page 16	The Financial Statements, page 23
Decision Makers: The Users of Accounting Information, page 5			Other Considerations in Financial Statement Preparation, page 13	Accounting for Business Transactions, page 17	Relationships among the Financial Statements, page 24
The History of Accounting, page 7				Evaluating Business Transactions, page 22	
					MyAccountingLab Relationships among the Financial Statements

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- DemoDoc: Basic Transactions
- Student PowerPoint Slides
- Audio Chapter Summary
- A variety of videos on Chapter 1 topics.

All MyAccountingLab resources are found by clicking on Chapter Resources and then Multimedia Library.

The **Summary** for Chapter 1 appears on page 30.
Accounting Vocabulary with definitions appears on page 33.

Connecting Chapter "X" appears at the beginning of each chapter and gives a guide to the content of the chapter with page references, as well as references to MyAccountingLab so you can connect to what you need quickly and easily.

What role does accounting play in Lisa Hunter's situation? Lisa had to decide how to organize her company. She set up her business as a proprietorship—a single-owner company—with herself as the owner. As her business grows, she may decide to expand it by taking on a partner. She might also choose to incorporate—that is, to form a corporation. In this chapter, we discuss all three forms of business organization: proprietorships, partnerships, and corporations.

You may already know various accounting terms and relationships, because accounting affects people's behaviour in many ways. This first accounting course will sharpen your focus by explaining how accounting works. As you progress through this course, you will see how accounting helps people like Lisa Hunter—and you—achieve business goals.

Accounting: The Language of Business

Accounting is the information system that measures business financial activities, processes that information into reports, and communicates the results to decision makers. For this reason it is called "the language of business." The better you understand the language, the better your decisions will be, and the better you can manage financial information. It is generally recognized that business managers believe it is more important for university students to learn accounting than any other business subject. Decisions concerning personal financial planning, education expenses, loans, car payments, income taxes, and investments are based on the *information system* that we call accounting.

IFRS

LO 1 Why is accounting important, and who uses the information?

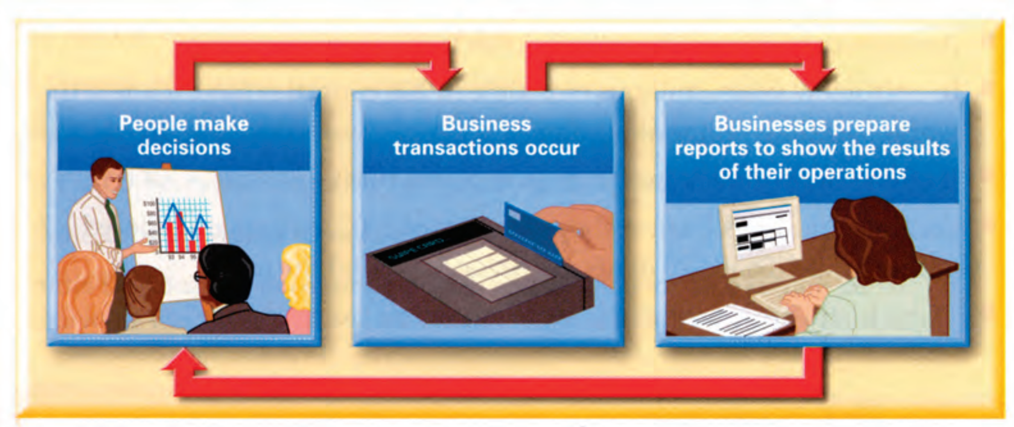
Learning Objectives in the margin signal the beginning of the section that covers the learning-objective topic. Look for the Learning Objective when you want to review this topic.

Financial statements are a key product of an accounting system and provide information that helps people make informed business decisions. **Financial statements** report on a business in monetary terms. Is my business making a profit? Should I hire assistants? Am I earning enough money to expand my business? Answering business questions like these requires a knowledge of financial statements.

Students sometimes mistake bookkeeping for accounting. *Bookkeeping* is a procedural element of accounting, just as arithmetic is a procedural element of mathematics (or just as skating is a procedural element of hockey). There are many accounting software packages that will handle detailed bookkeeping—in households, businesses, and organizations of all types. Exhibit 1–1 illustrates the role of accounting in business. The process starts and ends with people making decisions.

Boldfaced words are new terms that are explained here and defined in the Accounting Vocabulary section at the end of this chapter and the Glossary at the end of the book.

EXHIBIT 1–1 | The Accounting System: The Flow of Information



Exhibits summarize key ideas in a visual way.

Decision Makers: The Users of Accounting Information

Decision makers need information. The more important the decision, the greater the need for information. Virtually all businesses and most individuals keep accounting records to aid decision making. Here are some decision makers who use accounting information.

Individuals People use accounting information in day-to-day affairs to manage bank accounts, evaluate job prospects, make investments, and even in deciding whether to lease or buy a new car.

Businesses Business owners and managers use accounting information to set goals for their organizations. They evaluate their progress toward those goals, and they take corrective action when it is necessary. For example, Lisa Hunter makes decisions based on accounting information. She knows the amount of revenue that will be earned, since she and her client will agree on a fee for the consulting work she will perform. She needs to determine the scope of the work, how many consultants she will require, and how many hours it will take to complete the project. She needs to make sure that her costs do not exceed the fee she will receive from her client if she wants to make sure that she maintains a profitable business.

Investors Outside investors often provide the money a business needs to begin operations. To decide whether to invest, potential investors predict the amount of income to be earned on their investment. This evaluation means analyzing the financial statements of the business and keeping up with developments in the world of business.

Creditors Before lending money, creditors (lenders) such as banks evaluate the borrower's ability to make scheduled payments. This evaluation includes a report of the borrower's financial position and a prediction of future operations, both of which are based on accounting information.

Government Regulatory Agencies Most organizations face government regulation. For example, the provincial securities commissions, such as the British Columbia Securities Commission and the Ontario Securities Commission, dictate that businesses selling their shares to and borrowing money from the public disclose certain financial information to the investing public.

Taxing Authorities Provincial and federal governments levy taxes on individuals and businesses. Income tax is calculated by using accounting information as a starting point. A business's accounting system is required to keep track of provincial sales tax, goods and services tax, and harmonized sales tax that a company collects from its customers and pays to its suppliers. Businesses use these accounting records to help them determine their taxes that must be paid to the provincial and federal governments.

Not-for-profit Organizations Not-for-profit organizations such as churches, hospitals, government agencies, universities, and colleges, which operate for purposes other than to earn a profit, use accounting information to make decisions related to the organization in much the same way that profit-oriented businesses do.

Other Users Employees and labour unions may make wage demands based on the accounting information that shows their employer's reported income. Consumer groups and the general public are also interested in the amount of income that businesses earn. And newspapers may report "an improved profit picture" of a major company as it emerges from economic difficulties. Such news, based on accounting information, relates to the company's health.

Financial Accounting and Management Accounting

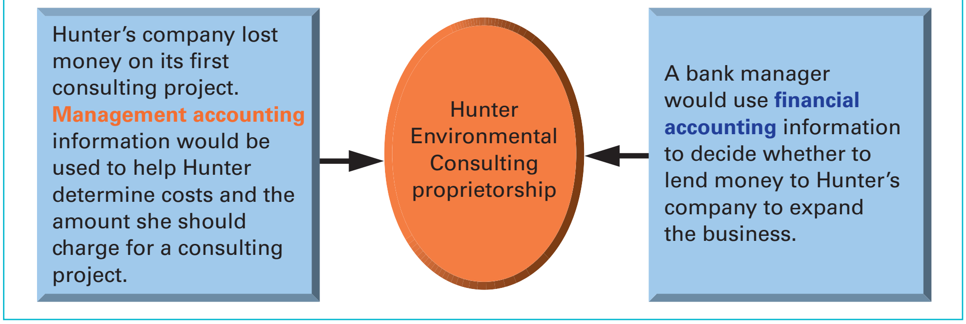
Users of accounting information are a diverse population, but they may be grouped as external users or internal users. This distinction allows us to classify accounting into two fields—financial accounting and management accounting.

Financial accounting provides information to people outside the company. Creditors and outside investors, for example, are not part of the day-to-day management of the company. Likewise, government agencies and the general public are external users of a company's accounting information. This book deals primarily with financial accounting.

Management accounting generates information for internal decision makers, such as company executives, department heads, university deans, and hospital administrators.

Exhibit 1–2 shows how financial accounting and management accounting are used by Hunter Environmental Consulting's internal and external decision makers.

EXHIBIT 1–2 How Financial Accounting and Management Accounting Are Used



The History and Development of Accounting

Accounting has a long history. Some scholars claim that writing arose in order to record accounting information. Accounting records date back to the ancient civilizations of China, Babylonia, Greece, and Egypt. The rulers of these civilizations used accounting to keep track of the cost of labour and materials used in building structures like the great pyramids. The need for accounting has existed as long as there has been business activity.

Accounting developed further as a result of the information needs of merchants in the city-states of Italy during the 1400s. In that busy commercial climate, the monk Luca Pacioli, a mathematician and friend of Leonardo da Vinci's, published the first known description of double-entry bookkeeping in 1494.

In the Industrial Revolution of the 19th century, the growth of corporations spurred the development of accounting. The corporation owners—the shareholders—were no longer necessarily the managers of their business. Managers had to create accounting systems to report to the owners and government how well their businesses were doing. Because managers want their performance to look good, society needs a way to ensure that the business information provided is reliable. To meet this need, generally accepted accounting principles were developed. These will be discussed in more detail shortly.

As required in other segments of society, accounting must be practised in an ethical manner. We look next at the ethical dimension of accounting.

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1. What is accounting?
2. Name three decision makers that rely on financial information, and briefly describe how they use it.
3. What is the difference between financial accounting and management accounting?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

Just Checking questions appear at the end of each Learning Objective, allowing you to test your mastery of the concepts in this Learning Objective before moving on to the next one. The solutions appear at the end of the chapter and on MyAccountingLab.

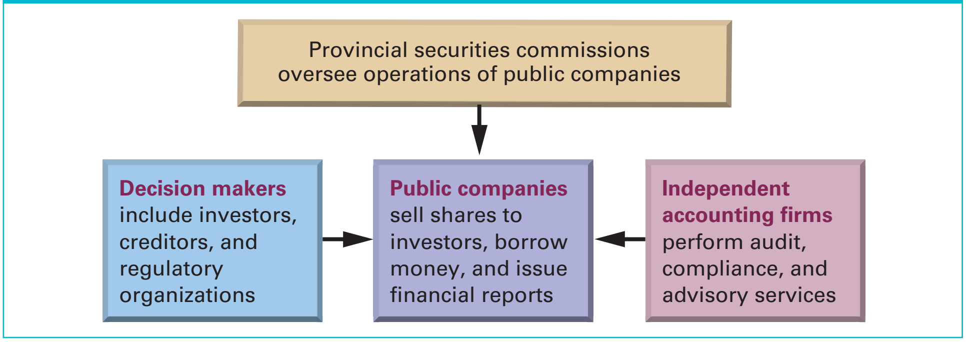
Ethical Considerations in Accounting and Business

IFRS

LO 2 Why is it important for accountants to be ethical?

Ethical considerations affect all areas of accounting and business. Investors, creditors, and regulatory bodies need relevant and reliable information about a company. Naturally, companies want to make themselves look as good as possible to attract investors, so there is a potential for conflict. An **audit** is a financial examination. Audits are conducted by independent accountants who express an opinion on whether or not the financial statements fairly reflect the economic events that occurred during the accounting period. It is vital that companies and their auditors behave in an ethical manner. Exhibit 1–3 illustrates the relationship among accounting and business entities that are public companies (companies that sell shares of stock to investors).

EXHIBIT 1–3 | Relationship among Accounting and Business Entities



Unfortunately for the accounting profession, accounting scandals involving both public companies and their auditors have made the headlines over the past fifteen years. At the turn of this century, Enron Corporation, which was the seventh-largest company in the United States, issued misleading financial statements. Enron was forced into bankruptcy and its auditors' actions were questioned. The impact of the Enron bankruptcy was felt by many different parties, including Enron shareholders, who saw their investments become worthless; employees who lost their jobs and their pensions; and the accounting profession, which lost some of its integrity and reputation as gatekeepers and stewards for the investing public. This situation shocked the business community and caused investors to question the reliability of financial information.

Since the financial health of a company is important to many different groups of users, these users must be confident that they can rely on the financial information they are given when they are making decisions. To increase users' confidence, the accounting profession and other interested stakeholder groups made important changes over the past decade to improve the quality of the financial information provided. We will describe these changes later in this chapter.

The Professional Accounting Bodies and Their Standards of Professional Conduct

The members of the four accounting organizations in Canada—Chartered Accountants (CAs), Certified General Accountants (CGAs), Certified Management Accountants (CMAs) and Chartered Professional Accountants (CPAs)—are all governed by rules of professional conduct created by their respective organizations. Many of the rules apply whether the members are public accountants working in public practice or private accountants working in industry or government. These rules concern the confidentiality of information the accountant is privy to, maintenance of the reputation of the profession, the need to perform accountancy work with integrity and due care, competence, refusal to be associated with false or misleading information, and compliance by the accountant with professional standards. Other rules are applicable only to those members in public practice, and deal with things like the need for independence, and how to advertise, seek clients, and conduct a practice.

The rules of professional conduct serve both the members of the accounting bodies and the public. The rules serve members by setting standards that they must meet, and providing a benchmark against which they will be measured by their peers. The public is served because the rules of professional conduct provide it with a list of the standards to which the members of the body adhere. This helps the public determine its expectations of members' behaviour. However, the rules of professional conduct should be considered a *minimum* standard of performance; ideally, the members should continually strive to exceed them.

Throughout this book, we provide several problems that allow you to consider ethical dilemmas. Consider them carefully. The perception that accountants follow the highest standard of professional conduct must also be the reality. In today's business climate, behaving in an ethical manner is crucial.

Codes of Business Conduct of Companies

Many companies have codes of conduct that apply to their employees in their dealings with each other and with the companies' suppliers and customers. Some of these companies mention their code in their annual report or on their website. For example, Vancouver City Savings Credit Union states on its website:

> **Our Values**
>
> **Integrity:** We act with courage, consistency and respect to do what is honest, fair and trustworthy.
>
> **Innovation:** We anticipate and respond to challenges and changing needs with creativity, enthusiasm and determination.
>
> **Responsibility:** We are accountable to our members, employees, colleagues and communities for the results of our decisions and actions.
>
> *Source:* From Vancouver City Savings Credit Union's website, www.vancity.com (accessed May 25, 2012)

The company indicates to its employees and to the general public how management expects employees to behave.

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4. What is an audit, and why is it important that it be performed by independent accountants?
5. Why do the professional accounting bodies establish rules of professional conduct for their members?
6. Refer to the Student Policies, Bylaws, and Codes of Conduct of your college or university. Why do these policies exist?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

Forms of Business Organizations

IFRS

LO 3 In what form can we set up a company?

A business can be organized as a

- Proprietorship
- Partnership
- Corporation

You should understand the differences among the three.

Proprietorship A **proprietorship** has a single owner, called the proprietor, who often manages the business. Proprietorships tend to be small retail stores, restaurants, and service businesses, but also can be very large. From an accounting

KEY POINTS

A proprietorship and a partnership (Ch. 12) are not legal entities separate from their owners, so the income from proprietorships and partnerships is taxable to their owners, not to the business. But in accounting, the owner and the business are considered separate entities, and separate records are kept for each. A corporation (Ch. 13) is a separate legal entity. The corporation is taxed on its income, and the owners are taxed on any income they receive from the corporation.

Key Points highlight important details from the text and are good tools for reviewing concepts.

viewpoint, each proprietorship is distinct from its owner. Thus, the accounting records of the proprietorship do not include the proprietor's personal accounting records. However, from a legal perspective, the business *is* the proprietor, so if the business cannot pay its debts, lenders can take the proprietor's personal assets (cash and belongings) to pay the proprietorship's debt. In this book, we start with a proprietorship because many students organize their first business that way.

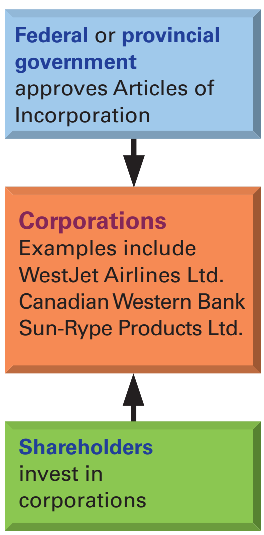
Partnership A **partnership** joins two or more individuals together as co-owners. Each owner is a partner. Many retail stores and professional organizations of physicians, lawyers, and accountants are partnerships. Most partnerships are small and medium-sized, but some are quite large; there are public accounting firms and law firms in Canada with several hundred partners. Accounting treats the partnership as a separate organization distinct from the personal affairs of each partner. But again, from a legal perspective, a partnership *is* the partners in a manner similar to a proprietorship. If the partnership cannot pay its debts, lenders can take each partner's personal assets to pay the partnership's debts.

Corporation A **corporation** is a business owned by **shareholders**. These are the people or other corporations who own shares of ownership in the business. The corporation is the dominant form of business organization in Canada. Although proprietorships and partnerships are more numerous, corporations engage in more business and are generally larger in terms of total assets, income, and number of employees. In Canada, generally, corporations must have *Ltd.* or *Limited, Inc.* or *Incorporated,* or *Corp.* or *Corporation* in their legal name to indicate that they are incorporated. Corporations need not be large; a business with only a few assets and employees could be organized as a corporation.

