

## CHAPTER

# 1

# THE ACCOUNTING ENVIRONMENT: WHAT IS ACCOUNTING AND WHY IS IT DONE?

## LEARNING OBJECTIVES

After studying the material in this chapter you will be able to:

- ▶ **LO 1** Explain accounting and its uses.
- ▶ **LO 2** Describe the accounting environment and understand that the accounting information an entity presents is affected by the accounting environment.
- ▶ **LO 3** Discuss how the interests of the people who prepare accounting information can conflict with the interests of the people who use the information.
- ▶ **LO 4** Understand the importance of accounting information for measuring the attributes of an entity.
- ▶ **LO 5** Describe generally accepted accounting principles in basic terms and identify the four qualitative characteristics that GAAP identify as necessary for accounting information to be useful.

There was a large crowd at the Rogers Centre in Toronto for the Sunday afternoon baseball game between the Toronto Blue Jays and the New York Yankees. Rogers Communications Inc. owns the Toronto major league baseball team and the stadium. The company had poured \$8 million into the stadium that year to install a new set of jumbo video screens



where fans could watch game statistics, as well as commercials from Rogers Sportsnet, one of over a dozen television stations the company owns. Red and white Rogers signs dotted the perimeter of the stadium. And some youngsters listened to the game's play-by-play on their portable radios, tuned to The Fan 590, a Rogers-owned AM radio station in Toronto. Here and there, women reached into their purses and men into their pockets to answer the ringing of their Rogers Wireless cell phones.

From cable television, to publishing, to mobile phones and the Internet, the Rogers Communications conglomerate is one of the country's most successful media empires. And it began with a single radio station in Toronto, named CHFI, bought in the 1960s by the founder, Ted Rogers, Jr. He found his calling in communications after the untimely death of his father, Edward Rogers, Sr., a media pioneer who invented the world's first battery-less radio.

Since the 1960s, Rogers Communications has grown into a \$7-billion dollar company. It's Canada's largest cable television provider, with 2.3 million subscribers. Rogers Wireless boasts more than six million subscribers for voice, data, and one-way paging. Rogers Media, which includes the Rogers Centre and the Blue Jays, publishes 70 magazines, including *Maclean's* and *L'actualité*, and operates more than 40 radio stations and several television channels, including Sportsnet. More recently, the family-owned business moved into the home telephone service, with the takeover of Call-Net Enterprises, the parent of Sprint Canada.

Rogers is based in Toronto and has about 18,000 employees. The Blue Jays won their game against New York, by a score of 6 to 5.





## INTRODUCTION

Accounting is full of mystery and intrigue. The reader of an accounting report, like the reader of a good mystery, must sort through clues, interpret and analyze information, exercise judgment, decide which information is relevant and which should be ignored, and use the information to come to a conclusion. In an accounting mystery the question is not who the murderer or thief is. Instead, an accounting detective might have to decide whether to invest, lend, do business with a particular organization, or ask for an increase in wages.

Solving an accounting mystery requires detective work. The numbers tell a story, but it is usually necessary to read between the lines. You cannot just take the numbers at face value. Working with accounting information is not cold, calculating, and impersonal. The effective accounting detective must also understand human behaviour. *People* prepare accounting information—people who have their own interests regarding how the accounting information will be used.

Over the years accounting has endured a bad reputation. The stereotype conjures up dull people doing dreary work—people do not think of accounting as “sexy.” Can you name any famous accountants? Have you ever heard of any television shows or movies about accounting? Probably the most famous accountants are the PricewaterhouseCooper representatives who deliver the results at the Academy Awards.

But accounting’s dreary reputation is not fair. There may be some dull accountants; there may even be a lot of dull accountants. But accounting is definitely not dull. In fact, using, preparing, and understanding accounting information requires a set of high-level cognitive skills—skills that include judgment, analysis, synthesis, evaluation, problem solving, critical thinking, and creativity.

The goal of *Financial Accounting: A Critical Approach* is to help you become an effective accounting detective. You will examine accounting from the perspectives of the people who prepare the information and those who use it. You will learn to interpret and understand financial statements and financial reporting, and master the tools to unravel their mysteries.

Regardless of whether you plan to become a professional accountant, pursue a career in another business discipline, or just learn something about accounting, *Financial Accounting: A Critical Approach* will provide you with some tools to help you make sense of the information in accounting reports and understand the strengths and limitations of accounting information.

## A CHALLENGE TO THE READER

Business and accounting are real-world subjects. The ideas and themes in an accounting textbook and course are easier to understand when you can connect them to real-world events. As we move through this book, links will be made with actual business problems and entities so that you can develop an understanding of accounting in context. You can help develop your own understanding of business by regularly reading the business press to learn about Canadian and international business issues, problems, and companies. Two excellent Canadian business newspapers are *The Globe and Mail’s Report on Business* and *The National Post’s Financial Post*. There are also many good business magazines and Web sites that will help you learn about Canadian and global business issues, personalities, and entities.

A sample of some well-known Canadian and international sources for business information follows on the next page.

In addition, the following Web sites are particularly helpful if you are looking for financial information about Canadian and U.S. publicly traded companies:

Canadian companies	<a href="http://www.sedar.com">www.sedar.com</a>
U.S. companies	<a href="http://www.sec.gov/edgar.shtml">www.sec.gov/edgar.shtml</a>

You should also observe the business world and economic activity as you go through your day. Business is everywhere. Think about the businesses you frequent (grocery stores, restaurants, clubs, gas stations, convenience stores, movie theatres, retail stores, pharmacies, and so on). Think about what makes them work. What are the keys to their success? How do they make money? What do they offer to customers? Talk to people about their businesses. You’ll find that most business people enjoy discussing their companies.



Publication	Web Site
<i>The Globe and Mail</i>	<a href="http://www.theglobeandmail.com">www.theglobeandmail.com</a>
<i>The National Post</i>	<a href="http://www.nationalpost.com">www.nationalpost.com</a>
<i>Canadian Business</i>	<a href="http://www.canadianbusiness.com">www.canadianbusiness.com</a>
<i>The Wall Street Journal</i> (U.S.)	<a href="http://www.wsj.com">www.wsj.com</a>
<i>The Financial Times</i> (U.K.)	<a href="http://www.ft.com">www.ft.com</a>
<i>The Economist</i> (U.K.)	<a href="http://www.economist.com">www.economist.com</a>
<i>CGA Magazine</i>	<a href="http://www.cga-canada.org">www.cga-canada.org</a>
<i>CA Magazine</i>	<a href="http://www.camagazine.com">www.camagazine.com</a>
<i>CMA Management</i>	<a href="http://www.managementmag.com">www.managementmag.com</a>
<a href="http://www.moneysense.ca">www.moneysense.ca</a>	
<a href="http://Bloomberg.com">Bloomberg.com</a> (U.S.)	
<a href="http://money.cnn.com">money.cnn.com</a> (U.S.)	

## WHAT IS ACCOUNTING?

**Accounting** is a system for producing information about an **entity** (an entity is an economic unit of some kind, such as a corporation, university, government, or even a person) and communicating that information to people who want it so they can make decisions. As with any form of communication there are plenty of opportunities for misunderstanding, confusion, misinterpretation, and misdirection.

Like other forms of communication, accounting is not always straightforward. The people who prepare accounting information often have many choices and techniques available to them. This means that, depending on the choices they make, accounting reports could present the same situation in several different ways. If you don't know how to navigate through these differences, you could misunderstand, misinterpret, become confused, or be misdirected by accounting reports. As a result, you could make poor decisions that could result in economic losses.

## WHY DO PEOPLE NEED AND WANT ACCOUNTING INFORMATION?

The more and better information or knowledge a person has about a situation, the better the decisions he or she can make. Without information, a "decision" is nothing more than a guess. For example, suppose you wanted to take a vacation over the winter break. You see an advertisement in the newspaper promoting Aruba as a fabulous winter vacation destination. Assuming you have never been to Aruba before and know little about it, would you simply accept the advertisement at face value? Most people wouldn't. You would probably want to find out whether Aruba offered what *you* wanted from a winter vacation. You might want to know about the weather, the beaches, the accommodations, the entertainment and activities available, and whether many people your age go there. You would also want to know whether the cost would fit your budget and if flight and hotel availability would suit your schedule. To obtain information you might ask friends and relatives if they know anything about Aruba. You could do research in the library or on the Internet. Or you could consult with expert sources that specialize in gathering travel information, such as a good travel agent or a travel guide published by an independent company. You would gather information until you were comfortable making a decision.

Not all information is equal. In making a decision, you will generally place more weight on the information that is the most reliable and most relevant to your needs. For example, travel



brochures published by Aruba's government travel department will likely be very attractive, but would they be as credible as information provided by an independent travel company? Would you rely on the opinions of an acquaintance whose likes and dislikes are very different from yours, or trust the advice of a good friend with whom you share many similarities?

It is usually not possible or worthwhile to collect all the information available on a subject. First, gathering and analyzing information is costly and takes time. At some point the benefit of obtaining more information is not worth the cost. This is known as the **cost/benefit trade-off**. The cost/benefit trade-off is the concept of comparing the benefits of an action with the costs of the action, and taking the action only if the benefits are greater than the costs. Information should be collected only if the benefit is greater than the cost. (For example, it is probably not worth the cost in time and money to call a hotel to find out the colour of their carpeting.) Second, most people cannot effectively manage large quantities of information. Too much information, or information overload, can impair a person's ability to make decisions.



### Question for Consideration

Explain why a potential vacationer to Aruba would likely find travel information published by Aruba's government travel department less credible than information provided by an independent travel company.

**Answer:** The objective of Aruba's government travel department is to encourage people to visit the island. It is likely that its publications will emphasize the favourable qualities of the island and downplay or ignore negative ones. In contrast, an independent travel company's objective is likely to provide a useful service to its customers that will encourage them to use the company's services again (the company will make more money if it can generate repeat business). As a result, the information from the independent travel agent is less likely to be biased. The vacationer is therefore likely to find the independent travel company's information more credible. This doesn't mean that the information provided by Aruba's government travel department wouldn't be useful. It means that a user of this information should recognize the probable bias and consider the implications of the bias when assessing the information.

