THOMAS TIETZ HARRISON BERBERICH SEGUIN

FINANCIAL ACCOUNTING

SEVENTH CANADIAN EDITION

Pearson Canada Inc., 26 Prince Andrew Place, North York, Ontario M3C 2H4.

9780135222171

ScoutAutomatedPrintCode

Library and Archives Canada Cataloguing in Publication
Title: Financial accounting / Walter T. Harrison, Jr. (Baylor University), C. William (Bill) Thomas (Baylor University), Wendy M. Tietz (Kent State University), Greg Berberich (University of Waterloo), Catherine Seguin (University of Toronto).
Names: Harrison, Walter T., Jr., author. | Thomas, C. William, author. | Tietz, Wendy M., author. | Berberich, Greg, 1968- author. | Seguin, Catherine L., author.
Description: Seventh Canadian edition. | Previously published: Toronto, Ontario: Pearson Canada Inc., 2018. | Includes index.
Identifiers: Canadiana 20190150920 | ISBN 9780135222171 (hardcover)
Subjects: LCSH: Accounting—Textbooks. | LCGFT: Textbooks.
Classification: LCC HF5636 .H37 2019 | DDC 657/.044—dc23

Pearson

Financial Accounting

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ABOUT THE AUTHORS

C. William (Bill) Thomas is the J.E. Bush Professor of Accounting and a Master Teacher at Baylor University. A Baylor University alumnus, he received both his BBA and MBA there and went on to earn his PhD from The University of Texas at Austin.

With primary interests in the areas of financial accounting and auditing, Dr. Thomas has served as the J.E. Bush Professor of Accounting since 1995. He has been a member of the faculty of the Accounting and Business Law Department of the Hankamer School of Business since 1971 and served as chair of the department for 12 years. He has been recognized as an Outstanding Faculty Member of Baylor University as well as a Distinguished Professor for the Hankamer School of Business. Dr. Thomas has received many awards for outstanding teaching, including the Outstanding Professor in the Executive MBA Programs as well as the designation of Master Teacher.

Thomas is the author of textbooks in auditing and financial accounting, as well as many articles in auditing, financial accounting and reporting, taxation, ethics, and accounting education. His scholarly work focuses on the subject of fraud prevention and detection, as well as ethical issues among accountants in public practice. He presently serves as the accounting and auditing editor of *Today's CPA*, the journal of the Texas Society of Certified Public Accountants, with a circulation of approximately 28,000.

Thomas is a certified public accountant in Texas. Prior to becoming a professor, Thomas was a practising accountant with the firms of KPMG, LLP, and BDO Seidman, LLP. He is a member of the American Accounting Association, the American Institute of CPAs and Association of International Certified Professional Accountants, and the Texas Society of Certified Public Accountants.

For my wife, Mary Ann.
C. William (Bill) Thomas

Wendy M. Tietz is a professor in the Department of Accounting in the College of Business Administration at Kent State University. She teaches introductory financial and managerial accounting in a variety of formats, including large sections, small sections, and online sections.

Dr. Tietz is a Certified Public Accountant (Ohio), a Certified Management Accountant, and a Chartered Global Management Accountant. She is a member of the American Accounting Association, the Institute of Management Accountants, the American Institute of CPAs and Association of International Certified Professional Accountants, and the Sustainability Accounting Standards Board Alliance. She has published articles in such journals as *Issues in Accounting Education, Accounting Education: An International Journal, IMA Educational Case Journal,* and *Journal of Accounting & Public Policy*. Dr. Tietz is also the coauthor of a managerial accounting textbook, *Managerial Accounting*, with Dr. Karen Braun. She received the 2017 Bea Sanders/AICPA Innovation in Teaching Award for her web tool for financial accounting instructors, the Accounting Case Template. In 2016, Dr. Tietz was awarded the Jim Bulloch Award for Innovations in Management Accounting Education from the American Accounting Association/Institute of Management Accountants for her accounting educator blog, *Accounting in the Headlines*. She also received the 2014 Bea Sanders/AICPA Innovation in Teaching Award for her blog. She regularly presents at AAA regional and national meetings. She is intensely interested in the power of storytelling, interactivity, and social media as educational practices to promote engagement and understanding.

Dr. Tietz received her PhD from Kent State University. She received both her MBA and BSA from the University of Akron. Prior to teaching, she worked in industry for several years, both as a controller for a financial institution and as the operations manager and controller for a recycled plastics manufacturer.

To my husband, Russ, who steadfastly supports me in every endeavor.
Wendy M. Tietz

Walter T. Harrison Jr. is professor emeritus of accounting at the Hankamer School of Business, Baylor University. He received his BBA from Baylor University, his MS from Oklahoma State University, and his PhD from Michigan State University.

Professor Harrison, recipient of numerous teaching awards from student groups as well as from university administrators, has also taught at Cleveland State Community College, Michigan State University, the University of Texas, and Stanford University.

A member of the American Accounting Association and the American Institute of CPAs and Association of International Certified Professional Accountants, Professor Harrison has served as chairman of the Financial Accounting

Standards Committee of the American Accounting Association, on the Teaching/Curriculum Development Award Committee, on the Program Advisory Committee for Accounting Education and Teaching, and on the Notable Contributions to Accounting Literature Committee.

Professor Harrison has lectured in several foreign countries and published articles in numerous journals, including *Journal of Accounting Research, Journal of Accountancy, Journal of Accounting and Public Policy, Economic Consequences of Financial Accounting Standards, Accounting Horizons, Issues in Accounting Education,* and *Journal of Law and Commerce*.

Professor Harrison has received scholarships, fellowships, and research grants or awards from PricewaterhouseCoopers, Deloitte & Touche, the Ernst & Young Foundation, and the KPMG Foundation.

Charles T. Horngren (1926–2011) was the Edmund W. Littlefield Professor of Accounting, emeritus, at Stanford University. A graduate of Marquette University, he received his MBA from Harvard University and his PhD from the University of Chicago. He was also the recipient of honourary doctorates from Marquette University and DePaul University.

A certified public accountant, Horngren served on the Accounting Principles Board for six years, the Financial Accounting Standards Board Advisory Council for five years, and the Council of the American Institute of Certified Public Accountants for three years. For six years he served as a trustee of the Financial Accounting Foundation, which oversees the Financial Accounting Standards Board and the Government Accounting Standards Board.

Horngren is a member of the Accounting Hall of Fame. As a member of the American Accounting Association, Horngren was its president and its director of research. He received its first annual Outstanding Accounting Educator Award. The California Certified Public Accountants Foundation gave Horngren its Faculty Excellence Award and its Distinguished Professor Award. He was the first person to have received both awards. The American Institute of Certified Public Accountants presented its first Outstanding Educator Award to Horngren. Horngren was named Accountant of the Year, in Education, by the national professional accounting fraternity, Beta Alpha Psi. Professor Horngren was also a member of the Institute of Management Accountants, from whom he received its Distinguished Service Award. He was a member of the institute's Board of Regents, which administers the certified management accountant examinations.

Horngren is an author of these other accounting books published by Pearson: *Cost Accounting: A Managerial Emphasis*, Fifteenth Edition, 2015 (with Srikant M. Datar and Madhav V. Rajan); *Introduction to Financial Accounting*, Eleventh Edition, 2014 (with Gary L. Sundem, John A. Elliott, and Donna Philbrick); *Introduction to Management Accounting*, Sixteenth Edition, 2014 (with Gary L. Sundem, Jeff Schatzberg, and Dave Burgstahler); *Horngren's Financial & Managerial Accounting*, Fifth Edition, 2016 (with Tracie L. Miller-Nobles, Brenda L. Mattison, and Ella Mae Matsumura); and *Horngren's Accounting*, Eleventh Edition, 2016 (with Tracie L. Miller-Nobles, Brenda L. Mattison, and Ella Mae Matsumura). Horngren was the consulting editor for Pearson's Charles T. Horngren Series in Accounting.

