



HARRISON HORNGREN THOMAS TIETZ BERBERICH SEGUIN

FINANCIAL ACCOUNTING

SIXTH CANADIAN EDITION



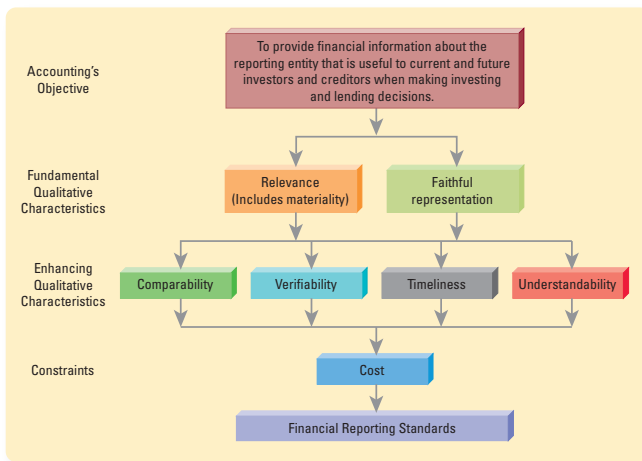
QUICK REVIEW

The Financial Statements and Their Elements

Question	Financial Statement	Elements
1. How well did the company perform 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. →

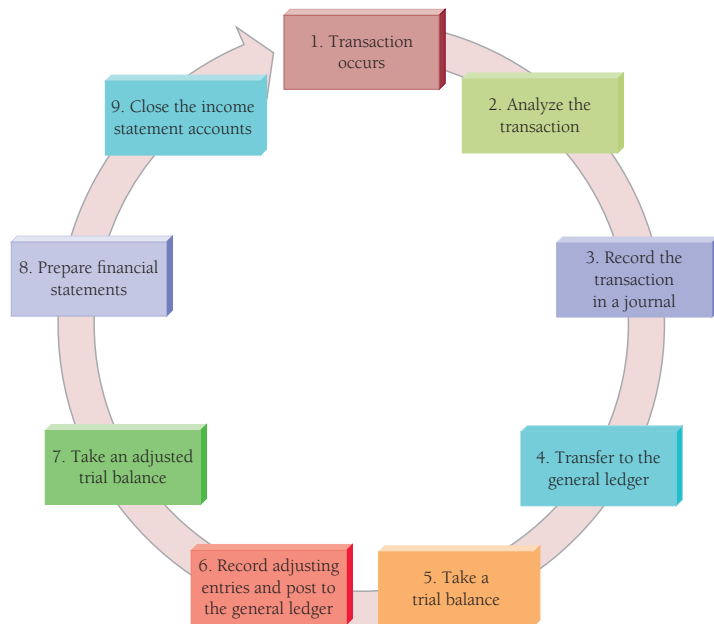
ASSETS		=	LIABILITIES		+	SHAREHOLDERS' EQUITY					
Assets			Liabilities			Share Capital		Retained Earnings		Dividends	
Debit	Credit		Debit	Credit		Debit	Credit	Debit	Credit	Debit	Credit
+	-		-	+		-	+	-	+	+	-
Normal balance				Normal balance		Normal balance	Normal balance	Normal balance	Normal balance	Normal balance	
						Revenues		Expenses			
						Debit	Credit	Debit	Credit		
						-	+	-	+		
							Normal balance		Normal Balance		

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 66.



	A	B	C	D
1	Tara Inc. Income Statement Month Ended April 30, 2017			
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		<u>\$ 7,300</u>	
10				

	A	B	C	D
1	Tara Inc. Statement of Retained Earnings Month Ended April 30, 2017			
2	Retained earnings, April 1, 2017		\$ 0	
3	Add: Net income for the month		7,300	
4	Subtotal		<u>7,300</u>	
5	Less: Dividends declared		(2,100)	
6	Retained earnings, April 30, 2017		<u>\$ 5,200</u>	
7				

	A	B	C	D	E
1	Tara Inc. Balance Sheet April 30, 2017				
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	<u>55,200</u>	
8	Total assets	<u>\$ 57,000</u>	Total liabilities and shareholders' equity	<u>\$ 57,000</u>	
9					

FINANCIAL ACCOUNTING

Dear Valued Colleagues,

Welcome to the Sixth Canadian Edition of *Financial Accounting*. We are grateful for your support as an adopter of our text as we celebrate over 15 years of success in the market. The Sixth Canadian Edition of *Financial Accounting* has been improved in many respects, as explained below.

Based on feedback from users and reviewers, some of the more advanced material in previous editions has been simplified or completely removed from the book to reduce the coverage of topics better suited to intermediate accounting courses. Also based on feedback about the Fifth Canadian Edition, some topics deemed less important by users and reviewers has been removed from the book, while other topics have been moved to more relevant chapters. As a result of these changes, the Sixth edition is more streamlined, with two fewer chapters and better-organized presentation of critical topics suitable for students in introductory financial accounting courses.

