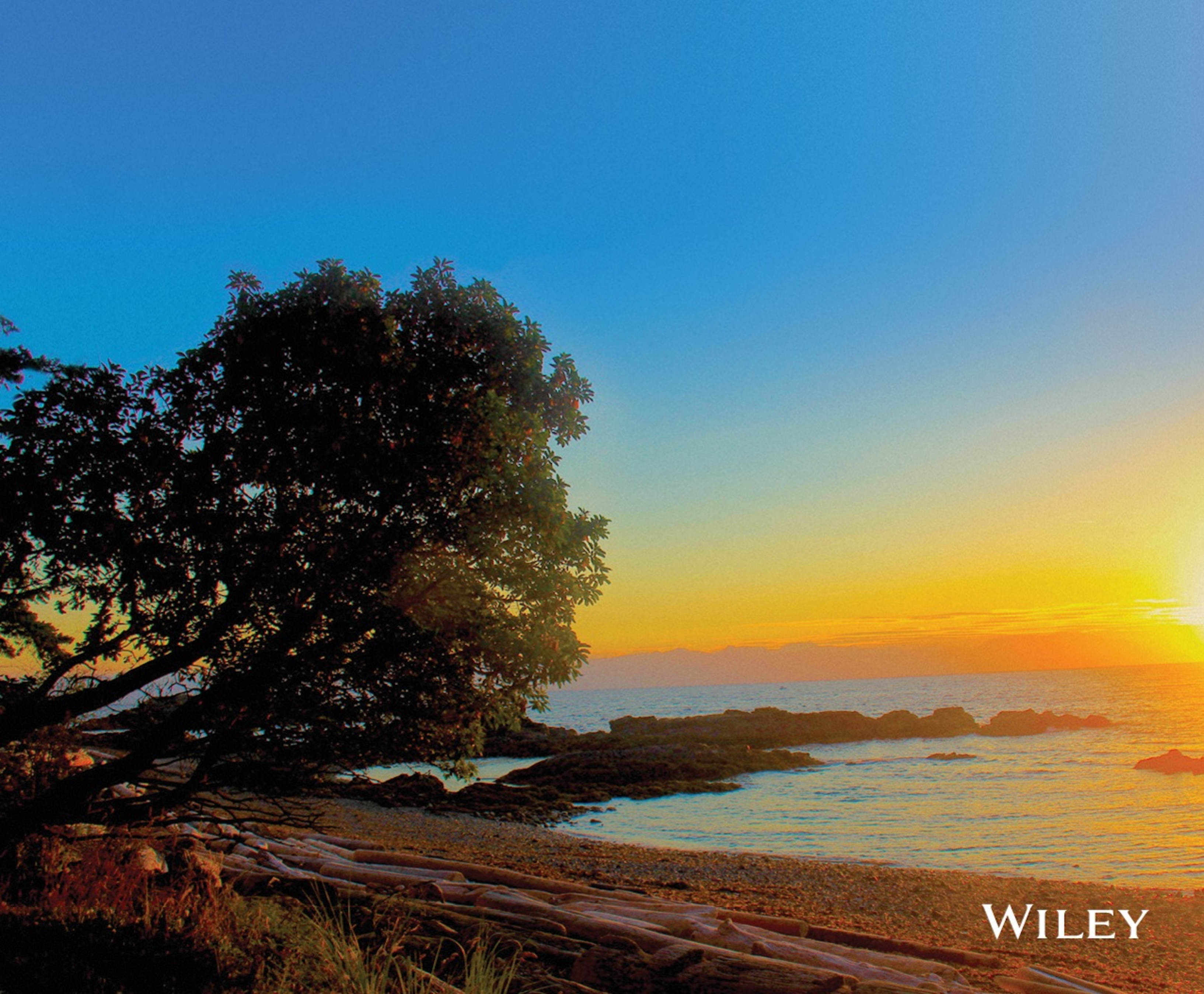
Understanding
FINANCIAL ACCOUNTING

SECOND CANADIAN EDITION

Christopher D. Burnley



WILEY

WUSC EUMC

GLOBALLY, ONLY 1% OF REFUGEES ARE ENROLLED IN HIGHER EDUCATION.

WUSC Local Committees are working on campuses across Canada to create more opportunities.

Photo: Blu Htoo, Burmese, Sponsored by Algoma University Local Committee in 2013

STUDENT REFUGEE PROGRAM

LEARN HOW YOU CAN GET INVOLVED

@WUSCcampus
wusc.ca/get-involved

Charitable registration number: 11930 4848 RR0001

Understanding Financial Accounting

Second Canadian Edition

CHRISTOPHER D. BURNLEY
Vancouver Island University

The first edition of *Understanding Financial Accounting* was based on *Financial Accounting: A User Perspective, Sixth Canadian Edition*

ROBERT E. HOSKIN
University of Connecticut

MAUREEN R. FIZZELL
Simon Fraser University – Retired

DONALD C. CHERRY
Dalhousie University – Retired

WILEY

VICE PRESIDENT, EDUCATION	Tim Stookesberry
DIRECTOR, BUSINESS, ACCOUNTING, AND FINANCE	Michael McDonald
EXECUTIVE EDITOR	Zoë Craig
DEVELOPMENT EDITOR	Daleara Hirjikaka
SENIOR MANAGER, CONTENT ENABLEMENT & OPERATIONS	Karen Staudinger
SENIOR MARKETING MANAGER	Anita Osborne
SENIOR CONTENT MANAGER	Dorothy Sinclair
PRODUCTION EDITOR AND MEDIA SPECIALIST	Meaghan MacDonald and Rachel Conrad
DESIGN	Wiley
PHOTO SPECIALIST	Mike Cullen
COVER DESIGN	Joanna Vieira/Wiley
COVER PHOTO	© Christopher Burnley

This book was set in 10/12 Stix by Aptara, Inc. Printed and bound by Quadgraphics-Versailles.

This book is printed on acid free paper. ∞

Founded in 1807, John Wiley & Sons, Inc. has been a valued source of knowledge and understanding for more than 200 years, helping people around the world meet their needs and fulfill their aspirations. Our company is built on a foundation of principles that include responsibility to the communities we serve and where we live and work. In 2008, we launched a Corporate Citizenship Initiative, a global effort to address the environmental, social, economic, and ethical challenges we face in our business. Among the issues we are addressing are carbon impact, paper specifications and procurement, ethical conduct within our business and among our vendors, and community and charitable support. For more information, please visit our website: www.wiley.com/go/citizenship.

