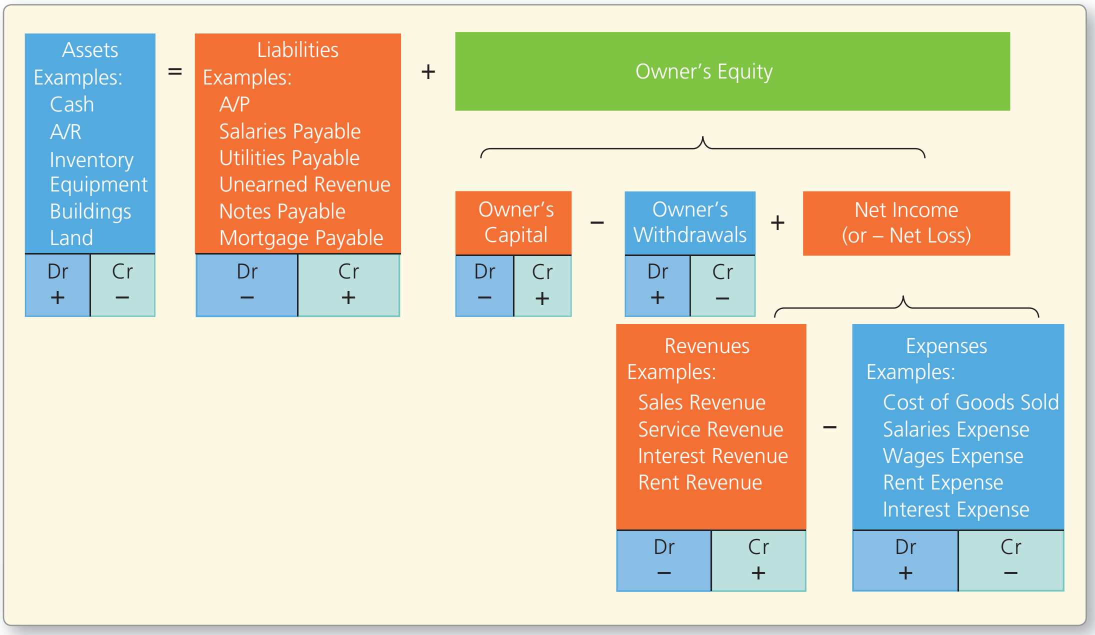
HORNGREN'S ACCOUNTING

10TH CANADIAN EDITION

MILLER-NOBLES MATTISON MATSUMURA MEISSNER JOHNSTON NORWOOD

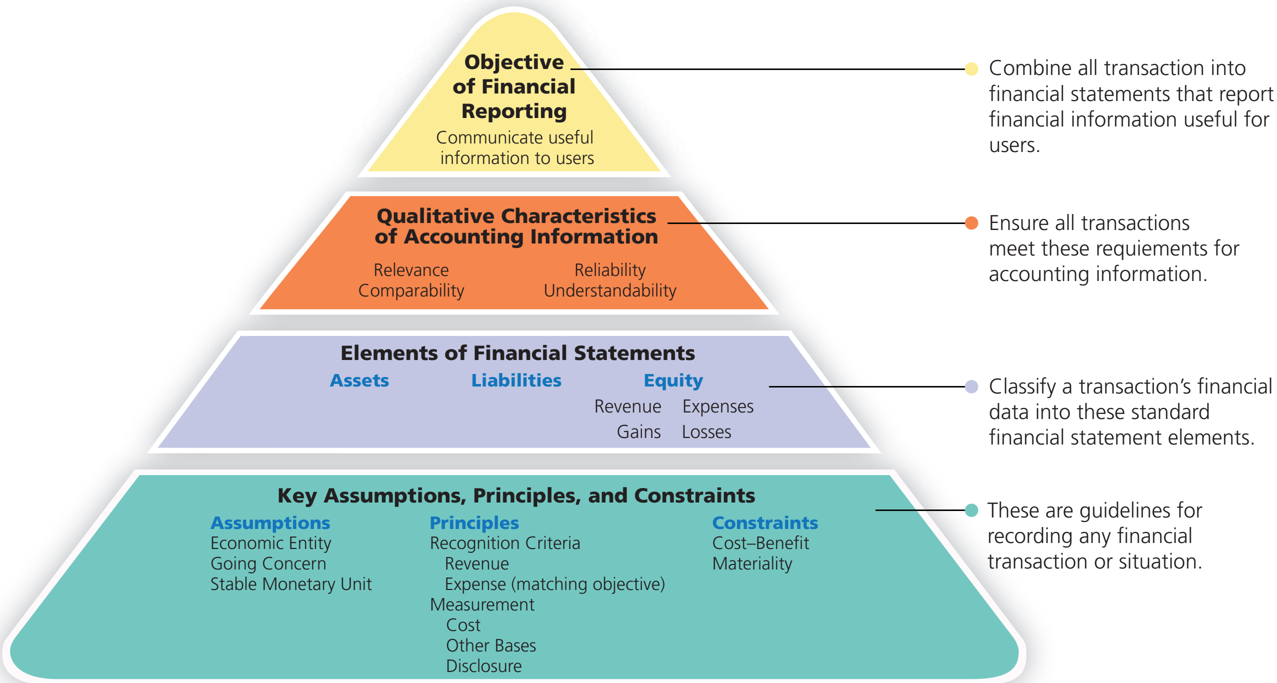
VOLUME TWO

THE ACCOUNTING EQUATION, VISUALIZED



USING THE FRAMEWORK FOR FINANCIAL REPORTING

Fundamental accounting concepts form the basis of how accounting should be done and reported to users under both Accounting Standards for Private Enterprises (ASPE) and International Financial Reporting Standards (IFRS). This hierarchy of financial statement concepts is the framework for financial reporting. As the pyramid shape shows, the financial reports issued by a company are the end product designed to satisfy the financial-information needs of various users, and they are built on a strong foundation of accounting principles.



