**CHAPTER 1**

Accounting and the Financial Statements

This chapter covers basic aspects of accounting and financial statements. It exposes students to different forms of business organizations, types of business activities, and the fundamental accounting equation, which provides useful insights in later chapters. The chapter describes relationships among the financial statements. The material in this chapter is generally easy to comprehend for the students.

**LEARNING OBJECTIVES**

**LO1. Explain the nature of accounting and identify the users of accounting information.**

* Accounting is the process of identifying, measuring, recording, and communicating financial information.
* This information is used both inside and outside the business to make better decisions.
* Accounting is also called the language of business.
* Financial accounting focuses on the needs of external decision makers as well as internal users.

**LO2. Identify the forms of business organizations and the types of business activities.**

* The three forms of business organizations are the sole proprietorship (owned by one person), the partnership (jointly owned by two or more individuals), and the corporation (a separate legal entity organized under the laws of a particular province or of Canada).
* Regardless of the form of business, all businesses are involved in three activities. Financing activities include obtaining funds necessary to begin and operate a business. Investing activities involve buying the assets that enable a business to operate. Operating activities are the activities of a business that generate a profit.

**LO3. Describe the relationships shown by the fundamental accounting equation.**

* The fundamental accounting equation captures all of the economic activities recorded by an accounting system.
* The left side of the accounting equation shows the assets, or economic resources, of a company.
* The right side of the accounting equation shows the claims on the company’s assets (liabilities or shareholders’ equity).
* Companies prepare four basic financial statements: statement of financial position (balance sheet), income statement, statement of changes in shareholders’ equity, and statement of cash flows.
* The rules and conventions of accounting are referred to as generally accepted accounting principles (GAAP).
* There are two main accounting standards for profit-seeking enterprises in Canada: International Financial Reporting Standards (IFRS) and Accounting Standards for Private Enterprises (ASPE).

**LO4. Prepare a classified statement of financial position and understand the information it communicates.**

* A statement of financial position reports the resources (assets) owned by a company and the claims against those resources (liabilities and shareholders’ equity) at a specific point in time.
* These elements are related by the fundamental accounting equation: Assets = Liabilities + Shareholders’ equity.
* To help users identify the fundamental economic similarities and differences between the various items on the statement of financial position, assets and liabilities are classified as either current or noncurrent (long-term). Shareholders’ equity is classified as either contributed capital or retained earnings.

**LO5. Prepare an income statement and understand the information it communicates.**

* The income statement reports how well a company has performed its operations over a period of time and provides information about the future profitability and growth of a company.
* The income statement includes the revenues and expenses of a company, which can be reported in either a single-step or multiple-step format.

**LO6. Prepare the statement of changes in equity and understand the information it communicates.**

* The statement of changes in equity reports how profit, dividends, share capital increases (decreases), and other changes in shareholders’ equity have affected the company’s statement of financial position.
* The retained earnings portion of this statement reports how much of a company’s profit was retained in the business and how much was distributed to owners for a period of time.
* The statement of changes in equity (or the statement of retained earnings) also provides users with insights into a company’s dividend payouts.

**LO7. Understand the information communicated by the statement of cash flows.**

* The statement of cash flows reports the sources of a company’s cash inflow and the uses of a company’s cash over time.
* Cash flows are classified into one of three categories: cash flows from operating activities, investing activities, or financing activities.
* The statement of cash flows can be used to assess the creditworthiness of a company.

**LO8. Describe the relationships among the financial statements.**

* There are natural relationships among the four basic financial statements so that financial statements are prepared in a particular order.
* Starting with the statement of financial position at the beginning of the accounting period, financial statements are generally prepared in the following order: income statement, the statement of changes in equity, and the statement of financial position at the end of the accounting period.
* The statement of cash flows explains the change in cash on the statements of financial position at the beginning and end of the accounting period.

