Fifth Canadian Edition

FINANCIAL ACCOUNTING

HARRISON | HORNGREN | THOMAS | BERBERICH | SEGUIN

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FIFTH CANADIAN EDITION

FINANCIAL ACCOUNTING

WALTER T. HARRISON, JR.
BAYLOR UNIVERSITY

CHARLES T. HORNGREN
STANFORD UNIVERSITY

C. WILLIAM (BILL) THOMAS
BAYLOR UNIVERSITY

GREG BERBERICH
UNIVERSITY OF WATERLOO

CATHERINE SEGUIN
UNIVERSITY OF TORONTO

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TORONTO

To Jeanette, Simon, and Juliana
—Greg Berberich

To Dennis, Andrea, Allison, and Mark
—Catherine I. Seguin

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Contents

About the Authors

Walter T. Harrison, Jr., is Professor Emeritus of Accounting at the Hankamer School of Business, Baylor University. He received his BBA degree from Baylor University, his MS from Oklahoma State University, and his PhD from Michigan State University.

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 Certified Public Accountants, 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.

Harrison has lectured in several foreign countries and published articles in numerous journals, including *The Accounting Review, 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*. He is coauthor of *Financial Accounting*, Seventh Edition, 2006 (with Charles T. Horngren) and *Accounting*, Eighth Edition (with Charles T. Horngren and Linda S. Bamber) published by Pearson Prentice Hall. Harrison has received scholarships, fellowships, research grants, or awards from Price Waterhouse & Co., Deloitte & Touche, the Ernst & Young Foundation, and the KPMG Peat Marwick Foundation.

Charles T. Horngren is 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 is also the recipient of honourary doctorates from Marquette University and DePaul University.

A Certified Public Accountant, Horngren served on the U.S. 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 in the United States.

A member of the American Accounting Association, Horngren has been 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 is the first person to have received both awards.

Horngren was named Accountant of the Year, Education, by the international professional accounting fraternity Beta Alpha Psi and is a member of the U.S. Accounting Hall of Fame.

Horngren is also a member of the Institute of Management Accountants, where he has 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 the author of other accounting books published by Pearson Prentice Hall and Pearson Canada Inc.: *Cost Accounting: A Managerial Emphasis*, Fifth Canadian Edition, 2010 (with George Foster, Srikant Datar, and Maureen Gowing) and *Accounting*, Canadian Eighth Edition, 2010 (with Walter T. Harrison, Linda S. Bamber, W. Morley Lemon, Peter R. Norwood, and Jo-Ann Johnston).

Horngren is the Consulting Editor of the Charles T. Horngren Series in Accounting.

Charles 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, Bill 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 from 1983 until 1995. He was recognized as an Outstanding Faculty Member of Baylor University in 1984 and Distinguished Professor for the Hankamer School of Business in 2002. Dr. Thomas has received several awards for outstanding teaching, including the Outstanding Professor in the Executive MBA Programs in 2001, 2002, and 2006. In 2004, he received the designation as 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. His most recent publication of national prominence is "The Rise and Fall of the Enron Empire," which appeared in the April 2002 Journal of Accountancy, and which was selected by Encyclopedia Britannica for inclusion in its Annals of American History. He presently serves as both technical and 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 practicing accountant with the firms of KPMG, LLP, and BDO Seidman, LLP. He is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Texas Society of Certified Public Accountants.

Greg Berberich, CPA, CA, PhD, is the Director of the Masters of Accounting program in the School of Accounting and Finance at the University of Waterloo, where he has been a Lecturer since 2011. Before that, 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.

Berberich 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*. Berberich was also the Treasurer of the Society for Teaching and Learning in Higher Education and the Associate Director of Teaching and Learning in Waterloo's School of Accounting and Finance. He has written a number of cases for use in university courses and professional training programs. This is Berberich's first time coauthoring a textbook.

Catherine I. Seguin, MBA, CGA, is a Senior Lecturer at the University of Toronto Mississauga. In addition to her books *Accounting for Not-for-Profit Organizations* for Carswell (Thomson-Reuters) and *Not-for-Profit Accounting*, published by CGA Canada, she revised the study guide that accompanied the third edition of this textbook. She also coauthored a practice book on management accounting and wrote a test bank for a financial accounting book for McGraw-Hill.

At the University of Toronto Mississauga, Catherine initiated, organized, and continues to run an internship course where fourth-year Bachelor of Commerce and Bachelor of Business Administration students are given an opportunity to gain practical business experience to complement their field of studies. She has organized, co-hosted, and chaired ongoing workshops that invite all University of Toronto Mississauga professors teaching first-year classes to discuss and learn what pedagogical and organizational issues they face. She serves as Dean's Designate for academic offences in the Social Sciences.