HORNGREN'S 10TH CANADIAN EDITION

ACCOUNTING

VOLUME TWO

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HORNGREN'S ACCOUNTING

10TH CANADIAN EDITION

TRACIE L. MILLER-NOBLES
Austin Community College

BRENDA MATTISON
Tri-County Technical College

ELLA MAE MATSUMURA
University of Wisconsin–Madison

CAROL A. MEISSNER
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Langara College

VOLUME TWO

PEARSON

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PEARSON

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In memory of *Charles T. Horngren* 1926–2011

Whose vast contributions to the teaching and learning of accounting impacted and will continue to impact generations of accounting students and professionals.

I would like to thank my students for keeping me on my toes. Hearing their new ideas and how they think about accounting makes teaching such a wonderful job.

Carol A. Meissner

I would like to thank my husband, Bill, and my family for their encouragement and support.

Jo-Ann L. Johnston

I would like to thank my wife, Helen, and my family very much for their support and encouragement.

Peter R. Norwood

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BRIEF CONTENTS

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CONTENTS

ABOUT THE AUTHORS

TRACIE L. MILLER-NOBLES, CPA, received her bachelor's and master's degrees in accounting from Texas A&M University. She is an associate professor at Austin Community College. Previously she served as a senior lecturer at Texas State University, San Marcos, Texas, and has served as department chair of the Accounting, Business, Computer Information Systems, and Marketing/Management Department at Aims Community College, Greeley, Colorado. In addition, Tracie has taught as an adjunct professor at University of Texas and has public accounting experience with Deloitte Tax LLP and Sample & Bailey, CPAs.

Tracie is a recipient of the Texas Society of CPAs Outstanding Accounting Educator Award, NISOD Teaching Excellence Award, and the Aims Community College Excellence in Teaching Award. She is a member of the Teachers of Accounting at Two Year Colleges, the American Accounting Association, the American Institute of Certified Public Accountants, and the Texas State Society of Certified Public Accountants. She is currently serving on the board of directors as secretary/webmaster of Teachers of Accounting at Two Year Colleges, as chair of the American Institute of Certified Public Accountants Pre-certification Executive Education committee, and as program chair for the Teaching, Learning and Curriculum section of the American Accounting Association. In addition, Tracie served on the Commission on Accounting Higher Education: Pathways to a Profession.

Tracie has spoken on such topics as using technology in the classroom, motivating nonbusiness majors to learn accounting, and incorporating active learning in the classroom at numerous conferences. In her spare time she enjoys spending time with her friends and family, and camping, fishing, and quilting.

BRENDA L. MATTISON has a bachelor's degree in education and a master's degree in accounting, both from Clemson University. She is currently an accounting instructor at Tri-County Technical College (TCTC) in Pendleton, South Carolina. Brenda previously served as Accounting Program Coordinator at TCTC and has prior experience teaching accounting at Robeson Community College, Lumberton, North Carolina; University of South Carolina Upstate, Spartanburg, South Carolina; and Rasmussen Business College, Eagan, Minnesota. She also has accounting work experience in retail and manufacturing businesses.

Brenda is a member of Teachers of Accounting at Two Year Colleges and the American Accounting Association. She is currently serving on the board of directors as vice-president of registration of Teachers of Accounting at Two Year Colleges.

Brenda engages in the scholarship of teaching and learning (SOTL). While serving as Faculty Fellow at TCTC, her research project was Using Applied Linguistics in Teaching Accounting, the Language of Business. Brenda has presented her research findings. Other presentations include using active learning and manipulatives, such as building blocks and poker chips, in teaching accounting concepts.

In her spare time, Brenda enjoys reading and spending time with her family, especially touring the United States in their motorhome. She is also an active volunteer in the community, serving her church, local Girl Scouts, and other organizations.

ELLA MAE MATSUMURA is a professor in the Department of Accounting and Information Systems in the School of Business at the University of Wisconsin—Madison, and is affiliated with the university's Center for Quick Response Manufacturing. She received a Bachelor of Arts degree in mathematics from the University of California, Berkeley, and a Master of Science and PhD degree from the University of British Columbia. Ella Mae has won two teaching excellence awards at the University of Wisconsin–Madison and was elected as a lifetime fellow of the university's Teaching Academy, formed to promote effective teaching. She is a member of the university team awarded an IBM Total Quality Management Partnership grant to develop curriculum for total quality management education.

Ella Mae was a co-winner of the 2010 Notable Contributions to Management Accounting Literature Award. She has served in numerous leadership positions in the American Accounting Association (AAA). She was co-editor of *Accounting Horizons* and has chaired and served on numerous AAA committees. She has been secretary–treasurer and president of the AAA's Management Accounting Section. Her past and current research articles focus on decision making, performance evaluation, compensation, supply chain relationships, and sustainability. She co-authored a monograph on customer profitability analysis in credit unions.

CAROL A. MEISSNER is a professor in both the School of Business and the Automotive Business School of Canada at Georgian College in Barrie, Ontario. She teaches in the Accounting Diploma, Automotive Business Diploma, and Bachelor of Business (Automotive Management) programs. Her favourite courses are introductory financial accounting and dealership financial statement analysis.

In 2014, Carol was awarded the Georgian College Board of Governors' Award of Excellence Academic for outstanding contributions to the college and an ongoing commitment to excellence.

Carol has broad experience in curriculum development. She has been a curriculum chair, program coordinator, member of several curriculum committees, and has been involved in writing and renewing degree, diploma, and graduate certificate programs. She is currently helping to launch the new Automotive Dealership Management graduate certificate program for automotive industry executives.

