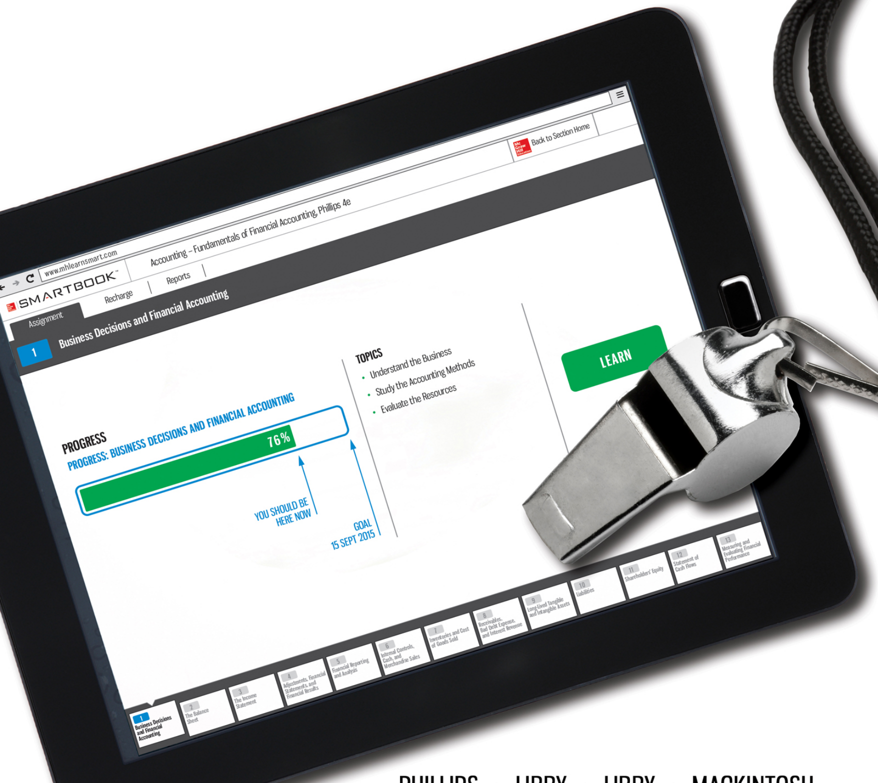
Fundamentals of

FINANCIAL ACCOUNTING

Fourth Canadian Edition



PHILLIPS • LIBBY • LIBBY • MACKINTOSH

Fundamentals of

FINANCIAL ACCOUNTING

Fourth Canadian Edition

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Dedication

I dedicate this book to the best teachers I've ever had:
my Mom and Dad, Barb, Harrison, and Daniel

FRED PHILLIPS

Jenni, John, and Emma Rose Drago, Herman and Doris Hargenrater,
Laura Libby, Oscar and Selma Libby

PATRICIA AND ROBERT LIBBY

I dedicate this book to my two daughters,
who teach me something new every day

BRANDY MACKINTOSH

Meet the Authors

Fred Phillips

Fred Phillips is a professor of accounting and the Baxter Scholar at the Edwards School of Business at the University of Saskatchewan, where he has taught courses in financial accounting and assurance. He holds a Ph.D. from the University of Texas at Austin, a bachelor's degree in accounting from the University of Manitoba, and the chartered accountancy designation from the Institute of Chartered Accountants of Saskatchewan.

Fred has published four textbooks and more than 30 articles and cases in peer-reviewed journals, including *Issues in Accounting Education, Journal of Accounting Research,* and *Organizational Behavior and Human Decision Processes.* He is an active member of the editorial boards of *Contemporary Accounting Research* and *Accounting Perspectives.* Fred has received many awards for his writing, research, and teaching, including the Canadian Academic Accounting Association Case Writing Award (four times), the American Accounting Association Award for Outstanding Research in Accounting Education (twice), the Edwards School of Business Most Effective Professor award (three times), the University of Saskatchewan Students' Union Teaching Excellence Award (twice), the University of Saskatchewan's Master Teacher Award, the University of Saskatchewan Provost's Award for Outstanding Innovation in Learning, and the 3M National Teaching Fellowship (the highest award for undergraduate teaching in Canada).

Robert Libby

Robert Libby is the David A. Thomas Professor of Accounting at Cornell University, where he teaches the introductory financial accounting course. He previously taught at the University of Illinois, Pennsylvania State University, the University of Texas at Austin, the University of Chicago, and the University of Michigan. He received his B.S. from Pennsylvania State University and his M.A.S. and Ph.D. from the University of Illinois; he also is a CPA.

Bob is a widely published author specializing in behavioural accounting. He was selected as the AAA Outstanding Educator in 2000 and received the AAA Outstanding Service Award in 2006. His prior text, *Accounting and Human Information Processing* (Prentice Hall, 1981), was awarded the AICPA/AAA Notable Contributions to the Accounting Literature Award. He received this award again in 1996 for a paper. He has published numerous articles in *The Accounting Review; Journal of Accounting Research; Accounting, Organizations and Society;* and other accounting journals. He has held a variety of offices in the American Accounting Association and is a member of the American Institute of CPAs and the editorial boards of *The Accounting Review; Accounting, Organizations and Society; Journal of Accounting Literature;* and *Journal of Behavioral Decision Making.*

Patricia A. Libby

Patricia Libby is associate professor of accounting and coordinator of the financial accounting course at Ithaca College, as well as faculty adviser to Beta Alpha Psi, Ithaca College Accounting Association, and Ithaca College National Association of Black Accountants. She previously taught graduate and undergraduate financial accounting at Eastern Michigan University and the University of Texas at Austin. Before entering academe, she was an auditor with Price Waterhouse (now PricewaterhouseCoopers) and a financial administrator at the University of Chicago. She received her B.S. from Pennsylvania State University, her M.B.A. from DePaul University, and her Ph.D. from the University of Michigan; she also is a CPA.

Pat conducts research on using cases in the introductory course and other parts of the accounting curriculum. She has published articles in *The Accounting Review, Issues in Accounting Education,* and *The Michigan CPA.* She has also conducted seminars nationwide on active learning strategies, including cooperative learning methods.

Brandy Mackintosh

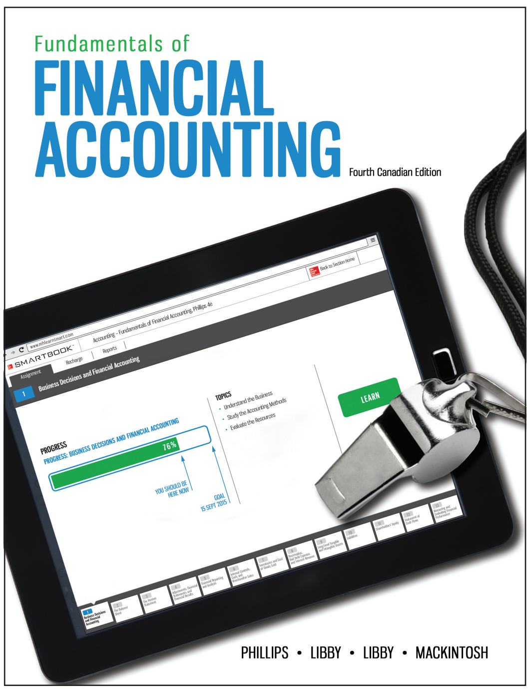
Brandy Mackintosh is an assistant professor at the Edwards School of Business at the University of Saskatchewan, where she teaches introductory and intermediate financial accounting. She has also taught advanced financial accounting, external auditing, and advanced financial reporting at the graduate level. Brandy was a finalist for the Edwards School of Business Most Effective Professor Award, a recipient of the Edwards School of Business Most Approachable Professor Award, as well as a recipient of the University of Saskatchewan's Teaching Excellence Award. Her scholarly interests relate to accounting education and case writing. She won the 2011 Canadian Academic Accounting Association case-writing competition (with Fred Phillips) and has published this work and another instructional case in *Issues in Accounting Education.*

Prior to joining the University of Saskatchewan, Brandy worked as an audit manager at Deloitte. She has an undergraduate accounting degree from the University of Saskatchewan and is a CA.