ISBN 978-1-119-40700-3 (E-Pub)

The inside back cover will contain printing identification and country of origin if omitted from this page. In addition, if the ISBN on the back cover differs from the ISBN on this page, the one on the back cover is correct.

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Dedication

Dedicated with love and gratitude to my father, Donald Burnley, for being such a wonderful role model in all that is important in life and for guiding me down the accounting path.

About the Author

© Dirk Heydemann

CHRISTOPHER BURNLEY, FCPA, FCA, is a professor in the Accounting Department at Vancouver Island University's Faculty of Management. Prior to his full-time academic career, Chris worked for 12 years in public practice and also audited federal government departments and United Nations agencies with the Office of the Auditor General of Canada. Chris also teaches in the CPA Professional Education Program for the CPA Western School of Business.

At Vancouver Island University (VIU), Chris has developed a number of new courses, has served as departmental chair, and served two terms as an elected faculty representative on the university's board of governors. He is active internationally, teaching and delivering guest lectures at VIU's partner institutions in Europe, Asia, and the South Pacific. He has been awarded numerous internal and external grants in support of his academic work and has presented at national conferences. Chris has also taught in the Master of Professional Accounting Program at the Edwards School of Business at the University of Saskatchewan, where he was recognized by the university with the Chartered Professional Accountants of Alberta teaching excellence award.

Chris has received a number of awards from the Canadian Academic Accounting Association for his academic work, including awards for case authoring and developing innovative ideas in accounting education.

Chris is active in the accounting profession, serving as a director on the board of the Chartered Professional Accountants of British Columbia, and is a past chair of the board of the Chartered Professional Accountants' Education Foundation of BC. In 2007, Chris was awarded the Ritchie W. McCloy Award for CA Volunteerism. Chris is also a co-author of the textbook *Financial Accounting: Tools for Business Decision-Making*, published by John Wiley & Sons Canada, Ltd.

Preface

The aim of *Understanding Financial Accounting* is to introduce students to the core concepts of financial accounting by illustrating the relevance of the material to a wide variety of decision-making contexts. The focus is on providing students with the tools to help them understand the rationale behind the numbers. If students can develop an understanding of the language of accounting, grasp what the accounting information means, and appreciate what managers are saying when they present the financial information, they will have laid a foundation they can build upon in whatever position they hold in the future.

The material is written at a level meant to be understandable for all students who put the time into working through it. It is based on 18 years of teaching the material to thousands of students with a wide variety of backgrounds, the majority of whom have been non-accounting majors, but also to others who have gone on to medal on national professional accounting exams.

Continuing Features

Cohesively Structured Content

The text has been structured around a series of **core questions** that students may ask themselves about the chapter topics and that they need to be able to answer in order to achieve the learning objectives. The material that follows each question then becomes more relevant to the students and provides them with a clear picture of why they need to understand it. The text also walks students through the basic mechanical elements of financial accounting, because it is very difficult for students to understand accounting information if they lack an understanding of the system used to generate it.

The Take 5 Videos

Each chapter includes a number of whiteboard screen capture videos that students can preview before coming to class or use for review after. These videos are a great tool for instructors who like to flip their classroom. In addition, new Take 5 Videos developed for this edition focus on solution walkthroughs of the end-of-chapter review problems that are in the text.

Opportunities for Classroom Discussion

Each chapter of the text includes features that can form the basis for classroom discussions. These include the **Ethics in Accounting** feature that highlights ethical issues that must be dealt with in relation to all kinds of accounting situations, the **For Example** feature that showcases and interprets financial statements of real companies, and the **Conceptual Framework** feature that discusses the theory behind accounting practices.

Unparalleled Review and Practice Opportunities

Concise and to-the-point chapter summaries recap the key points covered by each learning objective. Chapter End Review Problems, with accompanying Take 5 videos, walk the student through the steps required to solve complex problems.

Each chapter includes a variety of assignment material, enabling faculty to choose the level of breadth and depth at which they want to assess the students. This includes Discussion Questions, Application Problems (now expanded and divided into two sets), User Perspective Problems, Reading and Interpreting Financial Statements problems, and small Cases.

Key Enhancements

This second edition of *Understanding Financial Accounting* builds on the strength of the innovative first edition. All content has been carefully reviewed and revised to maximize student understanding. Significant work has gone into enhancing the reading content, the assessment material, and the material available in the *WileyPLUS* course.

Tightened Linkages between the Reading Content and the WileyPLUS Course

WileyPLUS is an innovative, research-based online environment for effective teaching and learning. Among its many features, *WileyPLUS* allows students to study and practise using the digital textbook, quizzes, and algorithmic exercises. The immediate feedback helps students understand where they need to focus their study efforts.

Based on cognitive science, *WileyPLUS* with ORION is a personalized adaptive learning experience that gives students the practice they need to build proficiency on topics while using their study time more effectively. The adaptive engine is powered by hundreds of unique questions per chapter, giving students endless opportunities for practice throughout the course. Orion is available with all chapters of this text.

This edition makes a clear link between the reading content and the wealth of pedagogical material available in the *WileyPLUS* course. The new **Assess Your Understanding** box at the end of many chapter sections directs students to the relevant Demonstration Problems in the *WileyPLUS* course. Additional Demonstration Problems are in *WileyPLUS* and there is now a companion Demonstration Problem for every Chapter End Review Problem, doubling the opportunities for students to practise working through problems.

Augmented End-of-Chapter Material

Revisions based on faculty and student usage data. The all-important end-of-chapter material has been significantly revised. These revisions were data-driven. Data from *WileyPLUS* was used to determine the questions most frequently assigned by faculty and the questions most often attempted by students. The number of popular end-of-chapter questions has been significantly increased, while infrequently assigned questions were removed. For example, the number of Application Problems has doubled, to more than 350.

Mirror problem set 'B' introduced for Application Problems. The Application Problems have been grouped into two sets, A and B, whose topics mirror each other, so they can be assigned separately or together for extra practice. The Application Problems are now organized by learning objective to better test students' understanding of each objective and to make it easier for faculty to quickly identify relevant problem material.

Unique, new Work In Progress problems. A new type of problem, Work In Progress, was added, which enhances students' critical thinking and communication skills by requiring them to correct or improve a statement about key concepts in the chapter.

Other additions and changes. The number of Discussion Questions and User Perspective Problems has been increased by roughly 20%. Finally, all Reading and Interpreting Published Financial Statements problems have been revised to reflect the most recent publicly available financial statements.