**LO9. Describe information contained in the annual report.**

* The notes to the financial statements clarify and expand on the information presented in the financial statements and are considered an integral part of a company’s financial statements.
* Management’s discussion and analysis provides a discussion and explanation of various items reported in the financial statements.
* The independent auditor’s report gives the auditor’s opinion as to whether the financial statements fairly present the financial condition and results of operations of the company.

**LO10. Understand the importance of professional ethics and law in accounting.**

* Maintenance of standards of ethical behaviour is essential to the conduct of any business activity. Violation of these standards often brings significant short- and long-term negative consequences for individuals and companies.
* The maintenance of high ethical standards is necessary for users to have faith in the accuracy of the financial statements, which is a key factor in the effective and efficient functioning of the economy.

**Cornerstones**

*Cornerstone 1-1 Using the fundamental accounting equation*

*Cornerstone 1-2 Preparing a classified statement of financial position*

*Cornerstone 1-3 Preparing an income statement*

*Cornerstone 1-4 Preparing a statement of retained earnings*

**CHAPTER OUTLINE**

*Discussion Question: After students read the opening scenario of Canadian Tire Corporation, ask them if financial statements are the most important factor that one should consider before investing in a corporation’s shares, and why.*

1. **What is Accounting?**

Regardless of company’s objectives, all entities use accounting to plan future operations, make decisions, and evaluate performance.

Accountingis the *process of identifying, measuring, recording, and communicating financial information* about a company’s activities so that decision makers can make informed decisions.

Exhibit 1-1: The Demand for Accounting Information and Typical Questions



The objective of financial accounting is to provide decision makers with information that will help them assess the amounts, timing, and uncertainties of a company’s future cash flows.

1. **Businesses: Form and activities**

## A. Forms of Business Organization

## Exhibit 1-2: Forms of Business Organization

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## B. Business Activities

All businesses engage in a multitude of activities, which can be categorized as financing, investing, or operating activities.

Financing Activities: Obtaining funds that are necessary to begin and operate a business. Funds come either either from issuance of shares or from borrowing money.

Investing Activities:Once a corporation has obtained funds through its financing activities, it buys assets that will enable it to operate. Corporations may also obtain intangible assets that lack physical substance, such as copyrights and patents.

Operating Activities: Once a corporation has acquired the assets it needs, it can begin to operate.

1. **Communication of Accounting Information**

**The Four Basic Financial Statements**

1. Statement of Financial Position
2. Income Statement
3. Statement of Changes in Shareholders’ Equity (Statement of Retained Earnings)
4. Statement of Cash Flows

**Questions Answered by Financial Statements**

1. How much better off is the company at the end of the year than it was at the beginning of the year?
2. What are the economic resources of the company and the claims against those resources?
3. From what sources did a company’s cash come, and for what did the company use cash during the year?

**Fundamental Accounting Equation**

**Assets = Liabilities + Shareholders’ Equity**

## Cornerstone 1-1: Using the Fundamental Accounting Equation

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 1-1 in the *Cornerstones* text as an example in class.
2. Use Exercises 1-14 and 1-15 as a demo, in-class exercise. Students can work the exercises individually or in teams.

**4. The Classified Statement of Financial Position**

The purpose of the statement of financial position is to report the financial position of a company (its assets, liabilities, and shareholders’ equity) at a specific point in time.

The relationship between the elements of the statement of financial position is given by the fundamental accounting equation

**(Assets = Liabilities + Shareholders’ equity)**

The statement of financial position is organized, or classified, to help users identify the fundamental economic similarities and differences between the various items within the statement of financial position.