Greg Berberich, CPA, CA, PhD, has been a Lecturer in the School of Accounting and Finance at the University of Waterloo since 2011. While at Waterloo, he has served as the Director of the Master of Accounting program and as the Associate Director of Teaching & Learning. Before Waterloo, he was a faculty member at Wilfrid Laurier University for nine years. He obtained his BMath and PhD from the University of Waterloo and completed his CPA and CA in Ontario.

He has taught financial accounting, auditing, and a variety of other courses at the undergraduate and graduate levels. He has presented papers at a variety of academic conferences in Canada and the United States and has served on the editorial board of the journal *Issues in Accounting Education*. He was also the Treasurer of the Society for Teaching and Learning in Higher Education for several years. He has written a number of cases for use in university courses and professional training programs.

For Aggie, who helps me stay balanced.
Greg Berberich

Catherine I. Seguin, MBA, CGA, is an Associate Professor, Teaching Stream, at the University of Toronto Mississauga.

She also acts as Dean's Designate for academic offences in the Social Sciences.

She has written the following books: *Understanding Accounting for Not-for-Profit Organizations* and *Accounting for Not-for-Profit Organizations* for Carswell (Thomson-Reuters) and *Not-for-Profit Accounting*, published by CGA Canada. In the not-for-profit community, she has served as Treasurer on several different boards.

To my family, who are always cheering me on:
Dennis, Andrea, Allison, Carlos, Mark, and Caileah
Catherine I. Seguin

PREFACE

HELPING STUDENTS BUILD A SOLID *FINANCIAL ACCOUNTING* FOUNDATION

Financial Accounting gives readers a solid foundation in the fundamentals of accounting and the basics of financial statements, and then builds upon that foundation to offer more advanced and challenging concepts and problems. The concepts and procedures that form the accounting cycle are also described and illustrated early in the text (Chapters 2 and 3) and are then applied consistently in the chapters that follow. This scaffolded approach helps students to better understand the meaning and relevance of financial information, see its significance within a real-world context, as well as develop the skills needed to analyze financial information in both their courses and career.

Financial Accounting has a long-standing reputation in the marketplace for being readable and easy to understand. It drives home fundamental concepts using relevant examples from real-world companies in a reader-friendly way without adding unnecessary complexity. While maintaining hallmark features of accuracy, readability, and ease of understanding, the Seventh Canadian Edition includes updated explanations, coverage, and ratio analysis with decision-making guidelines. These time-tested methodologies with the latest technology ensures that students learn basic concepts in accounting in a way that is relevant, stimulating, and fun, while exercises and examples from real-world companies help students gain a better grasp of the course material.

CHANGES TO THE SEVENTH CANADIAN EDITION

Students and instructors will benefit from numerous changes incorporated into this latest edition of *Financial Accounting*. Based on feedback from users and reviewers, the material covering investments and the time value of money (Chapter 7 in the Sixth Edition) has been moved to Appendix B of the textbook. (Full coverage of this material continues to be available in all the supplements.) As a result of this change, the Seventh Edition is more streamlined than previous editions, with ten chapters and a better flow of the introductory financial accounting topics, while keeping the investments and time value of money material conveniently in the textbook.

All materials have been updated to reflect the IFRS and ASPE principles in effect at the time of writing. Directly after the Learning Objectives, each chapter includes a list of relevant 2019 CPA Competencies addressed in that chapter. A summary of IFRS and ASPE differences is provided at the end of several chapters to identify the differences that exist between these two sets of principles. These differences are collected by chapter in Appendix C of the textbook.

The following is a summary of the significant changes made to the Seventh Canadian Edition of *Financial Accounting*:

CRITICAL THINKING QUESTIONS

NEW!

Critical Thinking questions have been added to each chapter to help students apply the chapter material to questions that are less directed and that require more thoughtful application of the chapter concepts in written answers. A new icon appears beside the Critical Thinking questions.

CT

NEW!

COMPREHENSIVE CASES

Comprehensive Cases have been added to give students the opportunity to apply the concepts from a number of chapters to one or two business situations to see how the accounting concepts work together in the real world. There are five new Comprehensive Cases, which cover Chapters 1 to 3, Chapters 4 to 6, Chapters 7 to 8, Chapter 9, and Chapter 10.

NEW!

ETHICAL DECISIONS

The Ethical Decisions section in every chapter now includes scenarios that require students to apply ethical principles from the CPA Canada Code of Professional Conduct.

FOCUS ON FINANCIAL STATEMENT ANALYSIS

Focus on Financial Statement Analysis questions appear at the end of each chapter. Students use the Dollarama Inc. financial statements that appear in Appendix A in the textbook to apply the chapter's accounting concepts to a familiar company's financial statements.

AVAILABLE ON MYLAB ACCOUNTING

ACCOUNTING CYCLE TUTORIAL

This interactive tutorial in MyLab Accounting helps students master the Accounting Cycle for early and continued success in financial accounting courses. The tutorial, accessed by computer, smartphone, or tablet, provides students with brief explanations of each concept of the Accounting Cycle through engaging, interactive activities. Students are immediately assessed on their understanding, and their performance is recorded in the MyLab Accounting gradebook. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet another resource within MyLab Accounting to help them be successful with the accounting cycle.

ACT COMPREHENSIVE PROBLEM

New! The Accounting Cycle Tutorial now includes a comprehensive problem that allows students to work with the same set of transactions throughout the accounting cycle. The comprehensive problem, which can be assigned at the beginning or the end of the full cycle, reinforces the lessons learned in the Accounting Cycle Tutorial activities by emphasizing the connections between the accounting cycle concepts.

TIME VALUE OF MONEY TUTORIAL

New! The Time Value of Money Tutorial in MyLab Accounting ensures that students understand the basic theory and formulas of the TVM, while also helping test their ability to *apply* the TVM in the measurement of financial statement items. Students work through two sections. The first is to help them understand the theory-using whatever method the instructors choose (manually, through Excel®, with tables, or via a calculator). The second is to give students the opportunity to apply the theory by giving them a number of scenarios regarding each financial statement.

DYNAMIC STUDY MODULES

New! Chapter-specific Dynamic Study Modules help students study effectively on their own by continuously assessing their activity and performance in real time. Here's how it works: students complete a set of questions with a unique answer format that also asks them to indicate their confidence level. Questions repeat until the student can answer them all correctly and confidently. Dynamic Study Modules explain the concept using materials from the text. These are available as graded assignments and are accessible on smartphones, tablets, and computers.

LEARNING CATALYTICS

Text-specific Learning Catalytics helps you generate class discussion, customize your lecture, and promote peer-to-peer learning with real-time analytics. As a student response tool, Learning Catalytics uses students' smartphones, tablets, or laptops to engage them in more interactive tasks and thinking.

- **NEW!** Upload a full PowerPoint® deck for easy creation of slide questions.
- Help your students develop critical thinking skills.
- Monitor responses to find out where your students are struggling.
- Rely on real-time data to adjust your teaching strategy.
- Automatically group students for discussion, teamwork, and peer-to-peer learning.

