

CHAPTER 1

Accounting in Action

LECTURE OUTLINE

Why is Accounting Important? (LO1)

1. Accounting is the information system that identifies, records and communicates economic events of organizations to interested users. A wide variety of users depend on transparent, relevant, understandable financial information that provides a true representation of the economic events. A vital element in communicating economic events is the accountant's ability to analyze and interpret this information.

2. Accountants use ratios, percentages, graphs, and charts to analyze and interpret financial information. They use this information to highlight significant financial trends and relationships.

- a. Whether you plan to own your own business, work for a business, invest in a business – whatever you choose, studying accounting will teach you to read and interpret financial information which is a valuable set of skills.
- b. Whether you plan to become a doctor, lawyer, social worker, teacher, engineer, architect or entrepreneur, a working knowledge of accounting will be relevant and useful to you.

Using Accounting Information

There are 2 broad categories of financial statement users: internal and external.

1. Internal users are those who work for the company and use accounting data in planning, organizing and running the organization. They include finance directors, marketing managers, human resources personnel and company officers. They require answers to questions such as:

Is there sufficient cash to pay the bills this month?

What price must be charged for this product in order to make a profit?

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ILLUSTRATION 1.1 illustrates questions asked by internal users. To answer these questions users need detailed information on a timely basis.

2. External users are those users outside of the business who need information about the financial position and performance of the company. Included in this group are:

1. Investors: Investors use accounting information to make decisions to buy, hold, or sell their ownership interest.
2. Creditors: Creditors use accounting information to evaluate the risks of granting credit or lending money to a business, such as suppliers and bankers.
3. Labour Unions: Labour unions want to know whether the owners can pay increased wages and benefits.
4. Customers: Customers are interested in whether a company will continue to honour its product warranties and support its product lines.
5. Taxing authorities such as Canada Revenue Agency want to know that the company respects tax laws.
6. Regulatory agencies such as provincial securities commissions want to know that the company is respecting established rules.
7. Economic planners use accounting information to forecast economic activity.

Investors and creditors are the main external users of accounting information, but as seen above there are many external users with a large variety of information needs and questions.

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ILLUSTRATION 1.2 illustrates questions asked by external users. Access to information for external users is limited to what is available publicly.

Objectives of Financial Reporting

The main objective of the financial statements is to provide useful information to investors and creditors (external users) to make decisions about a business.

1. Financial Statements must give information about:

Economic resources: what resources does a business have to be used in its operations?

What are the claims on the business' economic resources?

Is the business generating enough profits and enough cash to pay its debts and give a return to its investors?

Forms of Business Organization (LO2)

1. **Proprietorship.** A business owned by one person is generally a proprietorship. The owner receives all profits, suffers any losses, and is personally liable for all debts of the business. This is known as unlimited liability. There is no legal distinction between the owner and the business, so the life of the proprietorship is limited to the life of the owner. However, the records of the business activities must be kept separate from the activities of the owner. The profits of the business are recorded on the owner's personal income tax return.

2. **Partnership.** A business owned by two or more persons associated as partners is a partnership. It is similar to a proprietorship, except that more than one owner is involved. Partnerships are often used for service-type businesses, such as lawyers, doctors, architects and accountants. Each partner generally has unlimited liability for all debts of the partnership, even if one of the other partners created the debt.

3. **Corporation.** A business organized as a separate legal entity under federal or provincial corporation law and having ownership divided into transferable shares is called a corporation. Owners, called shareholders, enjoy limited liability for the debts of the business. In other words, they are not responsible for the debts of the corporate entity. Shareholders may sell their shares to other investors at any time. Since ownership can be transferred without dissolving the corporation, the corporation has an unlimited life. Examples of corporations are Royal Bank of Canada, Suncor Energy, Research Motion and Barrick Gold.