Current Accounting Standards

This edition has been revised to reflect new financial reporting standards, such as IFRS 15 (Revenue from contracts with customers) and IFRS 16 (Leases). The text covers in depth the five-step revenue recognition model and the impact of the new IFRS 15 on sales discounts, warranties, sales returns, gift cards, and loyalty programs. Chapter 4 was completely rewritten to reflect IFRS 15, and now provides the most comprehensive revenue recognition coverage of any introductory financial accounting text.

Enhanced Coverage in Several Areas

This edition has enhanced the discussion in several areas. For example, material has been added to Chapter 6 related to the responsibility for and limitations of internal controls, while content has been added to Chapter 11 on the types of preferred shares and why they are considered to be hybrid securities. As well, the number of For Example feature boxes has increased by more than 50%, to provide students with even more real-life examples to illustrate concepts.

Enhanced Self-Assessment Opportunities

This edition has strengthened the opportunities for students to assess their mastery of the content. At the end of many sections is a new feature, Assess Your Understanding, which directs students to the Chapter End Review Problems and *WileyPLUS* Demonstration Problems relevant to that topic and learning objective. This makes it much easier for students to know what material they should attempt to ensure that they understand the related content. The number of Chapter End Review Problems has more than doubled. Fully annotated solutions are provided for all of the Chapter End Review Problems, and additional Take 5 videos have been created to support students by walking them through the most difficult of these.

Specific Chapter Enhancements

The following are the notable revisions, additions, and improvements to the chapters in this second edition.

Chapter 1. Overview of Corporate Financial Reporting

- The discussion of financial accounting's focus on external users was expanded.

Chapter 2. Analyzing Transactions and Their Effects on Financial Statements

- Content was added on dual-listed companies, Ontario Securities Commission reporting deadlines, and the requirement for external audit.
- The revenue recognition criteria were replaced with the five-step model for revenue recognition, in accordance with IFRS 15.
- The definition of what it means when an expense is incurred was enhanced.
- The graphical presentation of the qualitative characteristics from the conceptual framework was revised.

Chapter 3. Double-Entry Accounting and the Accounting Cycle

- The chapter was revised to more clearly distinguish adjusting entries from regular journal entries.
- Sample adjusting journal entries were added, together with examples from public companies.

Chapter 4. Revenue Recognition and the Statement of Income

- The chapter was completely rewritten to reflect IFRS 15.
- Information was added on the contract-based approach.
- The five-step model for revenue recognition was added, using a question-based approach to move through the model. Examples presented included the sale of goods, the provision of services, and a sale with multiple performance obligations.
- Details were added to focus on four contractual arrangements that affect the recognition of revenue: sales with right of return, warranties, consignment arrangements, and third-party sale arrangements.
- Accounts were changed to be consistent with IFRS 15 (for example, the Sales Discounts and Sales Returns and Allowances accounts were removed).

Chapter 5. The Statement of Cash Flows

- The coverage was enhanced of options for classifying cash flows related to interest and dividends paid and received.
- The section on non-cash investing and financing activities was expanded.

- An exhibit was added outlining how changes in current asset and liability accounts impact cash flows.
- A For Example box was added providing more details on how changes in working capital items affect cash flows from operating activities.
- A For Example box was added linking the components of the statement of financial position to the statement of cash flows classification.

Chapter 6. Cash and Accounts Receivable

- Coverage of the responsibility for and limitations of internal controls was added.
- An exhibit was added to reflect the effect of journal entries flowing from the bank reconciliation.

Chapter 7. Inventory

- A section was added on the types of inventory errors and the impact they have on the financial statements.
- A learning objective was added on cost formulas under periodic inventory systems.
- The discussion of the gross margin inventory estimation method was expanded.
- Examples were added of public companies using each inventory cost formula.

Chapter 8. Long-Term Assets

- Examples were added of public companies using each depreciation method.
- Content was added regarding fully depreciated property, plant, and equipment (PP&E), idle PP&E, and PP&E held for sale.
- An exhibit was added to show how to determine the carrying amount if impairment charges are recognized.
- Examples of intangible assets of public companies were expanded.

Chapter 9. Current Liabilities

- The chapter was revised to reflect the impact of the new IFRS 15 regarding revenue recognition on gift cards, customer loyalty programs, and warranties.
- The core question on gift cards and loyalty programs was split into two questions.
- The terminology used in the unearned revenues discussion was updated to reflect the terminology in the new standard.
- The core question on accounting for warranties was completely rewritten to reflect the new accounting standards.

Chapter 10. Long-Term Liabilities

- The chapter was revised to reflect the new IFRS 16, Leases.

Chapter 11. Shareholders' Equity

- Content was added on types of preferred shares and on preferred shares as hybrid securities.
- Several new For Example boxes were added to provide more context for multiple types and classes of shares, share buybacks, initial public offerings and underwriting costs, non-voting shares, redeemable preferred shares, convertible preferred shares, and stock splits.

Chapter 12. Financial Statement Analysis

- The chapter was updated to reflect the new IFRS auditor reporting standard.
- A new learning objective was added, covering commonly used non-IFRS financial measures and other industry metrics.

Acknowledgements

The text's cover photo, taken not far from my home on eastern Vancouver Island, features an arbutus tree stretching out from the shoreline of the Salish Sea in search of the sun. Arbutus trees, which are Canada's only native broadleafed evergreen tree, are found along the coast in southern British Columbia. The arbutus tree is honoured by the Coast Salish peoples as their tree of knowledge because it knows how to find the sun. The Coast Salish also recognize it for its strength, which comes from its deep roots and strong inner core. The arbutus tree provides a wonderful metaphor for this text in a number of ways.

This edition draws strength from the roots put down by the first edition of the text. I would like to thank the students and faculty who provided feedback to improve this edition. This text's core is also strengthened as a result of the problem material that has been drawn from *Financial Accounting: A User Perspective*. I am indebted to Maureen Fizzell, Donald Cherry, and Robert Hoskin for authoring such rich, diverse material. The Hoskin text was one of the books I used when I began teaching financial accounting and it helped inform and shape the way I continue to present this material. These teachings continue to be reflected in this text.

Arbutus trees require very specific environmental conditions and are only found within about 8 km of the Pacific Ocean. Any new growth also requires the right environmental conditions. I have been fortunate to work with a group of colleagues at Vancouver Island University who have supported my teaching and writing over the past 18 years. I have learned from each of them and would like to thank them, especially Gordon Holyer, Tracy Gillis, Colin Haime, Sameer Mustafa, Erin Egeland, Jeremy Clegg, Vanessa Oltmann, and Steve Purse. I have also been fortunate to work with four deans of the Faculty of Management: Ian Ross, Mike Mann, David Twynam, and Suzanne Flannigan. Each created opportunities for me to grow and provided the space in which growth could occur.