Try It in Excel®. As educators, we often have conversations with those who recruit our students. Based on these conversations, we found that students often complete their study of financial accounting without sufficient knowledge of how to use Excel to perform accounting tasks. To respond to this concern, we have adapted most of the illustrations of key accounting tasks in the book to Excel format and have added new sections in key chapters entitled “Try It in Excel,” which describe line-by-line how to retrieve and prepare accounting information (such as adjusted trial balance worksheets, ratio computations, and financial statement analysis) in Excel format.

Student success. We feel we have the most advanced student learning materials in the market with MyAccountingLab. These include automatically graded homework, DemoDocs, and learning aid videos. We believe that the use of MyAccountingLab homework will greatly enhance student understanding of accounting with its instantaneous feedback. MyAccountingLab makes the study of financial accounting a more interactive and fun experience for students. In addition, we have adopted a scaffolding approach in the book and its resources. Chapter content and the end-of-chapter material builds from the basic short exercise featuring one basic single concept to more advanced problems featuring multiple learning objectives. The student can practice at the basic level and then build upon that success to advance on to more challenging problems.

Professor expectations. As professors, we know that you want a book that contains the most relevant and technically correct content available. We also know that you want excellent end-of-chapter material that is as up-to-date and error-free as possible. We reviewed and created the end-of-chapter questions, exercises, problems, and cases taking into account the types of assignments we ourselves use in class and assign as homework. Based on comments from adopters, we have thoroughly reviewed every end-of-chapter exercise and problem, with the goal of eliminating redundancy and adding relevance. The textbook and solutions manual have been put through a rigorous accuracy check to ensure that they are as complete and error-free as possible.

*Bill Thomas
Wendy Tietz
Greg Berberich
Catherine Seguin*

SIXTH CANADIAN EDITION

FINANCIAL ACCOUNTING

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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 Certified Public 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 honorary 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.

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, 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 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 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.

**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, where she has taught since 2000. She teaches introductory financial and managerial accounting in a variety of formats, including large sections, small sections, and web-based sections. She has received numerous college and university teaching awards while at Kent State University. Most recently she was named the Beta Gamma Sigma Professor of the Year for the College of Business Administration.

Dr. Tietz is a certified public accountant, a certified management accountant, and a chartered global management accountant. She is a member of the American Accounting Association (AAA), the Institute of Management Accountants (IMA), and the American Institute of Certified Public Accountants (AICPA). She has published articles in such *journals* as *Issues in Accounting Education*, *Accounting Education: An International Journal*, and *Journal of Accounting & Public Policy*. She received the 2014 Bea Sanders/AICPA Innovation in Teaching Award for her accounting educator blog entitled "Accounting in the Headlines." She regularly presents at AAA regional and national meetings. Dr. Tietz is also the coauthor of a managerial accounting textbook, *Managerial Accounting*, with Dr. Karen Braun.

Dr. Tietz received her PhD from Kent State University. She received both her MBA and BSA from the University of Akron. 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**

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.

**For Mark, in case he ever forgets the basic
accounting equation.
Greg Berberich**

Catherine I. Seguin, MBA, CGA, is Associate Professor, Teaching Stream, at the University of Toronto Mississauga. In addition to her 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, 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 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, Alberta, and Manitoba on the topic of not-for-profit accounting. Currently, she serves as Treasurer on the board of a small not-for-profit organization.

**To Dennis, Andrea, Allison, and Mark
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 Sixth 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 SIXTH 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, some of the more-advanced material in previous editions has been simplified or completely removed from the book to reduce the coverage of topics better suited to intermediate accounting courses. Also based on feedback about the Fifth Edition, some topics deemed less important by users and reviewers have been removed from the book, while other topics have been moved to more-relevant chapters. As a result of these changes, the Sixth Edition is more streamlined than previous editions, with two fewer chapters and better-organized presentation of critical topics suitable for students in introductory financial accounting courses (see the detailed chapter-by-chapter changes below for more information). All materials have been updated to reflect the IFRS and ASPE principles in effect at the time of writing (February 2016), or (in some cases) expected to be in effect by the time of the book's publication in 2017. Directly after the Learning Objectives, each chapter includes a list of relevant CPA Competencies addressed in that chapter. The visual presentation has been substantially improved to better suit what students will see in their careers, such as financial statements in spreadsheet formats. The following is a summary of the significant changes made to this edition:

- Chapter 1
- The subject company has been changed to Canadian Tire from TELUS.
 - The section on accounting's conceptual framework has been moved to follow the presentation of the financial statements, so students have an understanding of the financial statement elements before learning about the framework underlying them.
 - The introductions to accounting fraud and the financial reporting responsibilities of management and the auditors have been moved up to Chapter 1 so students have an understanding of these concepts throughout the remainder of the book.

