

Chapter 1

What is a business?

"The activity of making, buying, or selling goods or providing services in exchange for money."¹

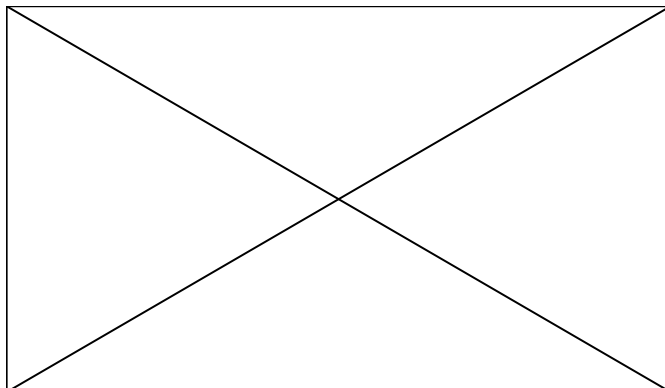
That's the definition according to Merriam-Webster and it focuses on for-profit businesses, which are businesses whose purpose is to make a profit. Note that there are other types of businesses such as not-for-profit (charities) or barter businesses (exchange one good or service for another); however, the focus of this course is on for-profit businesses.

What does a business do?

That depends on which business sector a business is in.

Video - What are the three main business sectors?

Businesses are divided into one of three main business sectors. After watching this video you should be able to define the sectors and categorize businesses into one of the three business sectors.



Videos will be embedded in the chapter and contain content that will be tested in both the midterm and final exam.

Students are required to watch the videos before the start of the class for the assigned chapter.

After watching the video, answer the questions on the following page.

You can ONLY obtain the answer to these questions, which will be tested on the midterm and the final exam, by watching the videos before class!

1. Write a definition of the primary sector. What industries would be categorized in the primary sector?

2. Write a definition of the secondary sector. Give examples of three businesses that would be categorized in the secondary sector.

3. Write a definition of the tertiary sector. Provide the names of three companies that would be categorized in the tertiary sector (e.g. Canadian Tire).

Check your understanding questions are for practice. The solution can be viewed by clicking the hyperlink BUT you only learn if you attempt the question yourself FIRST.

Check your understanding

A [fashion designer](#) would be categorized in which business sector? Be sure to explain WHY you think it belongs in that sector.

Do it yourself questions will be taken up during class but students are expected to attempt them before class.

Do it yourself

Categorize each of the following jobs or businesses into the correct business sector. Use 1 for primary, 2 for secondary, and 3 for tertiary.

	Name/Description	Business Sector
Q1	Medical researcher	
Q2	Clothing manufacturer	
Q3	Taxi driver	
Q4	Lawn care company	
Q5	Hershey Company	
Q6	Fish farms in British Columbia	
Q7	Ryerson University	

What is our focus?

In this course our focus will be the tertiary sector, concentrating first on retailers and then on wholesalers. A **retailer** earns a profit by reselling goods or providing services to consumers (also called the public) in order to satisfy their wants and needs. A **wholesaler** buys large quantities of goods from manufacturers, warehouses them, and then resells them to retailers. Wholesalers do not sell to consumers (the public).

Who cares about a business and why?

Stakeholders care about a business. **Stakeholders** are individuals or groups who either affect the business or are affected by the actions of the business. Every stakeholder has an **objective**, something they want from their relationship with the business. Stakeholders can be either internal or external. **Internal stakeholders** work for the business. Their objectives generally relate to their ability to keep their jobs, do their jobs more efficiently, get promoted, and get paid for their work. **External stakeholders** are outside of the business and their objectives generally relate to decisions they will make about money (also called resource allocation decisions) or about how the business can affect them, either positively or negatively.

Internal Stakeholders:	
Stakeholder	What They Want
General Employee	Earn high wages and keep their jobs
Marketing manager	Impact of advertising (marketing campaigns)
Company lawyer	Ensure laws are followed
Tax manager	Ensure taxes are minimized and tax laws are followed
Owners (sole proprietor)	Maximize profit, grow/expand the business

External Stakeholders:	
Stakeholder	What They Want
Shareholders (of a corporation)	Decide to invest or not invest, earn income from their investment
Governments	Ensure businesses pay taxes, employ more people, follow laws
Customers	Buy quality products at low prices, get the best warranties on products or services
Suppliers	Sell products/services to the business, get paid on time and in full
Creditors (banks)	Decide whether to lend money and how much, ensure business repays loan plus interest on time
Society/Community	Employ people from the community, improve the standard of living, run their businesses in an ethical manner, reduce/eliminate any negative environmental effects of their business practices, support local charities

Why is it important to know about stakeholders and their objectives?