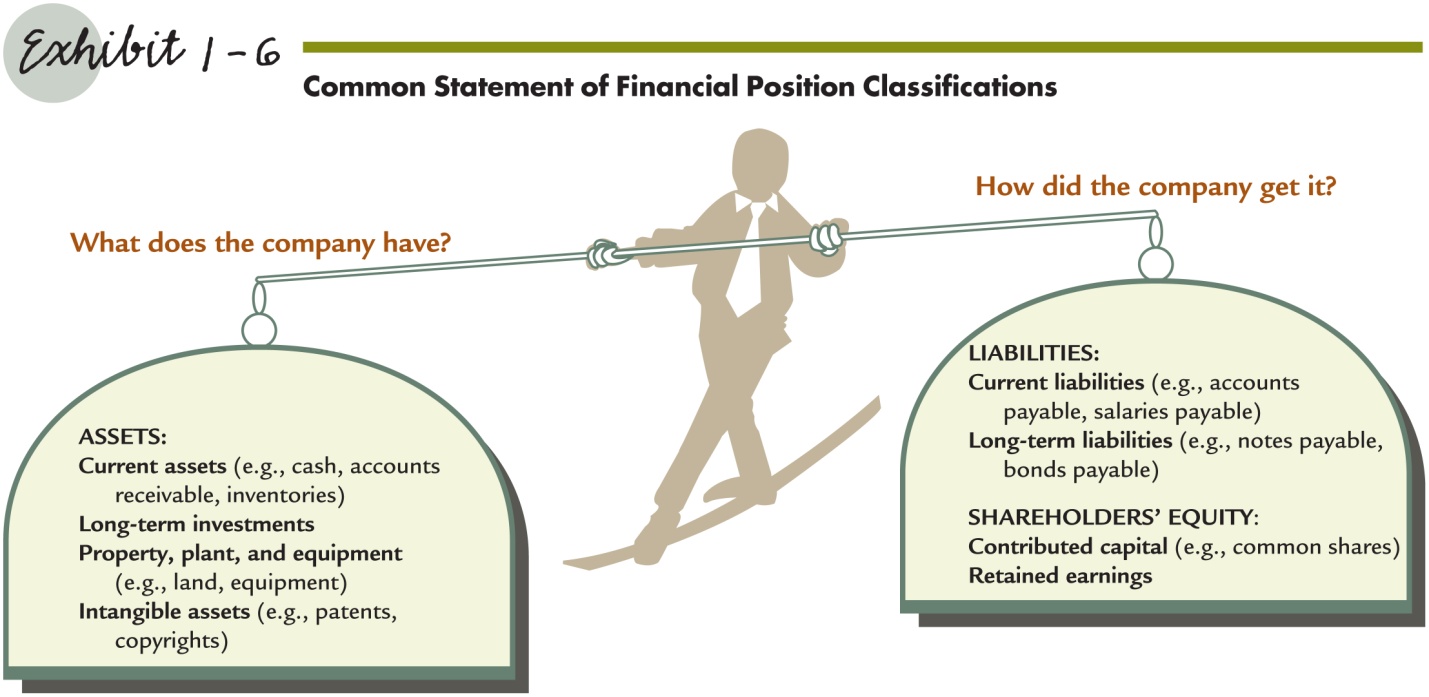
Current assets: Consist of cash and other assets that are reasonably expected to be converted into cash within one year or one operating cycle, whichever is longer.

Noncurrent assets: Assets that are not classified as current are classified as long-term or noncurrent.

Current liabilities: Consist of obligations that will be satisfied within one year or the operating cycle, whichever is longer.

Long-term liabilities: The obligations of the company that will require payment beyond one year or the operating cycle, whichever is longer.

Exhibit 1-6: Common Statement of Financial Position Classifications



## Cornerstone 1-2: Preparing a Classified Statement of Financial Position

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 1-2 in the *Cornerstones* text as an example in class.
2. Use Exercise 1-18 as a demo, in-class exercise. Students can work the exercise individually or in teams.
3. Discuss Concept Q&A. Many classifications on the statement of financial position are essential. Is it really important to place accounts within a category or is it enough to simply understand whether the account is an asset, a liability, or shareholders’ equity?

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Inventories | $ 2,300 | Accounts receivable | $ 4,200 | Accounts payable | $ 3,750 |
| Land | 12,100 | Cash | 2,500 | Common shares | 14,450 |
| Salaries payable | 1,200 | Equipment | 21,000 | Patents | 2,500 |
| Retained earnings | 11,300 | Accumulated depreciation | 5,800 | Notes payable | 8,100 |

Prepare Hightower Inc.’s statement of financial position on December 31, 2014.

