LEARNING OBJECTIVES

**After studying this chapter, you should be able to:**

1. Recognize the information conveyed in each of the four basic financial statements and how it is used by different decision makers (investors, creditors, and managers). p. 5
2. Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements. p. 19
3. Distinguish the roles of managers and auditors in the accounting communication process. p. 21
4. Appreciate the importance of ethics, reputation, and legal liability in accounting. p. 23

CHAPTER

# Financial Statements and Business Decisions

# 1

In June 2004, Sleeman Breweries Ltd., a leading brewer and distributor of premium beer in Canada, purchased Unibroue Inc.—the largest microbrewery in Quebec—for $40 million. The price Sleeman paid was decided by considering the value of the economic resources owned by Unibroue, its debts to others, its ability to sell goods for more than the cost to produce them, and its ability to generate the cash necessary to pay its current bills. Much of this assessment was based on financial information that Unibroue provided to Sleeman in the form of financial statements.

FOCUS COMPANY:

**Unibroue Inc.**

**VALUING AN ACQUISITION USING FINANCIAL STATEMENT INFORMATION**

## THE OBJECTIVES OF *FINANCIAL ACCOUNTING*

Determining the price that Sleeman was willing to pay for Unibroue is typical of the economic decisions that are made based on financial statements. Businesses use financial statements as the primary means to communicate financial information to parties outside the organization. The purpose of this text is to help you develop the ability to read and interpret financial statements of business organizations and understand the system that produces those statements. This book is aimed at two groups of readers: *future managers*, who will need to interpret and use financial statement information in business decisions, and *future accountants*, who will prepare financial statements for those managers. The book provides future managers with a firm basis for using financial statement information in their careers in marketing, finance, banking, manufacturing, human resources, sales, information systems, and other areas of management. It also provides future accountants with a solid foundation for further professional study.

Both managers and accountants must understand *financial statements* (what the statements tell you and what they do not tell you about a business enterprise), *business operations*, and *the use of financial statements in decision making* to perform their duties successfully. As a consequence, we integrate actual business practice in our discussions, starting with Chapter 1. We examine the fundamentals of financial accounting in a variety of business contexts relevant to your future careers. Each chapter's material is integrated around a *focus company* (in this chapter, Unibroue). The focus companies are drawn from 10 different industries, providing you with a broad range of experience with realistic business and financial accounting practices. When appropriate, the focus company's operations and financial statements are then compared to those of the *contrast companies.* When you complete this book, you will be able to read and understand financial statements of real companies.

The way that seasoned managers use financial statements in modern businesses has guided our selection of learning objectives and content. At the same time, our teaching approach recognizes that students using this book have no previous exposure to accounting and financial statements and often little exposure to the business world. The book also is aimed at helping you learn how to learn by teaching efficient and effective approaches for learning the material.

## UNDERSTANDING THE BUSINESS

### THE PLAYERS

Unibroue was founded in 1990 by André Dion and Serge Racine, who saw great potential in the craft beer market. These beers are produced and sold locally, and are often filtered but not pasteurized. Other mass produced beers are pasteurized and sold nationally and internationally. Predicting the rise in demand for craft beer, the founders started the company to produce specialty craft beer. They invested a major portion of their savings, becoming the sole owners of Unibroue Inc. As is common in new businesses, the founders also functioned as managers of the business (they were *owner-managers*).

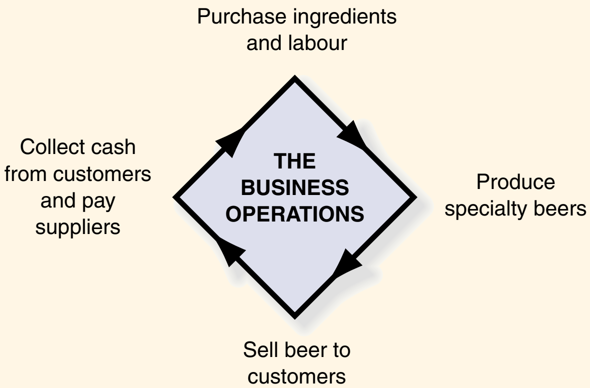
In the spring of 1992, Unibroue marketed its first beer, Blanche de Chambly, which was well-received by consumers. As a result of their first success, the founders soon discovered that they needed additional money to develop their business. So they borrowed money from a local bank and other lenders, or *creditors,* and used the funds to expand the business by introducing new brands to the market, such as Maudite, La Fin du Monde, U2, and 2004. Unibroue's annual launching of new specialty beers helped the company grow its sales from $4.9 million in 1993 to $25.6 million in 2003. The company's success attracted the attention of its competitors. On April 20, 2004, Sleeman Breweries Ltd. announced its intention to buy Unibroue; Sleeman subsequently acquired the company in June 2004.

*Investors*—such as Sleeman, which bought an entire company, or individuals who buy small percentages of large corporations—make their purchases hoping to gain in two ways. They hope to receive a portion of what the company earns in the form of cash payments called *dividends,* and they hope to eventually sell their share of the company at a higher price than they paid.

## THE BUSINESS OPERATIONS

To understand any company's financial statements, you must first understand its operations. As noted, Unibroue develops and markets specialty craft beers for personal consumption. Unibroue's beers are manufactured from natural ingredients including water, malted barley, malted or raw wheat, corn, spices, sugar, and yeast. Unibroue purchases some of these ingredients from other companies, referred to as *suppliers*. These ingredients are brewed into beer in a five-step process that starts with fermentation and proceeds to filtration/clarification, bottling and kegging, and, if necessary, refermentation in the bottle in a specially designed holding room.

Unibroue distributes its beers both through its own distribution network and through independent distributors. In 2003 its customers were large supermarket chains, such as Loblaws, convenience stores, cafés, and other licensed establishments.




## THE ACCOUNTING SYSTEM

Like all businesses, Unibroue has an **accounting** system that collects and processes financial information about an organization and reports that information to decision makers. Unibroue's managers (often called *internal decision makers*) and parties outside the firm such as the managers at Sleeman Breweries and the bank's loan officer (often called *external decision makers*) use reports produced by this system. Exhibit 1.1 outlines the two parts of the accounting system. Internal managers typically require continuous detailed information because they must plan and manage the day-to-day operations of the organization. Developing accounting information for internal decision makers is called *managerial* or *management accounting* and is the subject of a separate accounting course. The focus of this text is accounting for external decision makers, called *financial accounting*, and the four basic financial statements and related disclosures that are the output of that system.

**ACCOUNTING** is a system that collects and processes (analyzes, measures, and records) financial information about an organization and reports that information to decision makers.

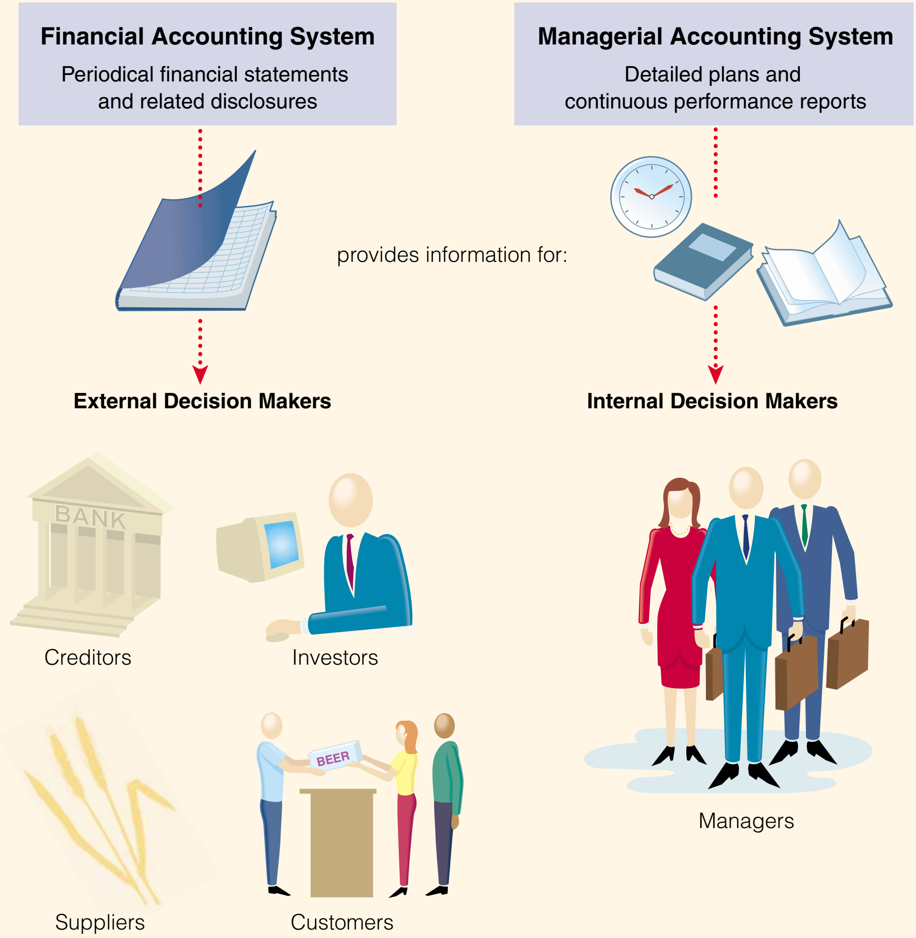
We begin this process with a brief but comprehensive overview of the four basic financial statements and the people and organizations involved in their preparation and use. This overview provides you with a context in which you can learn the more detailed material that is presented in the following chapters. In particular, we focus on how two primary users of the statements, investors (owners) and creditors (lenders), relied on each of Unibroue's four basic financial statements in their decisions to invest in or lend money to Unibroue. Later in the chapter, we begin to discuss a broader

**LEARNING OBJECTIVE 1**

Recognize the information conveyed in each of the four basic financial statements and how it is used by different decision makers (investors, creditors, and managers).

EXHIBIT **1.1**

**The Accounting System and Decision Makers**




range of uses of financial statement data in marketing, management, human resources, and other business contexts.

To understand the way that Sleeman Breweries used Unibroue's financial statements in its decision, we must first understand what specific information is presented in the four basic financial statements for a company such as Unibroue.

We present many new business and financial statement terms in this chapter. Instead of trying to memorize the definitions of every term used in this chapter, focus your attention on learning the general structure and content of the statements. Specifically, you should focus on these questions:

1. What categories of items (often called *elements*) are reported on each of the four statements? (What type of information does a statement convey, and where can you find it?)
2. How are the elements within a statement related? These *relationships* are usually described by an equation that tells you how the elements fit together.
3. Why is each element important to managers', owners', or creditors' decisions? (How important is the information to decision makers?)

The *Self-Study Quizzes* that occur throughout the chapter will test your ability to answer these questions. Remember that since this chapter is an overview, each concept discussed in this chapter will be discussed again in Chapters 2 through 6.

**ORGANIZATION** OF THE CHAPTER

| • The Basic Financial Statements | • Using Financial Statements to Determine Unibroue's Value | • Responsibilities for the Accounting Communication Process |
|---|---|---|
| The Balance Sheet | Determining Unibroue's Purchase Price | Generally Accepted Accounting Principles (GAAP) |
| The Income Statement | | Management Responsibility and the Demand for Auditing |
| The Statement of Retained Earnings | | Ethics, Reputation, and Legal Liability |
| The Cash Flow Statement | | |
| Relationships among the Statements | | |
| Notes | | |

## THE FOUR BASIC FINANCIAL STATEMENTS: AN OVERVIEW

The four basic financial statements include the *balance sheet,* the *income statement,* the *statement of retained earnings,* and the *cash flow statement.*[1] These are the basic statements normally prepared by profit-oriented corporations for use by investors, creditors, and other external decisions makers. They summarize the financial activities of the business. They can be prepared at any point in time and can apply to any time span (such as one year, one quarter, or one month). Like most companies, Unibroue prepares financial statements for investors and creditors at the end of each quarter (known as *quarterly reports*) and at the end of the year (known as *annual reports*).

The organization for which financial data are to be collected, called an **accounting entity**, must be precisely defined. The business entity itself, not the business owners, is viewed as owning the resources it uses and as owing its debts.

An **ACCOUNTING ENTITY** is the organization for which financial data are to be collected.

### THE BALANCE SHEET

The purpose of the **balance sheet** is to report the financial position (amount of assets, liabilities, and shareholders' equity) of an accounting entity at a particular point in time. We can learn a lot about what the balance sheet reports just by reading the statement from the top. The balance sheet of Unibroue Inc. presented by its former owners to Sleeman Breweries is shown in Exhibit 1.2.

A **BALANCE SHEET (STATEMENT OF FINANCIAL POSITION)** reports the financial position (assets, liabilities, and shareholders' equity) of an accounting entity at a point in time.

**Structure** The *heading* of the balance sheet identifies four significant items related to the statement:

1. *name of the entity*—Unibroue Inc.
2. *title of the statement*—Balance Sheet
3. *specific date of the statement*—At December 31, 2003
4. *unit of measure*—(in thousands of dollars)

[1]The income statement and the statement of retained earnings are sometimes combined into the statement of earnings and retained earnings.

EXHIBIT **1.2**

**Balance Sheet**

**UNIBROUE INC.**
**Balance Sheet**
**At December 31, 2003**
**(in thousands of dollars)**

| | | | |
|---|---|---|---|
| | **Assets** | | |
| *amount of cash in the company's bank accounts* | Cash | | $ 1,120 |
| *shares and treasury bills purchased with excess cash* | Short term investments | | 401 |
| *amounts owed by customers from prior sales* | Accounts receivable | | 4,219 |
| *ingredients and bottled but unsold beer* | Inventories | | 3,800 |
| *rent and insurance paid in advance* | Prepaid expenses | | 1,348 |
| *factories and production machinery* | Plant and equipment | | 22,717 |
| *land on which the factories are built* | Land | | 550 |
| | Total assets | | $34,155 |
| | **Liabilities** | | |
| *amounts owed to suppliers for prior purchases* | Accounts payable | $ 1,312 | |
| *amount of taxes owed to the government* | Income taxes payable | 310 | |
| *amounts owed on written debt contracts* | Notes payable | 7,327 | |
| *liabilities that resulted from complex accounting rules* | Future income taxes | 2,818 | |
| | Total liabilities | | $11,767 |
| | **Shareholders' Equity** | | |
| *amounts invested in the business by shareholders* | Share capital | $ 9,238 | |
| *past earnings not distributed to shareholders* | Retained earnings | 13,150 | |
| | Total shareholders' equity | | 22,388 |
| | Total liabilities and shareholders' equity | | $34,155 |

The notes are an integral part of these financial statements.
This balance sheet is an adaptation of Unibroue's actual balance sheet.