ACKNOWLEDGMENTS

Thanks are extended to Dollarama Inc. for permission to include portions of its annual report in Appendix A and MyLab Accounting. Appreciation is also expressed to the following individuals and organizations:

The annual reports of a number of Canadian companies.

Professors Bill Thomas, Wendy Tietz, Tom Harrison, and the late Charles Horngren.

Particular thanks are also due to the following instructors for reviewing the Sixth Canadian Edition and offering many useful suggestions for the Seventh Canadian Edition:

Shiraz Charania, *Langara College*
Liang Hsuan Chen, *University of Toronto*
Kirk Collins, *Trent University*
Megan Costiuk, *University of Regina*
Laura Dallas, *Kwantlen Polytechnic University*
Athina Hall, *University of Ontario Institute of Technology*
Kayla Macfarlane, *University of Ontario Institute of Technology*
Jaime Morales, *Trent University*
Mumsy Ullattikulam, *Langara College*

The authors acknowledge with gratitude the professional support received from Pearson Canada. In particular we thank Keara Emmett, Acquisitions Editor; Anita Smale, Developmental and Media Content Editor; Sarah Gallagher, Project Manager; Manas Roy, Production Editor; and Darcey Pepper, Marketing Manager.

A special thanks also goes out to Kathy Falk, at the University of Toronto, and Chris Deresh, from Douglas College, whose contributions to the Sixth Canadian Edition led to a stronger Seventh Canadian Edition. Kathy helped ensure our problem material was complete, accurate, and effective for the level taught in the chapter. Chris checked the coverage of CPA Competencies and provided his valuable and current knowledge on this.

PROLOGUE

Accounting Careers: Much More Than Counting Things

What kind of career can you have in accounting? Almost any kind you want. A career in accounting lets you use your analytical skills in a variety of ways, and it brings both monetary and personal rewards. Professional accountants work as executives for public companies, partners at professional services firms, and analysts at investment banks, among many other exciting positions.

Accounting as an art is widely believed to have been invented by Fra Luca Bartolomeo de Pacioli, an Italian mathematician and Franciscan friar in the sixteenth century. Pacioli was a close friend of Leonardo da Vinci and collaborated with him on many projects.

Accounting as the profession we know today has its roots in the Industrial Revolution during the eighteenth and nineteenth centuries, mostly in England. However, accounting did not attain the stature of other professions such as law, medicine, or engineering until early in the twentieth century. Professions are distinguished from trades by the following characteristics: (1) a unifying body of technical literature, (2) standards of competence, (3) codes of professional conduct, and (4) dedication to service to the public.

An aspiring accountant must obtain a university degree, pass several professional examinations, and gain three years of on-the-job training before they can receive a professional accounting designation. The most prevalent designation in Canada is the CPA, which stands for Chartered Professional Accountant. When you hold this designation, employers know what to expect about your education, knowledge, competencies, and personal attributes. They value your analytical skills and extensive training. Your CPA designation gives you a distinct advantage in the job market, and instant credibility and respect in the workplace. It's a plus when dealing with other professionals, such as bankers, lawyers, auditors, and federal regulators. In addition, your colleagues in private industry tend to defer to you when dealing with complex business matters, particularly those involving financial management.

Where Accountants Work

Where can you work as an accountant? There are four main types of employers.

Professional Accounting Firms

You can work for a professional accounting firm, which could range in size from a small local firm to a large international firm such as KPMG or EY. These firms provide assurance, tax, and consulting services to a variety of clients, allowing you to gain a broad range of experience if you so choose. Many accountants begin their careers at a professional accounting firm and then move into more senior positions in one of the job categories described below. Others may stay on, or join one of these firms after working elsewhere, to take advantage of the many rewarding careers these firms offer.

Public or Private Companies

Rather than work for an accounting firm and provide your expertise to a variety of clients, you can work for a single company that requires your professional knowledge. Your role may be to analyze financial information and communicate that information to managers who use it to plot strategy and make decisions. Or you may be called upon to help allocate corporate resources or improve financial performance. For example, you might do a cost-benefit analysis to help decide whether to acquire a company or build a factory. Or you might describe the financial implications of choosing one business strategy over another. You might work in areas such as internal auditing, financial management, financial reporting, treasury management, and tax planning. The most senior financial position in these companies is the chief financial officer (CFO) role; some CFOs rise further to become chief executive officers (CEOs) of their companies.

Government and Not-for-Profit Entities

Federal, provincial, and local governmental bodies also require accounting expertise. You could be helping to evaluate how government agencies are being managed, or advise politicians on how to allocate resources to promote efficiency. The RCMP hires accountants to investigate the financial aspects of white-collar crime. You might find yourself working for the Canadian Revenue Agency, one of the provincial securities commissions, or a federal or provincial Auditor General.

As an accountant, you might also decide to work in the not-for-profit sector. Colleges, universities, public and private primary and secondary schools, hospitals, and charitable organizations such as churches and the United Way all have accounting functions. Accountants in the not-for-profit sector provide many of the same services as those in the for-profit sector, but their focus is less on turning a profit than on making sure the organizations spend their money wisely and operate efficiently and effectively.

Education

Finally, you can work at a college or university, advancing the thought and theory of accounting and teaching future generations of new accountants. On the research side of education, you might study how companies use accounting information. You might develop new ways of categorizing financial data, or study accounting practices in different countries. You then publish your ideas in journals and books and present them to colleagues at meetings around the world. On the education side, you can help others learn about accounting and give them the tools they need to be their best.

Regardless of which type of organization you work for, as an accountant, your knowledge will be highly valued by your clients, colleagues, and other important stakeholders. As the economy becomes increasingly global in scope, accounting standards, tax laws, and business strategies will grow more complex, so it's safe to say that the expertise provided by professional accountants will continue to be in high demand. This book could serve as the first step on your path to a challenging and rewarding career as a professional accountant!

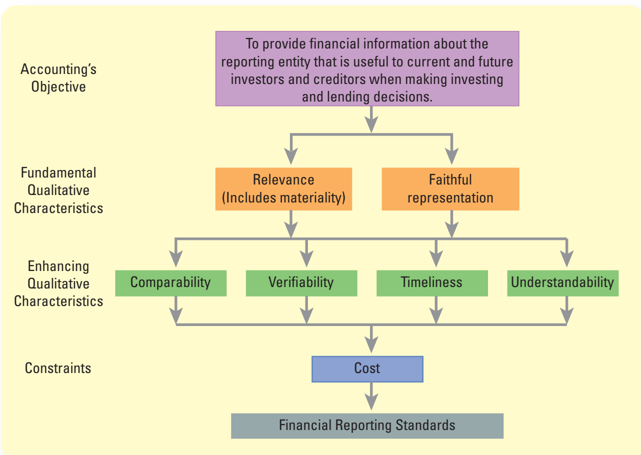
QUICK REVIEW

The Financial Statements and Their Elements

Question	Financial Statement	Elements
1. How much income did the company earn during the year?	Income statement	Total income (revenues + gains) − Total expenses (expenses + losses) Net income (or Net loss)
2. Why did the company's retained earnings change during the year?	Statement of retained earnings	Beginning retained earnings + Net income + Other comprehensive income (IFRS only) − Dividends Ending retained earnings
3. What is the company's financial position at the end of the year?	Balance sheet	Assets = Liabilities + Owners' equity
4. How much cash did the company generate and spend during the year?	Statement of cash flows	Operating cash flows ± Investing cash flows ± Financing cash flows Increase (or decrease) in cash

See Chapter 1, Exhibit 1-3, page 7.