A self-professed "learning junkie," Carol holds a Bachelor of Commerce degree, a Master of Business Administration degree, a Master of Arts degree in Education (Community College concentration), and a CPA designation. She has also earned Georgian College's Professional Development Teaching Practice Credential and is a graduate of Georgian's Aspiring Leaders program. She is a regular attendee at conferences related to teaching, accounting, and the automotive industry.

Carol has always been a teacher. She started as a part-time college instructor when she completed her first degree and has taught full time since 2005. Her "real world" experience includes car dealership controllership and self-employment as a part-time controller and consultant for a wide variety of businesses. Carol recently worked on several online projects for publishers and OMVIC as a subject matter expert. She is a trustee for OPSEU Local 35 and a member of the Secretary Treasurers Association of Ontario.

JO-ANN JOHNSTON is an instructor in the Accounting, Finance and Insurance Department at the British Columbia Institute of Technology (BCIT). She obtained her Diploma of Technology in Financial Management from BCIT, her Bachelor in Administrative Studies degree from British Columbia Open University, and her Master of Business Administration degree from Simon Fraser University. She is also a certified general accountant and completed the Canadian securities course.

Prior to entering the field of education, Jo-Ann worked in public practice and industry for over 10 years. She is a past member of the board of governors of the Certified General Accountants Association of British Columbia and has served on various committees for the association. She was also a member of the board of directors for the BCIT Faculty and Staff Association, and served as treasurer during that tenure.

In addition to teaching duties and committee work for BCIT, Jo-Ann is the financial officer for a family-owned business.

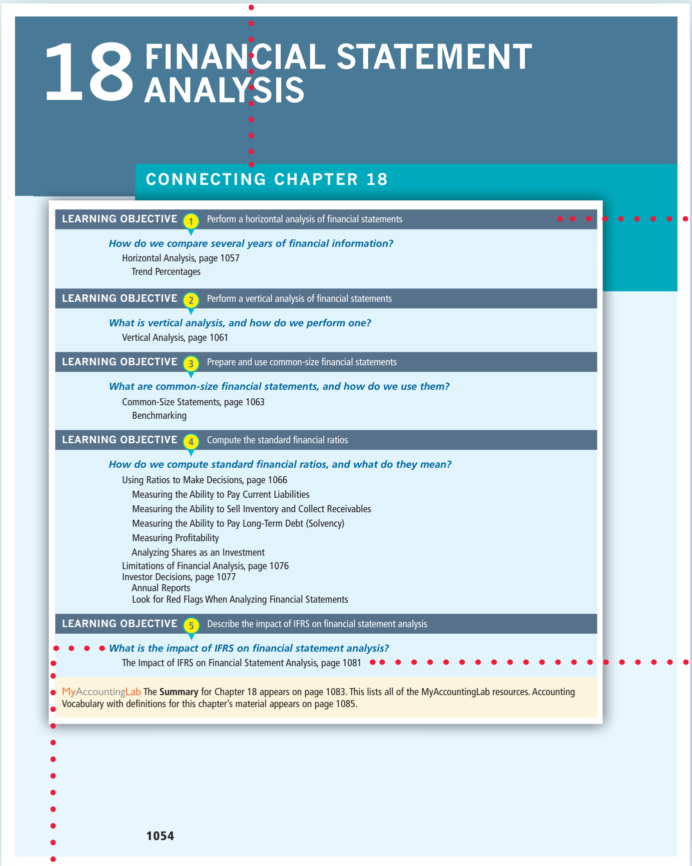
PETER R. NORWOOD is an instructor in accounting and coordinator of the Accounting program at Langara College in Vancouver. A graduate of the University of Alberta, he received his Master of Business Administration from the University of Western Ontario. He is a CPA, a fellow of the Institute of Chartered Accountants of British Columbia, a certified management accountant, and a fellow of the Society of Management Accountants of Canada.

Before entering the academic community, Peter worked in public practice and industry for over 15 years. He is a past president of the Institute of Chartered Accountants of British Columbia and chair of the Chartered Accountants School of Business (CASB). He is also the chair of the Chartered Accountants Education Foundation for the British Columbia Institute of Chartered Accountants and has been active on many provincial and national committees, including the Board of Evaluators of the Canadian Institute of Chartered Accountants. Peter is also a sessional lecturer in the Sauder School of Business at the University of British Columbia.

HORNGREN'S ACCOUNTING … REDEFINING TRADITION

MAKING CONNECTIONS

CONNECTING CHAPTER boxes appear at the beginning of each chapter. These features combine the chapter outline with the learning objectives, key questions, and page references.



18 FINANCIAL STATEMENT ANALYSIS

CONNECTING CHAPTER 18

LEARNING OBJECTIVE 1 Perform a horizontal analysis of financial statements

How do we compare several years of financial information?
Horizontal Analysis, page 1057
Trend Percentages

LEARNING OBJECTIVE 2 Perform a vertical analysis of financial statements

What is vertical analysis, and how do we perform one?
Vertical Analysis, page 1061

LEARNING OBJECTIVE 3 Prepare and use common-size financial statements

What are common-size financial statements, and how do we use them?
Common-Size Statements, page 1063
Benchmarking

LEARNING OBJECTIVE 4 Compute the standard financial ratios

How do we compute standard financial ratios, and what do they mean?
Using Ratios to Make Decisions, page 1066
Measuring the Ability to Pay Current Liabilities
Measuring the Ability to Sell Inventory and Collect Receivables
Measuring the Ability to Pay Long-Term Debt (Solvency)
Measuring Profitability
Analyzing Shares as an Investment
Limitations of Financial Analysis, page 1076
Investor Decisions, page 1077
Annual Reports
Look for Red Flags When Analyzing Financial Statements

LEARNING OBJECTIVE 5 Describe the impact of IFRS on financial statement analysis

What is the impact of IFRS on financial statement analysis?
The Impact of IFRS on Financial Statement Analysis, page 1081

MyAccountingLab The **Summary** for Chapter 18 appears on page 1083. This lists all of the MyAccountingLab resources. Accounting Vocabulary with definitions for this chapter's material appears on page 1085.