From a legal perspective, a corporation is formed when the federal government or a provincial government approves its articles of incorporation. Unlike a proprietorship or a partnership, once a corporation is formed, it is a legal entity separate and distinct from its owners. The corporation operates as an "artificial person" that exists apart from its owners and that conducts business in its own name. The corporation has many of the rights that a person has. For example, a corporation may buy, own, and sell property. The corporation may enter into contracts and sue and be sued.

EXHIBIT 1–4

The Formation and Ownership of a Corporation



Since corporations are entities separate from their owners, they will prepare financial reports separate from their owners. Over the years, the accounting profession has developed accounting and reporting standards that corporations must follow when preparing their financial reports. We will examine them in greater detail in the next section of this chapter. Corporations differ significantly from proprietorships and partnerships in another way. If a proprietorship or partnership cannot pay its debts, lenders can take the owners' personal assets to satisfy the business's obligations. But if a corporation goes bankrupt, lenders cannot take the personal assets of the shareholders. This *limited personal liability* of shareholders for corporate debts explains why corporations are so popular compared to proprietorships and partnerships, which have *unlimited personal liability*. Exhibit 1–4 shows the formation and ownership of a corporation.

Another factor for corporations is the division of ownership into individual shares. Companies such as WestJet, Canadian Imperial Bank of Commerce, and Canadian Tire Corporation, Limited, have issued millions of shares of stock and have tens of thousands of shareholders. An investor with no personal relationship either to the corporation or to any other shareholder can become an owner by buying 30, 100, 5,000, or any number of shares of its stock. For most corporations, the investor may sell the shares at any time. It is usually harder to sell one's investment in a proprietorship or a partnership than to sell one's investment in a corporation.

Limited-Liability Partnership (LLP) A **limited-liability partnership (LLP)** is a partnership in which one partner cannot create a large liability for the other partners. Each partner is liable only for his or her own actions and those actions under his or her control.

Exhibit 1–5 summarizes the differences between proprietorships, partnerships, and corporations.

Accounting for corporations includes some unique complexities. For this reason, we initially focus on proprietorships. We cover partnerships in Chapter 12 and begin our discussion of corporations in Chapter 13.

EXHIBIT 1–5 | Comparison of the Three Forms of Business Organization

	Proprietorship	Partnership	Corporation
1. Owner(s)	Proprietor—one owner	Partners—two or more owners	Shareholders—generally many owners
2. Life of organization	Limited by owner's choice or death	Limited by owners' choices or death of one of the partners	Indefinite
3. Personal liability of owner(s) for business debts	Proprietor is personally liable	Partners are personally liable*	Shareholders are not personally liable
4. Legal status	The proprietorship is the proprietor	The partnership is the partners*	The corporation is separate from the shareholders (owners)

*Unless it is a limited-liability partnership (LLP)

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7. How does a partnership differ from a proprietorship?
8. How does a corporation differ from either a proprietorship or a partnership?
9. List two advantages of the corporate form of business over a proprietorship.

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

Accounting Concepts

IFRS

LO 4

What are the rules of accounting, and why do we need them?

Earlier in this chapter, we discussed the importance of financial information to various user groups. Users must be confident that they can rely on the financial information they are given when they are making decisions. To increase users' confidence, accounting practices need to follow certain guidelines. The rules that govern how accountants measure, process, and communicate financial information are known as **generally accepted accounting principles**, or **GAAP**. Accounting principles draw their authority from their acceptance in the business community. They are generally accepted by those people and organizations who need guidelines in accounting for their financial undertakings.

For the past eighty years, individual countries determined their own GAAP. Their goal was to provide accounting standards that could be used by companies in their countries to produce reliable, comparable financial statements. During this period of time, most companies did not compete in an international economy and most of a company's shareholders were residents of the country where the company was headquartered.

In the past twenty-five years, the circumstances under which companies compete for business, and where their shareholders and creditors reside have changed.

Many more businesses either purchase or sell in markets outside their country, and shareholders of companies can reside anywhere in the world. The advent of technology has greatly aided this expansion.

Until recently, however, GAAP had not kept up with the changes in the way companies do business. Accounting standards were still national. It meant investors and creditors who had business dealings in different areas of the world had to understand various accounting standards. Although many of the standards were similar among countries, there were also many significant differences. For example, a Canadian company that sold its shares on a stock exchange in the United States actually had to prepare one set of financial statements under Canadian GAAP and another under United States GAAP or, at least, provide a reconciliation from one to the other. This duplication was inefficient and costly.

Given the likelihood that companies would continue to expand globally, a group of countries started to work together on accounting standards with a goal of developing international accounting standards that could be applied anywhere in the world. This group formed the International Federation of Accountants and developed **International Financial Reporting Standards**, or **IFRS**, as we more commonly refer to them. These standards have now been accepted by over 110 countries in the world. Canada adopted these standards in 2011 for companies that qualify as publicly accountable enterprises.

Publicly accountable enterprises, generally speaking, are companies that are publicly traded or for which a strong public interest exists. In Canada, publicly accountable enterprises are small in number but contribute heavily to our economy.

The IFRS standards are much more complex than many Canadian businesses require in preparing their financial statements. Most Canadian businesses are small to medium in size and are privately owned. The most significant users of their financial information are their creditors (likely their bank) and the government (for computing income taxes and sales taxes). Consequently, a second set of accounting standards, **Accounting Standards for Private Enterprises**, or **ASPE**, was developed for these types of businesses.

The primary reason for the development of ASPE is users' access to a company's financial information. For smaller, private businesses, whether they are proprietorships, partnerships, or corporations, the various user groups that interact with the company typically have better access to the owners and managers of the company. Therefore, the users do not need as much information from the financial statements, which makes record keeping and financial-statement production less costly for private companies. If a banker has a question about a private company's purchases of equipment, the banker can ask the owner directly. However, many of the user groups who need financial information about larger, publicly traded companies do not have the same access to the managers and, therefore, need more information in the financial statements. Financial statements prepared using IFRS provide this additional information. The focus of this textbook will be ASPE, with IFRS material appearing as the final Learning Objective in each chapter.

It is important to remember that publicly accountable enterprises *must* follow IFRS. Other for-profit enterprises can follow either ASPE or can choose to follow IFRS. For example, a company planning to trade its shares on a stock exchange in the future might choose to follow IFRS earlier for a smooth transition.

Both IFRS and ASPE are prepared under the authority of the Accounting Standards Board and are published as part of the Canadian Institute of Chartered Accountants (CICA) *Handbook*. These standards are very detailed and complete, and as you become more knowledgeable in accounting, you will need to become familiar with many of them.

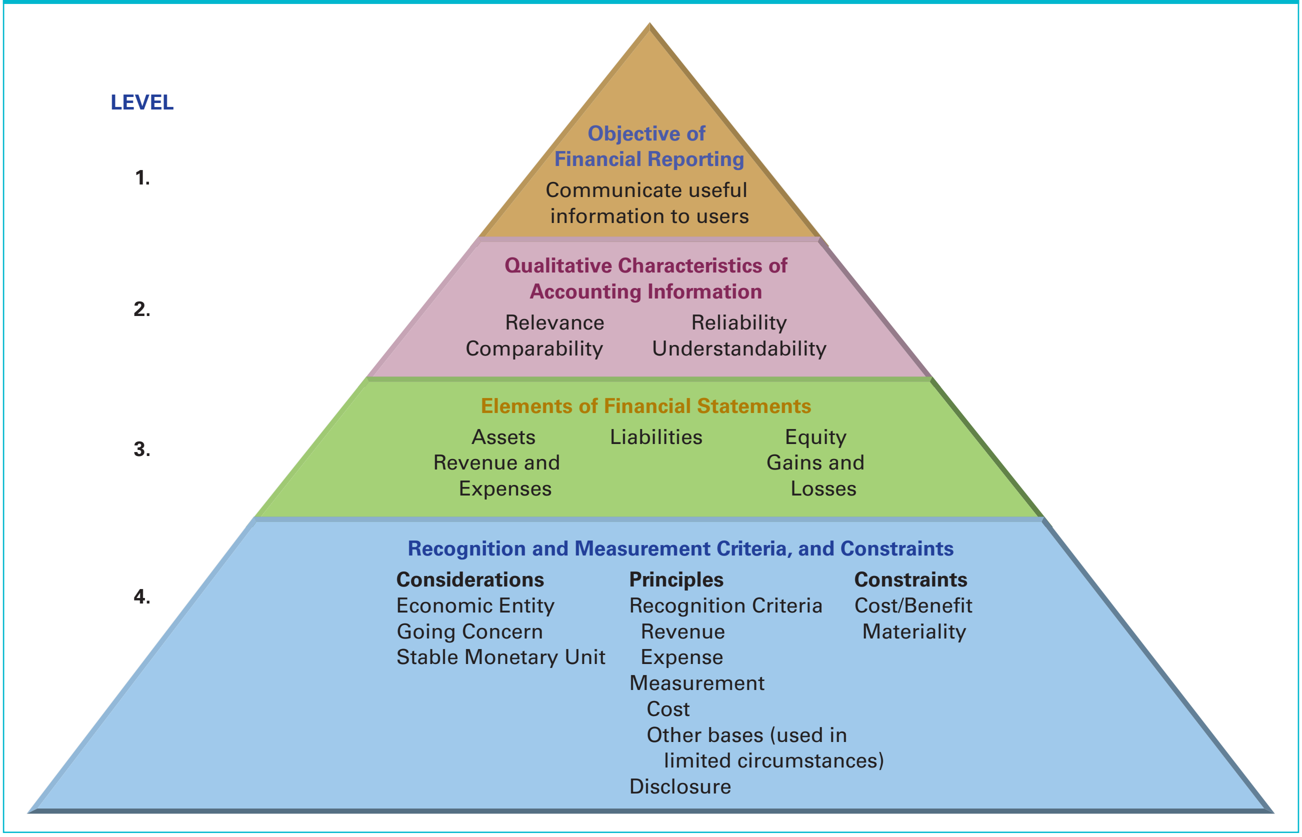
It is interesting to note that both IFRS and ASPE are "principles-based." This means that standards cannot possibly be developed for every accounting transaction a company will encounter, so the accountant must use professional judgment in some circumstances. Professional judgment is an acquired skill—you need a good knowledge of accounting standards and many years of experience in order to exercise sound professional judgment. However, it is important to note that the starting point in acquiring professional judgment is a solid understanding of the concepts of accounting.

In the *Handbook*, the introduction to both the ASPE and IFRS sections discuss financial statement concepts in some detail. These are the concepts on which ASPE and IFRS are based. Consequently, we will now introduce some of the more important fundamental concepts in accounting.

Framework for Financial Reporting

Fundamental accounting concepts form the basis of how accounting should be done and reported to users. Exhibit 1–6 provides a hierarchy of financial statement concepts. This is the framework for financial reporting. As the pyramid shape indicates, the financial reports issued by a company are the end product designed to satisfy the financial-information needs of various user groups, and they are built on a strong foundation of accounting principles. Let's look more closely at each level.

EXHIBIT 1–6 | A Hierarchy of Financial-Statement Concepts



Level 1: Exhibit 1–6 shows that the primary objective of financial statements is to communicate information that is useful to investors, creditors, and other users in making investment decisions or assessing the success of a company. What does this mean? Ideally, the financial information provided should allow an interested user to make decisions about its ongoing financial relationship with an organization.

Level 2: The qualitative characteristics of useful financial information identify the types of information that are likely to be the most useful to the various users of financial reports, which are existing and potential investors, lenders, and other creditors. The four characteristics identified are understandability, relevance, reliability, and comparability.

- The information must be *understandable* to users if they are to be able to use it.
- *Relevant* financial information is capable of making a difference in the decisions made by users. To be relevant, the information must allow users to predict future outcomes or provide feedback about previous management decisions, or both.
- Financial information is only useful if it is *reliable*. Information is reliable when it accurately represents the impact of the transactions that are summarized in the financial statements, and is free of error and bias.
- The comparability characteristic focuses on the relationship between two pieces of information rather than a particular piece of information. It enables users to identify similarities and differences between the information provided by two sets of financial statements.

Let's take a moment to understand the role of these characteristics. Assume that you have decided that you would like to invest some of your savings in the shares of a company. How would you decide on a company to invest in? Your starting point would likely be the financial statements. You are hoping that the financial statements are reliable (that the information reported accurately reflects the transactions of the company) and that the information is relevant (it provides information upon which you can base your investment decision). You might want to measure the results of the company against its results in previous years or you might like to compare the results of one company against the results of another company in the same industry (comparability).

If these characteristics are in place, it makes your investment decision a little easier. Certainly there is other information that you may want to study before you make your decision, but the financial statements are a good starting point.

Level 3: *Elements of financial statements* are the basic categories of items portrayed on the financial statements to meet the objectives outlined in Level 1. We will learn more about these items later in this chapter.

Level 4: This level outlines some basic considerations, principles, and constraints that accountants rely upon when producing the financial information required to satisfy the needs of users outlined in Level 1. The economic entity, going concern, and stable monetary unit considerations are basic assumptions used in both ASPE and IFRS.

In accounting, an **entity** is an organization or a section of an organization that stands apart from other organizations and individuals as a separate economic unit. Each entity is accounted for separately. This applies in situations where you keep your business's accounting separate from your personal accounting so that you can evaluate the success of your business. It also applies in situations where companies keep each department's accounting separate from all the other departments to assess and evaluate the performance of each department. Results for each department can then be combined to create results for the whole organization.

When accountants record financial information, they assume that the entity on which they are reporting is going to be in business for the foreseeable future. This **going-concern assumption** is important because it impacts the way we measure certain transactions. For example, a warehouse costing \$100,000 may be valuable to a company because it expects to use it for the next ten years, so the company records the cost of the warehouse as the \$100,000 it paid. However, if the company was forced to sell the warehouse tomorrow because it was going out of business, it might only be able to get \$50,000 for it because it is forced to accept whatever price it can get for the warehouse. In this situation, the cost of the warehouse should be \$50,000. The going-concern assumption allows the company to record the \$100,000 cost of the warehouse when it is purchased. We will discuss this assumption as necessary in future chapters.

In Canada, accountants record transactions in dollars because the dollar is the measure we use when we make purchases and sales. However, unlike other measures like a kilometer or a tonne, the value of a dollar can change over time. A rise in the general level of prices is called **inflation**. During inflation, a dollar will purchase less milk, less toothpaste, and less of other goods over time. When prices are relatively stable—when there is little inflation—the purchasing power of money is also stable. When the dollar's purchasing power is relatively stable, the **stable monetary unit assumption** allows accountants to ignore the effect of inflation in the accounting records. It allows accountants to add and subtract dollar amounts for activities that happened at different times.

To produce the financial information that users need, accountants must follow recognition criteria and principles to measure and disclose (or report) financial information, as shown in Level 4 of Exhibit 1–6. **Recognition** is the process of including an item in the financial statements of a company. How does an accountant decide when an item should be recognized in the financial statements? The criteria for determining when an item should be recognized are examined later in this chapter and in more detail in Chapter 3.

Measurement is the process of determining the amount at which an item is recognized in the financial statements. There are a number of bases on which an amount can be measured. Financial statements are prepared primarily using the historical-cost basis of measurement, commonly called the *cost principle*. The **cost principle of measurement** states that acquired assets and services should be recorded at their actual cost (also called *historical cost*). Even though the purchaser may believe the price paid is a bargain, the item is recorded at the price actually paid and not at the "expected" cost.

The cost principle of measurement also holds that the accounting records should continue reporting the historical cost of an asset for as long as the business holds the asset. Why? Because cost is a reliable measure.

Other bases of measurement can be used but only in limited circumstances. In particular circumstances, we may use replacement cost, realizable value, or present value. These other bases of measurement will be discussed only as needed in future chapters.

Level 4 in Exhibit 1–6 also includes two constraints that accountants must consider when they are producing financial information. The first constraint is that the benefits of the information produced should exceed the costs of producing the information. The second constraint is materiality. A piece of information is material if it would affect a decision maker's decision. Materiality is not defined in the standards but is a matter of the information preparer's judgment. For example, information about inventory is important to users of Rona Hardware's financial statements, since a change in inventory could change a decision maker's decision about investing in Rona or selling products to Rona. Thus, such information would be provided to decision makers. However, information about the office supplies at Rona would not likely change the investment decision of a Rona financial-statement user, so details of such information are not provided.

Exhibit 1–6 summarizes the key points for recording and reporting financial information: For any financial transaction or situation, the GAAP in Level 4 are used as guidelines for classifying the transaction's financial data into the standard financial-statement elements shown in Level 3. If these elements meet the Level-2 qualitative characteristics of accounting information, they are combined into financial statements that meet the Level-1 objective of reporting financial information useful for users. Financial information can be reported to users using either ASPE or IFRS, depending on whether the company is a publicly accountable enterprise (must use IFRS) or not (can use ASPE or IFRS).

This course will expose you to the generally accepted methods of accounting. We begin the discussion of GAAP in this section and introduce additional assumptions and principles as needed throughout the book. Throughout the text, we will link the accounting in that chapter to the framework for financial reporting using Why It's Done This Way boxes. The hierarchy of financial statement concepts forming the framework for financial reporting from Exhibit 1–6 is shown on the back inside cover of this textbook for easy reference.