The balance sheet is like a financial snapshot indicating the entity's financial position *at a specific point in time*—in this case, December 31, 2003—which is stated clearly on the balance sheet. Financial reports are normally denominated in the currency of the country in which they are located, in this case Canadian dollars. Similarly, U.S. companies report in U.S. dollars and Mexican companies in Mexican pesos. Medium-sized companies often report in thousands of dollars; that is, they round the last three digits to the nearest thousand. The cash amount of $1,120 on Unibroue's balance sheet actually means $1,120,000.

Unibroue's balance sheet first lists the company's assets, followed by liabilities and shareholders' equity. Assets are economic resources legally controlled by the entity and financed either by creditors (which creates liabilities) or owners (which creates shareholders' equity). Because Unibroue is a corporation, its owners' equity is designated shareholders' equity.

**BASIC ACCOUNTING EQUATION (BALANCE SHEET EQUATION):**
Assets = Liabilities + Shareholders' Equity.

Since each asset must have a source of financing, a company's assets must, by definition, equal the sum of its liabilities and shareholders' equity.[2] The **basic accounting equation**, often called the **balance sheet equation**, is written as

[2]A corporation is a business that is incorporated under the federal or provincial laws. The owners are called *shareholders* or *stockholders*. Ownership is represented by shares of capital that usually can be bought and sold freely. The corporation operates as a separate legal entity, separate and apart from its owners. The shareholders enjoy limited liability; they are liable for the debts of the corporation only to the extent of their investments. Chapter Supplement A discusses forms of ownership in more detail.

| Assets | = | Liabilities + Shareholders' Equity |
|---|---|---|
| Economic resources (e.g., cash, inventory) | | Sources of financing for the economic resources<br>Liabilities: from creditors<br>Shareholders' Equity: from shareholders |

The basic accounting equation shows what we mean when we refer to a company's *financial position:* the economic resources that the company owns and the sources of financing for those resources.

**Elements** *Assets* are economic resources controlled by the entity as a result of past transactions and from which future economic benefits can be obtained. Unibroue's assets include seven major items. The exact items listed as assets on a company's balance sheet depend on the nature of its operations. The seven items listed by Unibroue are the economic resources needed to produce and sell beer to its customers. Each of these economic resources is expected to provide future benefits to the company. To prepare for the fermentation process, Unibroue first needed *cash* to purchase *land* on which to build manufacturing facilities and install production machinery (*buildings and equipment*). Unibroue needs to have insurance to protect its resources against potential losses; advance payment of any insurance premiums gave rise to *prepaid expenses*. Unibroue then began purchasing ingredients, which led to the balance assigned to *inventories*. When Unibroue sells its beers to supermarkets and convenience stores, it sells them on credit and receives promises to pay called *accounts receivable*, which are collected in cash later. When the amount of cash exceeds the company's needs in the near future, Unibroue invests the excess cash in *short-term investments* (e.g., shares issued by other companies).

Every asset on the balance sheet is initially measured at the total cost incurred to acquire it. For example, the balance sheet for Unibroue reports Land, $550; this is the amount paid (in thousands) for the land when it was acquired. Balance sheets do not generally show the amounts for which the assets could currently be sold.

*Liabilities* are the entity's obligations that result from past transactions. They arise primarily from the *purchase of goods or services* on credit and through *cash borrowings* to finance the business.

There are four types of liabilities listed on Unibroue's balance sheet. The accounts payable arise from the purchase of goods and services from suppliers on credit without a formal written contract (or note). The income taxes payable represent an amount due to the taxation authorities as a result of the company's profitable operations in 2003. The notes payable result from cash borrowings based on formal written debt contracts with lending institutions such as banks.

The term "future income taxes" arises because the governments that collect tax require companies to calculate their income tax using the federal and provincial tax laws instead of specific accounting standards. Future income taxes represent the amount that would be paid to the federal and provincial governments if they ceased to require a separate calculation of taxable income that differs from the accounting income that is reported in the income statement to other external users.

*Shareholders' equity* indicates the amount of financing provided by owners of the business and earnings. Shareholders' equity arises from two sources: (1) *share capital*, or the investment of cash and other assets in the business by the owners, and (2) *retained earnings*, or the amount of earnings reinvested in the business (and thus not distributed to shareholders in the form of dividends).

In Exhibit 1.2, the Shareholders' Equity section reports two items. Unibroue's shareholders invested a total of $9,238,000 in the business and received over 4 million shares of capital in exchange for their contributions. This is reported as share capital.[3] Unibroue's total earnings (or losses incurred) less all dividends paid to the shareholders since formation of the corporation equalled $13,150,000 and is reported as *retained earnings*. Total shareholders' equity is the sum of the proceeds received on issuing shares to owners plus the retained earnings.

## FINANCIAL **ANALYSIS**

### INTERPRETING ASSETS, LIABILITIES, AND SHAREHOLDERS' EQUITY ON THE BALANCE SHEET

Assessment of Unibroue assets was important to its creditors, and to its prospective investor, Sleeman Breweries, because assets provide a basis for judging whether the company has sufficient resources available to operate the business.

Sleeman Breweries was interested in Unibroue's debts because of its concern whether the company had sufficient sources of cash to pay its debts. Unibroue's debts were also relevant to its bankers' decisions to lend money to the company because existing creditors share the bankers' claims against Unibroue's assets. If a business does not pay its creditors, they may force the sale of assets sufficient to meet their claims. The sale of assets often fails to cover all of a company's debts, and some creditors may take a loss.

Unibroue's shareholders' equity or net worth is important to creditors because their claims legally come before those of owners. If Unibroue goes out of business and its assets are sold, the proceeds of that sale must be used to pay back creditors before the owners receive any money. Thus, creditors consider shareholders' equity a protective cushion.[4]

**A Note on Format** A few additional formatting conventions are worth noting here. Assets are listed on the balance sheet by ease of conversion into cash. Liabilities are listed by their maturity (due date). Most financial statements include the monetary unit sign (in Canada, the $) beside the first dollar amount in a group of items (e.g., the cash amount in the assets). Also, it is common to place a single underline below the last item in a group before a total or subtotal (e.g., land). A dollar sign is also placed beside group totals (e.g., total assets) and a double underline below. The same conventions are followed in all four basic financial statements. We will discuss alternative balance sheet formats in more detail in Chapter 2.

## SELF-STUDY **QUIZ 1-1**

1. Unibroue's *assets* are listed in one section and *liabilities* and *shareholders' equity* in another. Notice that the two sections balance in conformity with the basic accounting equation. In the following chapters, you will learn that the basic accounting equation is the basic building block for the entire accounting process. Your task here is to verify that the shareholders' equity of $22,388,000 is correct, using the numbers for assets and liabilities presented in Exhibit 1.2 and the basic accounting equation in the form

**Assets − Liabilities = Shareholders' Equity**

[3]It should be noted that the amounts in share capital on Unibroue's balance sheet did not change when Unibroue's shareholders sold their shares to Sleeman Breweries since the transaction did not involve an additional contribution of cash or other assets to Unibroue. This transaction, which took place between Unibroue's original owners and Sleeman, occurred outside of the accounting entity, Unibroue, and thus was not recorded by its accounting system.

[4]Case CP1–5 (p. 43) considers various possibilities when a company goes out of business.

2. Learning which items belong in each of the balance sheet categories is an important first step in understanding their meaning. Mark each balance sheet item in the following list as an asset (A), liability (L), or shareholders' equity (SE), without referring to Exhibit 1.2.

| | |
|---|---|
| ______ Accounts payable | ______ Inventories |
| ______ Accounts receivable | ______ Land |
| ______ Cash | ______ Notes payable |
| ______ Share capital | ______ Retained earnings |
| ______ Plant and equipment | |

After you complete your answers, check them with the solutions on page 27. If you are unclear about any of the answers, you should refer back to the chapter material preceding the quiz before moving on.

## THE INCOME STATEMENT

**Structure** The **income statement (statement of income, statement of earnings**, or **statement of operations)** reports the accountant's primary measure of performance of a business: revenues generated less expenses incurred during the accounting period. While the term *profit* is commonly used in our language for this measure of performance, accountants prefer to use the technical terms *net income* or *net earnings*. Unibroue's net income measures its success in selling beer for more than it cost to generate those sales.

The **INCOME STATEMENT (STATEMENT OF INCOME, STATEMENT OF EARNINGS, STATEMENT OF OPERATIONS)** reports the revenues less the expenses of the accounting period.

A quick reading of Unibroue's income statement (Exhibit 1.3) provides an indication about its purpose and content. The heading of the income statement again identifies the name of the entity, the title of the statement, and the unit of measure used in the statement. Unlike the balance sheet, which reports financial information as of a certain date, the income statement reports information for a *specified period of time* (for the year ended December 31, 2003). The time period covered by the financial statements (one year in this case) is called an **accounting period**.

The **ACCOUNTING PERIOD** is the time period covered by the financial statements.

EXHIBIT **1.3**

**Income Statement**

| | | | |
|---|---|---|---|
| **UNIBROUE INC.** | | | *name of the entity* |
| **Income Statement** | | | *title of the statement* |
| **For the Year Ended December 31, 2003** | | | *accounting period* |
| **(in thousands of dollars)** | | | *unit of measure* |
| Revenues | | | |
| Sales revenue | $25,598 | | *revenue earned from sale of beer* |
| Total revenues | | $25,598 | |
| Expenses | | | |
| Cost of goods sold | 15,443 | | *cost to produce the beer sold* |
| Selling, distribution, and market development expense | 6,334 | | *expenses related to sales distribution and market development* |
| Administrative expense | 1,345 | | *operating expenses not related to production* |
| Interest expense | 736 | | *cost of using borrowed funds* |
| Total expenses | | 23,858 | |
| Income before income taxes | | 1,740 | |
| Income tax expense | | 596 | *income taxes on the period's pretax income* |
| Net income | | $1,144 | |

The notes are an integral part of these financial statements.
This income statement is an adaptation of Unibroue's actual income statement for 2003.

Notice that Unibroue's income statement has three major captions: revenues, expenses, and net income. The income statement equation that describes this relationship is

**Revenues − Expenses = Net Income**

**Elements** Companies earn *revenues* from the sale of goods or services to customers (in Unibroue's case, from the sale of beer). Revenues are normally reported on the income statement when the goods or services are sold to customers whether or not they have been paid for. Retail stores such as Wal-Mart or McDonald's often receive cash at the time of sale. However, when Unibroue sells its beer to supermarkets and convenience stores, it receives a promise of future payment called an *account receivable,* which is collected in cash at a later date. In either case, the business recognizes total sales (cash and credit) made during a specific accounting period as revenue for that period. Various terms are used in financial statements to describe different sources of revenue (e.g., provision of services, sale of goods, rental of property). Unibroue lists only one source, *sales revenue,* for beer delivered to customers.

*Expenses* represent the dollar amount of resources the entity used up, or consumed, to earn revenues during the period. Unibroue lists five items as expenses on the income statement. The *cost of goods sold* is the total cost to Unibroue to produce the beer delivered to customers during the year. These include the costs of ingredients used in production, wages paid to the factory workers, and even a portion of the cost of factories and equipment used to produce the goods that were sold (called *amortization*). *Selling expenses* include a variety of expenses such as the salaries of sales staff and expenses related to distribution of beer and the development of new markets. *Administrative expenses* also include many items such as the salaries of management personnel, plus other general costs of operating the company not directly related to production.

Unibroue also reported *interest expense,* which reflects the cost of using borrowed funds. Finally, as a corporation, Unibroue must pay income tax based on pretax income. Unibroue's income tax expense is approximately 34 percent of its pretax income.

Expenses may require the immediate payment of cash, a payment of cash at a future date, or the use of some other resource such as an inventory item that may have been paid for in a previous period. For accounting purposes, the expense reported in one accounting period may actually be paid for in another accounting period. Nevertheless, the company recognizes all expenses (cash and credit) incurred during a specific accounting period regardless of the timing of the cash payment. For example, let us assume that Unibroue owes $50,000 in sales commissions to salespeople who sold beer to supermarkets in December 2003, but did not pay the $50,000 until January 2004. In this case, the sales commissions would be recognized as expenses for the accounting period ending on December 31, 2003, because during December 2003 the salespeople exerted the efforts that resulted in commissions for their success at selling beer.

*Net income* or net earnings (often called *profit* or *the bottom line*) is the excess of total revenues over total expenses. If total expenses exceed total revenues, a net loss is reported. (Net losses are normally noted by parentheses around the income figure.) When revenues and expenses are equal for the period, the business has operated at breakeven.

We noted earlier that revenues are not necessarily the same as collections from customers and expenses are not necessarily the same as payments to suppliers. As a result, net income normally does not equal the net cash generated by operations. This latter amount is reported on the cash flow statement discussed later in the chapter.

## FINANCIAL **ANALYSIS**


### ANALYZING THE INCOME STATEMENT: BEYOND THE BOTTOM LINE

Investors such as Sleeman and creditors closely monitor a firm's net income because it indicates the firm's ability to sell goods and services for more than they cost to produce and deliver. Investors buy the company's shares when they believe that future earnings will improve and lead to a higher share price. Lenders also rely on future earnings to provide the resources to repay loans. The details of the statement also are important. For example, Unibroue had to sell more than $25 million worth of beer to make just over $1 million. The beer industry is very competitive. If a competitor were to lower prices just 10 percent, forcing Unibroue to do the same, or if Unibroue had to triple market development to catch up to a competitor, its net income could easily turn into a net loss. These factors and others help investors and creditors estimate the company's future earnings.

## SELF-STUDY **QUIZ 1-2**

1. Learning which items belong in each of the income statement categories is an important first step in understanding their meaning. Mark each income statement item in the following list as a revenue (R) or an expense (E) without referring to Exhibit 1.3.

| | |
|---|---|
| ______ Cost of goods sold | ______ Sales |
| ______ Administrative | ______ Selling and distribution |

2. During the year 2003, Unibroue delivered beer to customers for which the customers paid or promised to pay in the future amounts totalling $25,598,000. During the same year, it collected $25,270,000 in cash from its customers. Without referring to Exhibit 1.3, indicate which of the two numbers will be shown on Unibroue's income statement as *sales revenue* for 2003. Explain.
3. During the year 2003, Unibroue *produced* beer with a total cost of production of $15,115,000. During the same year, it *delivered* to customers beer that had cost a total of $15,443,000 to produce. Without referring to Exhibit 1.3, indicate which of the two numbers will be shown on Unibroue's income statement as *cost of goods sold* for 2003. Explain.

After you complete your answers, check them with the solutions on page 27.