What does a trip to Aruba have to do with studying accounting? Every day people make important decisions, both for themselves and on behalf of other entities. Individuals decide how to invest their retirement money. Bankers decide whether to lend money to struggling businesses. Labour union leaders assess how to approach negotiations with employers. Taxation authorities assess whether a taxpayer has paid the appropriate amount of tax. The point is, to make good decisions, whether they relate to a winter vacation or a business strategy, people must have good information available to them.

One important source of information for many business decisions is the accounting reports produced by entities. Accounting reports can be the standard financial statement package that most entities prepare each year, which includes balance sheets, income statements, statements of retained earnings, cash flow statements, and notes to the financial statements. Alternatively, accounting reports can be information that is designed for the use of a particular decision maker. (We will explore the standard financial statement package in depth in Chapter 2.)

Let's consider an example of how accounting information can help improve a business decision. Suppose you were approached by a person who was referred to you by a distant cousin and this person wanted you to lend a significant amount of your own money to her corporation. What would you want to know before you would agree to make the loan? Your first key question would be, "Will the company be able to pay back the money it borrowed, plus interest?" A second question would be, "If the company were unable to pay me back, what resources does it have that I could take and sell to recover my money?" What information would help you answer these questions? You could simply size up the person by examining how she is dressed, what she looks like, and how she speaks. However, this assessment would probably not tell you much that would allow you to answer the two questions we posed.

This is where accounting comes in. Accounting information could be very helpful for answering these two questions. Accounting could tell you how well the corporation has performed in the past and it could show you the amount of cash the company has been able to generate. Cash, of course, is important because that is what you hope to receive when the loan is paid back. You might also want a list of the resources the corporation owns so that you could see what would be available to you if the loan were not repaid. You might also like a list of to who else the corporation owes money. In addition, there is non-accounting information that would be helpful in your decision. For example, information about the people managing the corporation would be very useful. You can probably think of other information that would help you make your decision. Clearly, there is a wealth of information that could help you make an effective decision. A lot of this information is accounting information.

## THE TWO FIELDS OF ACCOUNTING: FINANCIAL ACCOUNTING AND MANAGERIAL ACCOUNTING

The study of accounting is usually divided into two broad fields: financial accounting and managerial accounting. **Financial accounting** refers to the field of accounting that provides information to people who are external to an entity. These external users of accounting information include investors, lenders, taxation authorities (Canada Revenue Agency), competitors, and many others. Usually users of financial accounting information don't have direct access to information about the entity and must rely on the entity to provide information to them. This book focuses on financial accounting.

**Managerial accounting** refers to the field of accounting that provides information to the managers of the entity and other decision makers who work for the entity. This information assists them in making decisions related to operating the entity, including setting the price of products, deciding whether the company should expand, determining which products are successful and which are not, figuring out how much of a product should be produced, and so on.



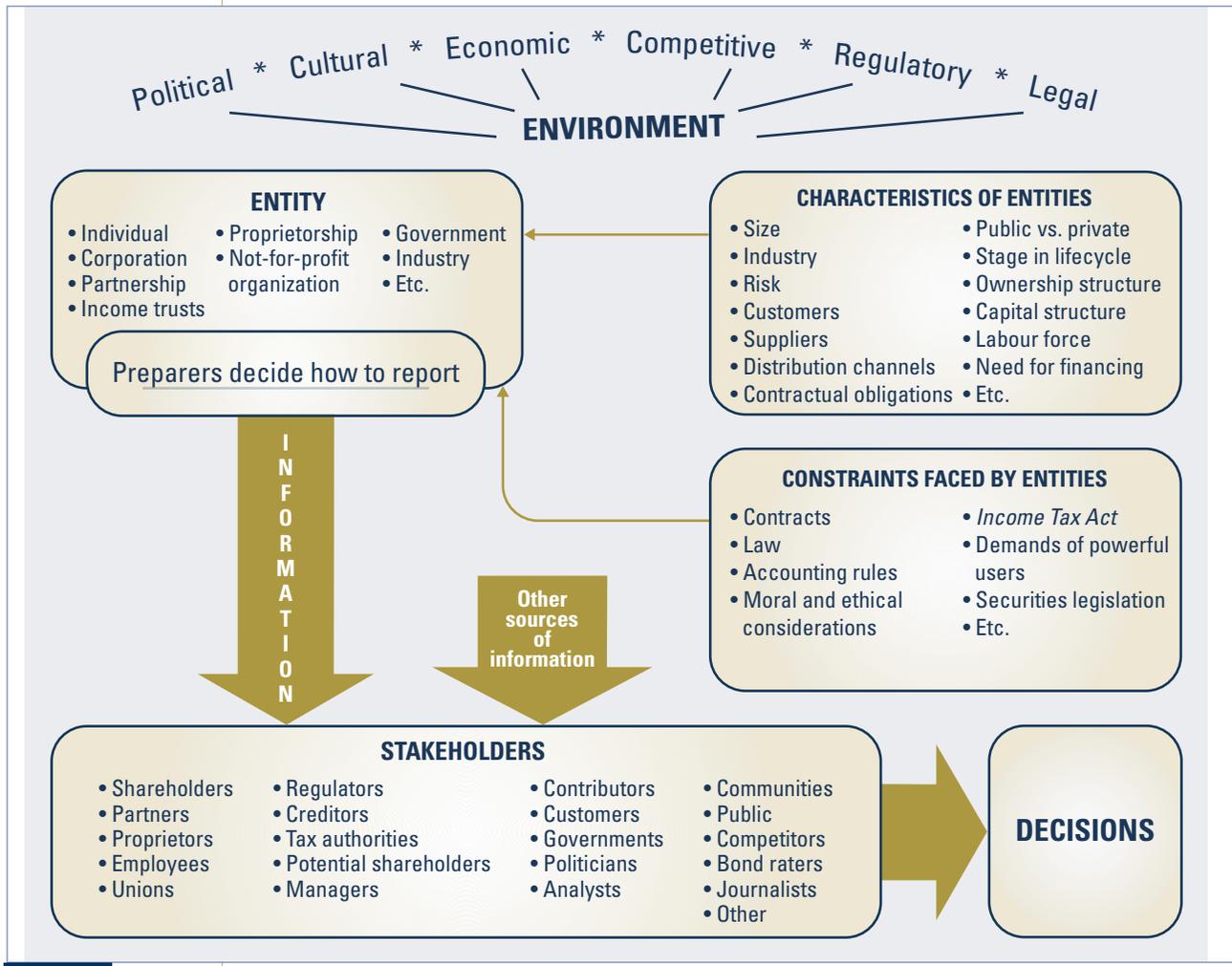
### Knowledge Check

- What is accounting?
- What is the cost/benefit trade-off? Why is it usually not possible to collect all possible information that might be useful for making a decision?
- Explain the difference between financial and managerial accounting. Give an example of a decision that reflects each of these two fields of accounting.

## THE ACCOUNTING ENVIRONMENT

Before we start our examination of accounting information, it is important to explore the environment in which accounting operates. It may come as a surprise that no single accounting report can suit all possible interested parties. An analogy may be useful in clarifying this point. Suppose your uncle approaches you to help him buy a car. He is very busy and has asked you to choose the car he should buy. What car would you suggest? Well, you might buy the car that appeals to you most, in the hope that he will let you borrow it. However, if you are going to buy a car that is suitable for your uncle, you will have to gather some information before you can decide. You will need to know how much he wants to spend, how many people will be travelling in the car, and how much importance your uncle places on characteristics such as safety, style, colour, make, fuel economy, speed, leg and head room, resale value, reliability, trunk/storage space, number of doors, and so on. If you don't consider these factors, your uncle might say, "Nice car, but a two-seater sports car doesn't leave any room for the baby," or "I love the Rolls-Royce, but I only make \$35,000 a year. How will I pay for it?"





**FIGURE 1-1**  
**The Accounting Environment**

This example illustrates that no one car is suitable for all drivers: the choice depends on each driver’s needs. Accounting is much the same. No one accounting report can provide the information that every decision maker needs. To best meet the needs of a decision maker, accounting information must be tailored. To do this, the people who prepare accounting information can often choose among alternative ways of doing their accounting so that they can tailor the information to the needs of the users (or, as we will see, to the needs of the preparers themselves!).

There are four key components of the accounting environment: entities, constraints, stakeholders, and overall environmental factors. These components are displayed in Figure 1–1 and discussed in detail below.

### Environment

Every society has institutions that influence the way people live their lives. Canada, for example, is a constitutional democracy with a mixed economy and a legal system based on British common law. The environmental “umbrella” at the top of Figure 1–1 identifies some of the important societal parameters that establish the structure of a society: that is, the political, cultural, economic, competitive, regulatory, and legal parameters. Think of accounting as an activity that takes place within these environmental parameters.

### Entities

An entity is an economic unit of some kind. An entity can be an individual, a business, part of a business, a charity, a school, a government, a club, or an industry—almost anything you care to define. Accounting can provide information about many different types of entities, including



the four different types of business entities—corporations, proprietorships, partnerships, and income trusts—as well as not-for-profit organizations, governments, and individuals. Entities are central to the accounting environment because it is entities that provide accounting information to decision makers.

**Corporations** A **corporation** is a separate legal entity created under the corporation laws of Canada, a province, or some other jurisdiction in the world. A corporation has many of the same rights and responsibilities as an individual. For example, a corporation must file a tax return (unlike a proprietorship or a partnership), a corporation can be sued, and a corporation can enter into contracts (for example, to borrow money or to provide goods or services to a customer).

When a corporation is formed, shares in the corporation are issued to the owners. The **shares** represent ownership of the corporation. An entity that owns shares of a corporation is known as a **shareholder**. Shares can also be issued at any time through the life of a corporation.

One of the most important features of a corporation is that it provides **limited liability** to its shareholders. Limited liability means that the shareholders of a corporation are not liable for the obligations of the corporation or the losses it suffers. For example, if a corporation borrows money and is unable to repay the loan, the lender cannot demand repayment from the shareholders. The lender can take action only against the corporation. In effect, shareholders' liability is usually limited to the amount of money they invested in the corporation.

Another attractive feature of corporations is that it is relatively easy to transfer share ownership from one entity to another without any effect on the corporation. The corporation simply carries on business with a new owner. For other types of entities, a transfer of ownership can be more difficult.