- Three Stop + Think exercises have been added, so there is now one for every learning objective.
 - Advanced or esoteric line items were removed from the sample Canadian Tire financial statements included as exhibits so students are not overwhelmed with concepts in the very first chapter, and instead can focus their attention on easier-to-understand line items.
 - Three new exercises/problems have been added to this chapter.
 - Excel has been incorporated into the end-of-chapter summary problem.
- Chapter 2
- Learning objectives 2, 3, and 5 have been reworded to make them more precise and distinct from each other.
 - The descriptions of several common types of accounts have been changed to add clarity and better reflect common practice.
 - Four Stop + Think exercises have been added, one for each of the last four learning objectives.
 - Detailed instructions for how to use Excel to illustrate the impact of business transactions on the accounting equation, prepare a trial balance, and prepare financial statements have been added.
 - Three new exercises/problems have been added to this chapter.
 - Excel has been incorporated into the mid-chapter and end-of-chapter summary problems.
- Chapter 3
- Four Stop + Think problems have been added, so now there is at least one for every learning objective in the chapter.
 - Two “Try It in Excel” features have been added to illustrate how Excel can be used to simplify the preparation of accounting information.
 - Three new exercises/problems have been added to this chapter.
 - Excel has been incorporated into the mid-chapter and end-of-chapter summary problems.
- Chapter 4
- This new chapter on Cash and Accounts Receivable combines elements of Chapter 4 from the previous edition on how to account for cash with elements from Chapter 5 on accounts receivable.
 - The exposition of several accounts receivable topics has been altered to improve clarity and understanding.
 - The coverage of short-term investments has been moved to Chapter 7 so it is presented alongside other investment topics.
 - Four Stop + Think problems have been added, so now there is at least one for every learning objective in the chapter.
 - Three new exercises/problems have been added to this chapter.
 - New requirements have been added to six new exercises/problems.
- Chapter 5
- This chapter on Inventory was Chapter 6 in previous editions of the book.
 - Learning objectives 1, 2, 4, and 5 have been reworded to make them more precise.
 - Four Stop + Think problems have been added, so now there is at least one for every learning objective in the chapter.
 - The exposition of several topics has been altered to improve clarity and understanding.
- Chapter 6
- This chapter on long-lived assets was Chapter 7 in previous editions of the book.
 - Coverage of the DuPont model has been removed.
 - Two Stop + Think problems have been added, so now there is at least one for every learning objective in the chapter.
 - Three “Try It in Excel” features have been added to illustrate how Excel can be used to simplify the preparation of accounting information.

- The exposition of several topics has been altered to improve clarity and understanding.
- Six new exercises/problems have been added to the end of chapter material.
- Additional requirements added to nine exercises/problems.

Chapter 7

- This chapter on Investments was Chapter 8 in previous editions of the book.
- Coverage of foreign currency translation has been removed.
- Four Stop + Think problems have been added, so now there is at least one for every learning objective in the chapter.
- The exposition of strategic and non-strategic investments has been altered to improve clarity and understanding, and brief coverage of consolidated financial statements has been added.
- Four new exercises/problems have been added to the end of chapter material.

Chapter 8

- This chapter on Liabilities was Chapter 9 in previous editions of the book.
- Coverage of Corporate Income Taxes has been moved from Chapter 11 in the previous edition to the Current Liabilities section of this chapter.
- Three Stop + Think problems have been added, so now there is at least one for every learning objective in the chapter.
- Two “Try It in Excel” features have been added to illustrate how Excel can be used to simplify the preparation of accounting information.
- Five new exercises/problems have been added to this chapter.
- Excel has been incorporated into the mid-chapter and end-of-chapter summary problems.

Chapter 9

- This chapter on Shareholders’ Equity was Chapter 10 in previous editions of the book.
- Four Stop + Think problems have been added, so now there is at least one for every learning objective in the chapter.
- The material on the Statement of Changes in Shareholders’ Equity has been moved from the old Chapter 11 to this chapter, where it fits better with the other chapter concepts.
- The presentation of the material on return on assets and return on equity has been simplified to make it more understandable for students at the introductory level.
- Ten new exercises/problems have been added to this chapter.

Chapter 10

- This chapter on the Statement of Cash Flows was Chapter 12 in previous editions of the book.
- Added one Stop + Think problem, so now there is one for every learning objective in the chapter.
- The subject company has been changed from TELUS Corporation to Canadian Tire Corporation.
- One new exercise/problem has been added to this chapter.

Chapter 11

- This chapter on Financial Statement Analysis was Chapter 13 in previous editions of the book.
- A comprehensive analysis case has been added to the end of the chapter.
- Three Stop + Think problems have been added, so now there is at least one for every learning objective in the chapter.
- Two “Try It in Excel” features have been added to illustrate how Excel can be used to simplify the preparation of accounting information.
- Excel has been incorporated into the mid-chapter summary problem.
- Four new exercises/problems have been added to the end of chapter material.

VISUAL WALK-THROUGH

Try It in Excel

NEW!

Special sections called **Try It in Excel** have been added to almost every chapter, giving students explicit instructions on how to build Excel templates that streamline and simplify various accounting tasks. These tasks include preparation of the adjusted trial balance worksheet, preparation of financial statements, computation of depreciation by various methods, and computation of effective-interest bond discount and premium amortization. The presentation of most illustrative financial statements, general ledgers, and journal entries have been converted to Excel as well.