## THE STATEMENT OF RETAINED EARNINGS

**Structure** Unibroue prepares a separate **statement of retained earnings**, shown in Exhibit 1.4. The heading identifies the name of the entity, the title of the statement, and the unit of measure used. Like the income statement, the statement of retained earnings covers a specific period of time (the accounting period), which in this case is one year. The statement of retained earnings reports the way that net income and the distribution of dividends affected the company's financial position during the accounting period. Net income earned during the year increases the balance of retained earnings. The declaration of dividends to the shareholders decreases retained earnings.[5] The retained earnings equation that describes these relationships is

The **STATEMENT OF RETAINED EARNINGS** reports the way that net income and the distribution of dividends affected the financial position of the company during the accounting period.

**Beginning Retained Earnings + Net Income − Dividends = Ending Retained Earnings**

[5]Net losses are subtracted. The complete process of declaring and paying dividends is discussed in a later chapter.

EXHIBIT **1.4**

**Statement of Retained Earnings**

| | | |
|---|---|---|
| *name of the entity* | **UNIBROUE INC.** | |
| *title of the statement* | **Statement of Retained Earnings** | |
| *accounting period* | **For the Year Ended December 31, 2003** | |
| *unit of measure* | **(in thousands of dollars)** | |
| *last period ending retained earnings* | Retained earnings, January 1, 2003 | $12,506 |
| *net income reported on the income statement* | Net income for 2003 | 1,144 |
| *dividends declared during the period* | Dividends for 2003 | (500) |
| *ending retained earnings on the balance sheet* | Retained earnings, December 31, 2003 | $13,150 |

The notes are an integral part of these financial statements.
This statement is an adaptation of Unibroue's actual statement of retained earnings for 2003.


**Elements** The statement begins with Unibroue's retained earnings at January 1, 2003 (the beginning of the accounting period). The net income reported on the income statement for the current period is added and dividends declared during the year are subtracted from this amount. During 2003, Unibroue earned $1,144,000, as shown in Exhibit 1.3. Also during 2003, Unibroue declared and paid a total of $500,000 in dividends to its shareholders.[6] The net result is that retained earnings at December 31, 2003 (the end of the accounting period) increased by $644,000 (= $1,144,000 − $500,000), or the portion of net income reinvested in the business.

The ending retained earnings amount of $13,150,000 is the same as that reported in Exhibit 1.2 on Unibroue's balance sheet. Thus, the statement of retained earnings shows the relationship between the income statement and the balance sheet.

## FINANCIAL **ANALYSIS**


### INTERPRETING RETAINED EARNINGS

Reinvestment of earnings, or retained earnings, is an important source of financing for Unibroue, representing more than one-third of its financing. Creditors closely monitor a firm's statement of retained earnings because the firm's policy on dividend payments to its shareholders affects its ability to repay its debts. Every dollar Unibroue pays to shareholders as a dividend is not available for use in paying back its debt to creditors. Investors examine retained earnings to determine whether the company is reinvesting a sufficient portion of earnings to support future growth.

## THE CASH FLOW STATEMENT

**Structure** Unibroue's cash flow statement is presented in Exhibit 1.5. The cash flow statement divides Unibroue's cash inflows (receipts) and outflows (payments) into three primary categories of cash flows in a typical business: cash flows from operating, investing, and financing activities. The heading identifies the name of the entity, the title of the statement, and the unit of measure used. Like the income statement, the cash flow statement covers a specified period of time (the accounting period), which in this case is one year.

As discussed earlier in this chapter, reported revenues do not always equal cash collected from customers because some sales may be on credit. Also, expenses reported on the income statement may not be equal to the cash paid out during the period

[6] Unibroue did not declare dividends since its formation, preferring to reinvest earnings in the business in order to sustain its growth. Nevertheless, we assume that dividends were declared in 2003 for illustrative purposes.

EXHIBIT **1.5**

**Cash Flow Statement**

| | | | |
|---|---|---|---|
| **UNIBROUE INC.** | | | *name of the entity* |
| **Cash Flow Statement** | | | *title of the statement* |
| **For the Year Ended December 31, 2003** | | | *accounting period* |
| **(in thousands of dollars)** | | | *unit of measure* |
| **Cash flows from operating activities** | | | *directly related to earning income* |
| Cash collected from customers | $25,270 | | |
| Cash paid to suppliers and employees | (22,329) | | |
| Cash paid for interest | (422) | | |
| Cash paid for taxes | (41) | | |
| Net cash flow from operating activities | | $ 2,478 | |
| **Cash flows from investing activities** | | | *purchase/sale of productive assets* |
| Cash paid to purchase short-term investment | (401) | | |
| Cash paid to purchase manufacturing equipment | $ (1,694) | | |
| Net cash flow from investing activities | | (2,095) | |
| **Cash flows from financing activities** | | | *from investors and creditors* |
| Repayment of notes payable | $ (1,063) | | |
| Cash paid for dividends | (500) | | |
| Net cash flow from financing activities | | (1,563) | |
| **Net decrease in cash during the year** | | $ (1,180) | *change in cash during the period* |
| **Cash at beginning of year** | | 2,300 | *last period's ending cash balance* |
| **Cash at end of year** | | $ 1,120 | *ending cash on the balance sheet* |

The notes are an integral part of these financial statements.
This statement is an adaptation of Unibroue's actual cash flow statement for 2003.

because expenses may be incurred in one period and paid for in another. As a result, net income (revenues minus expenses) does *not* usually equal the amount of cash received minus the amount paid during the period. Because the income statement does not provide any information concerning cash flows, accountants prepare the **cash flow statement** to report inflows and outflows of cash.

The **CASH FLOW STATEMENT** reports cash inflows and outflows that are related to operating, investing, and financing activities during the accounting period.

The cash flow statement equation describes the causes of the change in cash reported on the balance sheet from the end of the last period to the end of the current period:

$$\begin{aligned}\textbf{Change in Cash} = {} & \textbf{Cash Flows from Operating Activities} \\ & + \textbf{Cash Flows from Investing Activities} \\ & + \textbf{Cash Flows from Financing Activities}\end{aligned}$$

Note that each of the three cash flow sources can be positive or negative.

**Elements** *Cash flows from operating activities* are cash flows that are directly related to earning income. For example, when Loblaws and other customers pay Unibroue for the beer it has delivered to them, Unibroue lists the amounts collected as cash collected from customers. When Unibroue pays salaries to its salespeople or pays bills received from suppliers of malted barley or corn, it includes the amounts in cash paid to suppliers and employees.[7]

*Cash flows from investing activities* include cash flows related to the acquisition or sale of the company's productive assets. This year, Unibroue had two cash outflows for investing activities: the purchase of additional manufacturing equipment to meet the growing demand for its beer, and the purchase of short-term investments. *Cash flows from financing activities* are directly related to the financing of the company itself. They involve both receipts and payments of cash to investors and creditors (except for suppliers). This year, Unibroue paid $1,063,000 on notes payable, and $500,000 in dividends to the company's shareholders.

[7]Alternative ways to present cash flows from operating activities are discussed in Chapter 5.

## FINANCIAL **ANALYSIS**


### INTERPRETING THE CASH FLOW STATEMENT

Many analysts believe that the cash flow statement is particularly useful for predicting future cash flows that may be available for payment of debt to creditors and dividends to investors. Bankers often consider the Operating Activities section to be most important because it indicates the company's ability to generate cash from sales to meet its current cash needs. Any amount left can be used to repay the bank debt or expand the company.

Shareholders will invest in a company if they believe that it will eventually generate more cash from operations than it uses so that cash will become available to pay dividends and to expand. The Investing Activities section shows that Unibroue has made heavy investments in new manufacturing capacity, a good sign if demand continues to increase. The Financing Activities section indicates that Unibroue was able to pay dividends to shareholders and repay part of its notes payable because it generated cash from operating activities.

## SELF-STUDY **QUIZ 1-3**

1. During the year 2003, Unibroue delivered beer to customers that paid or promised to pay in the future amounts totalling $25,598,000. During the same year, it collected $25,270,000 in cash from its customers. Without referring to Exhibit 1.5, indicate which of the two numbers will be shown on Unibroue's cash flow statement for 2003.
2. Learning which items belong in each cash flow statement category is an important first step in understanding their meaning. Mark each item in the following list as a cash flow from operating activities (O), investing activities (I), or financing activities (F), without referring to Exhibit 1.5. Also place parentheses around the letter only if it is a cash *outflow*.

   ______ Cash paid for dividends
   ______ Cash paid for interest
   ______ Cash received from bank loan
   ______ Cash paid for taxes
   ______ Cash paid to purchase manufacturing equipment
   ______ Cash paid to suppliers and employees
   ______ Cash collected from customers

After you complete your answers, check them with the solutions on page 27.

### RELATIONSHIPS AMONG THE STATEMENTS

Our discussion of the four basic financial statements focused on the different elements reported in the statements, how the elements are related through the equation for each statement, and how the elements are important to the decisions of investors, creditors, and other external users. We have also discovered how the statements, all of which are outputs from the same system, are related to one another. In particular, we learned that:

1. Net income from the income statement results in an increase in ending retained earnings on the statement of retained earnings.
2. Ending retained earnings from the statement of retained earnings is one of the two components of shareholders' equity on the balance sheet.
3. The change in cash on the cash flow statement added to the cash balance at the beginning of the year equals the balance of cash at the end of the year, which appears on the balance sheet.

Thus, as external users, we can think of the income statement as explaining, through the statement of retained earnings, how the operations of the company improved its

EXHIBIT **1.6**

**Relationships among Unibroue's Statements**

**Income statement**

| | | |
|---|---|---|
| | Revenues | $ 25,598 |
| – | Expenses | 24,454 |
| | Net Income | $ 1,144 |

**Cash Flow Statement**

| | | |
|---|---|---|
| +/– | Cash Flows from Operating Activities | $ 2,478 |
| +/– | Cash Flows from Investing Activities | (2,095) |
| +/– | Cash Flows from Financing Activities | (1,563) |
| | Change in Cash | (1,180) |
| + | Cash at the Beginning of Period | 2,300 |
| | Cash at End of Period | $ 1,120 |

**Statement of Retained Earnings**

| | | |
|---|---|---|
| | Beginning Retained Earnings | $ 12,506 |
| + | Net Income | 1,144 |
| – | Dividends | (500) |
| | Ending Retained Earnings | $ 13,150 |

**Balance Sheet**

| | |
|---|---|
| Cash | $ 1,120 |
| Other Assets | 33,035 |
| Total Assets | $34,155 |
| Liabilities | $11,767 |
| Share Capital | 9,238 |
| Retained Earnings | 13,150 |
| Total Liabilities & Shareholders' Equity | $34,155 |

1 2 3

financial position during the year. The cash flow statement explains how the operating, investing, and financing activities of the company affected the cash balance on the balance sheet during the year. These relationships are illustrated in Exhibit 1.6 for Unibroue's financial statements.

## NOTES

At the bottom of each of Unibroue's four basic financial statements is this statement: *"The notes are an integral part of these financial statements."* This is the accounting equivalent of the warning on a package of cigarettes. It warns users that failure to read the **notes** (or **footnotes)** to these financial statements will result in an incomplete picture of the company's financial health. Notes provide supplemental information about the financial condition of a company, without which the financial statements cannot be fully understood.

**NOTES (FOOTNOTES)** provide supplemental information about the financial condition of a company, without which the financial statements cannot be fully understood.

There are three basic types of notes. The first type provides descriptions of the accounting rules applied in the company's statements. The second presents additional detail about a line on the financial statements. For example, Unibroue's inventory note indicates the costs of ingredients, beer that is in the process of being fermented, and bottled beer that is ready for sale to customers. The third type of note presents additional financial disclosures about items not listed on the statements themselves. For example, Unibroue leases one of its production facilities; terms of the lease are disclosed in a note. We will discuss many note disclosures throughout the book because understanding their content is critical to understanding the company.[8]

[8]The four basic financial statements and related notes are part of more elaborate documents called *annual reports* that are produced by public companies. Annual reports are normally split into two sections. The first section is a non-financial section that usually includes a letter to shareholders from the chairperson of the company's board of directors and the chief executive officer; descriptions of the company's management philosophy, products, its successes (and occasionally its failures); exciting prospects and challenges for the future; as well as beautiful photographs of products, facilities, and personnel.

The second section includes the core of the report. The principal components of this financial section include summarized financial data for 5 or 10 years, management's discussion and analysis of the company's financial condition and results of operations, the four financial statements and related notes, the auditor's report, recent stock price information, a summary of quarterly financial data, and a list of directors and officers of the company.

# FINANCIAL **ANALYSIS**

## MANAGEMENT USES OF FINANCIAL STATEMENTS

In our discussion of financial analysis thus far, we have focused on the perspectives of *investors* and *creditors*. In addition, managers within the firm often make direct use of financial statements. For example, Unibroue's *marketing managers* and *credit managers* use customers' financial statements to decide whether to extend credit to them for their purchases of bottled beer. Unibroue's *purchasing managers* analyze financial statements of suppliers to judge whether the suppliers have the resources to meet Unibroue's demand for ingredients and to invest in the development of new ingredients. Both Unibroue's *human resource managers* and the *employees' union* use the company's financial statements as a basis for contract negotiations over pay rates. The net income figure even serves as a basis for computing employees' *bonuses*.

When Unibroue's managers examine the financial statements of the company's customers and suppliers, they rely on these statements as the best source of financial information available to external users because they do not have access to internal financial information produced by their customers and suppliers. However, when they make internal decisions regarding Unibroue's operations, they rely on more detailed financial information obtained through the company's managerial accounting system.

## USING FINANCIAL STATEMENTS TO DETERMINE UNIBROUE'S VALUE

### DETERMINING UNIBROUE'S PURCHASE PRICE

Even at this early stage of your study of accounting, we can illustrate part of the process Sleeman Breweries went through to determine the price it was willing to pay for Unibroue Inc. The price Sleeman paid was decided by considering a variety of factors, including the value of Unibroue's assets, its debts to others, its ability to sell goods for more than their production cost, and its ability to generate the cash necessary to pay its current bills. These factors are the subject matter of the balance sheet, income statement, and cash flow statement.

One method for estimating the value of a company is with a *price/earnings ratio* (or *P/E ratio* or *P/E multiple*). The P/E ratio measures the multiple of current year's earnings that investors are willing to pay for the company's shares. All other things being equal, a high P/E ratio means that investors have confidence in the company's ability to produce higher profits in future years. As in the Unibroue case, competitors' P/E ratios often serve as a starting point in analyzing the price that should be paid for a company or its shares.