**Public corporations** are corporations whose shares can be purchased by anyone who is interested in owning a piece of the entity and has the money to buy the shares. The shares of public corporations are usually traded on a **stock exchange** such as the Toronto Stock Exchange (TSX) or TSX Venture Exchange. A stock exchange is a place (physical or virtual) where entities can buy and sell shares and other securities of publicly traded entities.

Corporations can also be privately owned. A **private corporation** is one whose shares and other securities are not available for purchase unless the private corporation or its shareholders agree. For example, you might set up a corporation to run a small business. (The cost of setting up a corporation is relatively small, perhaps \$1,500.) You could be the sole shareholder of the corporation and no one else could obtain shares of your corporation unless you wanted to sell them. Many small- and medium-sized businesses in Canada operate as private corporations. The most prominent corporations in Canada are public, but there are some well-known private corporations. Examples of some Canadian public and private corporations are shown in the table below.



TABLE 1-1 :: Examples of Public and Private Canadian Corporations			
Name of Corporation	Ownership	Type of Business	Web site
Canadian Tire Corporation	Public	Retail	www.canadiantire.ca
Research in Motion Limited	Public	Technology	www.rim.com
Westjet Airlines Ltd.	Public	Transportation	www.westjet.com
Loblaw Companies Limited	Public	Food Distribution	www.loblaw.ca
Petro-Canada	Public	Oil and Gas	www.petrocanada.ca
McCain Foods	Private	Food processing	www.mccain.com
Maple Lodge Farms Ltd.	Private	Food processing	www.maplelodgefarms.com
General Motors of Canada Limited*	Private	Auto Manufacturer	www.gmcanada.com
Irving Oil Limited	Private	Fuel Oil Dealer	www.irvingoil.com

\*General Motors of Canada Limited is a private company owned by General Motors Corporation, which is a public company.

**Proprietorships** A **proprietorship** is an unincorporated business that has one owner. Unlike a corporation, a proprietorship is not a separate legal entity. A proprietorship doesn't pay taxes. Instead, the **proprietor**, the person who owns the proprietorship, includes the money made by the proprietorship in his or her personal tax return, along with money made from other sources, such as employment. If the proprietorship doesn't meet its obligations, the entities that are owed money can attempt to recover what is owed to them by seizing the proprietor's personal assets such as his or her house, car, or bank account. One of the attractive features of a proprietorship is that it is easy and inexpensive to set up.

**Partnerships** A **partnership** is an unincorporated business owned by two or more entities called **partners**. (Partners do not have to be people; they can be corporations.) A partnership is like a proprietorship except that there is more than one owner. Partnerships do not pay taxes. Instead, the money earned by the partnership is included in the income of the partners. A partnership does not have limited legal liability. A lawsuit against a partnership places the assets of at least some of the partners at risk. Like a proprietorship, a partnership is relatively easy and inexpensive to set up. However, since a partnership involves more than one person, it is wise to have a partnership agreement, which lays out the rights and responsibilities of the partners. A partnership agreement adds cost and complexity to this form of business. Many professional organizations such as accounting firms (for example, Deloitte and Touche) and law firms are organized as partnerships.

**Income Trusts** The income trust is a relatively new form of business organization that is becoming increasingly common in Canada. Business entities organize as income trusts instead of corporations, primarily for tax reasons. The money earned by an income trust is not taxed if it is paid out to the owners. As a result, an income trust doesn't pay any tax and investors pay tax on the amounts they receive. This arrangement can be very attractive for investors.

**Not-for-profit Organizations** A large part of the Canadian economy is not devoted to making money or a profit. These **not-for-profit organizations** provide social, educational, professional, religious, health, charitable, or other similar services in Canadian communities and around the world. Not-for-profit organizations include hospitals, charities, religious organizations, unions, clubs, daycare centres, universities, and many others.

**Governments** Government plays a large role in the lives of Canadians. The various levels of government in Canada raise and spend hundreds of billions of dollars each year, mainly through different types of taxes. Given the large amount of money governments manage, financial reporting by governments is important if citizens are to evaluate how their tax dollars are being spent.



[www.mcgrawhill.ca/olc/friedlan](http://www.mcgrawhill.ca/olc/friedlan)



## Knowledge Check

- Identify and describe the four types of business entities.
- Explain the differences between public and private corporations.
- What is a not-for-profit organization? Provide some examples.

**Individuals** Individual people are also accounting entities. Individuals must often produce information in a quantitative form to meet the demands of everyday life. Consider the following examples:

- Most individuals must file a tax return each year with the **Canada Revenue Agency (CRA)**, the Canadian government agency responsible for the administration and enforcement of Canadian federal tax laws. This requires the accumulation and organization of information to complete the return.



[www.cra-arc.gc.ca](http://www.cra-arc.gc.ca)

- Most people insure their homes and belongings. To determine the appropriate amount of home-owner insurance that is needed, an individual must list his or her personal belongings and estimate a value for them.
- Most people have a chequing account. The cheque register, where you record each cheque that you write, represents a simple accounting system that lets you know how much money is in your bank account.
- Many people prepare budgets. A student may want to estimate how much it will cost to attend university each year and thus plan monthly or weekly spending to ensure that enough money is available to meet all financial needs for the year.

**Others** Though most common entities have been identified, accounting information can be compiled on an endless list of entities, depending on the users' needs. For example, some people may want data on a particular industry. While industries do not prepare financial statements, useful information can sometimes be obtained from sources such as trade associations, industry publications, public interest groups, and Statistics Canada.

## Stakeholders: Different Users, Different Decisions, Different Information

There are many different groups and individuals that are interested in—or have a “stake” in—an entity. These groups and individuals are referred to as **stakeholders** and may include entities such as owners, lenders, taxation authorities, government, consumers, and regulators. (See Figure 1–1, page 6.) Of course, not every possible stakeholder will be interested in every possible entity. Each stakeholder has his or her own perspective on an entity and has specific decisions to make. An owner will be concerned about different things than a lender, who will be concerned about different things than the public, employees, or government. Therefore, the information that would be most useful to a particular stakeholder group would not be the same as the information some other stakeholder would find most useful.

Stakeholders are often people who do not have direct and unrestricted access to an entity's databases and must rely on the entity to provide information for decision making. Ideally, each stakeholder would receive information that is tailored to his or her own needs. More likely though, the information an entity provides will be designed with some other stakeholder or purpose in mind, or for general use by a variety of different stakeholders.

For example, imagine you are deciding which university's business program you should enrol in and you contact a number of schools for information. One university sends you information about the overall university instead of detailed information about the business program. While the general university calendar might have some information about the business program, it would not be as useful as the business program calendar. To make the most informed decision about the business program, you need its particular calendar.

Let's examine some of the stakeholders of an entity and look at how accounting information can be useful to them.

**Owners** Often, the owners of a business don't manage it and are not involved in its day-to-day affairs (for example, most shareholders of public corporations). When the owners do not manage a business, they need information from the company for a number of reasons, including: to evaluate how well their investment is doing; to determine whether management is doing a good job; to assess the effectiveness of business strategies; to consider whether they should sell their interest in the entity; or to decide if the managers should be replaced.

**Lenders** Most entities need to borrow money at one time or another. Before lending money, a prospective lender, such as a banker, would want to investigate whether the borrower would be able to pay back the loan and, if the loan is not paid back, whether the borrower has assets the lender could take and sell to recover the money it lent.

**Suppliers** Most entities use goods and services supplied by others. For example, a retail store obtains the goods it sells, the utilities it uses, the office supplies it needs, and the advertising it





does from various third parties. Most of these goods and services are provided before they are paid for, so these suppliers might want to evaluate whether the entity will be able to pay for the goods and services before providing them.

**Taxation Authorities** The Canada Revenue Agency (CRA) uses accounting information to assess the taxes owed by a business or individual. In Canada each individual and corporation must file a tax return each year. The CRA requires taxpayers to calculate their taxes using methods that are consistent with the *Income Tax Act*, Canada's federal tax legislation. Provinces also have tax rules that must be followed.

**Governments** Other government departments also have an interest in accounting information. For example, governments may decide whether certain entities should receive government support or subsidies. Accounting information also has a political impact. Companies might attract the attention of politicians by making what the public perceives as “too much money.”

**Consumers** When someone buys an expensive product such as a computer or car, he or she may be concerned about whether the company will be around in the future to support the product. While most people who make major purchases do not consult manufacturers' accounting reports, many sources can provide information about a manufacturer's financial status. These include television, newspaper, and radio reports. As a result, a potential customer might decide not to buy from a company in financial trouble even though the product is attractive for other reasons.

**Regulators** Some industries and businesses in Canada are regulated, including cable television providers and local telephone companies, which are regulated by the Canadian Radio-television and Telecommunications Commission (CRTC); pipeline companies that transport oil and natural gas, which are regulated by the National Energy Board (NEB); and even some transportation companies, for example BC Ferries (which provides transportation services on British Columbia's coastal waters). Accounting information prepared by the regulated companies is used to help regulators set rates so that customers pay a reasonable price for the service and investors receive a reasonable return on their investment. Regulators may sometimes even define the accounting rules that a regulated company can use.

## Characteristics of Entities

Like people, no two entities are identical. Each has a set of characteristics that makes it unique. Some characteristics are obvious—for example, an entity's industry. Canada has businesses in a vast range of industries, including natural resources, agriculture, finance, manufacturing, high technology, hospitality, and services, to name a few. And even though several companies may be in the same industry, each may have different characteristics. Some may be public, others private, some may be large and others small, some may be unionized and others not, and each may do business in different markets. All of these characteristics are important for understanding an entity, what it does, and how it does its accounting.

Figure 1–1 (page 6) identifies a number of characteristics of entities. We will explore many of these as we proceed. At this point it is important to keep in mind that entities are not all the same and that the characteristics of an entity might influence the accounting choices it makes.

## Constraints

How an entity does its accounting and what information it reports are not entirely up to the people who prepare the information. Often, the choices available are constrained by contracts, laws, accounting rules, and the information needs and demands of powerful users of accounting information. Consider the following examples:

- The *Income Tax Act* requires, for certain situations, that particular accounting methods be used to calculate the amount of income tax that an entity must pay.