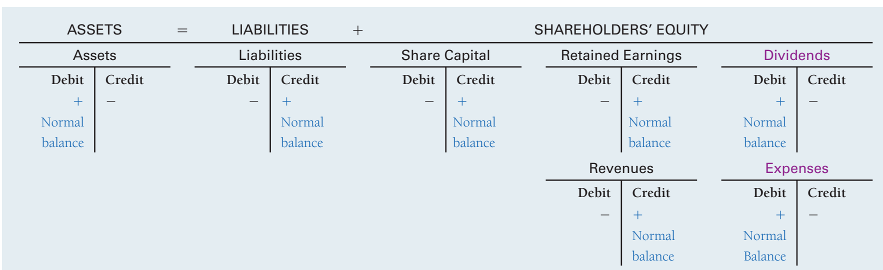
Accounting's Conceptual Framework



See Chapter 1, Exhibit 1-10, page 21.

The Expanded Rules of Debit and Credit

See Chapter 2, Exhibit 2-8, page 72.

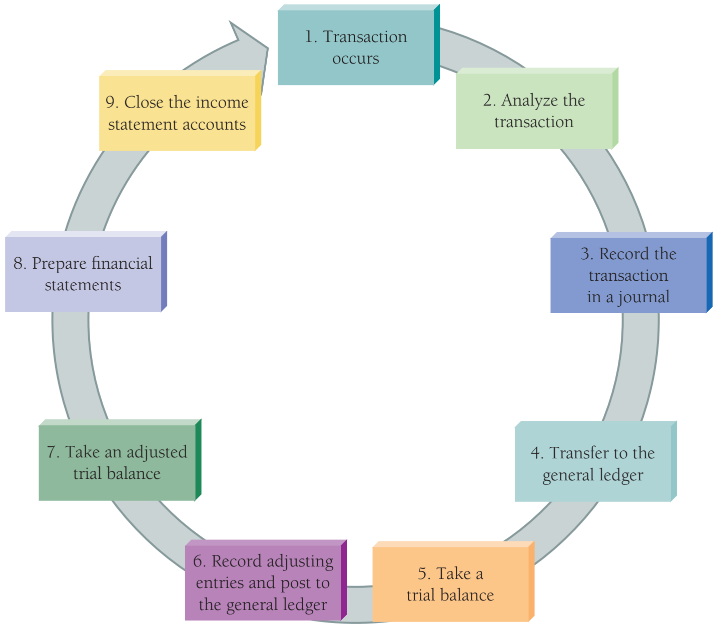


Adjusting Entries

Adjusting entries are recorded at the end of the accounting period, just before the financial statements are prepared. This ensures that all assets and liabilities have been recorded at period end, and all revenues earned and expenses incurred during the period have been included in the accounts.

Type of Adjusting Entry	Debit	Credit	Example
Deferral – Prepaid Expense	Expense	Asset	Prepaid rent, insurance, supplies
Deferral – Unearned Revenue	Liability	Revenue	Cash received but goods or services to be provided in the future
Depreciation	Expense	Contra-asset	Property, plant, and equipment
Accrual – Accrued Expense	Expense	Liability	Salaries, interest
Accrual – Accrued Revenue	Asset	Revenue	Revenue earned but not yet billed

The Accounting Cycle



The Relationships Among the Financial Statements

See Chapter 2, Exhibit 2-2, page 65.

	A	B	C	D
1	**Tara Inc.** Income Statement For the Month Ended April 30, 2020			
2	**Revenues**			
3	Service revenue ($7,000 + $3,000)		$ 10,000	
4	**Expenses**			
5	Salary expense	$ 1,200		
6	Rent expense	1,100		
7	Utilities expense	400		
8	Total expenses		2,700	
9	Net income		$ 7,300	
10				

	A	B	C	D
1	**Tara Inc.** Statement of Retained Earnings For the Month Ended April 30, 2020			
2	Retained earnings, April 1, 2020		$ 0	
3	Add: Net income for the month		7,300	
4	Subtotal		7,300	
5	Less: Dividends declared		(2,100)	
6	Retained earnings, April 30, 2020		$ 5,200	
7				

	A	B	C	D	E
1	**Tara Inc.** Balance Sheet As at April 30, 2020				
2	**Assets**		**Liabilities**		
3	Cash	$ 33,300	Accounts payable	$ 1,800	
4	Accounts receivable	2,000	**Shareholders' Equity**		
5	Office supplies	3,700	Common shares	50,000	
6	Land	18,000	Retained earnings	5,200	
7			Total shareholders' equity	55,200	
8	Total assets	$ 57,000	Total liabilities and shareholders' equity	$ 57,000	
9					

RATIOS USED IN THIS TEXT

Ratio analysis is one tool that managers, investors, and creditors use when analyzing a company. How do they determine if a company is able to pay its bills, sell inventory, collect receivables, and so on? They use the standard ratios discussed in this book.

Ratio	Computation	Information Provided
Measuring ability to pay current liabilities:		
1. Current ratio	$\dfrac{\text{Current assets}}{\text{Current liabilities}}$	Measures ability to pay current liabilities with current assets
2. Quick (acid-test) ratio	$\dfrac{\text{Cash} + \text{Short-term investments} + \text{Net current receivables}}{\text{Current liabilities}}$	Shows ability to pay all current liabilities if they come due immediately
Measuring turnover and cash conversion:		
3. Inventory turnover and days' inventory outstanding (DIO)	$\text{Inventory turnover} = \dfrac{\text{Cost of goods sold}}{\text{Average inventory}}$ $\text{Days' inventory outstanding (DIO)} = \dfrac{365}{\text{Inventory turnover}}$	Indicates saleability of inventory—the number of times a company sells its average level of inventory during a year
4. Accounts receivable turnover	$\dfrac{\text{Net credit sales}}{\text{Average net accounts receivable}}$	Measures ability to collect cash from credit customers
5. Days' sales in receivables or days' sales outstanding (DSO)	$\dfrac{\text{Average net accounts receivable}}{\text{Average daily sales}}$ or $\dfrac{365}{\text{Accounts receivable turnover}}$	Shows how many days' sales remain in Accounts Receivable—how many days it takes to collect the average level of receivables
6. Payables turnover and days' payable outstanding (DPO)	$\text{Accounts payable turnover} = \dfrac{\text{Cost of goods sold}}{\text{Average accounts payable}}$ $\text{Days' payable outstanding (DPO)} = \dfrac{365}{\text{Accounts payable turnover}}$	Shows how many times a year accounts payable turn over, and how many days it takes the company to pay off accounts payable
7. Cash conversion cycle	Cash conversion cycle = DIO + DSO − DPO where DIO = Days' inventory outstanding DSO = Days' sales outstanding DPO = Days' payable outstanding	Shows overall liquidity by computing the total days it takes to convert inventory to receivables and back to cash, less the days to pay off creditors