In the business community, she has participated in the consultation of the reform of the Canada Corporations Act for not-for-profit organizations. In the past, she has served on several boards of not-for-profit organizations and has been a professional development speaker for CGA Ontario on the topic of not-for-profit accounting. Currently, she serves as Treasurer on the board of a small not-for-profit organization.

Preface

Helping Students Build a Solid *Financial Accounting* Foundation

Financial Accounting introduces the financial statements and the conceptual framework that underlies them in Chapter 1 and builds on this foundation throughout the remaining 12 chapters. 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. By introducing financial accounting's most critical concepts and procedures early in the book and then repeatedly applying them in the context of new material in later chapters, students will finish the textbook with a sound grasp of introductory financial accounting principles.

This book also features a new coauthor, Greg Berberich, from the University of Waterloo, who brings 25 years of experience practising and teaching accounting to the Fifth Canadian Edition textbook. Greg contributed to seven of the book's 13 chapters and also suggested some of its new or revised pedagogical features.

Visual Walkthrough

UPDATED! Learning Objectives on the first page of every chapter clearly specify what students should be able to do once they have finished reading the chapter and completing the accompanying exercises, problems, and cases. Each objective also serves as the heading of the chapter section in which the related concepts are presented, providing students with a clear link between the objectives and the material that will help them achieve those objectives.

UPDATED! Chapter-Opening Vignettes provide students with clear links between chapter topics and the business decisions made by many familiar real-world companies. Some of the companies students will encounter include Apple, Le Château, WestJet, and TELUS.

UPDATED! User-Oriented Approach focuses students' attention on the relevance and interpretation of information in the financial statements by adding coverage of several new ratios, which will enhance their ability to evaluate a company's liquidity, turnover, and profitability. New end-of-chapter problems give students additional practice using these new ratios.

SPOTLIGHT

If you've ever shopped for a smartphone, tablet, or mobile Internet service, you have very likely been in a TELUS store. Based in British Columbia, TELUS Corporation is one of Canada's largest telecommunications companies, providing a range of products and services, including mobile computing devices, wireless voice and data access, satellite television, and home phone service. As of 2011, TELUS had 7.3 million wireless subscribers, 1.3 million Internet subscribers, and 509,000 TV subscribers. TELUS is fea-

LEARNING OBJECTIVES

1. **Explain** why accounting is the language of business
2. **Explain** accounting's conceptual framework and underlying assumptions
3. **Describe** the purpose of each financial statement and **explain** the elements of each one
4. **Explain** the relationships

making a final assessment of TELUS's 2011 financial performance. Imagine you work for a bank that TELUS 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 TELUS? 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,

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.

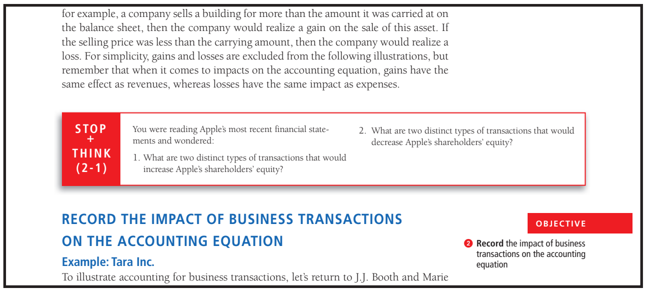
OBJECTIVE

2. **Explain** accounting's conceptual framework and underlying assumptions

EXPLAIN ACCOUNTING'S CONCEPTUAL FRAMEWORK AND UNDERLYING ASSUMPTIONS

Generally Accepted Accounting Principles

NEW! Focus on Analysis sections use the company TELUS Corporation, one of Canada's largest and most successful telecommunications companies, to illustrate key concepts throughout the book. Each chapter also features two problems that require students to analyze TELUS's financial statements, so they can clearly see how the concepts they are learning help them understand a real and well-known company's financial situation.


for example, a company sells a building for more than the amount it was carried at on the balance sheet, then the company would realize a gain on the sale of this asset. If the selling price was less than the carrying amount, then the company would realize a loss. For simplicity, gains and losses are excluded from the following illustrations, but remember that when it comes to impacts on the accounting equation, gains have the same effect as revenues, whereas losses have the same impact as expenses.

STOP + THINK (2-1)

You were reading Apple's most recent financial statements and wondered:

1. What are two distinct types of transactions that would increase Apple's shareholders' equity?
2. What are two distinct types of transactions that would decrease Apple's shareholders' equity?