BRIEF CONTENTS

CONTENTS

Your Personal Coach . . .



Phillips, Libby, Libby, and Mackintosh's *Fundamentals of Financial Accounting,* fourth Canadian edition, arms students with a secret weapon for success in financial accounting—the best personal coach on the market. The cover of this text contains a tablet showing our most updated learning tool called LearnSmart, and the quintessential representation of a coach—a whistle. Simple, maybe, but this whistle captures the essence of this text as your coach. The following are highlights of Phillips's innovative student-centred approach:

WRITING THAT STUDENTS CAN READ. What does it mean to say that a book is "readable"? In the case of *Fundamentals of Financial Accounting,* fourth Canadian edition, it simply means that it's the most enjoyable accounting textbook your students have ever read. Through a mix of conversational wording, humour, and everyday examples, *Fundamentals of Financial Accounting* achieves a style that maintains rigour without sacrificing student engagement. Open this textbook to any page and read for yourself; *Fundamentals of Financial Accounting* offers **the most engaging read** of any financial text.

STUDENT-FRIENDLY COVERAGE OF DIFFICULT TOPICS. Written with students in mind, *Fundamentals of Financial Accounting* handles difficult concepts in a way that reflects the balance of preparer and user concepts and keeps students from being overwhelmed.

- **The accounting process** is covered in three chapters (2, 3, and 4).
- The purpose of a **statement of cash flows** is introduced at the beginning of the text, but the mechanics of preparing one are studied at the end.
- **Financial statement analysis** is covered in two chapters (5 and 13).
- **Ratios** are introduced throughout the chapters and then pulled together at the end.
- **Individual concepts** are introduced throughout the text as needed to explain specific accounting practices, and then pulled together at the end.
- NEW **Award Winning Continuing Case:** Key accounting judgements that affect business decisions in the workplace are learned by students through an award-winning continuing case in the assignment material for chapters 5 through 12.

. . . in Financial Accounting

CURRENT. Phillips reflects current accounting standards in Canada. Covering both International Financial Reporting Standards (IFRS) and Accounting Standards for Private Enterprise (ASPE), Phillips discusses key differences between IFRS and ASPE in a boxed feature at the end of each chapter.

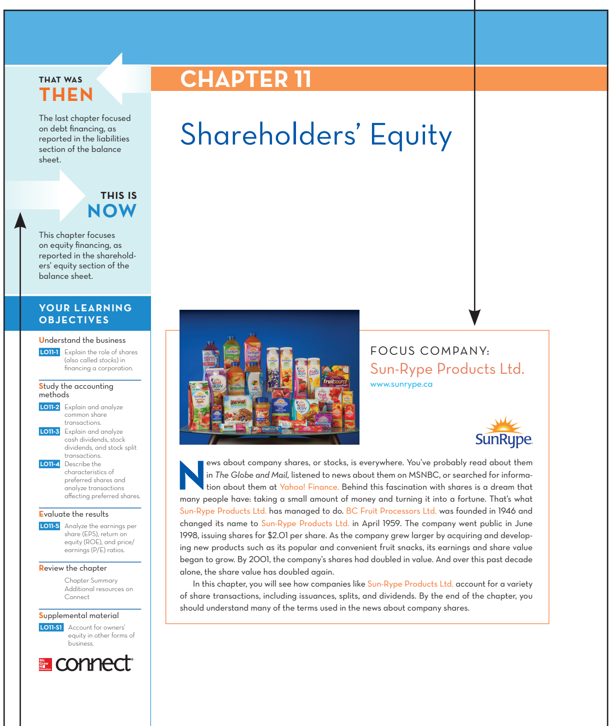
BALANCED. Phillips delivers a balanced approach. Throughout, understanding the preparation of financial statements is balanced with the importance of using the financial statements to guide decision making.

EXTENSIVE END-OF-CHAPTER EXERCISES AND PROBLEMS. Students build confidence and success with a wealth of end-of-chapter discussion questions, exercises, coached and comprehensive problems, skills development cases, and continuing cases.

CONNECT TECHNOLOGY. Connect—McGraw-Hill's online teaching and learning resource—for Phillips Fourth Canadian Edition, includes SmartBook adaptive reading experience powered by LearnSmart, assignable end-of-chapter exercise and problem material, algorithmic questions, Connect eBook, and Connect Insight, all in one convenient location. Phillips Connect is available for students to purchase separately, or available as an option to package with the print text.

Stay Focused . . .

The best way to learn to prepare and use financial statements is to study accounting in real business contexts.



THAT WAS
THEN

The last chapter focused on debt financing, as reported in the liabilities section of the balance sheet.

THIS IS
NOW

This chapter focuses on equity financing, as reported in the shareholders' equity section of the balance sheet.

CHAPTER 11

Shareholders' Equity

YOUR LEARNING OBJECTIVES

Understand the business

LO11-1 Explain the role of shares (also called *stocks*) in financing a corporation.

Study the accounting methods

LO11-2 Explain and analyze common share transactions.

LO11-3 Explain and analyze cash dividends, stock dividends, and stock split transactions.

LO11-4 Describe the characteristics of preferred shares and analyze transactions affecting preferred shares.

Evaluate the results

LO11-5 Analyze the earnings per share (EPS), return on equity (ROE), and price/earnings (P/E) ratios.

Review the chapter

Chapter Summary
Additional resources on Connect

Supplemental material

LO11-S1 Account for owners' equity in other forms of business.

connect

FOCUS COMPANY:
Sun-Rype Products Ltd.
www.sunrype.ca

SunRype

News about company shares, or stocks, is everywhere. You've probably read about them in *The Globe and Mail,* listened to news about them on MSNBC, or searched for information about them at Yahoo! Finance. Behind this fascination with shares is a dream that many people have: taking a small amount of money and turning it into a fortune. That's what Sun-Rype Products Ltd. has managed to do. BC Fruit Processors Ltd. was founded in 1946 and changed its name to Sun-Rype Products Ltd. in April 1959. The company went public in June 1998, issuing shares for $2.01 per share. As the company grew larger by acquiring and developing new products such as its popular and convenient fruit snacks, its earnings and share value began to grow. By 2001, the company's shares had doubled in value. And over this past decade alone, the share value has doubled again.

In this chapter, you will see how companies like Sun-Rype Products Ltd. account for a variety of share transactions, including issuances, splits, and dividends. By the end of the chapter, you should understand many of the terms used in the news about company shares.

FOCUS COMPANY APPROACH. The **focus company** approach integrates each chapter's material around a real-world company, its decisions, and its financial statements.

In choosing focus companies to use in *Fundamentals of Financial Accounting* fourth Canadian edition, we took care that our companies' products and services are used by students and will appeal to their curiosity. We further heighten student engagement by injecting our discussions with issues and questions that actually matter in the real world. *What decisions does Activision Blizzard make that keeps it running as the interactive entertainment software industry's leading publisher? How did Walmart go from yearly sales of $1 billion to making the same amount within a week 14 years later?* These are but a couple of the companies and issues discussed over the course of this book.