Ratio	Computation	Information Provided
Measuring ability to pay long-term debt:		
8. Debt ratio	$\frac{\text{Total liabilities}}{\text{Total assets}}$	Indicates percentage of assets financed with debt
9. Times-interest-earned ratio	$\frac{\text{Income from operations}}{\text{Interest expense}}$	Measures the number of times operating income can cover interest expense
Measuring profitability:		
10. Gross profit %	$\frac{\text{Gross profit}}{\text{Net sales}}$	Shows the percentage of profit that a company makes from merely selling the product, before any other operating costs are subtracted
11. Operating income %	$\frac{\text{Income from operations}}{\text{Net sales}}$	Shows the percentage of profit earned from each dollar in the company's core business, after operating costs have been subtracted
12. Return on net sales	$\frac{\text{Net income}}{\text{Net sales}}$	Shows the percentage of each sales dollar earned as net income
13. Asset turnover	$\frac{\text{Net sales}}{\text{Average total assets}}$	Measures the amount of net sales generated for each dollar invested in assets
14. Return on total assets	$\frac{\text{Net income}}{\text{Average total assets}}$	Measures how profitably a company uses its assets
15. Leverage ratio	$\frac{\text{Average total assets}}{\text{Average common shareholders' equity}}$	Otherwise known as the *equity multiplier,* measures the ratio of average total assets to average common shareholders' equity
16. Return on common shareholders' equity	$\frac{\text{Net income} - \text{preferred dividends}}{\text{Average common shareholders' equity}}$	Measures how much income is earned for every dollar invested by the company's common shareholders
17. Earnings per share of common stock	$\frac{\text{Net income} - \text{Preferred dividends}}{\text{Average number of common shares outstanding}}$	Measures the amount of net income earned for each share of the company's common stock outstanding
Analyzing shares as an investment:		
18. Price/earnings ratio	$\frac{\text{Market price per common share}}{\text{Earnings per share}}$	Indicates the market price of \$1 of earnings
19. Dividend yield	$\frac{\text{Dividend per share of common (or preferred) stock}}{\text{Market price per share of common (or preferred) stock}}$	Shows the percentage of a stock's market value returned as dividends to stockholders each period
20. Book value per share of common stock	$\frac{\text{Total shareholders' equity} - \text{Preferred equity}}{\text{Number of shares of common stock outstanding}}$	Indicates the recorded accounting amount for each share of common stock outstanding

The Financial Statements

1

SPOTLIGHT

If you have ever shopped for school, party, or craft supplies, you have likely patronized a Dollarama store. Based in Montreal, Dollarama owns and operates over 1,000 stores across all ten provinces. The company is one of Canada's largest value retail companies, offering customers a wide variety of quality consumer products, general merchandise, and seasonal goods at fixed price points up to $4.00. Whether you live in a large metropolitan area, mid-sized city, or small town, you are likely only a short distance from a Dollarama store. Dollarama is featured throughout this textbook as a way of connecting new financial accounting concepts to the actual business activities and financial statements of a familiar Canadian corporation.

As you can see from its Consolidated Statements of Net Earnings on the next page, Dollarama sells a lot of goods in a year—about $3.3 billion worth for the year ended January 28, 2018 (line 3). After deducting a variety of expenses incurred during fiscal 2018 (lines 4, 6–8, and 10), Dollarama reported net earnings of over $500 million for the year (line 11). In this chapter you will begin to learn where these numbers come from and what they mean. Welcome to the world of accounting!

Marc Seguin/Shutterstock

LEARNING OBJECTIVES

1. **Explain** why accounting is the language of business
2. **Describe** the purpose and **explain** the elements of each financial statement
3. **Prepare** financial statements and **analyze** the relationships among them
4. **Explain** and **apply** underlying accounting concepts, assumptions, and principles
5. Ethically **evaluate** business decisions

CPA COMPETENCIES

Competencies addressed in this chapter:

1.1.1 Evaluates financial reporting needs

1.1.2 Evaluates the appropriateness of the basis of financial reporting

1.1.3 Evaluates reporting processes to support reliable financial reporting

Based on Chartered Professional Accountant standards

	A	B	C
1	**Dollarama Inc.** Consolidated Statements of Net Earnings (Adapted) For the Years Ended January 28, 2018 and January 29, 2017*		
2	*(in millions of dollars)*	**2018**	**2017**
3	**Sales**	$ 3,266.1	$ 2,963.2
4	Cost of sales	1,965.2	1,801.9
5	**Gross profit**	1,300.9	1,161.3
6	General, administrative and store operating expenses	474.8	458.0
7	Depreciation and amortization	70.6	57.8
8	Financing costs	39.9	33.1
9	**Earnings before income taxes**	715.6	612.4
10	**Income taxes**	196.2	166.8
11	**Net earnings**	$ 519.4	$ 445.6
12			

*Dollarama's financial year (or fiscal year) ends on the Saturday closest to January 31 each year, which is why its 2017 and 2018 year-end dates are different.

Source: Data from U.S. Securities and Exchange Commission.

Many chapters of this book begin with an actual financial statement—in this chapter, it's the Consolidated Statements of Net Earnings of Dollarama Inc. for its 2018 and 2017 fiscal years. The core of financial accounting revolves around the basic financial statements:

- Income statement (sometimes known as the statement of net earnings)
- Statement of retained earnings (sometimes included in the statement of changes in owners' equity)
- Balance sheet (also known as the statement of financial position)
- Cash flow statement (also known as the statement of cash flows)
- Statement of other comprehensive income

Financial statements are the reports that companies use to convey the financial results of their business activities to various user groups, which can include managers, investors, creditors, and regulatory agencies. In turn, these parties use the reported information to make a variety of decisions, such as whether to invest in or loan money to the company. To learn accounting, you must learn to focus on decisions. In this chapter, we explain generally accepted accounting principles, their underlying assumptions and concepts, and the bodies responsible for issuing accounting standards. We discuss the judgment process that is necessary to make good accounting decisions. We also discuss the contents of the four basic financial statements that report the results of those decisions. In later chapters, we will explain in more detail how to construct the financial statements, as well as how user groups typically use the information contained in them to make business decisions.

Using Accounting Information

Dollarama's managers make a lot of decisions. Which stores have the highest sales? Which line of business is earning the most profit? Should Dollarama expand its offerings in Eastern Canada to match those in B.C. and Alberta? Accounting information helps company managers make these decisions.

Take a look at Dollarama's Consolidated Statements of Income on page 2. Focus on net earnings (line 11). Net earnings (or net income) is the excess of sales (or revenues) over expenses. You can see that Dollarama earned $519 million in net income for the year ended January 28, 2018. That's good news because it means that Dollarama's revenues exceeded its expenses by over $500 million in fiscal 2018.

Dollarama's Consolidated Statements of Net Earnings convey more great news. Sales grew from $2.96 billion in 2017 to $3.27 billion in 2018 (line 3), an increase of 10.5%. Also, Dollarama's 2018 net earnings of $519.4 million were 16.6% higher than its 2017 net earnings of $445.6 million (line 11). Based on these key numbers, Dollarama's 2018 operating performance improved significantly from 2017.

There would, however, be much more accounting information to analyze before making a final assessment of Dollarama's 2018 financial performance. Imagine you work for a bank that Dollarama would like to borrow $500 million from. How would you decide whether to lend them the money? Or suppose you have $5,000 to invest. What financial information would you analyze to decide whether to invest this money in Dollarama? Let's see how accounting information can be used to make these kinds of decisions.

EXPLAIN WHY ACCOUNTING IS THE LANGUAGE OF BUSINESS

OBJECTIVE

1 **Explain** why accounting is the language of business

Accounting is an information system that measures and records business activities, processes data into reports, and reports results to decision makers. Accounting is "the language of business." The better you understand the language, the better you can make decisions using accounting information.

Accounting produces the financial statements that report information about a business entity. The financial statements report a business's financial position, operating performance, and cash flows, among other things. In this chapter, we focus on Dollarama's 2018 financial statements. By the end of the chapter, you will have a basic understanding of these statements.