✓JUST CHECKING

MyAccountingLab

10. Explain why financial information must be both relevant and reliable.
11. Suppose you are considering the purchase of land for future expansion. The seller is asking $200,000 for land that cost her $100,000. An appraisal shows the land has a value of $180,000. You first offer $160,000. The seller counteroffers with $190,000. Finally, you and the seller agree on a price of $185,000. What dollar amount for this land is reported on your financial statements? Which accounting consideration or principle guides your answer?
12. Suppose you own a company that delivers newspapers. The company owns two trucks that are used for delivering the papers. You have decided that you need a new car for mainly personal purposes but you want the company to buy it for you. Is this appropriate? Name the consideration or principle that must be considered.

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

The Accounting Equation

IFRS

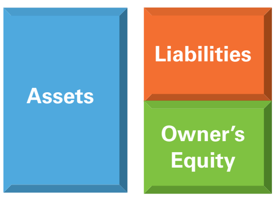
LO 5

How do business transactions affect the accounting records of a company?

Financial statements tell us how a business is performing and where it stands. They are the final product of the accounting process. But how do we arrive at the items and amounts that make up the financial statements? The most basic tool of the accountant is the **accounting equation**. It measures the resources of a business and the claims to those resources.

EXHIBIT 1–7

The Accounting Equation



Assets = Liabilities + Owner's Equity

Assets and Liabilities

Assets are economic resources controlled by an entity that are expected to benefit the business in the future. Cash, office supplies, merchandise inventory, furniture, land, and buildings are examples of assets.

Claims to those assets come from two sources. **Liabilities** are debts that are payable to outsiders. These *outside* parties are called *creditors*. For example, a creditor who has lent money to a business has a claim—a legal right—to a part of the assets until the business pays the debt. Many liabilities have the word *payable* in their titles. Examples include Accounts Payable, Notes Payable, and Salaries Payable. *Insider* claims to the business assets are owners' claims called **owner's equity** or **capital**. An owner's claim to some of the entity's assets begins when the owner invests in the business.

The accounting equation in Exhibit 1–7 shows how assets, liabilities, and owner's equity are related. Assets appear on the left side of the equation. The legal and economic claims against the assets—the liabilities and owner's equity—appear on the right side of the equation. As Exhibit 1–7 shows, *the two sides must be equal*:

Economic Resources		**Claims to Economic Resources**
		(Outsiders) (Insiders)
Assets	=	**Liabilities + Owner's Equity**

KEY POINTS

Increases in cash are not always revenues. Cash also increases when a company borrows money, but borrowing money creates a liability—not a revenue. Revenue results from rendering a service or selling a product, not necessarily from the receipt of cash.

Owner's Equity

Owner's equity is the amount of an entity's assets that remains after the liabilities are subtracted. For this reason, owner's equity is often referred to as *net assets*, and the accounting equation can be written to show this:

Assets − Liabilities = Owner's Equity

The purpose of business is to increase owner's equity through **revenues**, which are amounts earned by delivering goods or services to customers. Revenues increase owner's equity because they increase the business's assets but not its liabilities. As a result, the owner's share of business assets increases. Examples of revenue include sales revenue from selling goods, service revenue from selling services, interest revenue from saving money in a bank, and dividend revenue from investing in shares of stock. Exhibit 1–8 shows that owner investments and revenues increase the owner's equity of the business.

Exhibit 1–8 also shows that owner withdrawals and expenses decrease owner's equity. **Owner withdrawals** are those amounts or resources removed from the business by the owner. Withdrawals are the opposite of owner investments. **Expenses** are decreases in owner's equity that occur from using or consuming assets or increasing liabilities in the course of delivering goods and services to customers. Expenses are the cost of doing business and are the opposite of revenues. Expenses include the cost of office rent; interest payments; salaries of employees; insurance; advertisements; property taxes; utility payments for water; electricity; gas; and so forth.

Account names for different types of businesses are given in Appendix B at the end of this book.

KEY POINTS

Decreases in cash are not always expenses. Cash decreases when land is purchased, for example, but the purchase also increases the asset Land, which is not an expense. Expenses result from using goods or services in the course of earning revenue, not necessarily from the payment of cash.

EXHIBIT 1–8 | Transactions that Increase and Decrease Owner's Equity

Accounting for Business Transactions

Accounting is based on transactions, not opinions or desires. A **transaction** is any event that affects the financial position of the business entity *and* can be measured reliably. Many events may affect a company, including elections and economic booms. Accountants do not record the effects of these events because they cannot be measured reliably. An accountant records as transactions only events with dollar amounts that can be measured reliably, such as purchases and sales of merchandise inventory, payment of rent, and collection of cash from customers. In Exhibit 1-1 on page 5, transactions are the middle step in the flow of information in an accounting system.

To illustrate accounting for business transactions, let's go back to our opening story and trace the transactions for Lisa Hunter's company, Hunter Environmental Consulting (HEC), in the first year of her business. We will consider 11 events and analyze each in terms of its effect on the accounting equation of HEC. *Remember that the accounting equation must always remain in balance.* Transaction analysis is the essence of accounting.

KEY POINTS

A transaction is an event that must always satisfy these two conditions:

1. It affects the financial position of a business entity, and
2. It can be reliably recorded in the accounting records.

Transaction 1: Starting the Business Hunter invests $250,000 of her money to start the business. Specifically, she deposits $250,000 in a bank account entitled Hunter Environmental Services.

The effect of this transaction on the accounting equation of the HEC business entity is

	Assets		Liabilities	+	Owner's Equity	Type of Owner's Equity Transaction
	Cash	=			Lisa Hunter, Capital	
(1)	+250,000				+250,000	*Owner investment*

For every transaction, the amount on the left side of the equation must equal the amount on the right side. The first transaction increases both the assets (in this case, Cash) and the owner's equity of the business (Lisa Hunter, Capital). The transaction involves no liabilities of the business because it creates no obligation for HEC to pay an outside party. The Assets and Liabilities elements of the accounting equation will be expanded to show the specific accounts affected by a transaction, but Owner's Equity will not be expanded. Therefore, to the right of the transaction, we write "owner investment" to keep track of the reason for the effect on Owner's Equity.

LEARNING TIPS

Note that the sums of balances (which we abbreviate Bal.) on both sides of the equation are equal. This equality must always exist.

Learning Tips are suggestions for learning or remembering important concepts.

Transaction 2: Purchase of Land HEC purchases land for a future office location, paying $100,000. The effect of this transaction on the accounting equation is

	Assets				Liabilities + Owner's Equity	Types of Owner's Equity Transaction
	Cash	+	Land	=	Lisa Hunter, Capital	
Bal.	250,000				250,000	
(2)	−100,000	+	100,000			
Bal.	150,000		100,000		250,000	
(Total)	250,000				250,000	

The cash purchase of the land increases one asset, Land, and decreases another asset, Cash, by the same amount. After the transaction is completed, HEC has cash of $150,000, land of $100,000, no liabilities, and owner's equity of $250,000.

Transaction 3: Purchase of Office Supplies and Equipment HEC buys stationery and other office supplies, agreeing to pay $7,000 within 30 days. This transaction increases both the assets and the liabilities of the company, as follows:

	Assets						Liabilities	+	Owner's Equity
	Cash	+	Office Supplies	+	Land	=	Accounts Payable	+	Lisa Hunter, Capital
Bal.	150,000				100,000				250,000
(3)			+7,000				+7,000		
Bal.	150,000		7,000		100,000		7,000		250,000
(Total)	257,000						257,000		

The asset affected is Office Supplies, and the liability is called an **account payable**. A *payable is always a liability.* Because HEC is obligated to pay $7,000 in the future but signs no formal promissory note, we record the liability as an Account Payable. (If a promissory note had been signed, we would have recorded the liability as a **Note Payable**.)

Transaction 4: Earning of Service Revenue HEC earns service revenue by providing environmental consulting services for clients. Assume the business earns $30,000 and collects this amount in cash. The effect on the accounting equation is an increase in the asset Cash and an increase in Lisa Hunter, Capital, as follows:

	Assets				Liabilities +	Owner's Equity	Type of Owner's Equity Transaction
	Cash +	Office Supplies +	Land		Accounts Payable +	Lisa Hunter, Capital	
Bal.	150,000	7,000	100,000	=	7,000	250,000	
(4)	+ 30,000					+ 30,000	*Service revenue*
Bal.	180,000	7,000	100,000		7,000	280,000	
	287,000				287,000		

A revenue transaction causes the business to grow, as shown by the increase in total assets and in the sum of total liabilities plus owner's equity. A company like RONA or Canadian Tire that sells goods to customers is a merchandising business. Its revenue is called *sales revenue.* In contrast, HEC performs services for clients. HEC's revenue is called *service revenue.*

Transaction 5: Earning of Service Revenue on Account HEC performs consulting services for clients who do not pay immediately. In return for the services, HEC issues an invoice and the clients will pay the $25,000 amount within one month. This amount owed to HEC is an asset to HEC, an account receivable because the business expects to collect the cash in the future. In accounting, we say that HEC performed this service *on account* and earned the revenue. Performing the service, not collecting the cash, earns the revenue. This $25,000 of service revenue is as real an increase in the wealth of HEC's business as the $30,000 of revenue that was collected immediately in Transaction 4. HEC records an increase in the asset Accounts Receivable and an increase in Service Revenue, which increases Lisa Hunter, Capital, as follows:

KEY POINTS

All receivables are assets. All payables are liabilities.

	Assets					Liabilities +	Owner's Equity	Type of Owner's Equity Transaction
	Cash +	Accounts Receivable +	Office Supplies +	Land		Accounts Payable +	Lisa Hunter, Capital	
Bal.	180,000		7,000	100,000	=	7,000	280,000	
(5)		+ 25,000					+ 25,000	*Service revenue*
Bal.	180,000	25,000	7,000	100,000		7,000	305,000	
	312,000					312,000		

Transaction 6: Payment of Expenses During the month, HEC pays $12,000 in cash expenses: office rent, $4,000 (HEC purchased land to build an office in the future (transaction 2), but the company is renting fully furnished office space in the

meantime); employee salaries, $6,500 (for a full-time assistant and a junior consultant); and total utilities, $1,500. The effects on the accounting equation are

	Assets					=	Liabilities + Owner's Equity		Type of Owner's Equity Transaction
	Cash	+ Accounts Receivable	+ Office Supplies	+ Land			Accounts Payable	+ Lisa Hunter, Capital	
Bal.	180,000	25,000	7,000	100,000			7,000	305,000	
(6)	−4,000					=		−4,000	*Rent expense*
	−6,500							−6,500	*Salaries expense*
	−1,500							−1,500	*Utilities expense*
Bal.	168,500	25,000	7,000	100,000			7,000	293,000	
	300,000						300,000		

Expenses have the opposite effect of revenues. Expenses cause the business to shrink, as shown by the decreased balances of total assets and owner's equity.

Each expense should be recorded in a separate transaction. Here, for simplicity, the expenses are listed together. Alternatively, we could record the cash payment in a single amount for the sum of those three expenses, $12,000 ($4,000 + $6,500 + $1,500). In either case, the "balance" of the equation holds, as we know it must.

Transaction 7: Payment on Account HEC pays $5,000 to the store from which it purchased $7,000 worth of office supplies in Transaction 3. In accounting, we say that the business pays $5,000 *on account*. The effect on the accounting equation is a decrease in the asset Cash and a decrease in the liability Accounts Payable as follows:

	Assets				=	Liabilities + Owner's Equity	
	Cash	+ Accounts Receivable	+ Office Supplies	+ Land		Accounts Payable	+ Lisa Hunter, Capital
Bal.	168,000	25,000	7,000	100,000	=	7,000	293,000
(7)	− 5,000					−5,000	
Bal.	163,000	25,000	7,000	100,000		2,000	293,000
	295,000					295,000	

The payment of cash on account has no effect on the asset Office Supplies because the payment does not increase or decrease the supplies available to the business. Likewise, the payment on account does not affect expenses. HEC was paying off a liability, not an expense.

Transaction 8: Personal Transaction Lisa Hunter remodels her home at a cost of $30,000, paying cash from personal funds. This event is *not* a transaction of HEC. It has no effect on HEC's business affairs and, therefore, is not recorded by the business. It is a transaction of the Hunter *personal* entity, not the HEC business entity. We are focusing now solely on the *business* entity, and this event does not affect it. This transaction illustrates the *economic-entity* consideration.

Transaction 9: Collection on Account In Transaction 5, HEC performed consulting services for clients on account. The business now collects $15,000 from a client. We say that it collects the cash *on account*. It will record an increase in the asset Cash and a decrease in the asset Accounts Receivable. Should it also record an increase in service revenue? No, because HEC already recorded the revenue when it performed the service in Transaction 5. The effect on the accounting equation is

	Assets					Liabilities + Owner's Equity	
	Cash +	Accounts Receivable +	Office Supplies	Land		Accounts Payable +	Lisa Hunter, Capital
Bal.	163,000	25,000	7,000	100,000	=	2,000	293,000
(9)	+15,000	−15,000					
Bal.	178,000	10,000	7,000	100,000		2,000	293,000
	295,000					295,000	

Total assets are unchanged from the preceding transaction's total. Why? Because HEC merely exchanged one asset for another.

Transaction 10: Sale of Land Lisa sells 50% of the land purchased in Transaction 2. The sale price of $50,000 is equal to HEC's cost of the land. HEC sells the land and receives $50,000 cash, and the effect on the accounting equation is

	Assets					Liabilities + Owner's Equity	
	Cash	+ Accounts Receivable	+ Office Supplies +	Land		Accounts Payable +	Lisa Hunter, Capital
Bal.	178,000	10,000	7,000	100,000	=	2,000	293,000
(10)	+50,000			−50,000			
Bal.	228,000	10,000	7,000	50,000		2,000	293,000
	295,000					295,000	

Transaction 11: Withdrawing of Cash Lisa withdraws $6,000 cash for her personal use. The effect on the accounting equation is

	Assets					Liabilities + Owner's Equity		Type of Owner's Equity Transaction
	Cash +	Accounts Receivable +	Office Supplies +	Land		Accounts Payable +	Lisa Hunter, Capital	
Bal.	228,000	10,000	7,000	50,000	=	2,000	293,000	
	− 6,000						−6,000	*Owner withdrawal*
Bal.	222,000	10,000	7,000	50,000		2,000	287,000	
	289,000					2,89,000		

Hunter's withdrawal of $6,000 cash decreases the asset Cash and also the owner's equity of the business.

Owner withdrawals do not represent a business expense because the cash is used for the owner's personal affairs unrelated to the business. We record this decrease in owner's equity as Withdrawals or Drawings. The double underlines below each column indicate a final total after the last transaction.

MyAccountingLab

Accounting Cycle Tutorial

1. Balance Sheet Accounts and Transactions pages 1–12
2. Income Statement Accounts and Transactions pages 1–6

These references to **MyAccountingLab** are reminders that you can review these topics using the Accounting Cycle Tutorials on MyAccountingLab.

Evaluating Business Transactions

Exhibit 1–9 summarizes the 11 preceding transactions. Panel A of the exhibit lists the details of the transactions, and Panel B presents the analysis. As you study the exhibit, note that every transaction maintains the equality of the equation

Assets = Liabilities + Owner's Equity

EXHIBIT 1–9 Analysis of Transactions of Hunter Environmental Consulting

PANEL A: DETAILS OF TRANSACTIONS

(1) The business recorded the $250,000 cash investment made by Lisa Hunter.
(2) Paid $100,000 cash for land.
(3) Bought $7,000 of office supplies on account.
(4) Received $30,000 cash from clients for service revenue earned.
(5) Performed services for clients on account, $25,000.
(6) Paid cash expenses: rent, $4,000; employee salary, $6,500; utilities, $1,500.
(7) Paid $5,000 on the account payable created in Transaction 3.
(8) Remodelled Hunter's personal residence. This is not a transaction of the business.
(9) Collected $15,000 on the account receivable created in Transaction 5.
(10) Sold land for cash equal to its cost of $50,000.
(11) The business paid $6,000 cash to Hunter as a withdrawal.

PANEL B: ANALYSIS OF TRANSACTIONS

	Assets					Liabilities + Owner's Equity		Type of Owner's Equity Transaction
	Cash +	Accounts Receivable +	Office Supplies +	Land		Accounts Payable +	Lisa Hunter, Capital	
(1)	+250,000						+250,000	*Owner investment*
Bal.	250,000						250,000	
(2)	−100,000			+100,000				
Bal.	150,000			100,000			250,000	
(3)			+7,000			+7,000		
Bal.	150,000		7,000	100,000		7,000	250,000	
(4)	+30,000						+30,000	*Service revenue*
Bal.	180,000		7,000	100,000		7,000	280,000	
(5)		+25,000					+25,000	*Service revenue*
Bal.	180,000	25,000	7,000	100,000	=	7,000	305,000	
(6)	−4,000						−4,000	*Rent expense*
	−6,500						−6,500	*Salaries expense*
	−1,500						−1,500	*Utilities expense*
Bal.	168,000	25,000	7,000	100,000		7,000	293,000	
(7)	−5,000					−5,000		
Bal.	163,000	25,000	7,000	100,000		2,000	293,000	
(8)	Not a transaction of the business							
(9)	+15,000	−15,000						
Bal.	178,000	10,000	7,000	100,000		2,000	293,000	
(10)	+50,000			−50,000				
Bal.	228,000	10,000	7,000	50,000		2,000	293,000	
(11)	−6,000						−6,000	*Owner withdrawal*
Bal.	222,000	10,000	7,000	50,000		2,000	287,000	
	289,000					289,000		

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13. a. If the assets of a business are $75,000 and the liabilities total $65,000, how much is the owner's equity?

    b. If the owner's equity in a business is $50,000 and the liabilities are $20,000, how much are the assets?

