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Accounting in Action

The **Chapter Preview** outlines the major topics and subtopics you will see in the chapter.

Chapter Preview

The feature story about Aritzia Inc. highlights the importance of having good financial information to make good business decisions. This applies not just to companies but also to individuals. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or giving financial information. Good decision-making for companies and individuals depends on good information.

This chapter shows you that accounting is the system that produces useful financial information for decision-making.

The **Feature Story** helps you see how the chapter topic fits with the real world of accounting and business. The story will be mentioned throughout the chapter.

Feature Story

Accounting Keeps Aritzia Fashionably in the Black

VANCOUVER, B.C.—If you ever operated a babysitting or lawn-mowing service, you probably tried to make more

money by finding as many customers as possible and keeping expenses down. You were using the same principles that businesses use to maximize profit.

Enterprises need a successful business model—a way of generating regular sales that over the long run exceed expenses, which results in profit. Companies use accounting to record

financial information, which they report in financial statements that internal users (such as management) and external users (such as shareholders and banks) use to make decisions. For example, internal users need to know how much to charge for products or services to maximize profits without losing sales to competitors. External users need to decide if the company is worth investing in or lending money to.

Take as an example Aritzia Inc., one of Canada's leading women's clothing retailers. It designs, oversees the production of, and sells clothes and accessories that it markets under several in-house brands, including Tna, Talula, and Wilfred. It has more than 80 stores in Canada and the United States, as well as an online shopping site. Aritzia was founded by Brian Hill, who opened the first boutique in a Vancouver mall in 1984, followed by four more stores in the area. In the late 1990s, Aritzia opened stores across Canada.

But when Mr. Hill sought to move into the U.S. market in 2005, he didn't want to finance the expansion by himself. "If I financed the whole thing myself, it would have meant putting everything on the line again, something I have had to do over and over again in building Aritzia. It was time for me to take some money off the table and find a financial partner," said Mr. Hill, the company's chief executive officer. He chose Berkshire Partners, an American private equity firm, which took a majority stake in the company.

In 2016, Aritzia was looking to open even more stores, so it went public, selling shares on the Toronto Stock Exchange.

Mr. Hill and Berkshire Partners still control the company by owning multiple voting shares.

What kinds of things does Aritzia need to keep track of in its accounts? Like any company, Aritzia records revenues (sales), which totalled \$743 million in 2018, and expenses, which were \$686 million, resulting in a profit of \$57 million. It also records assets (the value of what it owns at a certain point in time) and liabilities (the value of what it owes to others).

Companies such as Aritzia need to boost revenues and reduce expenses. To increase revenues, Aritzia can use several strategies, including expanding or renovating existing stores, opening more stores in existing markets, opening stores in new markets, and launching new brands to appeal to new types of customers. To reduce expenses, Aritzia buys many of its raw materials directly from mills, and partners with long-standing manufacturers and new ones that use innovative manufacturing processes.

All of these efforts are recorded by accounting—a crucial business tool that keeps Aritzia fashionably in the black.

Sources: "Fashion Retailer Aritzia Files to Go Public," CBC.ca, August 18, 2016; Imran Amed, "CEO Talk: Brian Hill, Chief Executive Officer, Aritzia," *Businessoffashion.com*, August 25, 2009; Aritzia 2017 annual report; Aritzia corporate website, www.aritzia.com.

Learning Objectives show what you should be able to do after learning the specific concepts presented in the chapter.

Chapter Outline

LEARNING OBJECTIVES

<p>LO 1 Identify the use and users of accounting and the objective of financial reporting.</p>	<p>Why Is Accounting Important?</p> <ul style="list-style-type: none"> • Using accounting information • Objective of financial reporting 	<p>DO IT! 1.1 Users of accounting information</p>
<p>LO 2 Compare the different forms of business organization.</p>	<p>Forms of Business Organization</p> <ul style="list-style-type: none"> • Proprietorship • Partnership • Corporation 	<p>DO IT! 1.2 Types of business organization</p>
<p>LO 3 Explain the building blocks of accounting: ethics and the concepts included in the conceptual framework.</p>	<p>Generally Accepted Accounting Principles</p> <ul style="list-style-type: none"> • Ethics in financial reporting • Conceptual framework • Accounting standards 	<p>DO IT! 1.3 Building blocks of accounting</p>

<p>LO 4 Describe the components of the financial statements and explain the accounting equation.</p>	<p>The Accounting Model</p> <ul style="list-style-type: none"> • Financial statements • The expanded accounting equation 	<p>DO IT! 1.4 The accounting equation</p>
<p>LO 5 Analyze the effects of business transactions on the accounting equation.</p>	<p>Transaction Analysis</p>	<p>DO IT! 1.5 Tabular analysis</p>
<p>LO 6 Prepare financial statements.</p>	<p>Preparing Financial Statements</p> <ul style="list-style-type: none"> • Income statement • Statement of owner's equity • Balance sheet • Cash flow statement • Understanding the information in the financial statements 	<p>DO IT! 1.6 Financial statements</p>

Why Is Accounting Important?

LEARNING OBJECTIVE 1

Identify the use and users of accounting and the objective of financial reporting.

Accounting is the information system that identifies, records, and communicates the economic events of an organization to a wide variety of interested users. The world's economic systems depend on highly transparent and relevant financial reporting that provides a true representation of the economic events. When that does not happen, it can have disastrous results. Lehman Brothers, a major United States bank, used misleading accounting practices to reduce its debt and make its financial position healthier than it was. Not only were Lehman Brothers' investors and lenders unaware of the bank's financial difficulties when the company went into bankruptcy, but economists believe the bankruptcy was a major contributor to the worldwide economic crisis that began in 2008.

As a starting point to the accounting process, a company identifies the economic events relevant to its business. Examples of economic events are the sale of apparel and accessories by Aritzia Inc., the sale of coffee and donuts by Tim Hortons, and the payment of wages by Rogers Communications. Once a company like Aritzia identifies economic events, it records those events in order to provide a history of its financial activities. Recording consists of keeping a systematic, chronological diary of events, measured in dollars and cents. The systematic collection of these data allows Aritzia to prepare financial statements that are then used to communicate financial information to interested users. Financial statements report the recorded data in a standardized way to make the reported information meaningful. For example, Aritzia accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported in the aggregate. By presenting the recorded data in the aggregate, the accounting process simplifies the multitude of transactions and makes a series of activities understandable and meaningful.

Essential (key) terms are printed in blue when they first appear, and are defined in the end-of-chapter glossary.

A vital element in communicating economic events is the accountant's ability to analyze and interpret the reported information. Analysis involves using ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves explaining the uses, meaning, and limitations of reported data. Appendix A at the end of this text shows the financial statements of Aritzia Inc. We refer to these statements at various places throughout the textbook. At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

You should understand that the accounting process includes the bookkeeping function. Bookkeeping usually involves only the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves the entire process of identifying, recording, and communicating economic events.

You might think this is all well and good for students who want to become accountants, but what about someone who has plans to be anything *but* an accountant?

Understanding the basics of accounting is helpful for almost every endeavour you can think of. Whether you plan to own your own business in the future, work for someone else in their business, or invest in a business, learning how to read and interpret financial information is a valuable set of skills.

When you study accounting, you will also learn a lot about management, finance, and marketing, which will give you a solid foundation for your future studies. For example, you will learn how making a sale is meaningless unless it is a profitable sale and the money can eventually be collected from the customer. Marketing managers must also be able to decide pricing strategies based on costs. Accounting is what quantifies these costs and explains why a product or service costs what it does. So think of this textbook as your introduction to accounting across the organization.

It doesn't matter if you plan to become a doctor, lawyer, social worker, teacher, engineer, architect, or entrepreneur—whatever you choose, a working knowledge of accounting will be relevant and useful. Make the most of this course—it will serve you for a lifetime in ways you cannot now imagine.

Accounting in Action insight features give examples of accounting situations from different perspectives: all about you, across the organization, and in terms of business and ethics. At the end of the chapter, you will find answers to the questions that are asked after each insight.

All About You



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We all know the importance of literacy. But what about financial literacy—the ability to understand and manage your finances? It seems Canadians don't place the same importance on financial literacy—but with rising household debt levels, falling savings levels, increasing personal bankruptcies, and continuing economic uncertainty, they should. According to the most recent Statistics Canada survey on financial literacy, in 2014 only 7.1% of adult Canadians considered themselves “very knowledgeable” about their finances.

There is movement on several fronts to improve financial literacy. For example, the federal government in 2014 appointed its first-ever financial literacy leader, who helped launch a national financial literacy strategy the following year. One of the strategy's activities was partnering in a pilot project with the United Way of Ottawa to create an app to encourage people to save. More than 1,000 signed up for the Small Change app. Over four months in 2016, they saved a total of \$46,716 by doing things such as bringing their lunch to work and brewing their own coffee. Some financial gurus are also spreading the word about the need to get a grip on personal finance. Gail Vaz-Oxlade, for instance, is urging

Canadians to be “debt-free forever” through several best-selling books and popular TV shows. Financial literacy experts point out that making the right financial decisions can have a major impact on an individual's financial well-being, health, and happiness.

Learning the basics of accounting will help you make the right financial decisions. Accounting will help you make investment decisions, determine how much interest you are paying on your student loan or credit cards, and prepare your personal budget. To demonstrate the value of accounting to you, included in each chapter is an “All About You” feature and a related activity (BYP.5) that links accounting to your life as a student or to a situation you are likely to face.

Sources: “Improving Financial Literacy through Mobile Technology: Small Change Pilot Program Outcomes,” Financial Consumer Agency of Canada, January 2018; “Canadian Financial Capability Survey, 2014,” Statistics Canada, *The Daily*, November 6, 2014; Gail Vaz-Oxlade's personal website, www.gailvazoxlade.com.

How might learning accounting help you make sure that your employer or bank hasn't made an error with your paycheque or bank account?

Using Accounting Information

There are two broad groups of users of accounting information: internal users and external users.

Internal Users

Internal users of accounting information plan, organize, and run companies. They work for the company. This includes finance directors, marketing managers, human resources personnel, production supervisors, and company officers. In running a business, internal users must answer many important questions, as shown in **Illustration 1.1**.



Finance

Is there enough cash to pay the bills?



Marketing

What price should we sell smart phones for to maximize profits?



Human Resources

How many employees can we afford to hire this year?



Production

Which product line is the most profitable?

Photo Credits: Finance: John Kuczala/Getty Images; Marketing: Jonathan Kitchen/Getty Images; Production: Echo/Getty Images

ILLUSTRATION 1.1

Questions asked by internal users

To answer these and other questions, users need detailed information on a timely basis; that is, it must be available when needed. Some examples of information that internal users need include:

- forecasts of cash flows for the next year,
- projections of profit from new sales campaigns,
- analyses of salary costs, and
- budgeted financial statements.

Internal users generally have direct access to the business's accounting information and are able to request a wide variety of custom reports designed for their specific needs.

External Users

There are several types of external users of accounting information.

1. **Investors**, who are owners—or potential owners—of the business, use accounting information to make decisions to buy, hold, or sell their ownership interest.
2. **Creditors**—persons or other businesses that are owed money by the business, such as suppliers and bankers—use accounting information to evaluate the risks of granting credit or lending money.

Investors and creditors are the main external users of accounting information, but there are also many other external users with a large variety of information needs and questions. Some examples of other external users and their information needs are the following:

- Labour unions want to know whether the owners can afford to pay increased salaries and benefits to their members.
- Customers are interested in whether a company will continue to honour its product warranties and support its product lines.
- Taxing authorities, such as the Canada Revenue Agency, want to know whether the company respects the tax laws.
- Regulatory agencies, such as provincial securities commissions that regulate companies that sell shares to the public, want to know whether the company is respecting established rules.
- Economic planners use accounting information to forecast economic activity.

Some questions that external users may ask about a company are shown in **Illustration 1.2**.

ILLUSTRATION 1.2
Questions asked by external users



Investors

Is the company earning enough to give me a return on my investment?



Creditors

Does the company generate enough cash flow to pay me the amounts I am owed?



Labour Unions

Can the company afford to increase our members' benefits?



Customers

Will the company stay in business long enough to service the products I buy from it?

Photo Credits: Investors: Blend Images/Getty Images; Creditors: Claire Cordier/Getty Images; Labour Unions: DebbiSmirnoff/Getty Images; Customers: Kirby Hamilton/Getty Images

Unlike internal users, external users have access to only the accounting information available publicly and/or provided to them by the business. Determining what information should be provided to external users, and how, is the focus of financial accounting.

Objective of Financial Reporting

As stated, accounting information is communicated in financial reports, and the most common reports are financial statements. **The main objective of financial reporting is to provide useful information to investors and creditors (external users) to make decisions about providing resources to a business.** This information is most commonly supplied in general purpose financial statements, which we will discuss later in the chapter. Recall that internal users have access to a broader range of accounting information and do not necessarily need general purpose financial statements to make informed decisions, although they can be used by internal users as well.

To make the decision to invest in a business or to lend to a business, users need information about the business's ability to earn a profit and generate cash. Consequently, financial statements must give information about the following:

1. The business's economic resources. What resources does the business have that it can use to carry out its business activities?
2. The claims to the business's economic resources. What are the amounts owed by the business and the owner's rights to the business's resources?
3. Economic performance. Is the business generating a profit and enough cash to pay its debts, and provide a return to its owners?

We will learn more about financial statements in the following sections.

DO IT! exercises like the one here ask you to put your new knowledge to work. They also outline an Action Plan you need to follow to do the exercise. *Related exercise material* tells you which Brief Exercises (BE) and Exercises (E) at the end of the chapter have similar study objectives.

DO IT! 1.1 | Users of Accounting Information

The following is a list of some users of accounting information. For each user indicate:

- a. whether they are an internal or external user, and
- b. an example of a question that might be asked by that user.
 1. Creditor
 2. Canada Revenue Agency
 3. Investor
 4. General manager of the production department
 5. Manager of the human resources department

Solution

User	(a) Internal or External	(b) Question
1. Creditor	External	Will the business be able to pay back the loan?
2. Canada Revenue Agency	External	Is the company following the tax laws?
3. Investor	External	Should I invest money in the company?
4. General manager of the production department	Internal	How much will it cost to produce the product?
5. Manager of the human resources department	Internal	Can the company afford to give the employees raises?

Related exercise material: **BE1.1**, **E1.1**, and **E1.2**.

ACTION PLAN

- Understand that internal users work for the company and have direct access to the business's accounting information.
- Understand that external users are users who do not work for the company and have access to only the accounting information available publicly and/or provided to them by the company.
- Understand that users require information to make decisions.

Forms of Business Organization

LEARNING OBJECTIVE 2

Compare the different forms of business organization.

Now that we understand that accounting information is prepared to convey financial information to various users, it is important to note that how the financial statements are prepared depends on the form and nature of the business organization. Therefore, let's now discuss the different organizational forms a business can take. The most common forms of business organization are the proprietorship, partnership, and corporation.

Proprietorship

A business owned by one person is a **proprietorship**. The owner is usually the operator of the business. Small service businesses (hair stylists, plumbers, and mechanics), farms, and small retail stores (antique shops, corner grocery stores, and independent bookstores) are often proprietorships.

Often only a relatively small amount of money (capital) is needed to start in business as a proprietorship. The owner (the proprietor) receives any profits, suffers any losses, and is personally liable (responsible) for all debts of the business. This is known as **unlimited liability**.

There is no legal distinction between the business as an economic unit and the owner. Thus the life of a proprietorship is limited to the life of the owner. This also means that the profits of the business are reported and taxed on the owner's personal income tax return. However, for accounting purposes, the records of the proprietorship's business activities are kept separate from the personal records and activities of the owner.

Many businesses in Canada are proprietorships, but they earn only a small percentage of the revenue earned by Canadian businesses as a whole. In this textbook, we start with proprietorships because many students organize their first business this way.

Partnership

A business owned by two or more persons who are associated as partners is a **partnership**. In most aspects, a partnership is similar to a proprietorship, except that there is more than one owner. Partnerships are often used to organize service-type businesses, including professional practices (lawyers, doctors, architects, and accountants).

Typically, a partnership agreement (written or oral) defines the initial investments of each partner, the duties of each partner, how profit (or loss) will be divided, and what the settlement will be if a partner dies or withdraws. As in a proprietorship, for accounting purposes a partnership's business activities must be kept separate from the personal activities of each partner. The partners' share of the profit must be reported and taxed on the partners' personal income tax returns.

Each partner generally has unlimited liability for all debts of the partnership, even if one of the other partners created the debt. This means that any of the partners can be forced to give up his or her personal assets in order to repay the partnership debt, just as can happen to an owner in a proprietorship. We will learn more about partnerships in Chapter 12.

Helpful hints help clarify concepts or items that are being discussed.

HELPFUL HINT

You can usually tell if a company is a corporation by looking at its name. The words *Limited (Ltd.)*, *Incorporated (Inc.)*, or *Corporation (Corp.)* usually follow its name.

Corporation

A business that is organized (incorporated) as a separate legal entity under federal or provincial corporate law is a **corporation** (see **Helpful Hint**). A corporation can have one owner or many owners. A corporation is responsible for its debts and paying taxes on its profit. A corporation's ownership is divided into transferable shares. The corporation's separate legal status provides the owners of the shares (shareholders) with **limited liability** because they risk losing only the amount that they have invested in the company's shares. They are not personally liable for the debts of the corporate entity. Shareholders, also known as investors, may sell all or part of their shares to other investors at any time. Easy changes of ownership are part of what makes it attractive to invest in a corporation. Because ownership can be transferred through the sale of shares and without dissolving the corporation, the corporation enjoys an unlimited life.

Although there are many more proprietorships and partnerships than corporations in Canada, the revenue produced by corporations is far greater. Most of the largest companies in Canada—for example, Royal Bank of Canada, Canadian National Railway Company, Suncor Inc., and BCE Inc.—are corporations.

Corporations such as these are publicly traded. That is, their shares are listed on Canadian stock exchanges and the public can buy the shares. Public corporations commonly distribute their financial statements to shareholders, creditors, other interested parties, and the general public upon request. Aritzia Inc. is a public corporation, whose shares are traded on the Toronto Stock Exchange (TSX). You can access Aritzia's financial statements on its website and selected statements are also presented in Appendix A at the back of this textbook.

Other companies are private corporations, because they do not issue publicly traded shares. Some of the largest private companies in Canada include Hootsuite, Moosehead Breweries

Limited, McCain Foods Limited, and Goodlife Fitness Centres Inc. Like proprietorships and partnerships, these companies almost never distribute their financial statements publicly. We will discuss the corporate form of organization in Chapters 13 and 14.

Illustration 1.3 provides a summary of the important characteristics of each organizational form a business can take.

Characteristic	Proprietorship	Partnership	Corporation
Owners	Proprietor: one	Partners: two or more	Shareholders: one or more
Owner's liability	Unlimited	Unlimited	Limited
Private or public	Private	Usually private	Private or public
Taxation of profits	Paid by the owner	Paid by the partners	Paid by the corporation
Life of organization	Limited	Limited	Unlimited

ILLUSTRATION 1.3
Characteristics of business organizations

DO IT! 1.2 | Types of Business Organization

For each type of organization (proprietorship, partnership, and corporation) indicate:

1. Number and type of owners.
2. If it has limited or unlimited liability.
3. If it is a separate legal entity from its owners.

ACTION PLAN

- Understand the characteristics of the most common forms of business organization.

Solution

Proprietorship	Partnership	Corporation
1. Proprietor: one	Partners: two or more	Shareholders: one or more
2. Unlimited	Unlimited	Limited
3. Not a separate legal entity from its owners	Not a separate legal entity from the partners	Separate legal entity from the shareholders

Related exercise material: **BE1.2** and **E1.3**.

Generally Accepted Accounting Principles

LEARNING OBJECTIVE 3

Explain the building blocks of accounting: ethics and the concepts included in the conceptual framework.

In order to prepare useful financial information, the accounting profession has developed standards that are generally accepted and universally practised. This common set of standards is called **generally accepted accounting principles (GAAP)**. Generally accepted accounting principles represent broad principles, procedures, concepts, and standards that act as guidelines for accountants. Taken together, GAAP guide the reporting of economic events. However, for these standards to be meaningful, a fundamental business concept must be present—ethical behaviour.

Ethics in Financial Reporting

For financial information to have value to its users, whether internal or external, it must be prepared by individuals with high standards of ethical behaviour. The standards of conduct

by which actions are judged as right or wrong, honest or dishonest, fair or not fair are **ethics**. Ethics in accounting is of the utmost importance to accountants and decision makers who rely on the financial information they produce. Effective financial reporting depends on sound ethical behaviour.

Fortunately, most individuals in business are ethical. Their actions are both legal and responsible. They consider the organization's interests when they make decisions. Accountants and other professionals have extensive rules of conduct to guide their behaviour with each other and the public. In addition, many companies today have codes of conduct, or statements of corporate values, that outline their commitment to ethical behaviour in their internal and external relationships. The behaviour of management is critical for creating the appropriate tone from the top of the organization.

