1 The Financial Statements

LEARNING OBJECTIVES

1. **Learn** that financial statements are the product of accounting
2. **Apply** the accounting equation to business organizations
3. **Understand** financial statements and how to use them
4. **Explain** the relationships among the financial statements
5. **Understand** financial accounting standards
6. **Understand** the role of ethics in business and accounting decisions

SPOTLIGHT

Gildan Activewear Inc. is a Canadian clothing company that manufactures and markets products such as T-shirts, socks, fleeces, sport shirts, and underwear. If you have purchased a T-shirt with your school's logo on it, the T-shirt was probably manufactured by Gildan and sold as a "blank" to the company that printed your school's logo.

Gildan was incorporated in 1984. While Gildan's head office is in Montreal, it is truly an international company. Gildan's products are manufactured in a number of countries and sold in 34 countries around the world through sales offices in the Barbados, the United States, the United Kingdom, and China. Gildan reports the results of its business activity in its annual report, which includes Gildan's financial statements.

The terms *financial statements, International Financial Reporting Standards*, *revenues*, and *expenses* may be foreign to you now. But as you work your way through this book, these terms and many other accounting and business terms and concepts will become familiar to you. Welcome to the world of accounting.

OBJECTIVE

1 **Learn** that financial statements are the product of accounting

Financial statements are the business documents that companies use to report the results of their activities to various user groups, which can include managers, investors, creditors and regulatory agencies. These parties use the reported information to make a variety of economic decisions. The system of accounting produces financial statements. In this chapter you will consider

- The objectives of different user groups
- The different forms of business organizations
- The underlying assumptions, principles, and concepts of generally accepted accounting principles and the bodies responsible for issuing accounting standards
- The judgment process necessary to make good accounting decisions
- The contents of the four basic financial statements and how different user groups use the information to make business decisions

In later chapters you will learn in more detail how to construct the four financial statements outlined below and how to apply your knowledge to make economic decisions.

The end result of financial accounting is the basic financial statements:

- Income statement (the statement of operations)
- Statement of retained earnings
- Balance sheet (the statement of financial position)
- Statement of cash flows.

The October 4, 2009, financial statements of Gildan Activewear Inc. will be used as a basis for discussion throughout this chapter.

Most of you are taking this course to learn about accounting in a way that will serve you either as an accountant or as a manager such as vice-president of marketing, director of purchasing, or as a financial institution loan officer or investment manager. Accordingly, we have structured the text to prepare you for either career stream.

As an accountant you might find yourself

- Preparing financial statements for the organization that employs you
- Auditing financial statements as a public accountant
- Analyzing financial statements as a financial analyst working for an investment firm or a lending officer at a financial institution

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As a manager you might find yourself

- Having to certify the accuracy of financial statements presented by your company to a regulator
- Using financial statements of a company to determine whether or not to acquire shares of stock in a company
- Using information produced by your company's financial system to decide whether or not to increase production of a product the company produces or to move into a new market
- Using financial statements provided by a potential customer or borrower in deciding whether to grant credit to the potential customer or borrower

Economic Decisions

Gildan's managers have to make many business decisions. Should they introduce a new line of fleeces? Should the company set up a regional sales office in Australia or South Africa? Should Gildan consider acquiring a competitor such as Hanes? Should the company extend credit to a potential major customer? Accounting helps managers make these decisions.

Investors use accounting information to make the economic decision as to whether they should buy or sell Gildan shares. Creditors need accounting information to make the economic decision as to whether or not to grant credit to or make a loan to Gildan.

Suppose you have $5,000 to invest or you are a bank and Gildan has come to you for a loan. What information would you need in order to make your decision? Let's see how accounting works.

A Model of Business

All organizations have a business cycle that describes their operation. Gildan's model begins with the acquisition of materials to make the T-shirts, socks, fleeces, and underwear. The finished products are then sold to Gildan's customers. The customers pay Gildan for their purchases and the cycle begins again. The financial statements report the results of this business cycle.

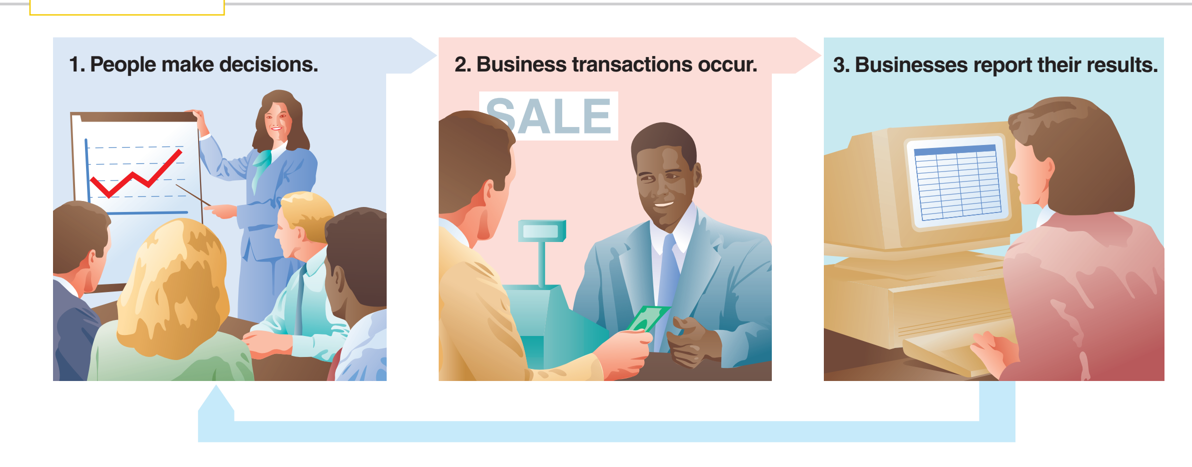
Accounting Is the Language of Business

Accounting is the information system that measures business activities, processes data into reports, and communicates results to decision makers. Accounting is "the language of business." The better you understand the language, the better you can manage your own finances.

Accounting produces the financial statements that report information about a business entity. The financial statements measure performance and tell us where a business stands in financial terms. In this chapter we focus on Gildan Activewear Inc. After completing this chapter, you will begin to understand financial statements.

Don't confuse bookkeeping and accounting. Bookkeeping is a mechanical part of accounting, just as arithmetic is a part of mathematics. Exhibit 1-1 illustrates the flow of accounting information and helps illustrate accounting's role in business. The accounting process starts and ends with people making decisions.

EXHIBIT 1-1 The Flow of Accounting Information



Who Uses Accounting Information?

Decision makers need information. A banker decides who gets a loan. Gildan Activewear decides whether to add a new product line. Let's see how some others use accounting information.

Investors and Creditors. Investors and creditors, such as shareholders and bankers, are the primary users of accounting information since they provide the money to finance Gildan Activewear Inc. An investor earns a return when the price of the company's shares increases and they sell their shares and when they receive a cash dividend on their shares. A banker decides who gets a loan and expects to be repaid. Banks earn money by charging the company interest.

The investor wants to be able to assess whether the company has been profitable in the past and thus is likely to earn future profits so that the share price will increase and the company will be able to pay dividends. The banker wants to determine whether the company will be able to pay the interest on the loan and will be able to repay the loan when it comes due. Both investor and creditor use accounting data to make their decisions.

Government and Regulatory Agencies. Most organizations face government regulation. For example, the Ontario Securities Commission (OSC), a provincial agency, requires public companies to report to the investing public. Gildan Activewear Inc., Potash Corporation of Saskatchewan, Magna International Inc., and other companies publish annual reports.

Taxing Authorities. There are all kinds of taxes. Gildan Activewear pays property tax on its assets and income tax on profits. Retailers collect tax from customers on purchases based on federal and provincial regulation. Most taxes are based on accounting data. Taxing authorities use the accounting information provided to them to determine if companies are paying the correct amount of taxes.

Individuals. People such as you manage bank accounts and decide whether to rent an apartment or buy a house. They budget the monthly income and expenditures of their businesses. Accounting provides the information to allow individuals to make these decisions.

Not-for-Profit Organizations. Not-for-profit organizations—churches, hospitals, and charities, such as Habitat for Humanity and the Canadian Red Cross—base their decisions on accounting data. In addition, accounting data is the basis of a not-for-profit's reporting on the organization's stewardship of funds received and its compliance with the reporting requirements of the Canada Revenue Agency.

Two Kinds of Accounting: Financial Accounting and Management Accounting

Both *external users* and *internal users* make use of accounting information. We can therefore classify accounting into two branches.

Financial accounting provides information for decision makers outside the organization, such as investors, creditors, government agencies, and the public. This information must be relevant for the needs of decision makers and must provide a faithful representation of the entity's economic activities. This textbook focuses on financial accounting.

Management accounting generates inside information for the managers of the organization. Examples of management accounting information include budgets, forecasts, and projections that are used in making strategic decisions of the organization. Internal information must be accurate and relevant for the decision needs of managers. Management accounting is covered in a separate course.

Organizing a Business

Accounting is used in every type of business. A business generally takes one of the following forms:

- Proprietorship
- Partnership
- Corporation

Exhibit 1-2 compares ways to organize a business.

Proprietorships. A **proprietorship** has a single owner, called the proprietor. Dell Computer started out in the college dorm room of Michael Dell, the owner. Proprietorships tend to be small businesses or individual professional organizations, such as physicians, lawyers, and accountants. From a legal perspective, the business

EXHIBIT 1-2 **The Various Forms of Business Organization**

	Proprietorship	Partnership	Corporation
Owner(s)	Proprietor—one owner	Partners—two or more owners	Shareholders—generally many owners
Life of entity	Limited by owner's choice or death	Limited by owners' choices or death	Indefinite
Personal liability of owner(s) for business debts	Proprietor is personally liable	Partners are usually personally liable	Shareholders are not personally liable
Accounting status	Accounting entity is separate from proprietor	Accounting entity is separate from partners	Accounting entity is separate from shareholders

is the proprietor, and the proprietor is personally liable for all business debts. But for accounting, a proprietorship is an entity separate from its proprietor. Thus, the business records do not include the proprietor's personal finances.

Partnerships. A **partnership** joins two or more persons as co-owners, and each owner is a partner. Individuals, corporations, partnerships, or other types of entities can be partners. Income and loss of the partnership "flows through" to the partners and they recognize it based on their agreed-upon percentage interest in the business. The partnership is not a taxpaying entity. Instead, each partner takes a proportionate share of the entity's taxable income and pays tax according to that partner's individual or corporate rate. Many retail establishments and some professional organizations of physicians, lawyers, and accountants are partnerships. Most partnerships are small or medium-sized, but some are gigantic, with several hundred partners. Accounting treats the partnership as a separate organization, distinct from the personal affairs of each partner. But the law views a partnership as the partners: Normally, each partner is personally liable for all the partnership's debts. For this reason, partnerships can be quite risky. Recently, professional partnerships such as public accounting firms and law firms have become **limited liability partnerships** (LLP), which limits claims against the partners to the partnership assets.

Corporations. A **corporation** is an incorporated business owned by **shareholders**. These people own shares of **stock**, which represent shares of ownership in a corporation. Corporations dominate business activity in Canada even though proprietorships and partnerships are more numerous. Corporations transact much more business and are larger in terms of total assets, income, and number of employees. Corporation names (in their entirety) include *Limited*, *Incorporated*, or *Corporation* (abbreviated *Ltd.*, *Inc.*, and *Corp.*, respectively) to indicate that they are corporations—for example, The Forzani Group Ltd., Gildan Activewear Inc., and Lions Gate Entertainment Corp. Some bear the name "Company," such as Hudson's Bay Company. A proprietorship and a partnership can also bear the name "Company."

A corporation is a business entity formed under federal or provincial law. From a legal perspective, unlike proprietorships and partnerships, a corporation is distinct from its owners. The corporation is like an artificial person and possesses many of the rights that a person has. Unlike proprietors and partners, the shareholders who own a corporation have no personal obligation for its debts. So we say shareholders have limited liability, as do partners in an LLP. Also unlike the other forms of organization, a corporation pays income taxes. In the other two cases, income tax is paid personally by the proprietor or partners.

A corporation's ownership is divided into shares of stock. One becomes a shareholder by purchasing the corporation's shares. Gildan Activewear Inc., for example, has issued more than 10,000,000 shares of stock. Any investor can become a co-owner by buying 1, 30, 100, 5,000, or any number of shares of its stock through the Toronto Stock Exchange (TSX), a national stock exchange. Gildan is an example of a public corporation. A corporation may be private, which means that the corporation's shares are privately held among either its founders or its family members.

Shares of a public corporation (publicly accountable enterprise) are widely held and publicly traded. Shares of a private corporation (private enterprise) are privately held among either its founders and or its family members.

Ultimate control of a corporation rests with the shareholders. They normally get one vote for each common share they own. Shareholders elect the members of the

board of directors, which sets policy for the corporation and appoints officers. The board elects a chairperson, who is the most powerful person in the corporation and may also carry the title chief executive officer (CEO), the top management position. Most corporations also have vice-presidents in charge of sales, manufacturing, accounting and finance, and other key areas.

Others. Accounting is also used to produce financial statements in other organizations such as not-for-profit organizations and government and other entities in the public sector.

The Accounting Equation

Gildan Activewear Inc.'s financial statements tell us how the business is performing and where it stands. They are the final product of financial accounting. But how do we arrive at the financial statements? Let's examine the *elements of financial statements,* which are the building blocks on which these statements rest.

OBJECTIVE

2 **Apply** the accounting equation to business organizations

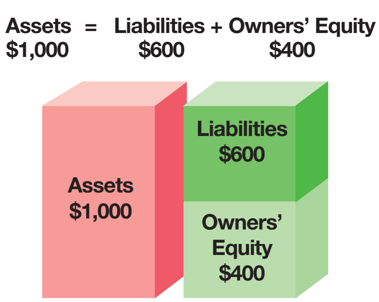
Assets and Liabilities

The financial statements are based on the **accounting equation**. This equation presents the resources of the business and the claims to those resources.

- **Assets** are the economic resources of a business that are expected to produce a benefit in the future. Gildan Activewear's cash, accounts receivable, inventories, and property, plant, and equipment are examples of assets. Claims on assets come from two sources.
- **Liabilities** are "outsider claims." They are debts payable to outsiders, called *creditors*. For example, a creditor who has loaned money to Gildan has a claim—a legal right—to a part of Gildan's assets until Gildan Activewear repays the debt.
- **Owners' equity** (also called **net assets** or **shareholders' equity** for a corporation or **capital**) represents the "insider claims" of a business. Equity means ownership, so shareholders' equity is the owners' interest in the assets of a corporation.

The accounting equation shows the relationship among assets, liabilities, and owners' equity. Assets appear on the left side of the equation and liabilities and owners' equity on the right side. As Exhibit 1-3 shows, the two sides must be equal.

EXHIBIT 1-3 **The Accounting Equation**



What are some of Gildan's assets? The first assets are **cash and cash equivalents**, the liquid (cash) assets that are the medium of exchange. Another important Gildan asset is **accounts receivable**, which primarily represents amounts due from customers who have purchased Gildan's products on account (credit). **Inventory** is another major asset; it includes the raw materials that go into Gildan's products and finished products that Gildan produces. Gildan also has assets in the form of **property, plant, and equipment**. These are the long-lived assets that the company uses to do business—manufacturing equipment, buildings, computers, and so on. Land, buildings, and equipment are also called tangible **capital assets**, **fixed assets**, or **plant assets**.

Gildan's liabilities include a number of payables, such as accounts payable and accrued liabilities. The word *payable* always signifies a liability. An **account payable** is a liability for goods or services purchased on credit and supported by the credit standing of the purchaser. **Long-term debt** is a liability that falls due beyond one year from the date of the financial statements.

Owners' Equity

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The owners' equity of any business is its assets minus its liabilities. We can write the accounting equation to show that the owners' claim to assets is a residual—what is left over after subtracting liabilities from assets.

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$$

The owners' equity of a corporation—called **shareholders' equity**, or simply *equity*—is divided into two main subparts:

- Contributed capital
- Retained earnings

The accounting equation can be written as

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$
$$\text{Assets} = \text{Liabilities} + \text{Contributed Capital} + \text{Retained Earnings}$$

Contributed capital is the amount the shareholders have invested in the corporation. The basic component of contributed capital is **common shares**, which the corporation issues to shareholders as evidence of ownership.

Retained earnings are the amount earned by income-producing activities and kept for use in the business.

Typically, three types of transactions affect retained earnings:

- **Revenues** are inflows of resources that increase retained earnings from delivering goods or services to customers. For example, Gildan's sale of T-shirts to a screenprint company that will add a college design and logo brings in revenue and increases Gildan's retained earnings.
- **Expenses** are decreases in retained earnings that result from operations. For example, the wages that Gildan pays its production people constitute an expense and decrease retained earnings. Expenses are the cost of doing business and are thus the opposite of revenues. Expenses include office supplies, salaries, and utility payments. Expenses also include depreciation of property, plant, and equipment such as computers and buildings.

- **Dividends** decrease retained earnings, because they are distributions to shareholders of assets (usually cash) generated by net income. A successful business may pay dividends to shareholders as a return on their investments. Remember: **Dividends are not expenses. Dividends never affect net income. Instead of being subtracted from revenues to compute net income, dividends are recorded as direct reductions of retained earnings.**

Businesses strive for **profit**, the excess of revenues over expenses.