1054

LEARNING OBJECTIVES provide a roadmap showing what will be covered and what is especially important in each chapter.

PAGE REFERENCES give students the ability to quickly connect to the topic they are seeking within the chapter.

KEY QUESTIONS are questions about the important concepts in the chapter, expressed in everyday language.

CHAPTER OPENERS set up the concepts to be covered in the chapter using stories students can relate to. They show why the topics in the chapter are important in the business world. These vignettes are now 100 percent Canadian content.

Many companies have needed to seek protection from their creditors due to mismanagement of the cash needed to sustain a business. This chapter focuses on the management or summarized changes in a company's cash account. An example of a company that has faced tough competition in the Canadian home and garden sector as well as stagnant economic conditions is RONA Inc.

RONA Inc. is a major Canadian retailer and distributor of hardware, building materials, and home renovation products. Major US retailers have been interested in RONA in recent years, but the company remains solid. RONA has over 530 franchises and affiliate stores under several different names or banners and in a number of strategically aligned formats. It has 13 distribution centres, and its specialized TruServ Canada wholesaler serves RONA's network as well as many other independent dealers operating under other names. Roughly 25,000 employees work at RONA, and the company has annual consolidated sales of $4.2 billion.

Fiscal 2013 was a rough year for Rona. Store closures and lower housing starts across the country led to a decline in consolidated revenue of 5.7 percent. However, strong capital management and the sale of one of its divisions for $214 million enabled RONA to generate cash flows of about $31 million. These funds were used to purchase shares as well as reduce corporate debt. Changes in RONA's cash position can be seen in the 2013 annual report.[1]

[1] RONA Inc., 2013 Annual Report. Retrieved from www.rona.ca/corporate/financial-documents.

975

NEW

INSTRUCTOR TIPS RIGHT IN THE CHAPTER

Found throughout the text, these handwritten notes mimic the experience of having an experienced teacher walk a student through concepts on the board. Many include mnemonic devices or examples to help students remember the rules of accounting.

The entry to record each year's amortization is:

Dec. 31	Amortization Expense—Delivery Truck	12,000	
	Accumulated Amortization—Delivery Truck		12,000

Notice that when there is more than one asset being amortized in a business, we update the account names to include the specific asset information.

Assume that this truck was purchased on January 1, 2017, and the business's fiscal year ends on December 31. A *straight-line* **amortization schedule** is presented in Exhibit 10–5. Spreadsheets are usually used to prepare these schedules.

LO 6 *How does IFRS apply to share capital?*

THE IMPACT OF IFRS ON SHARE CAPITAL

ASPE	IFRS
The principles governing accounting for share capital are essentially the same under accounting standards for private enterprises (ASPE), as described in this chapter, and under IFRS.	
The requirements under ASPE are less rigorous—they only require that disclosure be made for classes of shares that have actually been issued.	Under IFRS, companies must make certain disclosures about *all* classes of shares authorized by the corporation, whether those classes of shares have been issued or not.
When shares are issued for non-cash items, use fair value of either the item received or the item given up. Choose the information that is most reliable to record the transaction.	First consider the fair value of the non-cash item received in exchange for shares. If its value cannot be reliably determined, then use the fair value of the shares when recording the transaction.
Organization costs are capitalized under ASPE—recorded as an intangible asset—and then amortized.	Under IFRS, organization costs are expensed.

NEW

IFRS/ASPE COMPARISON Each applicable chapter ends with a table comparing how concepts in that chapter are dealt with for those using IFRS and ASPE.

EXHIBIT 13–7 | Shareholders' Equity Section of a Balance Sheet

LONGBOURN GOLF & RESORTS CORPORATION Partial Balance Sheet December 31, 2017	
Shareholders' Equity	
Contributed capital	
Preferred shares, $5.00, 10,000 shares authorized,	
1,000 shares issued and outstanding	$ 100,000
Common shares, 100,000 shares authorized,	
25,000 shares issued and outstanding	150,000
Total contributed capital	250,000
Retained earnings	743,700
Total shareholders' equity	$ 993,700

In the contributed capital section, "Preferred shares, $5.00," means the annual dividend is $5.00 per preferred share. The dividend can also be stated as a percent.

Notice the order of the contributed capital accounts: preferred shares are listed first followed by common shares.

There are two sections of shareholders' equity: contributed capital and retained earnings.

NEW

ANNOTATED EXHIBITS More annotated exhibits have been developed for this edition to improve clarity and reduce related explanations in the text.

Try It

3. Identify each of the following transactions as either an operating activity (O), an investing activity (I), a financing activity (F), or an activity that is not reported on a cash flow statement (N). Assume the direct method is used to report cash flows from operating activities.
   ____ Payment of income taxes
   ____ Issuance of preferred shares
   ____ Payment of employee salaries
   ____ Collections of accounts receivable
   ____ Payment for a delivery truck
   ____ Repayment of a long-term bank loan (principal only)
   ____ Receipt of loan interest
   ____ Payment of accounts payable
4. For the items listed in the previous question, indicate whether the transaction would increase (+), decrease (−), or have no effect (N) on cash.