The financial information a business provides is often the key information that external stakeholders use to make decisions (and remember that their decisions generally involve where they will put their hard earned money!) By better understanding the stakeholders and their objectives we can better understand the need for financial information and how important it is that stakeholders can depend on that information for their decision making.

Check your understanding

What is the main [objective of a customer](#) who buys a car from the Ford Motor Company?

Do it yourself

In order to meet their objectives, stakeholders have questions they need answered. Match the following stakeholders with the question(s) stakeholders would most likely ask about a business, given their objective(s).

	Stakeholders:	Question(s) stakeholders might ask, given what they want.
Q1.	Tax adviser to a business	
Q2.	Marketing manager	
Q3.	Auditor in a large accounting firm	
Q4.	Supplier	
Q5.	Creditor (banker)	

Question ID:	Questions:
A.	What is the expected revenue from a new product?
B.	Are tax laws being followed?
C.	Will a business be able to pay for its purchases on time?
D.	Does the business have enough cash to pay interest?
E.	Is the business following required accounting rules?

Recap:

You now know that businesses are either in the primary, secondary, or tertiary sector. This book will focus on the tertiary sector; first retailers, then wholesalers. You also know that every business has stakeholders - individuals or groups that either affect a business or are affected by the decisions a business makes. Stakeholders have questions about the business they want answered so they can make decisions to help them meet their objectives. Stakeholders can be either internal or external to the business.

What information do stakeholders use to answer their questions and make decisions?

Companies record their business transactions in an **accounting system**: an information system that collects, groups, and communicates a business's financial position, including its financial health and profitability. Without accounting information, stakeholders would not be able to make many of the decisions that help them meet their objectives.

Internal stakeholders have access to all the accounting information because they work in the business. They can use the accounting system to answer whatever questions they might have on a daily basis. External stakeholders do not have access to the business's accounting system because they are outside of the business. Instead, they depend on the financial statements that businesses produce. **Financial statements** tell a business's story, what they do and how

well they do it. They provide a business's financial performance, its current financial position, and its cash flows. External stakeholders use the financial statements to analyze a business and answer questions, which allows them to make decisions and meet their objectives.

Financial statements will be introduced in Chapter 3.

What qualities must financial information have to make it useful for decision making?

We know that external stakeholders use financial information to make decisions that will help them meet their objectives. These decisions are often resource allocation decisions, meaning that their decisions often involve the stakeholder's money. For instance, a creditor might be deciding whether to give a loan to a business and an investor might be deciding whether or not to buy the business's shares. Stakeholders can only make these kinds of decisions if the business provides them with the necessary financial information. Businesses are the preparers of the financial information, and stakeholders are the users.

If you were a stakeholder making a decision, what qualities would you want the financial information to have? Would you want the information to be truthful? Comparable to other businesses so you can make a choice between them? Up-to date information? In a format that is common to all businesses so you easily understand and compare it?

All of these qualities are called **qualitative characteristics**: qualities that stakeholders **want** financial information to have so they can use the information for decision making. Let's look at each of the qualities that external stakeholders want.

Quality:	Description:
Faithful	Truthful, meaning it is complete, free of error, and neutral (unbiased).
Relevant	Applicable or pertinent to your decision making, helps you predict the future and/or confirm decisions you made in the past.
Comparable	Can compare the same business from year to year OR between two different businesses in the same industry.
Verifiable	Anyone looking at the information would determine similar amounts.
Timely	Information is provided quickly (as old information is less useful).
Understandable	Group and present information so it is clear and concise.

Why is this important?

In order to use information to make decisions it is important to understand the quality of that information (how trustworthy it is). If information does not have these qualitative characteristics then it may mislead the stakeholders, causing them to make wrong decisions. Look at the next "Check your understanding" to better understand why the quality of information provided is so important for decision making.

Check your understanding

A car sales associate, Jim Morris, is trying to sell you a used Volkswagen Golf. He has given you a rundown of the car's history and, considering the low price of the car, it sounds like a great deal! He leaves to speak to his manager and you hear two other sales associates talking about Jim. Turns out Jim's sales have been slow this month and he really needs to make as many sales as possible so he can meet his sales target.