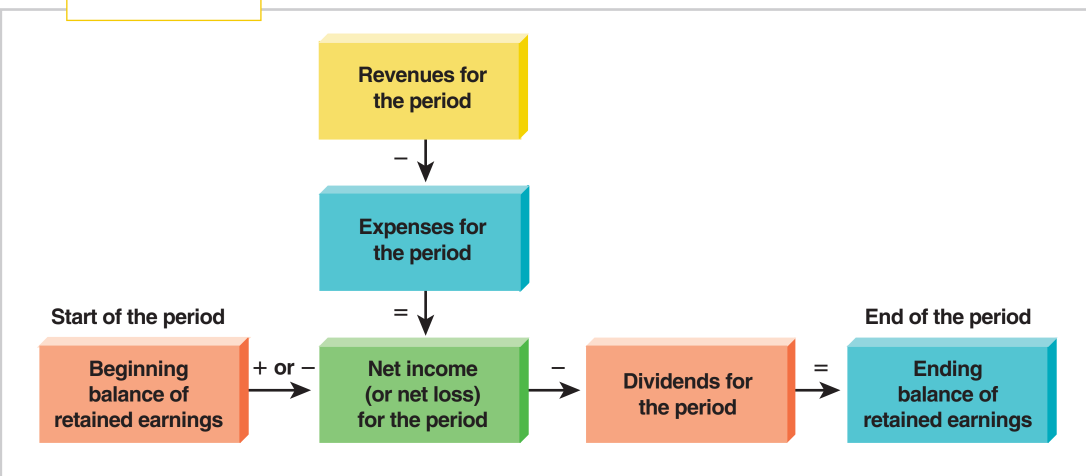
- When total revenues exceed total expenses, the result is called **net income**, or **net earnings** or **net profit**.
- When expenses exceed revenues, the result is a **net loss**.
- Net income or net loss is the "bottom line" on an income statement.

Exhibit 1-4 shows the relationships among

- Retained earnings
- Revenues − Expenses = Net income (or Net loss)
- Dividends

The owners' equity of proprietorships and partnerships is different from that of corporations. Proprietorships and partnerships don't identify contributed capital and retained earnings separately. Instead, they use a single heading—Capital—for example, Walker, Capital, for a proprietorship; and Chin, Capital, and Muesli, Capital, for a partnership.

EXHIBIT 1-4 The Components of Retained Earnings



STOP + THINK

1. If the assets of a business are $240,000 and the liabilities are $80,000, how much is the owners' equity?
2. If the owners' equity in a business is $160,000 and the liabilities are $130,000, how much are the assets?
3. A company reported monthly revenues of $129,000 and expenses of $85,000. What is the result of operations for the month?
4. If the beginning balance of retained earnings is $100,000, revenue is $75,000, expenses total $50,000, and the company pays a dividend of $10,000, what is the ending balance of retained earnings?

Answers:
1. $160,000 ($240,000 − $80,000)
2. $290,000 ($160,000 + $130,000)
3. Net profit of $44,000 ($129,000 − $85,000); revenues minus expenses
4. $115,000 [$100,000 beginning balance + net income $25,000 ($75,000 − $50,000) − dividends $10,000]

OBJECTIVE

3 **Understand** financial statements and how to use them

The Financial Statements

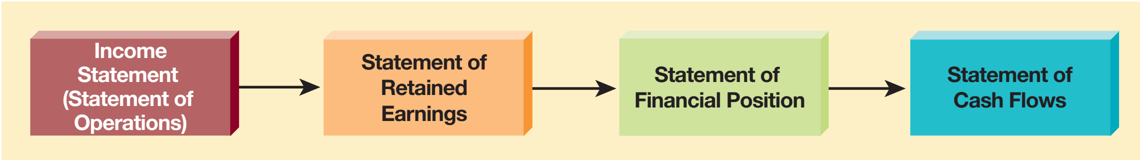
The financial statements present a company to users in financial terms. Each financial statement relates to a specific date or a particular time period. What would creditors and investors want to know about Gildan Activewear Inc. at the end of a fiscal period? Exhibit 1-5 summarizes four questions decision makers may ask. The answers come from one of the financial statements.

EXHIBIT 1-5 **How Information Is Reported on the Financial Statements**

Question	Financial Statement	Answer
1. How well did the company perform during the year?	Income statement (also called the statement of operations)	Revenues − Expenses Net income (or Net loss)
2. Why did the company's retained earnings change during the year?	Statement of retained earnings*	Beginning retained earnings + Net income (or − Net loss) − Dividends Ending retained earnings
3. What is the company's financial position at the end of the year?	Balance sheet (also called the statement of financial position)	Assets = Liabilities + Owners' equity
4. How much cash did the company generate and spend during the year?	Statement of cash flows	Operating cash flows ± Investing cash flows ± Financing cash flows Increase (or decrease) in cash

* Negative retained earnings are called a **deficit**. A deficit would be incurred if accumulated losses exceed accumulated profits.

The following diagram shows how the data flow from one financial statement to the next. The order is important.



We begin with the income statement in Exhibit 1-6. The dollar amounts in the following discussion of Gildan's financial statements are in thousands of U.S. dollars, as are the dollar amounts reported in their financial statements.

The Income Statement Measures Operating Performance

The **income statement**, **statement of operations**, or **statement of earnings** reports the company's revenues, expenses, and net income or net loss for a period. The bottom line is net income or net loss for the period. At the top of Exhibit 1-6 is the company's name, Gildan Activewear Inc. On the second line is the term "Consolidated Statements of Earnings and Comprehensive Income." Gildan Activewear Inc. is actually made up of several corporations that are owned by a common group of shareholders. Commonly controlled corporations like this are required to combine, or consolidate, all of their revenues, expenses, assets, liabilities, and shareholders' equity, and to report them all as one.

Most companies use the calendar year as their accounting year. Examples are EnCana Corporation, Magna International Inc., and Great-West Lifeco Inc. Other companies have year-ends during the year; for example, almost all of Canada's major

EXHIBIT 1-6 **Consolidated Statement of Earnings and Comprehensive Income (Adapted)**

Gildan Activewear Inc.
Consolidated Statements of Earnings and Comprehensive Income (Adapted)
(in thousands of U.S. dollars)

	Year ended October 4, 2009	Year ended October 5, 2008*
1. **Net sales**	**$1,038,319**	$1,249,711
2. Cost of sales	**807,986**	911,242
3. Gross profit	**230,333**	338,469
4. Selling, general, and administrative expenses	**134,785**	142,780
5. Restructuring and other charges	**6,199**	5,489
6. Operating income	**89,349**	190,220
7. Financial (income) expense, net**	**(304)**	9,240
8. Non-controlling interest in consolidated joint venture	**110**	230
9. Earnings before income taxes	**89,543**	180,750
10. Income taxes	**(5,786)**	34,400
11. **Net earnings and comprehensive income**	**95,329**	146,350

*The *CICA Handbook* Section 3031 "Inventories" was issued in 2007 and was effective for companies with fiscal years beginning on or after January 1, 2008. As a result, the company applied Section 3031 for the 2009 statements and recast the 2008 statements.

**Financial (income) expenses (net) includes interest expense of $1,824 in 2009 and $7,422 in 2008.

banks have October 31 year-ends. Companies usually adopt an accounting year that ends on the low point of their operations. For example. Gildan and the Forzani Group report their income based on a 52-week (or 53-week as Gildan did in 2007) rather than a 12-month period.

Gildan's income statement in Exhibit 1-6 reports operating results for two 52-week periods ending October 4, 2009, and October 5, 2008, respectively, to show trends for sales, expenses, and net income. To avoid clutter, Gildan reports in thousands of dollars. Note that Gildan reports in U.S. dollars because so much of its business is in the United States,* and its shares are listed on the New York Stock Exchange as well as on the Toronto Stock Exchange.

During the year ended October 4, 2009, Gildan's net sales declined from $1,249,711 for the 52 weeks ended October 5, 2008, to $1,038,319 thousand (see line 1). Net earnings and comprehensive income declined from $146,350 to $95,329 (see line 11).

USING FINANCIAL STATEMENTS IN DECISION MAKING

It is important to view financial statements in context; during the latter part of 2008 and throughout most of 2009, the whole world was in an economic crisis. Many companies lost money and many others became bankrupt. So, in fact, Gildan's performance was relatively good. The company's annual report reveals that its decline in sales in all four product lines was significantly less than the industry averages for those product lines and Gildan increased the market share in all four product lines. As you work your way through this text, you will see that financial statements are one, albeit an important one, of the sources decision makers use as inputs to their decisions.

The income statement reports two main categories:

- Revenues and gains
- Expenses and losses

We measure net income as follows:

$$\text{Net Income} = \text{Total Revenues and Gains} - \text{Total Expenses and Losses}$$

In accounting, the word *net* means the result after a subtraction. *Net* income is the profit left over after subtracting expenses and losses from revenues and gains. **Net income is the single most important item in the financial statements.**

Revenues. Companies do not always use the term *revenue* in their statement titles. For example, net sales revenue is often abbreviated as *net sales*. *Net* sales means sales revenue after subtracting all the goods customers have returned to the company. The Bay, Canadian Tire, and Jean Coutu get some goods back from customers due to product defects, or items that customers do not want for other reasons. Swiss Chalet and other restaurateurs don't have much in the way of sales returns. In Gildan's case, revenue comes from wholesale sales through the manufacturing and marketing of

*International accounting and foreign currency transactions are discussed in Chapter 10.

activewear primarily to companies that screenprint Gildan's T-shirts and to mass-market retailers.

Expenses. *Cost of sales* (also called *cost of goods sold*) represents the cost to Gildan Activewear Inc. of such expenses as raw materials, manufacturing costs, depreciation of manufacturing equipment and manufacturing facilities, transportation of finished goods to distribution centres and outbound freight costs. While some companies include all depreciation expense as a separate category on their financial statements, Gildan includes such costs in cost of sales.

USING FINANCIAL ACCOUNTING IN DECISION MAKING

Since different companies have different ways of categorizing expenses, it is important that you understand how the company whose financial statements you are examining categorizes or groups its expenses. The notes to the financial statements are an integral part of the financial statements and often provide the information the user requires.

In Gildan's case, Note 1, *Significant Accounting Policies* (n), discloses that depreciation expense is a cost of sales, Note 17, *Other Information* (b), reports the actual depreciation expense during the year. Other companies, such as Magna International, show depreciation as a separate item on the Statement of Income and Comprehensive Income.

Selling, general, and administrative expenses (line 4) includes such costs as warehousing and handling costs, selling and administrative personnel expenses, professional fees, non-manufacturing depreciation expense, and bad debt expense.

Restructuring and other charges (line 5) includes primarily the costs incurred during the year related to the closure, relocation and consolidation of manufacturing and distribution facilities.

Financial (income) expense, net (line 7) includes interest expense, bank and other financial charges and (gain) or loss on foreign exchange transactions.

Non-controlling interest in consolidated joint venture (line 8) is the other partner in the joint venture's share of the joint venture's operating income. Gildan includes the joint venture's net sales, cost of sales, and selling, general and administrative expenses, in the amounts reported on lines 1, 2, and 4 and so must deduct the amount on line 8 so that the amount on line 9 reflects only Gildan's share of the joint venture's income. Restructuring and other charges do not apply to the joint venture and so are not included in the calculation of the non-controlling interest.

Often, companies have other categories of revenue and expenses on their income statements. These revenues and expenses arise from activities outside a company's central, ongoing operations. For example, a company might dispose of property, plant, and equipment and suffer a loss (a loss has the same effect as an expense). Conversely, the company might have a gain (a gain has the same effect as a revenue item).

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Income tax expense (line 10). Corporations pay income tax just as individuals do. During 2009, Gildan's income tax expense was a recovery of $5,786 thousand as a result of different tax rates on earnings of foreign subsidiaries.

USING THE INCOME STATEMENT IN DECISION MAKING

The manager, the investor and the creditor are interested in evaluating the profitability of the corporation.

How well did Gildan Activewear Inc. do during 2009?

- The company was profitable. The bottom line reported a net income of $95,329.

Did sales increase?

- Sales decreased. This must be considered in the context of difficult economic conditions and above-average comparison to industry standards.

What trends are evident in gross margin and net income?

- Gross margin decreased from 27% to 22%; earnings before tax decreased from 14% to 9%. These decreases are directly related to the decrease in sales revenue.

What percentage of sales revenue ended up as profit?

- $\frac{\$95,329}{\$1,038,319} = 0.09$ That is, $0.09 of every sales dollar contributed to the profit.

Manager—Were performance goals achieved? The company was profitable but not as profitable as the previous year. It will be management's responsibility to develop strategies to increase net income by improving sales and/or reducing costs in fiscal 2010.

Investor—Is there sufficient income for dividend distribution and/or company expansion? Yes. In Gildan's example, the company is still expanding and not paying dividends. The investor would be aware of market conditions and company strategy for expansion, which would contribute to any investment decision.

Creditor—Will the company be able to pay interest costs? Note 2 reports that interest expense was $1,824. There is sufficient profit to cover current and increased interest costs.

Now let's move to the statement of retained earnings and Exhibit 1–7.

Statement of Retained Earnings

Retained earnings represent exactly what the term implies: that portion of net income the company has retained. Net income from the income statement also appears on the **statement of retained earnings** (line 2 in Exhibit 1-7). Net income increases retained earnings, and dividends decrease retained earnings. If Gildan had paid dividends during the year to its shareholders, retained earnings would have decreased. Why the decrease? Because the company did not retain the net income it gave to shareholders.

Gildan's statement of retained earnings needs explanation. Start with 2008. At October 5, 2008, Gildan had retained earnings of $689,190 (line 1). During 2009, Gildan earned net income of $95,329 (line 2). Gildan ended 2009 with retained earnings of $784,519 (line 3).

EXHIBIT 1-7 **Statement of Retained Earnings (Partial, Adapted)**

Gildan Activewear Inc.
Consolidated Statements of Shareholders' Equity (Partial, Adapted)
(in thousands of U.S. dollars)

	Year ended October 4, 2009	Year ended October 5, 2008*
Retained earnings:		
1. Balance, beginning of year	$689,190	$542,840
2. Net earnings	95,329	146,350
3. Balance, end of year	$784,519	$689,190

* The *CICA Handbook* Section 3031 "Inventories" was issued in 2007 and was effective for companies with fiscal years beginning on or after January 1, 2008. As a result, the company applied Section 3031 for the 2009 statements and recast the 2008 statements.

Which item on the statement of retained earnings comes directly from the income statement? It's net income. Line 2 of the retained earnings statement comes directly from line 11 of the income statement. Trace this amount from one statement to the other.

Give yourself a pat on the back. You're already learning how to analyze financial statements!

After a company earns net income, the board of directors decides whether to pay a dividend to the shareholders. Corporations are not obligated to pay dividends unless their boards decide to pay (i.e., declare) them. Usually, companies who are in development stages or growth mode (like Gildan Activewear Inc.) elect not to pay dividends, opting instead to plow the money back into the company to expand operations or purchase property, plant, and equipment. Established companies usually have enough accumulated retained earnings (and cash) to pay dividends.

USING THE STATEMENT OF SHAREHOLDERS' EQUITY IN DECISION MAKING

The manager, the investor, and the creditor are interested in seeing how much of Gildan's income was paid in dividends and how much was invested back (retained) in the business.

Manager—As Gildan is following a strategy of acquisition and debt repayment, management would choose to retain income in the business. This decision would also be influenced by the fact that economic conditions are just beginning to improve.

Investor—Gildan did not pay dividends, which should increase the share value of Gildan's shares. The individual investor's investment strategy will determine how the investor views this information.

Creditor—Gildan chose to retain cash in the business, which provides a creditor with a positive basis for review of Gildan's financial position.

The Balance Sheet Measures Financial Position

A company's **balance sheet**, also called the **statement of financial position**, reports three main categories: assets, liabilities, and shareholders' or owners' equity. Gildan Activewear Inc.'s Consolidated Balance Sheets, shown as Exhibit 1-8, are dated at the *moment in time* when the accounting periods end.

EXHIBIT 1-8 **Balance Sheet (Adapted)**

Gildan Activewear Inc.
Consolidated Balance Sheets
(in thousands of U.S. dollars)

	As at October 4, 2009	As at October 5, 2008*
Current Assets		
1. Cash and cash equivalents	$ 99,732	$ 12,357
2. Accounts receivable	166,762	215,833
3. Inventories	301,867	316,172
4. Prepaid expenses and deposits	11,604	10,413
5.	579,965	554,775
6. Property, plant, and equipment	414,538	436,516
7. Intangible assets	56,757	59,954
8. Other assets	9,985	17,277
9. Assets held for sale	6,544	10,497
10. Goodwill	6,709	6,709
11. Future income taxes	7,910	9,283
12. Total assets	$1,082,408	$1,095,011
Current Liabilities		
13. Accounts payable and accrued liabilities	$ 124,378	$ 149,344
14. Income taxes payable	11,822	46,627
15. Current portion of long-term debt	2,803	3,556
16.	139,003	199,527
17. Long-term debt	1,584	49,448
18. Future income taxes	23,764	27,331
19. Non-controlling interest in consolidated joint venture	7,272	7,162
Commitments and contingencies		
	171,628	283,468
Shareholders' equity		
20. Share capital	93,042	89,377
21. Contributed surplus	6,976	6,728
22. Retained earnings	784,519	689,190
23. Accumulated other comprehensive income	26,248	26,248
24.	810,767	715,438
25.	910,785	811,543
26. Total liabilities and shareholders' equity	$1,082,408	$1,095,011

* The *CICA Handbook* Section 3031 "Inventories" was issued in 2007 and was effective for companies with fiscal years beginning on or after January 1, 2008. As a result, the company applied Section 3031 for the 2009 statements and recast the 2008 statements.