Solutions appear at the end of this chapter and on MyAccountingLab

NEW

TRY IT! BOXES Found at the end of each learning objective section in the text, **Try It!** features (formerly Just Checking) give students the opportunity to apply the concepts they just learned to an accounting problem. For this edition, care was taken to streamline this feature to include fewer questions to avoid interrupting the flow of student learning. Deep linking in the eText will allow students to practise in MyAccountingLab without interrupting their interaction with the eText. **Try It! Solutions** are provided at the end of each chapter.

Why It's Done This Way

Objective of Financial Reporting

Why is it important to consolidate the financial results of companies under common control? The consolidated financial statements *communicate useful information* to interested users to help them assess the success of the company—this is the primary objective of the accounting framework. If the parent company provided financial information on each of its subsidiaries on a company-by-company basis only, users would find it difficult to pull all the pieces together on their own. Intercompany transactions would be difficult to identify unless a user had direct access to the same information as internal managers.

In the accounting framework, the *economic entity assumption* directs us to eliminate intercompany transactions because these occur *within* the larger economic entity (which is the consolidated group of companies) and would cause double-counting errors if they were not eliminated.

The framework's characteristic of *understandability* promotes disclosure in the notes to the financial statements. The parent company's notes to the financial statements must list the subsidiary companies and the parent's percentage of ownership of each. GAAP also require that companies provide **segmented information** in their financial statement notes. This segmented information is either by industry or by geography, and it is reported by companies that operate in different industries or regions of the world, including parent and subsidiary companies.

By presenting details about a parent company's subsidiaries and segmented information in the notes, consolidated financial statements communicate even more *useful information* to users to help them assess the success of the company.

REVISED WHY IT'S DONE THIS WAY BOXES

Descriptions in these boxes have been shortened to focus on the key new points in the chapter, without referencing levels. For instructors who want longer and more technical notes, these are included in the instructor's material.

REVISED END-OF-CHAPTER MATERIAL

The number of Starters and Exercises provided in each chapter has been increased, while maintaining both A and B Problem sets.

All learning objectives now have consistent coverage in end-of-chapter questions.

There is now more variety of questions provided.

ENGAGING REDESIGN The redesign of this text throughout includes clean and consistent art for T-accounts, journal entries, financial statements, and the accounting equation.

New art types include clear explanations and connection arrows to help students follow the transaction process. Illustrations are updated to be more modern and clean.

Margins have been decluttered, ensuring a smoother, more open and approachable look, while keeping the most important content visible.

Closing entry 3 would then credit Income Summary to close its debit balance and transfer the net loss to Lisa Hunter, Capital:

3 May 31	Lisa Hunter, Capital	1,000	
	Income Summary		1,000
	To close the Income Summary account and transfer net loss to the Capital account.		

After posting, these two accounts would appear as follows:

Income Summary

Clo. 2	27,500	Clo. 1	26,500
Bal.	1,000	Clo. 3	1,000

Lisa Hunter, Capital

Clo. 3	1,000		120,100
		Bal.	119,100

Changes to the Tenth Canadian Edition

Additional Starters and Exercises have been added to most chapters in Volume 2. Instructors wanted more of these types of questions and more variety in the questions, so the Tenth Canadian Edition has been updated to reflect this.

Chapter 12—Partnerships

- Coverage of a death of a partner has been reduced, since it is similar to other withdrawals from a partnership.
- Added more T-accounts to clarify how balances are calculated.

Chapter 13—Corporations: Share Capital and the Balance Sheet

- Streamlined coverage of the concepts of corporations to emphasize material that students need to know at this level.

Chapter 15—Long-Term Liabilities

- Included more calculator instructions to assist students who struggle with the math.
- Added shareholder loans as a topic to improve coverage of other important liabilities.
- Removed off-balance-sheet financing to keep focus of the chapter on the most important transactions.

Chapter 16—Investments and International Operations

- New exhibit added to clarify the accounting methods and financial statement effects of investments.
- Updated exchange rates to what was current at the time of writing.

Chapter 17—The Cash Flow Statement

- Added a Summary Problem to illustrate the direct method so that both methods are fully demonstrated.

Chapter 18—Financial Statement Analysis

- Reduced the number of comparative companies in ratio analyses.
- Reduced text to let the formulas speak for themselves.

Student and Instructor Resources

The primary goal of the supplements that accompany *Horngren's Accounting*, Tenth Canadian Edition, is to help instructors deliver their course with ease using any delivery method—traditional, self-paced, or online—and for students to learn and practise accounting in a variety of ways that meet their learning needs and study preferences.

MyAccountingLab

MyAccountingLab delivers proven results in helping individual students succeed. It provides engaging experiences that personalize, stimulate, and measure learning for each student, including a personalized study plan, mini-cases, and videos. MyAccountingLab is the portal to an array of learning tools for all learning styles—algorithmic practice questions with guided solutions are only the beginning!

For Students

The following features are **NEW** to MyAccountingLab for the Tenth Canadian Edition:

NEW! **Assignable Accounting Cycle Tutorial**—MyAccountingLab's new interactive tutorial helps students master the accounting cycle for early and continued success in the introduction to accounting course. The tutorial, accessed by computer, smartphone, or tablet, provides students with brief explanations of each concept of the accounting cycle through engaging videos and/or animations. Students are immediately assessed on their understanding, and their performance is recorded in the MyAccountingLab gradebook. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet another resource within MyAccountingLab to help them be successful with the accounting cycle.

NEW! **Enhanced Pearson eText**—The Enhanced eText keeps students engaged in learning on their own time, while helping them achieve greater conceptual understanding of course material. The worked examples bring learning to life, and algorithmic practice allows students to apply the concepts they are reading about. Combining resources that illuminate content with accessible self-assessment, MyAccountingLab with Enhanced eText provides students with a complete digital learning experience—all in one place.