Throughout this textbook, ethical considerations will be presented to highlight the importance of ethics in financial reporting. Every chapter includes an Accounting in Action Ethics Insight case that simulates a business situation that asks you to put yourself in the position of a key decision maker. When you analyze these ethical situations, you should follow the steps outlined in **Illustration 1.4**.

ILLUSTRATION 1.4 Steps used to analyze ethics cases and situations



1. Identify the ethical issues involved.

- Use your personal ethics or an organization's code of ethics to identify ethical situations and issues.
- Some business and professional organizations provide written codes of ethics for guidance in common business situations.

2. Identify the stakeholders—the persons or groups that may benefit or face harm.

- Ask the questions: Who are the impacted parties? What are their responsibilities and obligations?

3. Consider the alternative courses of action and the consequences of each for the various stakeholders.

- There may not always be one right answer. Some situations require an evaluation of the alternatives and the impact of each alternative on the identified stakeholders.
- Select the most ethical alternative, considering all the consequences.

Ethics Insight



Jennifer Trenchard/
Getty Images

What would you do if you suspected a co-worker was stealing? Would you confront them or tell your employer or the authorities? Would you keep quiet if you feared losing your job? What to do about suspected fraud is an ethical question facing not just those working in the accounting field, but employees in any role. Workplace fraud can take many forms. It could be an employee forging a cheque or stealing inventory. But it could also be an executive who falsifies financial information to make their department's sales figure look better, to meet company targets and collect a bonus, or to keep their job. According to the Association of Certified Fraud Examiners, the average occupational fraud committed worldwide in 2016 caused a loss of US\$150,000.

Organizations need to send a strong message that they won't tolerate fraud. One way of doing that is to protect and encourage employees who suspect fraud and report it to their employers. The federal government and most provinces in Canada have enacted their own public employee protection legislation. Another way to discourage fraud is to set up an internal crime hotline for employees to report suspected wrongdoing. When fraud is not reported, everyone is potentially harmed, not just the employer. Colleagues may lose jobs, customers may be misled, and shareholders and the public will lose trust in the accuracy of financial information.

Consider the following scenario: Jennifer is an accountant who works for Currie Financial Services Company. Currie has recently been given the opportunity to provide financial services to a large transportation company but Currie must compete against other financial service companies. Jennifer's boss has instructed her to prepare a presentation for the transportation company and include some performance statistics that he created. The potential client wants reassurance that whichever financial services provider it chooses will be in business a long time to serve its needs. Consequently, it wants to see financial figures from bidders that show they have been profitable over several years. Jennifer knows that the financial figures her boss wants her to show the potential client do not reflect Currie's actual performance but her boss told her they must "get that contract at all costs." He also said that those statistics are "likely to reflect actual performance in the future."

Sources: Association of Certified Fraud Examiners, "Report to the Nations on Occupational Fraud and Abuse," 2016; David Malamed, "Whistle Where You Work?"; *CA Magazine*, January/February 2012.

Who are the stakeholders in this situation? How would they be impacted by this situation?

Conceptual Framework

Some GAAP are so fundamental that we begin the study of them in introductory courses because they help us understand why we prepare and report accounting information in the manner we do.

As previously discussed in this chapter, the objective of financial reporting is to provide information to assist users in making decisions. **Illustration 1.5** is a representation of the **conceptual framework of accounting**, which is a coherent system that guides the development and application of accounting principles and standards and leads to the objective of financial reporting. In this chapter, we introduce some of the central concepts contained in the conceptual framework. The entire framework will be covered in more detail in Chapter 11.

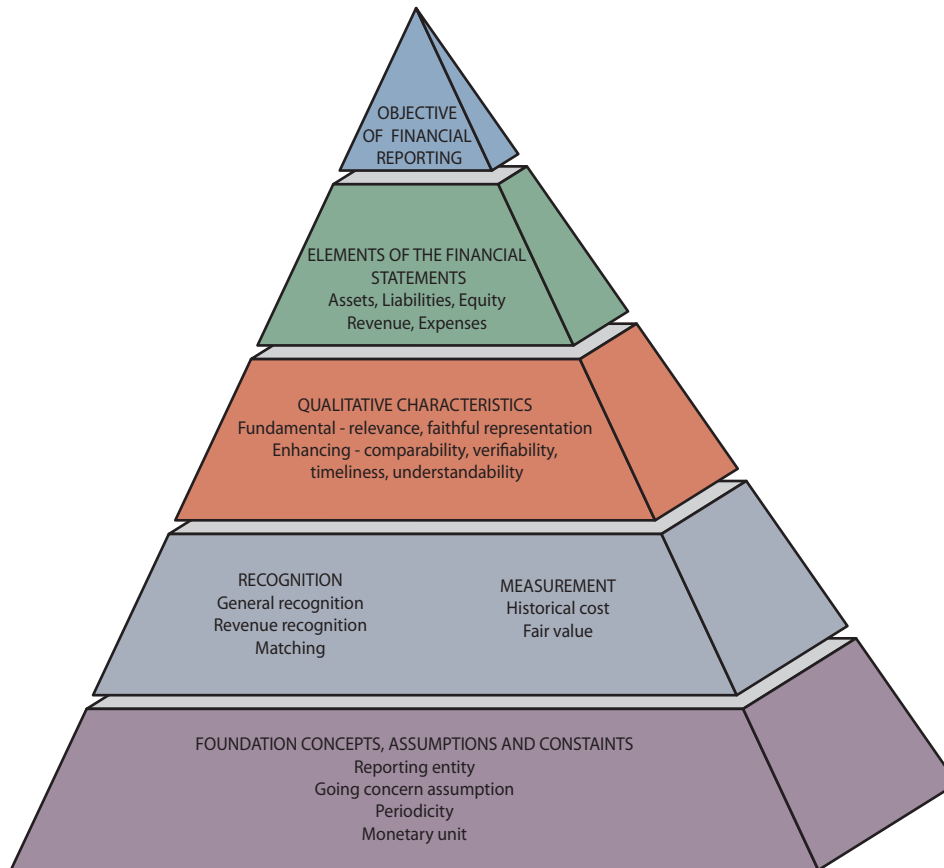


ILLUSTRATION 1.5

The conceptual framework of accounting

Reporting Entity Concept

Financial statements are prepared for a business or reporting entity. This is referred to as the **reporting entity concept**. **This concept requires that the accounting for a reporting entity's economic activities be kept separate and distinct from the accounting for the activities of its owner and all other reporting entities.** A reporting entity can be any organization or unit in society. Recall that proprietorships' and partnerships' records of their business activities are kept separate from the personal records of their owners. That is because proprietorships and partnerships are considered reporting entities for financial reporting purposes. Similarly, a corporation (such as Aritzia) is considered a reporting entity for financial reporting purposes. Other examples of reporting entities are a governmental unit (such as the Province of Manitoba), a municipality (such as the Ville de Montréal), a native band council (such as the Kingsclear First Nation), a school board (such as the Burnaby Board of Education), and a club (such as the Rotary Club of Melfort).

It is important to understand that a reporting entity (see **Alternative Terminology**) may not necessarily be a separate legal entity. For example, proprietorships and partnerships are not separate *legal* entities from their owners, but the reporting entity concept requires that they be treated as separate entities for accounting purposes.

Alternative Terminology notes give synonyms that you may hear or see in the workplace, in companies' financial statements, and occasionally in this textbook.

ALTERNATIVE TERMINOLOGY

A reporting entity is also referred to as an *economic entity*.

ALTERNATIVE TERMINOLOGY

The going concern assumption is also referred to as the *continuity assumption*.

Going Concern Assumption

The **going concern assumption** (see **Alternative Terminology**) is the assumption that the reporting entity will continue to operate in the foreseeable future. Although some businesses fail, most companies continue operating for a long time. **The going concern assumption presumes that the company will operate long enough to use its resources for their intended purpose and to complete the company's commitments.**

This assumption is one of the most important assumptions in GAAP because it has implications regarding what information is useful for decision makers and affects many of the accounting standards you will learn. If a company is a going concern, then financial statement users will find it useful for the company to report certain resources, such as land, at their cost. Land is acquired so a company can use it, not so it can be resold. Therefore, what matters is the amount the company gave up to acquire the land, not an estimate of its current value. If a company is not a going concern, and the land is going to be sold, then financial statement users will be more interested in the land's current value.

If a company is not regarded as a going concern, or if there are significant doubts about its ability to continue as a going concern, then this must be stated in the financial statements, along with the reason why the company is not regarded as a going concern. Otherwise, you can assume that the company is a going concern—even though this is not explicitly stated.

Periodicity Concept

ALTERNATIVE TERMINOLOGY

The Periodicity concept is also referred to as the *time period concept*.

Users require relevant accounting information; that is, the information must enhance or complete their understanding of a particular enterprise. In order for accounting information to be relevant, users require it on a timely basis. The **periodicity concept** (see **Alternative Terminology**) **guides organizations in dividing up their economic activities into distinct time periods.** The most common time periods are months, quarters, and years.

Fundamental Qualitative Characteristics

Fundamental characteristics include **relevance** and faithful representation. Accounting information has relevance if it would make a difference in a business decision. **Faithful representation** means that information accurately depicts what really happened. To provide a faithful representation, information must be **complete** (nothing important has been omitted), **neutral** (is not biased toward one position or another), and **free from error**.

Enhancing Qualitative Characteristics

In addition to the fundamental qualities, there are a number of enhancing qualities of useful information. These include **comparability**, **verifiability**, **timeliness**, and **understandability**. In accounting, **comparability** results when different companies use the same accounting principles. Comparability also implies that the accounting information should be consistent. **Consistency** means that a company uses the same accounting principles and methods from year to year. Information has the quality of **verifiability** if independent observers, using the same methods, obtain similar results. For accounting information to have relevance, it must be timely. This is referred to as **timeliness** and it means information must be available to decision makers before it loses its capacity to influence decisions. For example, public companies like Aritzia, Apple, or Best Buy provide their annual financial statements to investors within 60 days of their year end. Information has the quality of **understandability** if it is presented in a clear and concise fashion, so that reasonably informed users of that information can interpret it and comprehend its meaning.

Recognition

Not all events are recorded and reported in the financial statements. For example, suppose a new employee is hired. Should this event be recorded in the company's accounting records? The answer is no. Why? Not all events are recorded and reported in the financial statements. Only events that cause changes in the business's economic resources or changes to the claims on those resources are recorded and reported. These transactions are called **accounting transactions**. While the hiring of an employee will lead to future accounting transactions

(e.g., the payment of a salary after the work has been completed), an accounting transaction has not occurred at the time of hiring.

Recognition is the process of recording items in the accounting records. Once a transaction has been recognized or recorded, it will be included in the financial statements. One of the key recognition principles is the **revenue recognition principle**. When a company agrees to perform a service or sell a product to a customer, it has a **performance obligation**. When the company meets this performance obligation, it recognizes revenue. The **revenue recognition principle** therefore requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied, not when cash is exchanged. To illustrate, assume that Landon's Laundry cleans clothing on June 30 but customers do not claim and pay for their clothes until the first week of July. When should Landon's recognize the revenue? Landon's should recognize the revenue and record the transaction in June when it performed the service (satisfied the performance obligation) rather than in July when it received the cash.

This then gives rise to the **matching concept**, which often drives when we recognize certain costs incurred to operate the business (known as expenses and discussed later in the chapter). Generally when there is a direct association between the costs incurred and the earning of revenue, accounting attempts to match these costs and revenues. In our Landon's Laundry example, this means that Landon's should recognize wage costs incurred in performing the June 30 cleaning service in the same period in which it recognizes the service revenue.

Measurement

Measurement is the process of determining the amount that should be recognized. At the time something is acquired, the transaction is first measured at the amount of cash that was paid or at the value exchanged. For example, if Echo Company purchased land for \$100,000, the land is recorded in Echo's records at its cost of \$100,000. The land is an economic resource of the business and \$100,000 is referred to as the land's historical cost.

But what should Echo Company do if, by the end of the next year, the land's value has increased to \$120,000? Historical cost is the primary basis of measurement used in financial statements, which means that Echo Company would continue to report the land at its historical cost of \$100,000. This is often called the **historical cost** measurement method (see **Alternative Terminology**).

Historical cost has an important advantage over other valuations. It is definite and verifiable. The values exchanged at the time something is acquired can be objectively measured. Users can therefore rely on the information that is supplied, because they know it is based on fact. Historical cost is relevant if a business is a going concern and the resource is going to continue to be used in the business. We can ask the question, "what did the business give up to acquire the resource to use in the business?"

However, historical cost may not always be the most relevant measure of certain types of resources. Fair value may provide more useful information. For example, with an investment purchased for the purpose of trading to make a gain, the current value or market value of the investment provides more relevant information to the user. **Fair value** generally would be the amount the resource could be sold for in the market.

Fundamental to this discussion is that only transactions that can be reliably expressed as an amount of money can be included in the accounting records. This is known as the **monetary unit concept**. This concept makes it possible for accounting to quantify (measure) economic events. In Canada, we mainly use the Canadian dollar to record these transactions. However, some companies report their results in U.S. dollars. In Europe, the euro (€) is used; in China, the yuan (CNY) is used; and so on.

The monetary unit concept does prevent some relevant information from being included in the accounting records. For example, the health of the owner, the quality of service, and the morale of employees would not be included, because they cannot be reliably quantified in monetary amounts.

In summary, a transaction is recognized in the accounting records if there is a change in the business's economic resources or a change to the claims on those resources and the change can be reliably measured in monetary terms.

Illustration 1.6 summarizes the process that is used to decide whether or not to record an event.

ALTERNATIVE TERMINOLOGY

The historical cost measurement method is also known as the *cost measurement method*.

ILLUSTRATION 1.6
Transaction
identification process

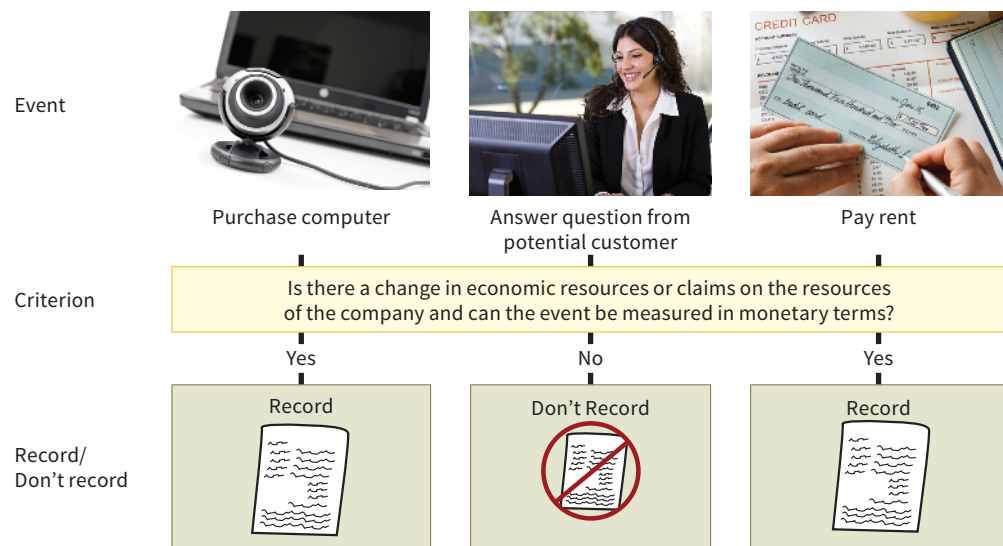


Photo Credits: jcgjphotography/Shutterstock; Courtney Keating/iStockphoto; YinYang/iStockphoto

Accounting Standards

HELPFUL HINT

In accounting, there are two types of economic events: (1) external events are transactions with another company; and (2) internal events occur within a company, such as the use of equipment in operations.

ALTERNATIVE TERMINOLOGY

The terms *standard* and *principle* are often used interchangeably in accounting.

HELPFUL HINT

Accounting standards use the word “enterprise” because it is a broader term than “company” or “business.” The word “enterprise” means that the accounting standard applies to the different forms of business organization, as well as specific projects. Throughout this text, instead of using the word “enterprise,” we will frequently use the words “company” or “business,” because they are more common terms.

To make the information in financial statements meaningful, accountants have to prepare the reports in a standardized way. As mentioned in the previous section, standards are developed from the guiding principles, assumptions, and concepts. Standards specify how to report **economic events** (see **Helpful Hint**). Business transactions can be complex and it is up to the professional accountant to ensure that transactions are correctly recorded and relevant. As previously mentioned, all standards, principles, assumptions, and concepts make up the body of knowledge known as generally accepted accounting principles (GAAP).

In Canada, the Accounting Standards Board (AcSB), an independent standard-setting body, has the main responsibility for developing GAAP. The AcSB’s most important criterion for accounting standards is this: the standard should lead to external users having the most useful financial information possible when they are making business decisions.

In Canada, accounting professionals follow different accounting standards (see **Alternative Terminology**) depending on the type of entity they work for. For-profit entities report their financial statements using either (1) International Financial Reporting Standards (IFRS) or (2) Accounting Standards for Private Enterprises (ASPE).

International Financial Reporting Standards (IFRS) are a set of global standards developed by the International Accounting Standards Board (IASB) and adopted for use in Canada by the AcSB. The IASB is charged with the responsibility to develop International Financial Reporting Standards that bring transparency, accountability, and efficiency to financial markets around the world. IFRS make it easier for users to compare financial information prepared across the globe. As markets become more global, it is often desirable to compare the results of companies from different countries. That is more difficult when different companies use different accounting standards. Therefore, in order to increase comparability, in recent years, more and more countries are adopting IFRS. IFRS is the main basis of financial reporting in nearly 120 countries, including Canada, Australia, Brazil, Russia, members of the European Union, China, India, Japan, and Mexico. At the time this textbook was being written, the United States had not yet agreed to adopt IFRS (in totality).

In Canada, IFRS standards must be followed by publicly accountable enterprises (see **Helpful Hint**). **Publicly accountable enterprises** include publicly traded corporations, as well as securities brokers and dealers, banks, and credit unions whose role is to hold assets for the public as part of their primary businesses. In this textbook, we will discuss publicly traded corporations. Discussion of the other types of businesses will be covered in more advanced courses. Aritzia is a publicly traded company and therefore it is required to follow IFRS.

The AcSB recognized that, for most private companies in Canada, users can generally obtain additional information from the company if required. Therefore, these users typically require less information in the financial statements. As a result, the AcSB developed **Accounting Standards for Private Enterprises (ASPE)**. Non-publicly traded companies can choose to use ASPE instead of IFRS. ASPE requires considerably less information in financial statements than is required by IFRS. Canadian private companies, such as McCain Foods and EllisDon Inc., have the choice to report under ASPE or IFRS. Because proprietorships and partnerships are private companies, these entities will generally follow ASPE for financial reporting.

ASPE While both IFRS and ASPE are “principle based” (designed to encourage the use of professional judgement in applying basic accounting principles), there are differences. Therefore, financial statement users will need to know which standards the company is following. Companies are required to report this in their financial statements. In this textbook, as we proceed through the material, we will point out where there are differences in the two sets of standards. However, the two sets of standards have a great deal in common regarding the type of material covered in an introductory accounting textbook. The authoritative source of all accounting standards is the handbook produced by Chartered Professional Accountants Canada (CPA Canada), the main professional accounting body in Canada, called the *CPA Canada Handbook*.

Regardless of the financial reporting framework, it is important to understand that GAAP is not static and that it changes over time. Standard setters continue to develop new GAAP and modify existing GAAP. Changes to GAAP may take a long time before being finalized. Therefore, the length of time involved in changing existing accounting standards or adding new ones can make it difficult to determine what information we should include in this textbook. Should we cover the currently approved standard or the proposed new standard? Normally the textbook will cover only the currently approved standards, which includes standards that are approved and not yet effective. But where we believe it is important to do so, we will discuss new standards that were proposed at the time the textbook was written.

The **ASPE word mark** indicates where differences between IFRS and ASPE are explained. These differences are also summarized at the end of each chapter.

DO IT! 1.3 | Building Blocks of Accounting

Indicate whether each of the five statements presented below is true or false.

1. The historical cost principle dictates that companies record economic resources at their cost. In later periods, however, the fair value of the resource must be used if fair value is higher than its cost.
2. Relevance means that financial information matches what really happened; the information is factual.
3. A business owner’s personal expenses must be separated from expenses of the business to comply with accounting’s reporting entity concept.
4. All events are recorded in the financial statements.
5. All companies in Canada must report their financial statements using IFRS.

Solution

1. False. The historical cost principle dictates that companies record economic resources at their cost. Under the historical cost principle, the company must also use cost in later periods.
2. False. Faithful representation, not relevance, means that financial information matches what really happened; the information is factual.
3. True.
4. False. Not all events are recorded and reported in the financial statements; only accounting transactions are recorded as business transactions. Accounting transactions are events that change the business’s economic resources or claims on those resources.
5. False. In Canada, publicly accountable entities must use IFRS, while private entities may report using ASPE.

Related exercise material: **BE1.3, BE1.4, BE1.5, BE1.6, and E1.4.**

ACTION PLAN

- Review the discussion of financial reporting standards.
- Develop an understanding of the key terms used.