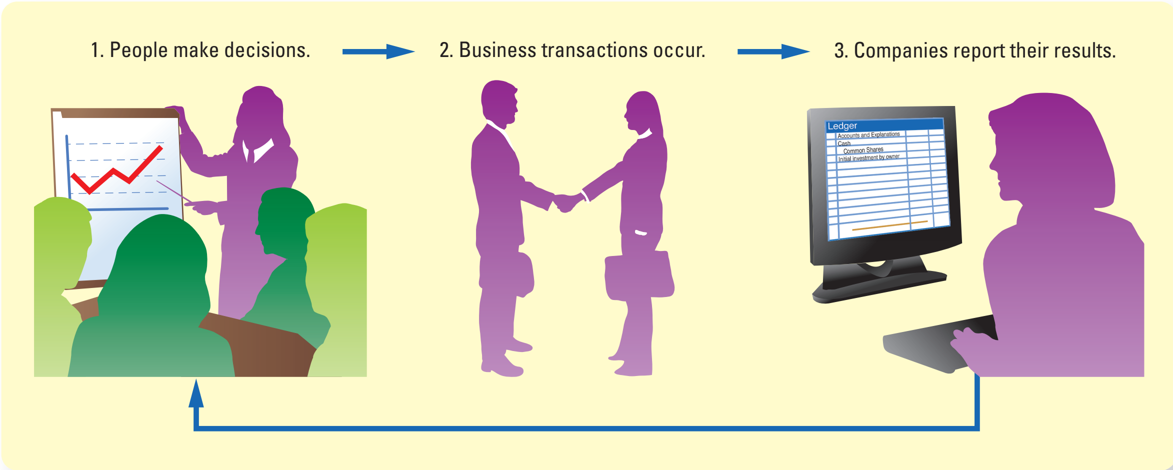
Don't confuse bookkeeping and accounting. Bookkeeping is a mechanical part of accounting, just as arithmetic is a mechanical part of mathematics. Accounting, however, requires an understanding of the principles used to accurately report financial information, as well as the professional judgment needed to apply them and then interpret the results. Exhibit 1-1 illustrates the flow of accounting information and helps illustrate accounting's role in business. The accounting process starts and ends with people making decisions.

Who Uses Accounting Information?

Almost everyone uses accounting information! Students use it to decide how much of their income to save for next year's tuition. Managers use it to decide if they should expand their business. Let's take a closer look at how these and other groups use accounting information.

MANAGERS. Managers have to make many business decisions. Should they introduce a new product line? Should the company set up a regional sales office in Australia or South Africa? Should they consider acquiring a competitor? Should the company extend credit to a potential major customer? Accounting information helps managers make these decisions.

EXHIBIT 1-1
The Flow of Accounting Information



INVESTORS AND CREDITORS. Investors and creditors provide the money to finance a business's activities. Investors want to know how much income they can expect to earn on their investment. Creditors want to know if and how a business is going to pay them back. Accounting information allows investors and creditors to make these decisions.

GOVERNMENT AND REGULATORY BODIES. Many government and regulatory bodies use accounting information. For example, the federal government requires businesses, individuals, and other organizations to pay income and sales taxes. The Canada Revenue Agency uses accounting information to ensure these organizations pay the correct amount of taxes. The Ontario Securities Commission requires companies whose stock is traded publicly to provide the Commission with many kinds of periodic financial reports. All of these reports contain accounting information.

INDIVIDUALS. People like you manage bank accounts and decide whether to rent an apartment or buy a house. They also determine their monthly income and then decide how much to spend and save each month. Accounting provides the information needed to make these decisions.

NOT-FOR-PROFIT ORGANIZATIONS. Not-for-profit organizations—churches, hospitals, and charities, such as Habitat for Humanity and the Canadian Red Cross—base their decisions on accounting information. In addition, accounting information is the basis of a not-for-profit's reporting on the organization's stewardship of funds received and its compliance with the reporting requirements of the Canada Revenue Agency.

Two Kinds of Accounting: Financial Accounting and Management Accounting

Accounting information falls into two categories: financial accounting and management accounting. The distinction is based primarily on who uses the information in each category. Both *internal and external users* rely on financial accounting information, whereas management accounting information is used by *internal users only*.

Financial accounting provides information for managers inside the business and for decision makers outside the organization, such as investors, creditors, government agencies, and the public. This information must be relevant for the needs of decision makers and must provide a faithful representation of the entity's economic activities. This textbook focuses on financial accounting.

Management accounting generates inside information for the managers of the organization. Examples of management accounting information include budgets, forecasts, and projections that are used to make strategic business decisions. Internal information must be accurate and relevant for the decision needs of managers. Management accounting is covered in a separate course.

Organizing a Business

A business can be organized in one of three forms: a proprietorship, a partnership, or a corporation. Exhibit 1-2 summarizes the key features of each form. Regardless of its form, every organization must produce accounting information so its stakeholders can make decisions about it.

EXHIBIT 1-2
The Various Forms of Business Organization

	Proprietorship	Partnership	Corporation
Owner(s)	Proprietor—one owner	Partners—two or more owners	Shareholders—generally many owners
Life of entity	Limited by owner's choice or death	Limited by owners' choice or death	Limited by owners' choice, but not their death
Personal liability of owner(s) for business debts	Proprietor is personally liable	Partners are usually personally liable	Shareholders are not personally liable
Accounting status	Accounting entity is separate from proprietor	Accounting entity is separate from partners	Accounting entity is separate from shareholders

PROPRIETORSHIPS. A **proprietorship** is an unincorporated business with a single owner, called the proprietor. Dell Computer started out in the college dorm room of Michael Dell, the owner. Proprietorships tend to be small businesses, such as the vendors that set up stalls at farmers' markets, or individual professional organizations, such as physicians, lawyers, and accountants. From a legal perspective, the business *is* the proprietor, and the proprietor is personally liable for all business debts. But for accounting, a proprietorship is an entity separate from its proprietor. Thus, the business records do not include the proprietor's personal finances.

PARTNERSHIPS. A **partnership** is an unincorporated business with two or more parties as co-owners, and each owner is a partner. Individuals, corporations, partnerships, or other types of entities can be partners. The income (or loss) of the partnership "flows through" to the partners and they recognize it based on their agreed-upon percentage interest in the business. The partnership is not a taxpaying entity. Instead, each partner takes a proportionate share of the entity's taxable income and pays tax according to that partner's individual or corporate rate. Many retail establishments and some professional organizations of physicians, lawyers, and accountants are partnerships. Most partnerships are small or medium-sized, but some are very large, with several hundred partners. Accounting treats the partnership as a separate organization, distinct from the personal affairs of each partner. But the law views a partnership as the partners: Normally, each partner is personally liable for all the partnership's debts. For this reason, partnerships can be quite risky. Recently, professional partnerships such as public accounting firms and law firms have become limited liability partnerships (LLPs), which limits claims against the partners to their partnership assets.

CORPORATIONS. A **corporation** is an incorporated business owned by its **shareholders**, who own **shares** representing partial ownership of the corporation. One of the major advantages of a corporation is the ability to raise large sums of capital by issuing shares to the public. Individuals, partnerships, other corporations, or other types of entities may be shareholders in a corporation. Most well-known companies, such as TD Bank, Rogers, and Apple, are corporations. As with Dollarama Inc., their legal names include *Corporation* or *Incorporated* (abbreviated *Corp*. and *Inc*.) to indicate they are corporations. Some, like the Ford Motor Company, bear the name *Company* to denote this fact.