I am indebted to a number of accounting academics without whom I would never have considered authoring a text. The efforts of Sandy Hilton, especially at the Canadian Academic Accounting Association, to create venues to support teaching and learning for faculty made a significant difference to me. Sandy has also supported my case authoring efforts for years and provided excellent advice at the outset of this project. Peter Norwood has created numerous opportunities for me to broaden my participation in the academic community and also willingly shared wisdom garnered from his years as a successful author. Scott Sinclair's feedback throughout in the development of the first edition resulted in a much improved text. I am also thankful for the advice and encouragement of Irene Gordon, Gary Spraakman, and Eldon Gardner in my earliest efforts as an author.

As a tree grows, new rings are added to its trunk. Many people have contributed growth rings to this text. Vito Di Turi, with whom I began my accounting journey some 30 years ago, made a significant contribution to this edition by developing much of the new problem material. Cecile Laurin and Maria Belanger also made noteworthy contributions to text and the end-of-chapter material. Julia Scott and Peggy Wallace both contributed to a number of chapters in the first edition of this text. Laurel Hyatt's research work has made for interesting opening vignettes, while her talents as an editor greatly improved the readability of the text. The editorial contributions of Tania Cheffins and Belle Wong are greatly appreciated. The project management expertise of Denise Showers and the typesetting team at Aptara is also greatly valued. I consider myself so fortunate to be part of the Wiley family. Their dedicated team provided outstanding support each step of the way. I am indebted to Zoë Craig for helping frame the initial vision and for her continuous encouragement throughout the process. The editorial talents of Dela Hirjikaka added much to the text and her efforts kept the project on track, bringing the numerous parts together in a seamless fashion. I am also thankful for the support of Meaghan MacDonald, Deanna Durnford, Karen Staudinger, Anita Osborne, and Joanna Vieira.

A number of faculty have also worked hard to develop the supplements that accompany this text:

Maria Belanger, Algonquin College
Jeremy Clegg, Vancouver Island University
Rosalie Harms, University of Winnipeg
Amy Hoggard, Camosun College
Sandy Kizan, Athabasca University
Cecile Laurin, Algonquin College
Debbie Musil, Kwantlen Polytechnic University
Joel Shapiro, Ryerson University
Laura Simeoni, York University
Marie Sinnott, College of New Caledonia
Vito Di Turi, University of Ottawa (Sessional)

Many other faculty reviewed the text at various stages of development, providing advice and constructive criticism that resulted in a better offering. I would like to thank them for their insights.

Manuscript development stage (first edition)

Ibrahim Aly, Concordia University
George Boland, Queen's University
Else Grech, Ryerson University
Sohyung Kim, Brock University
Jennifer Li, Brock University
Anne Macdonald, Simon Fraser University
Robert Madden, St. Francis Xavier University
Julie McDonald, Ryerson University
Jaime Morales, Trent University
Peter Norwood, Langara College
Sandy Qu, York University
Scott Sinclair, University of British Columbia
Sara Wick, University of Guelph

First edition

Robert Campbell, John Molson School of Business, Concordia University
Brenda Collings, University of New Brunswick Saint John
Erin Egeland, Vancouver Island University
Maureen Fizzell, Simon Fraser University (Burnaby Campus)
Steve Gibson, Simon Fraser University (Burnaby Campus)
Len Hostin, McMaster University
Srinivas Inguva, George Brown College
Robert Madden, St Francis Xavier University

Just as trees use the magic of photosynthesis to transform light energy into chemical energy, a magical process takes place in classrooms at campuses the world over. Much of what is best about this product has resulted from such classroom interactions. The echoes of the hundreds of introductory accounting classes and seminars I have taught over the past 18 years can be heard throughout the pages of this text. So much of what I have learned about presenting this material is thanks to the thousands of students from these classes. I am so thankful for the shared learning experience.

The strength of a tree is provided by its heartwood, so it is no surprise that, for this text, strength came from the people closest to my own heart. I am grateful for a wonderful collection of family and friends. Two key supports were my mother, Bernette, and my sister, Faith. My children, Jacob and Erin, have been a constant source of inspiration and have patiently dealt with me disappearing into my office for long hours of writing and have tolerated the working edition of the text as a constant presence wherever we are. I am most indebted to my partner and best friend, Caroline. She has always encouraged me to take on new challenges, providing constant and unwavering support. Caroline has inspired so much of what is wonderful in my life and this book is just another example of that.

I hope that the text will help you to develop your own strong understanding of financial accounting. Feedback and suggestions for improving future editions are welcome. Please email them to BurnleyAuthor@gmail.com.

CHRIS BURNLEY
Vancouver Island University

January 2018

Brief Contents

Contents

7 Inventory 7-1

8 Long-Term Assets 8-1

CHAPTER 1

kevin brine/Shutterstock

Overview of Corporate Financial Reporting

Dollar Store Business Is No Small Change

When Salim Rossy opened a general store in Montreal in 1910, he financed it with his earnings from peddling items like brooms and dishcloths in the countryside around Montreal. By the time his grandson Larry took charge in 1973, S. Rossy Inc. had grown into a chain of 20 five-and-dime stores, with most items priced at either 5 or 10 cents. In 1992, the company opened its first Dollarama store, selling all items for $1. Today, the business, now called Dollarama Inc., is Canada's largest dollar store chain. It operates more than 1,000 stores in every province and now sells goods between $1 and $4.

How do large companies such as Dollarama finance growth? Like many companies that reach a certain size, Dollarama became a public company, issuing shares that trade on the Toronto Stock Exchange (TSX). The company's initial public offering, in 2009, raised $300 million, which was used to open new stores. The company's growth has been steady ever since. By 2011, it had more locations than Canadian Tire, and recently it has opened an average of one new store a week. It plans to eventually operate 1,400 locations across Canada. At the end of its 2017 fiscal year (as at January 29, 2017), Dollarama had raised more than $420 million from issuing shares, and it had more than $2.9 billion in sales that year.

Company management is continually looking for ways to increase sales and reduce costs. It recently increased the maximum price of items from $3 to $4, widening the number of suppliers it can use and boosting the types of products it can carry. "Customers are responding positively to the offering," said Neil Rossy, who took over from his father Larry as Chief Executive Officer in 2016.

Shareholders and others, such as banks and suppliers, use a company's financial statements to see how the company has performed and what its future prospects might be. Shareholders use them to make informed decisions about things such as whether to sell their shares, hold onto them, or buy more. Creditors use financial statements to assess a company's ability to service its debts (pay interest and repay principal), while suppliers may use them to determine whether to allow the company to purchase on credit. Companies communicate all this information through financial reporting, and the tool used to prepare financial information is accounting.