The Accounting Model

LEARNING OBJECTIVE 4

Describe the components of the financial statements and explain the accounting equation.

We can think of the accounting model as what it takes to prepare financial statements, which are the end result of accounting. To prepare the financial statements, we need to use the accounting equation, which is the basis for recording and summarizing all transactions. The accounting model underpins everything we will do with transactions in the rest of the textbook.

Financial Statements

You will recall that the main objective of the financial statements is to provide information to allow investors and creditors (external users) to make decisions about a business. Here we will introduce four basic financial statements—the balance sheet, income statement, statement of owner’s equity, and cash flow statement—and show how this information is included in these statements. Later in the chapter, we will illustrate how to prepare these statements.

The specific financial statements prepared differ depending on the nature of the business organization; however, all businesses prepare a balance sheet and income statement. As you go through this section, we recommend you refer to Aritzia’s financial statements for the year ended February 25, 2018, in Appendix A of this textbook. We will refer to these statements often throughout the textbook.

Balance Sheet

Users need information on the economic resources that the business can use to carry out its business activities to earn a profit and the claims to these economic resources. In accounting, economic resources that are owned or controlled by a business are called “assets.” Claims on the economic resources are the amounts owed by the business and the owner’s rights to the resources. In accounting, amounts owed by the business are called “liabilities” and the owner’s right to these resources is called “owner’s equity.” **Assets, liabilities, and owner’s equity are referred to as elements of the financial statements and are reported in the balance sheet.**

The balance sheet is like a snapshot of the company’s financial condition at a specific point in time (usually the end of a month, quarter, or year). (See **Alternative Terminology**.) The heading of a balance sheet must identify the company, statement, and date. To indicate that the balance sheet is at a specific point in time, the date only mentions the point in time (e.g., as at December 31, 2021). Let’s look at the components of the balance sheet in more detail.

Assets **Assets** are present economic resources controlled by a business as a result of past events and have the potential to produce economic benefit. In a business, economic benefits generally refer to cash inflows (receipts) but can include other assets.

Assets are used to carry out activities, such as the production and distribution of merchandise. For example, imagine that a local pizza restaurant, called Campus Pizza, owns a delivery truck. The truck provides economic benefits because it is used to deliver pizzas. Campus Pizza also owns other assets, such as tables, chairs, a sound system, a cash register, an oven, dishes, supplies, and, of course, cash.

Other common assets include merchandise held for resale (commonly referred to as merchandise inventory), investments, land, buildings, patents, and copyrights. **Accounts receivable** is the asset created when a company sells goods or services to customers who promise to pay cash in the future. **Prepaid expense**, another common asset, is the asset

ALTERNATIVE TERMINOLOGY

The balance sheet is sometimes called the *statement of financial position*.

created when a business pays cash in advance and the goods or services will be used over time. Common types of prepaid expenses are insurance, rent, and supplies.

Liabilities **Liabilities** are present obligations, arising from past events, the settlement of which will include the transfer of economic benefits. An economic benefit here generally refers to cash outflows (payments) but can also include other assets or services. An obligation is a duty or responsibility that a company has no practical ability to avoid. For example, businesses of all sizes usually borrow money and purchase merchandise inventory on credit. If a business borrows money to do such things as purchase equipment, it usually has a note payable for the amount borrowed. A **note payable** is supported by a written promise to pay a specific amount, at a specific time, in the future. Obligations to pay cash to suppliers in the future are called **accounts payable**.

Sometimes customers might pay a business in advance of being provided a service or product. This advance by the customer is a liability called **unearned revenue**, because the business has an obligation to provide the service or product in the future. Businesses may also have salaries payable to employees, Goods and Services Tax (GST/HST) payable and Provincial Sales Tax (PST) payable to the federal and provincial governments (respectively), and property taxes payable to the municipality.

Recall that persons or other businesses that are owed money by the business, such as suppliers and bankers, are called “creditors.” The law requires that creditor claims be paid before ownership claims are paid.

Owner’s Equity The owner’s claim on the assets of the company is known as **owner’s equity**. It is equal to total assets minus total liabilities. Since the claims of creditors must be paid before ownership claims, the owner’s equity is often called “residual equity.” If the equity is negative—that is, if total liabilities are more than total assets—the term “owner’s deficiency” (or deficit) describes the shortage. Owner’s equity is a general accounting term that could be used for any type of organization. It is used most frequently for proprietorships. Partnerships use the term “partners’ equity”; corporations, such as Aritzia, use “shareholders’ equity.”

A summary of the balance sheet accounts, assets, liabilities, and owner’s equity is presented in **Illustration 1.7**.

ASSETS

- Present economic resources controlled by the business that have the potential to produce economic benefits.
 - Examples: accounts receivable, merchandise inventory, vehicles

LIABILITIES

- Present obligations to transfer an economic resource
 - Examples: accounts payable, salaries payable

OWNER’S EQUITY

- The owner’s claim on the assets
 - Residual amount of assets minus liabilities

ILLUSTRATION 1.7

The balance sheet: A snapshot in time

The Accounting Equation The relationship between assets, liabilities, and owner’s equity (which are shown on the balance sheet) is expressed as an equation, called the **accounting equation** (see **Alternative Terminology**). Assets must equal the sum of liabilities and owner’s equity. Liabilities are shown before owner’s equity in the accounting equation because creditors have the right to receive payment before owners. **Illustration 1.8** shows the accounting equation for Aritzia as at February 25, 2018 (balances presented are in thousands).

ALTERNATIVE TERMINOLOGY

The accounting equation is sometimes referred to as the *balance sheet equation*.

Resources		Claims Against the Resources		
Assets	=	Liabilities	+	Owner’s Equity
\$567,678	=	\$281,977	+	\$285,701

ILLUSTRATION 1.8

Accounting equation

The accounting equation is the same for all businesses regardless of their size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner grocery store as much as it does to a large corporation such as Aritzia (where owner's equity is called shareholders' equity). Not only is the balance sheet based on the equation, but as we will see, the equation is the basis for recording and summarizing the economic events of a company.

Because the balance sheet is based on the accounting equation, you should never see a balance sheet where assets are not equal to liabilities plus owner's equity. If you do, it contains one or more errors. In that situation, we would say that the balance sheet is not balanced.

Income Statement

ALTERNATIVE TERMINOLOGY

The income statement is sometimes called the *statement of earnings* or *statement of operations*.

ALTERNATIVE TERMINOLOGY

Profit is sometimes called *net income* or *earnings* or *net earnings*.

Users of the financial statements want to know if the business is generating a profit from its business activities. The main purpose of the **income statement** (see **Alternative Terminology**) is to report the profitability of the business's operations over a specified period of time (a month, quarter, or year). **Profit is measured by the difference between revenues and expenses** (see **Alternative Terminology**). **Revenue and expense are referred to as elements of the financial statements and are reported in the income statement along with profit or loss. Profit results when revenues are greater than expenses and conversely a loss results when expenses are greater than revenues.**

Revenues **Revenues** result from business activities that are undertaken to earn profit, such as performing services, selling merchandise inventory, renting property, and lending money. Revenues result in an increase in an asset or a decrease in a liability *and* an increase in owner's equity. They come from different sources and are given different names, depending on the type of business. Campus Pizza, for instance, has two categories of revenue: food sales and beverage sales. Common sources of revenue include sales, fees, services, commissions, interest, and rent.

Expenses **Expenses** are the costs of assets that are consumed and services that are used in a company's business activities. Expenses are decreases in assets or increases in liabilities, *and* result in a decrease in owner's equity. Withdrawals of assets by an owner are not considered expenses. Like revenues, there are many kinds of expenses and they are identified by various names, depending on the type of asset consumed or service used. For example, Campus Pizza reports the following expenses: cost of ingredients (such as meat, flour, cheese, tomato paste, and mushrooms); cost of beverages; salaries expense; utilities expense (electric, gas, and water expense); telephone expense; repairs expense; fuel expense; supplies expense (such as napkins, detergents, and aprons); rent expense; insurance expense; and interest expense.

Illustration 1.9 shows the items reported on the income statement for a particular period of time.

ILLUSTRATION 1.9

The income statement for a period of time

REVENUES

- Result from business activities undertaken to earn profit, such as performing services, selling merchandise inventory, renting property, and lending money
 - Examples: sales revenue, service revenue

EXPENSES

- The costs of assets consumed and services used in a company's business activities
 - Examples: cost of goods sold, salaries expense, rent expense, utilities expense

PROFIT

- Measured by the difference between revenues and expenses

The balance sheet and income statement report balances for all of the elements of the financial statements: assets, liabilities, equity, revenue, and expense. The next financial statement that is prepared—the statement of owner's equity—reports the change in equity from the beginning of the period to the end of the period.

Statement of Owner's Equity

The **statement of owner's equity** shows the changes in owner's equity for the same period of time as the income statement. In a proprietorship, owner's equity is increased by investments made by the owner and decreased by withdrawals made by the owner. Owner's equity is also increased when a business generates a profit from business activities or decreased if the business has a loss. Let's look at each of these equity components in more detail.

Investments **Investments by the owner** are contributions of cash or other assets (e.g., a vehicle or computer) made by the owners to the business. In a proprietorship, investments are recorded as increases to what is known as the owner's capital account. (Accounting records are made up of several accounts that group similar transactions, each one given a title such as Owner's Capital or Utilities Expense. An **account** records increases or decreases in assets, liabilities, or owner's equity items. We'll learn more about recording transactions in accounts in Chapter 2.) Accordingly, investments by owners result in an increase in an asset and an increase in owner's equity.

Drawings An owner may withdraw cash (or other assets) for personal use. In a proprietorship, these withdrawals could be recorded as a direct decrease to the owner's capital account. However, it is generally considered better to use a separate account called **drawings** so that the total withdrawals for the accounting period can be determined. Drawings result in a decrease in an asset and a decrease in owner's equity.

Profit As previously explained, revenues increase owner's equity and expenses decrease owner's equity. We also learned that profit results from revenues being greater than expenses and a loss results if expenses are greater than revenues. Therefore, profit increases owner's equity and losses decrease owner's equity.

Illustration 1.10 summarizes the transactions that change owner's equity.

<u>Increases in owner's equity</u>	<u>Decreases in owner's equity</u>
Investments by the owner	Drawings by the owner
Revenues	Expenses

ILLUSTRATION 1.10

Transactions that increase and decrease owner's equity

We will see later in the chapter how this information is shown in the statement of owner's equity.

Cash Flow Statement

Investors and creditors need information on the business's ability to generate cash from its business activities and how the business uses cash. The **cash flow statement** (see **Alternative Terminology**) gives information about the cash receipts and cash payments for a specific period of time. The cash flow statement gives answers to the following simple but important questions:

1. Where did the cash come from during the period?
2. What was the cash used for during the period?
3. What was the change in the cash balance during the period?

To help investors, creditors, and others analyze a company's cash, the cash flow statement reports the following:

1. the cash effects of the company's operating activities during a period;
2. the cash inflows and outflows from investing transactions (e.g., the purchase and sale of land, buildings, and equipment);
3. the cash inflows and outflows from financing transactions (e.g., borrowing and repayments of debt, and investments and withdrawals by the owner);
4. the net increase or decrease in cash during the period; and
5. the cash amount at the end of the period.

ALTERNATIVE TERMINOLOGY

The cash flow statement is sometimes called the *statement of cash flows*.

Accounting Differences by Type of Business Organization

Previously, you were introduced to different forms of business organization: the proprietorship, partnership, and corporation. Basically, accounting for assets, liabilities, revenues, expenses, and cash flows is the same, regardless of the form of business organization. The main distinction between the forms of organizations is found in (1) the terminology that is used to name the equity section, (2) the accounting for the owner's investments and withdrawals, and (3) the name of the statement showing the changes in owner's equity. In **Illustration 1.11**, we summarize these differences.

ILLUSTRATION 1.11

Accounting differences by type of business organization

	Proprietorship	Partnership	Corporation (reporting under IFRS)
Equity section called:	Owner's equity	Partners' equity	Shareholders' equity
Investments by owners added to:	Owner's capital	Partners' capital	Share capital
Profits added to:	Owner's capital	Partners' capital	Retained earnings
Withdrawals by owners called:	Drawings	Drawings	Dividends
Withdrawals deducted from:	Owner's capital	Partners' capital	Retained earnings
Name of statement:	Statement of owner's equity	Statement of partners' equity	Statement of changes in equity

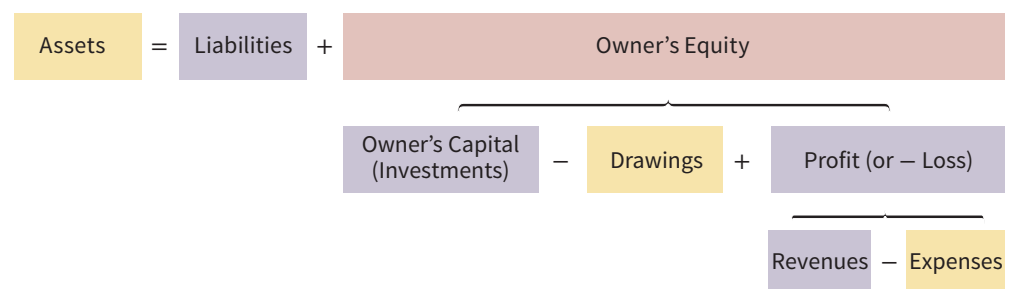
In a proprietorship, equity is summarized and reported as one line item on the balance sheet called "capital" and prefaced by the owner's name. In a partnership, equity is summarized and reported as one line item for each partner and each account is referred to as "capital" prefaced by the individual partner's name. In the next sections of this chapter, transaction analysis will be demonstrated and the presentation of the balance sheet for a proprietorship will be illustrated. Chapter 12 will illustrate the balance sheet for a partnership. In a corporation, investments by all of the shareholders are grouped together and reported on the balance sheet as "share capital." In a corporation, regardless of the number of shareholders, one account called Retained Earnings is used to record the accumulated profit (or earnings) that has been retained (i.e., not paid out to shareholders) in the company and is also reported on the balance sheet. We will cover corporation accounting in more depth in Chapters 13 and 14. For now, note that account and statement names in a corporation are different from proprietorships and partnerships.

The Expanded Accounting Equation

The basic accounting equation in Illustration 1.8 shows that assets are equal to liabilities plus owner's equity. Recall that the basic equation is a summary of the information shown on the balance sheet. But we also know that it is necessary to report on revenues, expenses, and other changes in owner's equity. In **Illustration 1.12**, we have expanded the basic accounting equation to show the different parts of owner's equity and the relationship between revenues, expenses, profit (or loss), and owner's equity.

ILLUSTRATION 1.12

Expanded accounting equation



By expanding the equation, we have created a framework that can be used to report the information required in the income statement and the statement of owner's equity, as well as the balance sheet. The components in the expanded accounting equation are known as the **elements of the financial statements**.

Remember that the equation must always balance. Assets must equal liabilities plus owner's equity. From the expanded equation, we can see that if revenue increases, owner's equity increases and therefore either assets increase or liabilities decrease to keep the equation balanced. Conversely, if expenses increase, owner's equity decreases and therefore either assets decrease or liabilities increase to keep the equation balanced.

DO IT! 1.4 | The Accounting Equation

The following are a few of the items that are reported in financial statements: (1) cash, (2) service revenue, (3) drawings, (4) accounts receivable, (5) accounts payable, and (6) salaries expense.

- a. Classify the items as assets, liabilities, or owner's equity. For the owner's equity items, indicate whether these items increase or decrease equity.
- b. Indicate which financial statement the item is reported in.

Solution

	(a) Type of Item	(b) Financial Statement
1. Cash	Asset	Balance sheet
2. Service revenue	Owner's equity—increase	Income statement
3. Drawings	Owner's equity—decrease	Statement of owner's equity
4. Accounts receivable	Asset	Balance sheet
5. Accounts payable	Liability	Balance sheet
6. Salaries expense	Owner's equity—decrease	Income statement

Related exercise material: **BE1.7, BE1.8, BE1.9, BE1.10, BE1.11, E1.6, and E1.7.**

ACTION PLAN

- Understand that assets are resources that are capable of providing future service or benefit that are owned or controlled by a business.
- Understand that liabilities are amounts owed by a business.
- Review which transactions affect owner's equity.
- Recall what information is included in each of the financial statements.

Transaction Analysis

LEARNING OBJECTIVE 5

Analyze the effects of business transactions on the accounting equation.

Once it has been determined that an event or transaction should be recognized, it must be analyzed for its effect on the components of the accounting equation before it can be recorded. This analysis must identify the specific items that are affected and the amount of change in each item.

Each transaction must have a dual effect on the equation for the two sides of the accounting equation to remain equal. For example, if an asset is increased, there must be a corresponding

1. decrease in another asset, or
2. increase in a liability, or
3. increase in owner's equity.

Two or more items could be affected by a transaction. For example, an asset (equipment) could increase by \$10,000, a different asset (cash) could decrease by \$6,000, and a liability (notes payable) could increase by \$4,000.

As a general example, we will now look at transactions conducted by Softbyte, a fictitious computer programming business, during its first month of operations. You should study these transactions until you are sure you understand them. They are not difficult, but they are important to your success in this course. Being able to analyze how transactions affect the accounting equation is essential for understanding accounting.

To keep it simple, we will not include cents in the dollar amounts we record in the following analysis of Softbyte’s transactions. In reality, it is important to understand that cents should be, and are, used when transactions are recorded in a company’s internal accounting records.

Transaction (1): Investment by Owner Andrew Leonid decides to open a computer programming business, which he names Softbyte. On September 1, 2021, he invests \$15,000 cash in the business, which he deposits in a bank account opened under the name of Softbyte. This transaction results in an equal increase in both assets and owner’s equity for Softbyte, as shown in **Illustration 1.13**.

ILLUSTRATION 1.13
Investment of cash by owner

Basic Analysis	The asset Cash is increased by \$15,000 and the owner’s equity account, A. Leonid, Capital, is increased by \$15,000.				
Equation Analysis	Assets	=	Liabilities	+	Owner’s Equity
	Cash	=			A. Leonid, Capital
	(1) +\$15,000	=			+\$15,000

Notice that the two sides of the basic equation remain equal. Note also that investments by an owner are **not** revenues and are not included in calculating profit. The increase therefore has to be recorded as an investment in the owner’s capital account rather than as revenue from operations.

Transaction (2): Purchase of Equipment for Cash Softbyte purchases computer equipment for \$7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of the assets changes. The specific effect of this transaction and the cumulative effect of the first two transactions are demonstrated in **Illustration 1.14**.

ILLUSTRATION 1.14
Purchase of equipment for cash

Basic Analysis	The asset Cash is decreased by \$7,000 and the asset Equipment is increased by \$7,000.				
Equation Analysis	Assets	=	Liabilities	+	Owner’s Equity
	Cash + Equipment	=			A. Leonid, Capital
	Old Balances \$15,000	=			\$15,000
	(2) -7,000 +7,000	=			
	New Balances \$ 8,000 + \$7,000	=			\$15,000
	\$15,000				\$15,000

Notice that total assets are still \$15,000, and that Leonid’s equity also remains at \$15,000, the amount of his original investment.

Transaction (3): Purchase of Supplies on Credit Softbyte purchases \$1,600 of computer paper and other supplies that are expected to last several months from the Alpha Supply

Company. Alpha Supply will allow Softbyte to pay this bill next month (in October). This transaction is referred to as a purchase on account, or a credit purchase. Assets are increased because the use of the paper and supplies is capable of producing economic benefits. Liabilities are increased by the amount that is due to Alpha Supply Company. **Illustration 1.15** shows the equation analysis for this transaction.

ILLUSTRATION 1.15 Purchase of supplies on credit

Basic Analysis	The asset Supplies is increased by \$1,600 and the liability Accounts Payable is increased by the same amount.									
Equation Analysis		Assets			=	Liabilities	+	Owner's Equity		
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	A. Leonid, Capital
	Old Balances	\$8,000	+	+	+	\$7,000	=	\$1,600	+	\$15,000
	(3)			+\$1,600			=	+\$1,600		
	New Balances	\$8,000	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000
		\$16,600					=	\$16,600		

Total assets are now \$16,600. This total is matched by a \$1,600 creditor's claim and a \$15,000 ownership claim.

Transaction (4): Services Provided for Cash Softbyte receives \$1,200 cash from customers for programming services it has provided. This transaction is Softbyte's main revenue-producing activity. Remember that revenue increases profit, which then increases owner's equity. **Illustration 1.16** shows the equation analysis for this transaction.

ILLUSTRATION 1.16 Services provided for cash

Basic Analysis	The asset Cash is increased by \$1,200 and the owner's equity account Service Revenue is increased by \$1,200.											
Equation Analysis		Assets			=	Liabilities	+	Owner's Equity				
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	A. Leonid, Capital	+	Revenues
	Old Balances	\$8,000	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000		
	(4)		+\$1,200				=				+\$1,200	
	New Balances	\$9,200	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$1,200
		\$17,800					=	\$17,800				

The two sides of the equation still balance at \$17,800.