TRY IT in EXCEL

The adjusted trial balance in Exhibit 3-4 was prepared using an Excel spreadsheet. You can use it as a template to solve future problems just by changing the initial trial balance data. To prepare the Excel template, follow these steps:

1. Open a blank Excel spreadsheet. Format the spreadsheet header and column headings exactly as you see in Exhibit 3-4.
2. Enter the account titles and account balances from the "Unadjusted Trial Balance" columns.
3. Sum the debits and credits in the "Unadjusted Trial Balance" columns.
4. Enter adjusting journal entries (a) through (g) one at a time in the "Adjustments" columns. For example, for adjusting journal entry (a) enter 1,000 in the debit column on the "Rent expense" line, and 1,000 in the credit column of the "Prepaid rent" line. Do not enter the letters (a) through (g); use only the amounts.
5. In the "Adjusted Trial Balance" debit and credit columns, enter formulas as follows:
 - For asset, dividend, and expense accounts: = + (debit amounts from "Unadjusted Trial Balance" and "Adjustments" columns) - (credit amounts from "Adjustments" columns).
 - For contra asset, liability, share capital, retained earnings, and service revenue accounts: = + (credit amounts from "Unadjusted Trial Balance" and "Adjustments" columns) - (debit amounts from "Adjustments" columns).
6. Sum the "Adjustments" debit and credit columns.
7. Sum the "Adjusted Trial Balance" debit and credit columns.

	A	B	C	D
1	Canadian Tire Corporation			
	Consolidated Statements of Income (Adapted)			
	For the Years Ended January 3, 2015 and December 28, 2013*			
2	(in millions of dollars)	2014*	2013*	
3	Revenue	\$ 12,462.9	\$ 11,785.6	
4	Cost of producing revenue	(8,416.9)	(8,063.3)	
5	Gross margin	4,046.0	3,722.3	
6	Other income (expense)	11.0	(3.0)	
7	Selling, general and administrative expenses	(3,052.9)	(2,828.9)	
8	Net finance costs	(108.9)	(105.8)	
9	Change in fair value of redeemable financial instrument	(17.0)	-	
10	Income before income taxes	878.2	784.6	
11	Income taxes	(238.9)	(220.2)	
12	Net income	\$ 639.3	\$ 564.4	
13				

Spreadsheet Formats Used Throughout Text

NEW!

NEW DESIGN! Excel-based financial statements are used so students will familiarize themselves with the accounting information format actually used in the business world.

Stop + Think

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 are available at the end of each chapter, so students can glance at them as they read the problems. Selected **Stop + Think** problems appear in MyAccountingLab.

STOP + THINK (4-3)

Neal Company had the following information relating to credit sales in 2017:

Accounts receivable, December 31, 2017	\$9,500
Allowance for uncollectible accounts, credit balance, December 31, 2017	900
(before adjustment)	
Sales during 2017	46,000
Collections from customers on account during 2017	49,500

The aging-of-receivables method determined the uncollectible accounts to be \$1,350. How much should Neal Company record as the bad debt expense for 2017?

CPA COMPETENCIES

Competencies* addressed in this chapter:

- 1.2.1 Develops or evaluates appropriate accounting policies and procedures
- 1.2.2 Evaluates treatment for routine transactions
- 1.3.1 Prepares financial statements
- 1.4.4 Interprets financial reporting results for stakeholders (external or internal)

Competencies

NEW!

CPA Competencies provide instructors and students with clear mapping between key accounting concepts, end-of-chapter problems, and relevant competencies from the *CPA Competency Map*.

Decision Guidelines

Illustrate how financial statements are used and how accounting information aids companies in decision making.

▶

DECISION GUIDELINES

DECISION FRAMEWORK FOR MAKING ETHICAL JUDGMENTS
 Making tough ethical judgments in business and accounting requires a decision framework. Answering the following four questions will help you to make ethical business decisions:

Decision	Guidelines
<ol style="list-style-type: none"> 1. What is the issue? 2. Who are the stakeholders, and what are the consequences of the decision to each of them? 3. What are the decision alternatives, and how do they affect each stakeholder? 4. What decision alternative will you choose? 	<ol style="list-style-type: none"> 1. The issue will usually deal with making a judgment about an accounting measurement or disclosure that results in economic consequences, often to numerous parties. 2. Stakeholders include anyone who might be affected by the decision—you, your company, and potential users of the information (investors, creditors, regulatory agencies). Consequences can be economic, legal, or ethical in nature. 3. Analyze the impact of the decision on all stakeholders, using economic, legal, and ethical criteria. Ask, "Who will be helped or hurt, whose rights will be exercised or denied, and in what way?" 4. Choose the alternative that best balances your economic, legal, and ethical responsibilities to your stakeholders. Also, assess how your decision makes you feel. If it makes you feel uneasy, determine why and consider choosing another alternative.

COOKING the BOOKS

with Inventory

No area of accounting has a deeper ethical dimension than inventory. Managers of companies whose profits do not meet shareholder expectations are sometimes tempted to "cook the books" to increase reported income. The increase in reported income may lead investors and creditors into thinking the business is more successful than it really is.

What do managers hope to gain from fraudulent accounting? In some cases, they are trying to keep their jobs. In other cases, their bonuses are tied to reported income: the higher the company's net income, the higher the managers' bonuses.

The easiest is simply to overstate ending inventory. The two most common ways to "cook the books" with inventory are (1) inserting fictitious inventory, thus overstating quantities; and (2) deliberately overstating unit prices used in the computation of ending inventory amounts. The upward-pointing arrows in the accounting equation indicate an overstatement: reporting more assets and equity than are actually present.