14. Indicate whether each account listed below is a(n) asset (A), liability (L), owner's equity (OE), revenue (R), or expense (E) account.

Accounts Receivable	_____	Salaries Expense	_____
Computer Equipment	_____	Consulting Service Revenue	_____
S. Scott, Capital	_____	Cash	_____
Rent Expense	_____	Notes Payable	_____
Supplies	_____	Supplies Expense	_____
S. Scott, Withdrawals	_____	Accounts Payable	_____

15. A customer pays a deposit of $20,000 to your company for a service that you will begin to provide six months from now. How do you account for this transaction?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

The Financial Statements

LO 6
Prepare and evaluate the financial statements

Once the analysis of the transactions is complete, what is the next step in the accounting process? How does a business present the results of the transactions? We now look at the *financial statements,* which are the formal reports of an entity's financial information. The primary financial statements are the:

- Income statement
- Statement of owner's equity
- Balance sheet
- Cash flow statement

Income Statement The **income statement** presents a summary of the *revenues* and *expenses* of an entity for a specific period of time, such as a month or a year. The income statement, also called the **statement of earnings** or **statement of operations**, is like a video of the entity's operations—a moving financial picture of business operations during the period. The income statement holds perhaps the most important single piece of information about a business—its *net income or net loss.* Business people run their businesses with the objective of having more revenues than expenses. An excess of total revenues over total expenses is called **net income, net earnings**, or **net profit**. If total expenses exceed total revenues, the result is called a **net loss**.

Statement of Owner's Equity The **statement of owner's equity** presents a summary of the changes that occurred in the entity's *owner's equity* during a specific period of time, such as a month or a year.

Increases in owner's equity arise from:

- Owner investments
- Net income (revenues exceed expenses)

Decreases in owner's equity arise from:

- Owner withdrawals
- Net loss (expenses exceed revenues)

Net income or net loss comes directly from the income statement. Owner investments and withdrawals are capital transactions between the business and its owner, so they do not affect the income statement.

Balance Sheet The **balance sheet** lists all the assets, liabilities, and owner's equity of an entity as of a specific date, usually the end of a month or a year. The balance sheet is like a snapshot of the entity. For this reason, it is also called the **statement of financial position**.

Cash Flow Statement The **cash flow statement** reports the cash coming in (*cash receipts*) and the cash going out (*cash payments* or *disbursements*) during a period. Business activities result in a net cash inflow (receipts greater than payments) or a net cash outflow (payments greater than receipts). The cash flow statement shows the net increase or decrease in cash during the period and the cash balance at the end of the period. We focus on the cash flow statement in Chapter 17.

Computers and software programs have had a significant impact on the preparation of the financial statements. Financial statements can be produced instantaneously after the data from the financial records are entered into the computer. Of course, in manual *and* computerized accounting systems, any errors that occur in the financial records will be passed on to the financial statements. For this reason, the person responsible for analyzing the accounting data is critical to the accuracy of the financial statements.

Financial Statement Headings

Each financial statement has a heading, which gives three pieces of data:

- The proper name of the business (in our discussion, Hunter Environmental Consulting)
- The full name of the particular statement
- The date or time period covered by the statement

A balance sheet taken at the end of year 2013 would be dated December 31, 2013. A balance sheet prepared at the end of March 2014 is dated March 31, 2014.

An income statement or a statement of owner's equity covering a year ending on December 31, 2013, is dated "For the Year Ended December 31, 2013." A monthly income statement or statement of owner's equity for September 2014 has in its heading "For the Month Ended September 30, 2014" or simply "For the Month of September 2014." Income *must* be identified with a particular time period. This is because if December 31, 2013 appeared in the heading of these statements, you would not know whether the net income amount was good or bad unless you knew the time period covered by the statements. The net income amount could be good if the time period were one day, but it could be bad if the time period were one year.

Relationships among the Financial Statements

Exhibit 1–10 on page 25 illustrates all four financial statements. Their data come from the transaction analysis in Exhibit 1–9. We are assuming the transactions occurred during the month of April 2014. Study the exhibit carefully, because it shows the relationships among the four financial statements.

Observe the following in Exhibit 1–10:

1. The *income statement* for the month ended April 30, 2014,
   a. Reports all *revenues* and all *expenses* during the period. Expenses are often listed alphabetically, but can also be listed in decreasing order of amount, with the largest expense first.
   b. Reports *net income* of the period if total revenues exceed total expenses, as in the case of HEC's operations for April. If total expenses exceed total revenues, a *net loss* is reported instead.

EXHIBIT 1–10 | Financial Statements of Hunter Environmental Consulting

HUNTER ENVIRONMENTAL CONSULTING
Income Statement
For the Month Ended April 30, 2014

Revenue:		
Service revenue		$55,000
Expenses:		
Rent expense	$4,000	
Salary expense	6,500	
Utilities expense	1,500	
Total expenses		12,000
Net income		$43,000

HUNTER ENVIRONMENTAL CONSULTING
Statement of Owner's Equity
For the Month Ended April 30, 2014

Lisa Hunter, capital, April 1, 2014	$ 0	
Add: Investment by owner	250,000	
Net income for the month	43,000	
		293,000
Less: Withdrawals by owner	(6,000)	
Lisa Hunter, capital, April 30, 2014	$287,000	

HUNTER ENVIRONMENTAL CONSULTING
Balance Sheet
April 30, 2014

Assets		Liabilities	
Cash	$222,000	Accounts payable	$ 2,000
Accounts receivable	10,000	Owner's Equity	
Office supplies	7,000	Lisa Hunter, capital	287,000
Land	50,000		
Total assets	$289,000	Total liabilities and owner's equity	$289,000

HUNTER ENVIRONMENTAL CONSULTING
Cash Flow Statement*
For the Month Ended April 30, 2014

Cash flows from operating activities			
Cash collections from customers**		$ 45,000	
Cash payments to suppliers***	$ (10,500)		
Cash payments to employees	(6,500)	(17,000)	
Net cash inflow from operating activities			28,000
Cash flows from investing activities			
Acquisition of land	$(100,000)		
Proceeds from sale of land	50,000		
Net cash outflow from investing activities			(50,000)
Cash flows from financing activities			
Investment by owner	$ 250,000		
Withdrawal by owner	(6,000)		
Net cash inflow from financing activities			244,000
Net increase in cash		$222,000	
Cash balance, April 1, 2014		0	
Cash balance, April 30, 2014		$222,000	

*Chapter 17 explains how to prepare this statement.
**$30,000 + $15,000 = $45,000
***$4,000 + $1,500 + $5,000 = $10,500

2. The *statement of owner's equity* for the month ended April 30, 2014,
   a. Opens with the owner's capital balance at the beginning of the period.
   b. Adds *investment by the owner* and adds *net income* (or subtracts *net loss*, as the case may be). Net income (or net loss) comes directly from the income statement (see arrow 1 in Exhibit 1–10).
   c. Subtracts *withdrawals by the owner*. The parentheses around an amount indicate a subtraction.
   d. Ends with the owner's capital balance at the end of the period.
3. The *balance sheet* at April 30, 2014, the end of the period,
   a. Reports all *assets*, all *liabilities*, and *owner's equity* of the business at the end of the period.
   b. Reports that total assets equal the sum of total liabilities plus total owner's equity.
   c. Reports the owner's ending capital balance, taken directly from the statement of owner's equity (see arrow 2).
4. The *cash flow statement* for the month ended April 30, 2014,
   a. Reports cash flows from three types of business activities (*operating*, *investing*, and *financing* activities) during the month. Each category of cash-flow activities includes both cash receipts, which are positive amounts, and cash payments, which are negative amounts (denoted by parentheses). Each category results in a net cash inflow or a net cash outflow for the period. We discuss these categories in detail in Chapter 17.
   b. Reports a net increase in cash (or a net decrease, as the case may be) during the month and ends with the cash balance at April 30, 2014. This is the amount of cash to report on the balance sheet (see arrow 3).

✓JUST CHECKING

MyAccountingLab

16. Indicate whether each account listed below appears on the balance sheet (B), income statement (I), statement of owner's equity (OE), or cash flow statement (CF). Some items appear on more than one statement.

Accounts Receivable	_____	Salaries Expense	_____
Computer Equipment	_____	Consulting Service Revenue	_____
S. Scott, Capital	_____	Cash	_____
Rent Expense	_____	Notes Payable	_____
Supplies	_____	Supplies Expense	_____
S. Scott, Withdrawals	_____	Accounts Payable	_____

17. Study Exhibit 1–10, which gives the financial statements for Hunter Environmental Services (HEC) at April 30, 2014, the end of the first month of operations. Answer these questions about HEC to evaluate the business's results.
    a. What was the business's result of operations for the month of April—a net income (profit) or a net loss, and how much? Which financial statement provides this information?
    b. How much owner capital did the company have at the beginning of April? At the end of April? Identify all the items that changed owner's capital during the month, along with their amounts. Which financial statement provides this information?
    c. How much cash does the company have as it moves into the next month—that is, May 2014? Which financial statement provides this information?
    d. How much do clients owe HEC at April 30? Is this an asset or a liability for the business? What does the business call this item?
    e. How much does the business owe outsiders at April 30? Is this an asset or a liability for the business? What does the business call this item?

Just Checking Solutions appear at the end of this chapter and on MyAccountingLab.

Summary Problem for Your Review

The **Summary Problem** for Your Review is an extensive, challenging review problem that pulls together the chapter concepts.

Samantha Torres opens a home design business in Calgary. She is the sole owner of the proprietorship, which she names Torres Home Design. During the first month of operations, July 2014, the following transactions occurred:

a. Torres invests $80,000 of personal funds to start the business.
b. The business purchases, on account, office supplies costing $2,000.
c. Torres Home Design pays cash of $56,000 to acquire a parcel of land. The business intends to use the land as a future building site for its business office.
d. The business provides services for clients and receives cash of $10,000.
e. The business pays $1,500 on the account payable created in Transaction (b).
f. Torres pays $6,500 of personal funds for a vacation for her family.
g. The business pays cash expenses for office rent, $2,500, and utilities, $500.
h. The business returns to the supplier office supplies that cost $300. The wrong supplies were shipped.
i. Torres withdraws $3,000 cash for personal use.

Required

1. Analyze the preceding transactions in terms of their effects on the accounting equation of Torres Home Design. Use Exhibit 1–9 on page 22 as a guide but show balances only after the last transaction.
2. Prepare the income statement, statement of owner's equity, and balance sheet of Torres Home Design after recording the transactions. Use Exhibit 1–10 on page 25 as a guide.

Name: Torres Home Design
Industry: Home design consulting
Fiscal Period: Month of July 2014

SOLUTION

1. Panel A: Details of Transactions
   a. Torres invested $80,000 cash to start the business.
   b. Purchased $2,000 in office supplies on account.
   c. Paid $56,000 to acquire land as a future building site.
   d. Earned service revenue and received cash of $10,000.
   e. Paid $1,500 on account.
   f. Paid for a personal vacation, which is not a transaction of the business.
   g. Paid cash expenses for rent, $2,500, and utilities, $500.
   h. Returned office supplies that cost $300.
   i. Withdrew $3,000 cash for personal use.

As you review the details of each transaction, think of the names of the accounts that will be affected.

Panel B: Analysis of Transactions

For each transaction, make sure the accounting equation Assets = Liabilities + Owner's Equity balances before going on to the next transaction.

	Assets				Liabilities +	Owner's Equity	Type of Owner's Equity Transaction
	Cash +	Office Supplies +	Land		Accounts Payable	Samantha Torres, Capital	
(a)	+ 80,000					+80,000	*Owner investment*
(b)		+2,000			+2,000		
(c)	− 56,000		+56,000				
(d)	+ 10,000			=		+10,000	*Service revenue*
(e)	− 1,500				−1,500		
(f)	Not a business transaction						
(g)	− 2,500					− 2,500	*Rent expense*
	− 500					− 500	*Utilities expense*
(h)		− 300			− 300		
(i)	− 3,000					− 3,000	*Owner withdrawal*
Bal.	26,500	1,700	56,000		200	84,000	
	$\underbrace{\qquad\qquad}_{84,200}$				$\underbrace{\qquad\qquad}_{84,200}$		

2. *Financial Statements of Torres Home Design*

TORRES HOME DESIGN		
Income Statement		
For the Month Ended July 31, 2014		
Revenue:		
Service revenue		$10,000
Expenses:		
Rent expense	$2,500	
Utilities expense	500	
Total expenses		3,000
Net Income		$ 7,000

TORRES HOME DESIGN	
Statement of Owner's Equity	
For the Month Ended July 31, 2014	
Samantha Torres, capital, July 1, 2014	$ 0
Add: Investment by owner	80,000
Net income for July	7,000
	87,000
Less: Withdrawal by owner	3,000
Samantha Torres, capital, July 31, 2014	$84,000

TORRES HOME DESIGN			
Balance Sheet			
July 31, 2014			
Assets		**Liabilities**	
Cash	$26,500	Accounts payable	$ 200
Office supplies	1,700		
		Owner's Equity	
Land	56,000	Samantha Torres, capital	84,000
Total assets	$84,200	Total liabilities and owner's equity	$84,200

The title must include the name of the company, "Income Statement," and the specific period of time covered. It is critical that the time period be defined.

Gather all the revenue and expense account names and amounts from Panel B. They appear in the Samantha Torres, Capital column.

- List the revenue account first.
- List the expense accounts next. Expenses are usually listed in alphabetical order.

The title must include the name of the company, "Statement of Owner's Equity," and the specific period of time covered. It is critical that the time period be defined.

The net income amount (or net loss amount) is transferred from the income statement.

The withdrawal amount is found in Panel B in the Samantha Torres, Capital column.

The title must include the name of the company, "Balance Sheet," and the date of the balance sheet. It shows the financial position on one specific date.

Gather all the asset and liability accounts and Bal. amounts from Panel B. List assets first, then liabilities. The owner's equity amount is transferred from the statement of owner's equity.

It is vital that Total Assets = Total Liabilities + Owner's Equity

Summary

The **Summary** gives a concise description of the material covered in the chapter along with page references, so you can link back into the chapter if you want to review particular material. It is organized by Learning Objective.

1 Learning Objective 1: Define accounting, and describe the users of accounting information.

Define accounting, and describe the users of accounting information

- Accounting is an information system for measuring, processing, and communicating financial information. Pg 5
- As the "language of business," accounting helps a wide range of users make business decisions.
- Examples of users include individual investors, businesses, government agencies, and lenders.

MyAccountingLab Video:

2 Learning Objective 2: Explain why ethics and rules of conduct are crucial in accounting and business.

Explain why ethics and rules of conduct are crucial in accounting and business

- Ethical considerations affect all areas of accounting and business. Pg 7
- Users need relevant and reliable information about companies to make decisions.
- The professional accounting groups in Canada have codes of ethics and rules of conduct to assure society that accountants behave ethically

MyAccountingLab Video:

3 Learning Objective 3: Describe and discuss the forms of business organizations

Describe and discuss the forms of business organizations

- The three basic forms of business organizations are the Pg 9
  - proprietorship
  - partnership (a limited-liability partnership, or LLP, is a special form of partnership), and
  - corporation.
- A summary and comparison of the three forms are given in Exhibit 1–5 on page 11.

MyAccountingLab Video:

4 Learning Objective 4: Explain the development of accounting standards, and describe the concepts and principles

Explain the development of accounting standards, and describe the concepts and principles

- Accounting concepts guide accountants in their work. Pg 11
- Accounting concepts that provide the basis for accounting standards for private enterprises (ASPE) and international financial reporting standards (IFRS) are summarized in Exhibit 1–6:
  - Level 1—The primary objective of financial statements is to provide information that is useful for users in their decision making.
  - Level 2—To be useful, the information must have the qualitative characteristics of understandability, reliability, relevance, and comparability.
  - Level 3—The Level 2 characteristics are achieved through the use of elements to categorize the financial information
  - Level 4—The Level 2 characteristics are also achieved by following the guidelines for recognition and measurement.

MyAccountingLab Video:

5 Learning Objective 5: Describe and use the accounting equation to analyze business transactions

Describe and use the accounting equation to analyze business transactions

- In its most common form, the accounting equation is Pg 16

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

- A transaction is an event that affects the financial position of an entity *and* can be reliably recorded.
- Transactions affect a business's assets, liabilities, and owner's equity. Therefore, transactions are often analyzed in terms of their effect on the accounting equation.