Whether or not Dollarama achieves the increased revenues and profits it hopes for by selling higher-priced items will be reported in the company's future financial statements. These financial statements will tell the story of whether Dollarama got the best bang for its buck.[1]

CORE QUESTIONS If you are able to answer the following questions, then you have achieved the related learning objectives.	**LEARNING OBJECTIVES** After studying this chapter, you should be able to:
Introduction to Financial Accounting • What is financial accounting?	**1.** Define financial accounting and understand its relationship to economic decision-making.
Users and Uses of Financial Accounting • Who needs an understanding of financial accounting and why?	**2.** Identify the main users of financial accounting information and explain how they use this information.
Forms of Business Organization • What is a corporation? • What differentiates a corporation from other forms of business?	**3.** Describe the major forms of business organization and explain the key distinctions between them.
Activities of a Business • What are the three categories of business activities? • What are examples of financing activities? • What are examples of investing activities? • What are examples of operating activities?	**4.** Explain the three categories of business activities and identify examples of transactions related to each category.
Financial Reporting • What information is included in a set of financial statements? • What is the reporting objective of the statement of income? What does it include? • What is the reporting objective of the statement of changes in equity? What does it include? • What is the reporting objective of the statement of financial position? What does it include? • What is the reporting objective of the statement of cash flows? What does it include? • What type of information is in the notes to a company's financial statements?	**5.** Identify and explain the content and reporting objectives of the four basic financial statements and the notes to the financial statements.

Introduction to Financial Accounting

LEARNING OBJECTIVE 1

Define financial accounting and understand its relationship to economic decision-making.

The opening story is an example of how a large company grows. Whether a business is borrowing money for a start-up or expansion, restructuring the organization, or deciding whether to purchase or lease equipment, it needs to have accounting information to make the best decisions. You, too, will use accounting information to help you make decisions, whether it's determining if you should buy a company's shares, apply for a job there, or enter into a contract with it.

What Is Financial Accounting?

Financial accounting is the process by which information on the transactions of an organization is captured, analyzed, and used to report to decision makers *outside* of the organization's management team. Financial accounting is sometimes referred to as external financial reporting due to its focus on providing accounting information to external decision makers. These external decision makers are often referred to as **financial statement users** and include the owners (normally referred to as **investors**) and those who have lent money to the organization (normally referred to as **creditors**). The primary purpose of financial accounting information is to aid these users in their economic decision-making relative to the organization. Because these users are generally outside of the organization and are not involved in its day-to-day operations, the financial accounting information they receive is often their only "window" into the organization.

Users inside the organization (**management**) also use financial accounting information, but they generally require the information at a different level of detail. For example, managers in a national retail chain may need information for a particular store rather than for the organization as a whole. Managers may need different information altogether, such as information needed to develop forward-looking budgets rather than to report on past transactions. It is important to note that management has access to all of the organization's financial information, including information that is never shared with those outside of the organization. This information is known as **managerial accounting** and will be the basis for another course in your business studies.

Management prepares two broad types of accounting reports:

- Reports for internal use only (for use by management): This is known as managerial accounting. Its purpose is to inform decision-making.
- Reports for external use (for use by others outside the organization): This is known as financial accounting. Its purpose is to help external users make decisions.

Financial accounting, the focus of this textbook, can be as simple as determining the daily sales of a food truck or as complex as recording and reporting on the economic condition of your university, a multinational corporation, or the Government of Canada. All of these entities need to know economic information in order to continue to operate efficiently and effectively. Financial accounting provides vital financial information that enables people and organizations to make decisions. Because it is very likely that you will be a financial statement user in some way, it is important that you have at least a basic understanding of what financial accounting is (and is not), what it is trying to accomplish, and how it does so.

The focus of this book is the financial accounting information produced by profit-oriented organizations, although we will occasionally refer to not-for-profit organizations or governments. We will concentrate on the **financial statements**, which are management's reports to the company's owners that are produced at the end of each accounting period, such as every quarter or every year. The annual financial statements are included in the company's **annual report** together with the **management discussion and analysis (MD&A)** of the company's results for the year. The annual report is made available to the company's owners, but many other parties, such as lenders, financial analysts, credit-rating agencies, securities regulators, and taxing authorities, also use it.

Users and Uses of Financial Accounting

LEARNING OBJECTIVE 2

Identify the main users of financial accounting information and explain how they use this information.

Who Needs an Understanding of Financial Accounting and Why?

Before we answer these questions, let's take some time to think a little about the game of hockey. (Yes, hockey. After all, what's a Canadian textbook without a hockey reference?) Whether you have lived in Canada your whole life or you are here studying from some other part of the world, chances are good that you have seen a professional hockey game on television or perhaps even in person. During the game, the TV commentary or the conversations of those around you would have included terms like *icing, charging, slashing, five-hole, hash marks, neutral zone*, and so on. These would have been confusing terms the first time you heard them, but once they were explained to you, your ability to follow the game and understand it at a deeper level would have improved. This is the same with financial accounting. Through the text's 12 chapters we will learn the language of financial accounting and how to interpret financial accounting information so you can come away with a deeper understanding of the subject.

So, let's rephrase our opening question and think about "who needs to understand the rules of professional hockey?" Many groups likely come to mind fairly quickly, including:

- players (including their agents and players' union)
- coaches and general managers
- referees, linesmen, and off-ice officials
- fans
- TV commentators, arena announcers, and sports journalists
- league officials
- team owners
- suppliers, advertisers, and landlords

We can call these people *stakeholders* because they have a stake in understanding hockey. Now, let's take this list of hockey stakeholders and find the parallel business stakeholders who would have a similar stake in a business, as shown in **Exhibit 1.1**.

Now, let's consider some of the questions that each of the stakeholders in a business may be trying to answer about that business that would require an understanding of financial accounting, as shown in **Exhibit 1.2**.