Assets. Assets are subdivided into two categories: current and long-term. **Current assets** includes cash and cash equivalents as well as those assets the company expects to convert to cash, sell, or consume during the next 12 months or within the business's normal operating cycle if longer than a year. Current assets for Gildan consist of cash and cash equivalents, accounts receivable, inventories, prepaid expenses, and deposits (lines 1 to 4). Gildan's current assets total $579,965 at October 4, 2009 (line 5).

Cash is a liquid asset that is a medium of exchange and *cash equivalents* include money market funds and other instruments that are easily convertible to cash. Gildan has $99,732 in cash and cash equivalents at October 4, 2009 (line 1).

Accounts receivable, $166,762 (line 2), are the amounts due to Gildan primarily for products purchased from the company on account (credit) and are amounts the company expects to collect from customers.

Inventory (Inventories) (line 3) are the company's second biggest current asset, totalling $301,867. Inventory is a common abbreviation for *merchandise inventory*; the two names are used interchangeably.

Prepaid expenses and deposits, $11,604 (line 4) represent prepayments for advertisements and for rent, insurance, and supplies that have not yet been used up. Prepaid expenses are assets because Gildan will benefit from these expenditures in the future.

Property, plant, and equipment of $414,538 (line 6) includes Gildan's land, buildings, computers, and production equipment. Gildan reports property, plant, and equipment at its net book value (historical cost minus accumulated depreciation). The actual Gildan financial statements have a footnote for property, plant, and equipment that shows the costs and accumulated depreciation of all the property, plant, and equipment owned by Gildan Activewear Inc. The note shows that Gildan deducts the accumulated depreciation from the total costs of the property, plant, and equipment to calculate the carrying amount of $414,538 thousand shown on the balance sheet. That amount is the portion of the property, plant, and equipment that has not yet been depreciated (used up). *Cost* means the acquisition price to Gildan. It does not mean that Gildan could sell its property, plant, and equipment at the cost prices. After all, the company may have acquired the assets several years ago.

Intangible assets, $56,757 (line 7), are assets with no physical form. Gildan's intangible assets include customer contracts and customer relationships. They are being amortized on a straight-line basis over 20 years.

Other assets, $9,985 (line 8), include long-term prepaid expenses, a long-term receivable, and restricted cash related to an acquisition.

Assets held for sale, $6,544 (line 9), includes property, plant, and equipment from closed facilities that are being held for sale.

Goodwill, $6,709 (line 10) represents the excess of the purchase price of a subsidiary over the net identifiable assets acquired.

Future income taxes, $7,910 (line 11), represents long-term tax benefits.

Overall, Gildan Activewear Inc. reports total assets of $1,082,408 (line 12) at October 4, 2009.

Liabilities. Liabilities are also divided into two categories: current and long-term. **Current liabilities** (lines 13 to 15) are debts payable within one year or within the entity's normal operating cycle if longer than a year. Current liabilities for Gildan Activewear Inc. at October 4, 2009, consist of accounts payable and accrued liabilities, income taxes payable, and the current portion (due in 2010) of the long-term debt. Gildan's current liabilities total $139,003 (line 16).

Accounts payable and accrued liabilities of $124,378 thousand (line 13) represents amounts owed for goods and services that Gildan has purchased but not yet paid for.

Income taxes, $11,822 (line 14), represents income taxes payable for the fiscal year ended October 4, 2009.

Current portion of long-term debt of $2,803 (line 15) represents the current portion of the long-term debt reported in line 17.

Long-term liabilities are those liabilities that are due beyond one year after the balance sheet date. The long-term liabilities include long-term debt, future income taxes, and non-controlling interest in consolidated joint venture.

Long-term debt of $1,584 (line 17) represents debt due in future years.

Future income taxes of $23,764 (line 18) on the liability side represent taxes payable in future years. They arise because of timing differences between income for accounting purposes and income for tax purposes.

Non-controlling interest in consolidated joint venture of $7,272 (line 19) is the other partner in the joint venture's share of the joint venture's net assets. Gildan includes the joint venture's assets and liabilities in the amounts shown on the Consolidated Balance Sheets and so must deduct the amount on line 19 so that the amount on line 12 minus the amounts on lines 13 to 18 reflect only Gildan's share of the joint venture's net assets.

At October 4, 2009, total liabilities are $171,623 (total assets of $1,082,408 minus total shareholders' equity of $910,785). This is just 15.8% of total assets.

STOP + THINK

Examine Gildan's balance sheet in Exhibit 1-8. Look at total assets on line 12. What is your opinion of the change in total assets and total liabilities during fiscal 2009? Is it good news, bad news, or no news? Why? To what other item should you relate the change in total assets? Identify that item, its change during 2009, and state why it too is important.

Answer:

It is important to look at the complete picture and not to focus just on a part. Total assets declined from $1,095,011 to $1,082,408, a decrease of $12,603, but total liabilities must have declined more as shareholders' equity increased from $811,543 to $910,78, an increase of $99,242. Gildan is in a stronger financial position at October 4, 2009, than it was at October 5, 2008.

Owners' Equity. The accounting equation states that

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$$

The assets (resources) and the liabilities (debts) of Gildan are fairly easy to understand. Owners' equity is harder to understand. Owners' equity is simple to calculate, but what does it *mean*?

MyAccountingLab

Accounting Cycle Tutorial
Income Statement Accounts and Transactions Tutorial

Gildan Activewear Inc. calls its owners' equity *shareholders' equity*, and this title is descriptive. Remember that a company's owners' equity represents the shareholders' ownership of business assets. Owners' equity for Gildan consists of common shares, represented by almost 121 million shares issued to shareholders for approximately $93,042 through October 4, 2009 (line 20).

Contributed surplus of $6,976 (line 21) results from transactions related to stock options. The subject is dealt with in an advanced accounting course.

Retained earnings are $784,519 (line 22). Trace the $784,519 ending balance of retained earnings from the statement of retained earnings in Exhibit 1-7 (line 3) to the balance sheet in Exhibit 1-8 (line 22). Retained earnings links the statement of retained earnings to the balance sheet.

Accumulated other comprehensive income of $26,248 (line 23) is the accumulated change in shareholders' equity from all sources other than from the owners of the business. For example, unrealized foreign currency translation gains and losses are included in accumulated other comprehensive income. Retained earnings and other comprehensive income total $810,767 (line 24).

At October 4, 2009, Gildan has total shareholders' equity of $910,785 (line 24). We can now prove that Gildan's total assets equal the company's total liabilities and equity (amounts in thousands):

Total assets (line 12)		$1,082,408	
Current liabilities (line 16)	$139,003		
Long-term liabilities (lines 17 to 19)	32,620		Must
Total liabilities		$171,623	equal
+ Total shareholders' equity (line 25)		910,785	
Total liabilities and shareholders' equity (line 26)		$1,082,408	

USING THE BALANCE SHEET IN DECISION MAKING

By examining the balance sheet, investors and creditors are able to determine whether or not the company is able to pay its debts.

Is Gildan collecting receivables?

- Yes. Accounts receivable for 2009 are less than 2008, which reflects the decrease in sales revenue year over year and indicates that accounts receivable are being collected on a timely basis.

Can Gildan pay its current liabilities?

- Yes. Current assets are more than 4 times greater than current liabilities in 2009, whereas the difference was 2.75 times in 2008.

Can Gildan pay its current and long-term liabilities?

- Yes. Total assets of $1,082,408 are greater than total liabilities of $171,623.

Manager—Will cash flow be available to cover costs of business in the next year? What is our debt obligation over the next fiscal period? Cash and accounts receivable will provide funds to pay current accounts payable, enabling management to purchase resources required for ongoing business activity. The current portion of long-term debt is $2,803, which will be paid in the next fiscal period.

Investor—Are retained earnings increasing? Has an investor's investment been diluted through the issuance of more shares? Retained earnings have increased, reflecting an increased value of the company's net worth. Some additional shares have been issued, however, an investor's position would not be materially diluted.

Creditor—Does Gildan have debt? Will it be able to repay any debt currently held?

Yes. Gildan does have current debt of $2,803 plus long-term debt of $1,584 thousand totalling $4,387. Gildan has sufficient funds to carry and pay this debt. A request for funds to expand the business would be considered positively in context of the October 4, 2009, balance sheet

The statement of cash flows is the last required financial statement.

The Statement of Cash Flows Measures Cash Receipts and Payments

Companies engage in three basic types of activities:

1. **Operating activities**
2. **Investing activities**
3. **Financing activities**

The **statement of cash flows** reports cash flows under these three categories. Think about the cash flows (cash receipts and cash payments) in each category:

- *Companies operate by buying, and then selling, goods and services to customers.* **Operating activities** result in net income or net loss, and they either increase or decrease cash. The income statement tells whether the company is profitable. The statement of cash flows reports whether operations provided cash or used cash. Operating activities are most important and they should be the company's main source of cash. Continuing negative cash flows from operations can lead to bankruptcy.
- *Companies invest in long-term assets.* Gildan buys buildings and equipment. When these assets wear out, the company disperses of them. These are investing activities. Both purchases and sales of property, plant, and equipment are investing cash flows. Investing cash flows are next most important after operation.
- *Companies need money for financing.* **Financing includes** both issuing and repurchasing shares of stock and borrowing and repaying funds. Gildan issues shares to its shareholders and repays long-term debt. These receipts and payments are financing cash flows.

Overview. Each category of cash flows—operating, financing, and investing—either increases or decreases cash. In Exhibit 1-9, which shows Gildan Activewear Inc.'s Consolidated Statement of Cash Flows, operating activities provided cash of $169,179 (line 16) in the year ended October 4, 2009. This signals strong cash flow from operations. Fiscal 2009's financing activities used $47,711 (line 23). Fiscal 2009's investing activities (purchase of property, plant, and equipment) used cash of $34,198 (line 29). That signals expansion. On a statement of cash flows, cash receipts appear as positive amounts. Cash payments are negative and enclosed by parentheses.

Overall Gildan Activewear Inc.'s cash increased by $87,375 in the year ended October 4, 2009 (line 31), and ended the year at $99,732 (line 33). Trace ending cash back to the balance sheet in Exhibit 1-8 (line 1). Cash links the statement of cash flows to the balance sheet. You've just performed more financial statement analysis.

EXHIBIT 1-9 **Statement of Cash Flows**

Gildan Activewear Inc.
Consolidated Statements of Cash Flows
(in thousands of U.S. dollars)

	Year ended October 4, 2009	Year ended October 5, 2008*
Cash flows from (used in) operating activities		
1. Net earnings	$ 95,329	$146,350
Adjustments for:		
2. Depreciation and amortization	55,407	57,135
3. Variation of depreciation included in inventories	(2,437)	(957)
4. Restructuring charges related to assets held for sale and property, plant, and equipment	978	2,174
5. Loss on disposal of property, plant, and equipment	561	1,369
6. Stock-based compensation costs	3,007	2,965
7. Future income taxes	(2,434)	(15,885)
8. Non-controlling interest	110	230
9. Unrealized net (gain) loss on foreign exchange and financial derivatives	(1,012)	(2,222)
10.	159,507	191,159
Changes in non-cash working capital balances:		
11. Accounts receivable	48,351	10,263
12. Inventories	16,742	(31,178)
13. Prepaid expenses and deposits	(1,191)	(881)
14. Accounts payable and accrued liabilities	(22,731)	25,700
15. Income taxes payable	(31,499)	43,802
16.	169,179	238,865
Cash flows from (used in) financial activities		
17. (Decrease) increase in amounts drawn under revolving long-term credit facility	(45,000)	(4,000)
18. Decrease in bank indebtedness	—	(2,739)
19. Increase in other long-term debt	44	2,805
20. Repayments of other long-term debt	(3,661)	(5,461)
21. Proceeds from the issuance of shares	906	1,138
22. Repurchase of shares	—	(12)
23.	(47,711)	(8,269)
Cash flows from (used in) investing activities		
24. Purchase of property, plant, and equipment	(44,938)	(97,030)
25. Business acquisition	(1,196)	(126,819)
26. Restricted cash related to business acquisition	3,958	(10,000)
27. Proceeds on disposal of assets held for sale	6,349	3,736
28. Net decrease (increase) in other assets	1,629	2,826
29.	(34,198)	(227,287)
30. Effect of exchange rate changes on cash and cash equivalents denominated in foreign currencies	105	(202)
31. Net increase (decrease) in cash and cash equivalents during the year	87,375	3,107
32. Cash and cash equivalents, beginning of year	12,357	9,250
33. Cash and cash equivalents, end of year	$ 99,732	$ 12,357

* The *CICA Handbook* Section 3031 "Inventories" was issued in 2007 and was effective for companies with fiscal years beginning on or after January 1, 2008. As a result, the company applied Section 3031 for the 2009 statements and recast the 2008 statements.

USING THE STATEMENT OF CASH FLOWS IN DECISION MAKING

Investors and creditors can examine the statement of cash flows to see the decisions management made in terms of receiving and spending the company's cash.

Did Gildan's operating activities provide strong cash flow?

- Yes. Most of the increase in funds was provided by operating activities.

Did Gildan invest during the fiscal period?

- Yes. Property, plant, and equipment were purchased.

Did Gildan increase its debt or issue shares?

- Debt was reduced as amounts drawn under revolving long-term credit facility were decreased and payment was made on long-term debt.
- Some shares were issued, proceeds of which were $906.

Manager—Can inventories be increased to increase sales levels? Yes, operating cash is available. Can the purchase of equipment for a new product line be finaced? Yes. As debt is being repaid, there is a good possibility for additional loans. There is opportunity to issue shares to raise capital for investment.

Investor—Does business have a strong base to go forward on? Yes. Operating activities are providing cash flow. Is the company investing its cash effectively? Yes. The company is purchasing property, plant, and equipment. Is the company issuing shares? Yes. The company continues to build a strong shareholder base.

Creditor—Is the company borrowing to provide operating cash flow? No. The company has borrowed to finance the purchase of assets and acquire other operating companies. Is the company paying down its debt? Yes. The revolving long-term credit facility has decreased and payment was made on long-term debt.

The Notes to the Financial Statements Provide Additional Information

The notes to the financial statements are an integral part of the financial statements and should be read carefully as part of a review of the financial statements. The notes provide information that cannot be reported conveniently on the face of the financial statements. For example, the notes tell the readers information such as what accounting policies were used in preparing the financial statements, and what methods were used to account for inventories and depreciation. An example of these notes can be found in Appendix A: Annual Report for Gildan Activewear Inc. Note that each of Gildan's financial statements carries the statement "See accompanying notes to the consolidated financial statements."

Let's now summarize the relationships that link the financial statements.

Relationships Among the Financial Statements

Huron Ltd. (Exhibit 1-10) provides a simple example of the relationships among the financial statements. These statements are summarized with all amounts assumed for the illustration. Study the exhibit carefully because these relationships apply to all organizations.

OBJECTIVE

4 **Explain** the relationships among the financial statements

EXHIBIT 1-10 **Relationships Among the Financial Statements**

Huron Ltd.
Income Statement
For the Year Ended December 31, 2011

Revenues	$ 700,000
Expenses	670,000
Net income	$ 30,000

①

Huron Ltd.
Statement of Retained Earnings
For the Year Ended December 31, 2011

Beginning retained earnings	$ 120,000
Net income	30,000
Cash dividends	(10,000)
Ending retained earnings	$140,000

②

Huron Ltd.
Balance Sheet
As at December 31, 2011

Assets	
Cash	$ 25,000
All other assets	275,000
Total assets	$300,000
Liabilities	
Total liabilities	$120,000
Shareholders' Equity	
Common shares	40,000
Retained earnings	140,000
Total liabilities and shareholders' equity	$300,000

③

Huron Ltd.
Statement of Cash Flows
For the Year Ended December 31, 2011

Net cash provided by operating activities	$ 90,000
Net cash used for investing activities	(110,000)
Net cash provided by financing activities	40,000
Net increase in cash	20,000
Beginning cash balance	5,000
Ending cash balance	$ 25,000

Specifically, note the following.

1. The income statement for the year ended December 31, 2011,
   a. Reports all revenues and all expenses during the period. Revenues and expenses are reported *only* on the income statement.
   b. Reports net income if total revenues exceed total expenses. If expenses exceed revenues, there is a net loss.
2. The statement of retained earnings for the year ended December 31, 2011,
   a. Opens with the beginning retained earnings balance.
   b. Adds net income (or subtracts net loss). Net income comes directly from the income statement (arrow ① in Exhibit 1-10).
   c. Subtracts dividends.
   d. Ends with the retained earnings balance at the end of the year.
3. The balance sheet at December 31, 2011, at the end of the accounting year
   a. Reports all assets, liabilities, and shareholders' equity at the end of the period. Only the balance sheet reports assets and liabilities.
   b. Reports that assets equal the sum of liabilities plus shareholders' equity. This balancing feature gives the balance sheet its name; it follows the accounting equation.
   c. Reports ending retained earnings, which comes from the statement of retained earnings (arrow ② in Exhibit 1-10).
4. The statement of cash flows for the year ended December 31, 2011,
   a. Reports cash flows from operating activities, investing activities, and financing activities. Each category results in net cash provided (an increase) or net cash used (a decrease).
   b. Reports that cash increased or decreased during the period and ends with the cash balance on December 31, 2011. Ending cash is reported on the balance sheet (arrow ③ in Exhibit 1-10).