What qualitative characteristics might Jim violate and why? What would have to be true for you to believe everything Jim says about the car?

Recap

You know the definition of each of the qualitative characteristics and why they are important for decision making; however, being able to apply that knowledge is critical. For testing purposes in this course you must be able to read a scenario (a short story about a situation or an event), name the qualitative characteristic that applies, and explain whether the qualitative characteristic is being followed or not followed (violated).

Your answer should be in the following format: "The qualitative characteristic (name of characteristic) is being (choose either violated or followed) because (explanation why you think this is the case) ." Your explanation MUST reference the definition of the qualitative characteristic that you chose.

The following three examples will help you to practice answering this type of question.

Do it yourself

For each of the independent scenarios given below, name the qualitative characteristic that you think applies and indicate if the qualitative characteristic has been VIOLATED (not followed) or FOLLOWED. Be sure to explain WHY you think that is true! More than one qualitative characteristic may apply.

The owner of a business buys a car for her daughter using the business's money and records the car on the business's accounting system. The car is never used for business purposes.

Cooper Company changed one of their accounting policies this year because the new policy will provide better information for decision making. The business has recalculated the financial information for all prior years and announced the change, including its impact on the financial statements, to all stakeholders.

Greene Company receives a bill for \$13,000 but records it as \$1,300.

How are qualitative characteristics used to produce useful information?

The qualitative characteristics are part of the standards (also called guidelines) accountants use to prepare financial information for external stakeholders. We know that information must be faithful, relevant, comparable, verifiable, timely, and understandable in order to be useful. It is sometimes difficult to apply these qualitative characteristics to the recording of financial transactions. As a result, the qualitative characteristics are used to develop assumptions that specify how accountants must record, measure, and report information. By following the qualitative characteristics and these assumptions, preparers of financial information ensure that financial information has the qualities that external shareholders need in order to use the information for decision making.

Assumption	Description:
Separate Entity	Only the activities of the business are included in the business's financial information.
Unit-of-Measure	All transactions must be reported using the monetary unit of the country the business's head office is located in, even if the business has offices in many countries.
Going Concern	Businesses will continue their operations well into the future.
Historic Cost	All purchases will be recorded at the amount that was paid for them.
Time Period (Periodicity)	Information will be provided quickly, when it is still relevant to the stakeholders (has the capacity to affect their decisions).
Full Disclosure	If something will affect the decisions of the external stakeholders, it must be reported.

Why is this important?

You saw from the example of the [used car salesperson](#) that it is impossible to make an informed decision unless the information provided can be trusted. When preparers use both the qualitative characteristics and the assumptions to record, measure, and report financial information, external stakeholders gain assurance that the information provided is useful for decision making.

Check your understanding

The qualitative characteristics and assumptions were developed as guidelines to help accountants record, measure, and report information to external shareholders. Their use helps to ensure that financial information encompasses all the characteristics of useful information: faithful, relevant, comparable, verifiable, timely, and understandable. Because the assumptions are based on the qualitative characteristics, you should be able to connect each of the assumptions to one, or more, of the qualitative characteristics.

Which assumption is built on the [qualitative characteristic "timely"](#)?

Do it yourself

Draw a line between the qualitative characteristic and the assumption you think was developed to ensure that financial information has that quality. Note that some characteristics may connect to more than one assumption.

Qualitative Characteristics

Faithful

Relevant

Comparable

Verifiable

Timely

Understandable

Assumptions

Separate Entity

Unit-of-Measure

Going Concern

Time Period

Historic Cost

Full Disclosure

How are the assumptions used?

Previously in the chapter you saw how qualitative characteristics are used as a guide when recording and reporting the financial information of a business. Since the assumptions are based on the qualitative characteristics, and are used by preparers to correctly record, measure and report information, they also help preparers to ensure that the financial information has the qualities stakeholders need to make decisions.

Do it yourself

You have already seen the scenarios, below, when you looked at qualitative characteristics. Now, instead of using the qualitative characteristics, choose the assumption that you think applies and indicate if it has been VIOLATED (not followed) or FOLLOWED. Be sure to explain WHY you think that is true! More than one assumption may be applicable.

The owner of a business buys a car for her daughter using the business's money and records the car on the business's accounting system. The car is never used for business purposes.

Cooper Company changed one of their accounting policies this year because the new policy will provide better information for decision making. The business has recalculated the financial information for all prior years and announced the change, including its impact on the financial statements, to everyone who uses the statements.