ASSETS	=	LIABILITIES	+	SHAREHOLDERS' EQUITY
↑	=	0	+	↑

Cooking the Books

These 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.

IFRS/ASPE Differences

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.

Summary of IFRS-ASPE Differences		
Concepts	IFRS	ASPE
Depreciation (p. 283)	This concept is called depreciation.	This concept is called amortization.
Significant components of an item of property, plant, or equipment (p. 298)	Significant components shall be depreciated separately.	Significant components are amortized separately only when it is practical to do so.
Impairment (p. 298)	A company shall assess at the end of each reporting period whether there are any signs that an asset may be impaired. Irrespective of any signs of impairment, a company must annually review goodwill and intangible assets with indefinite useful lives for impairment.	A company shall test an asset for impairment whenever events or circumstances indicate its carrying amount may not be recoverable.
Revaluation (p. 299)	If an impaired asset subsequently increases in value, a company may reverse all or part of any previous write-down but not on goodwill. A company may choose to use the revaluation model to measure its property, plant, and equipment.	A company may not reverse any write-downs, even if an impaired asset subsequently increases in value. A company must use the cost method; no revaluation is permitted.

End-of-Chapter Problems

New and updated additional problems have been added or revised to provide instructors with updated and comprehensive testing of all learning objectives in every chapter.

56-14 In 2017, Artesia, Inc., reported \$300 million in sales, \$18 million in net income, and average total assets of \$120 million. What is Artesia's return on assets in 2017? Assume an industry average of 16%. Did the company's return on assets improve or deteriorate? What could be some reasons for the change?

LEARNING OBJECTIVE 9
Calculate return on assets

56-15 Ochoa Optical, Inc., provides a full line of designer eyewear to optical dispensaries. Ochoa reported the following information for 2016 and 2017:

LEARNING OBJECTIVE 9
Calculate return on assets

	2017	2016
Sales revenue	\$500,000	\$450,000
Net income	\$45,000	\$42,500
Average total assets	\$250,000	\$240,000

Compute return on assets for 2016 and 2017. Did the return on assets improve in 2017? What would cause this ratio to change?



DIGITAL WALK-THROUGH

NEW!

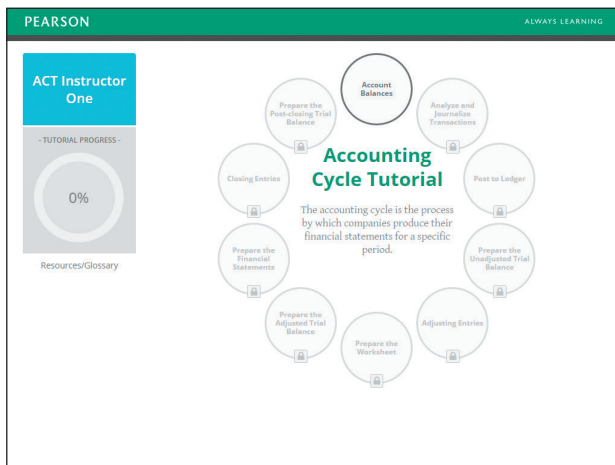
Pearson eText

The Pearson eText, available through MyAccountingLab, gives students access to their textbook anytime, anywhere. In addition to note taking, highlighting, and bookmarking, the Pearson eText offers interactive and sharing features. Instructors can share their comments or highlights, and students can add their own, creating a tight community of learners within the class.

NEW!

Auto-Graded Excel Projects

Using proven, field-tested technology, MyAccountingLab's new auto-graded Excel Projects allow instructors to seamlessly integrate Excel content into their course without having to manually grade spreadsheets. Students have the opportunity to practice important accounting skills in Microsoft Excel, helping them to master key concepts and gain proficiency in Excel. Students simply download a spreadsheet, work live on an accounting problem in Excel, and then upload that file back into MyAccountingLab, where they receive reports on their work that provide personalized, detailed feedback to pinpoint where they went wrong on any step of the problem.



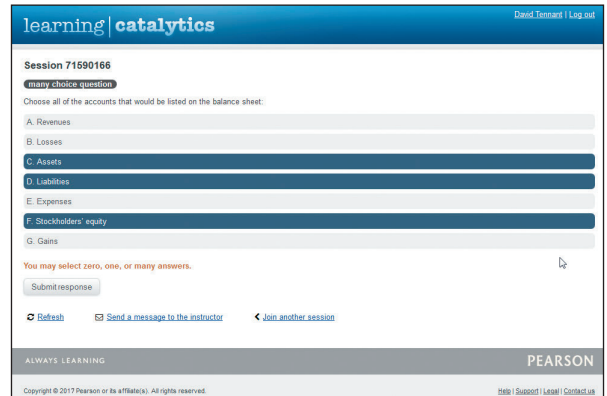
Accounting Cycle Tutorial (ACT)

NEW!

MyAccountingLab's new interactive tutorial helps students master the accounting cycle for early and continued success in their introductory accounting course. The tutorial, accessed by computer, smartphone, or tablet, provides students with brief explanations of each concept of the accounting cycle. Using embedded assessments, student performance is scored and recorded in the MyAccountingLab Gradebook. Learn more at <http://www.pearsonmylabandmastering.com/northamerica/myaccountinglab/educators/features/index.html>.