We don't have room to give details for each revenue and expense account in this illustration, so revenues (and expenses when we get to them) will be summarized under one column heading for Revenues and one for Expenses. However, it is important to keep track of the account titles that are affected (e.g., Service Revenue), because they will be needed when the income statement is prepared in the next section.

Transaction (5): Purchase of Advertising on Credit Softbyte receives a bill for \$250 from the local newspaper for advertising the opening of its business. It postpones payment of the bill until a later date. The cost of advertising is an expense, and not an asset, because the

benefits have already been used. Owner's equity decreases because an expense is incurred. Expenses reduce profit and owner's equity. **Illustration 1.17** shows the equation analysis for this transaction.

ILLUSTRATION 1.17 Purchase of advertising on credit

Basic
Analysis

The liability Accounts Payable is increased by \$250 and the owner's equity account Advertising Expense is increased by \$250.

Equation Analysis	Assets				=	Liabilities	+	Owner's Equity		
	Cash	+ Supplies	+ Equipment		=	Accounts Payable	+	A. Leonid, Capital	+ Revenues	- Expenses
Old Balances	\$9,200	+ \$1,600	+ \$7,000		=	\$1,600	+	\$15,000	+ \$1,200	
(5)					=	+250				-250
New Balances	\$9,200	+ \$1,600	+ \$7,000		=	\$1,850	+	\$15,000	+ \$1,200	- \$250
	\$17,800					\$17,800				

The two sides of the equation still balance at \$17,800. Note that, although the expense increases, this is shown as a negative number because expenses reduce owner's equity.

Expenses do not have to be paid in cash at the time they are incurred. When payment is made on the later date, the liability Accounts Payable will be decreased and the asset Cash will also be decreased [see transaction (8)].

Transaction (6): Services Provided for Cash and Credit Softbyte provides \$3,500 of programming services for customers. Cash of \$1,500 is received from customers, and the balance of \$2,000 is billed to customers on account. This transaction results in an equal increase in assets and owner's equity, as shown in **Illustration 1.18**.

ILLUSTRATION 1.18 Services provided for cash and credit

Basic
Analysis

Three specific items are affected: the asset Cash is increased by \$1,500; the asset Accounts Receivable is increased by \$2,000; and the owner's equity account Service Revenue is increased by \$3,500.

Equation Analysis	Assets				=	Liabilities	+	Owner's Equity		
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+	A. Leonid, Capital	+ Revenues	- Expenses
Old Balances	\$ 9,200		+ \$1,600	+ \$7,000	=	\$1,850	+	\$15,000	+ \$1,200	- \$250
(6)	+1,500	+2,000			=				+3,500	
New Balances	\$10,700	+ \$2,000	+ \$1,600	+ \$7,000	=	\$1,850	+	\$15,000	+ \$4,700	- \$250
	\$21,300					\$21,300				

You might wonder why owner's equity is increased by \$3,500 when only \$1,500 has been collected. The reason is that the assets from earning revenues do not have to be in cash. Owner's equity is increased when revenues are recognized. In Softbyte's case, revenues are recognized when the service (performance obligation) is provided and complete. When collections on account are received at a later date, Cash will be increased and Accounts Receivable will be decreased [see transaction (9)].

Transaction (7): Payment of Expenses The expenses paid in cash for September are store rent, \$600; salaries of employees, \$900; and utilities, \$200. These payments result in an equal decrease in assets and owner's equity, as shown in **Illustration 1.19**.

ILLUSTRATION 1.19 Payment of expensesBasic
Analysis

The asset Cash is decreased by \$1,700 in total (\$600 + \$900 + \$200) and owner's equity expense accounts are increased by the same amount, which then decreases owner's equity.

Equation Analysis	Assets				=	Liabilities	+	Owner's Equity							
	Cash	Accounts		Equipment	Payable	A. Leonid, Capital	Revenues	Expenses							
		Receivable	Supplies					Expenses							
Old Balances	\$10,700	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,850	+	\$15,000	+	\$4,700	-	\$ 250
(7)	-600														-600
	-900														-900
	-200														-200
New Balances	\$ 9,000	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,850	+	\$15,000	+	\$4,700	-	\$1,950
	\$19,600					\$19,600									

The two sides of the equation now balance at \$19,600. Three lines are needed in the analysis in order to show the different types of expenses that have been paid. Note that total expenses increase but, as explained in transaction (5), it is shown as a negative number because expenses decrease owner's equity.

Transaction (8): Payment of Accounts Payable Softbyte pays its \$250 advertising bill in cash. Remember that the bill was previously recorded in transaction (5) as an increase in Accounts Payable and a decrease in owner's equity. **Illustration 1.20** shows the equation analysis for this transaction.

ILLUSTRATION 1.20 Payment of accounts payableBasic
Analysis

The asset Cash is decreased by \$250 and the liability Accounts Payable is decreased by \$250.

Equation Analysis	Assets				=	Liabilities	+	Owner's Equity							
	Cash	Accounts		Equipment	Payable	A. Leonid, Capital	Revenues	Expenses							
		Receivable	Supplies					Expenses							
Old Balances	\$9,000	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,850	+	\$15,000	+	\$4,700	-	\$1,950
(8)	-250														-250
New Balances	\$8,750	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950
	\$19,350					\$19,350									

Notice that the payment of a liability for an expense that has previously been recorded does not affect owner's equity. The expense was recorded in transaction (5) and should not be recorded again.

Transaction (9): Receipt of Cash on Account The sum of \$600 in cash is received from some customers who were billed for services in transaction (6). This transaction does not change total assets, but it does change the composition of those assets, as shown in **Illustration 1.21**.

ILLUSTRATION 1.21 Receipt of cash on accountBasic
Analysis

The asset Cash is increased by \$600 and the asset Accounts Receivable is decreased by \$600.

Equation Analysis	Assets				=	Liabilities	+	Owner's Equity							
	Cash	Accounts		Equipment	Payable	A. Leonid, Capital	Revenues	Expenses							
		Receivable	Supplies					Expenses							
Old Balances	\$8,750	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950
(9)	+600		-600												
New Balances	\$9,350	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950
	\$19,350					\$19,350									

Note that a collection of an account receivable for services that were billed and recorded earlier does not affect owner's equity. Revenue was already recorded in transaction (6) and should not be recorded again.

Transaction (10): Signed Contract to Rent Equipment in October Andrew Leonid and an equipment supplier sign a contract for Softbyte to rent equipment for the months of October and November at the rate of \$250 per month. Softbyte is to pay each month's rent at the start of the month. There is no effect on the accounting equation because the assets, liabilities, and owner's equity have not been changed by the signing of the contract. An accounting transaction has not occurred. At this point, Softbyte has not paid for anything, nor has it used the equipment, and therefore it has not incurred any expenses. **Illustration 1.22** shows the equation analysis for this transaction.

ILLUSTRATION 1.22 Signed contract to rent equipment in October

	Assets				=	Liabilities	+	Owner's Equity							
	Accounts					Accounts		A. Leonid,							
	Cash	Receivable	Supplies	Equipment	=	Payable	+	Capital	Revenues	Expenses					
Old Balances	\$9,350	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950
(10) No entry															
New Balances	\$9,350	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950
	\$19,350					\$19,350									

Note that the new balances are all identical to the old balances because nothing has changed.

Transaction (11): Withdrawal of Cash by Owner Andrew Leonid withdraws \$1,300 in cash from the business for his personal use. This transaction results in an equal decrease in assets and owner's equity, as shown in **Illustration 1.23**.

ILLUSTRATION 1.23 Withdrawal of cash by owner

Basic
Analysis

The asset Cash is decreased by \$1,300, and the owner's equity account Drawings is increased by \$1,300, which then decreases owner's equity, as follows:

Equation
Analysis

	Assets				=	Liabilities	+	Owner's Equity									
	Accounts					Accounts		A. Leonid,	A. Leonid,								
	Cash	Receivable	Supplies	Equipment	=	Payable	+	Capital	Drawings	Revenues	Expenses						
Old Balances	\$9,350	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950		
(11)	-1,300																
New Balances	\$8,050	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	-	\$1,300	+	\$4,700	-	\$1,950
	\$18,050					\$18,050											

Note that both drawings and expenses reduce owner's equity, as shown in the accounting equation above. However, **owner's drawings are not expenses**. Expenses are incurred for the purpose of earning revenue and are reported in the income statement. Drawings do not generate revenue. They are a *disinvestment*; that is, the effect of an owner's cash withdrawal is the opposite of the effect of an owner's investment. Like owner's investments, drawings are not included in the determination of profit.

Summary of Transactions

Softbyte's transactions are summarized in **Illustration 1.24** to show their cumulative effect on the accounting equation. The transaction number and the specific effects of each transaction are indicated.

ILLUSTRATION 1.24 Tabular summary of Softbyte transactions

	Assets				=	Liabilities	+	Owner's Equity									
	Cash	Accounts Receivable	Supplies	Equipment		Accounts Payable	+	A. Leonid, Capital	-	A. Leonid, Drawings	+	Revenues	-	Expenses			
(1)	+\$15,000							+\$15,000									
(2)	-7,000			+\$7,000													
(3)			+\$1,600			+\$1,600											
(4)	+1,200										+\$1,200						
(5)						+250								-\$ 250			
(6)	+1,500	+\$2,000									+\$3,500						
(7)	-600													-600			
	-900													-900			
	-200													-200			
(8)	-250					-250											
(9)	+600	-600															
(10)	No entry																
(11)	-1,300										-\$1,300						
	<u>\$ 8,050</u>	<u>+</u>	<u>\$1,400</u>	<u>+</u>	<u>\$1,600</u>	<u>+</u>	<u>\$7,000</u>	<u>=</u>	<u>\$1,600</u>	<u>+</u>	<u>\$15,000</u>	<u>-</u>	<u>-\$1,300</u>	<u>+</u>	<u>\$4,700</u>	<u>-</u>	<u>\$1,950</u>
	\$18,050					\$18,050											

The illustration demonstrates some significant facts.

- Each transaction must be analyzed for its effects on:
 - the three components (assets, liabilities, and owner's equity) of the accounting equation, and
 - specific items within each component.
- The two sides of the equation must always be equal.

This section on transaction analysis does not show the formal method of recording transactions. We will start illustrating that in Chapter 2. But understanding how transactions change assets, liabilities, and owner's equity is fundamental to understanding accounting and also business in general.

DO IT! 1.5 | Tabular Analysis

Transactions for the month of August by Dawd & Co., a public accounting firm, are shown below. Make a table that shows the effects of these transactions on the accounting equation, like the tabular analysis shown in Illustration 1.24.

- The owner, John Dawd, invested \$25,000 of cash in the business.
- Equipment was purchased on credit, \$7,000.
- Services were performed for customers for \$8,000. Of this amount, \$2,000 was received in cash and \$6,000 is due on account.
- Rent of \$850 was paid for the month.
- Customers on account paid \$4,000 (see transaction 3).
- The owner withdrew \$1,000 of cash for personal use.

ACTION PLAN

- Analyze the effects of each transaction on the accounting equation.
- Use appropriate account names for the account titles (not descriptions).
- Keep the accounting equation in balance.

Solution

Assets		=	Liabilities	+	Owner's Equity			
Cash	+ Accounts Receivable	+ Office Equipment	= Accounts Payable	+ J. Dawd, Capital	- J. Dawd, Drawings	+ Revenues	- Expenses	
1. +\$25,000				+\$25,000				
2.		+\$7,000	+\$7,000					
3. +2,000	+\$6,000					+\$8,000		
4. -850							-\$850	
5. +4,000	-4,000							
6. -1,000					-\$1,000			
\$29,150	+ \$2,000	+ \$7,000	= \$7,000	+ \$25,000	- \$1,000	+ \$8,000	- \$850	
\$38,150			\$38,150					

Related exercise material: **BE1.12**, **BE1.13**, **BE1.14**, **E1.8**, **E1.10**, **E1.11**, **E1.12**, and **E1.13**.

Preparing Financial Statements

LEARNING OBJECTIVE 6

Prepare financial statements.

HELPFUL HINT

The income statement, statement of owner's equity, and cash flow statement all report information for a period of time. The balance sheet reports information at a point in time.

Once all transactions for the month have been recognized, financial statements can be prepared. You will recall that these include the balance sheet, income statement, statement of owner's equity, and cash flow statement. (See **Helpful Hint**.)

Illustration 1.25 shows Softbyte's statements prepared from the transaction analysis in Illustration 1.24 and how the statements are interrelated. It is important to note that, because of the interrelationships of the financial statements, they are always prepared in the following order:

1. income statement,
2. statement of owner's equity,
3. balance sheet, and
4. cash flow statement.

The essential features of Softbyte's four financial statements, and their interrelationships, are briefly described in the following sections.

Income Statement

The income statement is prepared from the data in the owner's equity columns (specifically the Revenues and Expenses columns) of Illustration 1.24. The statement's heading names the company and type of statement, and to indicate that it applies to a period of time, the income statement date names the time period. For Softbyte, this appears as Month Ended September 30, 2021, which means the statement is for a one-month period—September 1 to 30, 2021 (Illustration 1.25).

On the income statement, revenues of \$4,700 appear first, followed by a list of the expenses totalling \$1,950. Finally, profit of \$2,750 is determined. The income statement is always prepared first in order to determine the amount of profit or loss to be used in the statement of owner's equity.

ILLUSTRATION 1.25

Financial statements and their interrelationships (see Helpful Hint)

SOFTBYTE Income Statement Month Ended September 30, 2021		
Revenues		
Service revenue		\$4,700
Expenses		
Advertising expense	\$250	
Rent expense	600	
Salaries expense	900	
Utilities expense	<u>200</u>	
Total expenses		<u>1,950</u>
Profit		<u><u>\$2,750</u></u>

SOFTBYTE Statement of Owner's Equity Month Ended September 30, 2021		
A. Leonid, capital, September 1, 2021		\$ 0
Add: Investments	\$15,000	
Profit	<u>2,750</u>	<u>17,750</u>
		17,750
Less: Drawings		<u>1,300</u>
A. Leonid, capital, September 30, 2021		<u><u>\$16,450</u></u>

SOFTBYTE Balance Sheet September 30, 2021		
Assets		
Cash		\$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		<u>7,000</u>
Total assets		<u><u>\$18,050</u></u>
Liabilities and Owner's Equity		
Liabilities		
Accounts payable		\$ 1,600
Owner's equity		
A. Leonid, capital		<u>16,450</u>
Total liabilities and owner's equity		<u><u>\$18,050</u></u>

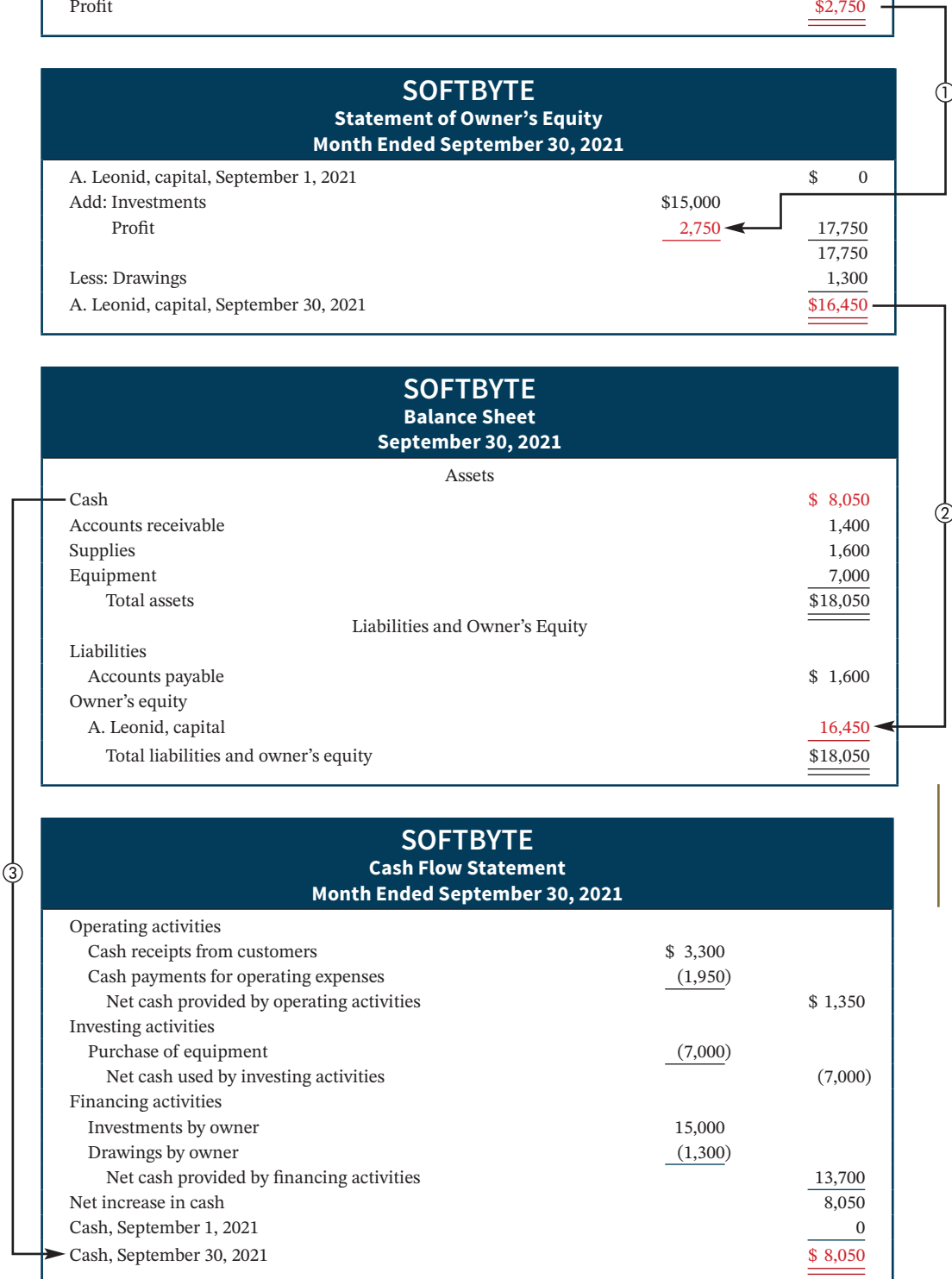
SOFTBYTE Cash Flow Statement Month Ended September 30, 2021		
Operating activities		
Cash receipts from customers	\$ 3,300	
Cash payments for operating expenses	<u>(1,950)</u>	
Net cash provided by operating activities		\$ 1,350
Investing activities		
Purchase of equipment	<u>(7,000)</u>	
Net cash used by investing activities		(7,000)
Financing activities		
Investments by owner	15,000	
Drawings by owner	<u>(1,300)</u>	
Net cash provided by financing activities		<u>13,700</u>
Net increase in cash		8,050
Cash, September 1, 2021		<u>0</u>
Cash, September 30, 2021		<u><u>\$ 8,050</u></u>

HELPFUL HINT
The arrows in this illustration show the relationships between the four statements.

①

②

③



Statement of Owner's Equity

Data for preparing the statement of owner's equity are taken from the owner's equity columns (specifically the Capital and Drawings columns) of the tabular summary (Illustration 1.24) and from the income statement. The heading of this statement names the company and type of statement, and shows the time period covered by the statement. Because the time period is the same as it is for the income statement, it is also dated Month Ended September 30, 2021.

The beginning owner's equity amount is shown on the first line of the statement. In this example, it is a zero balance because it is Softbyte's first period of operations. When financial statements are again prepared for Softbyte on October 31, 2021, the beginning owner's equity amount will be \$16,450, which is the ending balance on September 30, 2021. For a company that is continuing its operations, the beginning balance is equal to the ending balance from the previous period. What if Softbyte reported a loss in its first month? The loss would reduce owner's capital. Instead of adding profit, the loss would be deducted in the same section as owner's drawings.

Balance Sheet

The balance sheet is prepared from the Assets and Liabilities column headings and the month-end data shown in the last line of the tabular summary (Illustration 1.24), and from the statement of owner's equity. Owner's capital of \$16,450 at the end of the reporting period in the statement of owner's equity is reported on the balance sheet.

The heading of a balance sheet must identify the company, statement, and date. To indicate that the balance sheet is at a specific point in time, the date only mentions the point in time (there is no indication of a time period). For Softbyte, the date is September 30, 2021. Sometimes, the words "as at" precede the balance sheet date. Notice that the assets are listed at the top, followed by liabilities and owner's equity. This presentation is a common convention used in Canada but other orders of presentation are possible. Total assets must equal total liabilities and owner's equity. In other words, the balance sheet must balance.

Cash Flow Statement

Softbyte's cash flow statement, shown in Illustration 1.25, is for the same period of time as the income statement and the statement of owner's equity. Note that the positive numbers indicate cash inflows or increases. Numbers in parentheses indicate cash outflows or decreases. At this time, you do not need to know how these amounts are determined. In Chapter 17, we will look at the cash flow statement in detail. But you should note that Cash of \$8,050 on the September 30, 2021, balance sheet is also reported at the bottom of the cash flow statement.

Understanding the Information in the Financial Statements

Illustration 1.25 showed the financial statements for Softbyte. Every set of financial statements also has explanatory notes and supporting schedules that are an essential part of the statements. For example, as previously mentioned, at the very least a company will have to indicate if it is following IFRS or ASPE.