A key to Sleeman's decision to buy Unibroue was the fact that other companies in the same industry with similar performance and past growth were selling for 18 times their current year's earnings. Accordingly, the price Sleeman paid could be determined using the following computation:

$$\textbf{Price/Earnings Ratio} = \frac{\textbf{Market Price}}{\textbf{Net Income}}$$

$$\begin{aligned}\textbf{Market (Purchase) Price} &= \textbf{P/E Ratio} \times \textbf{Net Income}\\ &= \textbf{18} \times \textbf{Net Income}\\ &= \textbf{18} \times \textbf{\$1,144,000}\\ &= \textbf{\$20,592,000}\end{aligned}$$

The price that Sleeman paid to acquire Unibroue—$40 million—is much higher than the price suggested by the above formula. In some cases, companies are willing to pay a higher amount in order to acquire special assets that are valuable to the acquiring company. In this case, Sleeman had been looking for a Québec foothold for some time. The acquisition of Unibroue, which has a loyal customer base for its European-style beers, gives Sleeman a significant manufacturing presence in Québec, the country's second largest beer market. Sleeman paid more than 18 times last year's earnings because they believe that this acquisition will improve Unibroue's earnings in future years.

A difficult part of this analysis is deciding what price/earnings multiplier is appropriate for this situation. Sleeman carefully considered this issue, and its analysis involved more than this simple formula. However, the P/E ratio provides an estimation of the market value of Unibroue's net assets.[9]

## RESPONSIBILITIES FOR THE ACCOUNTING COMMUNICATION PROCESS

**LEARNING OBJECTIVE 2**

Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements.

*Effective communication* means that the recipient understands what the sender intends to convey. For the decision makers at Sleeman to use the information in Unibroue's financial statements effectively, they had to understand what information each statement conveys.

They also needed to know that the amounts reported in the statements fairly represent what is claimed. Financial statements that do not represent what they claim to are meaningless and cannot be used effectively to make decisions. For example, if the balance sheet lists $2,000,000 for a factory that does not exist, that part of the statement does not convey useful information.

Decision makers also needed to understand the *measurement rules* applied in computing the numbers on the statements. A swim coach would never try to evaluate a swimmer's time in the "100 freestyle" without first asking if the time was for a race in metres or in yards. Likewise, a decision maker should never attempt to use accounting information without first understanding the measurement rules that were used to develop the information. These measurement rules are called **generally accepted accounting principles**, or **GAAP**. These encompass not only specific rules, practices, and procedures relating to particular circumstances, but also broad principles and conventions of general application.

**GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)** are the measurement rules used to develop the information in financial statements.

### GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

**How Are Generally Accepted Accounting Principles Determined?** The accounting system that we use today has a long history. Its foundations are normally traced back to the works of an Italian monk and mathematician, Fr. Luca Pacioli. In 1494, he described an approach developed by Italian merchants to account for their activities as owner-managers of business ventures. Many others wrote works on accounting after Pacioli, but prior to 1933, each company's management largely determined its financial reporting practices. Thus, little uniformity in practice existed among companies.

Following the dramatic stock market decline of 1929, the Securities Act of 1933 and The Securities Exchange Act of 1934 were passed into law by the U.S. Congress. These acts created the **Securities and Exchange Commission (SEC)** and gave it broad powers to determine the measurement rules for financial statements that companies must provide to shareholders. In Canada, provincial securities legislation created securities commissions, most notably the **Ontario Securities Commission (OSC)**, to regulate the flow of financial information provided by publicly traded companies whose shares trade on Canadian stock exchanges, such as the Toronto Stock Exchange. Similar to the SEC, the OSC plays an influential role in promoting sound accounting practices by publicly traded companies.

The **SECURITIES AND EXCHANGE COMMISSION (SEC)** is the U.S. government agency that determines the financial statements that public companies must provide to shareholders and the measurement rules that they must use in producing those statements.

The **ONTARIO SECURITIES COMMISSION (OSC)** is the most influential Canadian regulator of the flow of financial information provided by publicly traded companies in Canada.

Since their establishment, these securities commissions have worked with organizations of professional accountants to establish groups that are given the primary responsibilities to work out the detailed rules that become generally accepted accounting

[9] The role of net income in determining the value of a company will be discussed in more detail in your corporate finance course and more advanced courses in financial statement analysis. See, for example, K.R. Palepu, P.M. Healy, and V.B. Bernard, *Business Analysis and Valuation*. Cincinnati, OH: South-Western, 2000, Chapter 11.

The **ACCOUNTING STANDARDS BOARD (AcSB)** is the private-sector body given the primary responsibility to work out the detailed rules that become accepted accounting standards.

principles. The current Canadian group that has this responsibility is the **Accounting Standards Board (AcSB)** of the Canadian Institute of Chartered Accountants. The AcSB is responsible for establishing standards of accounting and reporting by Canadian companies and not-for-profit organizations. These standards or recommendations, which are published in the *CICA Handbook*, have expanded over time because of the increasing diversity and complexity of current business practices.

Most managers do not need to learn all of the details included in these standards. Our approach is to focus on those details that have the *greatest impact on the numbers presented in financial statements* and are appropriate for an introductory course.

**Why Is GAAP Important to Managers and External Users?** Generally accepted accounting principles (GAAP) are of great interest to the companies that must prepare the statements and to the readers of these statements. GAAP provide guidance to companies in selecting the accounting methods that best reflect the results of their operations and financial situation. At the same time, generally accepted accounting methods help prevent managers from deliberately manipulating income figures that serve their interests by using accounting practices that are not in conformity with GAAP. Widely divergent accounting practices reduce the comparability of financial information produced by different companies; hence, GAAP limits the number of acceptable alternative accounting methods in order to enhance the comparability of financial information across companies and over time. Furthermore, understanding GAAP enables external users to assess the quality of the information presented in the financial statements and related notes.

*Companies and their managers and owners* are most directly affected by the information presented in the financial statements. Companies incur the cost of preparing the statements and bear the major economic consequences of their publication. These economic consequences include, among others:

1. effects on the selling price of a company's shares.
2. effects on the amount of bonuses received by management and employees.
3. loss of competitive advantage over other companies.

Recall that the amount that Sleeman was willing to pay to purchase Unibroue was determined in part by net income computed in accordance with GAAP. This presents the possibility that changes in accounting standards can affect the price buyers are willing to pay for companies.

Employees who receive part of their pay based on reaching stated targets for net income are directly concerned with any changes in how net income is computed. Managers and owners often are concerned that publishing more information in financial statements will give away trade secrets to other companies that compete with them. As a consequence of these and other concerns, changes in accounting standards are actively debated, political lobbying often takes place, and the accounting standards that are eventually issued are often a compromise among the wishes of interested parties.

## INTERNATIONAL **PERSPECTIVE**

**REAL WORLD EXCERPT**

*Telus*

ANNUAL REPORT

### ARE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES SIMILAR IN OTHER COUNTRIES?

While businesspeople compete in a single global economy, different sets of generally accepted accounting principles have developed within particular countries. Differences in political, cultural, and economic histories have produced a great number of cross-national differences in practice. These differences do affect the numbers presented in the financial statements. For example, Telus Corporation, the second largest Canadian provider of telecommunication products and services, is required to prepare two sets of financial statements in compliance with both Canadian and U.S. accounting rules because its shares are traded on Canadian and U.S. stock exchanges. Since Canadian and U.S. accounting rules differ with respect to measuring and reporting certain business transactions, the two sets of Telus's financial statements, which summarize the same business transactions, provide different financial results. The annual report of Telus for the year 2003 included the following:

| Years ended December 31 (millions) | 2003 | 2002 |
|---|---|---|
| Net income (loss) in accordance with Canadian GAAP | $331.5 | $ (229.0) |
| Net income (loss) in accordance with U.S. GAAP | 329.0 | (1,925.9) |

Telus's net income (loss) for the years 2002 and 2003 is not the same under Canadian and U.S. GAAP because the accounting rule makers have produced different sets of generally accepted accounting standards that are commensurate with the legal, political, economic, and business environments in these two countries. You will discover in later chapters that accounting is not an exact science and that generally accepted accounting principles can lead to different sets of standards that can, in practice, produce different sets of financial statements.

The International Accounting Standards Committee (IASC) and others are attempting to eliminate these differences. But currently, managers and users of financial statements who cross national borders must be aware of the specific nature of these reporting differences to interpret financial statements successfully. Although our primary focus is on Canadian GAAP, we briefly discuss practice in other countries when appropriate.

## MANAGEMENT RESPONSIBILITY AND THE DEMAND FOR AUDITING

**LEARNING OBJECTIVE 3**

Distinguish the roles of managers and auditors in the accounting communication process.

Who is responsible for the accuracy of the numbers in Unibroue's financial statements? Two documents taken from Unibroue's annual report provide us with much of the answer to this question.

The **report of management**, shown in Exhibit 1.7, makes two points clear. First, primary responsibility for the information in the financial statements lies with management, as represented by the highest officer of the company and its highest financial

EXHIBIT **1.7**

**Report of Management**

**REAL WORLD EXCERPT**

*Unibroue Inc.*

ANNUAL REPORT

**Management's Report Concerning Financial Statements**

Unibroue Inc.'s consolidated financial statements and the financial information included in this annual report are the responsibility of management. These financial statements have been prepared in accordance with generally accepted accounting principles in Canada and have been approved by the Board of Directors.

Unibroue Inc. maintains accounting and internal control systems which, in the opinion of management, ensure the reasonable accuracy of the financial information as well as the orderly and efficient conduct of the company's business.

Mainly through its Audit Committee, the Board of Directors assumes its responsibilities regarding the financial statements found in this annual report. This Committee which holds annual meetings with management and the external auditors has reviewed the financial statements of Unibroue Inc. and has recommended their approval by the Board of Directors.

The attached financial statements have been audited by the Chartered Accountants Raymond Chabot Grant Thornton, General Partnership.

André Dion, FCA
Chairman of the Board, President
and Chief Executive Officer

The **REPORT OF MANAGEMENT** indicates management's primary responsibility for financial statement information and the steps to ensure the accuracy of the company's records.

The **AUDIT REPORT (REPORT OF INDEPENDENT AUDITORS)** describes the auditors' opinion of the fairness of the financial statement presentations and the evidence gathered to support that opinion.

officer. Second, the managers take three important steps to ensure the accuracy of the company's records: (1) they maintain a system of controls over both the records and the assets of the company, (2) they hire outside independent auditors to attest to the fairness of the statement presentations, and (3) they form a committee of the board of directors to review these two safeguards. These safeguards are listed in the report of management.

The role of the independent auditor is described in more detail in the **audit report**, or **report of independent auditors** (Exhibit 1.8). The **audit report** describes the auditor's opinion of the fairness of the financial statement presentations and the evidence gathered to support that opinion. It is important to note that the main difference between the report of management and the report of the independent auditors concerns the responsibility for the financial information included in the company's annual report. As the report of the independent auditors indicates, the auditor's responsibility is to express an opinion on the Unibroue financial statements that have been prepared by its accounting personnel and reviewed by the *audit committee* of the *board of directors* that assumes responsibility for these financial statements.

In Canada, an accountant may be licensed as a *Chartered Accountant* (CA), a *Certified General Accountant* (CGA), or a *Certified Management Accountant* (CMA). These accounting designations are granted by the respective professional accounting organizations on completion of specific educational programs and experience requirements.[10] Professional accountants can offer various accounting services to the public, but only CAs and CGAs (in most Canadian provinces[11]) are permitted to issue audit reports of

EXHIBIT **1.8**

**Auditors' Report**

**REAL WORLD EXCERPT**

*Unibroue Inc.*

ANNUAL REPORT

**Auditors' Report to the Shareholders of Unibroue Inc.**

We have audited the consolidated balance sheets of Unibroue Inc. as at December 31, 2003 and 2002, and the consolidated statements of earnings and retained earnings, and of cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures on the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company at December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended, in conformity with Canadian generally accepted accounting principles.

Raymond Chabot Grant Thornton
General Partnership
Chartered Accountants

[10]Refer to the following Web sites for details of the educational and experience requirements for the respective designations:

Chartered Accountant: **www.cica.ca**
Certified General Accountant: **www.cga-canada.org**
Certified Management Accountant: **www.cma-canada.org**

[11]At the date of publication of this book, CGAs were not permitted to perform audits in the provinces of Nova Scotia and Prince Edward Island, and had limited audit rights in Québec. In British Columbia, CMAs are permitted to do assurance audits upon successful application to the Audit Certification Board.

publicly traded companies because they have certain responsibilities that extend to the general public as well as to the specific business that pays for their services.

An **audit** involves the examination of the financial reports (prepared by the management of the entity) to ensure that they represent what they claim and conform with GAAP. In performing an audit, the independent auditor examines the underlying transactions and the accounting methods used to account for these transactions. Because of the enormous number of transactions involving a major enterprise such as Wal-Mart that total billions of dollars each year, the auditor does not examine each transaction. Rather, professional approaches are used to ascertain beyond reasonable doubt that transactions were measured and reported properly.

An **AUDIT** is an examination of the financial reports to ensure that they represent what they claim and conform with generally accepted accounting principles.

Many unintentional and intentional opportunities exist for managers to prepare misleading financial reports. An audit performed by an independent auditor is the best protection available to the public. When that protection fails, however, the independent auditor is sometimes found liable for losses incurred by those who rely on the statements. You can learn more about auditing and other information assurance services in auditing courses.

## ETHICS, REPUTATION, AND LEGAL LIABILITY

**LEARNING OBJECTIVE 4**

Appreciate the importance of ethics, reputation, and legal liability in accounting.

If financial statements are to be of any value to decision makers, users must have confidence in the fairness of the information. These users will have greater confidence in the information if they know that the people who were associated with auditing the financial statements were required to meet professional standards of ethics and competence.

The three Canadian professional accounting organizations require all of their members to adhere to professional codes of ethics. These broad principles are supported by specific rules that govern the performance of audits by members of these organizations. These organizations stress how important it is for each member to behave in ways that enhance the reputation of the profession by voluntarily complying with ethical codes. For example, the Canadian Institute of Chartered Accountants places ethical behaviour and professionalism as the most important of the pervasive competencies possessed by its members.[12] The Certified General Accountants Association of Canada notes in its *Code of Ethical Principles and Rules of Conduct* that an accountant's actions will have an influence not only on the welfare of society but also on that of the profession.[13] The Society of Management Accountants of Canada has also issued a few publications related to ethical conduct, such as *Codes of Ethics, Practice and Conduct* and *Implementing Ethics Strategies within Organizations*.[14] Failure to comply with professional rules of conduct can result in serious penalties for professional accountants, including rescinding the professional designation of an offending member. The potential economic effects of damage to reputation and malpractice liability, however, provide even stronger incentives to abide by professional standards. Thus, the profession recognizes that its members' reputations for ethical conduct and competence are their most important assets.