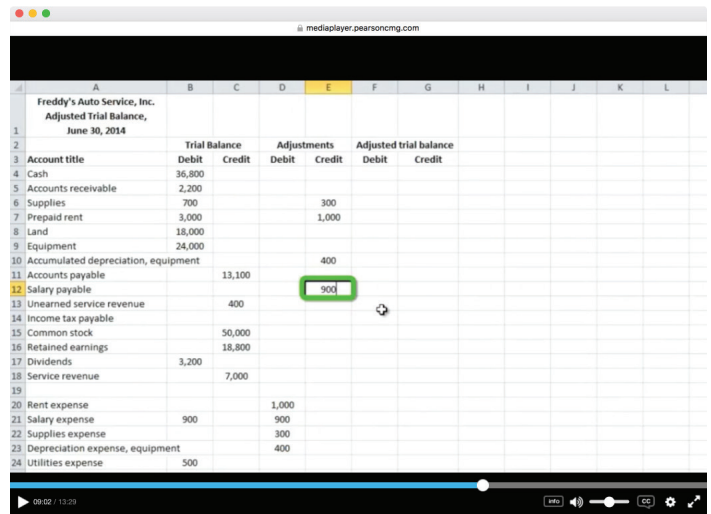
Learning Catalytics **NEW!**

Learning Catalytics, available through MyAccountingLab, is a “bring your own device” assessment and classroom activity system that expands the possibilities for student engagement. Using Learning Catalytics, you can deliver a wide range of automatically graded or open-ended questions that test content knowledge and build critical thinking skills. The wide variety of different answer types provide great flexibility, including graphical, numerical, textual input, and more.



Try It Videos

These videos, offered only in MyAccountingLab, guide students step-by-step through select exhibits in the text.



STUDENT AND INSTRUCTOR RESOURCES

MyAccountingLab

For Students

MyAccountingLab online Homework and Assessment Manager includes:

- Pearson eText
- Student PowerPoint® Presentations
- Accounting Cycle Tutorial
- Videos
- Demo Docs
- Glossary Flashcards
- Dynamic Study Modules

For Instructors

MyAccountingLab

MyAccountingLab delivers *proven results* in helping individual students succeed.

It provides *engaging experiences* that personalize, stimulate, and measure learning for each student. And, it comes from a *trusted partner* with educational expertise and an eye on the future. MyAccountingLab is the portal to an array of learning tools for all learning styles—practice questions with guided solutions are only the beginning. Student can access MyAccountingLab at www.pearsonmylabandmastering.com.

MyAccountingLab can be used by itself or linked to any learning management system. MyAccountingLab provides students with a variety of resources, including a personalized study plan, tutorials, videos, glossary flashcards, and PowerPoint® Presentations.

- **NEW! Auto-Graded Excel Projects:** MyAccountingLab's new auto-graded Excel Projects allow students to practise important accounting skills in Microsoft Excel to master key accounting concepts while gaining proficiency in Excel.
- **NEW! Worked Solutions:** These provide step-by-step explanations on how to solve select problems using the exact numbers and data that were presented in the problem. Instructors will have access to the Worked Out Solutions in preview and review mode.
- **NEW! Open Response:** Open Response questions require students to type in their answers instead of choosing their answer from a drop-down menu. This helps students think critically while further preparing them for the format of their exam.
- **NEW! Accounting in the Headlines:** One of the biggest challenges for accounting instructors is that students often feel disengaged from the course material, which can seem abstract and unrelated to their personal experiences. But by incorporating real-life examples, instructors can spark student interest and engagement especially when teaching accounting at the introductory level.

Accounting in the Headlines, an award-winning blog by renowned author Wendy Tietz, does just that with stories about real companies and events that can be used in the accounting classroom to illustrate introductory financial accounting concepts.

Concise, tailorable, and updated on a weekly basis, these articles easily fit into the typical introductory accounting curriculum, whether the course is delivered in-person or online.

<http://accountingintheheadlines.com>

Accounting in the Headlines multiple-choice questions are available for instructors to assign in MyAccountingLab's Assignment Manager.

- **NEW!** Selected Stop + Think problems, Mid-Chapter Summary Problems, and End-of-Chapter Summary Problems appear on MyAccountingLab, along with all end-of-chapter questions that have a shaded box behind their number. All problems include three static versions for instructor flexibility.

To learn more about how MyAccountingLab combines proven learning applications with powerful assessment, instructors can visit www.pearsonmylabandmastering.com.

Instructor's Resource Centre

These instructor supplements are available for download from a password-protected section of Pearson Canada's online catalogue, at www.pearsoncanada.ca/highered. Navigate to your book's catalogue page to view a list of those supplements that are available. Speak to your local Pearson sales representative for details and access.