Students often feel that they lack the real-world experience needed to understand accounting, a subject they believe has little impact on their daily lives. *Fundamentals of Financial Accounting*'s chapter openers provide real-world situations and examples that illustrate how accounting principles are part of day-to-day activities that students might not have thought about from an accounting perspective—such as what's involved when Cedar Fair purchases a new roller coaster or how The Hudson Bay Company manages its inventory. There's no better way to help students feel comfortable with accounting topics and to trigger an interest that invites them into the chapter.

THAT WAS THEN/THIS IS NOW. To provide connectivity in students' minds, each chapter opens by briefly putting into perspective the information learned in the previous chapter and what will be learned in the present chapter.

Net Income

Net income is a total that is calculated by subtracting expenses from revenues; it is not an account like Pizza Revenue or Wages Expense. Because it is a total, net income summarizes the overall impact of revenues and expenses in a single number. It is called a *net loss* if expenses are greater than revenues, and a *net income* if revenues are greater than expenses. **Net income indicates the amount by which shareholders' equity increases as a result of a company's profitable operations.** For this reason, net income (or loss) is a closely watched measure of a company's performance.

Exhibit 3.2 shows how revenues, expenses, and net income would be reported in Pizza Palace's income statement. Each account title describes the specific type of revenue or expense arising from the business's particular operations. This is true for all companies. Pizza Palace reports "Pizza Revenues," but Rogers Plus reports "Cable Service Revenue." Google reports "Traffic Acquisition Expenses," and Air Canada reports "Airport and Navigation Fees." You'll become more comfortable with various account titles as this course progresses but to keep things simple right now we'll stick to common types of revenues and expenses.

Net income: The excess of revenues over expenses.

COACH'S TIP

A more complete list of revenue and expense account titles appears in the Homework Helper section.

KEY TERMS. All key terms are defined in the margin beside the text in which the terms are first introduced, reinforcing student understanding and recapping important text points.

. . . on the Real World

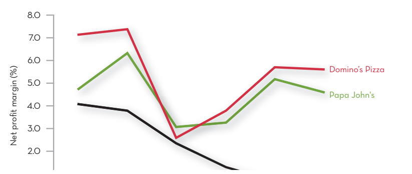
SPOTLIGHT FEATURES AND VIDEOS

Each chapter includes Spotlight features focusing on business decisions, ethics, internal controls, financial reporting, and the world (IFRS). These features are designed to further engage students and provide instructors with material for in-class discussion. Updated Spotlight videos accompany selected spotlight features.

SPOTLIGHT ON Financial Reporting

Net Profit Margin Before and After the Financial Crisis

The following graph indicates the net profit margins of three dominant pizza companies: Papa John's, Domino's Pizza, and California Pizza Kitchen. The graph shows a significant decline in net profit margin leading into the financial crisis of 2008, with a good



Spotlight on Financial Reporting These features connect chapter topics with real-world disclosures provided in the financial statements of our focus companies and other contrasting companies.

Spotlight on IFRS and ASPE Specific discussions on International Financial Reporting Standards (IFRS) and how they differ from Accounting Standards for Private Enterprises (ASPE) are grouped together in the Spotlight on IFRS and ASPE box at the end of each chapter.

SPOTLIGHT ON IFRS and ASPE

Topic	ASPE	IFRS
Presentation of changes in Shareholders' Equity accounts	• Changes in retained earnings are presented in the "Statement of Retained Earnings." • Changes in capital accounts are disclosed in the notes to the financial statements.	• Changes in all equity accounts are presented in a separate statement called "Statement of Changes in Equity."
Disclosure of Earnings per Share	• The disclosure of Earnings per Share is not required.	• The disclosure of Earnings per Share is required.

SPOTLIGHT ON ETHICS

35 Days Hath September?

It seems some managers—specifically those at Computer Associates (CA)—haven't learned the **time period assumption**. CA was charged with financial statement fraud for improperly recording 35 days of sales in September—a month that has only 30 days. To make it look like managers had met their September sales targets, CA included the first five days of sales from October in its September income statement. This accounting fraud led managers to be paid bonuses they hadn't earned and tricked investors into thinking CA was a successful company.

When the truth was revealed later, CA's shareholders quickly abandoned the company, causing its share price to fall 43 percent in a single day. CA ultimately paid shareholders $225 million to make up for its bad

Spotlight on Ethics The text ensures that students start off with a solid grounding in ethics. Shining the spotlight on ethical issues in each chapter prompts the student to think about tough ethical decisions and to practise making these decisions in the end-of-chapter cases.

SPOTLIGHT ON The World

Differences between ASPE and IFRS

IFRS differ from ASPE in many ways, particularly when accounting for tangible and intangible assets. Two of the most significant differences are:

1. ASPE requires tangible and intangible assets to be recorded at cost and not revalued for later increases in asset values. In contrast, IFRS allows companies the option of reporting these assets at fair values (e.g., appraisals), provided they use the fair value method consistently each year.
2. IFRS requires companies to capitalize costs of developing intangible assets, such as prototypes or models for making new products or tools. ASPE generally expenses such development costs because of the uncertainty

Spotlight on the World Students are kept apprised of the ongoing changes in the accounting profession around the world through these features.

SPOTLIGHT ON Business Decisions

Valuing Goodwill in a Business Acquisition

Most business acquisitions involve goodwill. For example, in 2006 Cedar Fair bought five theme parks from Paramount Parks. The total purchase price that Cedar Fair agreed to pay ($1.2 billion) exceeded the fair value of Paramount's net assets ($890 million). As shown below, Cedar Fair paid this extra $310 million to acquire the goodwill associated with the theme parks' businesses.

Cedar Fair Purchase of Five Paramount Parks Theme Parks (in millions)

Purchase price		**$1,200**
Assets purchased and liabilities assumed		
Current assets	$ 70	
Property and equipment	1,000	
Intangible assets	80	
Debt and other liabilities	(260)	
Net assets, at fair value		**890**
Goodwill		**$ 310**

Spotlight on Business Decisions Found throughout the text, these features help students to develop strong decision-making skills by illustrating the relevance of accounting in real-world decision making and the lessons learned from global economic crises.

Spotlight on Controls These features highlight applications of internal control principles in the workplace.

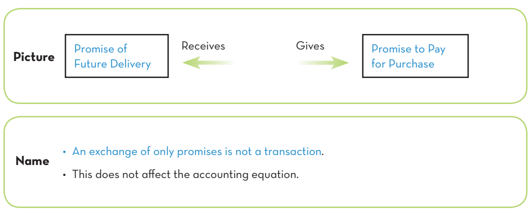
SPOTLIGHT ON Controls

Segregating Collections and Write-Offs

One way to control accounts receivable is to ensure that the same person does not both receive collections from customers and write off account balances. This segregation of duties helps to prevent errors and fraud. Without adequate segregation between these duties, a single dishonest employee could divert customer payments to his or her own bank account and then cover up the theft by writing off the customer's balance.

Dedicated and Coached...

Fundamentals of Financial Accounting, fourth Canadian edition, is loaded with so many innovative pedagogical features that you'll think we sent a teaching assistant along with the book. From quick review to head-scratching ethical dilemmas, this text's pedagogy gives students every opportunity to reinforce and expand on what they're learning.



COACH'S TIP

Not all business activities are considered accounting transactions.

COACH'S TIP. Virtually every student has been inspired by a great coach at some time or another. Throughout the chapters, Coach's Tips provide students with advice and guidance on learning the material. Coach's Tips appear again in the problem material to offer encouragement as students work to reinforce what they've learned.

COACHED PROBLEMS. Every chapter includes three problem sets: Coached Problems, Group A Problems, and Group B Problems. The Coached Problems go beyond the traditional check figures to advise students on the process of solving a problem rather than just its outcome.