Public Corporations vs. Private Corporations. Public corporations have their shares listed on one of the Stock exchanges and they commonly distribute their financial statements to interested parties and the general public. Private corporations do not issue publicly traded shares and they almost never distribute their financial statements publicly. Examples of private corporations are EllisDon Inc., and McCain Foods. An example of a public corporation is Corus Entertainment.

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ILLUSTRATION 1.3 Characteristics of business organizations.

Generally Accepted Accounting Principles (GAAP) (LO3)

GAAP represents broad principles, procedures, concepts and standards that act as guidelines for accountants. GAAP guides the reporting of economic events; however, in order to be meaningful, ethical behaviour must be present.

1. **Ethics in Financial Reporting** - Ethics is important to accountants and decision makers who rely on and prepare financial information. Financial information must be prepared with high standards of ethical behaviour.
2. In the process of analyzing an ethical situation, the following steps should be applied:
 - Identify the ethical issues involved.
 - Identify the stakeholders – the persons or groups that may benefit or face harm.
 - Consider the alternative courses of action and the consequences of each on the various stakeholders.

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ILLUSTRATION 1.4 illustrates the steps used to analyze ethical dilemmas.

Conceptual Framework

1. The conceptual framework of accounting is a coherent system that guides the development and application of accounting principles and supports to the objective of financial reporting.
2. **Economic Entity Concept.** - requires that the activities of the entity be kept separate and distinct from the activities of its owners, and all other economic entities. An economic entity can be any organization or unit. An economic entity may not necessarily be a separate legal entity.
3. **Going Concern Assumption.** - assumes that a company will continue to operate in the foreseeable future. This assumption assumes that the company will operate long enough to use its assets for their intended use and to fulfill its commitments. This is one of most important assumptions in GAAP. This assumption supports assets being recorded at cost. For example, if a company is not a going concern, and an asset such as land is going to be sold, then the readers of the financial statements would be more interested in the land's current worth rather than what was paid for it.
4. **Periodicity Concept** – guides organizations in dividing up their economic activities into distinct time periods.
5. **Fundamental Qualitative Characteristics**
 - Relevance** – accounting information is relevant if it would make a difference in a business decision.
 - Faithful Representation** – means that the information accurately depicts what really

happened. In order to do so information must be complete and free from error.

6. Enhancing Qualitative Characteristics

Comparability – results when different companies use the same accounting principles.

Verifiability – when independent observers using the same information will yield the same results.

Timeliness – information must be available to decision makers before it loses its capacity to influence decisions.

Understandability – the information is presented in a clear and concise fashion so that reasonably informed users of that information can interpret and comprehend its meaning.

7. Recognition – process of recording items in the accounting records

Revenue Recognition Principle – requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied, not when cash passes hands.

Matching Concept – guides when expenses are recognized.

8. Measurement – the process of determining the amount that should be recognized.

Cost Measurement Method – also known as the historical cost method.

Fair Value Method – generally would be the amount that the asset could be sold for in the market.

Accounting Standards

Financial information is communicated in accounting reports, the most common being financial statements. In order to make the information in the financial statements meaningful, accountants must prepare the reports in a standardized way. These standards specify how to report economic events.

1. Generally Accepted Accounting Principles (GAAP)

The common set of standards used by accountants in reporting economic events are called generally accepted accounting principles (GAAP) which includes broad principles and practices, as well as rules and procedures. The Chartered Professional Accountants of Canada, through an Accounting Standards Board (AcSB), is primarily responsible for establishing generally accepted accounting principles in Canada. The basic objective of financial reporting is to communicate information that is useful to investors, creditors and other users when they make decisions.

Canadian GAAP is the implementation of two sets of standards, International Financial Reporting Standards (IFRS), and Accounting Standards (ASPE) for Private Enterprises. Canadian public enterprises must follow **International Financial Reporting Standards (IFRS)**, a set of global standards developed by the International Accounting Standards Board (IASB). In Canada, the decision to adopt IFRS was made so that Canadian public companies are able to compete in

an increasingly global marketplace. Because the users of Private companies typically require less information in the financial statements, the AcSB developed **Accounting Standards for Private Enterprises (ASPE)**. Canadian Private Companies have the choice to report under IFRS or ASPE.