- **NEW! *Flipping Your Classroom Guide*:** Tips for each chapter on how to take your course from a traditional/in-class course to a hybrid, blended, or fully online format. Includes links to the discussion board prompts.
- ***Instructor's Resource Manual*:** This manual contains valuable resources, including chapter outlines, teaching tips, and assignment grids.
- ***Instructor's Solutions Manual*:** Contains solutions to all end-of-chapter questions, including short exercises, exercises, problems, and cases.
- ***Computerized Test Bank*:** More than 1,500 test questions, including multiple-choice, true-or-false, and essay questions, are provided in TestGen format. Pearson's computerized test banks allow instructors to filter and select questions to create quizzes, tests, or homework. Instructors can revise questions or add their own, and may be able to choose print or online options. These questions are also available in Microsoft Word format.
- ***PowerPoint Presentations*:** These presentations help facilitate classroom discussion.
- ***Image Library*:** An Image Library provides access to many of the figures and tables in the textbook.

Learning Solutions Managers

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

We hope you enjoy *Financial Accounting*.

ACKNOWLEDGMENTS

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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 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 these designations, employers know what to expect about your education, knowledge, abilities, 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 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!

1

The Financial Statements



Felix Choo/Alamy Stock Photo

LEARNING OBJECTIVES

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

SPOTLIGHT

If you've ever shopped for a bike, garden tools, or household items, you have very likely been in a Canadian Tire store. Based in Ontario, Canadian Tire Corporation is one of Canada's largest retail companies, selling a range of products and services through its various retail banners, including Mark's, PartSource, Sport Chek, and Pro Hockey Life. The company's market reach is tremendous: over 90% of Canada's population lives within 15 minutes of a Canadian Tire store; two out of three Canadian men read the Canadian Tire flyer every week; and more than 80% of the population shops at Canadian Tire stores each year. Canadian Tire 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, Canadian Tire sells a lot of goods and services—about \$12.5 billion worth for the year ended January 3, 2015 (line 3). After deducting a variety of expenses incurred during 2014 (lines 4, 6–9, and 11), Canadian Tire earned net income of over \$600 million for the year (line 10).

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!

* © Chartered Professional Accountants of Canada.

	A	B	C	D
1	Canadian Tire Corporation Consolidated Statements of Income (Adapted) For the Years Ended January 3, 2015 and December 28, 2013*			
2	(in millions of dollars)	2014*	2013*	
3	Revenue	\$ 12,462.9	\$ 11,785.6	
4	Cost of producing revenue	(8,416.9)	(8,063.3)	
5	Gross margin	4,046.0	3,722.3	
6	Other income (expense)	11.0	(3.0)	
7	Selling, general and administrative expenses	(3,052.9)	(2,828.9)	
8	Net finance costs	(108.9)	(105.8)	
9	Change in fair value of redeemable financial instrument	(17.0)	-	
10	Income before income taxes	878.2	784.6	
11	Income taxes	(238.9)	(220.2)	
12	Net income	\$ 639.3	\$ 564.4	
13				

*Canadian Tire's financial year (or fiscal year) ends on the Saturday closest to December 31 each year, which is common for many retail companies, so its 2014 fiscal year actually ended on January 3, 2015. Despite the 2015 year-end date, this was still the end of its 2014 fiscal year, so it is labelled and referred to as such here and throughout the textbook.

Source: Reprinted with permission from Canadian Tire Corporation.

Each chapter of this book begins with an actual financial statement—in this chapter, it's the Consolidated Statements of Income of Canadian Tire Corporation for the years ended January 3, 2015, and December 28, 2013. 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.

Using Accounting Information

Canadian Tire Corporation's managers make a lot of decisions. Which bikes are selling the best? Which line of business is earning the most profit? Should Canadian Tire expand its offerings in Eastern Canada to match those in B.C. and Alberta? Accounting information helps company managers make these decisions.

MyAccountingLab

MyAccountingLab provides students with a variety of resources including a personalized study plan, videos, and an interactive Accounting Cycle Tutorial (ACT). Margin logos in Chapters 2 and 3 direct you to the appropriate ACT Steps; Steps 1 to 4 are covered in Chapter 2 and Steps 5 to 10 are covered in Chapter 3. The ACT provides brief explanations of each concept of the accounting cycle, and allows you to assess and test your mastery at each Step.

Take a look at Canadian Tire Corporation's Consolidated Statements of Income on page 2. Focus on net income (line 12). Net income is the excess of revenues over expenses. You can see that Canadian Tire earned \$639 million in net income for the year ended January 3, 2015. That's good news because it means that Canadian Tire's revenues exceeded its expenses by over \$600 million in 2014.

Canadian Tire's Consolidated Statements of Income convey more great news. Revenues grew from \$11.8 billion in 2013 to \$12.5 billion in 2014 (line 3), an increase of about 6%. Also, Canadian Tire's 2014 net income of \$639 million was 13.3% higher than its 2013 net income of \$564 million (line 12). Based on these key numbers, Canadian Tire's 2014 operating performance improved significantly from 2013.

There would, however, be much more accounting information to analyze before making a final assessment of Canadian Tire's 2014 financial performance. Imagine you work for a bank that Canadian Tire 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 Canadian Tire? 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 Canadian Tire's 2014 financial statements. By the end of the chapter, you will have a basic understanding of these statements.