RECORD THE IMPACT OF BUSINESS TRANSACTIONS ON THE ACCOUNTING EQUATION

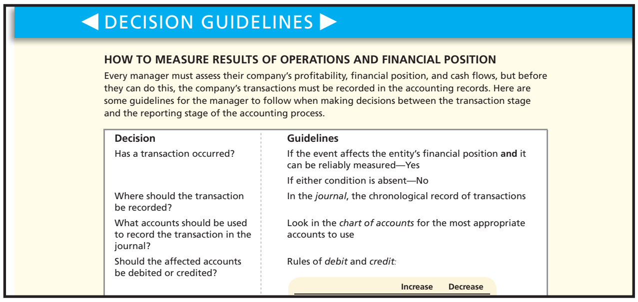
OBJECTIVE

2 **Record** the impact of business transactions on the accounting equation

Example: Tara Inc.

To illustrate accounting for business transactions, let's return to J.J. Booth and Marie

UPDATED! Stop + Think problems offer students the opportunity to pause in their reading and apply what they've just read to basic but realistic problems. The solutions to these problems have been moved to the end of each chapter, so students can't glance at them as they read the problems.

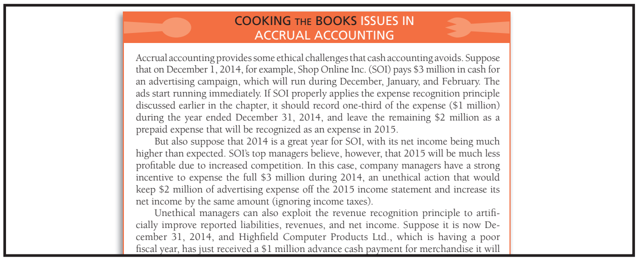

DECISION GUIDELINES

HOW TO MEASURE RESULTS OF OPERATIONS AND FINANCIAL POSITION

Every manager must assess their company's profitability, financial position, and cash flows, but before they can do this, the company's transactions must be recorded in the accounting records. Here are some guidelines for the manager to follow when making decisions between the transaction stage and the reporting stage of the accounting process.

Decision	Guidelines
Has a transaction occurred?	If the event affects the entity's financial position **and** it can be reliably measured—Yes If either condition is absent—No
Where should the transaction be recorded?	In the *journal*, the chronological record of transactions
What accounts should be used to record the transaction in the journal?	Look in the *chart of accounts* for the most appropriate accounts to use
Should the affected accounts be debited or credited?	Rules of *debit* and *credit*: Increase Decrease

NEW! Decision Guidelines show students how managers, investors, and creditors would apply key financial accounting concepts to make critical business decisions.

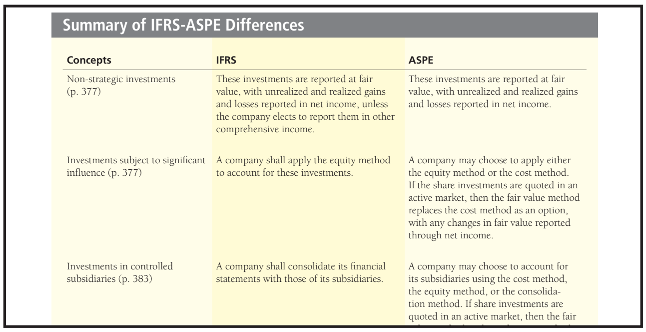

COOKING THE BOOKS ISSUES IN ACCRUAL ACCOUNTING

Accrual accounting provides some ethical challenges that cash accounting avoids. Suppose that on December 1, 2014, for example, Shop Online Inc. (SOI) pays $3 million in cash for an advertising campaign, which will run during December, January, and February. The ads start running immediately. If SOI properly applies the expense recognition principle discussed earlier in the chapter, it should record one-third of the expense ($1 million) during the year ended December 31, 2014, and leave the remaining $2 million as a prepaid expense that will be recognized as an expense in 2015.

But also suppose that 2014 is a great year for SOI, with its net income being much higher than expected. SOI's top managers believe, however, that 2015 will be much less profitable due to increased competition. In this case, company managers have a strong incentive to expense the full $3 million during 2014, an unethical action that would keep $2 million of advertising expense off the 2015 income statement and increase its net income by the same amount (ignoring income taxes).

Unethical managers can also exploit the revenue recognition principle to artificially improve reported liabilities, revenues, and net income. Suppose it is now December 31, 2014, and Highfield Computer Products Ltd., which is having a poor fiscal year, has just received a $1 million advance cash payment for merchandise it will

NEW! Cooking the Books highlight real fraud cases in relevant sections throughout the text, giving students context to the material they are learning through real-life business situations.