Public corporations issue their financial statements and supplementary materials in an annual report. The **annual report** is a document that includes useful non-financial information about the company, as well as financial information.

Non-financial information may include a management discussion of the company's mission, goals, and objectives; market position; and the people involved in the company. Financial

information may include a review of current operations and a historical summary of key financial figures and ratios, in addition to comparative financial statements. Public company financial statements are audited and include the auditors' report. There is also a statement of management responsibility for the statements.

Now is a good time to look again at Aritzia's financial statements in Appendix A. Carefully examine the format and content of each financial statement and compare them with Softbyte's financial statements in Illustration 1.25. What similarities can you find between Softbyte's financial statements and the more complicated financial statements for Aritzia?

You will see that Aritzia's transactions have been accumulated for the year ended February 25, 2018, and grouped together in categories. When similar transactions are grouped together, they are being reported in aggregate. By presenting recorded data in aggregate, the accounting information system simplifies a large number of transactions. As a result, the company's activities are easier to understand and are more meaningful. This simplification does mean less detail, however. Most companies report condensed information for two reasons: it's simpler, and it also avoids revealing significant details to competitors.

You should note that financial statement amounts are normally rounded to the nearest dollar, thousand dollars, or million dollars, depending on the size of the company. Aritzia rounds its numbers to the nearest thousand dollars. This is done to remove unimportant detail and make the information easier for the reader to understand.

DO IT! 1.6 | Financial Statements

Listed below, in alphabetical order, are the financial statement items for Park Accounting Services. Prepare an income statement, statement of owner's equity, and balance sheet for the month ended January 31, 2021.

Accounts payable	\$ 5,000	M. Park, capital, January 1, 2021	\$10,350
Accounts receivable	2,500	M. Park, drawings	3,000
Advertising expense	500	Prepaid rent	1,300
Cash	8,200	Rent expense	850
Equipment	10,000	Service revenue	11,000

Solution

PARK ACCOUNTING SERVICES
Income Statement
Month Ended January 31, 2021

Revenues		
Service revenue		\$11,000
Expenses		
Advertising expense	\$500	
Rent expense	<u>850</u>	
Total expenses		<u>1,350</u>
Profit		<u><u>\$ 9,650</u></u>

PARK ACCOUNTING SERVICES
Statement of Owner's Equity
Month Ended January 31, 2021

M. Park, capital, January 1, 2021	\$10,350
Add: Profit	<u>9,650</u>
	<u>20,000</u>



Less: Drawings	3,000
M. Park, capital, January 31, 2021	<u>\$17,000</u>

PARK ACCOUNTING SERVICES

**Balance Sheet
January 31, 2021**

Assets	
Cash	\$ 8,200
Accounts receivable	2,500
Prepaid rent	1,300
Equipment	<u>10,000</u>
Total assets	<u>\$22,000</u>
Liabilities and Owner's Equity	
Liabilities	
Accounts payable	\$ 5,000
Total liabilities	<u>5,000</u>
Owner's equity	
M. Park, capital	17,000
Total liabilities and owner's equity	<u>\$22,000</u>

Related exercise material: **BE1.15, BE1.16, BE1.17, BE1.18, E1.14, E1.15, E1.16, and E1.17.**

Review and Practice

Comparing IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Accounting standards	Required for publicly accountable enterprises and optional for private enterprises	Private enterprises only
Level of accounting information required	Users require extensive detailed information	Users require less information
Equity reporting	Statement of changes in equity	<ul style="list-style-type: none"> Proprietorships: Statement of owner's equity Partnerships: Statement of partners' equity Corporation: Statement of retained earnings

The **Demonstration Problem** is a final review before you work on the assignment material. The Action Plan strategies in the margins give you tips about how to approach the problem. The solution shows both the form and the content of complete answers.

Demonstration Problem

Adina Falk opened her own law office on July 1, 2021. During the first month of operations, the following transactions occurred:

1. Invested \$15,000 in cash in the law practice.
2. Hired a legal assistant to work part-time for \$1,500 per month.

3. Paid \$1,800 for July rent on office space.
4. Purchased equipment on account, \$3,000.
5. Provided legal services to clients for cash, \$2,500.
6. Borrowed \$7,000 cash from a bank on a note payable.
7. Provided legal services to a client on account, \$4,000.
8. Collected \$1,200 of the amount owed by a client on account (see transaction 7).
9. Paid monthly expenses: salaries, \$1,500; telephone, \$200; and utilities, \$300.
10. Withdrew \$2,000 cash for personal use.

Instructions

- a. Prepare a tabular analysis of the transactions.
- b. Prepare the income statement, statement of owner’s equity, and balance sheet for Adina Falk, Barrister & Solicitor.

ACTION PLAN

- Make sure that assets equal liabilities plus owner’s equity in each transaction.
- Investments and revenues increase owner’s equity. Withdrawals and expenses decrease owner’s equity.
- Prepare the financial statements in the order listed.
- The income statement shows revenues and expenses for a period of time.
- Profit (or loss) is calculated on the income statement and carried forward to the statement of owner’s equity.
- The statement of owner’s equity shows the changes in owner’s equity for the same period of time as the income statement.
- The owner’s capital at the end of the period is carried forward from the statement of owner’s equity to the balance sheet.
- The balance sheet reports assets, liabilities, and owner’s equity at a specific date.

Solution to Demonstration Problem

a.

Transaction	Assets			=	Liabilities		+	Owner’s Equity									
	Cash	Receivable	Equipment		Notes Payable	Accounts Payable		A. Falk, Capital	A. Falk, Drawings	Revenues	Expenses						
(1)	+\$15,000						+	+\$15,000									
(2) No Entry																	
(3)	-1,800									-\$1,800							
(4)			+\$3,000			+\$3,000											
(5)	+2,500								+\$2,500								
(6)	+7,000				+\$7,000												
(7)		+\$4,000							+\$4,000								
(8)	+1,200	-1,200															
(9)	-1,500									-1,500							
	-200									-200							
	-300									-300							
(10)	-2,000								-\$2,000								
	<u>\$19,900</u>	<u>+</u>	<u>\$2,800</u>	<u>+</u>	<u>\$3,000</u>	<u>=</u>	<u>\$7,000</u>	<u>+</u>	<u>\$3,000</u>	<u>+</u>	<u>\$15,000</u>	<u>-</u>	<u>\$2,000</u>	<u>+</u>	<u>\$6,500</u>	<u>-</u>	<u>\$3,800</u>
	\$25,700				\$25,700				\$25,700				\$25,700				

b.

ADINA FALK, BARRISTER & SOLICITOR		
Income Statement		
For the month ended July 31, 2021		
Revenue		
Service revenue		\$6,500
Expenses		
Rent expense	\$1,800	
Salaries expense	1,500	
Telephone expense	200	
Utilities expense	<u>300</u>	
Total expenses		<u>3,800</u>
Profit		<u>\$2,700</u>
ADINA FALK, BARRISTER & SOLICITOR		
Statement of Owner's Equity		
For the month ended July 31, 2021		
A. Falk, capital, July 1, 2021		\$ 0
Add: Investments	\$15,000	
Profit	<u>2,700</u>	<u>17,700</u>
		17,700
Less: Drawings		<u>2,000</u>
A. Falk, capital, July 31, 2021		<u>\$15,700</u>
ADINA FALK, BARRISTER & SOLICITOR		
Balance Sheet		
July 31, 2021		
Assets		
Cash		\$19,900
Accounts receivable		2,800
Equipment		<u>3,000</u>
Total assets		<u>\$25,700</u>
Liabilities and Owner's Equity		
Liabilities		
Notes payable		\$ 7,000
Accounts payable		3,000
Total liabilities		<u>10,000</u>
Owner's equity		
A. Falk, capital		<u>15,700</u>
Total liabilities and owner's equity		<u>\$25,700</u>

Summary of Learning Objectives

1 Identify the use and users of accounting and the objective of financial reporting.

Accounting is the information system that identifies, records, and communicates the economic events of an organization to a wide variety of interested users. Good accounting is important to people both inside and outside the organization. Internal users, such as management, use accounting information to plan, control, and evaluate business operations. External users include investors

and creditors, among others. Accounting data are used by investors (owners or potential owners) to decide whether to buy, hold, or sell their financial interests. Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money based on the accounting information. The objective of financial reporting is to provide useful information to investors and creditors to make these decisions. Users need information about the business's ability to earn a profit and generate cash. For our economic system to function smoothly, reliable and ethical accounting and financial reporting are critical.

2 Compare the different forms of business organization.

The most common examples of business organization are proprietorships, partnerships, and corporations. Proprietorships and partnerships are not separate legal entities but are separate entities for accounting purposes; income taxes are paid by the owners and owners have unlimited liability. Corporations are separate legal entities as well as separate entities for accounting purposes; income taxes are paid by the corporation and owners of the corporation have limited liability.

3 Explain the building blocks of accounting: ethics and the concepts included in the conceptual framework.

Generally accepted accounting principles are a common set of guidelines that are used to prepare and report accounting information. The conceptual framework outlines some of the body of theory used by accountants to fulfill their goal of providing useful accounting information to users. Ethical behaviour is fundamental to fulfilling the objective of financial accounting. The reporting entity concept requires the business activities of each reporting entity to be kept separate from the activities of its owner and other economic entities. The going concern assumption presumes that a business will continue operations for enough time to use its assets for their intended purpose and to fulfill its commitments. The periodicity concept requires businesses to divide up economic activities into distinct periods of time. Qualitative characteristics include fundamental and enhancing characteristics that help to ensure accounting information is useful.

Only events that cause changes in the business's economic resources or changes to the claims on those resources are recorded. Recognition is the process of recording items and measurement is the process of determining the amount that should be recognized. The historical cost concept states that economic resources should be recorded at their historical (original) cost. Fair value may be a more appropriate measure for certain types of resources. Generally, fair value is the amount the resource could be sold for in the market. The monetary unit concept requires that only transactions that can be expressed as an amount of money be included in the accounting records, and it assumes that the monetary unit is stable.

The revenue recognition principle requires companies to recognize revenue when a performance obligation(s) is satisfied. The matching concept requires that costs be recognized as expenses in the same period as revenue is recognized when there is a direct association between the cost incurred and revenue recognized.

In Canada, there are two sets of standards for profit-oriented businesses. Publicly accountable enterprises must follow International Financial Reporting Standards (IFRS) and private enterprises have the choice of following IFRS or Accounting Standards for Private Enterprises (ASPE).

4 Describe the components of the financial statements and explain the accounting equation.

Assets, liabilities, and owner's equity are reported in the balance sheet. Assets are present economic resources controlled by the business as a result of past events and have the potential to produce economic benefits. Liabilities are present obligations of a business to transfer an economic resource as a result of past events. Owner's equity is the owner's claim on the company's assets and is equal to total assets minus total liabilities. The balance sheet is based on the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$.

The income statement reports the profit or loss for a specified period of time. Profit is equal to revenues minus expenses. Revenues are the increases in assets, or decreases in liabilities, that result from business activities that are undertaken to earn profit. Expenses are the cost of assets consumed or services used in a company's business activities. They are decreases in assets or increases in liabilities, excluding withdrawals made by the owners, and result in a decrease to owner's equity.

The statement of owner's equity summarizes the changes in owner's equity during the period. Owner's equity is increased by investments by the owner and profits. It is decreased by drawings and losses. Investments are contributions of cash or other assets by owners. Drawings are withdrawals of cash or other assets from the business for the owner's personal use. Owner's equity in a partnership is referred to as partners' equity and in a corporation as shareholders' equity.

A cash flow statement summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

5 Analyze the effects of business transactions on the accounting equation.

Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset is increased, there must be a corresponding (1) decrease in another asset, (2) increase in a liability, and/or (3) increase in owner's equity.

6 Prepare financial statements.

The income statement is prepared first. Expenses are deducted from revenues to calculate the profit or loss for a specific period of time. Then the statement of owner's equity is prepared using the profit or loss reported in the income statement. The profit is added to (losses are deducted from) the owner's equity at the beginning of the period. Drawings are then deducted to calculate owner's equity at the end of the period. A balance sheet reports the assets, liabilities, and owner's equity of a business as at the end of the accounting period. The owner's equity at the end of period, as calculated in the statement of owner's equity, is reported in the balance sheet in the owner's equity section.

Glossary

Account A record of increases and decreases in a specific asset, liability, or owner's equity item. (p. 1-19)

Accounting The information system that identifies, records, and communicates the economic events of an organization to a wide variety of interested users. (p. 1-3)

Accounting equation $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$. (p. 1-17)

Accounting Standards for Private Enterprises (ASPE) A set of standards developed by the Accounting Standards Board (AcSB) that may be used for financial reporting by private enterprises in Canada. (p. 1-15)

Accounting transaction An economic event that is recorded in the accounting records because it changes the assets, liabilities, or owner's equity items of the organization. (p. 1-12)

Accounts payable A liability created by buying services or products on credit. It is an obligation to pay cash to a supplier in the future. (p. 1-17)

Accounts receivable An asset created when selling services or products to customers who promise to pay cash in the future. (p. 1-16)

Annual report Information that a company gives each year to its shareholders and other interested parties about its operations and financial position. It includes the financial statements and auditors' report, in addition to information and reports by management. (p. 1-30)

Assets Economic resources controlled by a business as a result of past events that have the potential to produce economic benefit. (p. 1-16)

Balance sheet A financial statement that reports the assets, liabilities, and owner's equity at a specific date. (p. 1-16)

Cash flow statement A financial statement that provides information about the cash receipts and cash payments for a specific period of time. (p. 1-19)

Comparability An enhancing qualitative characteristic that accounting information has if it can be compared with the accounting information of other companies because the companies all use the same accounting principles. (p. 1-12)

Conceptual framework of accounting A coherent system that guides the development and application of accounting principles. (p. 1-11)

Consistency The use of the same accounting policies from year to year. Consistency is part of the comparability enhancing qualitative characteristic of accounting information. (p. 1-12)

Corporation A business organized as a separate legal entity under corporation law, with ownership divided into transferable shares. (p. 1-8)

Creditors All of the persons or entities that a company owes money to. (p. 1-5)

Drawings Withdrawals of cash or other assets from an unincorporated business for the owner's personal use. Drawings result in a decrease in an asset and a decrease in owner's equity. (p. 1-19)

Elements of the financial statements The components in the financial statements: assets, liabilities, owner's equity, revenues, and expenses. (p. 1-21)

Ethics The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair. (p. 1-10)

Expenses The cost of assets consumed or services used in a company's ordinary business activities. Expenses are decreases in assets or increases in liabilities, excluding withdrawals made by the owners, and result in a decrease to owner's equity. (p. 1-18)

Fair value Generally the amount the asset could be sold for in the market assuming the company is a going concern, not the amount that a company would receive in an involuntary liquidation or distress sale. (p. 1-13)

Faithful representation A fundamental qualitative characteristic of accounting information meaning information accurately depicts what really happened. (p. 1-12)

Generally accepted accounting principles (GAAP) An accepted set of accounting standards that includes broad principles, procedures, concepts, and standards. GAAP guide the reporting of economic events. (p. 1-9)

Going concern assumption An assumption that a company will continue to operate in the foreseeable future. (p. 1-12)

Historical cost An accounting concept that states that assets should be recorded at their historical (original) cost. (p. 1-13)

Income statement A financial statement that presents the revenues and expenses and resulting profit (or loss) for a specific period of time. (p. 1-18)

International Financial Reporting Standards (IFRS) A set of global standards developed by the International Accounting Standards Board (IASB) used for financial reporting mostly by publicly accountable enterprises but also by certain private entities. (p. 1-14)

Investments by the owner The increase in owner's equity that results from assets put into the business by the owner. (p. 1-19)

Investors Owners or potential owners of a business. (p. 1-5)

Liabilities Present obligations, arising from past events, the settlement of which will include an outflow of economic benefits. (p. 1-17)

Limited liability The legal principle that the owners' liability for the debts of the business is limited to the amount they invested in the business. (p. 1-8)

Loss The amount by which expenses are greater than revenues. A loss decreases owner's equity. (p. 1-18)

Matching concept The accounting concept that prescribes when a cost incurred by a business should be recognized as an expense. The general concept states that, if a direct association exists between a cost incurred and a revenue recognized, the cost should be recognized as an expense in the same period as the revenue is recognized. (p. 1-13)

Measurement The process of determining the amount that should be recognized. (p. 1-13)

Monetary unit concept A concept that states that only transaction data that can be expressed as an amount of money may be included in the accounting records. It is also assumed that the monetary unit is stable. (p. 1-13)

Neutral The characteristic of accounting information when it is not biased toward one position or another. Neutrality is part of the faithful representation fundamental qualitative characteristic of accounting information. (p. 1-12)

Note payable A liability supported by a written promise to pay a specific amount, at a specific time, in the future. (p. 1-17)

Objective of financial reporting The goal of providing useful information to investors and creditors (external users) to make decisions about providing resources to a business. (p. 1-6)

Owner's equity The owner's claim on the assets of the company, which is equal to total assets minus total liabilities. (p. 1-17)

Partnership An association of two or more persons to carry on as co-owners of a business for profit. (p. 1-8)

Performance obligation The obligation of a company to perform a service or deliver goods to a customer. (p. 1-13)

Periodicity concept The accounting concept that guides organizations in dividing up their economic activities into distinct time periods. The most common time periods are months, quarters, and years. (p. 1-12)

Prepaid expense The asset created when a business pays cash for costs incurred in advance of being used or consumed. (p. 1-16)

Profit The amount by which revenues are greater than expenses. Profit increases owner's equity. (p. 1-18)

Proprietorship A small business owned by one person. (p. 1-8)

Publicly accountable enterprises Publicly traded companies, as well as securities brokers and dealers, banks, and credit unions, whose role is to hold assets for the public as part of their primary business. (p. 1-14)

Recognition The process of recording a transaction in the accounting records. (p. 1-13)

Relevance A fundamental qualitative characteristic that accounting information has if it makes a difference in a decision. (p. 1-12)

Reporting entity concept The concept that the accounting for a reporting entity's activities should be kept separate and distinct from the accounting for the activities of its owner and all other reporting entities. (p. 1-11)

Revenue recognition principle The principle that guides the recognition of revenue when a performance obligation is satisfied, not when cash is exchanged. (p. 1-13)

Revenues The result of business activities that are undertaken to earn profit, such as performing services, selling merchandise inventory, renting property, and lending money. Revenues result in an increase in assets, or decrease in liabilities, and an increase in owner's equity. (p. 1-18)

Statement of owner's equity A financial statement that summarizes the changes in owner's equity for a specific period of time. (p. 1-19)

Timeliness An enhancing qualitative characteristic that accounting information has if information is made available to decision makers before it loses its capacity to influence decisions. (p. 1-12)

Understandability An enhancing qualitative characteristic that requires information to be presented in a clear and concise fashion, so that reasonably informed users of that information can interpret it and comprehend its meaning. (p. 1-12)

Unearned revenue The liability created when a customer pays in advance of being provided with a service or product. (p. 1-17)

Unlimited liability The principle that the owners of a business are personally liable (responsible) for all debts of the business. (p. 1-8)

Verifiability The characteristic that information has if independent observers, using the same methods, obtain similar results. Verifiability is an enhancing qualitative characteristic. (p. 1-12)

Self-Study Questions

Answers are at the end of the chapter.

1. **(LO 1) K** The main objective of the financial statements is to provide useful information to
 - a. government in deciding if the company is respecting tax laws
 - b. increase the value of the company
 - c. investors and creditors that is useful when they are making decisions about the business
 - d. management that is useful when they are making decisions about the business
2. **(LO 1) K** Which of the following statements about users of accounting information is **incorrect**?
 - a. Management is an internal user.
 - b. Taxing authorities are external users.
 - c. Present creditors are external users.
 - d. Regulatory authorities are internal users.
3. **(LO 2) K** The three types of business organization forms are:
 - a. proprietorships, small businesses, and partnerships.
 - b. proprietorships, partnerships, and corporations.
 - c. proprietorships, partnerships, and large businesses.
 - d. financial, manufacturing, and service companies.
4. **(LO 3) K** Which of the following statements about International Financial Reporting Standards (IFRS) is correct?
 - a. All Canadian enterprises must follow IFRS.
 - b. Under IFRS, companies that operate in more than one country must produce separate financial statements for each of those countries.
 - c. All Canadian publicly accountable enterprises must use IFRS.
 - d. Canadian private enterprises are not allowed to use IFRS. They must use ASPE.
5. **(LO 3) C** Which of the following statements about the going concern assumption is correct?
 - a. The going concern assumption is the assumption that the reporting entity will continue to operate in the future.
 - b. Under the going concern assumption, all of the business's assets must be reported at their fair value.
 - c. The financial statements must report whether or not a company is a going concern.
 - d. The going concern assumption is not followed under ASPE.
6. **(LO 3) K** Which of the following best describes when an event should be recognized in the accounting records?
 - a. An event should be recognized in the accounting records if there is a change in assets, liabilities, or owner's equity and the change can be measured in monetary terms.
 - b. An event should be recognized in the accounting records if it involves an interaction between the company and another external entity.
 - c. Where there is uncertainty about a future event occurring or not, it should not be recognized.
 - d. Accountants use tradition to determine which events to recognize.
7. **(LO 4) AP** As at December 31, at its year end, Bruske Company has assets of \$12,500; revenues of \$10,000; expenses of \$5,500; beginning owner's capital of \$8,000; and drawings of \$1,500. What are the liabilities for Bruske Company as at December 31?
 - a. \$1,500
 - b. \$2,500
 - c. \$500
 - d. \$3,500
8. **(LO 5) AP** Performing services on account will have the following effects on the components of the basic accounting equation:
 - a. increase assets and decrease owner's equity.
 - b. increase assets and increase owner's equity.
 - c. increase assets and increase liabilities.
 - d. increase liabilities and increase owner's equity.
9. **(LO 5) AP** Bing Company pays \$700 for store rent for the month. The basic analysis of this transaction on the accounting records is:
 - a. the asset Cash is increased by \$700 and the expense Rent Expense is increased by \$700.
 - b. the asset Cash is decreased by \$700 and the expense Rent Expense is increased by \$700.
 - c. the asset Cash is decreased by \$700 and the liability Rent Payable is increased by \$700.
 - d. the asset Cash is increased by \$700 and the liability Rent Payable is decreased by \$700.
10. **(LO 6) C** Which of the following statements is true?
 - a. An income statement presents the revenues, expenses, and changes in owner's equity for a specific period of time.
 - b. The income statement shows information as at a specific point in time; the balance sheet shows information for a specified time period.
 - c. The statement of cash flows summarizes cash inflows (receipts) and outflows (payments) as at a specific point in time.
 - d. The income statement shows information for a specified time period; the balance sheet shows information as at a specific point in time.