MyAccountingLab Video:

6 Learning Objective 6: Prepare and evaluate financial statements

Prepare and evaluate the financial statements

- The *financial statements* communicate information for decision making by an entity's users, including managers, owners, and creditors. Pg 23
- The *income statement:*
  - summarizes the entity's operations in terms of revenues earned and expenses incurred during a specific period of time. Total revenues minus total expenses equal net income.
  - The *statement of owner's equity* reports the changes in owner's equity during the period.
  - The *balance sheet* lists the entity's assets, liabilities, and owner's equity at a specific date.
  - The *cash flow statement* reports the changes in cash during the period.
- High net income indicates success in business; a net loss indicates a lack of success in business.

MyAccountingLab Video: Relationships among the Financial Statements

MyAccountingLab Check **Accounting Vocabulary** on page 33 for all key terms used in Chapter 1 and the **Glossary** on page 000 for all key terms used in the textbook.

CHAPTER REVIEW:

MyAccountingLab Student PowerPoint Slides

MyAccountingLab Audio Chapter Summary

MyAccountingLab A variety of videos about Chapter 1 topics.

Note: All MyAccountingLab resources are found online under Chapter Resources – Multimedia Library

Test your understanding with these multiple-choice **Self-Study Questions**. Page references are given if you need review, and the answers are given after Self-Study Question 12.

SELF-STUDY QUESTIONS

MyAccountingLab

Test your understanding of the chapter by marking the correct answer for each of the following questions:

1. The organization that formulates generally accepted accounting principles is the (*p. 12*)
   a. Ontario Securities Commission (OSC)
   b. Public Accountants Council of Canada
   c. Accounting Standards Board (AcSB)
   d. Canada Revenue Agency (CRA)
2. Which of the following forms of business organization is an "artificial person" and must obtain legal approval from the federal government or a province to conduct business? (*p. 10*)
   a. Law firm
   b. Proprietorship
   c. Partnership
   d. Corporation
3. You have purchased some T-shirts for $6,000 and can sell them immediately for $8,000. What accounting consideration, assumption, or characteristic governs the amount at which to record the goods you purchased? (*p. 15*)
   a. Economic-entity consideration
   b. Reliability characteristic
   c. Cost principle
   d. Going-concern assumption
4. The economic resources of a business are called (*p. 16*)
   a. Assets
   b. Liabilities
   c. Owner's equity
   d. Accounts payable
5. If the assets of a business are $200,000 and the liabilities are $90,000, how much is the owner's equity? (*p. 16*)
   a. $290,000
   b. $110,000
   c. $200,000
   d. $90,000
6. A business has assets of $160,000 and liabilities of $180,000. How much is its owner's equity? (*p. 16*)
   a. $0
   b. ($20,000)
   c. $160,000
   d. $340,000
7. If the owner's equity in a business is $70,000 and the liabilities are $35,000, how much are the assets? (*p. 16*)
   a. $35,000
   b. $70,000
   c. $105,000
   d. $35,000
8. Purchasing office supplies on account will (*p. 18*)
   a. Increase an asset and increase a liability
   b. Increase an asset and increase owner's equity
   c. Increase one asset and decrease another asset
   d. Increase an asset and decrease a liability
9. Performing a service for a customer or client and receiving the cash immediately will (*p. 19*)
   a. Increase one asset and decrease another asset
   b. Increase an asset and increase owner's equity
   c. Decrease an asset and decrease a liability
   d. Increase an asset and increase a liability
10. Paying an account payable will (*p. 20*)
    a. Increase one asset and decrease another asset
    b. Decrease an asset and decrease owner's equity
    c. Decrease an asset and decrease a liability
    d. Increase an asset and increase a liability
11. The financial statement that summarizes assets, liabilities, and owner's equity is called the (*p. 24*)
    a. Cash flow statement
    b. Balance sheet
    c. Income statement
    d. Statement of owner's equity
12. The financial statements that are dated for a time period (rather than for a specific point in time) are the (*pp. 24–25*)
    a. Balance sheet and income statement
    b. Balance sheet and statement of owner's equity
    c. Income statement, statement of owner's equity, and cash flow statement
    d. All financial statements are dated for a time period.

Answers to Self-Study Questions

1. c 2. d 3. c 4. a 5. b 6. b 7. c 8. a 9. b 10. c 11. b 12. c

Check how well you answered the Self-Study Questions.

ACCOUNTING VOCABULARY

Accounting Vocabulary lists all the new boldfaced terms that were explained in the chapter with their definitions. They are also defined in the Glossary. Page references help you to review the terms.

MyAccountingLab

Like many other subjects, accounting has a special vocabulary. It is important that you understand the following terms.

Account payable A liability that is backed by the general reputation and credit standing of the debtor *(p. 19).*

Account receivable An asset, a promise to receive cash from customers to whom the business has sold goods or services *(p. 19).*

Accounting The system that measures business activities, processes that information into reports and financial statements, and communicates the findings to decision makers *(p. 5).*

Accounting equation The most basic tool of accounting: Assets = Liabilities + Owner's Equity (proprietorship) or Assets = Liabilities + Shareholders' Equity (corporation) *(p. 16).*

Accounting Standards for Private Enterprises (ASPE) Created by the Accounting Standards Board, guidelines for reporting the financial results of non-publicly accountable enterprises in Canada *(p. 12).*

Asset An economic resource a business owns that is expected to be of benefit in the future *(p. 16).*

Audit The examination of financial statements by outside accountants, the most significant service that public accountants perform. The conclusion of an audit is the accountant's professional opinion about the financial statements *(p. 7).*

Balance sheet List of an entity's assets, liabilities and owner's equity (proprietorship) or shareholders' equity (corporation) as of a specific date. Also called the *statement of financial position* *(p. 24).*

Capital Another name for the owner's equity of a business *(p. 16).*

Cash flow statement Reports cash receipts and cash payments classified according to the entity's major activities: operating, investing, and financing *(p. 24).*

Corporation A business owned by shareholders that begins when the federal government or provincial government approves its articles of incorporation. A corporation is a legal entity, an "artificial person," in the eyes of the law *(p. 10).*

Cost principle of measurement States that assets and services are recorded at their purchase cost and that the accounting record of the asset continues to be based on cost rather than current market value *(p. 15).*

Entity An organization or a section of an organization that, for accounting purposes, stands apart from other organizations and individuals as a separate economic unit. This is the most basic concept in accounting *(p. 14).*

Expense Decrease in owner's equity (proprietorship) or shareholders' equity (corporation) that occurs in the course of delivering goods or services to customers or clients *(p. 17).*

Financial accounting The branch of accounting that provides information to people outside the business *(p. 6).*

Financial statements Business documents that report financial information about an entity to persons and organizations outside the business *(p. 5).*

Generally accepted accounting principles (GAAP) Accounting guidelines, formulated by the Accounting Standards Board, that govern how businesses report their results in financial statements to the public *(p. 11).*

Going-concern assumption Accountants' assumption that the business will continue operating in the forseeable future *(p. 14).*

Income statement List of an entity's revenues, expenses, and net income or net loss for a specific period. Also called the *statement of earnings* or *statement of operations* *(p. 23).*

Inflation A rise in the general level of prices *(p. 15).*

International Financial Reporting Standards (IFRS) Created by the International Federation of Accountants, guidelines for reporting the financial results of publicly accountable enterprises and accepted by over 110 countries in the world. Canada adopted these standards in 2011 for publicly accountable enterprises *(p. 12).*

Liability An economic obligation (a debt) payable to an individual or an organization outside the business *(p. 16).*

Limited-liability partnership (LLP) A form of partnership in which each partner's personal liability for the business's debts is limited to a certain amount *(p. 11).*

Management accounting The branch of accounting that generates information for internal decision makers of a business, such as top executives *(p. 6).*

Measurement The process of determining the amount at which an item is recognized in the financial statements *(p. 15).*

Net earnings Another name for net income or net profit *(p. 23).*

Net income Excess of total revenues over total expenses. Also called *net earnings* or *net profit* *(p. 23).*

Net loss Excess of total expenses over total revenues *(p. 23).*

Net profit Another name for net income or net earnings *(p. 23).*

Note payable A liability evidenced by a written promise to make a future payment *(p. 19).*

Owner's equity In a proprietorship, the claim of an owner of a business to the assets of the business. Also called *capital* *(p. 16).*

Owner withdrawals Amounts removed from the business by an owner *(p. 17).*

Partnership An unincorporated business with two or more owners *(p. 10).*

Proprietorship An unincorporated business with a single owner *(p. 9).*

Publicly accountable enterprise A corporation that has its shares traded on a stock exchange or for which a strong public interest exists *(p. 12).*

Recognition The process of including an item in the financial statements of a company *(p. 15).*

Revenue Increase in owner's equity (proprietorship) or shareholders' equity (corporation) that is earned by delivering goods or services to customers or clients *(p. 17).*

Shareholder A person or company who owns one or more shares of stock in a corporation *(p. 10).*

Stable monetary unit assumption Accountants' basis for ignoring the effect of inflation and making no adjustments for the changing value of the dollar *(p. 15).*

Statement of earnings Another name for the income statement *(p. 23).*

Statement of financial position Another name for the balance sheet *(p. 24).*

Statement of operations Another name for the income statement. Also called the *statement of earnings* *(p. 23).*

Statement of owner's equity Summary of the changes in an entity's owner's equity during a specific period *(p. 23).*

Transaction An event that affects the financial position of a particular entity *and* may be reliably recorded *(p. 17).*

SIMILAR ACCOUNTING TERMS

Similar Accounting Terms are a link between the terms used in this book and similar terms you might have heard out-side your accounting class in the media or your day-to-day business dealings.

Accounting equation	Assets = Liabilities + Owner's Equity
Balance Sheet	Statement of Financial Position
Income Statement	Statement of Operations; Statement of Earnings
Net income	Net earnings; Net profit

Assignment Material

QUESTIONS

1. Distinguish between accounting and bookkeeping.
2. Identify five users of accounting information and explain how they use it.
3. Name two important historical reasons for the development of accounting.
4. Name three professional designations of accountants. Also give their abbreviations.
5. What organization formulates generally accepted accounting principles? Is this organization a government agency?
6. Identify the owner(s) of a proprietorship, a partnership, and a corporation.
7. Why do ethical standards exist in accounting? Which professional organizations direct their standards more toward independent auditors? Which organizations direct their standards more toward management accountants?
8. Why is the economic-entity assumption so important to accounting?
9. Give four examples of types of accounting entities.
10. Briefly describe the reliability characteristic.
11. What role does the cost principle of measurement play in accounting?
12. If assets = liabilities + owner's equity, then how can liabilities be expressed?
13. Explain the difference between an account receivable and an account payable.
14. What role do transactions play in accounting?
15. A company reported monthly revenues of $92,000 and expenses of $96,400. What is the result of operations for the month?
16. Give a more descriptive title for the balance sheet.
17. What feature of the balance sheet gives this financial statement its name?
18. Give another title for the income statement.
19. Which financial statement is like a snapshot of the entity at a specific time? Which financial statement is like a video of the entity's operation during a period of time?
20. What information does the statement of owner's equity report?
21. Give another term for the owner's equity of a proprietorship.
22. What piece of information flows from the income statement to the statement of owner's equity? What information flows from the statement of owner's equity to the balance sheet? What balance sheet item is explained by the cash flow statement?
23. Why does it make sense that Canadian companies whose shares are publicly traded on stock exchanges in Canada follow international financial reporting standards instead of standards developed for private companies in Canada?

STARTERS

A brief description and the Learning Objectives covered appear beside each Starter, Exercise, and Problem.

Starter 1–1 Ralph's Landscaping Service has been open for one year, and Ryan Ralph, the owner, wants to know whether the business earned a net income or a net loss for the year. First, he must identify the revenues earned and the expenses incurred during the year. What are revenues and expenses?

Explaining revenues and expenses
1 5

Starter 1–2 Suppose you need a bank loan to purchase lawn equipment for Ralph's Landscaping Service. In evaluating your loan request, the banker asks about the assets and liabilities of your business. In particular, the banker wants to know the amount of the business's owner's equity.

Users of financial information
1

Required

1. Is the banker considered an internal or an external user of financial information?
2. Which financial statement would provide the best information to answer the banker's questions?

Forms of business organizations
3 A

Starter 1–3 Louise Layton plans to open Louise's Floral Designs. She is considering the various types of business organizations and wishes to organize her business with unlimited life and limited liability features. Which type of business organization will meet Louise's needs best?

Applying accounting concepts and principles
4

Starter 1–4 Erin Chan is the proprietor of a property management company near the campus of a local university. The business has cash of $12,000 and furniture that cost $24,000 and has a market value of $30,000. Debts include accounts payable of $10,000. Chan's personal home is valued at $400,000 and her personal bank account contains $12,000.

Required

1. Consider the accounting concepts and principles discussed in the chapter, and define the principle that best matches each of the following situations:
   a. Chan's personal assets are not recorded on the property management company's balance sheet.
   b. Chan records furniture at its cost of $24,000, not the market value of $30,000.
   c. Chan does not make adjustments for inflation.
   d. The account payable of $10,000 is documented by a statement from the furniture company showing the property management company still owes $10,000 on the furniture. Chan's friend thinks the property management company should only owe about $6,000. The account payable is recorded at $10,000.
2. How much is the owner's equity of the property management company?

Using the accounting equation
5

Starter 1–5 Lazy Creek Kennel earns service revenue by caring for the pets of customers. Lazy Creek's main expense is the salary paid to an employee. Write the accounting equation for (a) the receipt of $500 cash for service revenue earned, and (b) the payment of $1,500 for salary expense.

Analyzing transactions
5

Starter 1–6 Outdoor Adventures Travel recorded revenues of $3,000 earned on account by providing travel service for clients.

Required

1. How much are the business's cash and total assets, assuming this is the only transaction?
2. Name the business asset that was increased as a result of this transaction.

Describing accounting concepts, principles, and constraints
4

Starter 1–7 Match the assumption, principle, or constraint description with the appropriate term by placing a, b, c, d, e, and f on the appropriate line.

a. Cost principle of measurement	______	Benefits of the information produced by an accounting system must be greater than the costs
b. Going-concern assumption	______	Amounts may be ignored if the effect on a decision maker's decision is not significant
c. Stable monetary unit assumption	______	Transactions are recorded based on the cash amount received or paid
d. Economic-entity assumption	______	Transactions are expressed using units of money
e. Cost/benefit constraint	______	Assumes that a business is going to continue operations indefinitely
f. Materiality constraint	______	Business must keep its accounting records separate from its owner's accounting records

Using the accounting equation
5

Starter 1–8 Suppose Mayne Island Kayaks rents kayaks to tourists. The company purchased a storage building for the kayaks for $200,000 and financed the purchase with a loan of $120,000 and an investment by the owner for the remainder. Use the accounting equation to calculate the owner's equity amount.

Starter 1–9 A potential customer is extremely interested in renting a number of kayaks from Mayne Island Kayaks and emails his intention to rent kayaks in the summer. Would an accountant consider this event a transaction to be recorded in the accounting records? Explain.

Defining transactions
5

Starter 1–10 What four main financial statements are provided in a company's annual report? An example of a company's' annual report is provided in Appendix A at the back of this textbook.

Examples of financial statements
6

Starter 1–11 Laurel Wedding Planners has just completed operations for the year ended December 31, 2014. This is the third year of operations for the company. As the owner, you want to know how well the company performed during the year. To address this question, you have assembled the data below. Use these data to prepare the income statement of Laurel Wedding Planners for the year ended December 31, 2014.

Preparing the income statement
6
Net income, $48,000

Insurance Expense	$3,000	Salary Expense	$50,000
Service Revenue	120,000	Accounts Payable	8,000
Supplies Expense	1,000	Supplies	2,500
Rent Expense	18,000	Withdrawals	40,000

Check figures appear in the margin when applicable to help you make sure you are "on track."

Starter 1–12 Review the income statement prepared in Starter 1-11. Evaluate the results of 2014 operations for Laurel Wedding Planners. Was it a good year or a bad year? Why or why not?

Evaluating business performance
6

EXERCISES

Exercise 1–1

Match each of the following accounting terms with its correct definition:

Using accounting vocabulary
5 6

TERMS:

1. Accounting equation
2. Asset
3. Balance sheet
4. Expense
5. Income statement
6. Liability
7. Net income
8. Net loss
9. Revenue
10. Cash flow statement
11. Statement of owner's equity

DEFINITIONS:

A. An economic resource that is expected to be of benefit in the future
B. An economic obligation (a debt) payable to an individual or an organization outside the business
C. Excess of total expenses over total revenues
D. Excess of total revenues over total expenses
E. The basic tool of accounting, stated as Assets = Liabilities + Owner's Equity
F. Decrease in equity that occurs from using assets or increasing liabilities in the course of delivering goods or services to customers
G. Amounts earned by delivering goods or services to customers
H. Report of cash receipts and cash payments during a period
I. Report of an entity's assets, liabilities, and owner's equity as of a specific date
J. Report of an entity's revenues, expenses, and net income or net loss for a period of time
K. Report that shows the changes in owner's equity for a period of time

Exercise 1–2

Jim and Andrea Kerslake want to open a restaurant. In need of cash, they meet with their bank manager for a loan. With little knowledge of finance, the Kerslakes don't know how the lending process works. Explain to them the information provided to the bank by the income statement (statement of operations) and the balance sheet (statement of financial position). Indicate why a lender would require this information.

Users of financial statements, explaining the income statement and the balance sheet
1 6

Exercise 1–3

Publicly accountable enterprises in Canada must use international financial reporting standards (IFRS) in preparing their financial statements. Provide two reasons why Canada switched to these standards.