These groups of business stakeholders are often known as *financial statement users*. Throughout this book, we will be looking at the information needs of many of these users and discussing how they use financial accounting information in making a variety of decisions. The breadth of this list of users illustrates that no matter which path you take in your business

EXHIBIT 1.1

Similarities between Hockey Stakeholders and Business Stakeholders

Hockey Stakeholders	Parallel Business Stakeholders
Players, including their agents and players' union	Employees, unions
Coaches and general managers	Management
Referees, linesmen, off-ice officials	Auditors, federal and provincial government departments, legislators
Fans	Potential investors, customers
Announcers, TV analysts, sports journalists	Stock analysts, brokers, financial advisors, business reporters
League officials	Stock exchange regulators
Team owners	Shareholders, board of directors
Suppliers, advertisers, landlords	Creditors, suppliers, landlords

EXHIBIT 1.2

Questions That Stakeholders in a Business May Be Asking

Business Stakeholders	Potential Questions They May Be Trying to Answer about the Business
Employees, unions	Is the business profitable? Will I earn a bonus this year? Could the company afford to negotiate increased wages? Is the company pension plan in decent shape?
Management	How do this year's sales compare with last year's? How do they compare with the budget? Are we maintaining our profit margins on certain product lines? How much do we owe our employees and suppliers?
Auditors, federal and provincial government departments, legislators	Has the company presented its financial information fairly? How does the company's financial information compare with the information submitted for taxation or payroll purposes?
Potential investors, customers	What are the long-term prospects for this company? Has the management team done a reasonable job? Will this company be around to honour its warranties?
Stock analysts, brokers, financial advisors, business reporters	What are the company's trends? What are the prospects for this company? How has this company performed relative to expectations?
Stock exchange regulators	Has the company complied with the financial reporting standards and listing requirements?
Shareholders, board of directors	Has the company generated a sufficient return on our investment? How effectively has management used the resources at their disposal? Does the company generate enough income to be able to pay dividends?
Creditors, suppliers, landlords	Should we extend credit to this company? Is this a credible and successful company that we want to attach our brand to? Should we enter into a lease with this company?

studies, having a basic understanding of accounting information will be essential to business success or could be a job requirement. As we move through the chapters, try to see yourself in one or more of these roles and think about the ways in which you can make use of the accounting information that you will no doubt come across.

The primary goal of this book is to help you become an intelligent user of accounting information by enhancing your ability to read and understand corporate financial statements. You may become a manager, accountant, banker, or financial analyst, and even if you do not end up working directly in the finance industry, you will invest in the shares or bonds of a company at some point in your life. If you work in a company, whether in sales, human resources, or other areas, your decisions will likely have an impact on what is reported to owners. Whatever your business role, you will make decisions about companies, such as whether to invest in their shares, lend them money, or sell them goods or services on credit. In making these decisions, it will be important for you to understand the information that is presented in corporate financial statements. You must know what each piece of information tells you about the company, but also what it does not tell you. You should also understand that some information that is useful in making certain decisions is not contained in the financial statements.

This book has been written for a broad readership, understanding that many of you will play multiple roles as owners (shareholders), creditors, and managers of companies. It starts with the assumption that you know little or nothing about accounting. It also assumes that you are not training to be an accountant, although that may be your objective. Therefore, this book does not emphasize accounting procedures. Instead, it emphasizes the underlying concepts of accounting and the analysis of financial statements. However, it is not really possible to have a knowledgeable understanding of the end result of the accounting process without first having an overall view of how the accounting system works. For this reason, the first three chapters present the basic mechanics of the accounting system. The remaining chapters are then devoted to more detailed accounting issues and concepts, and to a more in-depth analysis of financial statements.

We will now explore the financial statement users in more detail. **Exhibit 1.3** lists the various financial statement users, categorizing them as either internal or external users.

EXHIBIT 1.3

Users of Financial Statement Information

Internal users:
Management
External users:
Shareholders, the board of directors, and potential investors
Creditors (for example, financial institutions and suppliers)
Regulators (for example, a stock exchange)
Taxing authorities (for example, the Canada Revenue Agency)
Other corporations, including competitors
Securities (stock) analysts
Credit-rating agencies
Labour unions
Journalists

Since the focus of financial accounting is reporting to external users, let's look at these users and their information needs in greater detail.

Shareholders, the Board of Directors, and Potential Investors

A company is owned by its **shareholders**. There may be a single shareholder in the case of a **private company** or many thousands of shareholders in the case of a **public company**. We will discuss the distinctions between private and public companies a little later in the chapter, so for now it is just important to understand that companies are owned by their shareholder(s). In situations where there are numerous shareholders, they elect a **board of directors** to represent their interests. The board of directors is given the responsibility of overseeing the management team that has been hired to operate the company.

The board of directors, individual shareholders, and potential investors all require information to enable them to assess how well management has been running the company. Just like hockey fans look at the arena scoreboard to see how their team is doing in terms of the score, shots on goal, and so on, stakeholders in a business look at a company's financial reports to determine how it's doing in a number of areas. Business stakeholders want to make decisions about buying more shares or selling some or all of the shares they already own (similar to a hockey team's general manager deciding whether to acquire a star player or trade an underperforming one). They will analyze the current share price (as reflected on the stock exchange) and compare it with the original price that they paid for the shares. Are the shares now worth more or less? They will also be comparing the share price with the company's underlying value, which is reflected in the financial statements and other sources of information they have about the company.

Individual shareholders will also want to assess whether the current board of directors have effectively carried out their oversight role. They will seek to answer questions such as:

- Is the company heading in the right direction (that is, has the strategic direction approved by the board resulted in increased sales, profits, and so on)?
- Is it making decisions that result in increased value to the shareholders?
- Is the company generating a sufficient return on the resources invested in it by the shareholders?

Creditors

Creditors are those who lend money or otherwise extend credit to a company rather than invest in it directly as investors do. There are two major groups of creditors:

1. Financial institutions and other lenders
2. Suppliers, employees, and the various levels of government

Financial institutions, such as banks and credit unions, lend money to companies. They do so seeking to generate a return on these loans in the form of **interest**. Of course, the lenders also want to ensure that the money they lend out will eventually be repaid (that is, the loan **principal** will be repaid). Loans can either be short-term or extend over several years. These lenders need financial accounting information to assess the company's ability to service the loan. One of the ways this is done is by looking at the cash flows the company generates through its operations. They are also generally interested in the amount of the company's inventory, equipment, buildings, or land, because these may be pledged as security by the borrowing company in the event that it cannot repay the loan. Large companies also enter into long-term borrowing arrangements by issuing corporate bonds. Rather than borrowing from a single lender, companies that issue bonds borrow from many lenders. Nevertheless, these lenders are also concerned about the company's ability to service the debt (pay interest and repay principal) over the term of the bond, and their financial accounting information needs are similar to those of other lenders.

The other group of creditors includes suppliers, employees, and various levels of government. These groups often sell goods or provide services prior to receiving payment. For example, a supplier may agree to sell goods or provide services to a company and agree to wait 30 days for payment. Employees are another common creditor as they normally work for the company and then receive payment after the fact, such as at the end of every two weeks or at the end of a month. Different levels of government may also be creditors of a company as they wait to receive tax payments or payroll deduction amounts. These users may focus on the amount of cash in the company because they are concerned about being paid.