Summary of IFRS-ASPE Differences

Concepts	IFRS	ASPE
Non-strategic investments (p. 377)	These investments are reported at fair value, with unrealized and realized gains and losses reported in net income, unless the company elects to report them in other comprehensive income.	These investments are reported at fair value, with unrealized and realized gains and losses reported in net income.
Investments subject to significant influence (p. 377)	A company shall apply the equity method to account for these investments.	A company may choose to apply either the equity method or the cost method. If the share investments are quoted in an active market, then the fair value method replaces the cost method as an option, with any changes in fair value reported through net income.
Investments in controlled subsidiaries (p. 383)	A company shall consolidate its financial statements with those of its subsidiaries.	A company may choose to account for its subsidiaries using the cost method, the equity method, or the consolidation method. If share investments are quoted in an active market, then the fair

NEW! IFRS-ASPE Differences are summarized at the end of several chapters to identify the differences that exist between these two sets of Canadian generally accepted accounting principles. Appendix B also contains a summary of all the IFRS-ASPE differences mentioned in the book.

UPDATED! End-of-Chapter Summaries clearly highlight the key concepts related to each learning objective so that students will finish each chapter with an overview of its most critical material.

UPDATED! Summary Problems and Solutions appear at the midpoint and end of the chapters, providing students with guidance on how to solve in-depth problems using concepts that have just been discussed in the text.

NEW! Microsoft Excel™ in MyAccountingLab

- Now students can get real-world Excel practice in their classes.
- Instructors have the option to assign students End-of-Chapter questions that can be completed in an Excel-simulated environment.
- Questions will be auto-graded, reported to, and visible in the grade book.
- Excel remediation will be available to students.

Changes to the Fifth Canadian Edition

Students and instructors will benefit from numerous changes incorporated into this latest edition of *Financial Accounting*. New student-friendly boxes called **Decision Guidelines** show students how managers, investors, and creditors would apply key financial accounting concepts to make critical business decisions. New topical **Cooking the Books** boxes highlight real fraud cases in relevant sections throughout the text, giving students context to the material they are learning through real-life business situations. New comprehensive **IFRS-ASPE Differences tables** summarized at the end of several chapters identify the differences that exist between these two sets of Canadian generally accepted accounting principles. Appendix B also contains a summary of all the IFRS-ASPE differences mentioned in the book. All material has been updated to reflect the IFRS and ASPE principles in effect at the time of writing (February 2013), or (in some cases) expected to be in effect by the time of the book's publication in 2014. The following is a summary of other significant changes made to this edition:

Chapter 1
- The first chapter has been rewritten to present key concepts with greater clarity and to eliminate redundancies with material covered in detail in later chapters.
- The coverage of the main financial statements and their elements has been revised to incorporate formal IFRS terminology and definitions and to better highlight differences between IFRS and ASPE.
- Most of the accounting vocabulary terms have been rewritten so they are consistent with IFRS/ASPE definitions.

Chapter 2
- The chapter title and learning objectives have been revised to better reflect the main purpose of the chapter and the outcomes to be achieved.
- Much of the chapter has been rewritten to present key concepts and related examples more clearly.
- This chapter now includes a Decision Guidelines section that summarizes the flow of accounting information from the transaction stage through to the financial statements.

Chapter 3
- The material on revenue and expense recognition has been rewritten to thoroughly reflect the IFRS/ASPE criteria that guide the recognition of these items. The accompanying examples have also been revised to clearly illustrate the application of each recognition principle to different scenarios.
- The coverage of adjusting entries has been revised to eliminate redundancies and to describe each major type of adjusting entry using terminology that is consistent with the rewritten revenue and expense recognition principles described above.
- Detailed coverage of the current ratio and debt ratio has been added, including illustrations of the impacts of transactions on the ratios, accompanied by a Decision Guidelines section that summarizes the use of these ratios.

Chapter 6
- More detailed explanations of how to apply the weighted-average and FIFO costing methods under both perpetual and periodic inventory systems are provided in this chapter.

- The end-of-chapter material includes several new problems on applying the weighted-average costing method under a perpetual inventory system.

Chapter 7

- This chapter now includes coverage of the return on assets, asset turnover, and net profit margin ratios, along with coverage of how to interpret these ratios using DuPont analysis.
- The end-of-chapter material has several new problems that require students to use these new ratios.

Chapter 8

- The coverage of long-term investments has been moved up several chapters to Chapter 8 to immediately follow the chapters that discuss the asset side of the balance sheet.
- Coverage of the time value of money has been moved from the appendix to this chapter, and end-of-chapter problems on this topic have been added.

Chapter 9

- This chapter now has coverage of the accounts payable turnover and leverage ratios, along with new end-of-chapter problems requiring the use of these ratios.
- Material on short-term borrowings, such as bank overdrafts and lines of credit, as well as term loans, has been added.