COACHED PROBLEMS

LO3-1, 3-2, 3-3 **CP3-1 Recording Nonquantitative Journal Entries**

The following list includes a series of accounts for B-Ball Corporation, which has been operating for three years. These accounts are listed alphabetically and numbered for identification. Following the accounts is a series of transactions. For each transaction, indicate the account(s) that should be debited and credited by entering the appropriate account number(s) to the right of each transaction. If no journal entry is needed, write *none* after the transaction. Transaction (*a*) is used as an example.

TIP: In transaction (*h*), remember what the matching principle says.

TIP: Think of transaction (*j*) as two transactions: (1) incur expenses and liability and (2) pay part of the liability.

Account No.	Account Title	Account No.	Account Title
1	Accounts Payable	8	Note Payable
2	Accounts Receivable	9	Prepaid Insurance
3	Cash	10	Rent Expense
4	Contributed Capital	11	Service Revenue
5	Equipment	12	Supplies Expense
6	Income Tax Expense	13	Supplies
7	Income Tax Payable		

HOW'S IT GOING? Self-Study Practice 7.1

Use the Cost of Goods Sold equation to solve for the missing information for Cases 1 and 2. Then enter the information for either Case 1 or Case 2 into the T-account on the right.

		Case 1	Case 2
Beginning Inventory	5 units × $10	$ 50	$ 50
+ Purchases	20 units × $10	200	200
Goods Available for Sale			250
− Ending Inventory		100	
Cost of Goods Sold			$150

dr + Inventory		cr −
Beginning	50	
Purchases	200	
Goods Available		
		Goods Sold
Ending Inventory		

After you have finished, check your answers with the solution placed after the chapter summary.

HOW'S IT GOING? Research shows that students learn best when they are actively engaged in the learning process. So *Fundamentals of Financial Accounting* provides plenty of this active learning feature to engage the student, provide interactivity, and promote efficient learning. These quizzes ask students to pause at strategic points throughout each chapter to ensure they understand key points before moving ahead. Answers are strategically placed at the end of the chapter summary so that student's don't accidentally read them before answering the questions.

SOLUTIONS TO SELF-STUDY PRACTICE

Solution to SP7.1

Case 1: Goods available = $250, CGS = $150
Case 2: Ending inventory = $100

dr + Inventory		cr −
Beginning	50	
Purchases	200	
Goods Available	250	
	150	Goods Sold
Ending Inventory	100	

. . . for Student Motivation and Success

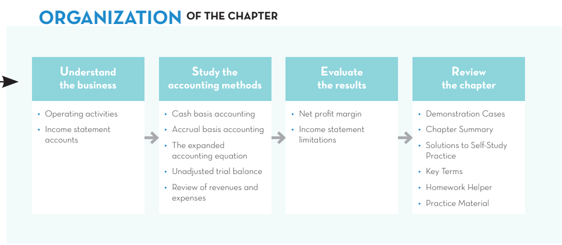
THE USER FRAMEWORK. The USER Framework provides a "road map" to each chapter, showing how accounting functions work at all levels of the firm. Students learn to

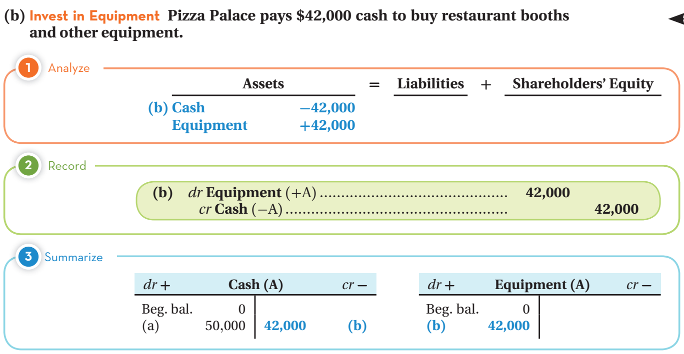
Understand the business decisions that managers make,

Study the accounting methods used,

Evaluate the reported results from the viewpoint of financial statement users, and

Review how the accounting methods affect the managers' decisions.





ANALYZE, RECORD, SUMMARIZE. A systematic accounting process is used to capture and report the financial effects of a company's activities. This process includes three basic steps:

Step 1: Analyze Transactions
Transaction analysis involves determining whether a transaction exists and, if it does, analyzing its impact on the accounting equation.

Steps 2 and 3: Record and Summarize
One way to record and summarize the financial effects of transactions would be to enter your understanding of their effects into a spreadsheet. By summing each spreadsheet column, you could compute new balances at the end of each month and report them on a balance sheet.

These helpful steps appear throughout various chapters to support learning.

Review and Practice Materials . . .

REVIEW OF THE CHAPTER

To effectively evaluate and guide student success with the appropriate feedback, you need homework and test materials that are easy to use and tied to the chapter discussions.

Each chapter of *Fundamentals of Financial Accounting* is followed by an extensive variety of end-of-chapter material that applies and integrates topics presented in the chapter. We have retained many of the popular items from prior editions and added new types of end-of-chapter materials, including a Homework Helper, multi-perspective discussion questions, comprehensive problems, and continuing cases.

DEMONSTRATION CASE. Each chapter provides demonstration cases of activities in real-life situations. These exercises have students analyzing, preparing, and summarizing actual information.

> **DEMONSTRATION CASE**
>
> eXcel
>
> Some analysts claim that the video game business is similar to the book business. In this demonstration case, we'll take a look at just how similar they are in terms of financial results. Books 'R' Us, Inc., is a company that operates only in the book business. Shortened versions of that company's financial statements are shown below.
>
> BOOKS 'R' US, INC.
> Income Statement (modified)
> (millions of dollars)
> For the Years Ended April 30
>
> | | 2014 | 2013 |
> |---|---|---|
> | Total Sales Revenue | $1,674 | $1,235 |

CHAPTER SUMMARY. Each chapter concludes with an end-of-chapter summary, organized by chapter learning objectives, that revisits the learning objectives from the beginning of the chapter.

> **CHAPTER SUMMARY**
>
> LO8-1 **Describe the trade-offs of extending credit.**
> - By extending credit to customers, a company is likely to attract a greater number of customers willing to buy from it.
> - The additional costs of extending credit include increased wage costs, bad debt costs, and delayed receipt of cash.
>
> LO8-2 **Estimate and report the effects of uncollectable accounts.**
> - Under generally accepted accounting principles, companies must use the allowance method to account for uncollectables. This method involves the following steps:
>   1. Estimate and record uncollectables with an end-of-period adjusting journal entry that increases Bad Debt Expense (debit) and increases the Allowance for Doubtful Accounts (credit).
>   2. Identify and write off specific customer balances in the period that they are determined to be uncollectable.
> - The adjusting entry (in step 1) reduces Net Income as well as Net Accounts Receivable. The write-off (in step 2) has offsetting effects on Accounts Receivable and the Allowance

KEY TERMS. The Key Terms list includes all key terms used in the chapter. Full definitions of all key terms are found in the Glossary near the back of the text.

> **KEY TERMS**
>
> Accounting
> Accounting Standards for Private Enterprises (ASPE)
> Accounts
> Balance Sheet
> Basic Accounting Equation
> Canadian Auditing Standards (CAS)
> Financial Statements
> Generally Accepted Accounting Principles (GAAP)
> Income Statement
> International Financial Reporting Standards (IFRS)
> Private Enterprise
> Publicly Accountable Profit-Oriented Enterprise
> Sarbanes-Oxley Act (SOX)
> Separate Entity Assumption
> Statement of Cash Flows
> Statement of Retained Earnings
> Unit of Measure Assumption
>
> See complete definitions in the glossary in the back of this text.

HOMEWORK HELPER. The Homework Helper immediately precedes each chapter's homework materials, highlighting subtleties discussed in the chapter and providing practice advice so that students can avoid common pitfalls when completing homework.