Understanding How Accounting Standards Are Set

OBJECTIVE

5 **Understand** financial accounting standards

Accountants follow professional guidelines called **GAAP**, which stands for **generally accepted accounting principles (GAAP)**. The Canadian Institute of Chartered Accountants (CICA) has the responsibility for issuing accounting standards that form the basis of GAAP used. GAAP are like the laws of accounting: rules for conducting behaviour in a way acceptable to the majority of people. The rules that govern how accountants measure, process, and communicate financial information fall under the heading GAAP.

The Accounting Standards Board (AcSB) was established by the CICA to "establish accounting and reporting standards for Canadian companies and not-for-profit organizations." The Public Sector Accounting Board (PSAB) was created by the CICA to "set accounting standards for the public sector." The Accounting Standards Oversight Council (AcSOC) was established by the CICA to "serve the public interest by overseeing and providing input into the activities of both the AcSB and the PSAB."*

* See www.cica.ca.

The Canadian Securities Administrators, a body composed of officials appointed by the provincial and territorial governments with securities exchanges to set securities law, issued National Policy Statement 27 (NP 27) designating the *CICA Handbook* as generally accepted accounting principles. The *Canada Business Corporations Act* also designated the *CICA Handbook* as GAAP, and the *Ontario Securities Act* followed suit. In these ways, the CICA became the official promulgator of generally accepted accounting principles. Exhibit 1-11 illustrates how the authority for setting GAAP is delegated to the CICA by the federal and provincial and territorial governments and the Securities Administrators.

The world of commerce is becoming more global and as accounting became more complex, the existence of different GAAP in each of the countries of the world made comparisons between companies almost impossible. The global accounting profession, international banks, multinational corporations, and organizations such as the World Bank recognized the need for international accounting standards. In response, the International Accounting Standards Board (IASB) was set up in 2001 in London, England. The IASB issues **International Financial Reporting Standards (IFRS)**, which are being adopted as generally accepted accounting principles in Canada and around the world (Exhibit 1-12).

In 2006, the AcSB made the decision to converge Canadian GAAP for Canadian publicly accountable enterprises with IFRS. The last year for reporting under Canadian GAAP will be the year ending December 31, 2010. Reporting under IFRS standards will be required for annual periods beginning on or after January 1, 2011.

EXHIBIT 1-11 Flow of Authority for Developing GAAP

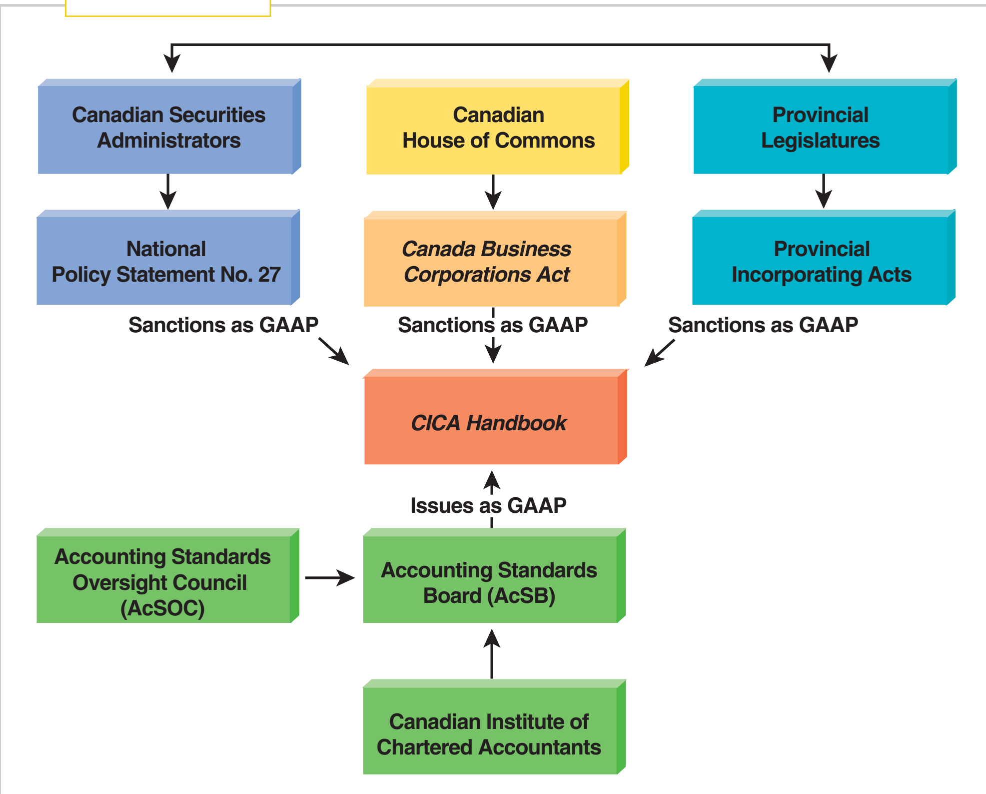
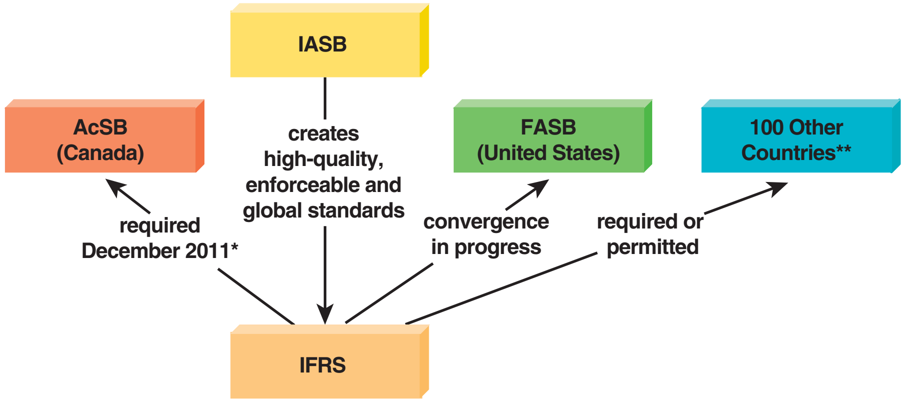


EXHIBIT 1-12 Creation and Convergence of International Financial Reporting Standards



*Required for publicly accountable enterprises
**Includes the European Union.

Publicly accountable enterprises (PAEs) are corporations that have issued or plan to issue shares or debt in public markets. PAEs are required to follow International Financial Reporting Standards established by the IASB. **Private enterprises (PEs)** are required to follow the accounting standards in Part II of the *CICA Handbook* entitled "Accounting Standards for Private Enterprises," (ASPE). These standards were developed by the AcSB. Since the financial information of private enterprises is not released or used by the public, requiring them to follow IFRS exclusively would be too time consuming and costly. While the focus of this text will be on IFRS, differences between GAAP for PAEs and GAAP for PEs will be highlighted throughout the book.

Multiple GAAPs

The *CICA Handbook – Accounting* previously included accounting principles that generally applied to entities in all sectors except the public sector. The Accounting Standards Board, in order to deal with convergence of Canadian accounting standards with IFRS, divided the *CICA Handbook – Accounting* into five parts:

- Part I: International Financial Reporting Standards, which must be followed by PAEs.
- Part II: Accounting Standards for Private Enterprises, which are followed by PEs.
- Part III: Accounting Standards for Not-for-Profit Organizations. The CICA is presently revising accounting standards for not-for-profit entities.
- Part IV: Accounting Standards for Pension Plans. Accounting standards for pension plans will be added to this part of the handbook once the Accounting Standards Board completes its deliberations on this topic.
- Part V: Pre-changeover Accounting Standards are applied by an entity prior to its adoption of parts I to IV of the handbook.

In addition, there is a *CICA Public Sector Accounting Handbook*, which includes standards and guidance issued by the Public Sector Accounting Board regarding federal, provincial and territorial, and municipal reporting units. This text will discuss the standards in Part I and the standards in Part II where applicable.

The Accounting Conceptual Framework and Accounting Characteristics and Assumptions

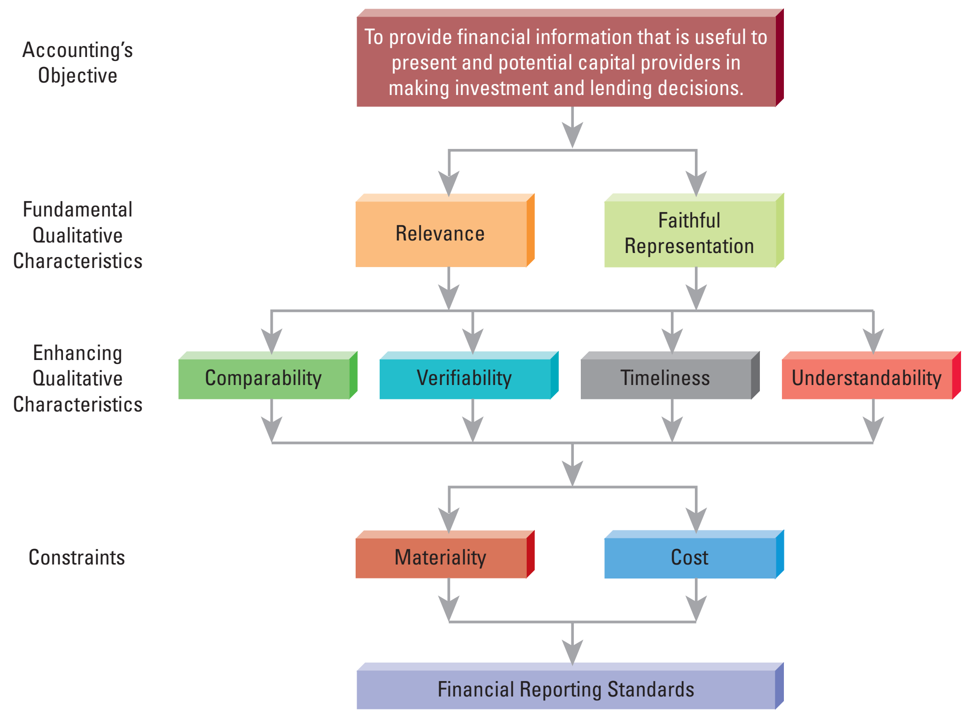
Financial standards follow a conceptual framework. Exhibit 1-13 gives an overview of the joint conceptual framework developed by the IASB and the Financial Accounting Standards Board (FASB) in the U.S. The overall *objective* of accounting is to provide financial information that is useful to present and future capital providers in making investment and lending decisions. In this sense capital means resources (usually cash). The two basic external providers of capital include investors (who exchange cash for shares) and creditors (who loan cash) to the entity.

To be useful, information must have the fundamental qualitative characteristics. Those include:

- Relevance
- Faithful representation

To have **relevance**, information must be capable of making a difference to the decision maker, having predictive or confirming value. **Faithful representation** means that decision-useful information about an economic phenomenon is

EXHIBIT 1-13 Conceptual Foundation of Accounting



Source: FASB, IASB, Joint Conceptual Framework for Reporting (Exposure Draft), 2008.

complete, neutral (free from bias), and not materially misstated (accurate). Accounting information must focus on the *economic substance* of a transaction, event, or circumstance, which may or may not always be the same as its legal form.

Accounting information must also have a number of *enhancing qualitative characteristics*. These include

- Comparability
- Verifiability
- Timeliness
- Understandability

Comparability means that the accounting information for a company must be prepared in such a way as to be capable of being both compared with information from other companies in the same period, and *consistent* with similar information for that company in previous periods. *Verifiability* means that the information must be capable of being checked for accuracy, completeness, and faithful representation. The process of verifying information is often done by *internal* as well as *external auditors*. Verifiability enhances the faithful representation of information, and thus makes the information more representative of economic reality. *Timeliness* means that the information must be made available to users early enough to help them make decisions, thus making the information more relevant to their needs. *Understandability* means that the information must be sufficiently transparent so that it makes sense to reasonably informed users of the information (investors, creditors, regulatory agencies, and managers).

Accounting information is also subject to constraints. These include

- Materiality
- Cost

Materiality means that the information must be important enough to the informed user so that if it were omitted or erroneous, it would make a difference in the user's decision. Only information that is material needs to be separately *disclosed* (listed or discussed) in the financial statements. If not, it does not need separate disclosure, but may be combined with other information. Accounting information is costly to produce, and the *cost should not exceed the expected benefits* to users. Management of companies is primarily responsible for preparing accounting information. Managers must exercise judgment in determining whether the information is sufficiently material and not excessively costly to warrant separate disclosure.

The Entity Assumption

The most basic accounting assumption (underlying idea) is that of the **entity**, which is any organization that stands apart as a separate economic unit. Sharp boundaries are drawn around each entity so as not to confuse its affairs with those of others.

Consider John Forzani, chairman of the board of The Forzani Group Ltd., the sporting goods chain. Mr. Forzani owns a home and automobiles, among other family possessions. He may owe money on some personal loans. All these assets and liabilities belong to John Forzani and have nothing to do with The Forzani Group Ltd. Likewise, The Forzani Group Ltd.'s cash, computers, and store equipment belong to the company, not to John Forzani. Why? Because the entity concept draws a sharp boundary around each entity. In this case The Forzani Group Ltd. is one entity and John Forzani is a separate entity.

Let's consider Gildan, which has several product lines—T-shirts, fleeces, underwear, and socks. Gildan management evaluates each product line as a separate entity. If socks sales are dropping, Gildan can identify the reason. But if sales figures from all product lines of the company are combined, then management cannot tell how many pairs of socks the company is selling. To correct the problem, managers need data for each product line of the company. The transactions of different units should not be accounted for together. Each unit should be evaluated separately.

The Going-Concern Assumption

The **going-concern assumption** assumes that the entity will remain in operation long enough to use existing assets—land, buildings, supplies—for their intended purposes. Consider the alternative to the going-concern assumption: going out of business. An entity that was not continuing would have to sell all its assets rather than use them. In that case, the most *relevant* measure of the assets would be their liquidation values (the amount the company would receive for the assets when sold in a forced sale). But going out of business is the exception rather than the rule. Therefore, the going-concern assumption takes for granted that a business will stay in business long enough to recover the cost of its assets by using those assets for their intended purpose.

The Cost Assumption

The **cost assumption** requires that assets and liabilities be measured at their cost when they are acquired or assumed. Cost is the amount paid for the asset. For example, if Gildan buys a building for $590,000 that the owner is offering for sale at $645,000 and that has an appraised value of $620,000, the purchase should be recorded at $590,000. The amount of the $590,000 would be the fair value of the asset *at the time of acquisition*.

The Stable-Monetary-Unit Assumption

In Canada, we record transactions in Canadian dollars, the medium of exchange. British accountants record transactions in pounds sterling, and Japanese accountants in yen. Europeans who belong to the European Union price goods and services in euros.

Unlike a litre or a kilometre, the value of a Canadian dollar or a Mexican peso changes over time against other currencies. A rise in the general price level is called *inflation*. During inflation, a dollar will purchase less milk, less toothpaste, and less of other goods. When prices are stable—when there is little inflation—a dollar's purchasing power is also stable.

Accountants assume that the dollar's purchasing power is relatively stable under the **stable-monetary-unit assumption**. We ignore inflation, and this allows us to add and subtract dollar amounts as though each dollar had the same purchasing power.

STOP + THINK

You are considering the purchase of land for future expansion. The seller is asking $50,000 for land that cost the seller $35,000. An appraisal shows a value of $47,000. You first offer $44,000, the seller makes a counter-offer of $48,000, and you agree on $46,000. What dollar value is recorded for the land in your accounting records?

Answer:
Record the land at $46,000, which is its cost.

ACCOUNTING FOR FINANCIAL STATEMENTS

I. The accountant must be aware of the objective of accounting, which is to provide financial information that is useful to present and potential capital providers in making investment and lending decisions.

In order to provide financial statements that contain such information, the fundamental qualitative characteristics of *relevance* and *faithful representation*, and the enhancing qualitative characteristics of *comparability*, *verifiability*, *timeliness*, and *understandability*, must be considered subject to the constraints of *materiality* and *cost*.

II. The accountant must be aware of certain assumptions that underlie the financial statements.

One of the more significant assumptions is that the business will remain a going concern for the foreseeable future (usually one year from the balance sheet date). The *going-concern assumption* means that the company will remain in business long enough to use its assets for their intended purposes.

Another assumption is the *entity* assumption, which states that all transactions included in the financial statements are transactions of the company and that no transactions are included that are not company transactions.

Ethics in Business and Accounting Decisions

OBJECTIVE

6 **Understand** the role of ethics in business and accounting decisions

ETHICS ALERT!

Ethical behaviour by those who prepare financial statements and those who audit the financial statements is very important because so many decision makers—managers, investors, creditors, regulators, and many others—rely on those financial statements. All those users rely on the competence and integrity of the preparers and the auditors. Financial markets in Canada, the United States, the United Kingdom, and many other countries operate as efficiently and effectively as they do because of the quality of the complex services provided by accountants within the companies and the auditors outside the companies who audit the financial statements. The market runs smoothly because participants have confidence in the quality of these services.

Companies need money to operate. To attract investors and obtain loans, companies must provide information to the public. Without that information, people won't invest. The Canadian and provincial governments have laws that require companies to report relevant information to outsiders. Relevant information has predictive value or feedback value and is timely and thus can influence a decision. Faithful representation means the information is verifiable and is free from bias.