Reasons for following international financial reporting standards (IFRS)
4

Exercise 1–4

Classifying accounts, working with financial statements

5 6

The accounting records of Chiang Consulting Services contain the following accounts:

Supplies Expense	Accounts Payable
Accounts Receivable	Rent Expense
J. Chiang, Capital	Cash
Salary Expense	J. Chiang, Withdrawals
Computer Equipment	Supplies
Consulting Service Revenue	Notes Payable

Required

1. Indicate whether each account listed is a(n) asset (A), liability (L), owner's equity (OE), revenue (R), or expense (E) account.
2. Indicate whether each account listed appears on the balance sheet (B), income statement (I), statement of owner's equity (SOE), or cash flow statement (CF). Some accounts can appear on more than one statement.

Exercise 1–5

Business transactions

5

Give an example of a business transaction that has each of the following effects on the accounting equation:

a. Increases an asset and increases a liability.
b. Increases one asset and decreases another asset.
c. Decreases an asset and decreases owner's equity.
d. Decreases an asset and decreases a liability.
e. Increases an asset and increases owner's equity.

Exercise 1–6

Transaction analysis

5

Peace River Enterprises, a business owned by Alan Sidhu, experienced the following events. State whether each event (1) increased, (2) decreased, or (3) had no effect on the *total assets* of the business. Identify any specific asset affected.

a. Sidhu increased his cash investment in the business.
b. Paid cash on accounts payable.
c. Purchased office equipment; signed a note payable in payment.
d. Performed service for a customer on account.
e. Sidhu withdrew cash for personal expenses.
f. Received cash from a customer on account receivable.
g. Sidhu used personal funds to purchase a swimming pool for his home.
h. Sold undesirable land for a price equal to the cost of the land; received cash.
i. Borrowed money from the bank.
j. Cash purchase of desirable land for a future building site.

Exercise 1–7

Characteristics of a proprietorship, accounting concepts and principles, using the accounting equation

3 4 5

Marpole Dry Cleaners liabilities, $50,000

Select financial information for three proprietorships follows:

	Assets	**Liabilities**	**Owner's Equity**
Economy Cuts	$?	$120,000	$40,000
Marpole Dry Cleaners	100,000	?	50,000
Dauphin Gift and Cards	145,000	115,000	?

Required

1. Compute the missing amount in the accounting equation for each entity.
2. Which accounting concept or principle tells us that the three companies will cease to exist if the owners die?

Exercise 1–8

Janice Thorpe owns Grinds Coffee House, near the campus of Western Community College. The company has cash of $18,000 and furniture that cost $40,000. Debts include accounts payable of $7,000 and a $30,000 note payable. Write the accounting equation of Grinds Coffee House. What is the owner's equity of the company?

Using the accounting equation
5
Owner's equity $21,000

Exercise 1–9

Prairie Snow removal began 2014 with total assets of $44,000 and total liabilities of $18,000. At the end of 2014, the business's total assets were $50,000 and total liabilities were $20,000.

Using the accounting equation, evaluating business performance
5 6
1. Increase in owner's equity $4,000

Required

1. Did the owner's equity of Prairie Snow Removal increase or decrease during 2014? By how much?
2. Identify two possible reasons for the change in owner's equity of Prairie Snow Removal during the year.

Exercise 1–10

Indicate the effects of the following business transactions on the accounting equation of a proprietorship. Transaction *a* is answered as a guide.

Transaction analysis
5

a. Received $50,000 cash from the owner.
   Answer: Increase asset (Cash)
   Increase owner's equity (Owner, Capital)
b. Paid the current month's office rent of $4,000.
c. Paid $3,500 cash to purchase office supplies.
d. Performed engineering services for a client on account, $6,000.
e. Purchased on account office furniture at a cost of $5,000.
f. Received cash on account, $3,000.
g. Paid cash on account, $2,500.
h. Sold land for $50,000, which was the business's cost of the land.
i. Performed engineering services for a client and received cash of $6,000.

This margin note reminds you that an Excel template is available in MyAccountingLab to help you answer this question.

Exercise 1–11

Gayle Hayashi, M.D., opens a medical clinic. During her first month of operation, January, the clinic, entitled Hayashi Medical Clinic, experienced the following events:

Excel Spreadsheet Template
Transaction analysis, accounting equation
5
Total assets $266,500

Jan.	6	Hayashi invested $250,000 in the clinic by opening a bank account in the name of Hayashi Medical Clinic.
	9	Hayashi Medical Clinic paid cash for land costing $150,000. There are plans to build a clinic on the land. Until then, the business will rent an office.
	12	The clinic purchased medical supplies for $10,000 on account.
	15	On January 15, Hayashi Medical Clinic officially opened for business.
	15–31	During the rest of the month, the clinic earned professional fees of $20,000 and received cash immediately.
	15–31	The clinic paid cash expenses: employee salaries, $5,000; office rent, $4,000; utilities, $500.
	28	The clinic sold supplies to another clinic at cost for $1,000.
	31	The clinic paid $4,000 on the account from January 12.

Required Analyze the effects of these events on the accounting equation of Hayashi Medical Clinic. Use a format similar to that of Exhibit 1–9, Panel B, on page 22 with headings for: Cash; Medical Supplies; Land; Accounts Payable; and Gayle Hayashi, Capital.

Exercise 1–12

Business organizations, transactions, net income
5 6
2. Net income $4,500

The analysis of the transactions that Oakdale Equipment Rental engaged in during its first month of operations follows. The business buys electronic equipment that it rents out to earn rental revenue. The owner of the business, Gary Oake, made only one investment to start the business and made no withdrawals from Oakdale Equipment Rental.

	Cash	+	Accounts Receivable	+	Rental Equipment	=	Accounts Payable	+	G. Oake, Capital
a.	+ 50,000								+ 50,000
b.	+ 1,000								+ 1,000
c.					+ 80,000		+ 80,000		
d.			+ 1,000						+ 1,000
e.	− 2,000								− 2,000
f.	+ 4,500								+ 4,500
g.	+ 500		− 500						
h.	− 5,000						− 5,000		

Required

1. Describe each transaction of Oakdale Equipment Rental.
2. If these transactions fully describe the operations of Oakdale Equipment Rental during the month, what was the amount of net income or net loss?

Exercise 1–13

B
Business organization, balance sheet
3 6
2. Total assets $110,000

Presented below are the balances of the assets and liabilities of Summerland Consulting Services as of September 30, 2014. Also included are the revenue and expense account balances of the business for September. Megan Hall, the owner, invested $60,000 when the business was formed.

Consulting Service Revenue	$62,000	Computer Equipment	$80,000
Accounts Receivable	25,000	Supplies	5,000
Accounts Payable	16,000	Note Payable	50,000
Salary Expense	10,000	Rent Expense	4,000
M. Hall, Capital	?	Cash	5,000

Required

1. What type of business entity or organization is Summerland Consulting Services? How can you tell?
2. Prepare the balance sheet of Summerland Consulting Services as of September 30, 2014.
3. What does the balance sheet report—financial position or operating results? Which financial statement reports the other information?

Exercise 1–14

Preparing the financial statements
6
Total assets $295,000

Examine Exhibit 1–9 on page 22. The exhibit summarizes the transactions of Hunter Environmental Services for the month of April 2013. Suppose the business completed transactions 1 to 7 and needed a bank loan on April 21, 2013. The vice-president of the bank requires financial statements to support all loan requests.

Required Prepare the income statement, statement of owner's equity, and balance sheet that Hunter Environmental Services would present to the banker on April 21, 2013, after completing the first seven transactions. Exhibit 1–10, page 25, shows the format of these financial statements.

Exercise 1–15

Excel Spreadsheet Template

Income statement for a proprietorship

6

1. Net income $57,000

The assets, liabilities, owner's equity, revenue and expenses of Philpott Company, a proprietorship, have the following final balances at December 31, 2015, the end of its first year of business. To start the business, Brian Philpott invested $90,000.

Note Payable	$ 50,000	Office Furniture	$ 50,000
Utilities Expense	18,000	Rent Expense	48,000
Accounts Payable	12,000	Cash	15,000
B. Philpott, Capital	90,000	Office Supplies	14,000
Service Revenue	610,000	Salary Expense	430,000
Accounts Receivable	35,000	Salary Payable	5,000
Supplies Expense	30,000	Research Expense	27,000
Equipment	100,000		

Required

1. Prepare the income statement of Philpott Company for the year ended December 31, 2015. What is Philpott Company's net income or net loss for 2015? (Hint: Ignore balance sheet items.)

SERIAL EXERCISE

The Serial Exercise involves a company that will be revisited throughout relevant chapters in Volume 1 and Volume 2. It begins as a proprietorship in Volume 1, and then grows to a partnership and then a corporation in Volume 2.You can complete the Serial Exercises using MyAccountingLab.

Exercise 1–16

Transaction analysis, accounting equation, financial statements

5 6

Total assets, $36,750

Kerr Consulting began operations and completed the following transactions during December 2013.

Dec.	2	Received $30,000 cash from owner Alex Kerr. The business gave owner's equity in the business to Kerr.
	2	Paid office rent for the month of December, $3,000
	3	Paid cash for a Dell computer, $2,000. The computer is expected to remain in service for five years.
	4	Purchased office furniture on account, $6,000. The furniture is expected to last for five years.
	5	Purchased supplies on account, $500.
	9	Performed consulting services for a client on account, $2,000.
	12	Paid utility expenses, $250.
	18	Performed consulting services for a client and received cash of $2,000
	21	Received $2,000 in advance for client services to be performed evenly over the next 30 days. (Use the account Unearned Revenue for this transaction.)
	22	Hired an office manager, on a part-time basis. She will be paid $2,000 per month. She started work immediately.
	23	Paid $500 for the supplies purchased on December 5.
	28	Collected $1,500 from the consulting client invoiced on December 9.
	31	Alex Kerr withdrew $2,000 for personal use.

Required

1. Analyze the effects of Kerr Consulting's transactions on the accounting equation. Use the format of Exhibit 1-9, Panel B, on page 22, and use these headings: Cash; Accounts Receivable; Supplies; Equipment; Furniture; Accounts Payable; Unearned Revenue; and Alex Kerr, Capital.

In Chapter 2, we will account for these same transactions in a different way—as the accounting is actually performed in practice.

CHALLENGE EXERCISES

Exercise 1–17

Using the financial statements
5 6
2Net income:
Fraser Co. $200,000
Delta Co. $170,000
Pine Co. $225,000

Compute the missing amounts for each of the following businesses.

	Fraser Co.	Delta Co.	Pine Co.
Beginning:			
Assets	$350,000	$300,000	$540,000
Liabilities	200,000	120,000	360,000
Ending:			
Assets	$500,000	$360,000	$?
Liabilities	250,000	160,000	480,000
Owner's equity:			
Investments by owner	$?	$ 0	$ 50,000
Withdrawals by owner	250,000	150,000	220,000
Income Statement:			
Revenues	$660,000	$350,000	$900,000
Expenses	460,000	?	675,000

Exercise 1–18

Using the accounting equation, preparing the statement of owner's equity
5 6
2. Net income $20,000

Merit Logistics' balance sheet data are shown below.

	January 1, 2014	December 31, 2014
Total assets	$300,000	$420,000
Total liabilities	260,000	340,000

Required

1. Compute the amount of net income or net loss for the company during the year ended December 31, 2014, if the owner invested $50,000 in the business and withdrew $30,000 during the year. Show all calculations.
2. Prepare the statement of owner's equity for Sandy Merit, the owner of Merit Logistics, for the year ended December 31, 2014. Use the format shown in Exhibit 1–10 on page 25.

BEYOND THE NUMBERS

Beyond the Numbers 1–1

Analyzing a loan request
1 6

As an analyst for Royal Bank, it is your job to write recommendations to the bank's loan committee. Vernon Engineering Co., a client of the bank, has submitted these summary data to support the company's request for a $150,000 loan:

Income Statement Data	2014	2013	2012
Total revenues	$550,000	$490,000	$475,000
Total expenses	400,000	345,000	305,000
Net income	$150,000	$145,000	$170,000

Statement of Owner's Equity Data	2014	2013	2012
Beginning capital	$230,000	$205,000	$215,000
Add: Net income	150,000	145,000	170,000
	$380,000	$350,000	$385,000
Less: Withdrawals	(175,000)	(120,000)	(180,000)
Ending capital	$205,000	$230,000	$205,000

Balance Sheet Data	2014	2013	2012
Total assets	$450,000	$425,000	$375,000
Total liabilities	$245,000	$195,000	$170,000
Total owner's equity	205,000	230,000	205,000
Total liabilities and owner's equity	$450,000	$425,000	$375,000

Required Analyze these financial statement data to decide whether the bank should lend $150,000 to Vernon Engineering Co. Consider the trends in net income and owner's equity, and the change in total liabilities in making your decision. Write a one-paragraph recommendation to the bank's loan committee.

Beyond the Numbers 1–2

Transaction analysis, effects on financial statements

5

Shining Star Camp conducts summer camps for children with physical challenges. Because of the nature of its business, Shining Star Camp experiences many unusual transactions. Evaluate each of the following transactions in terms of its effect on Shining Star Camp's income statement and balance sheet.

a. A camper suffered a dental injury that was not covered by insurance. Shining Star Camp paid $1,000 for the child's dental care. How does this transaction affect the income statement and the balance sheet?

b. One camper's mother is a physician. Shining Star Camp allows this child to attend camp in return for the mother's serving part-time in the camp infirmary for the two-week term. The standard fee for a camp term is $1,500. The physician's salary for this part-time work would be $1,500. How should Shining Star Camp account for this arrangement?

c. Lightning during a storm damaged the camp dining hall. The cost to repair the damage will be $5,000 over and above what the insurance company will pay.

ETHICAL ISSUES

Ethical Issue 1

The following excerpt was taken from the President's letter to the shareholders in CV Technology's 2007 Annual Report:

> In the fall of 2006, encouraged by enthusiasm from American retailers, we launched COLD-fX® in the U.S. In the face of unexpectedly high return rates from U.S. retailers, we announced on April 11, 2007 that we would restate our financial results, due to a reconsideration of the way we apply our revenue recognition policy. As a result of our announcement, Securities Commissions in Alberta, British Columbia, and Ontario issued interim trading halts on our shares. After restated financials were released, trading in the shares resumed on July 11, 2007.

Required

1. Why is it important that this type of information be disclosed?
2. Suppose you are the chief financial officer (CFO) responsible for the financial statements of CV Technologies. What ethical issues would you face as you consider what to report in the 2007 Annual Report?
3. What are the negative consequences to CV Technologies of not telling the truth? What are the negative consequences to CV Technologies of telling the truth?

Ethical Issue 2

The board of directors of Cloutier Inc. is meeting to discuss the past year's results before releasing financial statements to the public. The discussion includes this exchange:

> Sue Cloutier, company president: "Well, this has not been a good year! Revenue is down and expenses are up—way up. If we don't do some fancy stepping, we'll report a loss for the third year in a row. I can temporarily transfer some land that I own into the company's name, and that will beef up our balance sheet. Rob, can you shave $500,000 from expenses? Then we can probably get the bank loan that we need."
>
> Rob Samuels, company chief accountant: "Sue, you are asking too much. Generally accepted accounting principles are designed to keep this sort of thing from happening."

Required

1. What is the fundamental ethical issue in this situation?
2. Discuss how Cloutier's proposals violate generally accepted accounting principles. Identify the specific concept(s) or principle(s) involved.

PROBLEMS (GROUP A)

Problem 1–1A

Entity concept, transaction analysis, accounting equation

4 5

2. Total assets $61,000

Jon Conlin was a lawyer and partner in a large firm, a partnership, for five years after graduating from university. Recently, he resigned his position to open his own legal practice, which he operates as a proprietorship. The name of the new company is Conlin & Associates.

Conlin recorded the following events during the organizing phase of his new business and its first month of operations. Some of the events were personal and did not affect the legal practice. Others were business transactions and should be accounted for by the business.

July	4	Conlin received $100,000 cash from his former partners in the firm from which he resigned.
	5	Conlin invested $50,000 cash in his business, Conlin & Associates.
	5	The business paid office rent expense for the month of July, $3,000.
	6	The business paid $1,000 cash for letterhead stationery for the office.
	7	The business purchased office furniture on account for $7,000, promising to pay within six months.
	10	Conlin sold 2,000 shares of Royal Bank stock, which he had owned for several years, receiving $25,000 cash from his stockbroker.
	11	Conlin deposited the $25,000 cash from sale of the Royal Bank shares in his personal bank account.
	12	A representative of a large construction company telephoned Conlin and told him of the company's intention to transfer its legal business to Conlin & Associates.
	29	The business provided legal services for a client and submitted the bill for services, $10,000. The business expected to collect from this client within two weeks.
	31	Conlin withdrew $3,000 cash from the business.

Required

1. Classify each of the preceding events as one of the following (list each date, then choose a, b, or c):
   a. A business transaction to be accounted for by the business, Conlin & Associates.
   b. A business-related event but not a transaction to be accounted for by Conlin & Associates.
   c. A personal transaction not to be accounted for by Conlin & Associates.
2. Analyze the effects of the above events on the accounting equation of Conlin & Associates. Use a format similar to Exhibit 1-9, Panel B, on page 22.