Chapter 10

- Much of this chapter has been rewritten to present key concepts with greater clarity and to eliminate redundancies with material covered in detail in other chapters.
- Coverage of the DuPont analysis has been added, which provides a more detailed and useful way of analyzing a company's return on equity.

Chapter 11

- Information on the statements of comprehensive income and changes in shareholders' equity has been updated to reflect proper terminology and presentation of these statements.
- Coverage of the auditor's report has also been updated to reflect new standards and wording for this report.
- Many of the accounting vocabulary terms have been rewritten so they are consistent with IFRS/ASPE definitions.

Chapter 12

- Most of this chapter has been rewritten to provide additional guidance and to improve clarity on difficult concepts, especially regarding the classification of operating, investing, and financing activities, and the treatment of changes in non-cash operating working capital accounts. Related terminology and definitions are now consistent with IFRS and ASPE.
- A mid-chapter summary problem with a focus on the operating activities section has been added, as well as a Stop + Think box with a focus on using information in the statement of cash flows.
- Most of the accounting vocabulary terms have been revised to be consistent with IFRS/ASPE definitions.

Chapter 13

- Coverage of accounts payable turnover, leverage, and the cash conversion cycle has been added to this chapter, along with end-of-chapter problems related to this new material.

Student Resources

MyAccountingLab

MyAccountingLab is a powerful online learning tool that not only provides opportunities for limitless practice, but recreates the "I get it" moments from the classroom. MyAccountingLab provides a rich suite of learning tools, including:

- Static and algorithmic versions of exercises and problems from the textbook
- An online, interactive Accounting Cycle Tutorial
- Mini-Cases
- Help Me Solve It question-specific interactive coaching
- A dynamic eText with links to media assets
- Accounting videos, animations, and DemoDocs

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Study on the Go

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Features of MyAccountingCourse include:

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- Interactive lesson presentations with a proven learning model, robust content, and relevant video, audio, eText, downloadable MP3 lectures, and other rich media assets.
- Rich MyAccountingLab-based assessment, pre-tests, quizzes, homework, and tests.

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Instructor's Resources

Instructor's Teaching Tips Digital eText Resource

Instructors can easily locate useful teaching tips and resources throughout the eText located in MyAccountingLab. Easily identified by an apple icon throughout each chapter, intructors will find Chapter Overviews and Outlines, Assignment Grids, Ten-Minute Quizzes, and other valuable teaching resources including how to integrate MyAccountingLab into your course. Collated versions of this resource can also be downloaded from the Instructor Resources page at MyAccountingLab.

The following instructor resources are available to all adopters of this textbook:

- **Instructor's Solutions Manual:** This manual contains full solutions for all end-of-chapter material.
- **Instructor's Resource Manual:** This manual contains valuable resources, including chapter outlines, teaching tips, and assignment grids. The Instructor's Resource Manual is available in the eText via the MyAccountingLab.
- **Pearson TestGen:** Over 1,500 test questions, including multiple-choice, true-or-false, and essay questions, are provided in TestGen format. TestGen is a testing software that enables instructors to view and edit the existing questions, add questions, generate tests, and distribute the tests in a variety of formats.

Powerful search and sort functions make it easy to locate questions and arrange them in any order desired. TestGen also enables instructors to administer tests on a local area network, have the tests graded electronically, and have the results prepared in electronic or printed reports. TestGen is compatible with Microsoft and Apple operating systems and can be downloaded from the TestGen website located at www.pearsoned.com/testgen. Contact your local sales representative for details and access.

- **Microsoft PowerPoint Presentations:** PowerPoint presentations offer an outline of the key points for each chapter. A new template is utilized and new content is added for this edition of the PowerPoint program.
- **Image Library:** An Image Library provides access to many of the figures and tables in the textbook.

All of these instructor supplements, except for the Instructor's Resource Manual, are also available for download from a password-protected section of Pearson Canada's online catalogue (vig.pearsoned.ca). Navigate to your book's catalogue page to view a list of those supplements that are available. See your local sales representative for details and access.

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Elisabetta Ipino, *Concordia University*

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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 two or three years of on-the-job training before they can receive a professional accounting designation. Historically, the most common accounting designations in Canada were the CA (Chartered Accountant), CMA (Certified Management Accountant), and CGA (Certified General Accountant) designations. Recently, however, the Canadian accounting profession has become more unified, so now the most prevalent designation is the CPA, which stands for Chartered Professional Accountant, although the three legacy designations are still used in some jurisdictions.

When you hold one of these designations, employers know what to expect about your education, knowledge, abilities, and personal attributes. They value your analytical skills and extensive training. Your professional 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 Ernst & Young. 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!