Occasionally, a company will report biased information. It may overstate profits or understate the company's debts. In recent years, Livent Inc., the theatrical production company, allegedly kept two sets of books and falsified its financial reports. Several well-known U.S. companies were charged with reporting misleading information. Enron Corporation, at the time one of the largest companies in the United States, admitted understating its liabilities (debts). Xerox and WorldCom were accused of overstating profits. If these accusations were true, the published financial data of these companies were not a faithful representation and thus failed the basic test of good ethics. The result? People invested in them, lost money, and filed lawsuits to recover their losses. Reporting relevant information that is a faithful representation to the public is the ethical course of action.

Standards of Professional Conduct for Accountants. What are the criteria for ethical judgments in accounting? The three professional accounting bodies discussed below, other professional organizations, and large companies have codes of conduct that require high levels of ethical conduct. There is a need for high standards of ethical behaviour by accountants if people are going to rely on information for decision making produced by or audited by those accountants.

The influence of accounting in today's business world has emphasized the need for high professional, educational, and ethical standards for accountants. Through statutes passed by provincial legislatures, the three accounting organizations in Canada have received the authority to set educational requirements and professional standards for their members and to discipline members who fail to adhere to their codes of conduct. The acts make them self-regulating bodies, just as provincial associations of doctors and lawyers are.

The *Canadian Institute of Chartered Accountants (CICA)*, whose members are Chartered Accountants or CAs, is the oldest accounting organization in Canada. CAs belong to a provincial institute (*ordre* in Quebec) and through that body to the CICA. The provincial institutes and *ordre* grant the right to use the professional designation CA and have the responsibility for developing and enforcing the code of professional conduct that guides the actions of the CAs in that province.

Members of the *Certified General Accountants Association of Canada (CGAAC)* are allowed to use the designation Certified General Accountant or CGA. They belong to provincial associations (*ordre* in Quebec) and, in turn, to the CGAAC. The provincial associations and *ordre* grant the right to use the professional designation CGA and are responsible for developing and administering the code of professional conduct that guides the actions of the CGAs in that province.

Members of the *Society of Management Accountants of Canada (SMAC)* are permitted to use the designation Certified Management Accountant or CMA. They belong to provincial societies (*ordre* in Quebec) and, in turn, to the SMAC. The provincial societies and *ordre* grant the right to use the professional designation CMA and are responsible for developing and administering the code of professional conduct that guides the actions of CMAs in that province.

The recent corporate failures have driven home the need for good ethics among accountants as never before.

We Need an Audit to Validate the Financial Statements

Throughout this book we use actual examples to show how accounting relates to your daily activities.

Gildan Activewear Inc. reports that it is profitable. But did the company really sell that much activewear, underwear, and socks? Were profits really $95,329? Who reports these figures?

Gildan's top management is responsible for both (a) company operations—how well the company *really* performs—and (b) the information Gildan *reports* to the public. Can you see the conflict of interests here? A company's real performance may differ from what gets reported to the public. Company management has a built-in motivation to make the company look strong, especially when times are tough. Most managers are highly principled men and women, but a few managers have "cooked the books" to overstate their companies' *reported* profits.

How does society deal with this conflict of interests? Canadian and provincial regulation and securities acts require all companies that sell shares to the public to have an annual audit by independent accountants. Audits are intended to protect the public by ensuring that accounting data are relevant and a faithful representation. It turns out that Gildan Activewear Inc. passed the audit test. The accounting firm of KPMG LLP audited the financial statements of Gildan Activewear Inc. and stated that in its opinion, "the consolidated financial statements … present fairly, in all material respects, the financial position of the Company and subsidiaries as at October 4, 2009, and October 5, 2008, and the results of their operations and their cash flows for the years ended October 4, 2009, and October 5, 2008 …."

The take-away lesson is this: Avoid a company if its auditor does not state that the company's financial statements "present fairly …"

Good business requires decision making, which in turn requires the exercise of good judgment, at both the individual and corporate levels. Perhaps, as an accountant, you may have to decide whether to record a $50,000 expenditure for a piece of equipment as an asset on the balance sheet or an expense on the income statement. Alternatively, as a sales manager for a company like CHC Helicopter Corporation, you may have to decide whether $25 million of goods and services delivered to customers in 2010 would be more appropriately recorded as revenue in 2010 or 2011. Depending on the type of business, the facts and circumstances surrounding accounting decisions may not always make them clear cut, and yet the decision may determine whether the company shows a profit or a loss in a particular period! What are the factors that influence business and accounting decisions, and how should these factors be weighed? Generally, three factors influence business and accounting decisions: economic, legal, and ethical.

The ***economic*** factor states that often the decision being made is designed to maximize the economic benefits to the decision maker. Sometimes the legal and/or ethical dimensions of the economic decision are ignored—the decision is illegal and/or unethical.

The ***legal*** factor is based on the proposition that free societies are governed by laws. Laws are written to provide clarity and to prevent abuse of the rights of individuals or society. Democratically enacted laws both contain and express society's collective moral standards. Legal analysis involves applying the relevant laws to each decision, and then choosing the action that complies with those laws. A complicating factor for a global business may be that what is legal in one country might not be legal in another. In that case, it is usually best to abide by the laws of the most restrictive country.

The ***ethical*** factor recognizes that while certain actions might be both economically profitable and legal, they may still not be right. Therefore, most companies, and many individuals, have established standards for themselves to enforce a higher level of conduct than that imposed by law. These standards govern how we treat others and the way we restrain our selfish desires. This behavior and its underlying beliefs are the essence of ethics. **Ethics** are shaped by our cultural, socioeconomic, and religious backgrounds. An *ethical analysis* is needed to guide judgment for making decisions.

The decision rule in an ethical analysis is to choose the action that fulfills ethical duties—responsibilities of the members of society to each other. The challenge in an ethical analysis is to identify specific ethical duties and stakeholders to whom you owe these duties. As with legal issues, a complicating factor in making global ethical decisions may be that what is considered ethical in one country is not considered ethical in another.

Ethical training starts at home and continues throughout our lives. It is reinforced by the teaching that we receive in our church, synagogue, or mosque; the schools we attend; and by the persons and companies we associate with.

A thorough understanding of ethics requires more study than we can accomplish in this book. However, remember that, when making accounting decisions, do not check your ethics at the door!

A FRAMEWORK FOR MAKING ETHICAL JUDGMENTS

Weighing tough ethical judgments in business and accounting requires a decision framework. Answering the following four questions will guide you through tough decisions:

Decision	Guidelines
1. What is the issue?	1. The issue will usually deal with making a judgment about an accounting measurement or disclosure that results in economic consequences, often to numerous parties.
2. Who are the stakeholders, and what are the consequences of the decision to each?	2. Stakeholders are anyone who might be affected by the decision—you, your company, and potential users of the information (investors, creditors, regulatory agencies). Consequences can be ethical in nature.
3. Weigh the alternatives.	3. Analyze the impact of the decision on all stakeholders, using ethical criteria. Ask "Who will be helped or hurt, whose rights will be exercised or denied, and in what way?"
4. Make the decision and be prepared to deal with the consequences.	4. Exercise the courage to either defend the decision or to change it, depending on its positive or negative impact. How does your decision make you feel afterward?

To simplify, we might ask three questions:

1. Is the action legal? If not, steer clear, unless you want to go to jail or pay monetary damages to injured parties. If the action is legal, go on to questions (2) and (3).
2. Who will be affected by the decision and how? Be as thorough about this analysis as possible, and analyze it from an ethical standpoint.
3. How will this decision make me feel afterward? How would it make me feel if my family read about it in the newspaper?

In later chapters throughout the book, we will apply this model to different accounting decisions.

In the business setting, ethics work best when modelled "from the top." Corporate Knights Inc. (www.corporateknights.ca) is a Canadian media company that "publishes the world's largest circulation magazine with an explicit focus on corporate responsibility," *Corporate Knights*. The company also publishes reports listing the most socially responsible corporations on a number of different dimensions. Of particular interest for our purposes is Corporate Knights' 2009 report entitled "8th Annual Best 50 Corporate Citizens in Canada." The company's website lists the criteria that were used in compiling the list, which includes such companies as Hydro One, Petro-Canada, TELUS, RONA Inc., Mountain Equipment Co-op,, and Bombardier Inc. As you begin to make your decisions about future employers, put these companies on your list! It's easier to act ethically when those you work for recognize the importance of ethics in business practices. These companies have learned from experience that in the long run, ethical conduct pays big rewards, not only socially, morally, and spiritually, but economically as well!

Chapter Summaries

Each chapter ends with a summary that identifies the major issues raised in the chapter. Read it carefully to ensure that you are familiar with the contents of the chapter.

SUMMARY OF CHAPTER 1

Learning Objective 1: Learn that financial statements are the product of accounting

Accounting is an information system that measures business activities, processes data into reports, and communicates results to decision makers. These **decision makers or users** include investors and creditors (primary users), managers, government and regulatory agencies, taxing authorities, and individuals.

A business can be **organized** as a **proprietorship**, a **partnership**, or a **public** or **private corporation.** A public corporation's shares are traded on a stock exchange while a private corporation's shares are privately held.

Learning Objective 2: Apply the accounting equation to business organizations

The financial statements are based on the **accounting equation** whereby a**ssets equal liabilities and owners' equity**. **Assets** are the resources of the business and include cash, accounts receivable, inventory, and property, plant, and equipment. Financing for these resources comes from two sources: creditors (liabilities) and owners (shareholders). **Liabilities** include accounts payable, notes payable, and long-term debt. **Owners' equity** includes the capital contributed by the owners and retained earnings.

Retained earnings are increased by revenues and decreased by expenses and dividends.

Learning Objective 3: Understand the financial statements and how to use them

The **financial statements** include the **income statement**, **statement of retained earnings, balance sheet,** and **statement of cash flows.**

The **income statement** shows how well the company has performed by reporting the revenue minus all expenses. Users are interested in seeing if the company can sell its products or services and they watch for trends and what percentage of sales revenue ends up as profit.

The **statement of retained earnings** shows users what a company did with its net income and if any amount was distributed by way of dividends to its shareholders.

The **balance sheet** reports the financial position of a company at a point in time. It includes three main categories: assets, liabilities, and shareholders' equity. Users are interested in knowing if the company can collect its receivables and pay both its current and its long-term liabilities.

The **statement of cash flows** reports cash receipts and cash payments classified according to the company's major activities: operating, investing, and financing. Users want to know where the company's cash is coming from and how it is being used.

The **notes to the financial statements** are an integral part of the financial statements and provide information that cannot be reported conveniently on the face of the financial statements.

Learning Objective 4: Explain the relationships among the financial statements

The relationships between the income statement and the statement of retained earnings, between the statement of retained earnings and the balance sheet, and between the statement of cash flows and the balance sheet apply to all organizations.

Learning Objective 5: Understand financial accounting standards

Accountants follow professional guidelines called **generally accepted accounting principles (GAAP).** In Canada, accounting standards are set by boards established by the **Canadian Institute of Chartered Accountants (CICA). The Accounting Standards Oversight Committee (AcSOC)** oversees and provides insight to the deliberations of the **Accounting Standards Board (AcSB),** which sets accounting standards for Canadian companies and not-for-profit organizations, and the **Public Sector Accounting Board (SAB),** which sets standards for the public sector.

The **International Accounting Standards Board (IASB)** develops and issues **International Financial Reporting Standards (IFRS)** that are used in many countries around the world. The AcSB is converging IFRS with Canadian accounting standards. All **publicly accountable enterprises (PAEs)** in Canada are required to use IFRS for reporting in their financial statements. The AcSB has developed A**ccounting Standards for Private Enterprises (ASPE),** which must be used by **private enterprises (PE)** in Canada.

IFRS rest on a conceptual framework. The framework begins with the **objective** of financial reporting and includes the **fundamental qualitative characteristics** of **relevance** and **faithful representation**, as well as the **enhancing qualitative characteristics** of **comparability, verifiability, timeliness,** and **understandability,** all of which make accounting information useful. Accounting concepts include **the entity assumption**, **going-concern assumption**, **the cost assumption**, and **the stable-monetary-unit assumption. Multiple GAAPs** are discussed**.**

Learning Objective 6: Understand the role of ethics in business and accounting decisions

Ethical behaviour by those who prepare financial statements and those who audit the financial statements is very important because so many decision makers—managers, investors, creditors, regulators, and many others—rely on those financial statements.

The **Canadian Institute of Chartered Accountants (CICA)**, the **Certified General Accountants Association of Canada (CGAAC)** and the **Society of Management Accountants of Canada (SMAC)** have **codes of conduct** that require high levels of ethical conduct.

Audits are performed by independent accountants to ensure that financial statements are relevant and a faithful representation.

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END-OF-CHAPTER SUMMARY PROBLEM

J. J. Booth and Marie Savard incorporated Tara Inc., a consulting engineering company, and began operations on April 1, 2011. During April, the business provided engineering services for clients. It is now April 30, and J. J. and Marie wonder how well Tara Inc. performed during its first month. They also want to know the business's financial position at the end of April 30 and cash flows during the month.

The following data are listed in alphabetical order.

Accounts payable	$ 1,800	Land	$ 18,000
Accounts receivable	2,000	Office supplies	3,700
Adjustments to reconcile net income to net cash provided by operating activities	(3,900)	Payments of cash:	
Cash balance at beginning of April	0	Acquisition of land	40,000
Cash balance at end of April	33,300	Dividends	2,100
Cash receipts:		Rent expense	1,100
Issuance (sale) of shares	50,000	Retained earnings at beginning of April	0
Sale of land	22,000	Retained earnings at end of April	?
Common shares (contributed capital)	50,000	Salary expense	1,200
		Service revenue	10,000
		Utilities expense	400

Name: Tara Inc.
Industry: Consulting engineering corporation
Fiscal Period: Month of April 2011

Review the list of accounts provided and determine whether each account is an asset, liability, shareholders' equity, revenue, or expense. Then group the accounts by financial statement.

Required

1. Prepare the income statement, the statement of retained earnings, and the statement of cash flows for the month ended April 30, 2011, and the balance sheet at April 30, 2011. Draw arrows linking the pertinent items in the statements.
2. Answer the investors' underlying questions.
   a. How well did Tara Inc. perform during its first month of operations?
   b. Where does Tara Inc. stand financially at the end of the first month?
3. If you were a banker, would you be willing to lend money to Tara Inc.?
4. What additional information would you want to have before investing in Tara?

ANSWERS

Requirement 1

Financial Statements of Tara Inc.

The title must include the name of the company, "Income Statement," and the specific period of time covered. It is critical that the time period be defined.

Gather all the revenue and expense accounts from the account listing. List the revenue accounts first. List the expense accounts next.

Tara Inc.
Income Statement
For the Month Ended April 30, 2011

Revenue:		
Service revenue		$10,000
Expenses:		
Salary expense	$1,200	
Rent expense	1,100	
Utilities expense	400	
Total expenses		2,700
Net income		$ 7,300

①

Tara Inc.
Statement of Retained Earnings
For the Month Ended April 30, 2011

Retained earnings, April 1, 2011	$ 0
Add: Net income for the month	7,300
	7,300
Less: Dividends	(2,100)
Retained earnings, April 30, 2011	$5,200

The title must include the name of the company, "Statement of Retained Earnings," and the specific period of time covered. It is critical that the time period be defined.

The net income amount (or net loss amount) is transferred from the income statement. Retained earnings at the end of the period is the result of a calculation, and is an accumulation of the corporation's performance since it began.

Tara Inc.
Balance Sheet
As at April 30, 2011

②

Assets		**Liabilities**	
Cash	$33,300	Accounts payable	$ 1,800
Accounts receivable	2,000	**Shareholders' Equity**	
Office supplies	3,700	Common shares	50,000
Land	18,000	Retained earnings	5,200
		Total shareholders' equity	55,200
		Total liabilities and	
Total assets	$57,000	shareholders' equity	$57,000

The title must include the name of the company, "Balance Sheet," and the date of the balance sheet. It shows the financial position at the end of the day.

Gather all the asset, liability, and equity accounts from the account listing. List assets first, then liabilities, then equity accounts. The retained earnings amount is transferred from the statement of retained earnings.

It is imperative that total assets = total liabilities + shareholders' equity.

Tara Inc.
Statement of Cash Flows
For the Month Ended April 30, 2011

③

Cash flows from operating activities:		
Net income		$ 7,300
Adjustments to reconcile net income to net cash		
provided by operating activities		(3,900)
Net cash provided by operating activities		3,400
Cash flows from investing activities:		
Acquisition of land	$(40,000)	
Sale of land	22,000	
Net cash used for investing activities		(18,000)
Cash flows from financing activities:		
Issuance (sale) of shares	$ 50,000	
Payment of dividends	(2,100)	
Net cash provided by financing activities		47,900
Net increase in cash		$33,300
Cash balance, April 1, 2011		0
Cash balance, April 30, 2011		$33,300

The title must include the name of the company, "Statement of Cash Flows," and the specific period of time covered. It is critical that the time period be defined.

Net income comes from the income statement. The adjustments amount was provided. In later chapters, you will learn how to calculate this amount.

Include all transactions that involve investing the company's cash, which involve any changes in the property, plant, and equipment.

Include all cash transactions relating to shares and long-term debt obligations.

Requirements 2, 3, and 4

2. a. The company performed rather well in April. Net income was $7,300—very good in relation to service revenue of $10,000. Tara was able to pay cash dividends of $2,100.

b. The business ended April with cash of $43,300. Total assets of $57,000 far exceed total liabilities of $1,800. Shareholders' equity of $55,200 provides a good cushion for borrowing. The business's financial position at April 30, 2011, is strong.

c. The company has plenty of cash, and assets far exceed liabilities. Operating activities generated positive cash flow in the first month of operations. Lenders like to see these features before making a loan. Most bankers would be willing to lend to Tara Inc. at this time.