Questions

- (LO 1) C** “Accounting is ingrained in our society and it is vital to our economic system.” Do you agree? Explain.
- (LO 1) C** Distinguish between internal and external users of accounting information. Include in your answer what kinds of questions both internal and external users might want answered.
- (LO 1) K** What is the main objective of financial reporting?
- (LO 2) C** Explain the differences between the following forms of business organization: (a) proprietorship, (b) partnership, (c) corporation.
- (LO 3) C** Why is ethics important to the accounting profession? To statement users?
- (LO 3) K** Why are there two sets of standards for profit-oriented enterprises in Canada?
- (LO 3) K** What is the reporting entity concept?
- (LO 3) C** Describe the fundamental qualitative characteristics of relevance and faithful representation.
- (LO 3) C** What is the difference between historical cost and fair value measurements?
- (LO 3) C** What criteria must be fulfilled for an event to be recognized in the accounting records? Give two examples of events that would not be recognized.
- (LO 3) C** Explain the monetary unit concept.
- (LO 4) K** What is the accounting equation and what is its purpose?
- (LO 4) K** (a) Define assets, liabilities, and owner’s equity. (b) What items increase and decrease owner’s equity?
- (LO 4) K** What is the difference between Accounts Payable and Accounts Receivable?
- (LO 4) C** How is profit or loss determined?
- (LO 4) K** List the types of accounts that are reported on (a) the balance sheet and (b) the income statement.
- (LO 5) C** Can a business have a transaction in which only the left (assets) side of the accounting equation is affected? If yes, give an example.
- (LO 5) AP** Alessandro Bega withdrew \$8,000 from his business, Bega Pharmacy, which is organized as a proprietorship. Bega’s accountant recorded this withdrawal as an increase in an expense and a decrease in cash. Is this treatment correct? Why or why not?
- (LO 6) K** In what order should the financial statements be prepared? Why?
- (LO 6) C** James is puzzled as he reads **Aritzia Inc.’s** financial statements. He notices that the numbers have all been rounded to the nearest thousand. He thought financial statements were supposed to be accurate and he is now wondering what happened to the rest of the money. Respond to James’s concern.

When the financial results of **real companies** are used in the end-of-chapter material, the company’s name is shown in red.

Brief Exercises

Identify users of accounting information.

BE1.1 (LO 1) K A list of decisions made by different users of accounting information follows:

- Decide whether the company pays fair salaries.
- Decide whether the company can pay its obligations.
- Decide whether a marketing proposal will be cost-effective.
- Decide whether the company’s profit will permit an increase in drawings.
- Decide how the company should finance its operations.

The different users are identified in the table that follows. (a) Insert the number (1–5) of the kind of decision described above that each user would likely make. (b) Indicate whether the user is internal or external.

<u>User</u>	<u>(a)</u> <u>Kind of Decision</u>	<u>(b)</u> <u>Internal or External User</u>
Owner		
Marketing manager		
Creditor		
Chief financial officer		
Labour union		

Identify forms of business organization.

BE1.2 (LO 2) C Match each of the following forms of business organization with the correct set of characteristics: proprietorship (PP), partnership (P), and corporation (C).

- _____ Shared control; combined skills and resources
- _____ Easier to transfer ownership and raise funds; no personal liability; entity pays income tax
- _____ Simple to set up; owner pays income tax

BE1.3 (LO 3) AN Describe an ethical dilemma that each of the following individuals might encounter:

Discuss ethical issues.

- a. A student in an introductory accounting course
- b. A production supervisor
- c. A banker

BE1.4 (LO 3) C Indicate whether each of the following statements is true or false by placing a T or an F in the blank at the start of each statement.

Identify application of concepts.

- a. _____ Relevance is an enhancing qualitative characteristic.
- b. _____ Timeliness is enhanced when a business uses the same accounting methods from year to year.
- c. _____ Understandability is an enhancing qualitative characteristic that requires accounting information to be clear and concise.
- d. _____ Information is verifiable if two independent people, using similar methods, achieve similar results.
- e. _____ Information is neutral when it is unbiased.

BE1.5 (LO 3) C Indicate whether each of the following statements is true or false by placing a T or an F in the blank at the start of each statement.

Identify application of IFRS and ASPE.

- a. _____ Canadian publicly accountable enterprises have the choice to report under IFRS or ASPE.
- b. _____ All private enterprises must follow ASPE.
- c. _____ Companies are required to include a note in their financial statements stating if they are using IFRS or ASPE.
- d. _____ Using IFRS may help Canadian public companies attract investors from around the globe.

BE1.6 (LO 3) C Match each of the following terms with the best description below:

Identify GAAP concepts.

- 1. Historical cost
- 2. Revenue recognition
- 3. Going concern assumption
- 4. Reporting entity concept
- 5. Monetary unit concept
- a. _____ Transactions are recorded in terms of units of money.
- b. _____ Transactions are recorded based on the actual amount received or paid.
- c. _____ Indicates that personal and business record keeping should be kept separate.
- d. _____ Performance obligation has been satisfied.
- e. _____ Businesses are expected to continue operating indefinitely.

BE1.7 (LO 4) C Match the following components with the best description below and indicate if the component is reported on the balance sheet (BS) or income statement (IS).

Identify the components of the financial statements.

- 1. Assets
- 2. Liabilities
- 3. Owner's equity
- 4. Revenues
- 5. Expenses
- 6. Profit

<u>Description</u>	<u>Component</u>	<u>Balance Sheet or Income Statement</u>
a. The increase in assets, or decrease in liabilities, resulting from business activities carried out to earn profit.		
b. Resources controlled by a business that have the potential to produce economic benefits.		
c. The owner's claim on the residual assets of the company.		
d. Present obligations that are expected to result in an outflow of economic resources as a result of a past transaction.		
e. The cost of resources consumed or services used in the company's business activities.		

Solve accounting equation.

BE1.8 (LO 4) AP Presented below is the accounting equation. Determine the missing amounts:

Assets	=	Liabilities	+	Owner's Equity
\$75,000		\$24,000		(a)
(b)		\$150,000		\$91,000
\$89,000		(c)		\$52,000

Solve accounting equation.

BE1.9 (LO 4) AP Use the accounting equation to answer each of the following questions:

- a. The liabilities of Weber Company are \$120,000 and the owner's equity is \$232,000. What is the amount of Weber Company's total assets?
- b. The total assets of King Company are \$190,000 and its owner's equity is \$91,000. What is the amount of its total liabilities?
- c. The total assets of Smith Company are \$800,000 and its liabilities are equal to one half of its total assets. What is the amount of Smith Company's owner's equity?

Solve accounting equation.



Solution Walkthrough Videos also walk students through the approach and solution to selected questions.

BE1.10 (LO 4) AP Butler Company is owned by Rachel Butler. The company had total assets of \$850,000 and total liabilities of \$550,000 at the beginning of the year. Answer each of the following independent questions:

- a. During the year, total assets increased by \$130,000 and total liabilities decreased by \$80,000. What is the amount of owner's equity at the end of the year?
- b. Total liabilities decreased by \$95,000 during the year. The company incurred a loss of \$40,000. R. Butler made an additional investment of \$100,000 and made no withdrawals. What is the amount of total assets at the end of the year?
- c. Total assets increased by \$45,000 and total liabilities decreased by \$50,000. There were no additional owner's investments, and R. Butler withdrew \$40,000. What is the amount of profit or loss for the year?

Identify assets, liabilities, and owner's equity.

BE1.11 (LO 4) K Indicate whether each of the following items is an asset (A), liability (L), or part of owner's equity (OE).

- | | |
|------------------------------|--------------------------|
| _____ 1. Accounts receivable | _____ 4. Supplies |
| _____ 2. Salaries payable | _____ 5. Owner's capital |
| _____ 3. Equipment | _____ 6. Notes payable |

Determine effects of transactions on accounting equation.

BE1.12 (LO 5) AP Presented below are eight business transactions. Indicate whether the transactions increased (+), decreased (-), or had no effect (NE) on each element of the accounting equation.

- a. Purchased \$250 of supplies on account.
- b. Performed \$500 of services on account.
- c. Paid \$300 of operating expenses.
- d. Paid \$250 cash on account for the supplies purchased in item (a) above.
- e. Invested \$1,000 cash in the business.
- f. Owner withdrew \$400 cash.
- g. Hired an employee to start working the following month.
- h. Received \$500 from a customer who had been billed previously in item (b) above.
- i. Purchased \$450 of equipment in exchange for a note payable.

Use the following format, in which the first one has been done for you as an example:

Transaction	Assets	Liabilities	Owner's Equity			
			Capital	Drawings	Revenues	Expenses
a	+\$250	+\$250	NE	NE	NE	NE

Match basic transaction analysis with transaction description.

BE1.13 (LO 5) AP Match the following basic transaction analysis with the best description of the economic event.

1. Cash increased by \$9,000 and the owner's equity account, M. Vijayakumar, Capital, is increased by \$9,000.
2. Cash is decreased by \$6,000 and the asset account Prepaid Rent is increased.
3. Supplies is increased by \$1,000 and the liability account Accounts Payable is increased by \$1,000.
4. Accounts receivable is increased by \$900 and the revenue account Service Revenue is increased by \$900.

Description	Transaction Analysis
a. Cash paid in advance for rent.	_____
b. Owner invests cash in the business.	_____
c. Supplies are purchased on account.	_____
d. Company provides service on account.	_____

BE1.14 (LO 4, 5) AP Classify each of the following items as owner's investments (I), drawings (D), revenue (R), expenses (E), or as having no effect on owner's equity (NE):

Determine effects of transactions on owner's equity.

- a. _____ Advertising expense
- b. _____ Commission fees earned
- c. _____ Cash received from the company's owner
- d. _____ Amounts paid to employees
- e. _____ Services performed on account
- f. _____ Utilities incurred
- g. _____ Cash distributed to company owner

BE1.15 (LO 4, 6) AP Presented below is information from the statements of owner's equity for Kerkan Consulting for the first three years of operation. Determine the missing amounts:

Determine missing items in owner's equity.

	2019	2020	2021
J. Kerkan, capital, January 1	\$ 0	\$68,000	\$ (c)
Investment in the year	50,000	0	20,000
Profit (loss) for the year	25,000	(b)	17,000
Drawings in the year	(a)	33,000	12,000
J. Kerkan, capital, December 31	68,000	65,000	(d)



BE1.16 (LO 6) AP Prairie Company is owned and operated by Natasha Woods. In alphabetical order below are the financial statement items for Prairie Company. Using the appropriate items, prepare an income statement for the month ended October 31, 2021.

Prepare an income statement.

Accounts payable	\$90,000	N. Woods, capital, October 1, 2021	\$36,000
Accounts receivable	77,500	N. Woods, drawings	6,000
Advertising expense	3,600	Rent expense	2,600
Cash	59,300	Service revenue	23,000

BE1.17 (LO 6) AP Refer to the data in BE1.16. Using these data and the information from Prairie's income statement, prepare a statement of owner's equity.

Prepare a statement of owner's equity.

BE1.18 (LO 6) AP Refer to the data in BE1.16. Using these data and the information from Prairie's statement of owner's equity prepared in BE1.17, prepare a balance sheet for Prairie Company.

Prepare a balance sheet.

Exercises

E1.1 (LO 1) C 1. The following are users of financial information:

Identify users of accounting information.

- | | |
|-----------------------------|-------------------------------|
| _____ Customers | _____ Store manager |
| _____ Canada Revenue Agency | _____ Supplier |
| _____ Labour unions | _____ Chief Financial Officer |
| _____ Marketing manager | _____ Loan officer |

2. The following questions could be asked by an internal user or an external user.

- _____ Can the company afford to give our members a pay raise?
- _____ How does the company's profitability compare with other companies in the industry?
- _____ Do we need to borrow money in the near future?
- _____ What does it cost to manufacture each unit produced?
- _____ Has the company paid all income tax amounts owing?
- _____ Which product should we emphasize?

Identify users and uses of accounting information.

Instructions

- a. In part 1, identify the users as being either external users (E) or internal users (I).
- b. In part 2, identify each of the questions as being more likely asked by an internal user (I) or an external user (E).

E1.2 (LO 1) C lululemon athletica inc., a public company, is known around the world for its clothing and accessories. It has more than 400 stores in twelve countries.

Instructions

- a. Identify two internal users of lululemon’s accounting information. Write a question that each user might try to answer by using accounting information.
- b. Identify two external users of lululemon’s accounting information. Write a question that each user might try to answer by using accounting information.

Relate concepts to forms of business organization.

E1.3 (LO 2) C Listed below are several statements regarding different forms of business organization.

Instructions

For each statement, indicate if that statement is true or false for each of the forms of business organization by placing a T or an F in each column.

	<u>Proprietorship</u>	<u>Partnership</u>	<u>Publicly Traded Corporation</u>
a. Owners have limited liability.	_____	_____	_____
b. Records of the business are combined with the personal records of the owner or owners.	_____	_____	_____
c. Required to follow IFRS.	_____	_____	_____
d. Pays income taxes on its profits.	_____	_____	_____
e. Owners are called “shareholders.”	_____	_____	_____
f. Will have more than one owner.	_____	_____	_____
g. Has a limited life.	_____	_____	_____
h. Has a separate legal existence from its owners.	_____	_____	_____

Match accounting concepts with descriptions.

E1.4 (LO 3) C Below is a list of accounting concepts:

- 1. Relevance
- 2. Faithful representation
- 3. Comparability
- 4. Verifiability
- 5. Neutrality
- 6. Understandability

Instructions

Match each concept with the best description that follows:

- a. _____ An economic event is reported so it represents what actually happened.
- b. _____ Users find the information in the financial statements helps them to make decisions.
- c. _____ The accounting information shows the profit of a business without consideration of what the owner may want to report.
- d. _____ Financial statements make sense to business people.
- e. _____ Henry is able to confirm the information presented in the financial statements.
- f. _____ Très Chic Boutique uses the same accounting methods as other similar boutiques.

Match words with descriptions.

E1.5 (LO 1, 3, 5) K Here are some terms from the chapter:

- | | |
|---|---|
| 1. Accounts payable | 7. Assets |
| 2. Expenses | 8. Corporation |
| 3. Creditor | 9. Unearned revenue |
| 4. International Financial Reporting Standards (IFRS) | 10. Generally accepted accounting principles (GAAP) |
| 5. Prepaid expense | 11. Accounts receivable |
| 6. Profit | 12. Owner’s equity |

Instructions

Match each term with the best description that follows:

- _____ A company that raises money by issuing shares
- _____ An accepted set of accounting standards that includes broad principles, procedures, and concepts
- _____ Obligations to suppliers of goods
- _____ Amounts due from customers
- _____ Owner's claims against the residual company's resources
- _____ Payment of cash for costs incurred in advance of being used
- _____ A party that a company owes money to
- _____ Resources owned by a business that have the potential to provide economic benefit
- _____ The set of accounting standards that all publicly traded enterprises in Canada must follow
- _____ Results when revenues exceed expenses
- _____ The cost of assets consumed or services used in a company's ordinary business activities
- _____ A liability arising when a customer pays in advance of receiving service

E1.6 (LO 4) AP Below is a partially completed income statement and statement of owner's equity for Gary Dickson Engineering Company.

Determine missing items.

Consulting revenue		\$18,000
Expenses		
Advertising expense	\$ 400	
Rent expense	(a)	
Utilities expense	900	
Salaries expense	<u>3,500</u>	<u>6,800</u>
Profit (loss)		<u>\$ (b)</u>
G. Dickson, capital, August 1		\$ 5,000
Add: Investment	(e)	
Profit	<u>(c)</u>	<u>21,200</u>
		26,200
Less: Drawings		<u>(d)</u>
G. Dickson, capital, July 31		<u>\$21,700</u>

Instructions

Fill in the missing amounts.

E1.7 (LO 4) AP Shane Cooke began a business, Cooke Company, on January 1, 2021, with an investment of \$100,000. The company had the following assets and liabilities on the dates indicated:

Calculate profit (or loss).

<u>December 31</u>	<u>Total Assets</u>	<u>Total Liabilities</u>
2021	\$370,000	\$210,000
2022	440,000	290,000
2023	525,000	355,000

**Instructions**

Use the accounting equation and the change in owner's equity during the year to calculate the profit (or loss) for:

- 2021, assuming Shane Cooke's drawings were \$50,000 for the year.
- 2022, assuming Shane Cooke made an additional investment of \$40,000 and had no drawings in 2022.
- 2023, assuming Shane Cooke made an additional investment of \$10,000 and his drawings were \$60,000 for the year.

E1.8 (LO 5) C Below are some items found in the financial statements of Petra Zizler, Orthodontist.

Classify accounts.

	(a)	(b)
1. Accounts payable	<u> L </u>	<u> BS </u>
2. Accounts receivable	<u> </u>	<u> </u>
3. Cash	<u> </u>	<u> </u>

	(a)	(b)
	L	BS
4. Equipment	_____	_____
5. Interest payable	_____	_____
6. Interest revenue	_____	_____
7. Interest expense	_____	_____
8. Investment by the owner	_____	_____
9. Service revenue	_____	_____
10. Prepaid rent	_____	_____
11. P. Zizler, capital (opening balance)	_____	_____
12. P. Zizler, drawings	_____	_____
13. Salaries expense	_____	_____
14. Supplies	_____	_____
15. Supplies expense	_____	_____
16. Unearned revenue	_____	_____

Instructions

Indicate:

- whether each of the above items is an asset (A), liability (L), or part of owner's equity (Eq); and
- which financial statement—income statement (IS), statement of owner's equity (OE), or balance sheet (BS)—it would be reported on. The first one has been done for you as an example.

Identify GAAP.

E1.9 (LO 3, 5, 6) C James Company, a proprietorship, had the following selected business transactions during the year:

- Land with a cost of \$415,000 was recorded at its fair value of \$465,000.
- A lease agreement to rent equipment from an equipment supplier starting next year was signed. The rent is \$500 per month and the lease is for two years. Payments are due at the start of each month. Nothing was recorded in James Company's accounting records when the lease was signed.
- James paid the rent for an apartment for the owner's personal use and charged it to Rent Expense.
- James prepaid for a one-year insurance policy for \$1,200. The amount was charged to Insurance Expense.
- James included a note in its financial statements stating the company is a going concern.
- James included a note in its financial statements stating the company is following ASPE.

Instructions

- In each situation, identify whether the accounting treatment is correct or not, and why.
- If it is incorrect, state what should have been done.

Determine events to be recognized.

E1.10 (LO 3, 5) C The following is a list of independent events:

- A company pays \$10,000 cash to purchase equipment at a bankruptcy sale. The equipment's fair value is \$15,000.
- A Canadian company purchases equipment from a company in the United States and pays US\$5,000 cash. It cost the company \$5,200 Canadian to purchase the U.S. dollars from its bank.
- A company provides \$4,000 of services to a customer on account.
- A company hires a new chief executive officer, who will bring significant economic benefit to the company. The company agrees to pay the new executive officer \$500,000 per year.
- A company signs a contract to provide \$10,000 of services to a customer. The customer pays the company \$4,000 cash at the time the contract is signed. The performance obligation required by the company has not been completed.

Instructions

- Should the transaction be recorded in the accounting records? Explain why or why not.
- If the transaction should be recorded, indicate the amount. Explain.

Give examples of transactions.

E1.11 (LO 5) C A list of effects on the accounting equation follows.

- Increases an asset and increases a liability.
- Increases an asset and increases owner's equity.