> **HOMEWORK HELPER**
>
> **Alternative terms**
> - Days to Collect is also called *days' sales outstanding.*
>
> **Helpful reminders**
> - The percentage of credit sales method calculates the amount to record as Bad Debt Expense. The aging of accounts receivable method calculates the desired balance in the Allowance for Doubtful Accounts. This desired balance is compared to the existing balance to determine the amount to record as Bad Debt Expense.
> - Interest rates are always for a full year. To calculate interest for a shorter period, multiply the interest rate by the fraction of the year for which you are calculating interest.
>
> **Frequent mistakes**
> - Some students mistakenly think a write-off is an expense. It isn't. It is merely a way to clean up the accounts receivable records. Under the allowance method, no Bad Debt Expense is recorded when removing (writing off) specific customer accounts.

. . . Build Confidence and Success

PRACTICE MATERIAL

QUESTIONS. Each chapter includes 10 to 20 multi-perspective discussion questions that ask students to explain and discuss terms and concepts presented in the chapter. Selected questions, denoted with an icon, are designed to help students begin developing critical thinking skills. These questions are ideal for sparking debate at the beginning of class or when transitioning between or reviewing topics.

MINI-EXERCISES. These assignments illustrate and apply a single learning objective from the chapter.

EXERCISES. These additional assignments illustrate and apply single and multiple learning objectives from the chapter.

PROBLEMS (COACHED, GROUP A, AND GROUP B). Each chapter includes three problem sets to help students develop decision-making skills. Coached problems include question-specific tips to assist students who need a little help getting started. Groups A and B are similar problems, but without the coaching. Excel templates are tied to selected end-of-chapter assignments designated with this icon.

NEW

LEVEL UP QUESTIONS. In each chapter, particularly challenging questions designated by the level-up icon, require students to combine multiple concepts to advance to the next level of accounting knowledge.

COMPREHENSIVE PROBLEMS. Selected chapters include problems that cover topics from earlier chapters to refresh, reinforce, and build an integrative understanding of the course material. These are a great resource for helping students stay up to date throughout the course.

SKILLS DEVELOPMENT CASES. Each chapter offers cases designed to help students develop analytical, critical thinking and technological skills. These cases are ideal for individual assignments, class discussions, and group projects. Encourage your students to find financial information in an actual annual report. The first case of every chapter presents an opportunity to connect your students with real-world financial reporting.

NEW

CONTINUING CASE. In Chapter 1, students are introduced to Nicole's Getaway Spa (NGS). In each chapter, the Continuing Case feature extends this case and requires students to apply topics from the current chapter. Chapters 5 through 12 present a continuing case involving the Wiki Art Gallery (WAG). This case depicts a setting in which accounting information is used for determining a company's selling price. By examining accounting decisions, in an easy-to-use multiple-choice format, students can learn that not all numbers are what they appear at first glance.

What's New in the Fourth Edition?

In response to the feedback and guidance from numerous financial accounting faculty, Fundamentals of Financial Accounting, 4e, includes several important changes such as new focus companies, new chapter openers, more than 50 **new** end-of-chapter assignments, and refinements and updates to remaining questions, exercises, problems, and cases. As well, additional Help Me Solve It animations are now included that walk students through an end of chapter question hand picked by the author of this product and provide students with insight into understanding and completing the question. Several new features are introduced in this edition, including new Spotlight discussions highlighting the effects of the global financial crisis, new comprehensive problems (spanning multiple chapters), new critical thinking case questions in easy to use multiple-choice format, and a second continuing case with the full case online in Connect. Fundamentals of Financial Accounting, 4e has also kept certain features that were noted from reviewers as very useful and needed. These include the comparisons of the key differences between Accounting Standards for Private Enterprises (ASPE) and International Financial Reporting Standards (IFRS) in a boxed feature at the end of each chapter, and check figures for some Exercises and Group A and Group B Problems, just to name a few.

DETAILED CHANGES BY CHAPTER:

CHAPTER 1

- Revised illustrative financial statements and discussion, including reference to statement of comprehensive income
- **New** chapter supplement to explain relevance of accounting to non-accounting majors
- **New** Spotlight on Ethics about discovered accounting scandals
- Solution to Self-Study Practice now placed after the chapter summary
- Revisions to end of chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements

CHAPTER 2

- Refocused discussion on the balance sheet, and its relationship to financing, investing, and select operating activities
- **New** Spotlight on Financial Reporting about the importance of meeting deadlines
- Updated data for contrast company (Yum! Brands Inc.)
- **New** Spotlight on Financial Reporting comparing current ratios before and after the 2008–2009 financial crisis
- Solution to Self-Study Practice now placed after the chapter summary
- Revisions to end of chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements; **new** challenging "level-up" exercises

CHAPTER 3

- **New** discussion on the income statement, and evaluating net profit margin
- **New** Spotlight on Financial Reporting comparing net profit margin ratios before and after the 2008–2009 financial crisis
- Solutions to Self-Study Practice now placed after the chapter summary
- Revisions to end of chapter material: updated numerical data for real-world companies; revised exercises to include transaction analysis and determination of income effects; revised annual report case to reflect updated financial statements; **new** challenging "level-up" exercises and problems

CHAPTER 4

- **New** self-study practice focused on reasons for adjustments
- **New** illustration of adjustments in Exhibit 4.3
- **New** discussion to tie adjusted financial results to preliminary net profit margin from Chapter 3
- Solutions to Self-Study Practice now placed after the chapter summary
- Revisions to end of chapter material: updated numerical data for real-world companies; revised exercises to encourage reflection on income effects of adjustments; revised annual report case to reflect updated financial statements; **new** challenging "level-up" exercises and continuing problems

CHAPTER 5

- **New** illustration of financial statement users/uses in Exhibit 5.1
- Updated information regarding focus company and IFRS contrast company
- Solutions to Self-Study Practice now placed after the chapter summary
- Revisions to end of chapter material: updated numerical data for real-world companies; **new** challenging "level-up" exercises and problems; revised annual report case to reflect updated financial statements; three **new** comprehensive problems; new "level-up" critical thinking case (in multiple-choice format)

CHAPTER 6

- **New** illustration of service and merchandising operations in Exhibit 6.1
- **New** illustration of cash receipt controls in Exhibit 6.3
- Updated information regarding focus company and contrast companies
- **New** Spotlight on Financial Reporting comparing gross profit percentages before and after the 2008–2009 financial crisis
- Solutions to Self-Study Practice now placed after the chapter summary
- Revisions to end-of-chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements; **new** "level-up" exercise and critical thinking case (multiple-choice format)

CHAPTER 7

- **New** focus company, The Hudson Bay Company
- **New** illustration of FIFO and Weighted Average effects when costs are rising or declining
- **New** Spotlight on Financial Reporting discussing effect of $485 million Playbook write-down on Blackberry's share price
- Updated information regarding focus company and contrast companies
- New Spotlight on Financial Reporting comparing days to sell before and after the 2008–2009 financial crisis
- Solutions to Self-Study Practice now placed after the chapter summary
- Revision to end-of-chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements; new "level-up" comprehensive problems (Chapters 6 and 7 and Chapters 2 and 7) and critical thinking case (multiple-choice format)

CHAPTER 8

- **New** focus company, VF Corporation (maker of North Face jackets, JanSport backpacks, Wrangler Jeans)
- Updated visual provided to help illustrate how a balance sheet looks before and after an account write-off
- Updated information regarding focus company and contrast companies
- **New** Spotlight on Financial Reporting comparing days to collect before and after the 2008–2009 financial crisis
- Solutions to Self-Study Practice now placed after the chapter summary
- Revision to end-of-chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements; revised "level-up" comprehensive problem (Chapters 6 and 8) and **new** critical thinking case (multiple-choice format)