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FINANCIAL ACCOUNTING

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The Financial Statements

1

Bloomberg/Contributor/Getty Images

LEARNING OBJECTIVES

1. **Explain** why accounting is the language of business
2. **Explain** accounting's conceptual framework and underlying assumptions
3. **Describe** the purpose of each financial statement and **explain** the elements of each one
4. **Explain** the relationships among the financial statements
5. **Make** ethical business decisions

SPOTLIGHT

If you've ever shopped for a smartphone, tablet, or mobile Internet service, you have very likely been in a TELUS store. Based in British Columbia, TELUS Corporation is one of Canada's largest telecommunications companies, providing a range of products and services, including mobile computing devices, wireless voice and data access, satellite television, and home phone service. As of 2011, TELUS had 7.3 million wireless subscribers, 1.3 million Internet subscribers, and 509,000 TV subscribers. TELUS 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 Income on the next page, TELUS sells a lot of mobile devices and services—about \$10.3 billion worth for the year ended December 31, 2011 (line 3). After deducting a variety of expenses incurred during 2011 (lines 6–9, 12, and 14), TELUS earned net income of over \$1.2 billion for the year (line 15).

These terms—revenues, expenses, and net income—may be unfamiliar to you now, but after you read this chapter, you'll be able to explain these and many other accounting terms. Welcome to the world of accounting!

TELUS Corporation
Consolidated Statements of Income (Adapted)
For the Years Ended December 31, 2011 and 2010

(in millions of dollars)	**2011**	**2010**
Operating Revenues		
1. Service	$ 9,606	$9,131
2. Equipment	719	611
3.	10,325	9,742
4. Other operating income	72	50
5.	10,397	9,792
Operating Expenses		
6. Goods and services purchased	4,726	4,236
7. Employee benefits expense	1,893	1,906
8. Depreciation	1,331	1,339
9. Amortization of intangible assets	479	402
10.	8,429	7,883
11. **Operating Income**	1,968	1,909
12. Financing costs	377	522
13. **Income Before Income Taxes**	1,591	1,387
14. Income taxes	376	335
15. **Net Income**	$ 1,215	$1,052

Each chapter of this book begins with an actual financial statement—in this chapter, it's the Consolidated Statements of Income of TELUS Corporation for the years ended December 31, 2011 and 2010. The core of financial accounting revolves around the basic financial statements:

- Income statement (sometimes known as the statement of profit or loss)
- 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.

MyAccountingLab

MyAccountingLab provides students with a variety of resources including a personalized study plan, assignable Excel simulated questions, videos and animations, and an interactive Accounting Cycle Tutorial (ACT). Margin logos that appear throughout Chapters 2 and 3 direct you to the appropriate ACT section and material. There are three buttons on the opening page of each chapter module: **Tutorial** helps you review major concepts, **Application** gives you practice exercises, and **Glossary** allows you to review key terms.

Using Accounting Information

TELUS Corporation's managers make a lot of decisions. Which tablet is selling the best? Which smartphone is earning the most profit? Should TELUS 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 TELUS Corporation's Consolidated Statements of Income on page 2. Focus on net income (line 15). Net income is the excess of revenues over expenses. You can see that TELUS earned $1,215 million in net income for the year ended December 31, 2011. That's good news because it means that TELUS's revenues exceeded its expenses by over $1.2 billion in 2011.

TELUS's Consolidated Statements of Income convey more great news. Operating revenues grew from $9,742 million in 2010 to $10,325 million in 2011 (line 3), an increase of about 6%. Also, TELUS's 2011 net income of $1,215 million was 15.5% higher than its 2010 net income of $1,052 million (line 15). Based on these key numbers, TELUS's 2011 operating performance improved significantly from 2010.

There would, however, be much more accounting information to analyze before making a final assessment of TELUS's 2011 financial performance. Imagine you work for a bank that TELUS 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 TELUS? 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 TELUS's 2011 financial statements. By the end of the chapter, you will have a basic understanding of these statements.