3. Most bankers would be willing to lend to Tara Inc. at this time.

4. *What would you like to know in addition to the information provided in the financial statements?*

Consider the net income from the income statement.

Consider net worth, which is total assets minus total liabilities.

Review the Financial Statements

Quick Check (Answers are given on page 59.)

1. All of the following statements are true except one. Which statement is false?
   a. Bookkeeping is only a part of accounting.
   b. A proprietorship is a business with several owners.
   c. Professional accountants are held to a high standard of ethical conduct.
   d. The organization that formulates generally accepted accounting principles is the Canadian Institute of Chartered Accountants (CICA).
2. The recorded cost of assets at time of purchase is based on
   a. The amount paid for the assset.
   b. What it would cost to replace the asset.
   c. Current fair value as established by independent appraisers.
   d. Selling price.
3. The accounting equation can be expressed as
   a. Assets + Liabilities = Shareholders' Equity
   b. Shareholders' Equity − Assets = Liabilities
   c. Assets = Liabilities − Shareholders' Equity
   d. Assets − Liabilities = Shareholders' Equity
4. The nature of an asset is best described as
   a. Something with physical form that's valued at cost of purchase in the accounting records.
   b. An economic resource representing cash or the right to receive cash in the near future.
   c. An economic resource that's expected to benefit future operations.
   d. Something owned by a business that has a ready market value.
5. Which financial statement covers a period of time?
   a. Balance sheet
   b. Income statement
   c. Statement of cash flowss
   d. Both b and c
6. How would net income be most likely to affect the accounting equation?
   a. Increase assets and increase shareholders' equity.
   b. Increase liabilities and decrease shareholders' equity.
   c. Increase assets and increase liabilities.
   d. Decrease assets and decrease liabilities.
7. During the year, ChemDry Ltd. has $100,000 in revenues, $40,000 in expenses, and $3,000 in dividend payments. Shareholders' equity changed by
   a. +$27,000
   b. +$57,000
   c. +$12,000
   d. −$8,000
8. ChemDry Ltd. in Question 7 had
   a. Net income of $100,000
   b. Net income of $57,000
   c. Net income of $60,000
   d. Net loss of $40,000
9. Leah Corporation holds cash of $5,000 and owes $25,000 on accounts payable. Leah has accounts receivable of $30,000, inventory of $20,000, and land cost of $50,000. How much are Leah's total assets and shareholders' equity?

	Total assets	Shareholders' equity
a.	$100,000	$25,000
b.	$105,000	$80,000
c.	$105,000	$25,000
d.	$25,000	$105,000

10. Which item(s) is (are) reported on the balance sheet?
   a. Retained earnings
   b. Accounts payable
   c. Inventory
   d. All of the above

11. During the year, Mason Inc.'s shareholders' equity increased from $30,000 to $40,000. Mason earned net income of $15,000. How much in dividends did Mason declare in the year?
    a. $6,000
    b. $0
    c. $8,000
    d. $5,000
12. Stuebs Corporation had total assets of $300,000 and total shareholders' equity of $100,000 at the beginning of the year. During the year assets increased by $50,000 and liabilities increased by $40,000. Shareholders' equity at the end of the year is
    a. $90,000
    b. $110,000
    c. $140,000
    d. $150,000

Accounting Vocabulary

accounting The information system that measures business activities, processes that information into reports and financial statements, and communicates the results to decision makers. (p. 3)

accounting equation The most basic tool of accounting: Assets = Liabilities + Owners' Equity. (p. 7)

account payable A liability for goods or services purchased on credit and backed by the general reputation and credit standing of the debtor. (p. 8)

accounts receivable An asset, amounts due from customers to whom a business has sold goods or services. (p. 8)

asset An economic resource that is expected to produce a benefit in the future. (p. 7)

balance sheet List of an entity's assets, liabilities, and owners' equity as of a specific date. Also called the *statement of financial position*. (p. 16)

board of directors Group elected by the shareholders to set policy for a corporation and to appoint its officers. (p. 7)

capital Another name for the *owners' equity* of a business. (p. 7)

capital assets Another name for *property, plant, and equipment*. (p. 8)

cash and cash equivalents Money and any medium of exchange that a bank accepts at face value. (p. 8)

common shares The most basic form of share capital. Common shareholders own a corporation. (p. 8)

contributed capital The amount of shareholders' equity that shareholders have invested in the corporation. (p. 8)

corporation A business owned by shareholders. A corporation is a legal entity, an "artificial person" in the eyes of the law. (p. 6)

cost assumption Assumption that assets and services should be recorded at their actual cost when acquired. (p. 29)

current asset An asset that is expected to be converted to cash, sold, or consumed during the next 12 months, or within the business's normal operating cycle if longer than a year. (p. 17)

current liability A debt due to be paid within one year or within the entity's operating cycle if the cycle is longer than a year. (p. 17)

deficit Negative balance in retained earnings caused by net losses over a period of years. (p. 10)

dividends Distributions (usually cash) by a corporation to its shareholders. (p. 9)

entity An organization or a section of an organization that, for accounting purposes, stands apart from other organizations and individuals as a separate economic unit. (p. 28)

ethics Standards of right and wrong that transcend economic and legal boundaries. Ethical standards deal with the way we treat others and restrain our own actions because of the desires, expectations, or rights of others and our obligations to them. (p. 33)

expenses Decrease in retained earnings that results from operations; the cost of doing business; opposite of revenues. (p. 8)

faithful representation The fundamental qualitative characteristic that accounting information is complete, free from bias, and without material error. (p. 28)

financial accounting The branch of accounting that provides information to people outside the firm. (p. 5)

financial statements Business documents that report financial information about a business entity to decision makers. (p. 2)

financing activities Activities that obtain from investors and creditors the cash needed to launch and sustain the business; a section of the statement of cash flows. (p. 20)

fixed assets Another name for *property, plant, and equipment*. (p. 8)

generally accepted accounting principles (GAAP) Accounting standards, issued by the Canadian Institute of Chartered Accountants (CICA) Accounting Standards Board, that govern how accounting is practised in Canada. (p. 24)

going-concern assumption Holds that the entity will remain in operation for the foreseeable future. (p. 29)

income statement A financial statement listing an entity's revenues, expenses, and net income or net loss for a specific period. Also called the *statement of operations* or the *statement of earnings*. (p. 11)

International Financial Reporting Standards (IFRS) International accounting standards issued by the International Accounting Standards Board (IASB). Canada is converging Canadian GAAP with IFRS for Publicly Accountable Enterprises (PAEs) effective January 2011. (p. 25)

inventory The merchandise that a company sells; also includes raw materials for use in a manufacturing process. (p. 8)

investing activities Activities that increase or decrease the capital assets available to the business; a section of the statement of cash flows. (p. 20)

liability An economic obligation (a debt) payable to an individual or an organization outside the entity. (p. 7)

limited liability partnership A business organization in which the business partnership (not the partners) is liable for the partnership's debts. (p. 6)

long-term debt A liability that falls due beyond one year from the date of the financial statements. (p. 8)

long-term liabilities Liabilities that are due beyond one year after the balance sheet date. (p. 18)

management accounting The branch of accounting that generates information for the internal decision makers of a business, such as top executives. (p. 5)

net assets Another name for *owners' equity*. (p. 7)

net earnings Another name for *net income*. (p. 9)

net income Excess of total revenues over total expenses. Also called *net earnings* or *net profit*. (p. 9)

net loss Excess of total expenses over total revenues. (p. 9)

net profit Another name for *net income*. (p. 9)

operating activities Activities that create revenue or expense in the entity's major line of business; a section of the statement of cash flows. Operating activities affect the income statement. (p. 20)

owners' equity The claim of the owners of a business to the assets of the business. Also called *capital*, *shareholders' equity*, or *net assets*. (p. 7)

partnership An association of two or more persons who co-own a business. (p. 6)

plant assets Another name for *property, plant, and equipment*. (p. 8)

Private Enterprises (PEs) Corporations whose shares are privately held either by its founders and/or by family members. (p. 26)

profit The excess of revenues over expenses. (p. 9)

property, plant, and equipment Long-lived assets, such as land, buildings, and equipment, used in the operation of the business. Also called *plant assets*, *fixed assets*, or *tangible capital assets*. (p. 8)

proprietorship A business with a single owner. (p. 5)

publicly accountable enterprises (PAEs) Corporations that have issued or plan to issue shares or debt in a public market. (p. 26)

relevance The fundamental qualitative characteristic of accounting information that is capable of making a difference to the decision maker and has predictive or confirming value. (p. 27)

retained earnings The amount of shareholders' equity that the corporation of the business has earned through profitable operation and has not given back to shareholders. (p. 8)

revenues Increase in retained earnings from delivering goods or services to customers or clients. (p. 8)

shareholder A person who owns shares of stock in a corporation. (p. 6)

shareholders' equity The shareholders' ownership interest in the assets of a corporation. Also called *owners' equity*. (p. 7)

stable-monetary-unit assumption The reason for ignoring the effect of inflation in the accounting records, based on the assumption that the dollar's purchasing power is relatively stable. (p. 29)

statement of cash flows Reports cash receipts and cash payments classified according to the entity's major activities: operating, investing, and financing. (p. 20)

statement of earnings Another name for the *income statement*. (p. 11)

statement of financial position Another name for the *balance sheet*. (p. 16)

statement of operations Another name for the *income statement*. (p. 11)

statement of retained earnings Summary of the changes in the retained earnings of a corporation during a specific period. (p. 14)

stock Shares into which the owners' equity of a corporation is divided. (p. 6)

Assess Your Progress

MyAccountingLab

Make the grade with MyAccountingLab: The exercises and problems in this chapter can be found on MyAccountingLab at www.myaccountinglab.com. You can practise them as often as you want, and they feature step-by-step guided solutions to help you find the right answer.

Short Exercises

Learning Objective 1
Financial statements are the product of accounting

S1-1 Accounting definitions are precise, and you must understand the vocabulary to properly use accounting. Sharpen your understanding of key terms by answering the following questions:

1. How do the *assets* and *shareholders' equity* of Gildan Activewear Inc. differ from each other? Which one (assets or shareholders' equity) must be at least as large as the other? Which one can be smaller than the other?
2. How are Gildan Activewear Inc.'s *liabilities* and *shareholders' equity* similar? How are they different?

S1-2 Use the accounting equation to show how to determine the amount of the missing term in each of the following situations.

Learning Objective 2
Applying the accounting equation

Total Assets	=	Total Liabilities	+	Shareholders' Equity
a. $?		$150,000		$150,000
b. 290,000		90,000		?
c. 220,000		?		120,000

S1-3 Review the accounting equation on page 7.

Learning Objective 2
Using the accounting equation

1. Use the accounting equation to show how to determine the amount of a company's owners' equity. How would your answer change if you were analyzing your own household or a single IHOP restaurant?
2. If you know assets and owners' equity, how can you measure liabilities? Give the equation.

S1-4 Consider Walmart, the world's largest retailer. Classify the following items as an asset (A), a liability (L), or an owners' equity (E) item for Walmart:

Learning Objective 2
Classifying assets, liabilities, and owners' equity

_____ **a.** Accounts payable
_____ **b.** Common shares
_____ **c.** Cash
_____ **d.** Retained earnings
_____ **e.** Land
_____ **f.** Prepaid expenses
_____ **g.** Accounts receivable
_____ **h.** Long-term debt
_____ **i.** Merchandise inventories
_____ **j.** Notes payable
_____ **k.** Accrued expenses payable
_____ **l.** Equipment

S1-5

Learning Objective 3
Using the income statement

1. Identify the two basic categories of items on an income statement.
2. What do we call the bottom line of the income statement?

S1-6 Split Second Wireless Inc. began 2011 with total assets of $110 million and ended 2011 with assets of $160 million. During 2011 Split Second earned revenues of $90 million and had expenses of $20 million. Split Second paid dividends of $10 million in 2011. Prepare the company's income statement for the year ended December 31, 2011, complete with the appropriate heading.

Learning Objective 3
Preparing an income statement

S1-7 Mondala Ltd. began 2011 with retained earnings of $200 million. Revenues during the year were $400 million and expenses totalled $300 million. Mondala declared dividends of $40 million. What was the company's ending balance of retained earnings? To answer this question, prepare Mondala's statement of retained earnings for the year ended December 31, 2011, complete with its appropriate heading.

Learning Objective 3
Preparing a statement of retained earnings

S1-8 At December 31, 2011, Skate Sharp Limited has cash of $13,000, receivables of $2,000, and inventory of $40,000. The company's equipment totals $75,000, and other assets amount to $10,000. Skate Sharp owes accounts payable of $10,000 and short-term notes payable of $5,000, and also has long-term debt of $70,000.

Contributed capital is $15,000.

Prepare Skate Sharp Limited's balance sheet at December 31, 2011, complete with its appropriate heading.

Learning Objective 3
Preparing a balance sheet

S1-9 Brazos Medical, Inc., ended 2010 with cash of $24,000. During 2011, Brazos earned net income of $120,000 and had adjustments to reconcile net income to net cash provided by operations totalling $20,000 (this is a negative amount).

Brazos paid $300,000 for equipment during 2011 and had to borrow half of this amount on a long-term note. During the year, the company paid dividends of $15,000 and sold old equipment, receiving cash of $60,000.

Learning Objective 3
Preparing a statement of cash flows

Prepare Brazos' statement of cash flows with its appropriate heading for the year ended December 31, 2011. Follow the format in the summary problem on page 36.

Learning Objective 5
Applying accounting assumptions

S1-10 John Grant is chairman of the board of The Grant Group Ltd. Suppose Grant has just founded this company, and assume that he treats his home and other personal assets as part of The Grant Group Ltd. Answer these questions about the evaluation of The Grant Group Ltd.

1. Which accounting assumption governs this situation?
2. How can the proper application of this accounting assumption give John Grant a realistic view of The Grant Group Ltd.? Explain in detail.

Learning Objective 6
Making ethical judgments

S1-11 Accountants follow ethical guidelines in the conduct of their work. What are these standards of professional conduct designed to produce? Why is this goal important?

Learning Objective 4
Relationships among the financial statements

S1-12 Suppose you are analyzing the financial statements of a Canadian company. Identify each item with its appropriate financial statement, using the following abbreviations: income statement (IS), statement of retained earnings (SRE), balance sheet (BS), and statement of cash flows (SCF).

Three items appear on two financial statements, and one item shows up on three statements.

a. Dividends ___________
b. Salary expense ___________
c. Inventory ___________
d. Sales revenue ___________
e. Retained earnings ___________
f. Net cash provided by operating activities ___________
g. Net income ___________
h. Cash ___________
i. Net cash provided by financing activities ___________
j. Accounts payable ___________
k. Common shares ___________
l. Interest revenue ___________
m. Long-term debt ___________
n. Net increase or decrease in cash ___________

Exercises

Learning Objective 1
Organizing a business

E1-13 Quality Environmental Inc. needs funds, and Mary Wu, the president, has asked you to consider investing in the business. Answer the following questions about the different ways in which Wu might organize the business. Explain each answer.

a. What form of organization will enable the owners of Quality Environmental to limit their risk of loss to the amount they have invested in the business?
b. What form of business organization will give Wu the most freedom to manage the business as she wishes?
c. What form of organization will give creditors the maximum protection in the event that Quality Environmental fails and cannot pay its liabilities?

If you were Wu and could organize the business as you wish, what form of organization would you choose for Quality Environmental? Explain your reasoning.

Learning Objective 3
Evaluating business operations

E1-14 Ed Eisler wants to open a café in Digby, Nova Scotia. In need of cash, he asks the Bank of Montreal for a loan. The bank requires financial statements to show likely results of operations for the year and the expected financial position at year-end. With little knowledge of accounting, Eisler doesn't understand the request. Explain to him the information provided by the income statement and the balance sheet. Indicate why a lender would require this information.

Learning Objective 2
Applying accounting assumptions

E1-15 Identify the accounting assumption that best applies to each of the following situations.

a. Wendy's, the restaurant chain, sold a store location to Burger King. How can Wendy's determine the sale price of the store—by a professional appraisal, Wendy's cost, or the amount actually received from the sale?

b. If Trammel Crow Realtors had to liquidate its assets, their value would be less than carrying amounts of the assets.

c. Toyota wants to determine which division of the company—Toyota or Lexus—is more profitable.

d. You get an especially good buy on a laptop, paying only $399 for a computer that normally costs $799. What is your accounting value for this computer?

Learning Objective 2
Use the accounting equations

E1-16 Compute the missing amount in the accounting equation for each company (amounts in millions):

	Assets	Liabilities	Shareholders' Equity
TELUS	$?	$10,061	$ 6,926
Scotiabank	411,510	?	18,804
Shoppers Drugmart	5,644	2,434	?

Which company appears to have the strongest financial position? Explain your reasoning.

Learning Objective 2 3
Accounting equation; evaluating business

E1-17 Assume Maple Leaf Foods Inc. has current assets of $633.6 million; capital assets of $1,126.7 million; and other assets totalling $1,237.5 million. Current liabilities are $591.2 million and long-term liabilities total $1,245.2 million.

Required

1. Use these data to write Maple Leaf Foods' accounting equation.
2. How much in resources does Maple Leaf Foods have to work with?
3. How much does Maple Leaf Foods owe creditors?
4. How much of the company's assets do the Maple Leaf Foods shareholders actually own?