CHAPTER 9

- Updated Spotlight on the World example involving componentization
- Changed terminology back to depreciation for tangible assets and amortization for intangible assets
- **New** bar chart illustrations of depreciation method effects
- Updated information regarding focus company and contrast companies
- **New** Spotlight on Financial Reporting comparing fixed asset turnover before and after the 2008–2009 financial crisis
- Solutions to Self-Study Practice now placed after the chapter summary
- Revision to end-of-chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements; revised "level-up" comprehensive problem (Chapters 3, 4, 8, and 9) and **new** critical thinking case (multiple-choice format)

CHAPTER 10

- Revised illustration of contingent liability accounting in Exhibit 10.9
- Updated information regarding focus company
- Solutions to Self-Study Practice now placed after the chapter summary
- Revision to end-of-chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements; **new** "level-up" comprehensive problem (Chapters 9 and 10) and critical thinking case (multiple-choice format)

CHAPTER 11

- Brief discussion of Accumulated Other Comprehensive Income in Shareholders' Equity
- **New** comparison company added in Exhibit 11.8 in order to compare EPS, ROE and P/E ratios with the focus company
- Updated information regarding focus company
- Solutions to Self-Study Practice now placed after the chapter summary
- Revision to end-of-chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements; **new** "level-up" critical thinking case (multiple-choice format)

CHAPTER 12

- New discussion to tie cash flow patterns to stages of corporate lifecycle (deleted discussion of cash flow ratios)
- New Exhibit 12.8 showing the phases of a corporate lifecycle
- New Spotlight on Business Decisions showing disparity between net income and operating cash flows prior to Lehman Brothers' collapse
- New Supplement 12B demonstrating use of T-account approach to preparing an indirect method statement of cash flows
- New demonstration case illustrating preparation of indirect method statement of cash flows from comparative balance sheet and income statement information
- Updated information regarding focus company
- Solutions to Self-Study Practice now placed after the chapter summary
- Revision to end-of-chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements; **new** "level-up" critical thinking case (multiple-choice format)

CHAPTER 13

- Updated information regarding the focus company (Home Depot), including all narrative interpreting and comparing financial results
- Expanded financial information for focus company up to five years to allow for a better trend analysis, including the narrative interpretations
- Solutions to Self-Study Practice now placed after the chapter summary
- Revision to end-of-chapter material: updated numerical data for real-world companies; revised annual report case to reflect updated financial statements;

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Acknowledgements

I am extremely grateful to have had this opportunity to work on such an exciting project. The entire process has been an incredible journey that you can truly appreciate only when you have been directly involved. The process has been rewarding and enjoyable thanks to the contributions made by everyone.

The committed team at McGraw-Hill Ryerson was outstanding. A huge thank you goes out to Keara Emmett, the product manager, and Katherine Goodes, the senior project developer, for their talent, commitment, and support throughout this process. Their patience and insights were invaluable to me.

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Brandy Mackintosh, Edwards School of Business University of Saskatchewan

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Brandy Mackintosh, Edwards School of Business University of Saskatchewan

THAT WAS
THEN

If you think accounting is far removed from your personal life, you might be in for a surprise. Your ordinary life experiences, especially as a student, actually prepare you well to learn accounting.

THIS IS
NOW

This chapter focuses on the key financial reports that businesspeople rely on when evaluating a company's performance.

YOUR LEARNING OBJECTIVES

Understand the business

LO1-1 Describe various organizational forms and business decision makers.

Study the accounting methods

LO1-2 Describe the purpose, structure, and content of the four basic financial statements.

Evaluate the results

LO1-3 Explain how financial statements are used by decision makers.

LO1-4 Describe factors that contribute to useful financial information.

Review the chapter

Chapter Summary
Additional resources on Connect

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CHAPTER 1

Business Decisions and Financial Accounting

FOCUS COMPANY:
Pizza Palace, Inc.

PIZZA PALACE

Welcome to the world of business and financial accounting. One of our goals for this book is to help you see the role that accounting plays in helping people turn their good ideas into successful businesses. The founder of FedEx first introduced his ideas about a nationwide transportation business in a college essay. With the help of accounting, FedEx has become a multibillion dollar business. Perhaps the only thing stopping you from aspiring to have your own business is that you don't know everything that's involved in starting and running a business. We're here to help with that.

Another important goal for us is to explain topics in ways that you can relate to. We want you to see that your personal life experiences help you to learn accounting. Often, we will explain topics in the context of a real business. By reading about these experiences, you'll gain a realistic understanding of how accounting is a key part of all businesses. So, let's get started.

Pizza Palace is a fictional company owned by Emilio Santos. For ten years, Emilio had worked in several pizza restaurants in downtown Vancouver. During this time, he perfected a gourmet pizza concept that he believed would be a great addition to the local restaurant scene, so Emilio decided to start his own pizza business. Although eager to get started, Emilio had several questions to consider and decisions to make. He contacted Ally Paddison, a local chartered professional accountant (CPA), to ask her advice. As you will read in this chapter, Ally met with Emilio in June to help him understand what's involved in starting a business and monitoring its success. In the first four chapters, you will learn the steps that Emilio took to start his own business and turn his dream into reality.

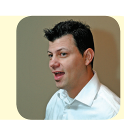
ORGANIZATION OF THE CHAPTER

Understand the business	Study the accounting methods	Evaluate the results	Review the chapter
• Organizational forms • Accounting for business decisions	• The basic accounting equation • Financial statements	• Using financial statements • Useful financial information	• Demonstration Case • Chapter Summary • Solution to Self-Study Practice • Key Terms • Homework Helper • Practice Material

Understand the Business

"Emilio, we should start by talking about how you want to organize your business."

"Well, I'm opening a gourmet pizza restaurant. What else do I need to know?"



ORGANIZATIONAL FORMS

LEARNING OBJECTIVE **1-1**

Describe various organizational forms and business decision makers.

Ally outlined three primary ways in which businesses can be organized: sole proprietorship, partnership, and corporation.

Sole Proprietorship

This is a form of business owned (and usually operated) by one individual. It is the easiest form of business to start because it doesn't require any special legal procedures. Just get a business licence and you're good to go. A sole proprietorship is considered a part of the owner's life, with all profits (or losses) becoming part of the taxable income of the owner, and the owner being personally liable for all debts of the business.

Partnership

A partnership is similar to a sole proprietorship, except that profits, taxes, and legal liability are the responsibility of two or more owners instead of just one. It is slightly more expensive to form than a sole proprietorship because a lawyer typically is needed to draw up a partnership agreement. The partnership agreement describes how profits are shared between partners and how that would change if new partners are added or existing partners leave. The key advantage of a partnership over a sole proprietorship is that it typically has more resources available to it, which can fuel the business's growth.

Corporation

Unlike sole proprietorships and partnerships, a corporation is a separate entity from both a legal and accounting perspective. This means that a corporation, not its owners, is legally responsible for its own taxes and debts. Thus, owners cannot lose more than their investment in the corporation, which is a major advantage to the owners. Two disadvantages of incorporation are that the legal fees for creating a corporation can be high and income tax returns must be filed for both the corporation and its owners.

Corporations can raise large amounts of money for growth because they divide ownership of the corporation into shares that can be sold to new owners. A share of the corporation's ownership is indicated in a legal document called a *share certificate*. The owners of a company's shares (shareholders) can buy and sell shares privately or publicly on a stock exchange if the company has legally registered to do so. Most corporations start out as private companies and will apply to become public companies ("go public") if they need a lot of financing, which they obtain from selling new share certificates to investors. Some big-name corporations, like London Drugs and Kal Tire, haven't gone public because they get enough financing from private sources, but many that you are familiar with such as Rogers Communications Inc. and Boston Pizza International Inc. are public companies.