3. Decreases an asset and decreases a liability.
4. Decreases owner's equity and decreases an asset.
5. Increases a liability and decreases owner's equity.
6. Increases one asset and decreases another asset.

Instructions

For each effect, give an example of a transaction that would cause it.

E1.12 (LO 5) AP At the beginning of March, Brister Software Company had Cash of \$12,000, Accounts Receivable of \$18,000, Accounts Payable of \$4,000, and G. Brister, Capital of \$26,000. During the month of March, the following transactions occurred:

1. Purchased equipment for \$23,000 from Digital Equipment. Paid \$3,000 cash and signed a note payable for the balance.
2. Received \$12,000 from customers for contracts billed in February.
3. Paid \$3,000 for March rent of office space.
4. Paid \$2,500 of the amounts owing to suppliers at the beginning of March.
5. Provided software services to Kwon Construction Company for \$7,000 cash.
6. Paid BC Hydro \$1,000 for energy used in March.
7. G. Brister withdrew \$5,000 cash from the business.
8. Paid Digital Equipment \$2,100 on account of the note payable issued for the equipment purchased in transaction 1. Of this, \$100 was for interest expense.
9. Hired an employee to start working in April.
10. Incurred advertising expense on account for March, \$1,500.

Analyze effects of transactions for existing company.



Instructions

Prepare a tabular analysis of the above transactions, as shown in Illustration 1.24 in the text. The first row contains the amounts the company had at the beginning of March.

E1.13 (LO 4, 5) AP A tabular summary of the transactions for Star & Co., an accounting firm, for its first month of operations, July 2021, follows:

Analyze transactions. Calculate profit and increase in owner's equity.



	Cash	+ Accounts Receivable	+ Prepaid Insurance	+ Equipment	=	Accounts Payable	+ B. Star, Capital	- B. Star, Drawings	+ Revenues	- Expenses
1	\$18,000			\$6,000			\$24,000			
2	-4,000			8,000		\$ 4,000				
3	-750		\$750							
4	3,500	\$4,800							\$8,300	
5	-2,000					-2,000				
6	-3,300							-3,300		
7	-800									-\$800 Rent
8	1,350	-1,350								
9	-2,700									-2,700 Salaries
10						420				-420 Utilities

Instructions

- a. Describe each transaction that occurred in the month.
- b. Calculate the amount of profit for the month.
- c. Calculate the increase in owner's equity for the month.

E1.14 (LO 6) AP An analysis of transactions for Star & Co. for July 2021 was presented in E1.13.

Prepare financial statements.

Instructions

Prepare an income statement and statement of owner's equity for July and a balance sheet at July 31.

Prepare income statement and statement of owner's equity.

E1.15 (LO 6) AP Atlantic Cruise Co. is owned by Irina Temelkova. The following information is an alphabetical listing of financial statement items for the company for the year ended May 31, 2021:

Accounts payable	\$ 47,750	Interest expense	\$ 20,960
Accounts receivable	42,950	Investments by owner	5,847
Advertising expense	3,640	Maintenance expense	82,870
Building	122,570	Notes payable	379,000
Cash	20,080	Other expenses	66,500
Equipment	553,300	Prepaid insurance	1,283
I. Temelkova, capital, June 1, 2020	311,182	Revenue	350,640
I. Temelkova, drawings	33,950	Salaries expense	126,950
Insurance expense	2,566	Supplies	16,800

Instructions

Prepare an income statement and a statement of owner's equity for the year.

Prepare balance sheet.

E1.16 (LO 6) AP Refer to the financial information in E1.15 for Atlantic Cruise Co. at May 31, 2021.

Instructions

Prepare the balance sheet.

Calculate profit and owner's equity and prepare balance sheet.

E1.17 (LO 6) AP Judy Cumby is the sole owner of Deer Park, a public camping ground near Gros Morne National Park. Judy has gathered the following financial information for the year ended March 31, 2021:

Revenues—camping fees	\$150,000	Revenues—general store	\$ 40,000
Operating expenses	150,000	Cash on hand	9,400
Supplies on hand	2,500	Original cost of equipment	110,000
Fair value of equipment	125,000	Notes payable	70,000
Accounts payable	11,500	J. Cumby, capital, April 1, 2020	17,000
Accounts receivable	21,000	J. Cumby, drawings	5,000
Camping fees collected for April	10,000	Insurance paid for in advance for April to June 2021	600

Instructions

- Calculate Deer Park's profit for the year.
- Calculate Judy's owner's equity for the period as at March 31, 2021.
- Prepare a balance sheet at March 31, 2021.

Problems: Set A

Identify users and uses of accounting information.

P1.1A (LO 1) S Specific financial decisions often depend more on one type of accounting information than another. Consider the following independent, hypothetical situations:

- Pierson Industries is thinking about extending credit to a new customer. The terms of credit would require the customer to pay within 45 days of receipt of the goods.
- Dean Gunnerson owns Toys and Sports Co., a manufacturer of quality toys and sports equipment. The company manufactures a line of mountain bikes and a line of treadmills. Dean wants to know which line is more profitable.
- The president of Hi-tech Adventure is trying to determine whether the company has enough cash to buy additional equipment.
- Standen Bank is thinking about extending a loan to a small company. The company would be required to make interest payments at the end of each year for five years, and to repay the loan at the end of the fifth year.

Instructions

- Identify types of user(s) of accounting information in each situation and indicate if they are external or internal.
- For each situation, state whether the user making the decision would depend mostly on information about (1) the business's economic resources and claims to the resources, or (2) the economic performance of the business. Justify your choice.

Taking It Further is an extra question at the end of each problem designed to challenge you to think beyond the basic concepts covered in the problem and to provide written explanations. Your instructor may assign problems with or without this extra element.

Taking It Further Why is it important to users of financial statements to know that the statements have been prepared by individuals who have high standards of ethical behaviour?

P1.2A (LO 2, 3) AP Four independent situations follow:

1. Tom Courtney, a student looking for summer employment, started a dog-walking service. He picks up the dog while its owner is at work and returns it after a walk.
2. Joseph Counsell and Sabra Surkis each own a bike shop. They have decided to combine their businesses and try to expand their operations to include snowboards. They expect that in the coming year they will need funds to expand their operations.
3. Three chemistry professors have formed a business that uses bacteria to clean up toxic waste sites. Each has contributed an equal amount of cash and knowledge to the venture. The use of bacteria in this situation is experimental, and legal obligations could result.
4. Abdur Rahim has run a successful but small organic food store for over five years. The increased sales at his store have made him believe the time is right to open a chain of organic food stores across the country. Of course, this will require a substantial investment for inventory and equipment, as well as for employees and other resources. Abdur has minimal personal savings.

Determine forms of business organization and type of accounting standards.

Instructions

- a. In each case, explain what form of organization the business is likely to take: proprietorship, partnership, or corporation. Give reasons for your choice.
- b. In each case, indicate what accounting standards, IFRS or ASPE, the business is likely to use in its financial statements. Give reasons for your choice.

Taking It Further Frequently, individuals start a business as a proprietorship and later incorporate the business. What are some of the advantages of doing this?

P1.3A (LO 4) AP The following selected data are for Carducci Importers for its first three years of operations:

Determine missing items.

	<u>2019</u>	<u>2020</u>	<u>2021</u>
January 1:			
Total assets	\$ 40,000	\$ (f)	\$ (j)
Total liabilities	0	50,000	(k)
Total owner's equity	(a)	75,000	(l)
December 31:			
Total assets	(b)	140,000	172,000
Total liabilities	50,000	(g)	65,000
Total owner's equity	(c)	97,000	(m)
Changes during year in owner's equity:			
Investments by owner during the year	7,000	0	(n)
Drawings by owner during the year	15,000	(h)	36,000
Profit or loss for the year	(d)	40,000	(o)
Total revenues for the year	132,000	(i)	157,000
Total expenses for the year	(e)	95,000	126,000

Instructions

Determine the missing amounts.

Taking It Further What information does the owner of a company need in order to decide whether he or she is able to withdraw cash from the business?

P1.4A (LO 4) AP Listed in alphabetical order, the following selected items (in thousands) were taken from Parker Information Technology Company's December 31, 2021, financial statements:

Classify accounts and prepare accounting equation.

1. <u> </u> <u> </u> <u> </u> Accounts payable	\$ 810	7. <u> </u> <u> </u> <u> </u> Rent expense	\$4,800
2. <u> </u> <u> </u> <u> </u> Accounts receivable	900	8. <u> </u> <u> </u> <u> </u> S. Parker, capital, Jan. 1	6,600
3. <u> </u> <u> </u> <u> </u> Cash	3,500	9. <u> </u> <u> </u> <u> </u> S. Parker, drawings	3,900
4. <u> </u> <u> </u> <u> </u> Consulting revenue	15,730	10. <u> </u> <u> </u> <u> </u> Salaries expense	3,200
5. <u> </u> <u> </u> <u> </u> Equipment	5,700	11. <u> </u> <u> </u> <u> </u> Utilities expense	350
6. <u> </u> <u> </u> <u> </u> Interest expense	790		

Instructions

- a. In each case, identify on the blank line in the first column whether the item is an asset (A), liability (L), capital (C), drawings (D), revenue (R), or expense (E) item. The first one has been done for you as an example.

- b. Indicate on the blank line in the second column which financial statement—income statement (IS), statement of owner's equity (OE), or balance sheet (BS)—each item would be reported on. The first one has been done for you as an example.
- c. Calculate the company's profit or loss for the year ended December 31, 2021.

Taking It Further Is it important for Parker Information Technology Company to keep track of its different types of expenses as separate items? Explain.

Assess accounting treatment.

P1.5A (LO 3, 5) C Four independent situations follow:

1. Human Solutions Incorporated believes its people are its most significant asset. It estimates and records their value on its balance sheet.
2. Sharon Barton, president and owner of Barton Industries, has instructed the accountant to report the company's land and buildings at its current value of \$500,000 instead of its cost of \$350,000. "Reporting the land and buildings at \$500,000 will make it easier to get a loan from the bank next month," Sharon states.
3. Will Viceira, owner of the Music To You Company, bought an electric guitar for his personal use. He paid for the guitar with company funds and debited the Equipment account.
4. West Spirit Oil Corp. is a very small oil and gas company that is listed on the Toronto Stock Exchange. The president asked each of the shareholders to approve using ASPE instead of IFRS to reduce expenses for accounting services. He received unanimous approval and has advised the company accountant to prepare the 2021 financial statements accordingly.

Instructions

- a. For each of the above situations, determine if the accounting treatment of the situation is correct or incorrect. Explain why.
- b. If the accounting treatment is incorrect, explain what should be done.

Taking It Further Why is it important for companies to follow generally accepted accounting principles when preparing their financial statements?

Analyze transactions and calculate owner's equity.

P1.6A (LO 4, 5, 6) AP Frank Petronick decided to start an accounting practice after graduation from university. The following is a list of events that occurred concerning Frank's practice during June 2021, the first month of operations.

- | | |
|--------|--|
| June 1 | After shopping around, Frank found an office to lease and signed a lease agreement. The lease calls for a payment of \$1,050 rent per month. |
| 4 | Borrowed \$3,846 from his grandmother so that he could buy some office furniture for his new office. |
| 4 | Deposited the \$3,846 plus \$530 of his own cash in a new bank account at BMO under the name Petronick Accounting Services. |
| 6 | Paid the landlord the first month's rent. |
| 8 | Purchased furniture for \$3,160 on account. |
| 11 | Moved into the office and obtained the first assignment from a client to prepare year-end financial statements for \$1,865. |
| 15 | Performed the work on the assignment and sent an invoice to the customer for \$1,865. |
| 15 | Paid half of the amount of the purchase of furniture. |
| 18 | Purchased supplies on account for \$344. |
| 26 | Paid for Internet services, \$49 cash. |
| 28 | Collected \$900 of the June 15 billing to the customer. |
| 30 | Withdrew cash from the business of \$128 for personal expenses. |

Instructions

- a. Prepare a tabular analysis of the effects of the above transactions on the accounting equation.
- b. From an analysis of the owner's equity, calculate the account balance in F. Petronick, Capital, at June 30.

Taking It Further Assume on June 30 there is \$144 of supplies on hand and that \$200 of supplies had been used during June. What amount should be reported as an asset, Supplies, on the June 30 balance sheet? What amount should be reported as Supplies Expense?

Analyze transactions and prepare balance sheet.

P1.7A (LO 3, 4, 5, 6) AP The following events concern Anita LeTourneau, a Manitoba law school graduate, for March 2021:

1. On March 4, she spent \$20 on a lottery ticket.
2. On March 7, she won \$250,000 in the lottery and immediately quit her job as a junior lawyer.

3. On March 10, she decided to open her own law practice, and deposited \$50,000 of her winnings in a business chequing account, LeTourneau Legal Services.
4. On March 14, she purchased a new luxury condominium with a down payment of \$150,000 from her personal funds plus a home mortgage of \$200,000.
5. On March 15, Anita signed a rental agreement for her law office space for \$2,500 a month, starting March 15. She paid the first month's rent, as it is due on the 15th of each month.
6. On March 19, she hired a receptionist. He will be paid \$500 a week and will begin working on March 24.
7. On March 20, she purchased equipment for her law practice from a company that had just declared bankruptcy. The equipment was worth at least \$15,000 but Anita was able to buy it for only \$10,000.
8. On March 21, she purchased \$400 of supplies on account.
9. On March 24, she purchased an additional \$6,500 of equipment for her law practice for \$3,000 plus a \$3,500 note payable due in six months.
10. On March 31, she performed \$3,500 of legal services on account.
11. On March 31, she received \$2,500 cash for legal services to be provided in April.
12. On March 31, she paid her receptionist \$500 for the week.
13. On March 31, she paid \$400 for the supplies purchased on account on March 21.

Instructions

- a. Prepare a tabular analysis of the effects of the above transactions on the accounting equation.
- b. Calculate profit and owner's equity for the month ended March 31.
- c. Prepare a balance sheet at March 31.

Taking It Further How should Anita determine which transactions should be recorded and which ones should not be recorded?

P1.8A (LO 4, 5, 6) AP Izabela Jach opened a medical office under the name Izabela Jach, MD, on August 1, 2021. On August 31, the balance sheet showed Cash \$3,000; Accounts Receivable \$1,500; Supplies \$600; Equipment \$7,500; Accounts Payable \$5,500; Note Payable \$3,000; and I. Jach, Capital, \$4,100. During September, the following transactions occurred:

Analyze transactions and prepare financial statements.

- | | | |
|-------|----|---|
| Sept. | 4 | Collected \$800 of accounts receivable. |
| | 5 | Provided services of \$10,500, of which \$7,700 was collected from patients and the remainder was on account. |
| | 7 | Paid \$2,900 on accounts payable. |
| | 12 | Purchased additional equipment for \$2,300, paying \$800 cash and leaving the balance on account. |
| | 15 | Paid salaries, \$2,800; rent for September, \$1,900; and advertising expenses, \$275. |
| | 18 | Collected the balance of the accounts receivable from August 31. |
| | 20 | Withdrew \$1,000 for personal use. |
| | 26 | Borrowed \$3,000 from the Bank of Montreal on a note payable. |
| | 28 | Signed a contract to provide medical services, not covered under the government health plan, to employees of CRS Corp. in October for \$5,700. CRS Corp. will pay the amount owing after the medical services have been provided. |
| | 29 | Received the telephone bill for September, \$325. |
| | 30 | Billed the government \$10,000 for services provided to patients in September. |

Instructions

- a. Beginning with the August 31 balances, prepare a tabular analysis of the effects of the September transactions on the accounting equation.
- b. Prepare an income statement and statement of owner's equity for September, and a balance sheet at September 30.

Taking It Further What are the differences between purchasing an item on account and signing a note payable for the amount owing?

P1.9A (LO 6) AP Pavlov's Home Renovations was started in 2008 by Jim Pavlov. Jim operates the business from an office in his home. Listed below, in alphabetical order, are the company's assets

Prepare financial statements.

and liabilities as at December 31, 2021, and the revenues, expenses, and drawings for the year ended December 31, 2021:

Accounts payable	\$ 7,850	Operating expenses	\$ 3,545
Accounts receivable	10,080	Prepaid insurance	1,685
Cash	8,250	Salaries expense	88,230
Equipment	29,400	Service revenue	153,750
Insurance expense	3,375	Supplies	595
Interest expense	1,195	Supplies expense	20,095
J. Pavlov, drawings	44,800	Unearned revenue	15,000
Notes payable	30,800	Vehicles	42,000

Jim's capital at the beginning of 2021 was \$45,850. He made no investments during the year.

Instructions

Prepare an income statement, statement of owner's equity, and balance sheet.

Taking It Further Why is it necessary to prepare the income statement first, then the statement of owner's equity, and the balance sheet last?

P1.10A (LO 6) AN Here are incomplete financial statements for Lee Company:

Determine missing amounts, and comment.

LEE COMPANY			
Balance Sheet			
February 28, 2021			
Assets		Liabilities and Owner's Equity	
Cash	\$ 9,500	Liabilities	
Accounts receivable	5,300	Notes payable	\$26,000
Land	(i)	Accounts payable	(iii)
Building and equipment	<u>41,500</u>	Total liabilities	43,800
		M. Lee, Capital	(iv)
Total assets	<u>\$ (ii)</u>	Total liabilities and owner's equity	<u>\$91,300</u>

LEE COMPANY		
Income Statement		
Year Ended February 28, 2021		
Revenues		
Service revenue		\$95,000
Expenses		
Salaries expense	\$32,000	
Other expenses	(v)	
Supplies expense	<u>1,500</u>	
Total expenses		<u>59,500</u>
Profit		<u>(vi)</u>

LEE COMPANY	
Statement of Owner's Equity	
Year Ended February 28, 2021	
M. Lee, capital, March 1, 2020	\$22,000
Add: Investments	(vii)
Profit	(viii)
	<u>62,500</u>
Less: M. Lee, drawings	(ix)
M. Lee, capital, February 28, 2021	<u>(x)</u>

Instructions

- Calculate the missing amounts (i) to (x).
- Write a memo explaining (1) the sequence for preparing the financial statements, and (2) the interrelationships between the income statement, statement of owner's equity, and balance sheet.

Taking It Further Why isn't the balance sheet dated the same way as the income statement and statement of owner's equity: "Year Ended February 28, 2021"?

P1.11A (LO 3, 4, 5, 6) AP The balance sheet of Reflections Book Shop at April 30, 2021, is as follows:

Discuss errors and prepare corrected balance sheet.

REFLECTIONS BOOK SHOP			
Balance Sheet			
April 30, 2021			
Assets		Liabilities and Owner's Equity	
Building	\$110,000	Accounts payable	\$ 15,000
Accounts receivable	37,000	Equipment	58,000
C. Dryfuss, capital	85,000	Supplies	1,000
Cash	10,000	“Plug”	338,000
Land	50,000		
Notes payable	120,000		
	\$412,000		\$412,000

Charles Dryfuss, the owner of the book shop, admits that he is not an accountant. In fact, he couldn't get the balance sheet to balance without “plugging” the numbers (making up numbers to give the desired result). He gives you the following additional information:

1. A professional real estate appraiser estimated the value of the land at \$50,000. The actual cost of the land was \$36,000.
2. Accounts receivable include amounts due from customers in China for 35,000 yuan, which is about \$5,000 Canadian. Dryfuss didn't know how to convert the currency for reporting purposes so he added the 35,000 yuan to the \$2,000 due from Canadian customers. He thought it more important to know how much he was owed by each customer in the currency they would likely pay him with anyway.
3. Dryfuss reasons that equipment is a liability because it will cost him money in the future to maintain these items.
4. Dryfuss reasons that the note payable must be an asset because getting the loan was good for the business. If he had not obtained the loan, he would not have been able to purchase the land and buildings.
5. Dryfuss believes that his capital account is also an asset. He has invested in the business, and investments are assets; therefore his capital account is an asset.

Instructions

- a. Identify any corrections that should be made to the balance sheet, and explain why by referring to the appropriate accounting principle, assumption, or concept.
- b. Prepare a corrected balance sheet for Reflections Book Shop at April 30. (*Hint:* The capital account may need to be adjusted in order to balance.)

Taking It Further Explain to Dryfuss why all transactions affect at least two financial statement items.

Problems: Set B

P1.1B (LO 1) S Specific financial decisions often depend more on one type of accounting information than another. Consider the following independent, hypothetical situations:

Identify users and uses of accounting information.

1. Samuel Colt owns a company called Organics To You, which operates a chain of 20 organic food stores across Canada. Samuel wants to determine which brand of pasta is the most profitable for the store.
2. The Backroads Company is considering extending credit to a new customer—Europe Tours Company. The terms of credit would require the customer to pay within 45 days of receipt of the goods.
3. The senior partner of Accountants R Us is trying to determine if the partnership is generating enough cash to increase the partners' drawings and still ensure the partnership has enough cash to expand its operations.

Instructions

- a. Identify types of user(s) of accounting information in each situation and indicate if they are external or internal.
- b. For each situation, state whether the user making the decision would depend mostly on information about (1) the business's economic resources and claims to the resources, or (2) the economic performance of the business. Justify your choice.