The Pearson eText gives students access to the text whenever and wherever they have online access to the Internet. eText pages look exactly like the printed text, offering powerful new functionality for students and instructors. Users can create notes, highlight text in different colours, create bookmarks, zoom, click hyperlinked words and phrases to view definitions, and view in single-page or two-page view.

NEW!

Dynamic Study Modules—Canadian study modules allow students to work through groups of questions and check their understanding of foundational accounting topics. As students work through questions, the Dynamic Study Modules assess their knowledge and only show questions that still require practice. Fully Assignable, flowing through the Gradebook, or Self-Directed Dynamic Study Modules can be completed online using a computer, tablet, or mobile device.

NEW!

Learning Catalytics —A "bring your own device" assessment and classroom activity system that expands the possibilities for student engagement. Using Learning Catalytics, you can deliver a wide range of auto-gradable or open-ended questions that test content knowledge and build critical thinking skills. Eighteen different answer types provide great flexibility, including graphical, numerical, textual input, and more.

NEW!

Audio Lecture Videos—These pre-class learning aids are available for every learning objective and are professor-narrated PowerPoint summaries that will help students prepare for class. These can be used in an online or flipped classroom experience or simply to get students ready for the lecture.

REVISED!

Adapative Assessment—Integrated directly into the MyAccountingLab Study Plan, Pearson's adaptive assessment is the latest technology for individualized learning and mastery. As students work through each question, they are provided with a custom learning path tailored specifically to the concepts they need to practise and master.

In addition, students will find the following assets to help improve their learning experience:

- Help Me Solve This Guides
- Worked Solutions
- Videos
- DemoDocs
- Check Figures
- Student PowerPoint Presentations
- Audio Chapter Summaries
- Accounting Cycle Tutorial Animations
- Excel Spreadsheet Templates
- General Ledger **(NEW!)**
- Open-Response Questions **(NEW!)**

For Instructors

Additional Resources

The following resources are available for Instructors at the Instructor's Resource Centre on the catalogue, at catalogue.pearsoned.ca:

- **Instructor's Solutions Manual.** This manual provides instructors with a complete set of solutions to all the end-of-chapter material in the text. Available in both Word and PDF formats.
- **Computerized Testbank.** The Testbank for *Horngren's Accounting* offers a comprehensive suite of tools for testing and assessment. TestGen allows educators to easily create and distribute tests for their courses, either by printing and distributing through traditional methods or by online delivery. The more than 100 questions per chapter can be sorted by the chapter's Learning Objectives, difficulty ranking, Bloom's Taxonomy, and—new to this edition—applicable Canadian Professional Accounting Standards. Types of questions included are Multiple Choice, True/False, Short Answer, and Essay. One NEW Essay question has been created for each chapter, building on cumulative learning across all previous chapters.

- **Test Item File.** All the test questions from the TestGen testbank are available in Microsoft Word format.
- **Instructor's Teaching Tips in Digital eText Resource:** Instructors can easily locate useful teaching tips and resources throughout the eText, which is annotated by apple icons throughout the chapters. This eText is located in MyAccountingLab.
- **PowerPoint Presentations.** Prepared for each chapter of the text, these presentations offer helpful graphics that illustrate key figures and concepts from the text.
- **Image Library.** We are pleased to provide the exhibits from the text in .jpg format for use in the classroom or for building your own lectures or PowerPoint presentations.

Learning Solutions Managers

Pearson's Learning Solutions Managers work with faculty and campus course designers to ensure that Pearson technology products, assessment tools, and online course materials are tailored to meet your specific needs. This highly qualified team is dedicated to helping schools take full advantage of a wide range of educational resources by assisting in the integration of a variety of instructional materials and media formats. Your local Pearson sales representative can provide you with more details on this service program.

Acknowledgements for *Horngren's Accounting*, Tenth Canadian Edition

Horngren's Accounting, Tenth Canadian Edition, is the product of a rigorous research process that included multiple reviews in the various stages of development to ensure the revision meets the needs of Canadian students and instructors. The extensive feedback from the following reviewers helped shape this edition into a clearer, more readable and streamlined textbook in both the chapter content and assignment material:

- Bharat Aggarwal, Seneca College
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The Chartered Professional Accountants, as the official administrator of generally accepted accounting principles in Canada, and the *CPA Canada Handbook*, are vital to the conduct of business and accounting in Canada. We have made every effort to incorporate the most current *Handbook* recommendations in this new edition of *Accounting* for both private enterprises (ASPE) and for publicly accountable enterprises subject to International Financial Reporting Standards (IFRS).

Thanks are extended to Indigo Books & Music Inc. and TELUS Corporation for permission to use their annual reports in Volumes I and II of this text and on MyAccountingLab. We acknowledge the support provided by the websites of various news organizations and by the annual reports of a large number of public companies.

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Our task is to provide educational material in the area of accounting to instructors and students to aid in the understanding of this subject area. We welcome your suggestions and comments on how to serve you better.

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12 PARTNERSHIPS

CONNECTING CHAPTER 12

LEARNING OBJECTIVE 1 Identify the characteristics of a partnership

What are the characteristics of a partnership?

LEARNING OBJECTIVE 2 Account for partners' initial investments in a partnership

How do we account for partners' investments in a partnership?

LEARNING OBJECTIVE 3 Allocate profits and losses to the partners by different methods

How can we allocate profits and losses to the partners?

LEARNING OBJECTIVE 4 Account for the admission of a new partner

How do we account for a new partner?

LEARNING OBJECTIVE 5 Account for the withdrawal of a partner

How do we account for the withdrawal of a partner?

LEARNING OBJECTIVE 6 Account for the liquidation of a partnership

How do we account for the ending of a partnership?

MyAccountingLab The **Summary** for Chapter 12 appears on page 702. This lists all of the MyAccountingLab resources. **Accounting Vocabulary** with definitions for this chapter's material appears on page 704.