Regulators

The regulators who are interested in financial statements are numerous. For example, the federal and provincial governments have regulations related to how companies report their financial information and are interested in ensuring that these regulations are followed. The stock exchanges, on which the shares of public companies are traded, have regulations about the timing and format of information that companies must convey to them and to investors. Companies not complying with these regulations can be delisted, meaning their shares cease to trade on the exchange, which greatly affects their ability to raise capital.

For Example


Heath Korvola/Getty Images

Canadian Bioceutical Corporation, an Ontario company with two medical cannabis enterprises in Arizona, is a publicly traded company whose shares trade on the Toronto Stock Exchange (TSX). It announced on July 25, 2017, that it had applied to the Ontario Securities Commission, the government regulator that oversees publicly traded companies, for a management cease trade order because the company was not going to be able to meet the July 31, 2017, filing deadline for its audited financial statements for the year ended March 31, 2017. The company noted that it could not meet the filing deadline due to delays caused by integrating the accounting and operating systems of newly acquired subsidiaries. Delays were also caused by having to translate the accounting records of these companies from the accounting standards used by U.S. public companies (called U.S. generally accepted accounting principles) to the accounting standards used by Canadian public companies (called International Financial Reporting Standards). As a result of the cease trade order, restrictions were placed on the trading of the company's shares on the TSX.

Taxing Authorities

The **Canada Revenue Agency (CRA)** is the federal taxing authority in Canada and is responsible for federal tax collection. Corporate taxes are primarily based on taxable income, which is calculated based on accounting net income. As such, the CRA is another key user of a company's financial accounting information.

Other Users

Additional users of financial statement information include other companies, securities analysts, credit-rating agencies, labour unions, and journalists. Other companies may want information about the performance of a company if they are going to enter into contracts with it. If it is a direct competitor, they may seek information that will help assess the competitor's strength and future plans. Securities analysts and credit-rating agencies use the financial statements to provide information about the strengths and weaknesses of companies to people who want to invest. Labour unions need to understand the company's financial health in order to negotiate labour contracts with management. Companies often give journalists news releases that disclose financial information such as expected earnings. The journalists may refer to the actual financial statements to validate the information they were given and to supplement the original information.

It is important to understand that all of these users are using the same set of financial statements in spite of the diversity of their information needs. The bodies that establish the international and domestic standards for financial reporting are aware of all of these users, but have taken the position that they will emphasize the needs of investors and creditors in the determination of standards. As such, many pieces of information that particular users may want cannot be found in the financial statements, and these users must look to other sources of information as well.

The types of financial information gathered and made available to stakeholders vary depending on the form of organization a business has, which we discuss next.

Forms of Business Organization

LEARNING OBJECTIVE 3

Describe the major forms of business organization and explain the key distinctions between them.

What Is a Corporation?

Businesses can be operated in a number of different forms, including as a corporation, as a proprietorship, or as a partnership. Most businesses of any significant size operate as corporations and, as such, this text will focus on the accounting information related to that form of business. However, most of the accounting issues that we will identify in the text also apply in some degree to the other forms of business. If you have a good understanding of corporate accounting, it is not a big challenge to understand the nuances of accounting for proprietorships or partnerships.

As previously mentioned, corporations are owned by shareholders, with the initial shareholders having provided cash or other assets to a corporation in exchange for share certificates. These shares are called **common shares**. One of the key distinctions between corporations and other forms of business is that corporations are separate legal entities; that is, they are legally distinct from their owners. This is where the "Limited" or "Ltd." that you see in the names of many corporations comes from; it refers to the fact that the company has limited legal liability. Since the corporations are separate legal entities, they can enter into contracts and be sued. In the event the company fails, the liability of shareholders is limited to their investment in the corporation.

There are two main types of corporations: public companies (which are also known as *publicly traded companies*) and private companies (which are also known as *privately held companies*). The distinction between the two is that the shares of public companies trade on public stock exchanges such as the Toronto Stock Exchange (TSX), while the shares of private companies trade privately and are not available through public exchanges. The shares of public companies are often widely held, meaning that they are owned by a large number of individuals or entities. Some portion of their ownership will usually change hands every day. On the other hand, shares of a private company are often narrowly held, meaning that they are owned by a relatively small number of people. It is not as easy to transfer ownership in a private company.

Shareholders are not typically involved in the day-to-day operations, except in small private corporations. Given that public companies have a large number of shareholders who are not involved in day-to-day activities, the shareholders typically elect a board of directors to represent them. The board of directors has the authority to hire (and fire if necessary) the management team who will manage the company's day-to-day operations. These senior executives, along with the other managers they hire, are known as *management*. To keep shareholders informed of the performance of their investment in the company, management reports periodically to the shareholders. Financial statements are normally prepared for shareholders quarterly (every three months). Annual financial statements are also produced and are included in the company's annual report. It is these annual financial statements that we will be focusing on.

For Example

There are more than 2.5 million businesses operating as corporations in Canada. The vast majority of these are small, privately held companies. In fact, there were only 3,155 public companies trading on Canada's two largest stock exchanges, the TSX and TSX Venture Exchange, as of June 30, 2017. While the number of public companies may be small, their value is very significant. These 3,155 public companies were valued at $2,857.9 billion, according to the quoted market value of their shares.

What Differentiates a Corporation from Other Forms of Business?

There are a number of key distinctions between corporations and the other forms of business: partnerships and proprietorships. **Exhibit 1.4** outlines a number of the key distinctions to help you understand them. It is important to be aware of these differences, but also to understand that there are circumstances in which it makes sense to organize a business using each one of these three main forms of business.

EXHIBIT 1.4 **Key Distinctions between the Forms of Business**

Distinguishing Feature	Corporation	Proprietorship	Partnership
Number of owners	Can be a single owner or multiple owners	Single owner	Multiple owners
Separate legal entity?	Yes, personal assets of shareholders *are not* at risk in the event of legal action against company	No, personal assets of owner *are* at risk in the event of legal action	No, partners' personal assets *are* at risk in the event of legal action
Owner(s) responsible for debts of the business?	Only to extent of investment	Yes	Yes
Taxed?	Yes, taxed separately	No, profits taxed in hands of owner	No, profits taxed in hands of owners
Costs to establish	Most expensive	Least expensive	Moderately expensive
Cost to maintain	Most expensive	Least expensive	Moderately expensive

Activities of a Business

LEARNING OBJECTIVE 4

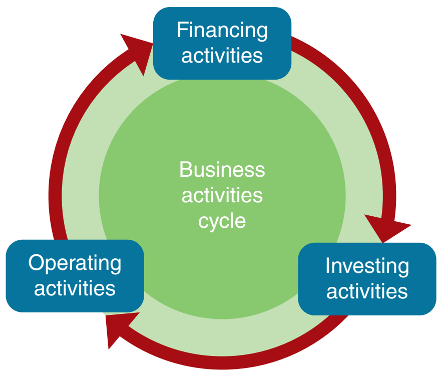
Explain the three categories of business activities and identify examples of transactions related to each category.