Other

Other organizational forms exist, such as a limited liability company (LLC), which combines characteristics of a partnership and a corporation. We will focus on corporations.

"I'm interested in limiting my legal liability and getting some financing by selling ownership shares to investors and putting in some of my own personal money, so I will create a private corporation called Pizza Palace, Inc. What's next?"

ACCOUNTING FOR BUSINESS DECISIONS

Most companies exist to earn profits for their shareholders. They earn profits by selling goods or services to customers for more than they cost to produce. Emilio's company will be successful if it is able to make pizzas at a cost of $2 and sell them for $9. To know just how successful his company is, Emilio will need to establish and maintain a good system of financial record-keeping—an accounting system. **Accounting** is an information system designed by an organization to capture (analyze, record, and summarize) the activities affecting its financial condition and performance and then report the results to decision makers, both inside and outside the organization. It's such a key part of business that business people typically talk about their companies using accounting terms, which is why accounting terminology is often called the "language of business."

Accounting: A system of analyzing, recording, and summarizing the results of a business's activities and then reporting the results to decision makers.

Every organization needs accountants to assist in reporting financial information for decision making and to help its owners understand the financial effects of those business decisions. Emilio can get this help in one of two ways. He can hire an accountant to work as an employee of his business (a **private accountant**) or he can contract with someone like Ally, who provides advice to a variety of businesses (a **public accountant**).

Previously, accountants could pursue a variety of certifications, including CA (**chartered accountant**), CFE (**certified fraud examiner**), CGA (**certified general**

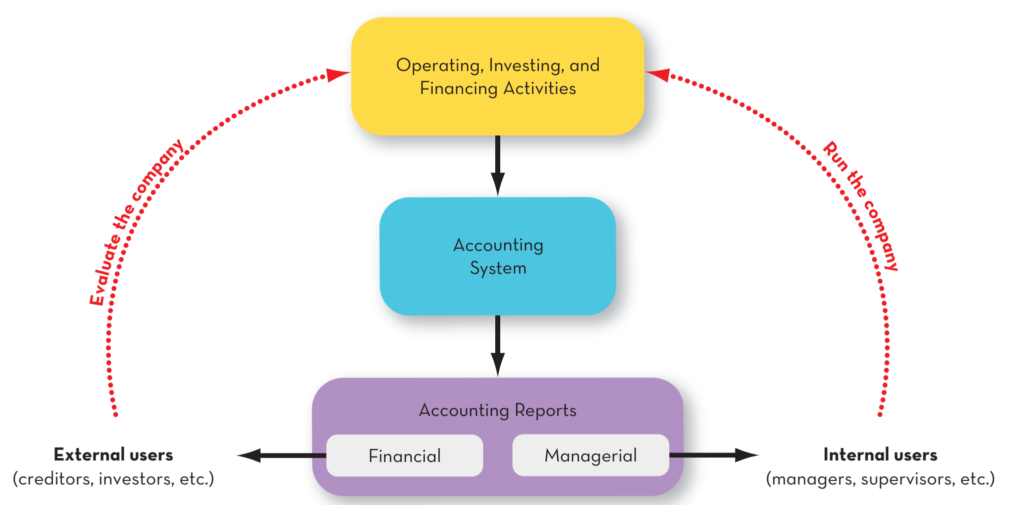
accountant), CMA (**certified management accountant**), and CIA (**certified internal auditor**), among others. Extensive discussions were held regarding the possible merge of CA's, CGA's, and CMA's in Canada, in order to move to a common professional accounting designation. This designation is a CPA, which stands for chartered professional accountant. At the time of printing this book, in most provinces and territories, all three accounting bodies have merged or are working towards merging. For additional information and updates on the accounting profession merger, visit www.cpacanada.ca.

Because Emilio's business is small, he doesn't yet need a full-time accountant. Instead, he agrees that Pizza Palace will pay fees to Ally for basic services. She'll help him to set up an accounting system and advise him on key business decisions.

"How will an accounting system help me run my business?"

The main goal of an accounting system is to capture information about the business and financing activities of a company so that it can be reported to decision makers, both inside and outside the business. Exhibit 1.1 illustrates this role and shows that this information can be presented in two kinds of reports. **Managerial accounting reports** include detailed financial plans and continually updated reports about the operating performance of the company. These reports are made available only to the company's employees (internal users) so that they can make business decisions related to production, marketing, human resources, and finance. For example, managerial accounting reports are needed when determining whether to build, buy, or rent a building; whether to continue or discontinue making particular products; how much to pay employees; and how much to borrow. As manager of a restaurant, Emilio will regularly need managerial accounting reports to monitor the quantity of supplies on hand, evaluate the various costs associated with making and selling his gourmet pizza, and assess the productivity of his employees.

EXHIBIT 1.1 The Accounting System Reports Information for Decision Makers



"Others outside your business will need financial information about your restaurant. For example, where will the money come from to start your business?"

"My wife and I will probably contribute $30,000 from personal savings. But I'll still need to ask the bank for a $20,000 loan to buy equipment. What will the bank want to know?"

Financial statements: Accounting reports that summarize the financial results of business and financing activities.

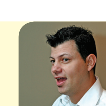
Ally described **financial accounting reports**, called **financial statements,** which are prepared periodically to provide information to people not employed by the business. These external financial statement users aren't given access to detailed internal records of the company, so they rely extensively on the financial statements. Creditors and investors are the two primary external user groups, but other external users also find the information helpful.

- **Creditors**—anyone to whom money is owed.
  - **Banks** use financial statements to evaluate the risk that they will not be repaid the money they've loaned to a company. Because banks are taking a risk when they loan money to a company, they want periodic financial reports from the company so they can keep an eye on how the business is doing and intervene if it looks like the company will have trouble repaying the loan.
  - **Suppliers** also want to be sure a business can pay them for the goods or services they deliver. They usually check the business's credit standing and may also ask for its financial statements before entering into significant business relationships.
- **Investors**
  - **Shareholders** are a major external user group. Both existing and future shareholders rely on financial statements to help evaluate whether the company is financially secure and likely to be a profitable investment.
- **Other external users**
  - Certain **customers** use financial statements to judge the company's ability to provide service on its products and honour warranties.
  - Various local, provincial, territorial, and federal **governments** collect taxes based on information used to prepare the financial statements.

In Pizza Palace's case, the bank will be the main external user. Emilio will be expected to prepare financial statements to obtain the loan and then regularly provide updated financial reports until the loan is repaid. If the company's shares are ever sold to other investors, these shareholders will rely on financial statements to estimate the value of their shares and determine whether to buy, sell, or hold Pizza Palace shares.

While Emilio understood everything Ally had told him up to this point, he had another major concern.

"I want to sound intelligent when I talk to my banker, but I don't know much about accounting."



"This is a common concern for new business owners, so let's start with the most basic thing you need to know about accounting."

Study the Accounting Methods

THE BASIC ACCOUNTING EQUATION

LEARNING OBJECTIVE **1-2**

Describe the purpose, structure, and content of the four basic financial statements.

One of the central concepts to understanding financial reports is that **what a company owns must equal what a company owes to its creditors and shareholders**. In accounting, there are special names for what a company owns (assets) and the claims on these items by creditors (liabilities) and shareholders (equity), as shown below.