A corporation is formed under federal or provincial law. From a legal perspective, unlike proprietorships and partnerships, a corporation is distinct from its owners. The corporation is like an artificial person and possesses many of the rights that a person has. Unlike proprietors and partners, the shareholders who own a corporation have no personal obligation for its debts; so we say shareholders have limited liability, as do partners in an LLP. Also, unlike other forms of organizations, a corporation pays income taxes. In the other two cases, income tax is paid personally by the proprietor or partners.

A corporation's ownership is divided into shares of stock. One becomes a shareholder by purchasing the corporation's shares. Dollarama, for example, has issued more than 100 million shares of stock. Any investor can become a co-owner of Dollarama by buying shares of its stock through the Toronto Stock Exchange (TSX).

The shares of a public corporation like Dollarama are widely held, which means they are owned by thousands of different shareholders who buy and sell the shares on a stock exchange. Shares of a private corporation are typically owned by a small number of shareholders, often including the founder and other family members.

The ultimate control of a corporation rests with the shareholders. They normally get one vote for each voting share they own. Shareholders also elect the members of the **board of directors**, which sets policy for the corporation and appoints officers. The board elects a chairperson, who is the most powerful person in the corporation and may also carry the title chief executive officer (CEO), the top management position. Most corporations also have vice-presidents in charge of sales, manufacturing, accounting and finance, and other key areas.

STOP + THINK (1-1)

State whether each of the following business organizations is a proprietorship, a partnership, or a corporation.

1. Farook and Ahmed each own 50% of the shares of Waterloo Motors Inc., a car dealership.
2. Jenna and James own and operate The Culinary Counter, a meal-preparation and catering business, in which they equally share the workload and profits.
3. Agata crafts handmade jewellery that she sells online and at local craft markets.

DESCRIBE THE PURPOSE AND EXPLAIN THE ELEMENTS OF EACH FINANCIAL STATEMENT

OBJECTIVE

2 **Describe** the purpose and **explain** the elements of each financial statement

The financial statements present a company's financial results to users who wish to examine the company's financial performance. What would users want to know about a company's performance? The answer to this question will vary by user, but Exhibit 1-3 presents four main questions most users would ask, as well as the financial statement that would be used to answer each question.

Each of the four financial statements reports transactions and events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the *elements of financial statements*. Exhibit 1-3 presents the main elements of each financial statement. Before we examine each statement and its elements, we will introduce the generally accepted accounting principles that are used to prepare these statements.

EXHIBIT 1-3
The Financial Statements and Their Elements

Question	Financial Statement	Elements
1. How much income did the company earn during the year?	Income statement	Total income (revenues + gains) − Total expenses (expenses + losses) Net income (or Net loss)
2. Why did the company's retained earnings change during the year?	Statement of retained earnings	Beginning retained earnings + Net income + Other comprehensive income (IFRS only) − Dividends Ending retained earnings
3. What is the company's financial position at the end of the year?	Balance sheet	Assets = Liabilities + Owners' equity
4. How much cash did the company generate and spend during the year?	Statement of cash flows	Operating cash flows ± Investing cash flows ± Financing cash flows Increase (or decrease) in cash

Generally Accepted Accounting Principles

Accountants prepare financial accounting information according to professional guidelines called **generally accepted accounting principles (GAAP)**. GAAP specify the standards for how accountants must record, measure, and report financial information. In Canada, GAAP are established by the Chartered Professional Accountants of Canada (CPAC).

Canada actually has multiple sets of GAAP, with each set being applicable to a specific type of entity or organization. **Publicly accountable enterprises (PAEs)**, which are corporations and other organizations that have issued or plan to issue shares or debt in public markets such as the Toronto Stock Exchange, *must* apply **International Financial Reporting Standards (IFRS)**. IFRS are set by the International Accounting Standards Board and have been adopted by over 100 countries to enhance the comparability of the financial information reported by public enterprises around the world.

Private enterprises, which comprise proprietorships, partnerships, and corporations that have not issued and do not plan to issue shares or debt on public markets, *have the option* of applying IFRS. Because IFRS are relatively complex and costly to apply, however, very few Canadian private enterprises have adopted them. Instead, they apply another set of GAAP known as **Accounting Standards for Private Enterprises (ASPE)**, which have been set by the CPAC. At the introductory financial accounting level, there are very few major differences between IFRS and ASPE, but we will discuss them where they do exist and also summarize them at the end of each chapter. In addition, all the IFRS—ASPE differences we discuss in the book have been compiled in Appendix C.

There are other sets of GAAP applicable to not-for-profit organizations, pension plans, and public sector entities, but they are too specialized to cover at the introductory level. If you choose to pursue accounting as a career, you will learn about them in the future.

The Income Statement Measures Operating Performance

The **income statement** (also known by various other names such as statement of earnings, statement of net earnings, or statement of profit or loss) measures a company's operating performance for a *specified period of time*. The period of time covered by an income statement is typically a month, a quarter (three months), or a year, and will always be specified in the heading of the statement. In the heading of Dollarama's income statement (which it calls the statement of net earnings) in Exhibit 1-4, we can see that it covers the years ended January 28, 2018, and January 29, 2017. Financial statements for the current year are easier to analyze and interpret when they can be compared to the prior year's statements, so you will always see the prior year's results presented beside those of the current year (unless it is an entity's first year of operations). Most companies have a *fiscal year* that ends on December 31 (known as a *calendar year-end*), but a company can choose whatever fiscal year-end date it desires. Most of Canada's big banks, for example, have a fiscal year-end of October 31. Some companies, such as Dollarama, have fiscal year-end dates that vary from year to year, usually because they fall on the Saturday closest to a calendar year-end date. The income statement has two main elements, income and expenses, which are discussed in more detail below.

INCOME. A company's **income** includes both **revenue** and **gains**. Revenue consists of amounts earned by a company in the course of its ordinary, day-to-day business

EXHIBIT 1-4
Consolidated Statements of Net Earnings (Adapted)

Source: Data from U.S. Securities and Exchange Commission.

	A	B	C
1	**Dollarama Inc.** Consolidated Statements of Net Earnings (Adapted) For the Years Ended January 28, 2018 and January 29, 2017		
2	***(in millions of dollars)***	**2018**	**2017**
3	**Sales**	$ 3,266.1	$ 2,963.2
4	Cost of sales	1,965.2	1,801.9
5	**Gross profit**	1,300.9	1,161.3
6	General, administrative and store operating expenses	474.8	458.0
7	Depreciation and amortization	70.6	57.8
8	Financing costs	39.9	33.1
9	**Earnings before income taxes**	715.6	612.4
10	**Income taxes**	196.2	166.8
11	**Net earnings**	$ 519.4	$ 445.6
12			

activities. Revenue is referred to by a variety of different names, including sales, fees, interest, dividends, royalties, and rent. The vast majority of a company's revenue is earned through the sale of its primary goods and services. Loblaws, for example, earns most of its revenue by selling groceries and other household goods. An accounting firm such as KPMG earns revenue by providing accounting, tax, and other professional services to its clients. Dollarama's ordinary business activities consist of the sale of goods at the more-than 1,000 stores it operates across Canada. On line 3 of Dollarama's 2018 income statement, we see that it earned Sales revenues of $3.27 billion in 2018. You will learn more about revenue and how to account for it in Chapter 3.