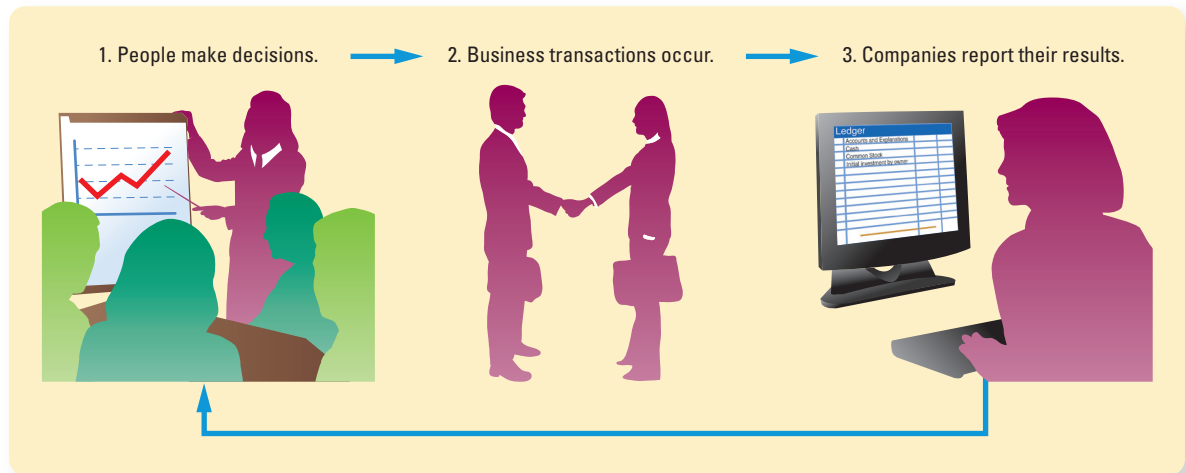
Don't confuse bookkeeping and accounting. Bookkeeping is a mechanical part of accounting, just as arithmetic is a mechanical part of mathematics. Accounting, however, requires an understanding of the principles used to accurately report financial information, as well as the professional judgment needed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

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.

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

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

The shares of a public corporation like Canadian Tire 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 OF EACH FINANCIAL STATEMENT AND EXPLAIN THE ELEMENTS OF EACH ONE

- 2 Describe the purpose of each financial statement and explain the elements of each one

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 principles that are used to prepare these statements.

EXHIBIT 1-3

The Financial Statements and Their Elements

Question	Financial Statement	Elements
1. How well did the company perform 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), 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 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 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.

The Income Statement Measures Operating Performance

The **income statement** (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 income statement. In the heading of Canadian Tire's income statement in Exhibit 1-4, we can see that it covers the years ended January 3, 2015, and December 28, 2013. 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 Canadian Tire, 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 Income (Adapted)

Source: Reprinted with permission from Canadian Tire Corporation.

	A	B	C
	Canadian Tire Corporation		
1	Consolidated Statements of Income (Adapted) For the Years Ended January 3, 2015 and December 28, 2013		
2	(in millions of dollars)		
3		2014	2013
4	Revenue	\$ 12,462.9	\$ 11,785.6
5	Cost of producing revenue	(8,416.9)	(8,063.3)
6	Gross margin	4,046.0	3,722.3
7	Other income (expense)	11.0	(3.0)
8	Selling, general and administrative expenses	(3,052.9)	(2,828.9)
9	Net finance costs	(108.9)	(105.8)
10	Change in fair value of redeemable financial instrument	(17.0)	-
11	Income before income taxes	878.2	784.6
12	Income taxes	(238.9)	(220.2)
13	Net income	\$ 639.3	\$ 564.4

activities. The vast majority of a company's revenue is earned through the sale of its primary goods and services. Loblaw's, 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. Canadian Tire's ordinary business activities include the sale of goods and services through the various retail banners it operates. On line 3 of Canadian Tire's 2014 income statement, we see that it earned Revenues of \$12,463 million in 2014. Revenue is referred to by a variety of different names, including sales, fees, interest, dividends, royalties, and rent. 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, Canadian Tire sold one of the buildings it owned 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. When gains are recognized in the income statement, they are usually listed separately, either directly in the statement or in the notes to the financial statements (discussed on page 17), because knowledge of these gains is useful for making decisions. Canadian Tire does not explicitly report any gains on its 2014 income statement, but the statement of cash flows shows that the company earned \$9 million in gains on the sale of property and other assets (line 8 in Exhibit 1-8) during 2014. The *other income* line on an income statement (line 6 in Exhibit 1-4) generally includes categories of revenues and gains that are not sufficiently material to report on separate lines of the statement. You will learn more about some common types of gains in Chapters 6 and 7.

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 Canadian Tire, these expenses include the cost of the bikes, auto parts, 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. Canadian Tire refers to this expense as the "Cost of producing revenue" on line 4 of its income statement. Other selling costs, as well as the wages it pays its employees, the rent it pays on its stores, and many more expenses, would be included in the \$3,053 million of "Selling, general and administrative expenses" on line 7 of Canadian Tire's income statement. On line 8, we see that Canadian Tire incurred "Net finance costs" of \$109 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 8. The last expense on Canadian Tire's income statement is "Income taxes" of \$239 million (line 11). You likely know a little bit about this kind of expense already, but it will be discussed more in Chapter 8. There are many more expenses that companies incur on a day-to-day basis but 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, Canadian Tire sold some equipment it owned for an amount that was less than what it was last