Greene Company receives a bill for \$13,000 but records it as \$1,300.

Putting it all together!

The qualitative characteristics and underlying assumptions are part of generally accepted accounting principles, called GAAP (pronounced as gap). Preparers of accounting information use GAAP as a guideline when preparing financial accounting information. The overall objective of GAAP is to provide financial information about a business that is useful to external stakeholders for decision making.

Going forward!

In Chapter 2 you will learn about the elements of financial statements; i.e. the categories used to group and sort financial information in order to increase its usefulness for decision making. Together with the qualitative characteristics and assumptions, they help businesses record, measure, and report financial information that is useful for external stakeholders' decision making. You will also be introduced to transaction analysis using these elements.

What do I need to know for a midterm or final exam?

- A. List and define each of the three business sectors.
- B. Categorize different businesses and jobs/careers into one of the three business sectors and be able to explain WHY it belongs there. For example: "Fashion designer is in the secondary sector because it involves the manufacturing of clothing out of raw material."
- C. Define stakeholder, internal stakeholder, and external stakeholder.
- D. List common internal stakeholders and their objectives.
- E. List common external stakeholders and their objectives.
- F. Explain what external stakeholders use in order to help them make decisions.
- G. Define the term "qualitative characteristics" in relation to financial information.
- H. List and define each of the qualitative characteristics of financial information.
- I. Define the term "assumptions" in relation to financial information.
- J. List and define each of the assumptions which underlie financial information.
- K. Recognize the interconnection between the qualitative characteristics and the assumptions.
- L. Apply your knowledge of both qualitative characteristics and assumptions. You must be able to read a scenario (a short story about a situation or an event), name the qualitative characteristic and/or the assumption that applies, and explain whether it is being followed or not followed (violated). Your answer should be in the form of "The (name the qualitative characteristic or assumption that applies) is being (followed or violated) because _____." Your "because" MUST reference the definition of the qualitative characteristic or assumption that you choose.
- M. Define GAAP. Why is GAAP used?

Watch out for....

Often when students are asked for a definition they give examples....or, when asked for examples, they give a definition and then lose marks because of it. Here is an example you can use to better understand the difference.

Define external stakeholder:

An external stakeholder is an individual or group outside of the business who either affects the activities of a business or who is affected by the activities of a business.

Provide examples of external stakeholders:

Shareholder, supplier, auditor.

Practice Questions

Question 1

Categorize each of the following jobs or businesses into the correct business sector. Use 1 for primary, 2 for secondary, and 3 for tertiary.

Name/Description	Business Sector
Carpenter	
Doctor	
McDonald's Corporation	
Hydro One	
Web designer	
Advertising company	
Dairy farmer	
The Keg Restaurant	
Firefighter	

Question 2

In order to meet their objectives, stakeholders have questions they need answered. Match the following stakeholders with the question(s) they would most likely ask about a business, given their objective(s). Note that stakeholders might have multiple questions but focus on which questions would be critical to each stakeholder.

	Stakeholders:	Question(s) that stakeholders might ask, given their objectives.
1.	Marketing manager	
2.	Auditor in a large accounting firm	
3.	Production manager in a manufacturing firm	
4.	Shareholder	
5.	Canada Revenue Agency	
6.	Creditor (banker)	
7.	Store manager	

Question ID:	Questions:
A.	Are there enough raw materials to manufacture the new product?
B.	What is total taxable income?
C.	Does the business have enough cash to pay dividends?

D.	What is the advertising budget for the current year?
E.	What is the business's current level of debt?
F.	Has the company followed GAAP when preparing their financial information?
G.	What products need to be ordered?

Question 3

Provide the definition of each of the qualitative characteristics WITHOUT looking at the chapter!

Quality:	Description:
Faithful	
Relevant	
Comparable	
Verifiable	
Timely	
Understandable	

Question 4

For each of the scenarios given below, name the qualitative characteristic that you think applies and indicate if that qualitative characteristic has been VIOLATED (not followed) or FOLLOWED. Be sure to explain WHY you think that is true! More than one qualitative characteristic may apply.

ABC Company has always included a 12 month period, from the beginning of January to the end of December, in its financial statements. This year, because December sales were very poor, the business has included 13 months, from the beginning of January to the end of the following January.

HDT Company is a new business that just started out. At the end of the year the business's accountant checks out how other businesses in this industry are recording their business transactions and ensure HDT uses similar policies.