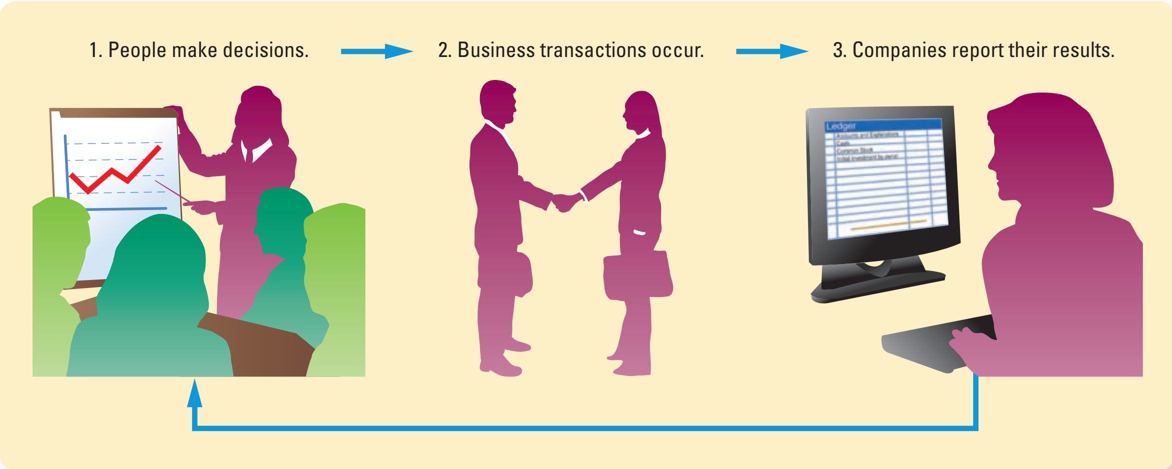
Don't confuse bookkeeping and accounting. Bookkeeping is a mechanical part of accounting, just as arithmetic is a mechanical part of mathematics. Accounting, however, requires an understanding of the principles used to accurately report financial information, as well as the professional judgment needed 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 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

Accounting is used in every type of business. A business generally takes one of the following forms:

- Proprietorship
- Partnership
- Corporation

Exhibit 1-2 compares ways to organize a business.

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 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

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' choices or death	Indefinite
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

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 TELUS Corporation, 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 the other forms of organization, 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. TELUS, for example, has issued more than 300 million shares of stock. Any investor can become a co-owner of TELUS by buying shares of its stock through the Toronto Stock Exchange (TSX).

The shares of a public corporation like TELUS 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.

OBJECTIVE

2 **Explain** accounting's conceptual framework and underlying assumptions

EXPLAIN ACCOUNTING'S CONCEPTUAL FRAMEWORK AND UNDERLYING ASSUMPTIONS

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 Canadian Institute of Chartered Accountants (CICA), one of the country's three professional accounting bodies.

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 in an effort to enhance the comparability of the financial information reported by public enterprises around the world.

Private enterprises, which 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 CICA. 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 B.

There are other sets of GAAP applicable to not-for-profit organizations, pension plans, and government 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.

Now let's examine the conceptual framework and assumptions underlying IFRS and ASPE.

Accounting's Conceptual Framework

Exhibit 1-3 gives an overview of the joint conceptual framework of accounting developed by the IASB and the Financial Accounting Standards Board (FASB) in the United States. This conceptual framework, along with several underlying assumptions, provides the foundation for the specific accounting principles included in IFRS and ASPE, though there are some small differences between the frameworks for the two sets of standards. The overall *objective* of accounting is to provide financial information about the reporting entity that is useful to current and future investors and creditors when making investing and lending decisions.