Learning Objective 2
Apply accounting equation

E1-18 We Store For You Ltd.'s comparative balance sheets at December 31, 2011, and December 31, 2010, report (in millions):

	2011	2010
Total assets	$40	$30
Total liabilities	10	8

Required

Below are three situations about We Store For You's issuance of shares and payment of dividends during the year ended December 31, 2011. For each situation, use the accounting equation and statement of retained earnings to compute the amount of We Store For You's net income or loss during the year ended December 31, 2011.

1. We Store For You issued shares for $2 million and paid no dividends.
2. We Store For You issued no shares and paid dividends of $3 million.
3. We Store For You issued shares for $11 million and paid dividends of $2 million.

Learning Objective 2
Applying the accounting equation to business operations

E1-19 Answer these questions about two companies.

1. Mortimer Limited began the year with total liabilities of $400,000 and total shareholders' equity of $300,000. During the year, total assets increased by 20%. How much are total assets at the end of the year?
2. Aztec Associates began a year with total assets of $500,000 and total liabilities of $200,000. Net income for the year was $100,000 and no dividends were paid. How much is shareholders' equity at the end of the year?

Learning Objective 3
Identifying financial statement information

E1-20 Assume MySpace Inc. is expanding into the United States. The company must decide where to locate, and how to finance the expansion. Identify the financial statement where decision makers can find the following information about MySpace Inc. In some cases, more than one statement will report the needed data.

a. Common shares
b. Income tax payable
c. Dividends
d. Income tax expense
e. Ending balance of retained earnings
f. Total assets
g. Long-term debt
h. Revenue
i. Cash spent to acquire equipment
j. Selling, general, and administrative expenses
k. Adjustments to reconcile net income to net cash provided by operations
l. Ending cash balance
m. Current liabilities
n. Net income
o. Cost of goods sold

Learning Objective 2 3
Applying the accounting equation; understand the balance sheet

E1-21 Amounts of the assets and liabilities of Torrance Associates Inc., as of December 31, 2011, are given as follows. Also included are revenue and expense figures for the year ended on that date (amounts in millions):

Property and equipment, net	$ 4	Total revenue	$ 35
Investment	72	Receivables	253
Long-term liabilities	73	Current liabilities	290
Other expenses	14	Common shares	12
Cash	28	Interest expense	3
Retained earnings, beginning	19	Salary and other employee expense	9
Retained earnings, ending	?	Other assets	43

Required

Prepare the balance sheet of Torrance Associates Inc. at December 31, 2011. Use the accounting equation to compute ending retained earnings.

Learning Objective 3
Understand the income statement

E1-22 This exercise should be worked only in connection with Exercise 1-21. Refer to the data of Torrance Associates Inc. in Exercise 1-21.

Required

1. Prepare the income statement of Torrance Associates Inc. for the year ended December 31, 2011.
2. What amount of dividends did Torrance declare during the year ended December 31, 2011? Hint: Prepare a statement of retained earnings.

Learning Objective 3
Use the finanacial statements

E1-23 Groovy Limited began 2011 with $95,000 in cash. During 2011, Groovy earned net income of $300,000, and adjustments to reconcile net income to net cash provided by operations totalled $60,000, a positive amount. Investing activities used cash of $400,000, and financing activities provided cash of $70,000. Groovy ended 2011 with total assets of $250,000 and total liabilities of $110,000.

Required

Prepare Groovy Limited's statement of cash flows for the year ended December 31, 2011. Identify the data items that do not appear on the statement of cash flows and indicate which financial statement reports these items.

Learning Objective 3
Preparing an income statement and a statement of retained earnings

E1-24 Assume a FedEx Kinko's at the University of Saskatchewan ended the month of July 2011 with these data:

Payments of cash:		Issuance (sale) of shares to	
Acquisition of equipment	$36,000	owners	$35,000
Dividends	2,000	Rent expense	700
Retained earnings at July 1, 2011	0	Common shares	35,000
Retained earnings at July 31, 2011	?	Equipment	36,000
Utilities expense	200	Office supplies expense	1,200
Adjustments to reconcile net income		Accounts payable	3,200
to cash provided by operations	3,200	Service revenue	14,000
Salary expense	4,000		
Cash balance July 1, 2011	0		
Cash balance July 31, 2011	8,100		
Cash receipts:			

Required
Prepare the income statement and the statement of retained earnings of this FedEx Kinko's for the month ended July 31, 2011.

Learning Objective 3
Preparing a balance sheet

E1-25 Refer to the data in the preceding exercise. Prepare the balance sheet of the FedEx Kinko's at July 31, 2011.

Learning Objective 3
Preparing a statement of cash flows

E1-26 Refer to the data in Exercise 1-24. Prepare the statement of cash flows of the FedEx Kinko's at the University of Saskatchewan for the month ended July 31, 2011. Draw arrows linking the pertinent items in the statements you prepared for Exercises 1-24 through 1-26.

Learning Objective 3
Using financial statements for decision making

E1-27 This exercise should be used in conjunction with Exercises 1-24 through 1-26. The owner of the FedEx Kinko's now seeks your advice as to whether the University of Saskatchewan store should cease operations or continue operating. Write a report giving the owner your opinion of operating results, dividends, financial position, and cash flows during the company's first month of operations. Cite specifics from the financial statements to support your opinion. Conclude your report with advice on whether to stay in business or cease operations.

Learning Objective 5
Relationships among financial statements

E1-28 Apply your understanding of the relationships among the financial statements to answer these questions.

a. How can a business earn large profits but have a small balance of retained earnings?
b. Give two reasons why a business can have a steady stream of net income over a five-year period and still experience a cash shortage.
c. If you could pick a single source of cash for your business, what would it be? Why?
d. How can a business lose money several years in a row and still have plenty of cash?

Quiz

Test your understanding of the financial statements by answering the following questions. Select the best choice from among the possible answers given.

Q1-29 The *primary* objective of financial reporting is to provide information

a. Useful for making investment and credit decisions
b. About the profitability of the enterprise
c. On the cash flows of the company
d. To the federal government

Q1-30 For a company of a certain size, which type of business organization provides the least amount of protection for bankers and other creditors of the company?

a. Proprietorship
b. Partnership
c. Both a and b
d. Corporation

Q1-31 International Financial Reporting Standards (IFRS) were developed because
a. Canadian GAAP were outdated
b. Corporations wanted to change their reporting
c. Different GAAP in countries of the world made global comparisons difficult
d. New assumptions were defined

Q1-32 During January, assets increased by $20,000 and liabilities increased by $4,000. Shareholders' equity must have
a. Increased by $16,000
b. Increased by $24,000
c. Decreased by $16,000
d. Decreased by $24,000

Q1-33 The amount a company expects to collect from customers appears on the
a. Income statement in the expenses section
b. Balance sheet in the current assets section
c. Balance sheet in the shareholders' equity section
d. Statement of cash flows

Q1-34 All of the following are current assets except
a. Cash
b. Accounts receivable
c. Inventory
d. Sales revenue

Q1-35 Revenues are
a. Increases in share capital resulting from the owners investing in the business
b. Increases in retained earnings resulting from selling products or performing services
c. Decreases in liabilities resulting from paying off loans
d. All of the above

Q1-36 The financial statement that reports revenues and expenses is called the
a. Statement of retained earnings
b. Income statement
c. Statement of cash flows
d. Balance sheet

Q1-37 Another name for the balance sheet is the
a. Statement of operations
b. Statement of earnings
c. Statement of profit and loss
d. Statement of financial position

Q1-38 Baldwin Corporation began the year with cash of $35,000 and a computer that cost $20,000. During the year Baldwin earned sales revenue of $140,000 and had the following expenses: salaries, $59,000; rent, $8,000; and utilities, $3,000. At year-end Baldwin's cash balance was down to $16,000. How much net income (or net loss) did Baldwin experience for the year?
a. ($19,000)
b. $70,000
c. $107,000
d. $140,000

Q1-39 Quartz Instruments had retained earnings of $145,000 at December 31, 2010. Net income for 2011 totalled $90,000, and dividends for 2011 were $30,000. How much retained earnings should Quartz report at December 31, 2011?
a. $205,000
b. $235,000
c. $140,000
d. $175,000

Q1-40 Net income appears on which financial statement(s)?
a. Income statement
b. Statement of retained earnings
c. Both a and b
d. Balance sheet

Q1-41 Cash paid to purchase a building appears on the statement of cash flows among the
a. Operating activities
b. Financing activities
c. Investing activities
d. Shareholders' equity

Q1-42 The shareholders' equity of Chernasky Company at the beginning and end of 2011 totalled $15,000 and $18,000, respectively. Assets at the beginning of 2011 were $25,000. If the liabilities of Chernasky Company increased by $8,000 in 2011, how much were total assets at the end of 2011? Use the accounting equation.

a. $36,000
b. $16,000
c. $2,000
d. Some other amount (fill in the blank)

Q1-43 Drexler Company had the following on the dates indicated:

	12/31/11	12/31/10
Total assets	$750,000	$520,000
Total liabilities	300,000	200,000

Drexler had no share transactions in 2011 and, thus, the change in shareholders' equity for 2011 was due to net income and dividends. If dividends were $50,000, how much was Drexler's net income for 2011? Use the accounting equation and the statements of retained earnings.

a. $100,000
b. $130,000
c. $180,000
d. Some other amount (fill in the blank)

Problems

(Group A)

P1-44A Assume that the Special Contract Division of FedEx Kinko's experienced the following transactions during the year ended December 31, 2011.

Learning Objective 1 3 4
Using financial statements and applying assumptions and characteristics to the income statement

a. Suppose the division provided copy services to TELUS for the discounted price of $250,000. Under normal conditions, Kinko's would have provided these services for $280,000. Other revenues totalled $50,000.
b. Salaries cost the division $20,000 to provide these services. The division had to pay employees overtime. Ordinarily the salary cost for these services would have been $18,000.
c. Other expenses totalled $240,000. Income tax expense was 30% of income before tax.
d. FedEx Kinko's has two operating divisions. Each division is accounted for separately to indicate how well each is performing. At year-end, FedEx Kinko's combines the statements of divisions to show results for FedEx Kinko's as a whole.
e. Inflation affects the amounts that FedEx Kinko's must pay for copy machines. To show the effects of inflation, net income would drop by $3,000.
f. If FedEx Kinko's were to go out of business, the sale of its assets would bring in $150,000 in cash.

Required

1. Prepare the Special Contracts Division income statement for the year ended December 31, 2011.
2. As CEO, identify the accounting assumption or characteristics used in accounting for the items described in a through f. State how you have applied the assumption or characteristic in preparing the division income statement.

Learning Objective 2 3
Applying the accounting equation; understanding financial statements

P1-45A Compute the missing amounts (shown by a ?) for each company (in millions).

	Link Ltd.	Chain Inc.	Fence Corp.
Beginning			
Assets	$ 78	$ 30	?
Liabilities	47	19	$ 2
Common shares	6	1	2
Retained earnings	?	10	3
Ending			
Assets	?	$ 48	$ 9
Liabilities	$ 48	30	?
Common shares	6	1	2
Retained earnings	27	?	4
Owners' equity			
Dividends	$ 3	$ 2	$ 0
Income statement			
Revenues	$216	?	$20
Expenses	211	$144	19
Net income	?	9	1

At the end of the year, which company has the

- Highest net income?
- Highest percentage of net income to revenues?

Hint: Prepare a statement of retained earnings to help with your calculations.

Learning Objective 3
Balance sheet

P1-46A Dan Shoe, the manager of STRIDES Inc., prepared the company's balance sheet while the accountant was ill. The balance sheet contains numerous errors. In particular, Shoe knew that the balance sheet should balance, so he plugged in the shareholders' equity amount needed to achieve this balance. The shareholders' equity amount is *not* correct. All other amounts are accurate.

STRIDES Inc.
Balance Sheet
For the Month Ended July 31, 2011

Assets		Liabilities	
Cash	$ 25,000	Accounts receivable	$ 20,000
Store fixtures	10,000	Sales revenue	80,000
Accounts payable	16,000	Interest expense	800
Rent expense	4,000	Note payable	9,000
Salaries expense	15,000	Total	109,800
Land	44,000		
Advertising expense	3,000	**Shareholders' Equity**	
		Shareholders' equity	7,200
Total assets	$117,000	Total liabilities and shareholders' equity	$117,000

Required

1. Prepare the correct balance sheet and date it properly. Compute total assets, total liabilities, and shareholders' equity.
2. Is STRIDES Inc. actually in better or worse financial position than the erroneous balance sheet reports? Give the reason for your answer.

3. Identify the accounts listed on the incorrect balance sheet that are not reported on the balance sheet. State why you excluded them from the correct balance sheet you prepared for Requirement 1. On which financial statement should these accounts appear?

Learning Objective 3 4
Balance sheet, entity assumption

P1-47A Alexa Markowitz is a realtor. She buys and sells properties on her own, and she also earns commission as an agent for buyers and sellers. She organized her business as a corporation on March 16, 2011. The business received $60,000 cash from Markowitz and issued common shares. Consider the following facts as of March 31, 2011:

a. Markowitz has $5,000 in her personal bank account and $14,000 in the business bank account.
b. Office supplies on hand at the real estate office total $1,000.
c. Markowitz's business spent $25,000 for a ReMax franchise, which entitles her to represent herself as an agent. ReMax is a national affiliation of independent real estate agents. This franchise is a business asset.
d. The business owes $60,000 on a note payable for some undeveloped land acquired for a total price of $110,000.
e. Markowitz owes $100,000 on a personal mortgage on her personal residence, which she acquired in 2002 for a total price of $350,000.
f. Markowitz owes $1,800 on a personal charge account with Holt Renfrew.
g. Markowitz acquired business furniture for $10,000 on March 25. Of this amount, the business owes $6,000 on accounts payable at March 31.

Required

1. Prepare the balance sheet of the real estate business of Alexa Markowitz Realtor Inc. at March 31, 2011.
2. Does it appear that the realty business can pay its debts? How can you tell?
3. Explain why some of the items given in the preceding facts were not reported on the balance sheet of the business.

Learning Objective 3
Income statement, statement of retained earnings, balance sheet

P1-48A The assets and liabilities of Web Services Inc. as of December 31, 2011, and revenues and expenses for the year ended on that date are listed here.

Land	$ 8,000	Equipment	$ 11,000
Note payable	32,000	Interest expense	4,000
Property tax expense	2,000	Interest payable	2,000
Rent expense	15,000	Accounts payable	15,000
Accounts receivable	25,000	Salary expense	40,000
Service revenue	150,000	Building	126,000
Supplies	2,000	Cash	8,000
Utilities expense	3,000	Common shares	15,000

Beginning retained earnings were $60,000, and dividends totalled $30,000 for the year.

Required

1. Prepare the income statement of Web Services Inc. for the year ended December 31, 2011.
2. Prepare the company's statement of retained earnings for the year.
3. Prepare the company's balance sheet at December 31, 2011.
4. As CEO of Web Services Inc., after answering these questions, will you be pleased by Web Services's performance in 2011?
   a. Was Web Services profitable during 2011? By how much?
   b. Did retained earnings increase or decrease? By how much?
   c. Which is greater, total liabilities or total equity? Who owns more of Web Services's assets, creditors or Web Services's shareholders?

Learning Objective 3
Preparing a statement of cash flows

P1-49A The following data are from financial statements of Stuart Inc. for the fiscal year ended March 1, 2011 (in millions):

Purchases of capital assets and other assets	$ 144	Accounts receivable	$168
Issuance of long-term debt	164	Redemption of common shares	177
Net loss	(251)	Payment of dividends	31
Adjustments to reconcile net income (loss) to cash provided by operations	397	Common shares	715
Revenues	1,676	Issuance of common shares	1
Cash, beginning of year	41	Sales of capital assets and other assets	1
end of year	0	Retained earnings	752
Cost of goods sold	1,370	Repayment of long-term debt	1

Required

1. Prepare a statement of cash flows for the fiscal year ended March 1, 2011. Follow the format of the summary problem on page 36. Not all items given are reported in the statement of cash flows.
2. What was the largest source of cash? Is this a sign of financial strength or weakness?

Learning Objective 3 6
Analyzing a company's financial statements; relationships among the financial statements

P1-50A Summarized versions of the Gonzales Corporation's financial statements are given below for two years.

	(in thousands) 2011	2010
Statement of Operations		
Revenues	$ k	$16,000
Cost of goods sold	11,500	a
Other expenses	1,300	1,200
Earnings before income taxes	4,000	3,700
Income taxes (35% tax rate)	l	1,300
Net earnings	$ m	$ b
Statement of Retained Earnings		
Beginning balance	$ n	$ 3,500
Net earnings	o	c
Dividends	(300)	(200)
Ending balance	$ p	$ d
Balance Sheet		
Assets:		
Cash	$ q	$ e
Capital assets	3,000	1,800
Other assets	r	11,200
Total assets	$ s	$15,000
Liabilities:		
Current liabilities	$ t	$ 5,600
Notes payable and long-term debt	4,500	3,200
Other liabilities	80	200
Total liabilities	$ 9,100	$ f

Shareholders' Equity:		
Common shares	$ 300	$ 300
Retained earnings	u	g
Total shareholders' equity	v	6,000
Total liabilities and shareholders' equity	$ w	$ h
Statement of Cash Flows		
Net cash provided by operating activities	$ x	$ 1,900
Net cash used for investing activities	(1,000)	(900)
Net cash used for financing activities	(700)	(1,010)
Increase (decrease) in cash	400	i
Cash at beginning of year	y	2,010
Cash at end of year	$ z	$ j

Required

1. Determine the missing amounts denoted by the letters.
2. As Gonzales Corporation's CEO, use financial statements to answer these questions about the company. Explain each of your answers, and identify the financial statement where you found the information.
   a. Did operations improve or deteriorate during 2011?
   b. What is the company doing with most of its income—retaining it for use in the business or using it for dividends?
   c. How much in total resources does the company have to work with as it moves into the year 2012?
   d. At the end of 2010, how much did the company owe outsiders? At the end of 2011, how much did the company owe? Is this trend good or bad in comparison to the trend in assets?
   e. What is the company's major source of cash? Is cash increasing or decreasing? What is your opinion of the company's ability to generate cash?