**5. The Income Statement**

Reports the results of a company’s operations—the sale of goods and services and the associated cost of operating the company for given period. The long-term survival of a company depends on its ability to produce net income by earning revenues in excess of expenses.

Income enables a company to pay for the capital it uses (dividends to shareholders and interest to creditors) and to attract new capital necessary for continued existence and growth.

The income statement has two main items:

1. Revenue
2. Expenses

Income statement formats:

1. Single-step income statement:

It has only two categories; total revenues and total expenses.

Total expenses are subtracted from total revenues in a single step to arrive at net income. The advantage of a single-step income statement is its simplicity.

Net Income = Total Revenues – Total Expenses

1. Multiple-step income statement: Provides classifications of revenues and expenses that financial statement users find useful. It contains three important subtotals:
2. Gross Margin = Net Sales – Cost of Goods Sold
3. Income from Operations = Gross margins – Operating Expenses
4. Net Income = Income from operations – Non operating revenues and expenses

Exhibit 1-10: Typical Nonoperating Items

Typical Nonoperating Items

Other Revenues and Gains

Other Expenses and Losses

* Interest revenue on investments
* Dividend revenue from investments in shares of other companies
* Rent revenue
* Gain on sale of property, plant, and equipment
* Interest expense from loans
* Losses from sale of property, plant, and equipment
* Losses from accidents or vandalism
* Losses from employee strikes
* Income tax expense

The income statement provides information about the future profitability and growth of a company.

## Cornerstone 1-3: Preparing an Income Statement

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 1-3 in the *Cornerstones* text as an example in class.
2. Use Exercise 1-19 as a demo, in-class exercise. Students can work the exercise individually or in teams.

**6. Statement of Retained Earnings**

Owners of a company contribute capital in two ways:

1. Directly—purchases of common shares from the company.
2. Indirectly—company retains some or all of the net income earned each year rather than paying it out in dividends.

It is used to monitor a company’s dividend payouts to its shareholders.

## Cornerstone 1-4: Preparing a Statement of Retained Earnings

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 1-4 as an example in class.
2. Use Exercise 1-20 as a demo, in-class exercise. Students can work the exercise individually or in teams.

**7. Statement of Cash Flows**

Cash flows are classified into three categories:

1. Cash flows from operating activities—includes cash sales and collections of accounts receivable as well as cash payments for goods, services, salaries, and interest.
2. Cash flows from investing activities— includes any cash flow related to the acquisition or sale of investments and long-term assets such as property, plant, and equipment.
3. Cash flows from financing activities—includes the issuance and repayment of debt, common share transactions, and the payment of dividends.

**8. Relationships Among the Statements**

Net income from the income statement increases retained earnings on the statement of changes in equity (or statement of retained earnings for a private company). Ending retained earnings from the statement of retained earnings is reported in the shareholders’ equity section of the statement of financial position at the end of the accounting period.

**9. OTHER ITEMS in the Annual Report**

The annual report includes the financial statements of a company and other important information such as the notes to the financial statements, management’s discussion and analysis of the condition of the company, and the auditor’s report.

**Notes to the Financial Statements:** Clarify and expand upon the information presented in the financial statements.

**Management’s Discussion and Analysis:** Management uses this opportunity to highlight favourable and unfavourable trends and significant risks facing the company.

**Report of Independent Auditors:** Objective is to gather evidence that will enable the auditor to form an opinion as to whether the financial statements fairly present the financial position and result of operations of the company. Auditor’s opinion of the financial statements is presented in the form of an audit report.

**10. Professional Ethics**

**Professional Ethics:** Confidence that standards of ethical behaviour will be maintained even when individuals have incentives to violate those standards is essential to the conduct of any business activity. Violation of ethical standards may bring clear and direct penalties but more often brings subtle and long-lasting negative consequences for individuals and companies. Ethical principles require accountants to serve the public interest with integrity.