Determine forms of business organization and types of accounting standards.

Taking It Further Why is it important to users of financial statements to know that the statements have been prepared by individuals who have high standards of ethical behaviour?

P1.2B (LO 2, 3) AP Four independent situations follow:

1. Three computer science students have formed a business to develop a new social media application (app) for the Internet. Each has contributed an equal amount of cash and knowledge to the venture. While their app looks promising, they are concerned about the legal liabilities that their business might confront.
2. Shamira Hatami, a student looking for summer employment, opened a small cupcake shop out of her summer vacation home.
3. Robert Steven and Tom Cheng each own a snowboard manufacturing business and have now decided to combine their businesses. They expect that in the next year they will need funds to expand their operations.
4. Darcy Becker, Ellen Leboeuf, and Meg Dwyer recently graduated with marketing degrees. Friends since childhood, they have decided to start a consulting business that focuses on branding strategies for small and medium-sized businesses.

Instructions

- a. In each case, explain what form of organization the business is likely to take: proprietorship, partnership, or corporation. Give reasons for your choice.
- b. In each case, indicate what accounting standards, IFRS or ASPE, the business is likely to use in its financial statements. Give reasons for your choice.

Taking It Further What are the advantages of two individuals first forming a partnership to run a business, and later incorporating?

Determine missing items.

P1.3B (LO 4) AP The following selected data are for Alexei Imports for its first three years of operations.

	<u>2019</u>	<u>2020</u>	<u>2021</u>
January 1:			
Total assets	(a)	\$75,000	\$127,000
Total liabilities	0	(e)	(k)
Total owner's equity	60,000	(f)	(l)
December 31:			
Total assets	75,000	(g)	170,000
Total liabilities	(b)	45,000	(m)
Total owner's equity	45,000	(h)	100,000
Changes during year in owner's equity:			
Investments by owner during the year	5,000	(i)	0
Drawings by owner during the year	0	10,000	(n)
Profit or loss for the year	(c)	35,000	30,000
Total revenues for the year	(d)	(j)	160,000
Total expenses for the year	120,000	95,000	(o)

Instructions

Determine the missing amounts.

Taking It Further What information does the owner of a company need in order to decide whether he or she needs to invest additional cash in the business?

Classify accounts and prepare accounting equation.

P1.4B (LO 4) AP Listed in alphabetical order, the following selected items (in thousands) were taken from Paradise Mountain Family Resort's December 31, 2021, financial statements:

1. <u> L </u> <u> BS </u> Accounts payable	\$ 195	10. _____ Operating expenses	\$ 871
2. _____ Accounts receivable	160	11. _____ Other assets	615
3. _____ Cash	120	12. _____ Other liabilities	396
4. _____ Equipment	600	13. _____ Other revenue	52
5. _____ Insurance expense	15	14. _____ Rent revenues	1,295
6. _____ Interest expense	45	15. _____ Salaries payable	125
7. _____ Land and buildings	1,495	16. _____ T. Yuen, capital, January 1	934
8. _____ Notes payable	950	17. _____ T. Yuen, drawings	20
9. _____ Prepaid insurance	30	18. _____ Unearned rent revenue	24

Instructions

- In each case, identify on the blank line, in the first column, whether the item is an asset (A), liability (L), capital (C), drawings (D), revenue (R), or expense (E) item. The first one has been done for you as an example.
- Indicate on the blank line, in the second column, which financial statement—income statement (IS), statement of owner's equity (OE), or balance sheet (BS)—each item would be reported on. The first one has been done for you as an example.
- Calculate the company's profit or loss for the year ended December 31, 2021.

Taking It Further Is it important for Paradise Mountain Family Resort to keep track of its different types of expenses as separate items? Explain.

P1.5B (LO 3, 4) C Three independent situations follow:

Assess accounting treatment.

- In preparing its financial statements, Karim Company estimated and recorded the impact of the recent death of its president.
- Because of a "flood sale," equipment worth \$300,000 was purchased by Montigny Company for only \$200,000. The equipment was recorded at \$300,000 on Montigny's books.
- Vertical Lines Company was on the verge of filing for bankruptcy, but a turnaround in the economy has resulted in the company being very healthy financially. The company president insists that the accountant put a note in the financial statements that states the company is a real going concern now.

Instructions

- For each of the above situations, determine if the accounting treatment of the situation is correct or incorrect. Explain why.
- If the accounting treatment is incorrect, explain what should be done.

Taking It Further Why is it important for companies to follow generally accepted accounting principles when preparing their financial statements?

P1.6B (LO 4, 5, 6) AP Kensington Bike Repair Shop was started on April 1 by L. Depres. A summary of the April transactions follows:

Analyze transactions and calculate owner's equity.

- | | | |
|-------|----|--|
| April | 1 | Invested \$21,000 to start the repair shop. |
| | 2 | Purchased equipment for \$9,000, paying \$3,000 cash and signing a note payable for the balance. |
| | 5 | Paid rent for the month, \$1,050. |
| | 7 | Purchased \$975 of supplies on account. |
| | 9 | Received \$3,200 in cash from customers for repair services. |
| | 16 | Provided repair services on account to customers, \$2,900. |
| | 26 | Collected \$1,200 on account for services billed on April 16. |
| | 27 | Paid for supplies purchased on April 7. |
| | 28 | Paid \$290 for advertising. |
| | 29 | Withdrew \$1,300 for personal use. |
| | 30 | Received April utility bill, \$200. |
| | 30 | Paid part-time employee salaries, \$1,400. |
| | 30 | Billed a customer \$750 for repair services. |
| | 30 | Received an advance from a customer for repairs to be performed in May, \$2,100. |

Instructions

- Prepare a tabular analysis of the effects of the above transactions on the accounting equation.
- From an analysis of the owner's equity, calculate the account balance in L. Depres, Capital at April 30.

Taking It Further Assume on April 30 there is \$500 of supplies on hand and that \$475 of supplies had been used during April. What amount should be reported as an asset, Supplies, on the April 30 balance sheet? What amount should be reported as Supplies Expense?

P1.7B (LO 3, 4, 5, 6) AP Lynn Barry started her own consulting firm, Barry Consulting, on June 1, 2021. The following transactions occurred during the month of June:

Analyze transactions and prepare balance sheet.

- | | | |
|------|---|--|
| June | 1 | Sold her shares in Big Country Airlines for \$7,000, which she deposited in her personal bank account. |
| | 1 | Transferred \$6,000 from her personal account to a business account in the name of Barry Consulting. |

- June 2 Paid \$900 for office rent for the month.
 3 Purchased \$545 of supplies on account.
 5 Paid \$95 to advertise in the *County News*.
 9 Received \$3,275 for services provided.
 12 Withdrew \$600 for personal use.
 15 Performed \$5,000 of services on account.
 17 Paid \$1,800 for employee salaries.
 21 Received \$3,000 for services provided on account on June 15.
 22 Paid for the supplies purchased on account on June 3.
 25 Signed a contract to provide consulting services to a client for \$5,500. Services will be performed and paid for in July.
 26 Borrowed \$5,500 from the bank and signed a note payable.
 29 Used part of the cash borrowed from the bank on June 26 to purchase equipment for \$2,150.
 30 Paid \$150 for telephone service for the month.
 30 Received \$2,500 from client for consulting to be provided in July.

Instructions

- Prepare a tabular analysis of the effects of the above transactions on the accounting equation.
- Calculate profit and owner's equity for the month ended June 30.
- Prepare a balance sheet at June 30.

Taking It Further How should Lynn determine which transactions should be recorded and which ones should not be recorded?

Analyze transactions and prepare financial statements.

P1.8B (LO 4, 5, 6) AP Fraser Baker opened Baker's Accounting Service in Winnipeg on September 1, 2021. On September 30, the balance sheet showed Cash \$5,700; Accounts Receivable \$2,100; Supplies \$350; Equipment \$7,600; Accounts Payable \$4,300; and F. Baker, Capital \$11,450. During October, the following transactions occurred:

- Oct. 1 Paid \$3,800 of the accounts payable.
 1 Paid \$900 rent for October.
 4 Collected \$1,550 of the accounts receivable.
 5 Hired a part-time office assistant at \$80 per day to start work the following week.
 8 Purchased additional equipment for \$4,000, paying \$500 cash and signing a note payable for the balance.
 14 Performed \$900 of accounting services on account.
 15 Paid \$300 for advertising.
 18 Collected \$400 from customers who received services on October 14.
 20 Paid \$500 for family dinner celebrating Fraser's son's university graduation.
 25 Borrowed \$8,000 from the Manitoba Bank on a note payable.
 26 Sent a statement reminding a customer that he still owed the company money from September.
 28 Earned revenue of \$5,400, of which \$3,100 was paid in cash and the balance was due in November.
 29 Paid the part-time office assistant \$720 for working nine days in October.
 29 Received \$2,800 cash for accounting services to be performed in November.
 30 Received the telephone bill for the month, \$205.
 30 Withdrew \$1,200 cash for personal expenses.

Instructions

- Beginning with the September 30 balances, prepare a tabular analysis of the effects of the October transactions on the accounting equation.
- Prepare an income statement and statement of owner's equity for October, and a balance sheet at October 31.

Taking It Further Fraser is confused about the accounting treatment of the October 20 transaction. Explain the reason for this treatment.

Prepare financial statements.

P1.9B (LO 6) AP Judy Johansen operates an interior design business, Johansen Designs. Listed below, in alphabetical order, are the company's assets and liabilities as at December 31, 2021, and the revenues, expenses, and drawings for the year ended December 31, 2021:

Accounts payable	\$ 6,590	Prepaid insurance	\$ 600
Accounts receivable	6,745	Rent expense	18,000
Cash	11,895	Salaries expense	70,500
Equipment	9,850	Service revenue	132,900
Furniture	15,750	Supplies	675
Insurance expense	1,800	Supplies expense	3,225
Interest expense	350	Telephone expense	3,000
J. Johansen, drawings	40,000	Unearned revenue	2,500
Notes payable	7,000	Utilities expense	2,400

Judy's capital at the beginning of 2021 was \$35,800. She made no investments during the year.

Instructions

Prepare an income statement, statement of owner's equity, and balance sheet.

Taking It Further Why is the balance sheet prepared after the statement of owner's equity?

P1.10B (LO 6) AN Here are incomplete financial statements for Deol Company:

Determine missing amounts, and comment.

DEOL COMPANY Balance Sheet October 31, 2021			
Assets		Liabilities and Owner's Equity	
Cash	\$ 5,000	Liabilities	
Accounts receivable	10,000	Notes payable	\$59,600
Land	(i)	Accounts payable	(ii)
Building and equipment	<u>45,000</u>	Total liabilities	66,500
		Owner's equity	
		B. Deol, capital	(iii)
Total assets	<u>\$110,000</u>	Total liabilities and owner's equity	<u>\$ (iv)</u>

DEOL COMPANY Income Statement Year Ended October 31, 2021		
Revenues		
Service revenue		\$80,000
Expenses		
Salaries expense	\$37,500	
Other expenses	(v)	
Supplies expense	<u>6,000</u>	
Total expenses		<u>62,500</u>
Profit		<u>\$ (vi)</u>

DEOL COMPANY Statement of Owner's Equity Year Ended October 31, 2021	
B. Deol, capital, November 1, 2020	\$35,000
Add: Investments	(vii)
Profit	<u>(viii)</u>
	57,500
Less: B. Deol, drawings	<u>(ix)</u>
B. Deol, capital, October 31, 2021	<u>\$ (x)</u>

Instructions

- Calculate the missing amounts (i) to (x).
- Write a memo explaining (1) the sequence for preparing the financial statements, and (2) the inter-relationships between the income statement, statement of owner's equity, and balance sheet.

Taking It Further Why aren't the income statement and the statement of owner's equity dated the same way as the balance sheet: "October 31, 2021"?

Discuss errors and prepare corrected balance sheet.

P1.11B (LO 3, 4, 5, 6) AP GG Company was formed on January 1, 2021. On December 31, Gil Goodman, the owner, prepared a balance sheet:

GG COMPANY			
Balance Sheet			
December 31, 2021			
Assets		Liabilities and Owner's Equity	
Cash	\$ 15,000	Accounts payable	\$ 45,000
Accounts receivable	55,000	Boat loan payable	13,000
Supplies	20,000	G. Goodman, capital	25,000
Boat	18,000	Profit for 2021	25,000
	<u>\$108,000</u>		<u>\$108,000</u>

Gil willingly admits that he is not an accountant. He is concerned that his balance sheet might not be correct. He gives you the following additional information:

- The boat actually belongs to Gil Goodman, not to GG Company. However, because he thinks he might take customers out on the boat occasionally, he decided to list it as an asset of the company. To be consistent, he also listed as a liability of the company the personal bank loan that he took out to buy the boat.
- Gil spent \$15,000 to purchase more supplies than he usually does, because he heard that the price of the supplies was expected to increase. It did, and the supplies are now worth \$20,000. He thought it best to record the supplies at \$20,000, as that is what it would have cost him to buy them today.
- Gil has signed a contract to purchase equipment in January 2022. The company will have to pay \$5,000 cash for the equipment when it arrives and the balance will be payable in 30 days. Guy has already reduced Cash by \$5,000 because he is committed to paying this amount.
- The balance in G. Goodman, Capital is equal to the amount Gil originally invested in the company when he started it on January 1, 2021.
- Gil paid \$1,200 for a one-year insurance policy on December 31. He did not include it in the balance sheet because the insurance is for 2022 and not 2021.
- Gil knows that a balance sheet needs to balance but on his first attempt he had \$108,000 of assets and \$83,000 of liabilities and owner's equity. He reasoned that the difference was the amount of profit the company earned this year and added that to the balance sheet as part of owner's equity.

Instructions

- Identify any corrections that should be made to the balance sheet, and explain why by referring to the appropriate accounting concept, assumption, or principle.
- Prepare a corrected balance sheet for GG Company at December 31. (*Hint:* To get the balance sheet to balance, adjust owner's equity.)

Taking It Further Assume that Gil did not make any withdrawals from the company in 2021, nor any investments other than his initial investment of \$25,000. What was the actual profit for the year?

Chapter 1: Broadening Your Perspective

Financial Reporting and Analysis

Financial Reporting Problem

BYP1.1 Aritzia Inc.'s financial statements have been reproduced in Appendix A at the back of the textbook.

Instructions

- Many companies use a calendar year for their financial statements. What does Aritzia Inc. use?
- Where in the financial statements does it indicate that Aritzia statements have been prepared using IFRS?
- What five financial statements has Aritzia presented in its financial statements?
- Where in the financial statements does it indicate that Aritzia reports the financial amounts in thousands of Canadian dollars?
- What were Aritzia's total assets as at February 25, 2018? As at February 26, 2017?
- What were Aritzia's total liabilities as at February 25, 2018? As at February 26, 2017?
- What is the amount of change in Aritzia's profit (Aritzia calls this "net income") from 2017 to 2018?

Interpreting Financial Statements

BY1.2 Apple Inc. is an international corporation that designs, manufactures, and markets a range of mobile communication and

media devices, personal computing products, and portable digital music players, as well as a variety of related software, networking solutions, and hardware products. In the assets section of its 2017 balance sheet, the following data were presented:

APPLE INC.		
Balance Sheets (partial)		
(in U.S. millions)		
Assets	September 30, 2017	September 24, 2016
Cash and cash equivalents	\$ 20,289	\$ 20,484
Short-term marketable securities	53,892	46,671
Accounts receivable, less allowance	17,874	15,754
Inventories	4,855	2,132
Vendor non-trade receivables	17,799	13,545
Other current assets	13,936	8,283
Long-term marketable securities	194,714	170,430
Property, plant and equipment, net	33,783	27,010
Goodwill	5,717	5,414
Acquired intangible assets, net	2,298	3,206
Other non-current assets	10,162	8,757
Total assets	<u>\$375,319</u>	<u>\$321,686</u>

Instructions

- For a company such as Apple, what do you think its most important economic resource is? Where is this recorded on the balance sheet? At what value (if any) should it be shown?
- Do the assets reported on the balance sheet above tell you what Apple is worth? What information does the balance sheet give you about the company's value?

Critical Thinking

Collaborative Learning Activity

Note to instructor: Additional instructions and material for this group activity can be found on the Instructor Resource Site and in *WileyPLUS*.

BY1.3 In this group activity, students will be asked to identify (or determine) the information they would require if they were making a decision whether or not to lend money or to invest in a company.

Communication Activity

BY1.4 Robert Joote is the owner of Peak Company. Robert has prepared the following balance sheet:

PEAK COMPANY	
Balance Sheet	
Month Ended December 31, 2021	
Assets	
Equipment	\$20,500
Cash	10,500
Supplies	2,000
Accounts payable	(5,000)
Total assets	<u>\$28,000</u>
Liabilities and Owner's Equity	
R. Joote, capital	\$23,500
Accounts receivable	(3,000)
R. Joote, drawings	(2,000)
Prepaid insurance	(2,500)
Notes payable	12,000
Total liabilities and owner's equity	<u>\$28,000</u>

Robert didn't know how to determine the balance for his capital account so he just "plugged" the number. (He made up a number that would give him the result that he wanted.) He had heard somewhere that assets had to equal the total of liabilities and owner's equity so he made up a number for capital so that these would be equal.

Instructions

In a memo, explain to Robert (a) how to determine the balance for his capital account, (b) why his balance sheet is incorrect, and (c) what he should do to correct it. Include in your explanation how the financial statements are interrelated, and why the order of preparation is important.

"All About You" Activity

BY1.5 In the "All About You" feature, we introduced the idea that being financially literate has a major impact on our ability to meet our financial goals and even on our health and happiness. We all face financial decisions each day. Some of these decisions are small and others are critical. Making the right financial decisions is important to your well-being. Following are three financial decisions that you as a student will likely have to make.

- You have to pay for your tuition, books, and spending money during college. You are trying to decide what kind of summer job you should apply for and whether or not you need to work part-time during the school year.
- You need to have transportation to get back and forth to college each day. You are trying to decide if you can afford to buy a second-hand car and pay for parking or whether you

should use public transit. You will have to borrow money to purchase the car.

3. You will be graduating this year and have received job offers from two different companies. You are deciding which company you should work for, and you want to accept a position in a company that is financially stable and has growth potential.

Instructions

- a. For each decision, indicate what financial information you would want to have in order to make an optimal decision.
- b. Based on what you have learned in Chapter 1, how will learning about accounting help you with the above decisions?

The **Santé Smoothie Saga** starts in this chapter and continues in every chapter. This feature chronicles the growth of a hypothetical small business to show how the concepts you learn in each chapter can be applied in the real world.

Santé Smoothie Saga

BY1.6 Natalie Koebel spent much of her youth playing sports. She passed many hours on the soccer field and in the dance studio. As Natalie grew older, her passion for healthy living continued as she started practicing yoga. Now, at the start of her second year in college, Natalie is investigating various possibilities for starting her own business as part of the requirements of the Entrepreneurship program she is taking. A long-time friend insists that Natalie has to somehow include healthy living in her business plan and, after a series of brainstorming sessions, Natalie settles on the idea of operating a smoothie business. She will start on a part-time basis. She will make the product at home, bottle it, and take it to the yoga studio where she exercises because they have agreed to purchase it on a regular basis. Now that she has started thinking about it, the possibilities seem endless. During the summer, she will concentrate on fresh fruit and vegetable smoothies. The first difficult decision is coming up with the perfect name for her business. In the end, she settles on “Santé Smoothies” and then moves on to more important issues.

Instructions

- a. What form of business organization—proprietorship, partnership, or corporation—do you recommend that Natalie use for her business? Discuss the benefits and weaknesses of each form and give the reasons for your choice.
- b. Will Natalie need accounting information? If yes, what information will she need and why? How often will she need this information?
- c. In addition to Natalie, who do you anticipate to be the users of Natalie’s accounting information? What information will these identified users need and why?
- d. Identify specific asset, liability, and equity accounts that Santé Smoothies will likely use to record its business transactions.
- e. Should Natalie open a separate bank account for the business? Why or why not?

Answers to Chapter Questions

All About You Insight, p. 1-4

Q: How might learning accounting help you make sure that your employer or bank hasn’t made an error with your paycheck or bank account?

A: Learning accounting will provide you with tools that will help you track your transactions and ensure that the bank balance is correct. You will learn how to calculate how much your paycheck should be. You will learn how to calculate interest on loans and the total cost of borrowing. Examining your potential employer’s financial statements will help you predict if the company will have enough cash to pay you now and if the company has growth potential. Stay tuned to the “All About You” features and related activities for more!

Ethics Insight, p. 1-10

Q: Who are the stakeholders in this situation? How would they be impacted by this situation?

A: The stakeholders include Jennifer, who risks violating her profession’s ethical code of conduct if she goes along with the falsified performance statistics; Currie’s employees, who may lose their jobs if the company doesn’t get more contracts; Currie’s competitors, who are at an unfair disadvantage if they lose the contract to Currie based on its falsified information; and the transportation company, which risks Currie not being able to fulfill its contract in the long term if it goes out of business because its performance is not as good as it presented.

Answers to Self-Study Questions

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