Problem 1–2A

Shawn Steele is a realtor. He buys and sells properties on his own, and he also earns commission revenue as a real estate agent. He organized his business as a sole proprietorship on November 15, 2013. Consider the following facts as of November 30, 2013:

a. The business owed $30,000 on a note payable for some undeveloped land. This land had been acquired by the business for a total price of $70,000.

b. Steele's business had spent $15,000 for a Re/Max Ltd. real estate franchise, which entitled him to represent himself as a Re/Max agent. Re/Max is a national affiliation of independent real estate agents. This franchise is a business asset.

c. Steele owed $250,000 on a personal mortgage on his personal residence, which he acquired in 2001 for a total price of $500,000.

d. Steele had $25,000 in his personal bank account and $9,000 in his business bank account.

e. Steele owed $1,000 on a personal charge account with The Bay.

f. The business acquired business furniture for $9,000 on November 25. Of this amount, the company owed $3,000 on account at November 30.

g. The real estate office had $500 worth of office supplies on hand on November 30.

Required

1. Steele is concerned about liability exposure. Which proprietorship feature, if any, limits his personal liability?
2. Prepare the balance sheet of the real estate business of Shawn Steele, Realtor, at November 30, 2013.
3. Identify the personal items given in the preceding facts that would not be reported in the financial records of the business.

Problem 1–3A

Business transactions and analysis

5

Tisdale Suppliers was recently formed as a proprietorship. The balance of each item in the business's accounting equation is shown below for June 21 and for each of the nine following business days.

		Cash	Accounts Receivable	Supplies	Land	Accounts Payable	Owner's Equity
June	21	$19,000	$9,000	$3,000	$18,000	$9,000	$40,000
	22	26,000	9,000	3,000	18,000	9,000	47,000
	23	16,000	9,000	3,000	28,000	9,000	47,000
	24	16,000	9,000	7,000	28,000	13,000	47,000
	25	12,000	9,000	7,000	28,000	9,000	47,000
	26	15,000	6,000	7,000	28,000	9000	47,000
	27	22,000	6,000	7,000	28,000	9,000	54,000
	28	17,000	6,000	7,000	28,000	4,000	54,000
	29	14,000	6,000	10,000	28,000	4,000	54,000
	30	4,000	6,000	10,000	28,000	4,000	44,000

Required Assuming that a single transaction took place on each day, describe briefly the transaction that was most likely to have occurred. Begin with June 22 and complete up to June 30. Indicate which accounts were affected and by what amount. No revenue or expense transactions occurred on these dates.

Problem 1–4A

Excel Spreadsheet Template

Income statement, statement of owner's equity, balance sheet, evaluating business performance

6

1. Net income $135,000

Presented below are the amounts of (a) the assets and liabilities of Superior Marketing Consultants as of December 31, 2014 and (b) the revenues and expenses of the company for the year ended December 31, 2014. The items are listed in alphabetical order.

Accounts Payable	$57,000	Insurance Expense	$4,500
Accounts Receivable	36,000	Interest Expense	15,000
Advertising Expense	48,500	Land	37,500
Building	300,000	Note Payable	195,000
Cash	15,000	Salary Expense	240,000
Computer Equipment	165,000	Salary Payable	22,500
Courier Expense	7,000	Service Revenue	450,000
Furniture	45,000	Supplies	7,500

The opening balance of owner's equity was $300,000. At year end, after the calculation of net income, the owner, Susan Wong, withdrew $103,500.

Required

1. Prepare the business's income statement for the year ended December 31, 2014.
2. Prepare the statement of owner's equity of the business for the year ended December 31, 2014.
3. Prepare the balance sheet of the business at December 31, 2014.
4. Answer these questions about the business:
   a. Was the result of operations for the year a profit or a loss? How much was it?
   b. Did the business's owner's equity increase or decrease during the year? How would this affect the business's ability to borrow money from a bank in the future?
   c. How much in total economic resources does the business have at December 31, 2014, as it moves into the new year? How much does the business owe? What is the dollar amount of the owner's portion of the business at December 31, 2014?

Problem 1–5A

Balance sheet for a proprietorship

6

1. Total assets $330,000

The bookkeeper of Oliver Services Co., a proprietorship, prepared the balance sheet of the company while the accountant was ill. The balance sheet is not correct. The bookkeeper knew that the balance sheet should balance, so he "plugged in" the owner's equity amount needed to achieve this balance. The owner's equity amount, however, is not correct. All other amounts are accurate except the "Total assets" amount.

OLIVER SERVICES CO.			
Balance Sheet			
For the Month Ended July 31, 2013			
Assets		**Liabilities**	
Cash	$ 70,000	Service revenue	$220,000
Office supplies	5,000	Note payable	55,000
Land	130,000	Accounts payable	45,000
Advertising expense	10,000		
Office furniture	50,000		
Accounts receivable	75,000	Owner's Equity	
Rent expense	22,000	J. Enderby, capital	42,000
Total assets	$362,000	Total liabilities and owner's equity	$362,000

Required

1. Prepare the corrected balance sheet, and date it correctly. Compute total assets, total liabilities, and owner's equity.
2. Consider the original balance sheet as presented and the corrected balance sheet you prepared for Requirement 1. Did the total assets presented in your corrected balance sheet increase, decrease, or stay the same compared to the original balance sheet? Why?

Problem 1–6A

Transaction analysis, accounting equation, financial statements
5 6
2. Net income $45,000

Mary Reaney is the proprietor of a career counselling and employee search business, Reany Personnel Services. The following amounts summarize the financial position of the business on August 31, 2014:

									=	Liabilities	+	Owner's Equity
	Assets											
	Cash	+	Accounts Receivable	+	Supplies	+	Furniture and Computers		=	Accounts Payable	+	M. Reaney, Capital
Bal.	40,000		35,000				95,000			55,000		115,000

During September 2014 the following company transactions occurred:

a. Reaney deposited $80,000 cash in the business bank account.
b. Performed services for a client and received cash of $5,000.
c. Paid off the August 31, 2013, balance of accounts payable.
d. Purchased supplies on account, $6,000.
e. Collected cash from a customer on account, $7,500.
f. Consulted on a large downsizing by a major corporation and billed the client for services rendered, $48,000.
g. Recorded the following business expenses for the month:
   (1) Paid office rent for September 2013—$5,000.
   (2) Paid advertising—$3,000.
h. Sold supplies to another business for $1,000 cash, which was the cost of the supplies.
i. Reaney withdrew $8,000 cash.

Required

1. Analyze the effects of the above transactions on the accounting equation of Reaney Personnel Services. Adapt the format of Exhibit 1–9, Panel B, on page 22.
2. Prepare the income statement of Reaney Personnel Services for the month ended September 30, 2014. List expenses in decreasing order of amount.
3. Prepare the business's statement of owner's equity for the month ended September 30, 2014.
4. Prepare the balance sheet of Reaney Personnel Services at September 30, 2014.

Problem 1–7A

Accounting concepts/principles
4

Tanner Glass had been operating his law practice in Mississauga under the name Tanner Glass, Lawyer, for two years and had the following business assets and liabilities (at their historical costs) on April 30, 2015:

Cash	$45,000
Accounts Receivable	30,000
Supplies	2,000
Furniture and Computers	75,000
Accounts Payable	20,000

The following business transactions took place during the month of May 2015:

May	1	Glass deposited $30,000 cash into the business bank account.
	3	Glass completed legal work for a home builder. He charged the builder $5,000, not the $6,000 the work was worth, in order to promote business from the builder.
	5	The business bought furniture from Ajax Furniture for $8,000, paying $2,000 cash and promising to pay $1,000 per month at the beginning of each month starting June 1, 2015, for six months. Glass would like to expense the entire amount to reduce net income for tax reasons.
	10	The company signed a lease to rent additional space at a cost of $2,000 per month. Glass will occupy the premises effective June 1, 2015
	18	Determining that the business would need more cash in June, Glass went to the bank and borrowed $20,000 on a personal loan and transferred the money to the company.
	25	Glass purchased a painting for his home from one of his clients. He paid for the $3,000 purchase with his personal credit card.
	28	Glass withdrew $5,000 from the business. He used $2,000 of the money to repay a portion of the loan arranged on May 18.
	31	The business did legal work with a value of $10,000 for Apex Computers Ltd. Apex paid for the work by giving the company computer equipment with a selling price of $12,000.

Required Identify the accounting characteristic, assumption, or principle that would be applicable to each of the transactions and discuss the effects it would have on the financial statements of Tanner Glass, Lawyer.

Problem 1–8A

Accounting concepts/principles, transaction analysis, accounting equation, financial statements, evaluation

4 5 6

3. Net income $54,000

Terrace Board Rentals was started on January 1, 2013, by Ryan Terrace with an investment of $50,000 cash. The company rents out snowboards and related gear from a small store. During the first 11 months, Terrace made additional investments of $20,000 and borrowed $40,000 from the bank. He did not withdraw any funds. The balance sheet accounts, excluding Terrace's capital account, at November 30, 2013, are as follows:

Cash	$45,000
Accounts Receivable	15,000
Rental Gear	32,000
Rental Snowboards	48,000
Store Equipment	30,000
Accounts Payable	12,000
Note Payable	40,000

The following transactions took place during the month of December 2013:

Dec.	1	The business paid $5,000 for the month's rent on the store space.
	4	The business signed a one-year lease for the rental of additional store space at a cost of $4,000 per month. The lease is effective January 1. The business will pay the first month's rent in January.
	6	Rental revenues for the week were: Gear, $4,000; Boards, $10,000. 75% of the fees were paid in cash and the rest on account.
	10	The business paid the accounts payable from November 30, 2013.
	12	The business purchased gear for $20,000 and boards for $40,000, all on account.
	13	Rental revenues for the week were: Gear, $7,000; Boards, $14,000. All the fees were paid in cash.
	15	The company received payment for the accounts receivable owing at November 30, 2013.
	18	The company purchased store equipment for $10,000 by paying $3,000 cash with the balance due in 60 days.
	20	Rental revenues for the week were: Gear, $8,000; Boards, $14,000. Half the fees were paid in cash and half on account.
	21	Terrace withdrew $7,000.
	24	The company paid the balance owing for the purchases made on December 12.
	27	Rental revenues for the week were: Gear, $6,000; Boards, $10,000. All the fees were paid in cash.

27	The company received payment for rental fees on account from December 6.
31	The company paid its employees for the month of December. The total wages expense was $10,000.
31	Terrace paid the utility bill for the month of December, which was $4,000.

Required

1. What is the total net income earned by the business over the period of January 1, 2013 to November 30, 2013?
2. Analyze the effects of the December 2013 transactions on the accounting equation of Terrace Board Rentals. Include the account balances from November 30, 2013.
3. Prepare the income statement for Terrace Board Rentals for the month ended December 31, 2013.
4. Prepare the statement of owner's equity for Terrace Board Rentals for the month ended December 31, 2013.
5. Prepare the balance sheet for Terrace Board Rentals at December 31, 2013.
6. Terrace has expressed concern that although the business seems to be profitable and growing, he constantly seems to be investing additional money into it and has been unable to make any withdrawals for the work he has put into it. Prepare a reply to his concerns.

PROBLEMS (GROUP B)

Problem 1–1B

Entity concept, transaction analysis, accounting equation
4 5

Linda McLean is an architect and was a partner with a large firm, a partnership, for 10 years after graduating from university. Recently she resigned her position to open her own architecture office, which she operates as a proprietorship. The name of the new entity is McLean Design.

McLean recorded the following events during the organizing phase of her new business and its first month of operations. Some of the events were personal and did not affect the practice of architecture. Others were business transactions and should be accounted for by the business.

July	1	McLean sold 1,000 shares of Canadian Tire stock, which she had owned for several years, receiving $60,000 cash from her stockbroker.
	2	McLean deposited the $60,000 cash from the sale of the Canadian Tire shares into her personal bank account.
	3	McLean received $100,000 cash from her former partners in the architecture firm from which she resigned.
	5	McLean deposited $80,000 into a bank account in the name of McLean Design.
	5	McLean Design paid office rent for the month of July, $4,000.
	6	A representative of a large real estate company telephoned Linda McLean and told her of the company's intention to transfer its design business to her business, McLean Design.
	7	McLean Design paid $3,000 cash for office supplies, including letterhead and stationery.
	9	McLean Design purchased office furniture on account for $10,000, promising to pay in three months.
	23	McLean Design finished design work for a client and submitted the bill for design services, $12,000. It expects to collect from this client within one month.
	31	McLean withdrew $5,000 for personal use.

Required

1. Classify each of the preceding events as one of the following (list each date and then choose a, b, or c):
   a. A business transaction to be accounted for by the business, McLean Design.
   b. A business-related event but not a transaction to be accounted for by McLean Design.
   c. A personal transaction not to be accounted for by McLean Design.

2. Analyze the effects of the above events on the accounting equation of McLean Design. Use a format similar to Exhibit 1–9, Panel B, on page 22.

Problem 1–2B

Balance sheet, entity concept
4 6

Lupita Goodwin is a realtor. She buys and sells properties on her own, and she also earns commission revenue as a real estate agent. She invested $70,000 on March 10, 2014, in the business, Lupita Goodwin Realty. Consider the following facts as of March 31, 2014:

a. Goodwin had $10,000 in her personal bank account and $90,000 in the business bank account.

b. The real estate office had $6,000 of office supplies on hand on March 31, 2014.

c. Lupita Goodwin Realty had spent $25,000 for a Royal Lapage franchise, which entitled the company to represent itself as a Royal Lapage member firm. This franchise is a business asset.

d. The company owed $130,000 on a note payable for some undeveloped land that had been acquired by the company for a total price of $165,000.

e. Goodwin owed $185,000 on a personal mortgage on her personal residence, which she acquired in 2001 for a total price of $320,000.

f. Goodwin owed $2,000 on a personal charge account with Sears.

g. The company acquired business furniture for $18,000 on March 26. Of this amount, Lupita Goodwin Realty owed $14,000 on account at March 31, 2014.

Required

1. Goodwin is concerned about liability exposure. Which proprietorship feature, if any, limits her personal liability?
2. Prepare the balance sheet of the real estate business of Lupita Goodwin Realty at March 31, 2014.
3. Identify the personal items given in the preceding facts that would not be reported on the balance sheet of the business.

Problem 1–3B

Business transactions and analysis
5

Recently, Kate Cameron formed a management accounting practice as a proprietorship. The balance of each item in the proprietorship accounting equation follows for November 16 and for each of the eight following business days.

	Cash	Accounts Receivable	Office Supplies	Furniture	Accounts Payable	Owner's Equity
Nov. 16	$6,000	$10,000	$ 1,000	$8,000	$6,000	$19,000
17	7,000	9,000	1,000	8,000	6,000	19,000
18	6,000	9,000	1,000	8,000	5,000	19,000
19	6,000	9,000	1,500	8,000	5,500	19,000
20	8,000	9,000	1,500	8,000	5,500	21,000
23	7,000	9,000	1,500	8,000	4,500	21,000
24	9,000	9,000	1,500	6,000	4,500	21,000
25	8,500	9,000	2,000	6,000	4,500	21,000
26	7,500	9,000	2,000	6,000	4,500	20,000

Required Assuming that a single transaction took place on each day, describe briefly the transaction that was most likely to have occurred. Begin with November 17 and complete up to November 26. Indicate which accounts were affected and by what amount. Assume that no revenue or expense transactions occurred on these dates.

Excel Spreadsheet Template

Problem 1–4B

Income statement, statement of owner's equity, balance sheet
5

The amounts of (a) the assets and liabilities of Harada Office Cleaning as of December 31, 2014, and (b) the revenues and expenses of the company for the year ended on December 31, 2014, appear below. The items are listed in alphabetical order.

Accounts Payable	$ 40,000	Land	$100,000
Accounts Receivable	50,000	Notes Payable	200,000
Building	350,000	Property Tax Expense	10,000
Cash	25,000	Repairs Expense	30,000
Equipment	110,000	Salary Expense	280,000
Interest Expense	14,000	Service Revenue	650,000
Interest Payable	3,000	Supplies	10,000
Furniture	18,000	Utilities Expense	25,000

The beginning amount of owner's equity was $200,000. During the year, the owner, Yoshi Harada, withdrew $71,000.

Required

1. Prepare the income statement of Harada Office Cleaning for the year ended December 31, 2014.
2. Prepare the statement of owner's equity of the business for the year ended December 31, 2014.
3. Prepare the balance sheet of the business at December 31, 2014.
4. Answer these questions about Harada Office Cleaning.
   a. Was the result of operations for the year a profit or a loss? How much was it?
   b. Did the business's owner's equity increase or decrease during the year? How would this affect the business's ability to borrow money from a bank in the future?
   c. How much in total economic resources does the company have at December 31, 2014, as it moves into the new year? How much does the company owe? What is the dollar amount of the owner's portion of the business at December 31, 2014?

Problem 1–5B

Balance sheet 6

The bookkeeper of McBride Insurance Agency prepared the balance sheet of the company while the accountant was ill. The balance sheet contains errors. In particular, the bookkeeper knew that the balance sheet should balance, so she "plugged in" the owner's equity amount needed to achieve this balance. The owner's equity amount, however, is not correct. All other amounts are accurate except the "Total assets" amount.