- Corporations must meet the requirements of the law they are incorporated under (such as the *Canada Business Corporations Act*).
- Many companies must follow the accounting rules known as generally accepted accounting principles (GAAP).
- Companies that trade on Canadian stock exchanges must meet the requirements of the securities laws of their province and the rules of the stock exchange.
- Entities often enter voluntarily into contracts with other parties to do their accounting in a certain way.

## Stakeholders versus Preparers

Accounting information must be considered from two perspectives: the stakeholders' perspective and the preparers' perspective. **Preparers** (or managers of an entity) are the people responsible for deciding what, how, and when information is going to be presented in an entity's financial statements and other accounting reports. Preparers are the people who make the decisions—senior managers such as controllers, chief financial officers, and even chief executive officers. They are not the people who physically prepare the statements.

It is important to recognize that preparers are not neutral providers of accounting information. Their own personal interests may influence their preparation of accounting reports. Consider the following situations:

- Managers' bonuses are sometimes based on the numbers contained in accounting reports. (A manager might want to enhance the accounting numbers to improve his or her bonus.)
- The amount of tax an entity pays is related to its accounting numbers. (The manager might account in a way so as to pay as little tax as is legally possible.)
- When a business is sold, the selling price can be based on the accounting numbers. (The manager might want to enhance the accounting numbers to increase the selling price of the business.)

There is clearly potential for conflict here. Stakeholders want information that will be useful for their decision making. Managers have an interest in supplying useful information to stakeholders, but they are also interested in acting on their own behalf. Making matters more complicated are the rules under which most Canadian entities report. Generally accepted accounting principles, or GAAP, provide managers a great deal of latitude in deciding what, how, and when information is presented in an entity's accounting statements. In other words, managers have the motivation and the ability to present accounting information in ways that do not necessarily meet the needs of stakeholders.

At this point, sirens might be going off in your head. "This doesn't sound very honest." "They cook the books!" "You can't trust accounting numbers." "Accountants are unethical." Sometimes these reactions are valid. However, the reality about accounting information is usually not so black and white. Preparers can often choose among different acceptable ways to account because trying to set rules that apply to all situations can be difficult and counterproductive. The diversity of entities, stakeholders, and entity characteristics, along with the complexity of economic activity, require flexibility—enough to allow information to be presented in an appropriate way for the circumstances as well as to allow accounting to adapt to new business arrangements and changes in the accounting environment. However, such flexibility also allows some managers to play fast and loose with the rules. Sometimes managers focus only on their personal interests and the interests of their entities rather than on ensuring that stakeholders get the information they need to make good decisions. To make matters worse, it is often difficult in this complex environment to figure out managers' motivations and the full impact of managers' accounting choices.

To place this discussion in context, consider this statement by Paul Beeston, former president of the Toronto Blue Jays Baseball Club, former president and chief operating officer of Major League Baseball, and an accountant:

"Anyone who quotes profits of a baseball club is missing the point. Under generally accepted accounting principles, I can turn a \$4 million profit into a \$2 million loss, and I can get every national accounting firm to agree with me."<sup>1</sup>



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## Knowledge Check



- What are stakeholders? Give some examples of different stakeholders.
- Provide some reasons why the personal interests of preparers may influence how they might prepare their financial statements.
- Entities have different characteristics. Identify some of the characteristics that distinguish one entity from another.



## Question for Consideration



Consider the quote by Paul Beeston on page 11. In the context of our discussion of the accounting environment, what do you think Mr. Beeston meant by his statement?  
**Answer:** Mr. Beeston was making the point that accounting rules, even under GAAP, are flexible and allow preparers considerable latitude in choosing how, what, and when accounting information is presented. This flexibility implies that the numbers reported in financial statements can vary depending on the choices that the preparers make and that a range of numbers can be considered as being “within the rules.”

The apparent conflict between stakeholders and managers creates a need for independent people who can examine the information provided by the managers and offer assurance to the stakeholders that the information meets certain stated principles. The people who examine entities' financial information on behalf of external stakeholders are called **external auditors**. Their examination of an entity's information is known as an **external audit**. An external audit involves examining an entity's financial statements and the data supporting the information in the financial statements. Auditors audit to ensure that the financial statements are fair representations of the underlying economic activity of the entity and that the accounting is done in accordance with GAAP.

It is important that external auditors be independent of the entity they are auditing to add credibility to the information provided by an entity. That means an auditor cannot be involved in managing the entity, have an ownership interest, or participate in any type of relationship that will bring the independence of the auditor into question. For example, if you were buying a used car and wanted to be sure that the car you were interested in buying was in excellent condition, would you have more confidence in the opinion of the used car dealer or that of an independent mechanic? Clearly, the car dealer has an interest in making you believe that the car is of high quality since he or she will benefit from the sale.

There are other types of auditors in addition to the external auditors described above:

- Internal auditors are employed by an entity and conduct audits on behalf of the entity's management. Internal audits help ensure the credibility of the information produced by the entity for management decision making.
- The Canada Revenue Agency (CRA) has auditors whose job is to verify that taxpayers adhere to the *Income Tax Act* and pay the appropriate amount of tax.

Let's conclude this section with an accounting example. On December 15, 2008 a Toronto Blue Jays fan orders season tickets for the 2009 baseball season (the Blue Jays are owned by Rogers



Communications Inc. (Rogers)). The tickets cost \$10,000 and the fan pays a \$500 deposit when they're ordered. The rest must be paid in full on February 28, 2009. The baseball games will be played from April through October. When do you think the Blue Jays (and Rogers) should report that they've sold these season tickets? Should the Blue Jays report the sale when the tickets are ordered (December 15, 2008), when they're paid for (February 28, 2009), or when the games are actually played (April through October 2009)? Accountants can actually disagree as to when to report the sale. But the economic activity still proceeds while the accountants are scratching their heads figuring out when to report the sale. In other words, when the accountants decide to record this sale does not change when the order is received, when the cash is collected, or when the games are played.

While the actual economic activity is unaffected by how the Blue Jays do their accounting, how the accounting is done can affect the entity, the managers, and the stakeholders. The choice made can affect the amount of tax the Blue Jays pay, the size of bonus the sales manager earns, perhaps the terms of a bank loan, and even the price of Rogers' shares. Accounting information matters. Accounting information can affect the wealth and wellbeing of the preparers and the various stakeholders of an entity. (A term that is often used to describe an event that affects the wealth and wellbeing of an entity and its stakeholders is that the event has *economic consequences*. This term will be used frequently in *Financial Accounting: A Critical Approach*.) Because of these economic consequences it is essential for students of accounting to understand the nature of accounting information. It is also the economic consequences of accounting information along with the flexibility of accounting rules that make accounting such a fascinating discipline.

As we move through *Financial Accounting*, you'll see what choices are available to managers and how those different choices affect the information that is presented to stakeholders. The purpose for introducing this unexpected side of accounting is to make you aware of what accounting is really like. Accounting is not certainty, it is not truth, and there are few right answers.



## Insight



This discussion of the accounting environment should make it clear that there is potential for significant and frequent ethical dilemmas. Managers, auditors, and accountants continually face choices about what, how, and when information should be presented in an entity's financial statements and other accounting reports. These choices are often difficult and usually are not simple choices between the right way and the wrong way. Economic activity can be complex and deciding how to account requires careful judgment. Managers have an ethical and moral responsibility to provide information that is a reasonable representation of the entity's economic activity. But it is important to understand that intelligent, ethical, and responsible managers, auditors, and accountants can have legitimate differences of opinion about how accounting should be done in a given situation. The "right" answer is not always obvious!

## Accounting Scandals

In the last 10 years the business and accounting worlds have been rocked by scandals that have damaged the credibility of accounting information. Companies like Enron, Nortel, WorldCom, Parmalat, and Livent, have become notorious for their abuse of financial reporting. In each case stakeholders have suffered large economic losses. In addition, the prominent accounting firm of Arthur Andersen was effectively forced out of the public accounting business as a result of the Enron scandal.

Nortel Networks Corporation, long one of Canada's technology leaders and at one time the most valuable public company in the country, suffered through serious accounting problems in



the years after 2000. It took Nortel several years to get its accounting right—delaying, reissuing, and restating its financial statements a number of times because of accounting errors, violation of accounting rules and principles, and attempts by managers to mislead the people who used the company’s financial statements so they could pursue their own interests. In 2004, for example, it was discovered that management used accounting “tricks” to report profits in 2003 that allowed bonuses to be paid to all Nortel employees, including significant bonuses to senior executives. Nortel’s accounting woes occurred in the same period that its stock price fell from a high of over \$120 per share in 2000 to a low of \$0.67 in 2002 and then remained well under \$10.00 from then on.

There has been a silver lining to these accounting scandals. People have become much more aware of how important good accounting information is and how detrimental poor-quality accounting information is to effective decision making. As a result of these scandals, laws affecting financial reporting and accountants have been tightened in the U.S. and subsequently in Canada. It is hoped that these laws will improve the integrity and reliability of financial statement information.

### Professional Accountants in Canada

In Canada there are three groups of professional accountants: Certified General Accountants (CGAs), Certified Management Accountants (CMAs), and Chartered Accountants (CAs). A person with one of these designations has demonstrated that they have the knowledge, skills, and abilities required by the professional body. A member of the public who hires a professional accountant can be confident that he or she will be able to carry out his or her duties properly. Members of a professional accounting body have important responsibilities. They are expected to act in a professional, ethical, and competent manner at all times and to adhere to the code of conduct of their professional organization.

Becoming a professional accountant isn’t easy. Each professional body has its own requirements but, in general, to earn an accounting designation it is necessary to:

- receive a university degree;
- complete specific course requirements to learn the body of knowledge needed to be an effective practitioner;
- pass the examinations administered by the professional body;
- obtain experience on the job.

## ACCOUNTING IS FOR MEASUREMENT

Accounting systems are designed to accumulate data that are then organized, processed, and converted into information that is useful to stakeholders. The information produced by accounting systems allows stakeholders to measure different attributes of an entity, such as:

- how it performed
- how efficient it was
- how its managers performed and how much bonus they should receive
- how much it owes to lenders
- how much it is worth
- how much tax it should pay

Let’s look at some examples of how accounting can be used for measuring. Suppose that over the summer you had a job in a mining town in northern Canada. You expected that you would earn enough money during the summer to pay for next year’s tuition and be able to take a winter vacation with your friends. After the first couple of months you look at your bank account information on the Internet and become worried that you aren’t saving enough money.