DHD Company has not produced financial statements in 2 years. The bank has asked repeatedly but the owner of DHD Company has ignored the bank's request.

Question 5

Provide the definition of each of the assumptions WITHOUT looking at the chapter!

Assumption	Description:
Separate Entity	
Unit-of-Measure	
Going Concern	
Historic Cost	
Time Period (Periodicity)	
Full Disclosure	

Question 6

You have already seen the scenarios below when you looked at qualitative characteristics. Now that you know the assumptions, choose the assumption that you think applies and indicate if it has been VIOLATED (not followed) or FOLLOWED. Be sure to explain WHY you think that is true! More than one assumption may apply.

ABC Company has always included a 12 month period, from the beginning of January to the end of December, in its financial statements. This year, because December sales were very poor, the business has included 13 months, from the beginning of January to the end of the following January.

HDT Company is a new business that just started out. At the end of the year the company's accountant checks out how other businesses in this industry are recording their business transactions and ensure HDT uses similar policies.

DHD Company has not produced financial statements in 2 years. The bank has asked repeatedly but the owner of DHD Company has ignored the bank's request.

Question 7

Name all the qualitative characteristics and then name the assumptions. DO NOT look at the chapter...do it from memory...because, for midterms and exams, you have to be able to name and define every single one of them! When you have named them indicate, using connecting lines, which assumption was developed in response to which qualitative characteristic. Note that some characteristics may connect to more than one assumption.

Qualitative Characteristic	Connection (use connecting lines)	Assumptions

Solutions - Check your understanding

Check your understanding

Fashion designers would be categorized in which business sector, and why?

That depends on what the fashion designers do! If the fashion designers are part of the process of turning fabric into finished goods (clothing) they would be part of the secondary sector. If the fashion designers only design the clothing (which is a service) then they would be part of the tertiary sector.

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Check your understanding

What is the main objective of a customer who buys a car from the Ford Motor Company?

There may be a number of answers including:

- get the best car for the money
- good service record for the car being purchased
- how long the warranty period is and what it covers
- whether Ford is considered a reliable car company
- whether the car's gas consumption is economical

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Check your understanding

A used car sales associate, Jim Morris, is trying to sell you a used Volkswagen Golf. He has given you a rundown of the car's history and, considering the low price of the car, it sounds like a great deal! He leaves to speak to his manager and you hear two other sales associates talking about Jim. Turns out Jim's sales have been slow this month and he really needs to make as many sales as possible over the next 5 days so he can meet his sales target.

What qualitative characteristics might Jim violate and why? What would have to be true for you to believe everything Jim says about the car?

Jim MIGHT be violating the faithful qualitative characteristic because he needs to make the sale in order to meet his sales targets. He therefore has an incentive to exaggerate the car's good qualities and hide the car's poor qualities. What the buyer would need to have, in order to believe everything Jim says about the car, would be documentation from an outside source

(say, an insurance company's record of all claims made against the car or a police report about all past accidents). Another thing that might help is certification of the car's condition from an outside mechanic licensed by a government agency. Note that there is no way that anyone buying the car can be 100% sure about the information given, but the more outside information available that confirms what Jim says, the greater the likelihood that what he is saying is of good quality.

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Check your understanding

Which assumption is built on the qualitative characteristic "timely"?

The qualitative characteristic “timely” means that information is provided quickly enough so that it is still useful for decision making. The time period assumption says that information is provided while it is still relevant for decision making, which is only true if it is current. They both mean the same thing.

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Practice Questions - Solutions

Question 1

Name/Description	Business Sector
Carpenter	2
Doctor	3
McDonald's Corporation	3
Hydro One	1
Web designer	3
Advertising company	3
Dairy farmer	1
The Keg Restaurant	3
Firefighter	3

Question 2

	Stakeholders:	Question(s) that stakeholders might ask, given their objectives.
1.	Marketing manager	D
2.	Auditor in a large accounting firm	F
3.	Production manager in a manufacturing firm	A
4.	Shareholder	C
5.	Canada Revenue Agency	B
6.	Creditor (banker)	E
7.	Store manager	G

Question 3

Quality:	Description:
Faithful	Truthful, meaning it is complete, free of error, and neutral (unbiased).
Relevant	Applicable or pertinent to your decision making, helps you predict the future and/or confirm decisions you made in the past.
Comparable	Can compare the same business from year to year OR between two different businesses in the same industry.
Verifiable	Anyone looking at the information would determine similar amounts.
Timely	Information is provided quickly (as old information is less useful).
Understandable	Group and present information so it is clear and concise.