Gains represent other items that result in an *increase* in economic benefits to a company and may, but usually do not, occur in the course of the company's ordinary business activities. If, for example, Dollarama sold one of the buildings it owns for an amount that exceeded what it was last recorded at in the financial statements, the excess would be recognized as a gain on the income statement. Significant gains are reported on a separate line of the income statement because knowledge of these gains is useful for making decisions. Dollarama does not report any gains on its 2018 income statement. You will learn more about some common types of gains in Chapters 6 and Appendix B.

EXPENSES. A company's expenses consist of **losses** as well as those expenses that are incurred in the course of its ordinary business activities. **Expenses** consist mainly of the costs incurred to purchase the goods and services a company needs to run its business on a day-to-day basis. For Dollarama, these expenses include the cost of the party supplies, kitchenware, and other goods it sells to customers, which is an expense commonly known as the *cost of goods sold* or *cost of sales*, an item you will learn more about in Chapter 5. Dollarama's cost of sales was $1.97 billion in 2018 (line 4). The wages it pays its employees, the rent it pays on its stores, and many more expenses, would be included in the $474.8 million of "General, administrative and store operating expenses" on line 6 of Dollarama's income statement. On line 8, we see that Dollarama incurred "Financing costs" of $39.9 million, which consist mostly of the interest expense it paid on the money it has borrowed from banks and other lenders (less, or net of, any interest it earned on investments), a topic that will be covered in Chapter 7. The last expense on Dollarama's income statement is "Income taxes" of $196.2 million (line 10). You likely know a little bit about this kind of expense already, but it will be discussed more in Chapter 7. There are many more expenses that companies incur on a day-to-day basis that are not typically disclosed separately on the income statements of public companies, either because they are not large enough to present or because they are too sensitive to disclose to competing companies. You will encounter many of these expenses as you progress through the book.

Losses are the opposite of gains, and represent items that result in a *decrease* in economic benefits to a company. Like gains, they may, but usually do not, occur in the course of the company's ordinary business activities. If, for example, Dollarama sold some equipment it owns for an amount that was less than what it was last recorded at in the financial statements, the difference would be recognized as a loss on the income statement. As with gains, significant losses are reported on a separate line of the income statement. Dollarama does not report any losses on its 2018 income statement, but in its Statement of Cash Flows in Exhibit 1-8, we can see it did suffer a very small loss on disposal of assets of $207,000. You will learn more about some common types of losses in Chapter 6.

The income statement also reports a company's **net income**, which is calculated as follows:

Net Income = Total Revenues and Gains − Total Expenses and Losses

In accounting, the word *net* refers to the amount of something that is left after something else has been deducted from an initial total. In this case, *net income* is the amount of *income* that is left after *total expenses* (expenses + losses) have been deducted from *total income* (revenues + gains) for the period. When total expenses exceed total income, the result is called a **net loss**. Net income is sometimes known as **net earnings** or **net profit**, and is *usually considered the most important amount in a company's financial statements*. It is a key component of many financial ratios, including return on equity and earnings per share, which you will learn about in later chapters of this book.

A company whose net income is consistently increasing is usually regarded by investors and creditors as a healthy and high-quality company. In the long run, the company's value should increase. On line 11 of Dollarama's income statement, we see that its net earnings increased from $445.6 million in 2017 to $519.4 million in 2018, so Dollarama's managers, investors, and creditors should have been pleased with its 2018 operating performance. You will see Dollarama's net earnings of $519.4 million carried forward to its statement of retained earnings, which is discussed in the next section.

The Statement of Retained Earnings Reports Changes in Retained Earnings

A company's **retained earnings** represent the accumulated net income (or net earnings) of the company since the day it started business, less any net losses and dividends declared during this time. When the accumulated amount is negative, the term **deficit** is used to describe it. The **statement of retained earnings** reports the changes in a company's retained earnings during the same period covered by the income statement. Under ASPE, this statement is often added to the bottom of the income statement, although it may also be presented as a completely separate statement. Under IFRS, information on the changes in retained earnings is included in the *statement of changes in shareholders' equity*, which you will learn more about in Chapter 8. At the beginning of 2018, Dollarama had a deficit of $343 million (line 3 of Exhibit 1-5). Let's look at the major changes to Dollarama's deficit during 2018.

- Because retained earnings represent a company's accumulated net income, the first addition to the opening balance is Dollarama's net earnings of $519 million (line 4), which comes directly from line 11 of the income statement in Exhibit 1-4.
- On line 5, we see that Dollarama declared dividends of $49 million during 2018. Dividends represent the distribution of past earnings to current shareholders of the company. You will learn more about dividends in Chapter 8.

After accounting for other reductions during 2018 (line 6; these reductions result from transactions covered in upper-level accounting courses), Dollarama reports a closing deficit of $663 million on line 7. This balance will be carried forward to the shareholders' equity section of the balance sheet, which is the next financial statement we will introduce to you.

	A	B	C
1	**Dollarama Inc.** Consolidated Statements of Deficit (Adapted) For the Years Ended January 28, 2018 and January 29, 2017		
2	*(in millions of dollars)*	**2018**	**2017**
3	**Balance, beginning of year**	$ (343)	$ (62)
4	Net earnings	519	446
5	Dividends	(49)	(48)
6	Other reductions	(790)	(679)
7	**Balance, end of year**	$ (663)	$ (343)
8			

EXHIBIT 1-5
Consolidated Statements of Deficit (Adapted)

Source: Data from U.S. Securities and Exchange Commission.

The Balance Sheet Measures Financial Position

A company's financial position consists of three elements: the assets it controls, the liabilities it is obligated to pay, and the equity its owners have accumulated in the business. These elements are reported in the **balance sheet**, which under IFRS is also known as the **statement of financial position**. (For simplicity, this financial statement will be referred to as the balance sheet throughout the textbook.) The balance sheet reports a company's financial position *as at a specific date*, which always falls on the last day of a monthly, quarterly, or annual reporting period. Because it is presented as at a specific date, you can think of the balance as a snapshot of the company's financial position at a particular point in time. The Dollarama balance sheet in Exhibit 1-6 reports its financial position as at the year-end dates of January 28, 2018 and January 29, 2017.

The balance sheet takes its name from the fact that the assets it reports must *always* equal—or be in balance with—the sum of the liabilities and equity it reports. This relationship is known as the **accounting equation**, and it provides the foundation for the double-entry method of accounting you will begin to learn in Chapter 2. Exhibit 1-7 illustrates the equation using the figures from Dollarama's 2018 balance sheet in Exhibit 1-6.

IFRS and ASPE define assets, liabilities, and equity using different terms, but the definitions are essentially equivalent. The IFRS definitions are used below, primarily because they are more concise than the ASPE definitions.

ASSETS. An **asset** is a resource controlled by the company as a result of past events and from which the company expects to receive future economic benefits. Let's use two of Dollarama's assets to illustrate this formal definition. One of Dollarama's assets is Accounts Receivable of $15.3 million (line 6), which represent money receivable from (or owed by) customers who purchased Dollarama's products on account (or on credit) on a past date, with the promise to pay the money owing at a later date. In the future, when customers do pay off their accounts, Dollarama will receive the economic benefit of Cash (line 4), another asset, which it can use to fund future business activities. Dollarama had $54.8 million in cash in its bank accounts and at its stores at the end of 2018.

We classify assets into two categories on the balance sheet: **current assets** and **non-current assets**. We classify an asset as current when we expect to convert it to cash, sell it, or consume it *within one year* of the balance sheet date, or within the business's normal operating cycle if it is longer than one year. Current assets are listed in order of their **liquidity**, which is a measure of how quickly they can be converted to cash, the most liquid asset. At the end of 2018, Dollarama