**TABLE 1-2** **Your Summer Expenses: An Example of a Basic Accounting System**

List of Money Spent During the Summer		
Date	Purpose	Amount
April 1	Rent	\$300
•	•	•
•	•	•
•	•	•
April 13	Magazines	5.75
April 13	Entertainment	22.50
April 13	Groceries	44.85
•	•	•
•	•	•
•	•	•
May 17	Groceries	45.25
May 18	Entertainment	12.75
May 19	Miscellaneous	14.50
•	•	•
•	•	•
•	•	•
May 31	Clothes	47.99
May 31	Taxi	5.00

Fortunately, at the start of the summer you decided to keep track of the money you spent during the summer by recording the information in a notebook. An excerpt from the “book” for April and May is shown in Table 1–2. Your book represents a very basic accounting system.

The contents of the notebook are just raw data. To be useful, the data have to be organized, processed, and converted into information. You could go through your notebook and classify expenditures into categories such as food, entertainment, and rent. Table 1–3 shows an example of how you could organize the data in your book.

With the information organized as in Table 1–3 it is easy to see how much money you made, how much you spent and what you spent it on, and how much you have left over.

Next, we can consider how you could use the information in Table 1–3. Your concern is that you’re not saving enough money, so you could use the information to identify ways you could reduce spending. For example, you might reduce the amount you’re spending on entertainment by going out less often or finding less expensive forms of entertainment. Or you might consider ways to reduce the amount you’re spending on groceries. Perhaps on reflection you find that you are buying expensive food items when less expensive (but equally nutritious) ones could be purchased. You might consider finding less expensive accommodation or even try to work more hours. Notice that Table 1–3 helps you identify ways that you can address your problem but it doesn’t actually tell you what to do. The decision maker (you, in this case) must use the information to come up with a solution.

A crucial point to keep in mind is that how you organize the data depends on what you or some other stakeholder wants to know. If you didn’t care how you spent your money, a statement like the one in Table 1–4 might suffice. On the other hand, Table 1–3 does not tell you the type of entertainment you enjoyed, what groceries you bought, or what the miscellaneous items represent, so you might find that Table 1–3 is not detailed enough.

You should also recognize that your ability to extract information from an accounting system is limited to the data entered into the system. For example, it would be possible to find out how much money you spent on different kinds of groceries only if you initially broke down your



**TABLE 1-3** **Classifying Your Summer Earnings and Spending: An Example of a Basic Accounting Report**

Summary of Earnings and Spending		
<b>April and May</b>		
Amount earned (gross pay)	\$5,258.88	
Amount withheld*	<u>946.60</u>	
Deposited in the bank (net pay)		<u>\$4,312.28</u>
<b>Amounts spent</b>		
Books, magazines, etc.	75.33	
Clothes	138.25	
Entertainment	221.55	
Groceries	327.58	
Local transportation	45.56	
Miscellaneous	99.98	
Rent	<u>600.00</u>	
Amount spent		<u>1,508.25</u>
Amount saved in April and May		<u><u>\$2,804.03</u></u>

\*Employers are required to withhold money from employees' pay for taxes, employment insurance, and Canada Pension Plan contributions. The amount earned before withholding is called gross pay. The amount after deductions is called net pay.

**TABLE 1-4** **Summarizing Your Summer Earnings and Spending: An Example of a Basic Accounting Report**

Summary of Summer Earnings and Spending		
Amount earned (gross pay)	\$5,258.88	
Amount withheld*	<u>946.60</u>	
Deposited in the bank (net pay)		<u>\$4,312.28</u>
Amount spent during April and May		<u>1,508.25</u>
Amount saved in April and May		<u><u>\$2,804.03</u></u>

grocery spending in your notebook. That is, you couldn't find out how much money you spent on soft drinks if you didn't record soft drink spending separately in the notebook.

This example demonstrates how accounting can summarize information in a way that is useful for solving a problem. Let's consider an example that looks at another perspective on measurement.

Imagine that you are a first-year student who has just moved into a new apartment near your university or college. You need to get insurance for the apartment. You have furnished it with personal belongings, and it also has appliances supplied by the building's owner. How much insurance do you need? You want to have enough insurance to protect the things you own and the things you are responsible for, such as the building owner's appliances. The insurance company needs to know how much insurance you require so that it can write a policy and set a premium for you, based on the amount and type of insurance you want.

To estimate the amount of insurance you need, you will have to go through the apartment and take an "inventory" of the things you want to insure. (An inventory is a list of the items in your apartment, as shown in Table 1-5.)

Column 1 of Table 1-5 lists the contents of the apartment, but it doesn't say anything about how much insurance coverage you need. You have to assign a measure of value to each item so that you can "sum up" to a total. The total is important because if you don't know the worth of



TABLE 1-5 ■■■ Items in a Student's Apartment			
Inventory of Apartment Contents			
Column 1	Column 2	Column 3	Column 4
Item	What it cost	What it would cost to replace	What it could be sold for
Television	\$ 500	\$ 650	\$ 225
Computer	1,900	1,500	700
Furniture	1,200	1,350	900
Books	750	875	300
Clothes	1,600	1,950	1,000
Stereo	900	1,100	700
Jewellery	500	625	300
Appliances	2,000	2,600	1,400
Art	300	300	200
Other	1,000	1,200	750
Total	<u>\$10,650</u>	<u>\$12,150</u>	<u>\$6,475</u>

what you want to insure you may buy too little insurance, leaving you ill-prepared in the event of a fire or robbery. If you buy too much insurance you are wasting money on premiums, since the insurance company will not pay out more than the amount of the loss. (For example, if you have \$50,000 of insurance coverage and everything you own is destroyed in a fire but is worth \$10,000, the insurance company will pay you only \$10,000.)

Now things get more complicated. What is the appropriate “value” to assign to each item? In Table 1–5 three different measurements of value have been used for each item, as follows:

- Column 2 gives the amount paid for each item.
- Column 3 shows the amount that would have to be paid to replace the item with an equivalent new item. (For example, the TV might be a ten-year-old model that is no longer made, so you would have to get something comparable that is available today.)
- Column 4 is the amount each item could be sold for.

Notice that the total of each column is quite different from the others.

All of these amounts represent valid measures of the items in your apartment, but which would be appropriate for determining the amount of insurance that you need? That will depend on your needs. If you want the insurance to return you to the situation you were in before you suffered your loss then using the cost to replace amounts in Column 3 would be best. Using Column 3 would allow replacement of the items lost (this is called replacement cost insurance). For example, if your television was stolen, replacement cost insurance would allow you to obtain an equivalent television. If you wanted the insurance to simply compensate you for the loss you suffered, then Column 4 should be used. Using Column 4 would allow you to recover the cash value of the items you lost. So if your 10-year old television was stolen, your loss would be the market value of an identical 10-year-old TV. (The insurance company would not get estimates of the worth of the specific items, but would use a formula to estimate the extent to which they were used, based on the type of item and its age.)

There are two important points to note from our insurance example. The first is the importance of measurement. To decide on the amount of insurance needed it was necessary to come up with a measure of the total worth of the items in the apartment. The second point is that there is often more than one way to measure the same thing. We have easily come up with three ways to measure the “value” in terms of dollars of the items in your apartment. Which one is best? That question cannot be answered in absolute terms. The “best” one depends on the situation and the needs of the decision maker.



## Insight



It is important to keep in mind that whereas most accounting reports use money as the basis for measurement, it is not the only possible basis. Accounting and accountants can provide information in many different ways. For example, accountants could be involved in providing information on the amount of pollution that a company produces. They could be involved in measuring the effectiveness of a medical care system (mortality rates, utilization of beds and equipment, etc.). Accountants could help develop measures of customer satisfaction or evaluate whether a government is getting value for the money it spends. These examples require measurements that are not stated in terms of money.



## Question for Consideration



A few months ago you borrowed \$1,000 from an acquaintance and now you don't have the cash to pay back the loan. In place of the cash you owe you have offered the acquaintance some of your personal belongings. If the list in Table 1–5 represents your belongings, which measurement basis (which column) would be most appropriate to use to determine which items the acquaintance could reasonably take?

**Answer:** Column 4, what the items could be sold for, would be most appropriate. Since you owe \$1,000, the acquaintance should receive items that would allow her to receive the equivalent of \$1,000 in cash. The acquaintance does not have to actually sell the items, but the items she receives could be sold for \$1,000.

## THE RULES OF THE GAME

Accounting is a tool that has been developed to provide information for decision making. Unlike gravity, accounting has no natural laws that define how it should be done. As a result, it is necessary to establish the rules of the game. If there were no rules it would be much more costly and difficult to make sense of the information contained in accounting reports because it would be necessary to learn and understand how each entity was doing its accounting.

The rules in accounting are known as **generally accepted accounting principles** or **GAAP**. GAAP are the principles, conventions, practices, procedures, and rules that define acceptable accounting practices and guide the preparation of financial statements in certain situations. In other words, GAAP represent a structure for preparing financial statements.

The importance of a set of rules can be demonstrated with an analogy. When we drive, there are certain conventions and rules that people follow that contribute to safe driving. In every community in Canada a red light means stop and a green light means go. A yellow light is a bit more ambiguous and different drivers respond differently to yellow lights. (This is actually just like GAAP, where some of the “rules” can be interpreted differently by different preparers of accounting information.) Everywhere in Canada we drive on the right side of the road. However, in some countries, such as the United Kingdom, Jamaica, and Zimbabwe, people drive on the left side of the road. In the same way that traffic rules can vary from one country to another, so can GAAP.

Now imagine the difficulty a driver would have if every community had different rules of the road—if there were different coloured lights in different positions. The result would be chaos. Traffic would move more slowly as visiting drivers tried to figure out the rules in each

community. Getting around the community would be more costly in terms of time, fuel expense, insurance (since there would probably be more accidents), and fines (since people would likely violate the rules more often and there would be more tickets issued). In sum, the existence of standardized rules of the road reduces the cost of getting around.