Financial statements fraud is a fairly rare event, due in part to the diligent efforts of practising professional accountants. In fact, many such frauds are first identified by the firm's accounting staff or its external auditors who advise regulatory authorities of possible wrongdoing. In doing so, these "whistle blowers" place the interest of the public at large ahead of their own interests and act accordingly. However, in case of malpractice, independent auditors may be held liable for losses suffered by those who relied on the audited financial statements.

[12] *The CA Competency Map*. The Canadian Institute of Chartered Accountants, Toronto: Canada, 2004, pp. 17–21, accessible through the CICA's Web site: **www.cica.ca**.

[13] *Code of Ethical Principles and Rules of Conduct*. Certified General Accountants Association of Canada, Vancouver: Canada, 2004, accessible through the CGA's Web site: **www.cga-online.org**.

[14] These publications are accessible through the Society's Web site: **www.cma-canada.org**.

It is important to note that the vast majority of managers and owners do act in an honest and responsible manner. However, when the top officers in an organization collude to deceive other parties, they may temporarily succeed. In many cases, even the most diligent audit may not immediately uncover the results of fraud involving collusion of the top officers of a corporation, such as occurred in a number of well-publicized cases like YBM and Livent in Canada, Enron and WorldCom in the United States, and Parmalat in Italy. However, those who were involved in fraudulent behaviour were eventually identified and were sanctioned for their behaviour by the appropriate legal authorities.

Misrepresentations by managers highlight the crucial importance of the public accounting profession in ensuring the integrity of the financial reporting system. The recent failures in publicly disclosing financial information that is not in conformity with existing accounting standards cost billions of dollars to the shareholders, creditors, and employees of these companies. In addition, these fraudulent cases raised many questions about the integrity of managers and auditors. More importantly, these spectacular financial reporting failures led to significant reforms of the accounting profession and the imposition of new government regulations both in Canada and the United States that make it more difficult and costly for company managers to engage in fraudulent activities.[15]

## DEMONSTRATION **CASE**

At the end of most chapters, one or more demonstration cases are presented. These cases provide an overview of the primary issues discussed in the chapter. Each demonstration case is followed by a recommended solution. You should read the case carefully and then prepare your own solution before you study the recommended solution. **This self-evaluation is highly recommended.**

The introductory case presented here reviews the elements reported on the income statement and the balance sheet and how the elements within the statements are related.

ABC Service Corporation was organized by Able, Baker, and Casella on January 1, 2006. On that date, the investors exchanged $36,000 cash for all of the shares of the company. On the same day, the corporation borrowed $10,000 from a local bank and signed a three-year note, payable on December 31, 2008. Interest of 10 percent is payable each December 31. On January 1, 2006, the corporation purchased service supplies for $20,000 cash. Operations started immediately.

[15]In the wake of the wave of U.S. corporate scandals, the U.S. Congress passed in 2002 a significant piece of legislation known as the Sarbanes-Oxley Act, or Sarbox for brevity. Sarbox requires companies to comply with a series of measures intended to improve on corporate governance in order to discourage corporate fraud by managers. To achieve this, companies are required to evaluate their internal controls and financial reporting procedures on an annual basis. Public companies must now present standardized summaries of their internal control procedures in their annual report, stating that management is responsible for adequate internal control structures. Furthermore, the company's independent auditor must issue a report attesting to management's assertion on the effectiveness of the company's internal controls and procedures. At the time of writing this text, Canadian regulators and standard setters had adopted similar requirements for Canadian public companies. For example, the Ontario Securities Commission had put in place new rules that are similar to those required by the Sarbanes-Oxley legislation, but tailored to specific Canadian circumstances and priorities. Under these rules, chief executive officers and chief financial officers of publicly traded companies are required to (1) certify the fair presentation of annual reports, (2) have an audit committee that is independent of management and includes members who are financially literate, and (3) have their external audit conducted by a public accounting firm registered with the Canadian Public Accountability Board, the new independent watchdog for public company auditors (Ontario Securities Commission, Annual Report 2004). Moreover, the Auditing and Assurance Standards Board of the Canadian Institute of Chartered Accountants has recently introduced a new section of the *CICA Handbook* that provides the guidance necessary to issue a report on the effectiveness of an entity's internal control over financial reporting in conjunction with a financial statement audit.

At the end of 2006, the corporation had completed the following additional business transactions (summarized):

(*a*) Performed services and billed customers for $100,000, of which $94,000 was collected by year-end.
(*b*) Used up $5,000 of service supplies while rendering services.
(*c*) Paid $54,000 for other service expenses.
(*d*) Paid $1,000 in annual interest expense on the note payable.
(*e*) Paid $8,000 of income taxes to the Canada Revenue Agency.

***Required:***
Complete the following two financial statements for 2006 by entering the correct amounts. The suggested solution follows the blank statements.

**ABC SERVICE CORPORATION**
**Income Statement**
**__________ (date)**
**(in dollars)**

| | | | Computation |
|---|---|---|---|
| **Revenues** | | | |
| Service revenue | | $ ______ | ________ |
| **Expenses** | | | |
| Service expenses | $ ______ | | ________ |
| Interest expense | ______ | | ________ |
| Total pretax expenses | | ______ | |
| Income before income tax | | $ ______ | |
| Income tax expense | | ______ | ________ |
| **Net Income** | | $ ______ | |

**ABC SERVICE CORPORATION**
**Balance Sheet**
**__________ (date)**
**(in dollars)**

| | | | Computation |
|---|---|---|---|
| **Assets** | | | |
| Cash | | $ ______ | ________ |
| Accounts receivable | | ______ | ________ |
| Service supplies | | ______ | ________ |
| Total assets | | $ ______ | |
| **Liabilities** | | | |
| Note payable (10%) | $ ______ | | ________ |
| Total liabilities | | $ ______ | |
| **Shareholders' Equity** | | | |
| Share capital | $ ______ | | ________ |
| Retained earnings | ______ | | ________ |
| Total shareholders' equity | | ______ | |
| Total liabilities and shareholders' equity | | $ ______ | |

**We strongly recommend that you prepare your own answers to these requirements and then check your answers with the suggested solution.**

## SUGGESTED SOLUTION

**ABC SERVICE CORPORATION**
**Income Statement**
**For the Year Ended December 31, 2006**
**(in dollars)**

| | | | Computation |
|---|---|---|---|
| **Revenues** | | | |
| Service revenue | | *$100,000* | *Total billed to customers* |
| **Expenses** | | | |
| Service expenses | *$59,000* | | *$5,000 + $54,000* |
| Interest expense | *1,000** | | |
| Total pretax expenses | | *60,000* | |
| Income before income tax | | *$ 40,000* | |
| Income tax expense | | *8,000* | |
| **Net Income** | | *$ 32,000* | |

*This amount equals 10 percent of the amount borrowed ($10,000 × 10%).

Note that the *income before income tax* is the difference between revenues and pretax expenses, and that income tax expense is deducted from income before income tax to arrive at *net income*.

**ABC SERVICE CORPORATION**
**Balance Sheet**
**At December 31, 2006**
**(in dollars)**

| | | | Computation |
|---|---|---|---|
| **Assets** | | | |
| Cash | | *$ 57,000* | *$36,000 + $10,000 − $20,000 + $94,000 − $54,000 − $1,000 − $8,000* |
| Accounts receivable | | *6,000* | *$100,000 − $94,000* |
| Service supplies | | *15,000* | *$20,000 − $5,000* |
| Total assets | | *$ 78,000* | |
| **Liabilities** | | | |
| Note payable (10%) | *$10,000* | | *Given, bank loan* |
| Total liabilities | | *$ 10,000* | |
| **Shareholders' Equity** | | | |
| Share capital | *$36,000* | | *Given* |
| Retained earnings | *32,000** | | *From income statement* |
| Total shareholders' equity | | *68,000* | |
| Total liabilities and shareholders' equity | | *$ 78,000* | |

*Given that ABC Service Corporation started on January 1, 2006, and there were no dividends declared in 2006, the ending balance of retained earnings equals the net income for 2006. Hence, there is no need to prepare the statement of retained earnings for 2006.

## SOLUTIONS TO **SELF-STUDY QUIZZES**

### Self-Study Quiz 1-1

1. Assets ($34,155,000) − Liabilities ($11,767,000) = Shareholders' Equity ($22,388,000).
2. L, A, A, SE, A, A, A, L, SE (reading down the columns).

### Self-Study Quiz 1-2

1. E, E, R, E (reading down the columns).
2. Sales revenue in the amount of $25,598,000 is recognized because sales revenue is normally reported on the income statement when the goods or services have been delivered to customers who have either paid or promised to pay for them in the future.
3. Cost of goods sold is $15,443,000 because expenses are the dollar amount of resources used up to earn revenues during the period. Only the beer that has been delivered to customers is used up. The beer still on hand is part of the asset inventory.

### Self-Study Quiz 1-3

1. $25,270,000 is recognized on the cash flow statement because this number represents the actual cash collected from customers related to current and prior years' sales.
2. (F), (O), F, (O), (I), (O), O.

## CHAPTER **TAKE-AWAYS**

1. **Recognize the information conveyed in each of the four basic financial statements and how it is used by different decision makers (investors, creditors, and managers).** **p. 5**

   The *balance sheet* is a statement of financial position that reports dollar amounts for the assets, liabilities, and shareholders' equity at a specific point in time.

   The *income statement* is a statement of operations that reports revenues, expenses, and net income for a stated period of time.

   The *statement of retained earnings* explains changes to the retained earnings balance that occurred during the reporting period.

   The *cash flow statement* reports inflows and outflows of cash for a specific period of time.

   The statements are used by investors and creditors to evaluate different aspects of the firm's financial position and performance.

2. **Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements.** **p. 19**
   GAAP are the measurement rules used to develop the information in financial statements. Knowledge of GAAP is necessary for accurate interpretation of the numbers in financial statements.

3. **Distinguish the roles of managers and auditors in the accounting communication process.** **p. 21**
   Management has primary responsibility for the accuracy of a company's financial information. Auditors are responsible for expressing an opinion on the fairness of the financial statement presentations based on their examination of the reports and records of the company.

4. **Appreciate the importance of ethics, reputation, and legal liability in accounting.** **p. 23**
   Users will have confidence in the accuracy of financial statement numbers only if the people associated with their preparation and audit have reputations for ethical behaviour and competence. Management and auditors can also be held legally liable for fraudulent financial statements and malpractice.

In this chapter, we studied the basic financial statements that communicate financial information to external users. Chapters 2, 3, 4, and 5 will provide a more detailed look at financial statements and examine how to translate data about business transactions into these statements. Learning the relationship between business transactions and financial statements is the key to using financial statements in planning and decision making. Chapter 2 begins our discussion of how the accounting function collects data about business transactions and processes the data to provide periodic financial statements, with emphasis on the balance sheet. To accomplish this purpose, Chapter 2 discusses key accounting concepts, the accounting model, transaction analysis, and analytical tools. We examine typical business activities of an actual service-oriented company to demonstrate the concepts in Chapters 2, 3, 4, and 5.

## Chapter Supplement A

### Types of Business Entities

This textbook emphasizes *accounting for profit-making business entities*. The three main types of business entities are sole proprietorship, partnership, and corporation. A *sole proprietorship* is an unincorporated business owned by one person; it usually is small in size and is common in the service, retailing, and farming industries. Often the owner is the manager. Legally, the business and the owner are not separate entities. However, accounting views the business as a separate entity that must be accounted for separately from its owner.

A *partnership* is an unincorporated business owned by two or more persons known as *partners*. Some partnerships are large in size (e.g., international public accounting firms and law firms). The agreements between the owners are specified in a partnership contract that deals with matters such as division of income among partners and distribution of resources of the business on termination of its operations. A partnership is not legally separate from its owners. Legally, each partner in a general partnership is responsible for the debts of the business (each general partner has *unlimited liability*). The partnership, however, is a separate business entity to be accounted for separately from its several owners.

A *corporation* is a business incorporated federally under the Canada Business Corporations Act or provincially under similar provincial Acts. The owners are called *shareholders* or *stockholders*. Ownership is represented by shares of capital that usually can be bought and sold freely. When an approved application for incorporation is filed by the organizers, a charter is issued by either the federal or the provincial government. This charter gives the corporation the right to operate as a legal entity, separate from its owners. The shareholders enjoy *limited liability*. Shareholders are liable for the corporation's debts only to the extent of their investments. The corporate charter specifies the types and amounts of share capital that can be issued. Most provinces require a minimum of two shareholders and a minimum amount of resources to be contributed at the time of organization. The shareholders elect a governing board of directors, which in turn employs managers and exercises general supervision of the corporation. Accounting also views the corporation as a separate business entity that must be accounted for separately from its owners.

In terms of economic importance, the corporation is the dominant form of business organization in Canada. This dominance is caused by the many advantages of the corporate form: (1) limited liability for the shareholders, (2) continuity of life, (3) ease in transferring ownership (shares), and (4) opportunities to raise large amounts of money by selling shares to a large number of people. The primary disadvantages of a corporation are (1) the loss of control by shareholders, (2) complex reporting procedures for a variety of government agencies, and (3) that income may be subject to double taxation (it is taxed when it is earned and again when it is distributed to shareholders as dividends). In this textbook, we emphasize the corporate form of business. Nevertheless, the accounting concepts and procedures that we discuss also apply to other types of businesses.

Specific aspects of the three types of business entities are compared in Exhibit 1.9.

## Chapter Supplement B

### Employment in the Accounting Profession Today

Since 1900, accounting has attained the stature of professions such as law, medicine, engineering, and architecture. As with all recognized professions, accounting is subject

EXHIBIT **1.9**

**Comparison of Three Types of Business Entities**

| | Proprietorship | Partnership | Corporation |
|---|---|---|---|
| Number of owners | One owner | Two or more owners | Many owners |
| Legal status of entity | Not separate from that of its owner(s) | | Separate legal entity |
| Responsibility of owners for debts of business entity | Unlimited legal liability | | Owners' liability is limited to their investment. |
| Accounting status | Each entity is separate from its owner(s) for accounting purposes | | |

to professional competence requirements, is dedicated to service to the public, requires a high level of academic study, and rests on a common body of knowledge. As indicated earlier, three Canadian accounting designations are available to an accountant: CA, CGA, and CMA. These designations are granted only on completion of requirements specified by the respective professional organizations. Although specific requirements vary among the three professional organizations, they include a university degree with a specified number of accounting courses, good character, a minimum of two years of relevant professional experience, and successful completion of a professional examination. Similar accounting designations exist in other countries, most notably the *Certified Public Accountant* (CPA) in the United States.