What Are the Three Categories of Business Activities?

To understand the information in financial statements, it is useful to think about the fundamental types of activities that all businesses engage in and report on. As illustrated in **Exhibit 1.5**, all

EXHIBIT 1.5
The Three Categories of Business Activities

Take5 Video



of the activities of businesses can be grouped into three categories: (1) **financing activities**, (2) **investing activities**, and (3) **operating activities**. Each of these involves inflows and outflows of cash into and out of the company.

Now, let's explore each category.

What Are Examples of Financing Activities?

The first activities of all companies involve obtaining the funding (or *financing*) needed to purchase the equipment or buildings they need to start operations. At the outset of the business, funding may also be required to pay for the initial purchase of inventory, pay a landlord a deposit on rented space, pay for advertising, and so on. While these activities are a necessity for new companies, they also continue as companies grow and expand. Companies obtain funding from two primary sources: (1) investors and (2) creditors, as explained in the **Key Points**.

KEY POINTS

A company's financing comes from two sources:

- investors, through the issuance of shares
- creditors, through taking out loans or making purchases on credit

Companies obtain funding from investors by issuing them shares (common shares) in the company in exchange for cash or other assets. These shares represent the investor's ownership interest in the company. For example, if the investor owns 10% of the shares issued by the company, they normally own 10% of the company. Since investors own, or hold, shares in the company, we normally refer to them as *shareholders*. Shareholders purchase shares seeking to generate a return, which may be realized in two different ways. First, they hope to receive **dividends**. These are payments made by a company that distribute a portion of the company's profits to shareholders. The other way shareholders seek to make a return is by being able to sell their shares to other investors for more than they paid for the shares. This gain or increase in value is known as **capital appreciation**. Of course, when the sale occurs, investors may also experience a loss if they receive less than the initial amount paid for the shares. The funds that flow into the company from issuing shares to its shareholders form part of what is called **shareholders' equity**.

For Example

Companies often try to establish a pattern of declaring and paying dividends in order to make their shares attractive to investors. The **Bank of Montreal** holds the record among Canadian public companies for the longest continuous stretch of paying dividends to its shareholders, having done so each year since 1829!

Once a company has some shareholders' equity, it is then able to seek funding from the second primary financing source, creditors. Creditors are entities that lend money to a company. Banks are the most common example of a creditor. Creditors seek a return from the money they lend to a company. This return is the interest they receive for the time they have allowed the company to use their money. Of course, creditors also expect to get their money back. This is known as a *return of principal*.

If a company is operating profitably, it has an internal source of new funding because generally not all of those profits are being paid out to shareholders as dividends. Any profits that are kept or retained by the company are known as **retained earnings**. If a company's retained earnings are less than the funding it requires to grow (such as money to purchase additional equipment or carry new lines of inventory), the only way it can expand is to obtain more funds from investors (existing shareholders or new investors) or to borrow from creditors. How much to borrow from creditors and how much funding to obtain from investors are important decisions that the company's management must make. Those decisions can determine whether a company grows, goes bankrupt, or is bought by another company. **Exhibit 1.6** shows examples of financing activities.

EXHIBIT 1.6
Typical Financing Activities

Typical Financing Activities

Inflows:	Borrowing money
	Issuing shares
Outflows:	Repaying loan principal
	Paying dividends

What Are Examples of Investing Activities?

Once a company obtains funds, it must invest them to accomplish its goals. Most companies make both long-term and short-term investments in order to carry out the activities that help them achieve their goals. Most short-term investments (such as the purchase of raw materials and inventories) are related to the day-to-day operations of the business and are therefore considered operating activities. Many long-term investments are related to the purchase of property, plant, and equipment that can be used to produce goods and services for sale. Companies can also invest in the shares of other companies, and these may be either long-term or short-term investments. The **Key Points** summarize the two types of investing activities.

KEY POINTS

A company's investing activities are related to two things:

- buying and selling property, plant, and equipment
- buying and selling the shares of other companies

Exhibit 1.7 shows examples of investing activities.

EXHIBIT 1.7

Examples of Typical Investing Activities

Typical Investing Activities

Inflows:	Proceeds from the sale of property, plant, and equipment
	Proceeds from the sale of shares of other companies
Outflows:	Purchase of property, plant, and equipment
	Purchase of shares of other companies

What Are Examples of Operating Activities?

Operating activities are all of the activities associated with developing, producing, marketing, and selling the company's products and/or services. While financing and investing activities are necessary to conduct operations, they tend to occur on a more sporadic basis than operating activities. The day-to-day ongoing activities of a company are generally classified as operating activities, as explained in the **Key Points**.

Exhibit 1.8 shows examples of operating activities.

EXHIBIT 1.8

Examples of Typical Operating Activities

Typical Operating Activities

Inflows:	Sales to customers
	Collections of amounts owed by customers
Outflows:	Purchases of inventory
	Payments of amounts owed to suppliers
	Payments of expenses such as wages, rent, and interest
	Payments of taxes owed to the government

KEY POINTS

A company's operating activities are related to the company's revenues and expenses, which fall into two basic categories:

- inflows from sales to and collections from customers
- outflows related to payment of the expenses of the business

Of the three categories of activities, operating activities are considered the most critical to a company's long-run success or failure. If the company is not successful at generating cash flows from its operations, it will ultimately run out of cash as financing sources will dry up because it will be unable to attract new investors or lenders. It would have to sell the property, plant, and equipment that it uses to generate its revenues, which would mean it would not be able to continue operating.

Exhibit 1.9 illustrates the principal inflows and outflows associated with the three categories of business activities.

The financial statements provide information about a company's operating, financing, and investing activities. By the end of this book, you should be able to interpret financial statements as they relate to these activities. To help you become a successful user of financial statement information, in Appendix A at the back of the book, we present the financial statements of **Dollarama Inc.**, which were included in the company's 2017 annual report. As noted in the feature story, Dollarama is a Canadian retailer. Let's walk through the various types of information contained in this part of Dollarama's annual report.