Here are a few preliminary points to note about GAAP:

- GAAP are not universal. GAAP differ in each country. Canadian GAAP are quite similar but not identical to GAAP in the United States, but can be very different from GAAP in other countries in the world.
- Not every entity follows GAAP or has to follow GAAP. GAAP are followed by public corporations because it is required by securities and corporation law. However, GAAP do not have to be followed by private corporations, partnerships, or proprietorships unless there is some specific reason for doing so.
- GAAP are flexible. They offer preparers many choices that can affect the information contained in financial statements. The flexibility of GAAP requires that users be very careful when examining and interpreting financial statements.
- GAAP in Canada are the responsibility of the Accounting Standard Board of the Canadian Institute of Chartered Accountants (CICA) and the GAAP it lays down are published in the *CICA Handbook*. However, much of GAAP come from sources other than the *Handbook*, including the accounting methods actually used by entities. The *CICA Handbook* has the force of law behind it because the provincial securities commissions and the federal and provincial laws that regulate corporations recognize the *CICA Handbook* as the source of GAAP in Canada.
- In 2005 the CICA announced that it was getting out of the standard-setting business, at least for public companies, and would be adopting International Financial Reporting Standards (IFRS). IFRS are produced by the International Accounting Standards Board, which has worked for many years to develop a set of accounting standards that could be used by entities around the world. The CICA also indicated that it would try to create a new set of standards for private businesses that have significant external stakeholders and that it would work to remove GAAP requirements for private businesses with no external reporting requirements.

We will explore GAAP in depth in Chapter 5, but at this point we can take a look at some of the basic Canadian GAAP concepts. The *CICA Handbook* describes four qualitative characteristics that financial statement information must have if it is to be useful to users. The four characteristics are:

1. **Understandability.** Users must be able to understand information if it is to be useful to them. GAAP require that accounting information should be understandable to users who have a reasonable understanding of business and accounting, and a willingness to study the information provided.
2. **Relevance.** The information provided to users must be relevant or useful for the decisions they have to make. The *CICA Handbook* explains that relevant information is information that helps users make predictions about the future performance of the entity, provides feedback on decisions that were made in the past, and is provided to users in a timely manner so that it will be useful for decision making.
3. **Reliability.** For information to be useful to users, it must be a reasonable representation of the attribute being measured. The *CICA Handbook* identifies the components of reliability as verifiability, representational faithfulness, and freedom from bias. Information is verifiable if independent and knowledgeable people can come up with the same measurements for the attribute being measured. Financial statements are representationally faithful if they are a reasonable representation of the economic activity of an entity. Information is free from bias if it is not presented in a way that is designed to influence or manipulate users' decisions.
4. **Comparability.** Users should be able to compare the accounting information provided by different entities and the information of a particular entity from period to period.



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For example, the ability to make predictions about the future performance of an entity can be helped by looking at historical performance trends of the entity. If the entity changes its accounting in each period the ability to interpret the trends would be impaired.

It is essential for any user or preparer of accounting information to know and understand GAAP. However, every user, preparer, and accountant must also understand that GAAP have significant problems and limitations. GAAP are not applicable to every user and every decision in every situation. Sophisticated users of financial statements will know when not to rely on GAAP-based statements, when to adjust the GAAP statements, and when to look elsewhere for information. Sophisticated users will also understand the flexibility that preparers of financial statements have, even under GAAP, and understand that this flexibility can have a significant effect on the information reported in the statements.

One of the main objectives of this book is to help readers understand and appreciate financial statements, with all their blemishes. We will look at accounting practice and accounting information with a critical eye so that you will become sophisticated users and preparers of accounting information.

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## ■ ■ Solved Problem

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### Bayton Ltd.—Part 1

Bayton Ltd. (Bayton) is an operator of garbage dumps in western Canada. Bayton operates by purchasing land from private owners, having the land zoned for a garbage dump, and then developing and operating the dump. The planning and development of the dumps is done in close cooperation with the local communities that the dump will serve. Bayton does not provide garbage collection services; these are provided by local governments or by private companies that have contracts with local governments. The garbage collectors pay a fee to Bayton based on the weight of the garbage dumped.

Bayton is a privately owned corporation. The company has 15 investors who live all across Canada. A team of professional managers who have considerable experience in the waste management business runs Bayton. The managers are paid a salary plus a bonus based on the performance of the company, as measured by its accounting information. The company employs over 500 people, many of whom are unionized. In addition to money invested by the owners of the company, Bayton has borrowed heavily from several banks and other lenders.

#### Required:

Identify all of the stakeholders in Bayton and explain their “stake” in the company. Not all the stakeholders are explicitly referred to in the scenario. You will have to think about the business situation carefully to identify some of the stakeholders. (You may be able to identify other stakeholders in addition to those in the Solution.)

#### Solution:

Stakeholders	Stake
1. Shareholders (owners)	The shareholders are Bayton’s owners. Part of their wealth is invested in the company.
2. Lenders	Bayton owes the lenders money. The lenders are concerned about Bayton’s ability to repay amounts owed to them.
3. Managers	Managers are interested in maintaining their jobs and enhancing their reputations in the job market. In addition, part of the managers’ compensation is based on the performance of Bayton.
4. Canada Revenue Agency (CRA)	Bayton Ltd. is a taxpaying entity and the CRA is interested in ensuring that it pays its taxes and complies with the <i>Income Tax Act</i> .



- |   |  |
|---|--|
| 5. People located in communities where dumps are or will be located | Garbage dumps are often unpopular neighbours. People who live near existing garbage dumps want to ensure that the dumps are being managed responsibly and that Bayton will be able to carry out its obligations in the future. People living near prospective garbage dumps may want to take steps to prevent a dump from being set up near their homes. |
| 6. Government   | Garbage dumps can be politically very sensitive issues. Governments want to ensure that Bayton Ltd.'s garbage dumps do not cause them political problems.  |
| 7. Employees/unions   | Bayton Ltd.'s employees rely on the company for their incomes. Unions negotiate contracts with Bayton Ltd. on behalf of their employees.   |
| 8. Environmental regulatory agencies                                | Because of the potential environmental problems associated with Bayton's garbage dumps, many jurisdictions have regulatory agencies whose responsibilities include monitoring the company's waste management practices, ensuring compliance with government standards, and reporting to the government and public.                                       |
| 9. Communities  | Communities require a means of disposing of their garbage. Ensuring a reliable method of disposal is crucial for many communities. Bayton provides the means for these communities to dispose of their garbage.  |
| 10. Garbage collection companies                                    | Garbage collection companies require a place to dump the garbage they collect and must pay fees to do so.  |
| 11. Environmental groups  | Garbage dumps pose potentially serious environmental problems. Improper waste management practices can lead to contamination of land and ground water. Private environmental groups monitor the dumps and the companies operating them.  |

### Bayton Ltd.—Part 2

In 1975 Bayton paid \$250,000 (\$500 per hectare) for a 500-hectare piece of land that it intended to develop into a garbage dump. For various reasons Bayton has not yet developed the land, but Bayton's president has stated that it will do so at the appropriate time. Over the last two years there have been two transactions involving the sale of land located near Bayton's property. In the first transaction, which occurred 20 months ago, the land was sold for \$825 per hectare. In the second transaction, which occurred eight months ago, the land was sold for \$730 per hectare.

Recently, a business person made an offer for Bayton's land of \$690 per hectare or \$345,000. The president of Bayton hired an independent appraiser to estimate the value of the land so that he could assess the offer. The appraiser estimated that the land was worth between \$340,000 and \$390,000. For the purpose of calculating municipal property taxes, two years ago the municipality where the land is located placed a value on it of \$290,000. The president himself thinks that Bayton could sell the land for \$410,000 if Bayton chose to sell it.

#### Required:

Identify and explain the different measurements of the value of Bayton's land. Discuss the relevance and reliability of the different measurements. Make sure you refer to the decisions that have to be made by some of the stakeholders.

#### Solution:

There are a number of different measurements available for valuing Bayton's land, none of which represent the actual current value of the land. The measurements are:

Measurement	Explanation	Relevance and Reliability
Cost: \$250,000	The amount Bayton paid for the land.	Cost is a very reliable measure of the value of the land because documentation exists indicating the price that Bayton paid for the land in 1975. This measure will be verifiable, representationally faithful,



Property tax value: \$290,000	The value assigned to the land by the municipality for determining the property taxes.	and unbiased. The cost is relevant for income tax purposes because the amount of tax paid when Bayton sells the land will be related to the price it paid for it. The cost may also be relevant to shareholders if they want to know how much profit Bayton made by holding the land since 1975 and then selling it. The cost of the land is not very relevant for most other decisions. Cost is not useful for determining whether or not the land should be sold, the amount of money that a lender would lend to Bayton based on the market value of land, or the amount that a buyer should pay for the land if Bayton decided to sell it. For these decisions the market value of the land is more relevant.
Bayton's president's estimate: \$410,000	The amount that Bayton's president thinks the company can sell the land for.	This amount is relevant for determining the amount of property tax that Bayton must pay. Otherwise this value does not likely have any other useful purpose. The value was determined two years ago, which makes it somewhat out of date, and since it is not clear how the amount was determined, its relevance for non-property-tax purposes is difficult to assess.
Independent appraiser's estimate: \$340,000–\$390,000	The price range that an independent appraiser estimated the land is worth.	This amount may be relevant as a benchmark for management for determining whether the land should be sold or kept. The value is not very reliable for prospective buyers of the land because it is biased, as it may be in the president's self-interest to make a high estimate.
Sale of nearby land: \$412,500 based on the first sale and \$365,000 based on the second sale.	These amounts are calculated by multiplying Bayton's 500 hectares by the price per hectare paid in the transactions for the nearby land.	This estimate will be somewhat relevant and reliable to some stakeholders. The estimate is reliable because it comes from an unbiased source, but it is not very precise because the appraiser has given quite a broad estimate. It is also difficult to know what land will sell for before it is sold. The estimate would be relevant to lenders who are interested in lending money to Bayton because the lender would want to know how much money could be recovered if Bayton were unable to repay the loan. The estimate would also be relevant to Bayton itself and to prospective buyers of the land because it provides an unbiased estimate of the land's current market value.
		The values for the land that was sold are reliable: they are supported by independent transactions and so there is no question about the amounts involved. However, these amounts are not necessarily reliable with respect to Bayton's land. There are three significant problems regarding the relevance of these amounts: (1) the transactions took place some time ago, so they may not reflect current market conditions, which would be an important concern to prospective lenders or buyers; (2) the land that was sold may not be similar to Bayton's land despite being nearby; and (3) the price does not inform us about the circumstances surrounding the sales (the seller in one of the transactions may have required cash urgently and therefore could not wait to get a higher price). These three factors limit the relevance of the selling price of the other pieces of land.