Accountants usually are engaged in professional practice or are employed by businesses, government entities, and not-for-profit organizations. The accounting profession is continuously changing. While many accountants still provide traditional accounting and tax services to businesses, individual clients, and government organizations, other areas of practice have become increasingly common in the accounting profession today. Demand for value-added accounting services (e.g., financial analysis, evaluation and implementation of new information technology and business processes, management advisory and consulting services, forensic accounting, and environmental accounting) is reshaping the nature of educational programs that prepare students to become professional accountants.[16]

## PRACTICE OF PUBLIC ACCOUNTING

Although an individual may practise public accounting, usually two or more individuals organize an accounting firm in the form of a partnership (in many cases, a limited liability partnership, or LLP). Accounting firms vary in size from a one-person office, to regional firms, to the Big Four firms (Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and PricewaterhouseCoopers), which have hundreds of offices located worldwide. Accounting firms usually render three types of services: assurance services, management consulting services, and tax services.

**Assurance Services** Assurance services are independent professional services that improve the quality of information, or its context, for decision makers. The most important assurance service performed by professional accountants in public practice is financial statement auditing. The purpose of an audit is to lend credibility to the financial reports, that is, to ensure that they fairly represent what they claim. An audit involves an examination of the financial reports (prepared by the management of the entity) to ensure that they conform with GAAP. Other areas of assurance services include integrity and security of electronic commerce and reliability of information systems.

**Management Consulting Services** Many independent accounting firms offer management consulting services. These services usually are accounting-based and

[16]Refer to the following Web site for more details about the types of services and skills that should be provided by accountants in the future: www.nextgenaccountant.com/research_hili/research_sum.html.

encompass such activities as the design and installation of accounting, data processing, and profit-planning and control (budget) systems; financial advice; forecasting; inventory controls; cost-effectiveness studies; and operational analysis. This facet of public accounting practice has grown rapidly. The perceived influence of offering such services on auditor independence has recently caused large accounting firms to dissociate their consulting practice from their audit function.

**Tax Services** Accountants in public practice usually provide income tax services to their clients. These services include both tax planning as a part of the decision-making process and the determination of the income tax liability (reported on the annual income tax return). Because of the increasing complexity of provincial and federal tax laws, a high level of competence is required, which accountants specializing in taxation can provide. The accountant's involvement in tax planning often is quite significant. Most major business decisions have significant tax impacts; in fact, tax-planning considerations often govern certain business decisions.

## EMPLOYMENT BY ORGANIZATIONS

Many accountants, including CAs, CGAs, and CMAs, are employed by profit-making and not-for-profit organizations. An organization, depending on its size and complexity, may employ from a few to hundreds of accountants. In a business enterprise, the chief financial officer (usually a vice-president or controller) is a member of the management team. This responsibility usually entails a wide range of management, financial, and accounting duties.

In a business entity, accountants typically are engaged in a wide variety of activities, such as general management, general accounting, cost accounting, profit planning and control (budgeting), internal auditing, and computerized data processing. A primary function of the accountants in organizations is to provide data that are useful for internal managerial decision making and for controlling operations. The functions of external reporting, tax planning, control of assets, and a host of related responsibilities normally are also performed by accountants in industry.

## EMPLOYMENT IN THE PUBLIC AND NOT-FOR-PROFIT SECTORS

The vast and complex operations of governmental units, from the local to the international level, create a need for accountants. The same holds true for other not-for-profit organizations such as charitable organizations, hospitals, and universities. Accountants employed in the public and not-for-profit sectors perform functions similar to those performed by their counterparts in private organizations.

A survey of positions occupied by accounting professionals and related salaries is available at www.accountemps.com.

## FINDING **FINANCIAL INFORMATION**

**BALANCE SHEET**
*Assets = Liabilities + Shareholders' Equity*

**INCOME STATEMENT**
*Revenues*
*− Expenses*
*Net Income*

**STATEMENT OF RETAINED EARNINGS**
*Retained Earnings, beginning of the period*
*+ Net Income*
*− Dividends*
*Retained Earnings, end of the period*

**CASH FLOW STATEMENT**
*Cash Flow from Operating Activities*
*+ Cash Flow from Investing Activities*
*+ Cash Flow from Financing Activities*
*Net Change in Cash*

## KEY **TERMS**

**Accounting** p. 5
**Accounting Entity** p. 7
**Accounting Period** p. 11
**Accounting Standards Board (AcSB)** p. 20
**Audit** p. 23
**Audit Report (Report of Independent Auditors)** p. 22
**Balance Sheet (Statement of Financial Position)** p. 7
**Basic Accounting Equation (Balance Sheet Equation)** p. 8
**Cash Flow Statement** p. 15
**Generally Accepted Accounting Principles (GAAP)** p. 19
**Income Statement (Statement of Income, Statement of Earnings, or Statement of Operations)** p. 11
**Notes (Footnotes)** p. 17
**Ontario Securities Commission (OSC)** p. 19
**Report of Management** p. 22
**Securities and Exchange Commission (SEC)** p. 19
**Statement of Retained Earnings** p. 13

## QUESTIONS

1. Define *accounting*.
2. Briefly distinguish financial accounting from managerial accounting.
3. The accounting process generates financial reports for both internal and external users. Identify some of the groups of users.
4. Briefly distinguish investors from creditors.
5. What is an accounting entity? Why is a business treated as a separate entity for accounting purposes?
6. Complete the following:

| Name of Statement | Alternative Title |
|---|---|
| *a.* Income statement | *a.* ____________ |
| *b.* Balance sheet | *b.* ____________ |
| *c.* Audit report | *c.* ____________ |

7. What information should be included in the heading of each of the four primary financial statements?
8. What are the purposes of (a) the income statement, (b) the balance sheet, (c) the cash flow statement, and (d) the statement of retained earnings?
9. Explain why the income statement and the cash flow statement are dated "For the Year Ended December 31, 2005," whereas the balance sheet is dated "At December 31, 2005."
10. Briefly explain the importance of assets and liabilities to the decisions of investors and creditors.
11. Briefly define the following: *net income* and *net loss*.
12. Explain the accounting equation for the income statement. Define the three major items reported on the income statement.
13. Explain the accounting equation for the balance sheet. Define the three major components reported on the balance sheet.
14. Explain the accounting equation for the cash flow statement. Explain the three major components reported on the statement.
15. Explain the accounting equation for the statement of retained earnings. Explain the four major items reported on the statement of retained earnings.
16. Financial statements discussed in this chapter are aimed at *external* users. Briefly explain how a company's *internal* managers in different functional areas (e.g., marketing, purchasing, human resources) might use financial statement information.
17. Briefly describe how accounting measurement rules (generally accepted accounting principles) are determined in Canada.
18. Briefly explain the responsibility of company management and the independent auditors in the accounting communication process.
19. (Supplement A) Briefly differentiate among a sole proprietorship, a partnership, and a corporation.
20. (Supplement B) List and briefly explain the three primary services that accountants in public practice provide.

## MULTIPLE-CHOICE **QUESTIONS**

1. Which of the following is *not* one of the four basic financial statements?
   a. balance sheet
   b. audit report
   c. income statement
   d. cash flow statement
2. As stated in the audit report, or *Report of Independent Accountants,* the primary responsibility for a company's financial statements lies with
   a. the owners of the company
   b. independent financial analysts
   c. the auditors
   d. the company's management
3. Which of the following is true?
   a. AcSB created OSC
   b. GAAP created AcSB
   c. OSC created CICA
   d. AcSB created GAAP
4. Which of the following statements is false?
   a. Retained earnings is increased by net income and decreased by a net loss.
   b. Retained earnings is a component of shareholders' equity on the balance sheet.
   c. Retained earnings is an asset on the balance sheet.
   d. Retained earnings represents earnings not distributed to shareholders in the form of dividends.
5. Which of the following is *not* one of the four items required to be shown in the heading of a financial statement?
   a. the financial statement preparer's name
   b. the title of the financial statement
   c. the unit of measure in the financial statement
   d. the name of the business entity
6. How many of the following statements are true?
   - The cash flow statement separates cash inflows and outflows into three major categories: operations, investing, and financing.
   - The ending cash balance shown on the cash flow statement must agree with the amount shown on the balance sheet at the end of the same fiscal period.
   - The total increase or decrease in cash shown on the cash flow statement must agree with the "bottom line" (net income or net loss) reported on the income statement.

   a. none
   b. one
   c. two
   d. three
7. Which of the following is *not* a typical footnote included in an annual report?
   a. A note describing the auditor's opinion of the management's past and future financial planning for the business
   b. A note providing more detail about a specific item shown in the financial statements
   c. A note describing the accounting rules applied in the financial statements
   d. A note describing financial disclosures about items not appearing in the financial statements
8. Which of the following statements is true?
   a. The income statement is sometimes called the statement of operations.
   b. The income statement reports revenues, expenses, and liabilities.
   c. The income statement reports only revenue for which cash was received at the point of sale.
   d. The income statement reports the financial position of a business at a particular point in time.
9. Which of the following statements is false?
   a. The accounts shown on a balance sheet represent the basic accounting equation for a particular business entity.
   b. The retained earnings balance shown on the balance sheet must agree to the ending retained earnings balance shown on the statement of retained earnings.
   c. The balance sheet reports the changes in specific account balances over a period of time.
   d. The balance sheet reports the amount of assets, liabilities, and shareholders' equity of an accounting entity at a point in time.
10. Which of the following statements regarding GAAP is true?
    a. Canadian GAAP is the body of accounting knowledge followed by all countries in the world.
    b. Changes in GAAP can affect the interests of managers and shareholders.

c. GAAP is the abbreviation for generally accepted auditing procedures.
d. Changes to GAAP must be approved by the Senate Finance Committee.

**For more practice with multiple-choice questions, go to our Web site at www.mcgrawhill.ca/college/libby, click on "Student Edition" in the upper left menu, click on this chapter's name and number from the list of contents, and then click on "Multiple-Choice Quiz" from the menu on the left.**

## EXERCISES

**E1–1 Matching Definitions with Terms or Abbreviations** ■ LO1, 2

Match each definition with its related term or abbreviation by entering the appropriate letter in the space provided.

| Term or Abbreviation | Definition |
|---|---|
| ______ (1) OSC | A. A system that collects and processes financial information about an organization and reports that information to decision makers. |
| ______ (2) Audit | B. Measurement of information about an entity in the monetary unit of the country—dollars or other national currency. |
| ______ (3) Sole proprietorship | C. An unincorporated business owned by two or more persons. |
| ______ (4) Corporation | D. The organization for which financial data are to be collected (separate and distinct from its owners). |
| ______ (5) Accounting | E. An incorporated entity that issues shares as evidence of ownership. |
| ______ (6) Separate entity | F. Initial recording of financial statement elements at acquisition cost. |
| ______ (7) Audit report | G. An examination of the financial reports to ensure that they represent what they claim and conform with generally accepted accounting principles. |
| ______ (8) Cost principle | H. Chartered Accountant. |
| ______ (9) Partnership | I. An unincorporated business owned by one person. |
| ______ (10) CGA | J. A report that describes the auditors' opinion of the fairness of the financial statement presentations and the evidence gathered to support that opinion. |
| ______ (11) AcSB | K. Ontario Securities Commission. |
| ______ (12) CA | L. Accounting Standards Board. |
| ______ (13) Unit of measure | M. A company that can be bought and sold by investors on established stock exchanges. |
| ______ (14) GAAP | N. Generally accepted accounting principles. |
| ______ (15) Publicly traded | O. Certified General Accountant. |

**E1–2 Matching Financial Statement Items to Financial Statement Categories** ■ LO1

Procter & Gamble

According to its annual report, "Procter & Gamble markets a broad range of laundry, cleaning, paper, beauty care, health care, food and beverage products in more than 140 countries around the world, with leading brands including Tide, Ariel, Crest, Crisco, Vicks and Max Factor." The following are items taken from its recent balance sheet and income statement. Note that different companies use slightly different titles for the same item. Mark each item in the following list as an asset (A), liability (L), or shareholders' equity (SE) that would appear on the balance sheet or a revenue (R) or expense (E) that would appear on the income statement.

______ (1) Accounts payable
______ (2) Accounts receivable
______ (3) Cash and cash equivalents
______ (4) Cost of products sold
______ (5) Property, plant, and equipment
______ (6) Income taxes
______ (7) Interest expense
______ (8) Inventories
______ (9) Land
______ (10) Marketing, administrative, and other operating expenses
______ (11) Long-term debt
______ (12) Net sales
______ (13) Notes payable
______ (14) Retained earnings
______ (15) Taxes payable

■ **LO1** Tootsie Roll

**E1–3 Matching Financial Statement Items to Financial Statement Categories**

Tootsie Roll Industries is engaged in the manufacture and sale of candy. Major products include Tootsie Roll, Tootsie Roll Pops, Tootsie Pop Drops, Tootsie Flavor Rolls, Charms, and Blow Pop lollipops. The following items were listed on Tootsie Roll's recent income statement and balance sheet. Mark each item from the balance sheet as an asset (A), liability (L), or shareholders' equity (SE) and each item from the income statement as a revenue (R) or expense (E).

| | |
|---|---|
| _______ (1) Accounts payable | _______ (10) Buildings |
| _______ (2) Accounts receivable | _______ (11) Cash and cash equivalents |
| _______ (3) Cost of goods sold | _______ (12) Land |
| _______ (4) Distribution and warehousing | _______ (13) Machinery and equipment |
| _______ (5) Dividends payable | _______ (14) Marketing, selling, and advertising |
| _______ (6) General and administrative | _______ (15) Net sales |
| _______ (7) Income taxes payable | _______ (16) Notes payable to banks |
| _______ (8) Inventories | _______ (17) Provision for income taxes* |
| _______ (9) Investments | _______ (18) Retained earnings |

■ **LO1** Honda Motor Co.

**E1–4 Preparing a Balance Sheet**

Established less than 50 years ago, Honda Motor Co., Ltd., of Japan is a leading international manufacturer of automobiles and the largest manufacturer of motorcycles in the world. As a Japanese company, it follows Japanese GAAP and reports its financial statements in millions of yen (the sign for yen is ¥). A recent balance sheet contained the following items (in millions). Prepare a balance sheet as at March 31, 2004, solving for the missing amount.

| | |
|---|---|
| Cash and cash equivalents | ¥ 724,421 |
| Share capital | 291,204 |
| Accounts payable and other current liabilities | 3,334,819 |
| Inventories | 765,433 |
| Investments | 541,066 |
| Long-term debt | 1,394,612 |
| Net property, plant, and equipment | 1,435,531 |
| Other assets | 846,943 |
| Other liabilities | 724,937 |
| Retained earnings | 2,583,196 |
| Total assets | 8,328,768 |
| Total liabilities and shareholders' equity | ? |
| Trade accounts, notes, and other receivables | 4,015,374 |

■ **LO1**

**E1–5 Completing a Balance Sheet and Inferring Net Income**

Terry Lloyd and Joan Lopez organized Read More Store as a corporation; each contributed $50,000 cash to start the business and received 4,000 shares of capital. The store completed its first year of operations on December 31, 2006. On that date, the following financial items were determined: cash on hand and in the bank, $42,900; amounts due from customers from sales of books, $36,000; unused portion of store and office equipment, $43,000; amounts owed to publishers for books purchased, $8,000; one-year note for $1,000, signed on January 15, 2006 and payable to a local bank. No dividends were declared or paid to the shareholders during the year.