(Group B)

Learning Objective 1 3 4
Applying assumptions and characteristics to the income statement

P1-51B Snap Fasteners Inc. experienced the following transactions during the year ended December 31, 2011:

a. All other expenses, excluding income taxes, totalled $14.9 million for the year. Income tax expense was 35% of income before tax.
b. Snap has several operating divisions. Each division is accounted for separately to show how well each division is performing. However, Snap's financial statements combine the statements of all the divisions to report on the company as a whole.
c. Inflation affects Snap's cost to manufacture goods. If Snap's financial statements were to show the effects of inflation, assume the company's reported net income would drop by $0.250 million.
d. If Snap were to go out of business, the sale of its assets might bring in over $5 million in cash.
e. Snap sold products for $56.2 million. Company management believes that the value of these products is approximately $60.5 million.
f. It cost Snap $40.0 million to manufacture the products it sold. If Snap had purchased the products instead of manufacturing them, Snap's cost would have been $43.0 million.

Required

1. Prepare Snap's income statement for the year ended December 31, 2011.
2. For items a through f, identify the accounting assumption or characteristic that determined how you accounted for the item described. State how you have applied the assumption or characteristics in preparing Snap's income statement.

Learning Objective 2 3
Applying the accounting equation; understanding the financial statements

P1-52B Compute the missing amounts (?) for each company (in millions).

	Gas Limited	Groceries Inc.	Bottlers Corp.
Beginning			
Assets	$11,200	$ 3,256	$ 909
Liabilities	4,075	1,756	564
Ending			
Assets	$12,400	$?	$1,025
Liabilities	4,400	1,699	565
Owners' Equity			
Issuance/(Repurchase) of shares	$ (36)	$ (0)	$?
Dividends	341	30	0
Income Statement			
Revenues	$11,288	$11,099	$1,663
Expenses	?	10,879	1,568

Which company has the

- Highest net income?
- Highest percentage of net income to revenues?

Hint: Prepare a statement of owners' equity, which begins with opening shareholders' equity and adds and subtracts changes to conclude with closing shareholders' equity.

Learning Objective 3
Balance sheet

P1-53B Ned Robinson, the manager of Lunenberg Times Inc., prepared the balance sheet of the company while the accountant was ill. The balance sheet contains numerous errors. In particular, the manager knew that the balance sheet should balance, so he plugged in the shareholders' equity amount needed to achieve this balance. The shareholders' equity amount, however, is *not* correct. All other amounts are accurate.

Lunenberg Times Inc.
Balance Sheet
For the Month Ended October 31, 2011

Assets		Liabilities	
Cash	$ 25,000	Accounts receivable	$ 10,000
Office furniture	15,000	Sales revenue	70,000
Note payable	16,000	Salary expense	20,000
Rent expense	4,000	Accounts payable	8,000
Inventory	30,000		
Land	34,000	**Shareholders' Equity**	
Advertising expense	2,500	Shareholders' equity	18,500
Total assets	$126,500	Total liabilities	$126,500

Required

1. Prepare the correct balance sheet and date it properly. Compute total assets, total liabilities, and shareholders' equity.
2. Is Lunenberg Times Inc. actually in better or worse financial position than the erroneous balance sheet reports? Give the reason for your answer.
3. Identify the accounts listed in the incorrect balance sheet that are *not* reported on the corrected balance sheet. State why you excluded them from the correct balance sheet you prepared for Requirement 1. Which financial statement should these accounts appear on?

Learning Objective 3 5
Balance sheet; entity assumption

P1-54B Luis Fantano is a realtor. He buys and sells properties on his own and also earns commission as an agent for buyers and sellers. Fantano organized his business as a corporation on July 10, 2011. The business received $75,000 from Fantano and issued common shares. Consider these facts as of July 31, 2011:

a. Fantano owes $5,000 on a personal charge account with Visa.
b. Fantano's business owes $80,000 on a note payable for some undeveloped land acquired for a total price of $135,000.
c. Fantano has $5,000 in his personal bank account and $10,000 in the business bank account.
d. Office supplies on hand at the real estate office total $1,000.
e. Fantano's business spent $35,000 for a Century 21 real estate franchise, which entitles him to represent himself as a Century 21 agent. Century 21 is a national affiliation of independent real estate agents. This franchise is a business asset.
f. Fantano owes $125,000 on a personal mortgage on his personal residence, which he acquired in 2001 for a total price of $300,000.
g. Fantano acquired business furniture for $18,000 on July 15. Of this amount, his business owes $10,000 on open account at July 31.

Required

1. Prepare the balance sheet of the realty business of Luis Fantano Realtor Inc. at July 31, 2011.
2. Does it appear that Fantano's realty business can pay its debts? How can you tell?
3. Identify the personal items given in the preceding facts that would not be reported on the balance sheet of the business.

Learning Objective 3 4
Income statement, statement of retained earnings, balance sheet; relationships among the financial statements

P1-55B The assets and liabilities of Auto Mechanics Ltd. as of December 31, 2011, and revenues and expenses for the year ended on that date follow.

Interest expense	$ 4,000	Accounts receivable	$ 25,000
Land	95,000	Advertising expense	10,000
Note payable	95,000	Building	140,000
Accounts payable	21,000	Salary expense	85,000
Rent expense	6,000	Salary payable	12,000
Cash	10,000	Service revenue	210,000
Common shares	75,000	Supplies	3,000
Furniture	20,000	Property tax expense	5,000

Beginning retained earnings were $40,000, and dividends totalled $50,000 for the year.

Required

1. Prepare the income statement of Auto Mechanics Ltd. for the year ended December 31, 2011.
2. Prepare the Auto Mechanics Ltd. statement of retained earnings for the year.
3. Prepare Auto Mechanics' balance sheet at December 31, 2011.
4. Using the information prepared in Requirements 1 through 3:
   a. Was Auto Mechanics Ltd. profitable during 2011? By how much?
   b. Did retained earnings increase or decrease? By how much?
   c. Which is greater, total liabilities or total equity? Who owns more of Auto Mechanics Ltd.'s assets, the creditors or the shareholders?

Learning Objective 3
Preparing a statement of cash flows

P1-56B The data below are adapted from the financial statements of Long Boat Ltd. at the end of a recent year (in thousands).

Adjustments to reconcile net income to cash provided by operations	$ 65	Sales of capital assets	$ 2
Revenues	3,870	Payment of long-term debt	26
Bank overdraft, beginning of year	(11)	Cost of goods sold	3,182
Cash, end of year	23	Common shares	212
Purchases of capital assets	123	Accounts receivable	271
Long-term debt	234	Issuance of common shares	4
Net income	180	Change in bank loan	(44)
Retained earnings	1,000	Payment of dividends	24

Required

1. Prepare Long Boat's statement of cash flows for the year. Follow the solution to the summary problem starting on page 36. Not all the items given appear on the statement of cash flows.
2. Which activities provided the bulk of Long Boat's cash? Is this a sign of financial strength or weakness?

Learning Objective 3 5
Analyzing a company's financial statements; relationships among the financial statements

P1-57B Condensed versions of Your Phone Ltd.'s financial statements, with certain amounts omitted, are given for two years.

	(thousands) 2011	2010
Statement of Income		
Revenues	$94,500	$ a
Cost of goods sold	k	65,400
Other expenses	15,660	13,550
Income before income taxes	5,645	9,300
Income taxes	1,975	3,450
Net income	$ l	$ b
Statement of Retained Earnings		
Beginning balance	$ m	$10,000
Net income	n	c
Dividends	(480)	(450)
Ending balance	$ o	$ d
Balance Sheet		
Assets:		
Cash	$ p	$ 400
Capital assets	23,790	e
Other assets	q	17,900
Total assets	$ r	$38,500
Liabilities:		
Current liabilities	$11,100	$10,000
Long-term debt and other liabilities	s	12,500
Total liabilities	24,500	f
Shareholders' Equity:		
Common shares	$ 400	$ 600
Retained earnings	t	g
Total shareholders' equity	u	16,000
Total liabilities and shareholders' equity	$ v	$ h

Statement of Cash Flows		
Net cash provided by operating activities	$ w	$ 3,600
Net cash used for investing activities	(2,700)	(4,150)
Net cash provided by financing activities	250	900
Increase (decrease) in cash	50	i
Cash at beginning of year	x	50
Cash at end of year	$ y	$ j

Required

1. Determine the missing amounts denoted by the letters.
2. Use Your Phone's financial statements to answer these questions about the company. Explain each of your answers.
   a. Did operations improve or deteriorate during 2011?
   b. What is the company doing with most of its income—retaining it for use in the business or using it for dividends?
   c. How much in total resources does the company have to work with as it moves into 2012? How much in total resources did the company have at the end of 2010?
   d. At the end of 2010, how much did the company owe outsiders? At the end of 2011, how much did the company owe?
   e. What is the company's major source of cash? What is your opinion of the company's ability to generate cash? How is the company using most of its cash? Is the company growing or shrinking?

Apply Your Knowledge

Decision Cases

Learning Objective 3
Evaluating business operations; using financial statements

Case 1. Two businesses, Web Services and PC Providers, have sought business loans from you. To decide whether to make the loans, you have requested their balance sheets.

Web Services
Balance Sheet
October 31, 2011

Assets		Liabilities	
Cash	$ 11,000	Accounts payable	$ 13,000
Accounts receivable	4,000	Notes payable	377,000
Furniture	36,000	Total liabilities	390,000
Software	79,000	**Shareholders' Equity**	
Computers	300,000	Shareholders' equity	40,000
		Total liabilities and	
Total assets	$430,000	shareholders' equity	$430,000

PC Providers Inc.
Balance Sheet
October 31, 2011

Assets		Liabilities	
Cash	$ 9,000	Accounts payable	$ 12,000
Accounts receivable	24,000	Note payable	28,000
Merchandise inventory	85,000	Total liabilities	40,000
Furniture and fixtures	9,000		
Building	82,000	**Shareholders' Equity**	
Land	14,000	Shareholders' equity	183,000
		Total liabilities and	
Total assets	$223,000	shareholders' equity	$223,000

Required

1. Using only these balance sheets, to which entity would you be more comfortable lending money? Explain fully, citing specific items and amounts from the respective balance sheets.
2. Is there other financial information you would consider before making your decision? Be specific.

Learning Objective 3
Analyzing a company's financial statements

Case 2. After you have been out of college for a year, you have $5,000 to invest. A friend has started My Dream Inc., and she asks you to invest in her company. You obtain My Dream Inc.'s financial statements, which are summarized at the end of the first year as follows:

My Dream Inc.
Income Statement
For the Year Ended December 31, 2011

Revenues	$80,000
Expenses	60,000
Net income	$20,000

My Dream Inc.
Balance Sheet
December 31, 2011

Cash	$13,000	Liabilities	$35,000
Other assets	67,000	Equity	45,000
Total assets	$80,000	Total liabilities and equity	$80,000

Visits with your friend turn up the following facts:

a. The company owes an additional $10,000 for TV ads that was incurred in December but not recorded in the books.
b. Software costs of $20,000 were recorded as assets. These costs should have been expensed. My Dream paid cash for these expenses and recorded the cash payment correctly.
c. Revenues and receivables of $10,000 were overlooked and omitted.

Required

1. Prepare corrected financial statements.
2. Use your corrected statements to evaluate My Dream's results of operations and financial position.
3. Will you invest in My Dream? Give your reason.

Ethical Issue

During 2002, Enron Corporation admitted excluding large liabilities from its balance sheet. WorldCom confessed to recording expenses as assets. In 2002, Livent Inc.'s senior executives were charged with reducing expenses and inflating profits. All of these companies needed to improve their appearance as reported in their financial statements.

Required

1. What is the fundamental ethical issue in these situations?
2. Who are the stakeholders and what are the consequences of the actions taken by the three companies? Use the accounting equation to explain your answer.
3. What alternatives should these companies have considered?
4. The actions in all three cases were illegal. What do you think were the consequences of the three companies' management decisions?

Focus on Financials

Gildan Activewear Inc.

This case is based on the financial statements of Gildan Activewear Inc. (www.gildan.com). As you work with Gildan Activewear Inc. throughout this course, you will develop the ability to use actual financial statements.

Learning Objective 3
Evaluating business operations

Required

Refer to the Gildan Activewear Inc. financial statements in Appendix A at the end of the book.

1. Suppose you own shares in Gildan. If you could pick one item on the company's income statement to increase year after year, what would it be? Why is this item so important? Did this item increase or decrease during the year ended October 4, 2009? Is this good news or bad news for the company?
2. What was Gildan's largest expense each year? In your own words, explain the meaning of this item. Give specific examples of items that make up this expense. Why is this expense less than sales revenue?
3. Use the balance sheet as at October 4, 2009, of Gildan Activewear Inc. in Appendix A to answer these questions. At the end of October 4, 2009, how much in total resources did Gildan have to work with? How much did the company owe? How much of its assets did the company's shareholders actually own? Use these amounts to write Gildan's accounting equation at October 4, 2009 (express all items in thousands of dollars).
4. How much cash did Gildan have at October 5, 2008? How much cash did it have at October 4, 2009? Where does Gildan get most of its cash? How does the company spend its cash?

Focus on Analysis

Learning Objective 3
Evaluating by using financial statements

Gildan Activewear Inc.

This case is based on the financial statements of Gildan Activewear Inc. (www.gildan.com). As you work with Gildan Activewear Inc. throughout this course, you will develop the ability to analyze financial statements of actual companies.

Required

Refer to the Gildan Activewear Inc. financial statements in Appendix A at the end of the book.

1. Write Gildan's accounting equation at October 4, 2009 (express all items in thousands of dollars). Does Gildan's financial condition look strong or weak? How can you tell?
2. What was the result of Gildan's operations during 2009? Identify both the name and the dollar value of the result of operations for 2009. Does an increase (decrease) signal good news or bad news for the company and its shareholders?
3. Examine shareholders' equity on the balance sheet and the statement of retained earnings. What were the changes in shareholders' equity during 2009? What caused these changes?
4. Which statement reports cash as part of Gildan's financial position? Which statement tells why cash increased (or decreased) during the year? What items caused Gildan's cash to change the most in 2009?
5. Which two items on the balance sheet changed the most compared to 2008? What management decisions likely led to the change?

Group Project

Project 1. As instructed by your professor, obtain an annual report of a Canadian company.

Required

1. Take the role of a loan committee of the Royal Bank of Canada. Assume the company has requested a loan from your bank. Analyze the company's financial statements and any other information you need to reach a decision regarding the largest amount of money you would be willing to lend. Go as deeply into the analysis and the related decision as you can. Specify the following:
   a. Any restrictions you would impose on the borrower.
   b. The length of the loan period (that is, over what period will you allow the company to pay you back).

Note: The long-term debt note to the financial statements gives details of the company's liabilities.

2. Write your group decision in a report addressed to the bank's board of directors. Limit your report to two double-spaced word-processed pages.
3. If your professor directs you to, present your decision and analysis to the class. Limit your presentation to 10 to 15 minutes.

Project 2. You are the owner of a company that is about to "go public" (that is, issue its shares to outside investors). You wish to make your company look as attractive as possible to raise $1 million in cash to expand the business. At the same time, you want to give potential investors a reliable and relevant picture of your company.

Required

1. Design a presentation to portray your company in a way that will enable outsiders to reach an informed decision as to whether to invest in your company. The presentation should include the following:
   a. Name and location of your company

b. Nature of the company's business (be specific and detailed to provide a clear picture of the nature, history, and future goals of the business)
c. How you plan to spend the money you raise
d. The company's comparative income statement, statement of retained earnings, balance sheet, and statement of cash flows for two years: the current year and the preceding year. Make the data as realistic as possible with the intent of receiving $1 million.

2. Prepare a word-processed presentation that does not exceed five pages.
3. If directed by your professor, distribute copies of your presentation to the class with the intent of interesting your classmates in investing in your company. Make a 10- to 15-minute investment pitch to the class. Measure your success by the amount of investment commitment you receive.

Quick Check Answers

1. *b*
2. *a*
3. *d*
4. *c*
5. *d*
6. *a*
7. *b ($100,000 − $40,000 − $3,000 = $57,000)*
8. *c ($100,000 − $40,000 = $60,000)*
9. *b [Total assets = $105,000 ($5,000 + $30,000 + $20,000 + $50,000). Shareholders' equity: $80,000 ($105,000 − $25,000)]*
10. *d*
11. *d [$30,000 + Net income ($15,000) − Dividends = $40,000; Dividends = $5,000]*
12. *b*

	Assets	=	Liabilities	+	Equity
Beginning	$300,000	=	$200,000	+	$100,000
Increase	50,000	=	40,000	+	10,000*
Ending	350,000	=	240,000	+	110,000*

*Must solve for these amounts.