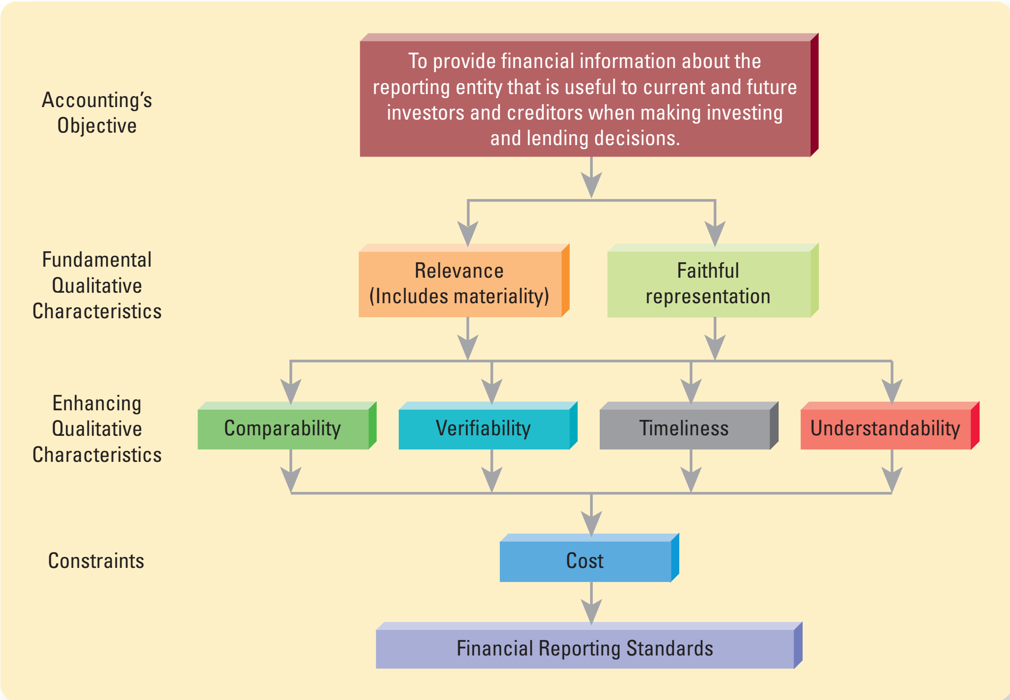
Fundamental Qualitative Characteristics

To be useful, information must have two *fundamental qualitative characteristics*:

- **relevance** and
- **faithful representation**.

To be **relevant**, information must have *predictive value, confirmatory value*, or both. Information has predictive value if it can be employed by users to predict an entity's future business or financial outcomes. It has confirmatory value if it confirms or changes prior evaluations of an entity. In addition, the information must be **material,** which means that it is significant enough in nature or magnitude that omitting or misstating it could affect the decisions of an informed user. All material information must be recorded or disclosed (listed or discussed) in the financial statements.

EXHIBIT 1-3
Accounting's Conceptual Framework



For accounting information to provide a faithful representation to users, it must reflect the *economic substance* of a transaction or event, which may not be the same as its legal form. The information must also be complete, neutral (free of bias), and accurate (free of material error). When accounting information possesses these facets of faithful representation, it is *reliable* to users.

Enhancing Qualitative Characteristics

To be useful, accounting information must also possess four *enhancing qualitative characteristics*:

- **comparability**,
- **verifiability**,
- **timeliness**, and
- **understandability**.

For accounting information to be *comparable*, it must be reported in a way that makes it possible to compare it to similar information being reported by other companies. It must also be reported in a way that is consistent with how it was reported in previous accounting periods.

Accounting information is *verifiable* when it can be checked for accuracy, completeness, and reliability. Verifiability enhances the chance that accounting information reflects a faithful representation of the economic substance of a transaction or event.

Timeliness means reporting accounting information to users in time for it to influence their decisions. Accounting information tends to become less relevant as it gets older, so it should be reported to users as soon after the end of the accounting period as possible, without sacrificing the other qualitative characteristics in the process.

Accounting information is *understandable* when it is clearly and concisely classified and presented to reasonably knowledgeable and diligent users of the information. At times, however, even informed and careful users will require assistance in understanding certain complex transactions and events.

The Cost Constraint

Accounting information is costly to produce. A primary constraint in the decision to disclose accounting information is that the cost of disclosure should not exceed the expected benefits to users. Management of an entity is primarily responsible for preparing accounting information. Managers must exercise judgment in determining whether the information is necessary for complete understanding of underlying economic facts and not excessively costly to provide.

This book introduces you to the basic financial reporting standards that have been devised using this conceptual framework. Before we begin exposing you to these standards, let's examine the assumptions that underlie this conceptual framework.

Assumptions Underlying the Conceptual Framework

The conceptual framework has only one explicit underlying assumption: the **going-concern assumption**. There are, however, three other assumptions that are implicit in the framework, so we present them here as well. They are the **separate-entity, historical-cost**, and **stable-monetary-unit assumptions**.

GOING-CONCERN ASSUMPTION. We typically prepare financial information under the assumption that the reporting entity is a going concern, which means that we expect it to continue operating normally for the foreseeable future. A company that is not a going concern is at risk of going bankrupt or closing down, so it may need to significantly scale down its operations or sell some of its assets at heavily discounted rates. When this risk is present, the financial statements are typically prepared on a basis that differs from the usual standards in IFRS or ASPE. If a different basis is used in such circumstances, it must be clearly disclosed to the users of the financial statements.

SEPARATE-ENTITY ASSUMPTION. We also prepare financial statements under the assumption that the business activities of the reporting entity are separate from the activities of its owners, so we do not mix the assets, liabilities, income, or expenses of the entity with those of its owners when reporting the entity's operating performance and financial position. Consider Gerald Schwartz, the chairman, president, chief executive officer, and major shareholder of ONEX Corporation, a large Canadian public company. Mr. Schwartz personally owns a house, automobiles, and investments in various companies. His personal assets, however, would not be included among the land, buildings, vehicles, and investments reported on ONEX's financial statements because his assets are separate from those of the entity he owns and operates. The separate-entity assumption draws a clear boundary around the business activities of the reporting entity, and only the activities within this boundary are reported in the entity's financial statements.