***Required:***

1. Complete the following balance sheet as at December 31, 2006.
2. What was the amount of net income for the year?

*In Canada and the United States, "provision for income taxes" is most often used as a synonym for "income tax expense."

| **Assets** | | **Liabilities** | | |
|---|---|---|---|---|
| Cash | $ ______ | Accounts payable | $ ______ | |
| Accounts receivable | ______ | Note payable | ______ | |
| Store and office equipment | ______ | Interest payable | 120 | |
| | | Total liabilities | | $ ______ |
| | | **Shareholders' Equity** | | |
| | | Share capital | $ ______ | |
| | | Retained earnings | 12,780 | |
| | | Total shareholders' equity | | ______ |
| Total assets | $ ______ | Total liabilities and shareholders' equity | | $ ______ |

**E1–6 Analyzing Revenues and Expenses and Preparing an Income Statement** ■ LO1

Assume that you are the owner of The Collegiate Shop, which specializes in items that interest students. At the end of September 2007, you find (for September only) the following:

*a.* Sales, per the cash register tapes, of $120,000, plus one sale on credit (a special situation) of $2,000.

*b.* With the help of a friend (who majored in accounting), you determined that all of the goods sold during September had cost $45,000 to purchase.

*c.* During the month, according to the chequebook, you paid $38,000 for salaries, rent, supplies, advertising, and other expenses; however, you have not yet paid the $600 monthly utilities for September.

***Required:***

On the basis of the data given, what was the amount of income for September (disregard income taxes)? Show computations. (*Hint*: A convenient form to use has the following major side captions: Revenue from Sales, Expenses, and the difference—Net Income.)

**E1–7 Preparing an Income Statement and Inferring Missing Values** ■ LO1

Wal-Mart

Wal-Mart Stores, Inc., is the largest retail chain in the United States, operating more than 2,000 stores. A recent annual income statement contained the following items (in millions). Solve for the missing amounts and prepare a condensed income statement for the year ended January 31, 2004. (*Hint:* First order the items as they would appear on the income statement and then solve for the missing values.)

| | |
|---|---|
| Cost of sales | $198,747 |
| Interest costs | 832 |
| Net income | ? |
| Net sales | 258,681 |
| Operating, selling, and general and administrative expenses | 44,909 |
| Provision for income taxes* | 5,118 |
| Other expenses | 21 |
| Total costs and expenses | ? |
| Total revenues | ? |
| Income before income tax | ? |

**E1–8 Analyzing Revenues and Expenses and Completing an Income Statement** ■ LO1

Home Realty, Incorporated, has been operating for three years and is owned by three investors. J. Doe owns 60 percent of the 9,000 shares that are outstanding, and is the

*In Canada and the United States, "provision for income taxes" is a common synonym for "income tax expense."

managing executive in charge. On December 31, 2006, the following financial items for the entire year were determined: commissions earned and collected in cash, $150,000; rental service fees earned and collected, $15,000; expenses paid including salaries, $62,000; commissions, $35,000; payroll taxes, $2,500; rent, $2,200; utilities, $1,600; promotion and advertising, $8,000; income taxes, $18,500; and miscellaneous expenses, $500. At December 31, there were $16,000 of commissions earned but not collected yet, and the rent for December was not paid. Complete the following income statement:

______________________
______________________
______________________

| | | |
|---|---|---|
| Revenues | | |
| Commissions | $ ______ | |
| Rental service fees | ______ | |
| Total revenues | | $ ______ |
| Expenses | | |
| Salaries | $ ______ | |
| Commission | ______ | |
| Payroll tax | ______ | |
| Rent | ______ | |
| Utilities | ______ | |
| Promotion and advertising | ______ | |
| Miscellaneous | ______ | |
| Total expenses (excluding income taxes) | | ______ |
| Income before income taxes | | $ ______ |
| Income tax expense | | ______ |
| Net income | | $ 50,500 |

■ **LO1**

**E1–9 Inferring Values Using the Income Statement and Balance Sheet Equations**
Review the chapter explanations of the income statement and the balance sheet equations. Apply these equations in each independent case to compute the two missing amounts for each case. Assume that it is the end of 2005, the first full year of operations for the company.
(*Hint:* Organize the listed items as they are presented in the balance sheet and income statement equations and then compute the missing amounts.)

| Independent Cases | Total Revenues | Total Expenses | Net Income (Loss) | Total Assets | Total Liabilities | Shareholders' Equity |
|---|---|---|---|---|---|---|
| A | $100,000 | $82,000 | $ | $150,000 | $70,000 | $ |
| B | | 80,000 | 12,000 | 112,000 | | 60,000 |
| C | 80,000 | 86,000 | | 104,000 | 26,000 | |
| D | 50,000 | | 13,000 | | 22,000 | 77,000 |
| E | | 81,000 | (6,000) | | 73,000 | 28,000 |

■ **LO1**

**E1–10 Preparing an Income Statement and Balance Sheet**
Huang Corporation was organized by five individuals on January 1, 2006. At the end of January 2006, the following monthly financial data are available:

| | |
|---|---|
| Total revenues | $130,000 |
| Total expenses (excluding income taxes) | 80,000 |
| Income tax expense (all unpaid as at January 31) | 15,000 |
| Cash balance, January 31, 2006 | 30,000 |
| Receivables from customers (all considered collectable) | 15,000 |
| Merchandise inventory (by inventory count at cost) | 42,000 |
| Payables to suppliers for merchandise purchased from them (will be paid during February 2006) | 11,000 |
| Share capital (2,600 shares) | 26,000 |

No dividends were declared or paid during 2006.

***Required:***
Complete the following two statements:

**HUANG CORPORATION**
**Summary Income Statement**
**For the Month of January 2006**

| | | |
|---|---|---|
| Total revenues | | $ ______ |
| Less: Total expenses (excluding income tax) | | ______ |
| Income before income tax | | ______ |
| Less: Income tax expense | | ______ |
| Net income | | ______ |

**HUANG CORPORATION**
**Balance Sheet**
**As at January 31, 2006**

| | | |
|---|---|---|
| **Assets** | | |
| Cash | | $ ______ |
| Receivables from customers | | ______ |
| Merchandise inventory | | ______ |
| Total assets | | $ ______ |
| **Liabilities** | | |
| Payables to suppliers | | $ ______ |
| Income taxes payable | | ______ |
| Total liabilities | | ______ |
| **Shareholders' equity** | | |
| Share capital | $ ______ | |
| Retained earnings | ______ | |
| Total shareholders' equity | | ______ |
| Total liabilities and shareholders' equity | | $ ______ |

**E1–11 Analyzing and Interpreting an Income Statement and Price/Earnings Ratio** ■ **LO1**

Pest Away Corporation was organized by three individuals on January 1, 2005, to provide insect extermination services. At the end of 2005, the following income statement was prepared:

**PEST AWAY CORPORATION**
**Income Statement**
**For the Year Ended December 31, 2005**

| | | |
|---|---|---|
| Revenues | | |
| Service revenue (cash) | $204,000 | |
| Service revenue (credit) | 24,000 | |
| Total revenues | | $228,000 |
| Expenses | | |
| Salaries | $ 78,000 | |
| Rent | 21,000 | |
| Utilities | 12,000 | |
| Advertising | 14,000 | |
| Supplies | 25,000 | |
| Interest | 8,000 | |
| Total expenses | | 158,000 |
| Income before income tax | | $ 70,000 |
| Income tax expense | | 21,000 |
| Net income | | $ 49,000 |

***Required:***

1. What was the average amount of monthly revenue?
2. What was the amount of monthly rent?
3. Explain why supplies are reported as an expense.
4. Explain why interest is reported as an expense.
5. What was the average income tax rate for Pest Away Corporation?
6. Can you determine how much cash the company had on December 31, 2005? Explain.
7. If the company had a market value of $588,000, what is its price/earnings ratio?

■ LO1 Dell Computer

**E1–12 Focus on Cash Flows: Matching Cash Flow Statement Items to Categories**

Dell Computer is a leading designer and manufacturer of personal computers. The following items were taken from its recent cash flow statement. Note that different companies use slightly different titles for the same item. Without referring to Exhibit 1.5, mark each item in the list as a cash flow from operating activities (O), investing activities (I), or financing activities (F). Place parentheses around the letter only if it is a cash outflow.

_______ (1) Cash paid to suppliers and employees
_______ (2) Cash received from customers
_______ (3) Income taxes paid
_______ (4) Interest and dividends received
_______ (5) Interest paid
_______ (6) Proceeds from sale of investment in Conner Peripherals, Inc.
_______ (7) Purchases of property, plant, and equipment
_______ (8) Repayment of borrowings

■ LO1

**E1–13 Preparing a Cash Flow Statement**

NITSU Manufacturing Corporation is preparing the annual financial statements for the shareholders. A cash flow statement must be prepared. The following data on cash flows were developed for the entire year ended December 31, 2006: cash inflow from operating revenues, $270,000; cash expended for operating expenses, $180,000; sale of unissued NITSU shares for cash, $30,000; cash dividends declared and paid to shareholders during the year, $22,000; and payments on long-term notes payable, $80,000. During the year, a tract of land was sold for $15,000 cash (which was the same price that NITSU had paid for the land in 2005), and $38,000 cash was expended for two new machines. The machines were used in the factory. The beginning-of-the-year cash balance was $63,000.

***Required:***

Prepare a cash flow statement for 2006. Follow the format illustrated in the chapter.

■ LO1

**E1–14 Analyzing Cash Flows from Operations**

Paul's Painters, a service organization, prepared the following special report for the month of January 2005:

**Service Revenue, Expenses, and Income**

| | | |
|---|---|---|
| Service revenue | | |
| Cash services (per cash register tape) | $115,000 | |
| Credit services (per charge bills; not yet collected by end of January) | 20,500 | |
| | | $135,500 |
| Expenses: | | |
| Salaries and wages expense (paid by cheque) | $ 60,000 | |
| Salaries for January not yet paid | 3,000 | |
| Supplies used (taken from stock, purchased for cash during December) | 2,000 | |
| Estimated cost of using company-owned truck for the month (called *amortization*) | 500 | |
| Other expenses (paid by cheque) | 16,000 | 81,500 |
| Income before income tax | | 54,000 |
| Income tax expense (not yet paid) | | 13,500 |
| Income for January | | $ 40,500 |

***Required:***

1. The owner (who knows little about the financial part of the business) asked you to compute the amount by which cash had increased in January 2005 from the operations of the company. You decided to prepare a detailed report for the owner with the following major captions: Cash Inflows (collections), Cash Outflows (payments), and the difference—Net Increase (or Decrease) in Cash.
2. Reconcile the difference—net increase (or decrease) in cash—you computed in requirement 1 with the income for January 2005.

## PROBLEMS

**P1–1 Preparing an Income Statement and a Balance Sheet** (AP1–1) **LO1**

Assume that you are the president of Nuclear Company. At December 31, 2005, the end of the first year of operations, the following financial data for the company are available:

| | |
|---|---|
| Cash | $ 22,000 |
| Receivables from customers (all considered collectable) | 12,000 |
| Inventory of merchandise (based on physical count and priced at cost) | 90,000 |
| Equipment owned, at cost less used portion | 45,000 |
| Accounts payable owed to suppliers | 44,370 |
| Salary payable for 2005 (on December 31, 2005, this was owed to an employee who was away because of an emergency and will return around January 10, 2006, at which time the payment will be made) | 2,000 |
| Total sales revenue | 140,000 |
| Expenses, including the cost of the merchandise sold (excluding income taxes) | 89,100 |
| Income taxes expense (at 30% of pretax income); all paid during 2005 | ? |
| Share capital, 7,000 shares outstanding | 87,000 |
| No dividends were declared or paid during 2005. | |

***Required*** (show computations):

1. Prepare a summarized income statement for the year ended December 31, 2005.
2. Prepare a balance sheet at December 31, 2005.

**P1–2 Analyzing a Student's Business and Preparing an Income Statement** (AP1–2) **LO1**

While pursuing her undergraduate studies, Brigitte Lebeau needed to earn sufficient money for the coming academic year. Unable to obtain a job with a reasonable salary, she decided to try the lawn care business for three months during the summer. After a survey of the market potential, Brigitte bought a used pick-up truck on June 1 for $1,500. On each door she painted "Brigitte's Lawn Service, Phone 471-4487." She also spent $900 for mowers, trimmers, and tools. To acquire these items, she borrowed $2,500 cash by signing a note payable, promising to pay the $2,500 plus interest of $75 at the end of the three months (ending August 31).

At the end of the summer, Brigitte realized that she had done a lot of work, and her bank account looked good. This fact prompted her to become concerned about how much profit the business had earned.

A review of the cheque stubs showed the following: bank deposits of collections from customers totalled $12,600. The following cheques had been written: gas, oil, and lubrication, $920; truck repairs, $210; mower repair, $75; miscellaneous supplies used, $80; helpers, $4,500; payroll taxes, $175; payment for assistance in preparing payroll tax forms, $25; insurance, $125; telephone, $110; and $2,575 to pay off the note including interest (on August 31). A notebook kept in the truck, plus some unpaid bills, reflected that customers still owed her $800 for lawn services rendered and that she owed $200 for gas and oil (credit card charges). She estimated that the cost for use of the truck and the other equipment (called *amortization*) for three months amounted to $500.

***Required:***

1. Prepare a quarterly income statement for Brigitte's Lawn Service for the months of June, July, and August 2005. Use the following main captions: Revenues from Services,

Expenses, and Net Income. Because this is a sole proprietorship, the company will not be subject to income tax.