Question 4

ABC Company has always included a 12 month period, from the beginning of January to the end of December, in its financial statements. This year, because December sales were very poor, the business has included 13 months, from the beginning of January to the end of the following January.

Faithful - violated - the information is not free of error as it includes an extra month.

Relevant - violated - the additional month is not useful for decision making as it did not happen last year nor will it happen in the next year.

Comparable - violated - cannot compare to last year because it was 12 months then, or next year as it will only be 11 months. Can't compare it to other companies either as they will include only 12 months.

HDT Company is a new business that just started out. At the end of the year the business's accountant checks out how other businesses in this industry are recording their business transactions and ensure HDT uses similar policies.

Comparable - followed - can compare to different businesses in the same industry.

DHD Company has not produced financial statements in 2 years. The bank has asked repeatedly but the owner of DHD Company has ignored the bank's request.

Timely - information is now too old and therefore is no longer useful for decision making.

Question 5

Assumption	Description:
Separate Entity	Only the activities of the business are included in the business's financial information.
Unit-of-Measure	All transactions must be reported using the monetary unit of the country the business's head office is located in, even if the business has offices in many countries.
Going Concern	Businesses will continue their operations well into the future.
Historic Cost	All purchases will be recorded at the amount that was paid for them.
Time Period (Periodicity)	Information will be provided quickly, when it is still relevant to the stakeholders (has the capacity to affect their decisions).
Full Disclosure	If something will affect the decisions of the external stakeholders, it must be reported.

Question 6

ABC Company has always included a 12 month period, from the beginning of January to the end of December, in its financial statements. This year, because December sales were very poor, the business has included 13 months, from the beginning of January to the end of the following January.

None of the assumptions are directly applicable. NOTE: this is the reason why preparers of financial information follow BOTH the qualitative characteristics AND the assumptions.

HDT Company is a new business that just started out. At the end of the year the company's accountant checks out how other businesses in this industry are recording their business transactions and ensure HDT uses similar policies.

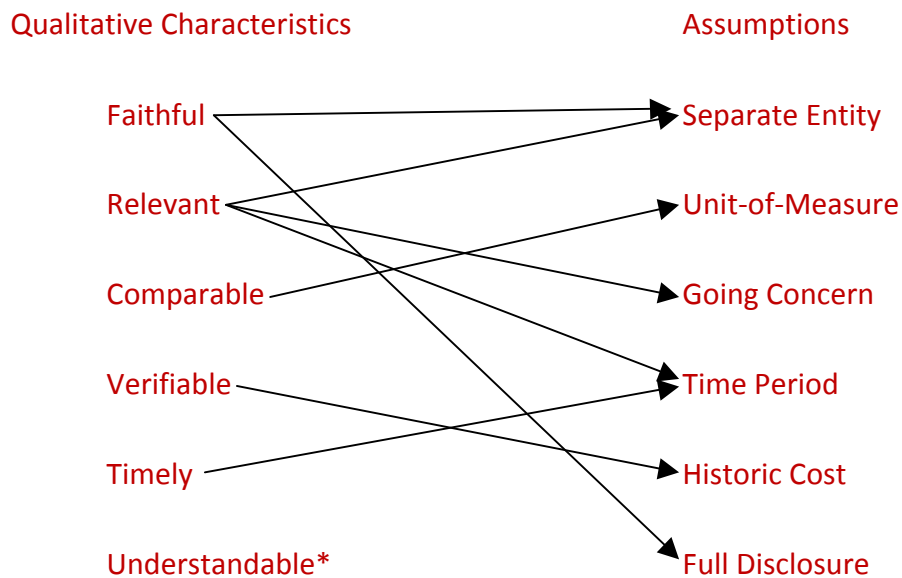
None of the assumptions are directly applicable. NOTE: this is the reason why preparers of financial information follow BOTH the qualitative characteristics AND the assumptions.

DHD Company has not produced financial statements in 2 years. The bank has asked repeatedly but the owner of DHD Company has ignored the bank's request.

Time period assumption - violated - old information is not useful for stakeholder decision making.

Question 7

Note that students may connect the characteristics in different ways. This is acceptable as long as they can EXPLAIN why the two connect.



*Understandable ties into all of the Assumptions.

References:

¹ Downloaded from <http://www.merriam-webster.com/dictionary/business>