## SUMMARY OF KEY POINTS

- ▶ **LO 1** Accounting is a system for producing information about an entity and communicating that information to people who want or need the information for making decisions. Effective decision making requires information, and accounting is a crucial source of information. The numbers in an accounting report tell a story but the numbers cannot be taken at face value. Using, preparing, and understanding accounting information requires a set of high-level cognitive skills, including judgment, analysis, synthesis, evaluation, problem solving, critical thinking, and creativity.

Preparers of accounting information often have considerable leeway and choice in how they will do their accounting. The existence of choices makes it necessary for users to exercise a great deal of care to ensure they are aware of the choices that the preparer made and of how those choices affect their decisions.
- ▶ **LO 2** Accounting does not operate in a vacuum. You cannot sensibly use or provide accounting information without considering the accounting environment, which includes the social, political, legal, cultural, and economic environment of a society; the types of entities that are of interest to stakeholders and the characteristics of those entities; the different stakeholders that may have an interest in an entity; and the constraints that limit the accounting choices an entity can make. The diversity of the accounting environment makes it impossible for a single accounting report to be appropriate for all situations. Accounting reports must be tailored to suit the circumstances of an entity's accounting environment.
- ▶ **LO 3** The stakeholders in an entity who require accounting information for their decision making rely on the entity to provide the information. The managers who prepare the information are not neutral. When preparing accounting reports, managers may be influenced by their own personal interests, and these interests may conflict with those of the stakeholders.
- ▶ **LO 4** Accounting systems are designed to accumulate data that are then organized, processed, and converted into information that is useful to stakeholders. The information produced by accounting systems allows stakeholders to measure different attributes of an entity.
- ▶ **LO 5** GAAP are the principles, conventions, practices, procedures, and rules that define acceptable accounting practices and guide the preparation of financial statements in certain situations. A set of rules for preparing accounting information can help reduce the cost and difficulty of communication between entities and users. Canadian GAAP describe four qualitative characteristics that financial statement information must have to be useful to users: understandability, relevance, reliability, and comparability. GAAP do not provide solutions to all accounting problems. GAAP are not universal, not every entity needs or is required to follow GAAP, and GAAP are flexible.

## KEY TERMS

accounting, p. 3	partner, p. 8
Canada Revenue Agency (CRA), p. 8	partnership, p. 8
comparability, p. 19	preparers, p. 11
corporation, p. 7	private corporation, p. 7
cost/benefit trade-off, p. 4	proprietor, p. 8
entity, p. 3	proprietorship, p. 8
external audit, p. 12	public corporation, p. 7
external auditors, p. 12	relevance, p. 19
financial accounting, p. 5	reliability, p. 19
generally accepted accounting principles (GAAP), p. 18	share, p. 7
limited liability, p. 7	shareholder, p. 7
managerial accounting, p. 5	stakeholder, p. 9
not-for-profit organization, p. 8	stock exchange, p. 7
	understandability, p. 19

## SIMILAR TERMS

The left column gives alternative terms that are sometimes used for the accounting terms introduced in this chapter, which are listed in the right column.

non-profit organization	<b>not-for-profit organization, p. 8</b>
stockholder	<b>shareholder, p. 7</b>
stock market	<b>stock exchange, p. 7</b>

## ASSIGNMENT MATERIALS

### Questions

- Q1-1.** Provide a definition of accounting that someone without a business background would understand.
- Q1-2.** Explain the difference between managerial and financial accounting.
- Q1-3.** Explain why it is important when studying business and accounting to make links between the classroom and the real world.
- Q1-4.** There are many different stakeholders in an entity. Explain why the same information may not be suitable or appropriate for all stakeholders.
- Q1-5.** Distinguish between preparers and users of accounting information.
- Q1-6.** Explain why the self-interests of preparers of accounting information can affect what information is reported to stakeholders and how it is reported.
- Q1-7.** What is a corporation? What are the attractive features of organizing a business as a corporation?
- Q1-8.** What is a publicly owned corporation? How does it differ from a privately owned corporation?
- Q1-9.** What is a not-for-profit organization? Give an example of a not-for-profit organization. What is the purpose of the organization you identified?
- Q1-10.** Why is information important for good decisions?
- Q1-11.** Explain the cost/benefit trade-off. What are its implications for decision making?
- Q1-12.** When you make a decision, should you collect all possible related information? What limits would you set on the information you gather?
- Q1-13.** What are generally accepted accounting principles (GAAP)?
- Q1-14.** Why is it useful to have a set of rules such as GAAP to guide preparers of accounting information?
- Q1-15.** Why is it necessary for a user of accounting information to understand the rules (such as GAAP) that the preparer used when preparing the information?
- Q1-16.** According to the *CICA Handbook*, what are the four qualitative characteristics that financial statement information must have to be useful to users?
- Q1-17.** Describe and explain some of the limitations of GAAP that were described in this chapter.
- Q1-18.** What is an external audit of financial information and why can it be important for many stakeholders of an entity?
- Q1-19.** Why is it useful for non-accounting students to be familiar with and understand financial statements?

## Exercises

- E1-1.** (Consider the information relevant for making a decision, LO 2) You meet a stranger on a street corner in Edmonton. She asks you for instructions on the best way to get from Edmonton to Ottawa. What would you tell her?
- E1-2.** (Understanding the qualitative characteristics of accounting, LO 5) According to the *CICA Handbook* there are four qualitative characteristics that financial statement information must have if it is to be useful to users. Describe these characteristics in detail:
- Understandability.
  - Relevance.
  - Reliability.
  - Comparability.
- E1-3.** (Considering the stakeholders in a university or college, LO 2) Consider the university or college you attend. Who are the stakeholders in your university? Explain the interest or “stake” each stakeholder has in the university. What types of decisions would each of these stakeholders have to make regarding the university? What type of information would be useful to each of these stakeholders? Explain.
- E1-4.** (Assessing the credibility of information, LO 3) You are looking to buy a new computer. You read an advertisement in a computer newspaper that describes Aylsham Computer Products Inc.’s (Aylsham) computer as the best value for the money for students. Based on this advertisement, would you purchase the computer? Why? What additional information would you require to decide whether to buy an Aylsham computer?
- E1-5.** (Assessing the credibility of information, LO 3) A chain of donut shops claims to have the world’s best coffee. Do you believe the claim? Explain. How would you go about determining whether the chain had the world’s best coffee?
- E1-6.** (Consider the information relevant for making a decision, LO 2) Your brother has just asked you to lend him \$5,000 to help him buy a car. Would you lend him the money? How would you decide? What would you want to know before you made a final decision?
- E1-7.** (Consider the information relevant for making a decision, LO 2) Your cousin is in her last year of high school and is in the process of deciding which university to attend. Since you went through the process just a few years ago, she has asked you for advice about the best university to attend. What would you tell your cousin? What questions would you ask her before you could provide an answer?
- E1-8.** (Considering different ways of measuring, LO 4) For each of the following situations, explain which method of valuing the item in question would be most useful:

Measurement method	Explanation of the method
Cost	What you paid for the item.
Replacement cost	What it would cost to replace the item with an identical item in the same condition.
Replacement cost new	What it would cost to replace the item with an identical item that is new.
Net realizable value	What the item could be sold for now.

- You lost your favourite CD and want to get another copy of it.
- You need to get some money fast and you have nothing in your bank account, so you are thinking of selling your car.

- c. You purchased a DVD player from a store that had a special sale offering to let you “use it for a year and if you don’t like it you can get your money back.” You decide you don’t like the DVD player.
- d. Your 1995 Ford Mustang was stolen and you are looking to get another one just like it.

**E1-9.** (Consider the different ways of measuring the attributes of a home, LO 4) There are many attributes of an item that you can measure. For a car, you could measure how fast it can go, its gas mileage, the number of doors it has, what you could sell it for, and many more. Notice that only one of these measures is stated in terms of money. Now consider your home. How many different attributes of your home could you measure? What would be the use for each measurement? Which measure of your home is best? Explain.

**E1-10.** (Consider different ways of organizing information, LO 4) Your 99-year-old grandfather died recently and left you his beloved library of books. At the time of his death, your grandfather’s library contained over 5,000 books. The books had been packed away in boxes and the boxes have been delivered to you. After opening the boxes you realize that the books were not organized in any particular way. You decide to build a library in your basement and organize and catalogue the books. What are some of the ways you could organize the books in the library? What are the benefits and limitations of the different ways of organizing the books? What are the benefits of organizing the books at all?



**E1-11.** (Take a first look at an annual report, LO 1, 2, 3, 4, 5) Read the Rogers Communications Inc. financial statements for 2005 provided in Appendix A. You can also look at the entire Rogers annual report on this text’s Web site at [www.mcgrawhill.ca/friedlan](http://www.mcgrawhill.ca/friedlan). List seven questions that came to mind while reading the financial statements (or the annual report). Your questions should cover topics such as why particular information is reported or what it means.

## Problems

**P1-1.** (Consider who should make accounting choices, LO 2, 3, 4, 5) Figure 1–1 of the accounting environment and the chapter as a whole emphasized that it is the managers of an entity who choose the accounting methods that an entity uses. Do you think the managers should have this responsibility or should it belong to someone else? Who else could possibly fulfill this task? Explain your answer fully.

**P1-2.** (Explain the reason stakeholders would want information about an entity, LO 2) Consider the following stakeholders in an entity. Why would the stakeholder want information about the entity? Explain.

- a. A customer considering a major purchase (such as a computer or an appliance).
- b. A government minister evaluating whether to provide assistance to a business.
- c. The head of the CRTC (the regulatory agency responsible for the cable industry) determining whether a rate increase should be awarded to a cable company.
- d. A shareholder in a company.

**P1-3.** (Explain the reason stakeholders would want information about an entity, LO 2) Consider the following stakeholders in an entity. Why would the stakeholder want information about the entity? Explain.

- a. A person considering making a donation to a charity.
- b. Canada Revenue Agency (the federal government department responsible for tax collection).

- c. A banker considering whether to lend money to a small business.
- d. The head of a labour union preparing for negotiations with management of a company.