2. Do you see a need for one or more additional financial reports for this company for 2005 and thereafter? Explain.

■ LO1

**P1–3 Comparing Income with Cash Flow (A Challenging Problem)**

New Delivery Company was organized on January 1, 2006. At the end of the first quarter (three months) of operations, the owner prepared a summary of its operations as shown in the first row of the following tabulation:

| | Computation of | |
|---|---|---|
| **Summary of Transactions** | **Income** | **Cash** |
| *a.* Services performed for customers, $66,000, of which one-sixth remained uncollected at the end of the quarter. | +$66,000 | +$55,000 |
| *b.* Cash borrowed from the local bank, $25,000 (one-year note). | | |
| *c.* Small service truck purchased for use in the business: cost, $9,000; paid 30% down, balance on credit. | | |
| *d.* Expenses, $36,000, of which one-sixth remained unpaid at the end of the quarter. | | |
| *e.* Service supplies purchased for use in the business, $3,000, of which one-fourth remained unpaid (on credit) at the end of the quarter. Also, one-fifth of these supplies were unused (still on hand) at the end of the quarter. | | |
| *f.* Wages earned by employees, $20,000, of which one-half remained unpaid at the end of the quarter. | | |
| Based only on the above transactions, compute the following for the quarter: | | |
| Income (or loss) | | |
| Cash inflow (or outflow) | | |

***Required:***

1. For each of the six transactions given in this tabulation, enter what you consider to be the correct amounts. Enter a zero when appropriate. The first transaction is illustrated.
2. For each transaction, explain the basis for your responses.

■ LO1

**P1–4 Evaluating Data to Support a Loan Application (A Challenging Problem)**

On January 1, 2006, three individuals organized West Company as a corporation. Each individual invested $10,000 cash in the business. On December 31, 2006, they prepared a list of resources owned (assets) and a list of the debts (liabilities) to support the company's request for a loan of $70,000 submitted to a local bank. None of the three investors had studied accounting. The two lists prepared were as follows:

| | |
|---|---|
| Company resources | |
| Cash | $ 12,000 |
| Service supplies inventory (on hand) | 7,000 |
| Service trucks (four practically new) | 76,000 |
| Personal residences of organizers (three houses) | 190,000 |
| Service equipment used in the business (practically new) | 30,000 |
| Bills due from customers (for services already completed) | 17,000 |
| Total | $332,000 |
| Company obligations | |
| Unpaid wages to employees | $ 19,000 |
| Unpaid taxes | 8,000 |
| Owed to suppliers | 10,000 |
| Owed on service trucks and equipment (to a finance company) | 50,000 |
| Loan from organizer | 10,000 |
| Total | $ 97,000 |

***Required:***

Prepare a short memo indicating:

1. Which of these items do not belong on the balance sheet (bear in mind that the company is considered to be separate from the owners)?
2. What additional questions would you raise about measurement of items on the lists? Explain the basis for each question.

3. If you were advising the local bank on its loan decision, which amounts on the lists would create special concerns? Explain the basis for each concern and include any recommendations that you have.
4. In view of your responses to (1) and (2), calculate the amount of shareholders' equity as at December 31, 2006. Show your computations.

## ALTERNATE PROBLEMS

**AP1–1 Preparing an Income Statement and a Balance Sheet (P1–1)** ■ LO1

Assume that you are the president of McClaren Corporation. At June 30, 2007, the end of the first year of operations, the following financial data for the company are available:

| | |
|---|---|
| Cash | $13,150 |
| Receivables from customers (all considered collectable) | 9,500 |
| Inventory of merchandise (based on physical count and priced at cost) | 61,000 |
| Equipment owned, at cost less used portion | 36,000 |
| Accounts payable owed to suppliers | 35,500 |
| Salary payable for 2007 (on June 30, 2007, this was owed to an employee who was away because of an emergency and will return around July 7, 2007, at which time the payment will be made) | 1,500 |
| Total sales revenue | 90,000 |
| Expenses, including the cost of the merchandise sold (excluding income taxes) | 60,500 |
| Income taxes expense (at 30% of pretax income); all paid during 2007 | ? |
| Share capital, 5,000 shares outstanding | 62,000 |
| No dividends were declared or paid during 2007. | |

***Required*** (show computations):

1. Prepare a summarized income statement for the year ended June 30, 2007.
2. Prepare a balance sheet at June 30, 2007.

**AP1–2 Analyzing a Student's Business and Preparing an Income Statement (P1–2)** ■ LO1

Upon graduation from high school, John Abel immediately accepted a job as an electrician's assistant for a large local electrical repair company. After three years of hard work, John received an electrician's licence and decided to start his own business. He had saved $12,000, which he invested in the business. First, he transferred this amount from his savings account to a business bank account for Abel Electric Repair Company, Incorporated. His lawyer had advised him to start as a corporation. He then purchased a used panel truck for $9,000 cash and second-hand tools for $1,500; rented space in a small building; inserted an ad in the local paper; and opened the doors on October 1, 2005. Immediately, John was very busy; after one month, he employed an assistant.

Although John knew practically nothing about the financial side of the business, he realized that a number of reports were required and that costs and collections had to be controlled carefully. At December 31, 2005, prompted in part by concern about his income tax situation, John recognized the need for financial statements. His wife Jane developed some financial statements for the business. On December 31, 2005, with the help of a friend, she gathered the following data for the three months just ended. Bank account deposits of collections for electric repair services totalled $32,000. The following cheques had been written: electrician's assistant, $8,500; payroll taxes, $175; supplies purchased and used on jobs, $9,500; oil, gas, and maintenance on truck, $1,200; insurance, $700; rent, $500; utilities and telephone, $825; and miscellaneous expenses (including advertising), $600. Also, uncollected bills to customers for electric repair services amounted to $3,000. The $200 rent for December had not been paid. The average income tax rate is 30 percent. John estimated the cost of using the truck and tools (*amortization*) during the three months to be $1,200.

***Required:***

1. Prepare a quarterly income statement for Abel Electric Repair Company, Incorporated, for the three months of October through December 2005. Use the following main captions: Revenue from Services, Expenses, Income before Income Taxes, and Net Income.
2. Do you think that John may have a need for one or more additional financial reports for 2005 and thereafter? Explain.

# CASES AND PROJECTS

## FINDING AND INTERPRETING FINANCIAL INFORMATION

**LO1, 3** **CP1–1** **Finding Financial Information**

Van Houtte Inc.

Refer to the financial statements of Van Houtte Inc. in Appendix B at the end of this book.

***Required:***

1. What is the amount of net income for the current fiscal year?
2. What amount of revenue was earned in the current fiscal year?
3. How much inventory does the company have at the end of the current fiscal year?
4. By what amount did cash and cash equivalents* change during the year?
5. Who is auditor for the company?

**LO1, 3** **CP1–2** **Finding Financial Information**

The Forzani Group Ltd.

Refer to the financial statements of The Forzani Group Ltd. on the Online Learning Centre Web site at **www.mcgrawhill.ca/college/libby/studentresources**.

***Required:***

Read the annual report. Look at the income statement, balance sheet, and cash flow statement closely and attempt to infer the types of information they report. Then answer the following questions based on the report.

1. What types of products does the company sell?
2. Did the chief executive officer (CEO) believe that the company had a good year?
3. On what day of the year does its fiscal year end?
4. For how many years does it present complete
   *a.* balance sheets?
   *b.* income statements?
   *c.* cash flow statements?
5. Are its financial statements audited by independent accountants? How do you know?
6. Did its total assets increase or decrease over the last year?
7. What was the ending balance of inventories?
8. Write out its basic accounting (balance sheet) equation in dollars at year-end.

**LO1** **CP1–3** **Comparing Companies**

Van Houtte vs. The Forzani Group

Refer to the financial statements and the accompanying notes of Van Houtte Inc. given in Appendix B and of The Forzani Group Ltd. on the Online Learning Centre Web site at **www.mcgrawhill.ca/college/libby/student/resources**.

***Required:***

1. Both companies report "basic" earnings per share on their income statements and the market price per share of their stock either in their annual reports or on their Web sites. Using current year's earnings per share and the highest stock price per share reported for the most recent year, compute the price/earnings ratio. Which company provided the highest price/earnings ratio for the current year? (*Note:* For Van Houtte, use a market price of $23.50 per share.)
2. Which company do investors believe will have the higher growth in earnings in the future?

## FINANCIAL REPORTING AND ANALYSIS CASES

**LO1** **CP1–4** **Using Financial Reports: Identifying and Correcting Deficiencies in an Income Statement and a Balance Sheet**

Performance Corporation was organized on January 1, 2005. At the end of 2005, the company had not yet employed an accountant; however, an employee who was "good with numbers" prepared the following statements at that date:

---

**Cash equivalents* are short-term investments readily convertible into cash and whose value is unlikely to change.

**PERFORMANCE CORPORATION**
**December 31, 2005**

| | |
|---|---|
| Income from sales of merchandise | $175,000 |
| Total amount paid for goods sold during 2005 | (90,000) |
| Selling costs | (25,000) |
| Amortization (on service vehicles used) | (10,000) |
| Income from services rendered | 47,000 |
| Salaries and wages paid | (57,000) |

**PERFORMANCE CORPORATION**
**December 31, 2005**

| | | |
|---|---|---|
| Resources | | |
| Cash | | $ 32,000 |
| Merchandise inventory (held for resale) | | 42,000 |
| Service vehicles | | 50,000 |
| Retained earnings (profit earned in 2005) | | 30,000 |
| Grand total | | $154,000 |
| Debts | | |
| Payable to suppliers | | $ 22,000 |
| Note owed to bank | | 25,000 |
| Due from customers | | 20,000 |
| Total | | $ 67,000 |
| Supplies on hand (to be used in rendering services) | $ 8,000 | |
| Accumulated amortization* (on service vehicles) | 10,000 | |
| Share capital, 6,500 shares | 65,000 | |
| Total | | 83,000 |
| Grand total | | $150,000 |

***Required:***

1. List all of the deficiencies that you can identify in these statements. Give a brief explanation of each one.
2. Prepare a proper income statement for Performance Corporation for 2005 (correct net income is $30,000) and a proper balance sheet at December 31, 2005 (correct total assets are $142,000).

**CP1–5 Using Financial Reports: Applying the Balance Sheet Equation to Liquidate a Company** ■ **LO1**

On June 1, 2007, Bland Corporation prepared a balance sheet just prior to going out of business. The balance sheet totals showed the following:

| | |
|---|---|
| Assets (no cash) | $90,000 |
| Liabilities | 50,000 |
| Shareholders' equity | 40,000 |

Shortly thereafter, all of the assets were sold for cash.

***Required:***

1. How would the balance sheet appear immediately after the sale of the assets for cash for each of the following cases? Use the format given here.

| | | Balances Immediately after Sale | | | | |
|---|---|---|---|---|---|---|
| | **Cash Received for the Assets** | **Assets** | **–** | **Liabilities** | **=** | **Shareholders' Equity** |
| Case A | $ 90,000 | $_____ | | $_____ | | $_____ |
| Case B | 80,000 | $_____ | | $_____ | | $_____ |
| Case C | 100,000 | $_____ | | $_____ | | $_____ |
| Case D | 35,000 | $_____ | | $_____ | | $_____ |

**Accumulated amortization* represents the cost related to the used portion of the asset and should be subtracted from the asset balance.

2. How should the cash be distributed in each separate case? (*Hint:* Creditors must be paid in full before owners receive any payment.) Use the format given here:

| | To Creditors | To Shareholders | Total |
|---|---|---|---|
| Case A | $______ | $______ | $______ |
| Case B | $______ | $______ | $______ |
| Case C | $______ | $______ | $______ |
| Case D | $______ | $______ | $______ |

## CRITICAL THINKING CASES

■ LO1, 3

### CP1–6 Making Decisions as a Manager: Reporting the Assets and Liabilities of a Business

Elizabeth Watkins owns and operates Liz's Boutique (a sole proprietorship). An employee prepares a financial report for the business at each year-end. This report lists all of the resources (assets) owned by Watkins, including such personal items as the home she owns and occupies. It also lists all of the debts of the business, but not her personal debts.

***Required:***

1. From an accounting point of view, do you disagree with what is being included in and excluded from the report of business assets and liabilities? Explain.
2. Upon questioning, Watkins responded, "Don't worry about it; we use it only to support a loan from the bank." How would you respond to this comment?

■ LO3

### CP1–7 Making Decisions as an Owner: Deciding about a Proposed Audit

You are one of three partners who own and operate Mary's Maid Service. The company has been operating for seven years. One of the other partners has always prepared the company's annual financial statements. Recently you proposed that the statements be audited each year because it would benefit the partners and preclude possible disagreements about the division of profits. The partner who prepares the statements proposed that his Uncle Ray, who has a lot of financial experience, can do the job and at little cost. Your other partner remained silent.

***Required:***

1. What position would you take on the proposal? Justify your response.
2. What would you strongly recommend? Give the basis for your recommendation.

■ LO3, 4


### CP1–8 Evaluating an Ethical Dilemma: Ethics and Auditor Responsibilities

A key factor that an auditor provides is independence. The *codes of professional conduct* typically state that a member in public practice should be independent in fact and appearance when providing auditing and other attestation service.

***Required:***

Do you consider the following circumstances to suggest a lack of independence? Justify your position. (Use your imagination. Specific answers are not provided in the chapter.)

1. Karl Ottman is a partner with a large audit firm and is assigned to the Ford audit. Karl owns 10 shares of Ford.
2. Jane Winkler has invested in a mutual fund company that owns 500,000 shares of Sears Canada Inc. She is the auditor of Sears.
3. Bob Franklin is a clerk/typist who works on the audit of BCE Inc. He has just inherited 50,000 shares of BCE. (Bob enjoys his work and plans to continue despite his new wealth.)
4. Nancy Chen worked on weekends as the controller for a small business that a friend started. Nancy quit the job in midyear and now has no association with the company. She works full-time for a large accounting firm and has been assigned to do the audit of her friend's business.
5. Sylvie Karam borrowed $100,000 for a home mortgage from First City National Bank. The mortgage was granted on normal credit terms. Sylvie is the partner in charge of the First City audit.

# FINANCIAL REPORTING AND ANALYSIS TEAM PROJECT

**CP1–9 Team Project: Examining an Annual Report**

■ **LO1, 3**




As a team, select an industry to analyze. *Reuters* provides lists of industries and their make-up at **www.investor.reuters.com**. Each group member should acquire the annual report for one publicly traded company in the industry, with each member selecting a different company. (Library files, the SEDAR service at **www.sedar.com**, or the company's Web site are good sources. The Annual Report Gallery at **www.reportgallery.com** provides links to the Web sites of well-known companies.) On an individual basis, each group member should write a short report answering the following questions about the selected company.

1. What types of products or services does it sell?
2. On what day of the year does its fiscal year end?
3. For how many years does it present complete
   *a*. balance sheets?
   *b*. income statements?
   *c*. cash flow statements?
4. Are its financial statements audited by independent auditors? If so, by whom?
5. Did its total assets increase or decrease over the last year?
6. Did its net income increase or decrease over the last year?

Discuss any patterns that you observe as a team. Then, as a team, write a short report comparing and contrasting your companies, using the six attributes listed above.