Jenny Lo and Sam Lachlan are considering opening a miniature golf course in Wasaga Beach, Ontario. The golf course will have 18 holes with dinosaurs, windmills, water features, and more. Jenny has been carefully evaluating the tourism industry in the town and believes that the golf course will be busy enough during the summer tourist season to close during the winter months, allowing Jenny and Sam plenty of time to ski and snowboard in the off season.

Jenny and Sam are considering organizing the business as a partnership. Jenny is willing to contribute a piece of property in the prime downtown area that she just inherited. She is also interested in managing the day-to-day operations of the business. Sam, with his degree in accounting, has agreed to handle the accounting and business aspects of the golf course.

Now all Jenny and Sam need to decide is how the partnership will be organized. Some questions they are considering include, What are the specific responsibilities of each partner? How should profits and losses be shared between the partners? What if one of the partners wants out of the partnership in the future? How would the partnership add a new partner?

A **partnership** is an association of two or more persons who co-own a business for profit. This definition is common to the various provincial partnership acts, which tend to prescribe similar rules with respect to the organization and operation of partnerships in their jurisdictions.

Forming a partnership is easy. It requires no permission from government authorities and involves no legal procedures, with the exception that most provinces require partnerships to register information such as the names of the partners and the name under which the business will be conducted.[1] When two people decide to go into business together, a partnership is automatically formed.

A partnership combines the assets, talents, and experience of the partners. Business opportunities closed to an individual may open up to a partnership. As the chapter-opening story illustrates, this is an important characteristic of a partnership. The miniature golf course will likely be successful because it is able to combine the skills of its two owners. It is unlikely that Jenny or Sam would be able to operate the business as well if either tried to do it on his or her own.

Partnerships come in all sizes. Many partnerships have fewer than 10 partners. Some medical practices may have 10 or more partners, while some of the largest law firms in Canada have more than 500 partners. The largest accounting firm in Canada has more than 800 partners. Exhibit 12–1 lists the 10 largest public accounting firms in Canada. The majority of them are partnerships.

EXHIBIT 12–1 | The 10 Largest Accounting Firms in Canada (by Revenue)

Rank 2013	Firm	Partners	Professional Staff	Offices
1	Deloitte LLP	865	5,316	55
2	PricewaterhouseCoopers LLP	513	4,263	25
3	KPMG LLP	696	3,795	37
4	Ernst & Young LLP	358	2,992	17
5	Grant Thornton Canada	404	2,983	135
6	MNP LLP	357	1,026	58
7	BDO Canada LLP	392	2,229	111
8	Collins Barrow	207	541	41
9	Richter	58	415	2
10	Mallette	66	472	24

Source: "Canada's Accounting Top 30," *The Bottom Line*, April 2014, www.thebottomlinenews.ca/documents/Canadas_Accounting_Top_30.pdf, accessed August 1, 2014.

Why It's Done This Way

Objective of Financial Reporting

Beginning with this chapter, you will learn more about the different types of organization structures that were first introduced in Chapter 1. So far, we have only really looked at accounting for proprietorships.

The good news is that the principles and concepts in the accounting framework apply equally to all types of organizations, including partnerships. Accounting differences among types of organizations only relate to the equity section of the balance sheet.

[1] Smyth, J.E., D.A. Soberman, A.J. Easson, and S.S. McGill, *The Law and Business Administration in Canada*, 13th ed. (Toronto: Pearson Canada Inc., 2013), 598–602.

CHARACTERISTICS OF A PARTNERSHIP

Starting a partnership is voluntary. A person cannot be forced to join a partnership, and partners cannot be forced to accept another person as a partner (unless existing partners vote and the majority accept the new partner). The following characteristics distinguish partnerships from proprietorships and from corporations.

LO 1
What are the characteristics of a partnership?

The Written Partnership Agreement

A business partnership is somewhat like a marriage. To be successful, the partners must cooperate. However, business partners do not vow to remain together for life. To make certain that each partner fully understands how the partnership operates, partners should draw up a **partnership agreement**. Although the partnership agreement may be oral, a written agreement between the partners reduces the chance of a misunderstanding. This agreement is a contract between the partners, so transactions under the agreement are governed by contract law. The provincial legislatures in Canada have passed their respective versions of a partnership act, the terms of which apply in the absence of a partnership agreement or in the absence of particular matters in the partnership agreement.[2]

The partnership agreement should specify the following points:

- Name, location, and nature of the business
- Name, capital investment, and duties of each partner
- Procedures for admitting a new partner
- Method of sharing profits and losses among the partners
- Withdrawals of assets allowed to the partners
- Procedures for settling disputes among the partners
- Procedures for settling with a partner who withdraws from the firm
- Procedures for removing a partner who will not withdraw or retire from the partnership voluntarily
- Procedures for liquidating the partnership—selling the assets, paying the liabilities, and giving any remaining cash to the partners

KEY POINTS

A partnership is not required to have a formal written agreement. But a written agreement prevents confusion as to the sharing of profits and losses, partners' responsibilities, admission of new partners, how the partnership will be liquidated, and so on. However, there can still be disagreements even when there is a written agreement.

Limited Life

A partnership has a limited life. If one partner withdraws from the business or dies, the partnership dissolves and its books are closed. If the remaining partners want to continue as partners in the same business, they form a new partnership with a new set of financial records and a new partnership agreement. **Dissolution** is the ending of a partnership and does not require liquidation; that is, the assets need not be sold to outside parties for a new partnership to be created. Often the new partnership continues the former partnership's business, and the new partnership may choose to continue to use the dissolved partnership's name. Some types of large partnerships, such as PricewaterhouseCoopers LLP (PwC), retain the firm name even after partners resign from the firm.