Both IFRS and ASPE are considered “principles-based” as opposed to “rules-based” standards. “Principles-based” standards are designed to encourage the use of professional judgement. It is important to understand that GAAP is not static and that it changes over time. The AcSB and IASB continue to create new standards and modify GAAP.

Accounting Model (LO4)

1. The main objective of the financial statements is to provide information about the business' resources, claims to its resources, and its ability to earn a profit and generate cash to allow investors and creditors (external users) to make decisions about a business. There are four basic financial statements: the balance sheet, income statement, statement of owner's equity and cash flow statement.

2. The **Balance Sheet** (sometimes called statement of financial position) provides information about the economic resources that the business can use to carry out its business activities to earn a profit and the claims to these economic resources. The balance sheet is like a snapshot of the company's financial condition at a specific moment in time (usually the end of a month, quarter, or year). Assets, liabilities, and owner's equity are reported in the balance sheet.

Assets are economic resources controlled by a business as a result of past event. Every asset has the potential of producing future economic benefits which results in future cash inflows. Example of assets are: accounts receivable, prepaid expenses, and vehicles.

Liabilities are current obligations, arising from past events, to make a future payment of assets or services. In other words, liabilities are present debts and obligations. The persons or entities a company owes money to are called **creditors**. Examples of Liabilities are: note payable, accounts payable and unearned revenue (which represents advance payments made by customers).

Owner's equity is the owner's claim on total assets. It is equal to total assets minus total liabilities. It is a residual claim, since claims of creditors rank ahead of those of owners. This amount is often called net assets. In a proprietorship, owner's equity is increased by investments made by the owner and decreased by withdrawals made by the owner. “Owner's

equity” is a term used for proprietorships. Partnerships use the term “partner’s equity” and corporations use the term “shareholder’s equity”.

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Use **ILLUSTRATION 1.7** The Balance Sheet: a snapshot in time.

The accounting equation (sometimes referred to as the balance sheet equation) is:

Assets = Liabilities + Owner’s Equity

It applies to all economic entities regardless of size, nature, or form of business organization.

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Use **ILLUSTRATION 1.8** to demonstrate the accounting equation.

3. The **Income Statement** (sometimes called statement of earnings or statement of operations) reports the profitability of the business’s operations over a specified period of time (a month, quarter, or year).

Revenues increase owner’s equity and expenses decrease owner’s equity. **Profit** results when revenues exceed expenses for the period. Therefore, profit increases owner’s equity. A **loss** is the result when revenues are less than expenses for the period. Therefore, a loss decreases owner’s equity. Profit is also referred to as net income or earnings.

Revenues are increases in net assets (i.e. an increase in an asset or a decrease in a liability and an increase in owner’s equity) that result from business activities performed to earn profit. Common sources of revenue include sales, fees, services, commissions, interest, and rent.

Expenses are the costs of assets consumed or services used in the company’s ordinary business activities. Expenses are decreases in assets or increases in liabilities, excluding withdrawals made by the owners, and result in a decrease to owner’s equity. Examples of expenses are: telephone expense, supplies expense, and rent expense.

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Use **ILLUSTRATION 1.9** The income statement for a period of time.

4. **Statement of Owner’s Equity** shows the changes in owner’s equity for the same period of time as the income statement. In a proprietorship, owner’s equity is increased by investments made by the owner and profits made by the business, and decreased by withdrawals made by the owner and losses made by the business.

Investments. When an owner invests assets into the business, the owner’s capital account

increases by the value of the assets invested. Therefore, investments increase an asset and owner's equity.

Drawings are withdrawals of cash or other assets from an unincorporated business for the personal use of the owner. Drawings can be recorded as a decrease to owner's equity directly or they can be recorded in a separate account called **drawings**. Drawings results in a decrease of an asset and a decrease in owner's equity.