- P1-4. (Identify the stakeholders in an entity and the decisions they make, LO 2)** Consider the following entities. Identify the stakeholders in each of these entities. What types of decisions would each of these stakeholders want to make?
- a. Air Canada.
  - b. Government of Canada.
  - c. The Canadian Cancer Society.
  - d. McCain Foods Limited.
- P1-5. (Identify the stakeholders in an entity and the decisions they make, LO 2)** Consider the following entities. Identify the stakeholders in each of these entities. What types of decisions would each of these stakeholders want to make?
- a. A local convenience store owned and operated by a family.
  - b. A large, publicly owned company.
  - c. A private, not-for-profit golf club.
  - d. The government of a small Canadian city.
- P1-6. (Consider the decisions stakeholders make and the nature of the information they require, LO 1, 2)** Consider the following decisions that a stakeholder of an entity might have to make. For each decision, identify the stakeholder who would likely be making the decision and indicate whether the decision would be considered a financial or managerial accounting decision. Remember that the classification as financial or managerial accounting depends on who the decision maker is. Explain your answer.
- a. The price a manufacturer's products should sell for.
  - b. Whether a loan should be made to a small business.
  - c. Whether a corporation has paid an appropriate amount of tax.
- P1-7. (Consider the decisions stakeholders make and the nature of the information they require, LO 1, 2)** Consider the following decisions that a stakeholder of an entity might have to make. For each decision, identify the stakeholder who would likely be making the decision and indicate whether the decision would be considered a financial or managerial accounting decision. Remember that the classification as financial or managerial accounting depends on who the decision maker is. Explain your answer.
- a. Whether a local clothing store should move to a larger location so that it could sell a wider range of clothes.
  - b. Whether to purchase the shares of a large oil company.
  - c. Whether unionized employees should receive a significant wage increase.
- P1-8. (Considering the information needed to decide whether to invest in a business, LO 1, 2, 4)** A friend of yours has just called you up with "a great business opportunity." Your friend is starting up a new e-business and needs money to purchase computer equipment. Your friend says he is going to invest \$10,000 in the business and wants to know whether you want to invest as well. Would you invest in the new e-business? Why or why not? What additional information would you want to have before making a decision?
- P1-9. (Considering the information needed to decide whether to invest in a business, LO 1, 2, 4)** Two of your friends own and operate a business that rents bicycles and inline skates at a local lake. They have told you that they want to expand the business but said they are short of the money needed for the expansion and have asked you to become a partner by investing \$8,000. Would you invest the \$8,000? How would you decide? What additional information would you want to have before making a final decision?

**P1-10. (Classify and organize information so that it is useful for decision making, LO 1, 4)**

Mike is a university student who is often short of cash. A month may pass and he has no idea where his money went. After suffering with this problem for several months, Mike decides to monitor his spending for the next month. He buys a small notebook to write down the amount spent and the purpose of the spending. The summary of Mike's spending for the month follows:

Date	Amount	Purpose
Feb 4	\$8.75	Starting balance (cash in wallet)
Feb 4	50.00	Cash from ATM
Feb 4	-15.75	Movie and beer
Feb 6	-3.00	Photocopy of Steve's notes
Feb 6	-4.50	Lunch
Feb 10	-22.50	Book for course
Feb 11	-2.50	Snacks
Feb 12	50.00	Cash from ATM
Feb 12	-18.25	Date with Alexa
Feb 15	-10.00	Long-distance phone card
Feb 17	-3.00	Contribution to charity drive
Feb 19	50.00	Cash from ATM
Feb 19	-22.50	Card and gift for Dad
Feb 20	-8.75	Overdue fees at library
Feb 20	-17.40	Share of phone bill for dorm room
Feb 21	10.00	Borrow from Lisa
Feb 21	-23.00	Food/drink for dorm room
Feb 24	50.00	Cash from ATM
Feb 24	-10.00	Pay Lisa back
Feb 27	-18.75	Partying after exam
Feb 28	\$38.85	Amount remaining in wallet

**Required:**

Prepare a statement that organizes the information from the month's spending in a useful way. Explain why you organized the information the way that you did. How could you use the information if you were Mike?

**P1-11. (Classify and organize information so that it is useful for decision making, LO 1, 4)**

Mei is a university student who has been unable, so far, to find a summer job. While she has enough money to pay for school next year, she is concerned that she is not managing her money as well as she could. She decides to monitor her spending for the next month so that she can get an idea of where her money is going. She buys a small notebook and writes down the amount spent and the purpose of the spending. Mei's summary of her spending for July is shown below:

Date	Amount	Purpose
July 4	\$0.00	Starting balance (cash in purse)
July 4	100.00	Cash from ATM
July 4	-15.75	Partying with friends
July 6	-45.00	Clothes
July 6	-4.50	Lunch
July 10	-22.50	Novel

July 11	-8.50	Movie
July 12	70.00	Cash from ATM
July 12	-38.25	Software
July 15	-22.45	Gift for Dad's birthday
July 17	-3.00	Coffee and donuts with friends
July 19	50.00	Cash from ATM
July 19	-15.50	Beverages for party
July 20	-8.75	Snacks
July 20	-12.50	Monthly Internet access fee
July 21	-23.00	Cosmetics
July 21	100.00	Borrowed from Mom
July 24	50.00	Cash from ATM
July 24	-20.00	Tennis lesson
July 27	-125.00	Deposit for university courses in fall
July 31	\$5.30	Amount remaining in purse

**Required:**

Prepare a statement that organizes the information from the month's spending in a useful way. Explain why you organized the information the way that you did. How could you use the information if you were Mei?

**P1-12. (Evaluate different ways of measuring the value of a house, LO 4)** Rajiv owns a home in suburban Ottawa. You obtain the following information about the home:

a. Purchase price in 1978	\$175,000
b. Selling price of a similar house on another street last year	\$625,000
c. Price offered (and turned down) for Rajiv's house two months ago	\$575,000
d. What it would cost to rebuild the house if it were destroyed	\$235,000

**Required:**

Explain how each of the measures of the "value" of Rajiv's house could be used by a decision maker. What decision would the person be making? How would the information be useful?

**P1-13. (Evaluate different ways of measuring the value of a vintage automobile, LO 4)** Otto Collector owns a vintage 1925 Ford automobile. You obtain the following information about the car:

a. What Otto paid for the car in 1983	\$29,000
b. Selling price of a similar car one year ago	\$80,000
c. Price offered (and turned down) by Otto for his car last month	\$95,000
d. What the car sold for new in 1925	\$800

**Required:**

Explain how each of the measures of the "value" of Otto's car could be used by a decision maker. What decision would the person be making? How would the information be useful?

**P1-14. (Consider the usefulness of audited information, LO 1, 2, 3)** For each of the following situations explain whether and why having an independent review of the information provided—that is, an audit—would be useful. Suggest the type of person who might be appropriate for conducting the audit.

- A donut shop advertises that it has the world's best coffee.
- A used car dealer says that a car you are interested in is in excellent condition.

- c. A store's rent to the mall owner is \$1,200 per month plus 5% of the amount of sales the store makes. For the year just ended the store reports to the mall owner that its sales were \$250,000.
- d. A graduate university program requests a list of grades a student earned in her undergraduate program.

- P1-15. (Consider the usefulness of audited information, LO 1, 2, 3)** For each of the following situations explain whether and why having an independent review of the information provided—that is, an audit—would be useful. Suggest the type of person who might be appropriate for conducting the audit.
- a. An individual files an income tax return with the Canada Revenue Agency in which she reports the amount of money her business earned during the previous year.
  - b. An electronics store states that it has “the lowest prices, guaranteed!”
  - c. A public corporation predicts that it will double its profit next year.
  - d. A job applicant submits a résumé to a prospective employer outlining his employment history and educational background.
- P1-16. (Identify the characteristics of different entities, LO 2, 3)** Identify two distinct entities. These could be corporations, partnerships, proprietorships, not-for-profit organizations, or any other type of entity you are familiar with or can obtain information about. Identify the characteristics of each entity. (You can use the characteristics listed in Figure 1–1 on page 6.) Explain how the entities differ.
- P1-17. (Identify the characteristics of different entities, LO 2, 3)** Identify two different corporations that are in a similar business. Identify the characteristics of each corporation. (You can use the characteristics listed in Figure 1–1 on page 6 as a guide). Explain how the corporations are similar and how they differ.
- P1-18. (Identify the stakeholders in an accounting partnership, LO 2, 3)** Bricket, Brack, and Bosh (BBB) is a small accounting firm in Oshawa, Ontario. The firm has four partners and ten other employees. All of the partners belong to professional accounting organizations. The firm provides accounting, tax, and consulting services to small- and medium-sized businesses in the community. When the firm does work for clients it is often used by third parties such as banks or prospective investors. For example, BBB might audit a client's financial statements, which are then given to the bank as part of a loan application. BBB is also part of a group of independent accounting firms in Ontario that will do work for clients of other firms in the group. For example, if BBB has a client that has an office elsewhere in Ontario, it might use the services of a firm in the group to do necessary work at that office.

**Required:**

Identify all of the stakeholders in Bricket, Brack, and Bosh and explain their “stake” in the partnership. Not all the stakeholders are explicitly referred to in the scenario. You will have to think about the business situation carefully to identify some of the stakeholders.

- P1-19. (Identify the stakeholders in a not-for-profit organization, LO 2, 3)** Safety House provides shelter and services to homeless and runaway youth in Vancouver. Safety House began as a group home in the early 1980s that provided a safe haven to street children in the city but now provides additional services including a telephone support line, outreach programs, substance abuse programs, and other necessary community services. In recent years it has become an advocacy group for children, to make government and the public aware of the problems faced by youth, as well as working with government and community social service agency to improve the lives of children and families. Safety House is managed by people with experience in social services and employs

about 100 people who fill a wide range of roles providing needed services to young people. Safety House raises money from the public through a variety of fundraising programs and receives a significant amount of money from the provincial government.

**Required:**

Identify all of the stakeholders in Safety House and explain their “stake” in the organization. Not all the stakeholders are explicitly referred to in the scenario. You will have to think about the situation carefully to identify some of the stakeholders.

## ENDNOTES

1. Andrew Zimbalist, *Baseball and Billions*, updated ed. (New York: Basic Books, 1994), p. 62.