Mutual Agency

Mutual agency means that every partner is a mutual agent of the firm. Any partner can bind the business to a contract within the scope of the partnership's regular business operations. If a partner enters into a contract with a person or another business to provide a service, then the firm—not just the partner who signed the contract—is bound to provide that service. If the partner signs a contract to buy her

[2] Ibid., 598–618.

own car, however, the partnership is not liable because the car is a personal matter; it is not within the scope of the regular business operations of the partnership.

The following example shows the impact mutual agency can have on a partnership. Richard Harding and Simon Davis formed a partnership to deal in lumber and other building materials. The partners agreed that their company should not handle brick or any stone materials and that neither partner had the right to purchase these commodities. While Harding was away during the summer, Davis purchased a quantity of these materials for the company because he could buy them at a cheap price. Two months later, when Harding returned, business was very slow, and brick and stone were selling at a price lower than Davis had paid for them. Harding, therefore, refused to accept any more deliveries under the contract. Harding argued that Davis had no authority to buy these goods since the partnership was not organized to deal in brick and stone. The supplier of the brick and stone said that he did not know the partnership was not in the brick and stone business. In fact, he believed that it did handle these goods since all of the other lumber companies in the area bought or sold brick and stone. Because the supplier acted in good faith, he claimed that Harding and Davis should accept the remaining deliveries of brick and stone according to the agreement that was made. Who is correct? Under normal circumstances, the brick and stone supplier is correct because the mutual agency characteristic of a partnership allows partners to bind each other in business contracts. The agreements made within the partnership would not be known by an outside party like the supplier, so the supplier would have a solid case and could sue the partnership to abide by the contract.[3]

LEARNING TIPS

Chapter 1 introduced these concepts for a sole proprietorship. You may want to go back and review them now.

Unlimited Liability

Each partner has **unlimited personal liability** for the debts of the business. When a partnership cannot pay its debts with business assets, the partners must pay with their personal assets. (There are exceptions, which are described in the next section, Types of Partnerships.) If either partner is unable to pay his or her part of the debt, the other partner (or partners) must make payment.

Unlimited liability and mutual agency are closely related. A dishonest partner or a partner with poor judgment may commit the partnership to a contract under which the business loses money. In turn, creditors may force *all* the partners to pay the debt from their personal assets. Hence, a business partner should be chosen with great care.

Co-ownership of Property

Any asset—cash, inventory, machinery, computers, and so on—that a partner invests into the partnership becomes the joint property of all the partners. The partner who invested the asset is no longer its sole owner.

No Partnership Income Tax

The partnership *reports* its income to the government tax authority (the Canada Revenue Agency), but the partnership pays *no* income tax. The net income of the partnership is divided and flows through the business to the partners, who pay personal income tax on their share.

For example, suppose that the Willis & Jones partnership earned net income of $150,000, shared equally by the two partners. The partnership would pay no income tax *as a business entity*. However, each partner would pay income tax *as an individual* on his or her $75,000 share of partnership income.

[3] This case is based on the scenario described at ChestofBooks.com, "B. Apparent Scope of Authority," http://chestofbooks.com/business/law/Case-Method/B-Apparent-Scope-Of-Authority.html#ixzz1qimHxY2o, accessed August 14, 2012.

Advantages/Disadvantages

Exhibit 12–2 lists the advantages and disadvantages of partnerships (compared with proprietorships and corporations). Most features of a proprietorship also apply to a partnership, most importantly:

- Limited life
- Unlimited liability
- No business income tax

EXHIBIT 12–2 | Advantages and Disadvantages of Partnerships

Partnership Advantages

Versus Proprietorships:

- A partnership can raise more capital since capital comes from more than one person.
- A partnership brings together the abilities of more than one person.
- Partners working well together can achieve more than by working alone: 1 + 1 > in a good partnership.

Versus Corporations:

- A partnership is less expensive to organize than a corporation, which requires articles of incorporation from a province or the federal government.
- A partnership is subject to fewer governmental regulations and restrictions than is a corporation.

Partnership Disadvantages

- A partnership agreement may be difficult to formulate. Each time a new partner is admitted or a partner leaves the partnership, the business needs a new partnership agreement.
- Relationships among partners may be fragile. It is hard to find the right partner.
- Mutual agency and unlimited liability create personal obligations for each partner.
- Lack of continuity of the business is faced by a partnership but not a corporation.

TYPES OF PARTNERSHIPS

There are two basic types of partnerships: general and limited.

General Partnerships

A **general partnership** is the basic form of partnership organization. Each partner is a co-owner of the business with all the privileges and risks of ownership. The general partners share the profits, losses, and the risks of the business.

Limited Partnerships

Partners can avoid unlimited personal liability for partnership obligations by forming a *limited partnership.* A **limited partnership** has at least two classes of partners:

- There must be at least one *general partner,* who takes primary responsibility for the management of the business. The general partner also takes most of the risk of failure if the partnership goes bankrupt (liabilities exceed assets). In some limited partnerships, such as real estate limited partnerships, the general partner often invests little cash in the business. Instead, the general partner's contribution is her or his skill in managing the organization. Usually, the general partner is the last owner to receive a share of partnership profits and losses. But the general partner may earn all excess profits after the limited partners get their share of the income.
- The *limited partners* are so named because their personal obligation for the partnership's liabilities is limited to the amount they have invested in the business. Limited partners have limited liability similar to the limited liability that shareholders in a corporation have. Usually, the limited partners have invested the bulk of the partnership's assets and capital. They, therefore, usually have the first claim

KEY POINTS

Since all partners are personally liable for any debt of the business, it is extremely important to choose a partner carefully. This is one reason some investors/partners prefer the *limited partnership* form of business organization.