Resources Owned . . .	=	Resources Owed . . .		
by the **company**		to **creditors**		to **shareholders**
Assets	=	**Liabilities**	+	**Shareholders' Equity**

The relationship between assets (A), liabilities (L), and shareholders' equity (SE) is known as the **basic accounting equation** (also called the *balance sheet equation*). The business itself, not the shareholders who own the business, is viewed as owning the assets and owing the liabilities. This is called the **separate entity assumption,** which requires that a business's financial reports include only the activities of the business and not those of its shareholders.

The elements of the basic accounting equation are fundamental to reading and understanding financial statements, so let's look at each in detail.

Basic accounting equation: A = L + SE.

Separate entity assumption: The financial reports of a business are assumed to include the results of only that business's activities.

Assets

An **asset** is an economic resource presently controlled by the company; it has measurable value and is expected to benefit the company by producing cash inflows or reducing cash outflows in the future. For Pizza Palace, assets include things like cash, supplies, cookware, and equipment such as tables, chairs, and pizza ovens. Some companies may have assets that don't appear on their financial statements, such as good hardworking employees. These employees do not appear on the financial statements because they don't have measurable value, however that doesn't mean they are not assets.

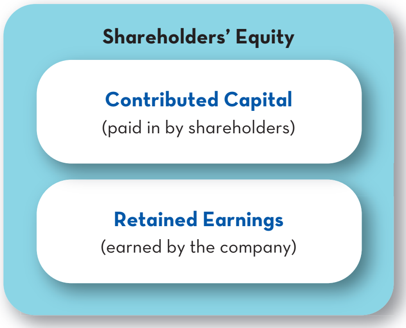
Liabilities

Liabilities are measurable amounts that the company owes to creditors. If Pizza Palace borrows from a bank, it would owe a liability called a *Note Payable.* This particular name is used because banks require borrowers to sign a legal document called a *note,* which describes details about the company's promise to repay the bank. Pizza Palace is likely to also owe suppliers for ingredients and other supplies delivered to Pizza Palace. When a company buys goods from another company, it usually does so on credit by promising to pay for the goods at a later date. The amount owed is called an *Account Payable* because purchases made using credit are said to be "on account." Pizza Palace could also owe wages to employees (*Wages Payable*) and taxes to governments (*Taxes Payable*). From a legal perspective, creditors have priority over shareholders. Thus, if a company goes out of business, liabilities must be paid before any amounts are paid to shareholders.

Shareholders' Equity

Shareholders' equity represents the owners' claims on the business. As illustrated below, these claims arise for two reasons:

1. First, the owners have a claim on amounts they contributed directly to the company in exchange for its shares (Contributed Capital).



2. Second, the owners have a claim on amounts the company has earned through profitable business operations (Retained Earnings).

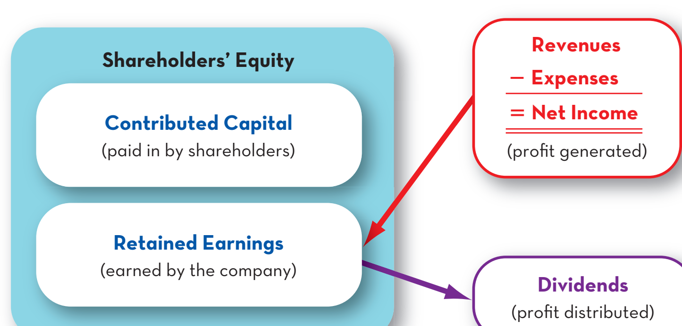
Retained Earnings is particularly important because a business can survive only if it is profitable. It will be profitable if the total amount earned from selling goods and services is greater than the costs incurred to generate those sales. Theoretically, these profits belong to the company's owners, so they increase shareholders' equity. Through these profits, owners can get back more money from the company than they paid in (a return on their investment).

Given the importance of a company's profits, accounting systems separately track the two components of profit: revenues and expenses.

Revenues Revenues are earned by selling goods or services to customers. For Pizza Palace, revenues are measured at the amount the company charges its customers for pizza.

Expenses Expenses are all costs of doing business that are necessary to earn revenues. For Pizza Palace, these include advertising, utilities, rent, wages, insurance, repairs, and supplies used in making pizza. Expenses are said to be incurred to generate revenues. The word *incurred* means that the activities giving rise to a cost (e.g., running an advertisement, using electricity) have occurred in the period in which the related revenues have been generated.

Net Income Although *profit* is used in casual conversation, the preferred term in accounting is *net income.* Net income is calculated as revenues minus expenses. For Pizza Palace to be profitable, its revenues must be greater than its expenses. (If revenues are less than expenses, the company would have a net loss, but for now we'll optimistically assume that Pizza Palace is going to earn a profit.) **By generating net income, a company increases its shareholders' equity**, as illustrated below. This net income can be left in the company to accumulate (with prior year's net income that has been retained) or it can be paid out to the company's shareholders for their own personal use (called *dividends*).



Dividends A company's net income (profits) is accumulated in Retained Earnings until a decision is made to distribute them to shareholders in what is called a *dividend.* The simplest type of dividend, and the most common for a small business like Pizza Palace, is a dividend paid in cash. **Dividends are not an expense incurred to generate earnings**. Rather, dividends are a distribution of earnings. They are determined at the discretion of the company's board of directors. If Emilio wanted, he could choose to leave all the profits in Pizza Palace by never declaring a dividend.

"Okay, I think I get it, but can you tell me how all those items relate to each other and where they are reported in the financial statements?"

FINANCIAL STATEMENTS

Assets, liabilities, shareholders' equity, revenues, expenses, and dividends appear in different reports that collectively are called *financial statements.* The term *financial statements* refers to four accounting reports, typically prepared in the following order:

1. **Income Statement**
2. **Statement of Retained Earnings**
3. **Balance Sheet**
4. **Statement of Cash Flows**

Financial statements can be prepared at any time during the year, although they are most commonly prepared monthly, every three months (quarterly reports), and at the end of the year (annual reports). Companies are allowed to choose their fiscal year-end date. The fiscal year can be a 12-month period ending on a day other than December 31, or the fiscal year can be what is called a calendar year-end, which is a 12-month period ending on December 31. The toy maker Mattel, Inc., uses a calendar year-end because this is the start of its slow business period. The Saskatchewan Roughriders Football Club Inc. has chosen a fiscal year-end of March 31, which is during the off-season of the football schedule and is a slower time of year for the organization.

The Income Statement

The first financial statement prepared is the **income statement** (also called the *statement of operations*). Ally gives Emilio Exhibit 1.2 to show what Pizza Palace's income statement might look like for the month ended September 30, assuming he is able to open his restaurant on September 1. The heading of the income statement identifies who, what, and when: the name of the business, the title of the report, and the time period covered by the financial statement. Larger businesses with thousands or millions of dollars in revenues and expenses add a fourth line under

Income statement: Reports the amount of revenues less expenses for a period of time. Also called the *statement of operations.*

EXHIBIT 1.2 Income Statement

		Explanation
PIZZA PALACE, INC.		Who: Name of the business
Income Statement (Projected)		What: Title of the statement
For the Month Ended September 30, 2014		When: Accounting period
Revenues		
Pizza Revenue	$11,000	Revenue earned from the sale and delivery of pizza to customers
Total Revenues	11,000	**Total amount earned during September**
Expenses		
Supplies Expense	4,000	Cost of pizza ingredients used up in September
Wages Expense	2,000	Cost of employee wages for work done in September
Rent Expense	1,500	Cost of rent for the month of September
Utilities Expense	600	Cost of utilities used in September
Insurance Expense	300	Cost of insurance coverage for September
Advertising Expense	100	Cost of advertising done in September
Income Tax Expense	500	Cost of taxes on September's income
Total Expenses	9,000	**Total expenses incurred in September to generate revenues**
Net Income	$ 2,000	**Difference between total revenues and total expenses**