Revenues increase owner's equity and expenses decrease owner's equity. Therefore, **profits** increase owner's equity and **losses** decrease owner's equity.

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ILLUSTRATION 1.10 illustrates transactions that increase and decrease owner's equity.

5. **Cash Flow Statement** gives information about the cash receipts and cash payments made by a business over a specific period of time. The cash flows are divided into three categories: operating activities, investing activities (e.g. the purchase and sales of property, plant and equipment) and financing activities (e.g. the borrowing and repayment of debt).

Accounting Differences by Type of Business Organization

1. In a proprietorship, equity is called **owner's equity**. Investments by the owner are added to the Owner's capital account and withdrawals by the owner are recorded in a Drawings account. In a partnership, equity is called **partners' equity**. Each partner has a Capital account and a Drawings account. In a corporation, equity is known as **shareholders' equity**. It consists of two categories: the investments made by the shareholders, called **share capital**, and the profit (or earnings) generated and kept by the company, called **retained earnings**. **Dividends** are distributions to the shareholders, and are similar to drawings. Dividends are deducted from retained earnings.

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ILLUSTRATION 1.11 illustrates the accounting differences by different accounting organizations.

The Expanded Accounting Equation

1. The Accounting Equation can be expanded to include all the different parts of owner's equity and show the relationships between revenues, expenses, profits (losses) and owner's equity.

2. From the expanded equation we can see that if revenue increases, owner's equity increases and therefore either assets increase or liabilities decrease to keep the equation balanced. Conversely if expenses increase, owner's equity decreases and therefore either assets decrease or liabilities increase to keep the equation balanced.

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ILLUSTRATION 1.12 illustrates the expanded accounting equation.

Transaction Analysis (LO5)

1. Transactions are the economic events of a company that are recorded. Once it has been determined that an event or transaction should be recognized, it must be analyzed for its effect on the components of the accounting equation before it can be recorded. This analysis must identify the specific items that are affected and the amount of change in each item.
2. The two sides of the accounting equation must always be equal.
Each transaction must have a dual effect on the equation.
If an asset is increased, there must be a corresponding:
 Decrease in another asset, or
 Increase in a liability, or
 Increase in owner's equity

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ILLUSTRATION 1.24 summarizes the cumulative effect of Softbyte's transactions on the accounting equation.

3. Each transaction must be analyzed in terms of its effects on specific items within the components of the accounting equation. The two sides of the equation remain equal.

Preparing Financial Statements (LO6)

1. An **income statement** presents the revenues and expenses and the resulting profit or loss for a specific period of time.
2. A **statement of owner's equity** summarizes the changes in owner's equity for a specific period of time.
3. A **balance sheet** reports the assets, liabilities, and owner's equity of a company at a specific date.
4. A **cash flow statement** summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.

5. The financial statements are interrelated. The income statement is prepared first. The profit or loss becomes part of the statement of owner's equity, which is prepared next. The ending capital balance from the statement of owner's equity then becomes part of the balance sheet. Lastly, the ending cash balance from the balance sheet appears in the cash flow statement.

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Use **ILLUSTRATION 1.25** to demonstrate the relationship between the four financial statements.

Understanding the Information in the Financial Statements

1. Financial statements of publicly traded companies are presented in an annual report.
2. The annual report includes useful non-financial information about the company, as well as financial information. Non-financial information may include a management discussion of various aspects of the company, such as the company's mission, goals and objectives. Financial information may include a review of current operations, ratio analysis of historical information, and comparative financial statements.
3. The financial statements of public companies are audited and include an auditors' report. The annual report also includes a statement of management responsibility for the statements.

Comparing IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Accounting standards	Required for publicly accountable enterprises and optional for private enterprises	Private enterprises only
Level of accounting information required	Users require extensive detailed information	Users require less information
Equity reporting	Statement of changes in equity	<ul style="list-style-type: none"> • Proprietorships: Statement of owner's equity • Partnerships: Statement of partners' equity • Corporation: Statement of retained earnings