McBRIDE INSURANCE AGENCY
Balance Sheet
For the Month Ended October 31, 2014

Assets		**Liabilities**	
Cash	$24,000	Premium revenue	$53,000
Insurance expense	2,000	Accounts payable	23,000
Rent expense	6,000	Note payable	40,000
Salary expense	8,000		
Office furniture	20,000		
Accounts receivable	22,000	Owner's Equity	
Utilities expense	2,000	C. McBride, capital	(8,000)
Notes receivable	24,000		
Total assets	$108,000	Total liabilities and owner's equity	$108,000

Required

1. Prepare the corrected balance sheet, and date it correctly. Compute total assets, total liabilities, and owner's equity.
2. Identify the accounts listed above that should *not* be presented on the balance sheet and state why you excluded them from the corrected balance sheet you prepared for Requirement 1.

Problem 1–6B

Transaction analysis, accounting equation, financial statements
5 6

Miranda Sykes operates an interior design studio called Sykes Design Studio. The following amounts summarize the financial position of the business on April 30, 2014:

	Assets							=	Liabilities	+	Owner's Equity
	Cash	+	Accounts Receivable	+	Supplies	+	Land	=	Accounts Payable	+	M. Sykes, Capital
Bal.	27,000		26,000				102,000		33,000		122,000

During May 2014, the company did the following:

a. Sykes received $20,000 as a gift and deposited the cash in the business bank account.

b. Paid the beginning balance of accounts payable.

c. Performed services for a client and received cash of $5,000.

d. Collected cash from a customer on account, $4.000.

e. Purchased supplies on account, $3,000.

f. Consulted on the interior design of a major office building and billed the client for services rendered, $16,000.

g. Recorded the following business expenses for the month:
(1) Paid office rent for May 2014—$6,000.
(2) Paid advertising—$4,000.

h. Sold supplies to another interior designer for $1,000 cash, which was the cost of the supplies.

i. Sykes withdrew $7,000 cash for personal use.

Required

1. Analyze the effects of the above transactions on the accounting equation of Sykes Design Studio. Adapt the format of Exhibit 1–9, Panel B, on page 22.
2. Prepare the income statement of Sykes Design Studio for the month ended May 31, 2014. List expenses in decreasing order of amount.
3. Prepare the statement of owner's equity of Sykes Design Studio for the month ended May 31, 2014.
4. Prepare the balance sheet of Sykes Design Studio at May 31, 2014.

Problem 1–7B

Accounting concepts/principles
4

John Chang has been operating a plumbing business as a proprietorship (John Chang Plumbing) for four years and had the following business assets and liabilities (at their historical costs) on May 31, 2015:

Cash	$60,000
Accounts Receivable	30,000
Shop Supplies	10,000
Shop Equipment	80,000
Accounts Payable	33,000

The following events took place during the month of June 2015:

June 1 John's brother retired and sold his equipment to John for $30,000. The equipment had cost $50,000 and had a replacement cost of $38,000.

3 The business did some plumbing repairs for a customer. The business would normally have charged $1,500 for the work, but had agreed to do it for $1,000 cash in order to encourage more business from the customer.

10 The business signed a lease to rent additional shop space for the business at a cost of $3,000 per month. The business will occupy the premises effective July 1, 2015.

18	Finding he was low on cash, John went to the bank and borrowed $8,000 on a personal loan.
22	The value of John's equipment has doubled. John does not understand why accountants ignore the effect of inflation in the accounting records.
28	John withdrew $12,000 from the business and used $7,000 to repay the personal bank loan of June 18.

Required Identify the accounting assumption, principle, or characteristic that would be applicable to each of the events, and discuss the effects it would have on the financial statements of John Chang Plumbing.

Problem 1–8B

Accounting concepts/principles, transaction analysis, accounting equation, financial statements, evaluation

4 5 6

Wilson Marketing Consulting, a proprietorship owned by Lin Wilson, was started on January 1, 2013, with an investment of $50,000 cash. The company prepares marketing plans for clients. It has been operating for one year. Business was quite slow in the first year of operations but has steadily increased. Wilson has made additional investments of $30,000 but has not made any withdrawals. The general ledger showed the following balances as of December 31, 2013:

Cash	$25,000
Accounts Receivable	30,000
Software	21,000
Office Furniture	15,000
Computer Equipment	32,000
Accounts Payable	18,000
L. Wilson, Capital	105,000

The following transactions took place during the month of January 2014:

Jan.	2	Wilson invested $20,000 in the business.
	2	The business paid $4,000 for the month's rent on the office space.
	4	The business signed a lease for the rental of additional office space at a cost of $3,500 per month. The lease is effective February 1. The business will pay the first month's rent in February.
	6	The business developed a systems design for Banting Ltd. and received $10,000 now plus additional $7,000 payments to be received on the 15th of the month for the next three months.
	10	The business paid $1,000 to a courier service.
	12	Wilson signed an agreement to provide design work to Smith Inc. for $15,000 to be paid upon completion of the work.
	14	The company purchased $5,000 of software that will be required for the Smith assignment. The company paid $3,000 and promised to pay the balance by the end of the month.
	15	The company received $7,000 as the monthly payment from Banting Ltd. from January 6.
	18	The company purchased computer equipment for $10,000 by paying $4,000 cash with the balance due in 60 days.
	23	The company completed a network design for Salem Ltd., which promised to pay $12,000 by the end of the month.
	29	The company paid the balance owing for the software purchased on January 14.
	31	Employees of Wilson Marketing Consulting are paid at the end of each month. The total wages expense for January were $10,000.
	31	Wilson Marketing Consulting paid the utilities expense for January, $1,000.
	31	Lin Wilson withdrew $5,000 for personal use.

Required

1. What is the total net income earned by the business over the period of January 1, 2013, to December 31, 2013?
2. Analyze the effects of the January 2014 transactions on the accounting equation of Wilson Marketing Consulting. Be sure to include the account balances from December 31, 2013.

3. Prepare the income statement for Wilson Marketing Consulting for the month ended January 31, 2014.
4. Prepare the statement of owner's equity for Wilson Marketing Consulting for the month ended January 31, 2014.
5. Prepare the balance sheet for Wilson Marketing Consulting at January 31, 2014.
6. Lin Wilson has expressed concern that although the business seems to be profitable and growing, she constantly seems to be investing additional money into it and has been unable to make any withdrawals for the work she has put into it. Prepare a reply to her concerns.

CHALLENGE PROBLEMS

Problem 1–1C

Understanding the going concern assumption
4

The going-concern assumption is becoming an increasing source of concern for users of financial statements. There are instances of companies filing for bankruptcy several months after issuing their annual audited financial statements. The question is: Why didn't the financial statements predict the problem?

A friend has just arrived on your doorstep; you realize she is very angry. After calming her down, you ask what the problem is. She tells you that she had inherited $40,000 from an uncle and invested the money in the common shares of Outdoor Sports Equipment Corp. (OSEC). She had carefully examined OSEC's financial statements for the latest year end and had concluded that the company was financially sound. This morning, she had read in the local paper that the company had gone bankrupt and her investment was worthless. She asks you why the financial statements valued the assets at values that are in excess of those the Trustee in Bankruptcy expects to realize from liquidating the assets. Why have the assets suddenly lost so much of the value they had six months ago?

Required Explain to your friend why assets are valued on a going-concern basis in the financial statements and why they are usually worth less when the company goes out of business. Use inventory and accounts receivable as examples.

Problem 1–2C

Accounting for business transactions
5

You and three friends have decided to go into the landscape business for the summer to earn money to pay for your schooling in the fall. Your first step was to sign up customers to satisfy yourselves that the business had the potential to be profitable. Next, you planned to go to the bank to borrow money to buy the equipment you would need.

After considerable effort, your group obtained contracts from customers for 200 residences for the summer. One of your partners wants to prepare a balance sheet showing the value of the contracts as an asset. She is sure that you will have no trouble with borrowing the necessary funds from the bank on the basis of the proposed balance sheet.

Required Explain to your friend why the commitments (signed contracts) from customers cannot be recognized as assets. What suggestions do you have that might assist your group in borrowing the necessary funds?

Extending Your Knowledge

DECISION PROBLEMS

Decision Problem 1

Using financial statements to evaluate a request for a loan

1 6

Two businesses, Tyler's Bicycle Centre and Ryan's Catering, have sought business loans from you. To decide whether to make the loans, you have requested their balance sheets.

TYLER'S BICYCLE CENTRE			
Balance Sheet			
December 31, 2014			
Assets		**Liabilities**	
Cash	$ 27,000	Accounts payable	$ 36,000
Accounts receivable	42,000	Notes payable	354,000
Merchandise inventory	55,000	Total liabilities	390,000
Store supplies	2,000		
Furniture and fixtures	26,000	**Owner's Equity**	
Building	246,000	T. Jones, capital	230,000
Land	222,000		
Total assets	$620,000	Total liabilities and owner's equity	$620,000

RYAN'S CATERING			
Balance Sheet			
December 31, 2014			
Assets		**Liabilities**	
Cash	$ 30,000	Accounts payable	$ 9,000
Accounts receivable	12,000	Note payable	204,000
Office supplies	6,000	Total liabilities	213,000
Inventory	60,000		
Office furniture	15,000	**Owner's Equity**	
Investments*	600,000	R. Smith, capital	510,000
Total assets	$723,000	Total liabilities and owner's equity	$723,000

*The investments of $600,000 can be sold today for $750,000.

Required

1. Based solely on these balance sheets, which entity would you be more comfortable lending money to? Explain fully, citing specific items and amounts from the balance sheets.
2. In addition to the balance sheet data, what other financial statement information would you require? Be specific.

Decision Problem 2

Using accounting information
1 5 6

A friend learns that you are taking an accounting course. Knowing that you do not plan a career in accounting, the friend asks why you are "wasting your time.'' Explain to the friend:

1. Why you are taking the course.
2. How accounting information is used or will be used:
   a. In your personal life.
   b. In the business life of your friend, who plans to be a farmer.
   c. In the business life of another friend, who plans a career in sales.

FINANCIAL STATEMENT CASES

These and similar cases in later chapters focus on the financial statements of two real Canadian companies—Gildan Activewear Inc and Rainmaker Entertainment Inc. Gildan Activewear Inc. (Gildan) is a global marketer of and the largest North-American manufacturer of basic apparel, particularly blank t-shirts, sports shirts, and fleece that are then screenprinted with logos by other companies. Gildan is also the world's largest supplier of sport, casual, and dress socks to customers in the United States. Headquartered in Montréal, Gildan has 300,000 employees worldwide, with manufacturing facilities in South America and the Caribbean Basin, and plans to grow in Asia and Europe. Rainmaker Entertainment Inc. (Rainmaker) is a multi-faceted animation studio and is one of Canada's largest producers of computer-generated (CG) animation. Rainmaker develops its own projects and also produces full-length DVDs for other top North American companies. The company is headquartered in Vancouver. As you study each financial statement problem using these two companies, you will gradually build the confidence to understand and use actual financial statements.

Financial Statement Case 1

Identifying items from a company's financial statements
6

5. October 31, 2008, net income $102,019 thousand

Refer to the Gildan financial statements located in Appendix A at the end of this book. There are two things to notice in the overall presentation of the financial statements. First, all amounts are reported in thousands of dollars. Second, Gildan has a 52-week fiscal year. Most companies' financial statements are stated at a month end, but many retail and merchandising companies (companies that sell products rather than services) choose to use a 52-week year instead. Consequently, the fiscal year end changes from year to year. In Gildan's case, the year end was October 2 in 2011 and October 3 in 2010.

Required

1. How much cash and cash equivalents did Gildan have at October 2, 2011?
2. What were total assets at October 2, 2011? At October 3, 2010?
3. Write the company's accounting equation at October 2, 2011, by filling in the dollar amounts:

   Assets = Liabilities + Shareholders' Equity

4. Identify total revenue for the year ended October 2, 2011. Do the same for the year ended October 3, 2010. Did revenue increase or decrease in fiscal 2011?
5. How much net income or net loss did Gildan experience for the year ended October 2, 2011? Was 2011 a good year or bad year compared to 2010?

Financial Statement Case 2

Identifying items from a company's financial statements
6

5. Dec. 31, 2008, net loss ($11,673 thousand)

Refer to the Rainmaker financial statements located on MyAccountingLab.

Required

1. How much trade and other accounts receivable did Rainmaker have at December 31, 2011?
2. What were total assets at December 31, 2011? At December 31, 2010?
3. Write the company's accounting equation at December 31, 2011, by filling in the dollar amounts:

   Assets = Liabilities + Shareholders' Equity

4. Identify total sales revenue for the year ended December 31, 2011, and the year ended December 31, 2010. Did revenue increase or decrease during 2011?
5. How much net income or net loss did Rainmaker experience for the year ended December 31, 2011? Was 2011 a good year or bad year compared to 2010?

JUST CHECKING Solutions for Chapter 1

1. Accounting is the information system that measures business financial activities, processes that information into reports, and communicates the results to decision makers.
2. Individuals use accounting in day-to-day affairs. Businesses use accounting information to set goals for their organization. Investors need accounting information to evaluate their investments or potential investments. Creditors could use financial information to evaluate their ongoing relationship with a company.
3. Financial accounting communicates financial information about a company to interested users who are external to the company (investors, creditors, and regulators, for example). Management accounting is a branch of accounting that is used within a company to help make better future-oriented decisions.
4. An audit is a financial examination. It is performed by an independent accountant so that outside users of the financial statements can have confidence that the information provided in the financial statements is materially correct and that the information is free from any bias of the owners.
5. Professional accountants who prepare and audit financial statements have an obligation to uphold the public trust. In other words, members of the investing public are relying on the capabilities and ethics of professional accountants to ensure that the financial information accurately portrays the financial position of the company. The rules of professional conduct ensure that accountants will behave in a professionally responsible manner.
6. The Student Policies, Bylaws, and Codes of Conduct of a college or university exist to encourage students to behave in an ethical manner.
7. A proprietorship has a single owner. Legally, the business is an extension of the individual. Separate accounting records are kept for the proprietorship. A partnership joins two or more individuals together as co-owners. Each owner is a partner. Accounting treats the partnership as a separate organization distinct from the personal affairs of each partner. From a legal perspective, a partnership is equivalent to a proprietorship.
8. A corporation is a separate legal entity, owned by shareholders. The shareholders own shares in the company. Thus, unlike proprietorships or partnerships, the corporation is not an extension of the owner but a separate company, with different legal obligations.
9. One advantage of the corporate form of ownership compared to the proprietorship form is, in most instances, it is easier for a shareholder to sell the shares (the investment) in a corporation than to sell the investment in a partnership or proprietorship. A second advantage is the shareholders of a corporation have limited legal liability, while the legal liability of a proprietorship extends to the owner.
10. Relevant information influences decisions, and is useful for making predictions and for evaluating past performance. Reliable information is free from error and the bias of a particular viewpoint; it is in agreement with the underlying events and transactions. If you think about the objective of financial reporting, the financial statements must be both relevant and reliable in order to communicate useful information to interested users.
11. The measurement criteria in Level 4 (see Exhibit 1-6) tells us that the historical cost basis of measurement should be used. This transaction would be recognized at the amount of cash paid for the land. You paid $185,000 for the land. Therefore, $185,000 is the cost to report on your financial statements.
12. If the car is not going to be used for business purposes, the car should be the personal responsibility of the owner. The economic-entity assumption means that assets of the business should not be mixed with the assets of the owner to ensure that the results of the business can be identified and analyzed accurately.
13. To answer both questions, use the accounting equation:
    a. **Assets − Liabilities = Owner's Equity**
    $75,000 − $65,000 = $10,000
    b. **Assets = Liabilities + Owner's Equity**
    $70,000 = $20,000 + $50,000
14. Indicate whether each account listed below is a(n) asset (A), liability (L), owner's equity (OE), revenue (R), or expense (E) account.

Accounts Receivable	A
Computer Equipment	A
S. Scott, Capital	OE
Rent Expense	E
Supplies	A
S. Scott, Withdrawals	OE
Salary Expense	E
Consulting Service Revenue	R
Cash	A
Notes Payable	L
Supplies Expense	E
Accounts Payable	L

15. Think about the accounting equation. The receipt of the cash will increase the assets by $20,000. What about the other side of the accounting equation? The company cannot justify recording the amount as a service revenue (an increase in owner's equity) because the $20,000 has not yet been *earned* What would happen if the company doesn't complete the service? It is likely that the company would have to return the money to the customer. Thus, the company should record the amount as a liability until it earns the $20,000, since it owes the service to the customer.
16.

Accounts Receivable	B
Computer Equipment	B
S. Scott, Capital	B, OE
Rent expense	I
Supplies	B
S. Scott, Withdrawals	B, OE
Salary Expense	I
Consulting Service Revenue	I
Cash	B, CF
Notes Payable	B
Supplies Expense	I
Accounts Payable	B

17. a. Net income = $43,000. The income statement provides this information.
    b. From the statement of owner's equity:
    Beginning owner capital = $0; Ending owner capital = $287,000
    Increases: Investment by owner = $250,000; Net income for the month = $43,000
    Decrease: Withdrawal by owner = $6,000
    c. Cash = $222,000. The balance sheet or cash flow statement provides this information.
    d. Clients owe the business $10,000, which is an asset called Accounts Receivable.
    e. The business owes outsiders $2,000, which is a liability called Accounts Payable.