Discuss Concept Q&A. Is there a single equation or financial statement that captures the business activities (operating, investing, and financing) that all companies engage in?

## ANALYTICAL THINKING

Extra analytical thinking exercises for the chapter that may be directed to the students for discussion include the following:

* Can a financial statement be made for a person (i.e., for you as a student), or can it only be made for a business?
  + *A financial statement is a formal record of the financial activities of a business, person, or any other entity. For instance, you may be asked to prepare a financial statement for the bank when you submit an application for a new loan to borrow money.*
* Identify some specific users of financial statements and the purpose of their financial statement analysis.
  + *Shareholders (owners) and managers require financial statements in order to make important decisions that affect the continued operations of the business. Employees and labour unions use these reports in making collective bargaining agreements. Prospective investors use financial statements to assess the viability of investing in a business opportunity. Financial institutions, such as banks, use them to decide whether to grant a company a new loan or extend existing loans to finance expansion or other significant expenditures.*
* Do the four basic financial statements all have to be prepared for the same period of time, or are they independent of one another, such that a financial statement package could contain a statement of financial position as at May 31, the income statement would report the results of the year ended December 31, and the statement of cash flows would report the results of the quarter ended December 31?
  + *While financial statements can be prepared at any point or for any period of time, most companies prepare financial statements at the end of each month, quarter, and year. All of the individual basic statements in the financial statement package must cover the same time period, as there are relationships among the four financial statements. Note that the statement of financial position is prepared at a point in time (like a snapshot of the company’s asset, liabilities, and shareholders’ equity), whereas the other basic financial statements are prepared for a period of time that explains the activities between the previous statement of financial position and the current statement of financial position.*
* Pavlo, a small business owner, is reading his financial statements and notices that the accountant has categorized his assets between current and noncurrent. Pavlo disagrees with this classification as he believes that the account is trying to identify which assets Pavlo is currently using in the business operations and which assets are not currently being used in the business operations. Is Pavlo correct about the classifications? Explain.
  + *No, Pavlo is not correct. The basic classification between current and noncurrent assets refers to the timeframe as to when that particular will be converted to cash or used up, not as to whether the asset is currently being “utilized” in active business operations.*
* What are the similarities and differences between a single-step format and a multiple-step format income statement?
  + *Both income statement formats will result in exactly the same net income (loss). The difference is in the presentation of the elements within the body of the income statement and the use of important subtotals in the multiple-step income statement that aid in financial statement analysis.*
* As a shareholder of a corporation, could you choose to verify the accuracy of the financial statements yourself rather than hiring and relying on an independent auditor?
  + *An independent auditor is an accounting professional who conducts an examination of a company’s financial statements to gather evidence that will enable the auditor to form an opinion as to whether the financial statements fairly present the financial position and financial performance of the company. Because financial statement users, such as the shareholders, cannot directly observe or access a company’s accounting practices, a company is required to hire an auditor to give the users of the financial statements assurance or confidence that the financial statements are a fair presentation of its financial health and performance.*
* Why are professional ethics important in accounting? What are some ethical dilemmas that an accountant may encounter?
  + *Knowledge of, and adherence to, ethics can help accountants and auditors overcome ethical dilemmas, allowing for the right choice that, although it may not benefit the company or the individual making the decision, will benefit the public, who rely on the accountant’s information and the auditor’s reporting.*
  + *Ethical dilemmas may include the following: insider trading; overstating net income to maximize profit-sharing bonus as part of a compensation package; or overestimating revenues and underestimating expenses to inflate net income and inflate share prices.*

## APPLICATIONS

Applications for the chapter include the following:

*A. In-Class Group Practice Tests.* See the end-of-chapter multiple choice questions provided in the text for an in-class, group test or for use with a personal response system. With a group test, each student takes the quiz or test individually. Then ask students to break into teams of four or five to grade the test and discuss answers.

*B. End-of-Chapter Exercises, Problems, and Cases.* See the end-of-chapter exercises, problems, and cases provided in the text to further enhance the concepts demonstrated in the chapter.