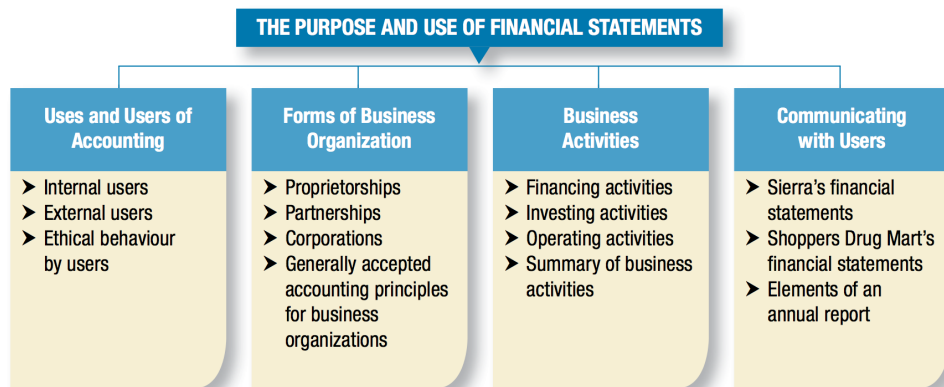


preview of  
CHAPTER

1

How do you start a business? How do you make it grow into a widely recognized brand name like Shoppers Drug Mart in our chapter-opening feature story? How do you determine whether your business is making or losing money? When you need to expand your operations, where do you get money to finance the expansion—should you borrow, issue shares, or use company funds? To be successful in business, countless decisions have to be made—and decisions require accounting information, as mentioned in our feature story.

The purpose of this chapter is to show you accounting's role in providing useful financial information for decision-making. The chapter is organized as follows:



## Uses and Users of Accounting

**STUDY OBJECTIVE 1**

Identify the uses and users of accounting.

**Essential terms** are printed in blue when they first appear. They are listed and defined again in the glossary at the end of the chapter.

**Accounting** is the information system that identifies and records the economic events of an organization, and then communicates them to a wide variety of interested users. Why does accounting matter to these users? The world's economic systems depend on highly transparent, reliable, and accurate financial reporting. Because of this, accounting has long been labelled "the language of business."

That's one of the reasons why so many Canadians, even those who do not plan on becoming accountants, study accounting. For example, Monique Leroux, president and CEO of Desjardins Group; Elizabeth Marshall, a senator; Zarin Mehta, president and executive director of the New York Philharmonic; George Melville, chairman and owner of Boston Pizza International; Syd Pallister, CFO of Gibbs-Delta Tackle; and Paul Sobey, president and CEO of Empire Company Limited, all have studied accounting in depth.

Whether you plan to become an accountant or not, a working knowledge of accounting will be relevant and useful in whatever role you assume as a user of accounting information. Whether you plan to own your own business, work for someone else in their business, or invest in a business, understanding accounting will be helpful to you. To demonstrate the value of accounting to you as an individual, each chapter includes an "All About You" feature and a related activity in the end-of-chapter material that links an accounting concept to your personal or business life.

Users of accounting information can be divided broadly into two types: internal users and external users. We will discuss each of these in the sections that follow.

### INTERNAL USERS

Internal users of accounting information plan, organize, and run companies. They work for the company. These include finance directors, marketing managers, human resource personnel, production supervisors, and company officers.

In running a business, internal users must answer many important questions, as shown in Illustration 1-1.



**Finance**

Is there enough cash to pay the bills?



**Marketing**

What price should we sell iPads for to maximize profits?



**Human Resources**

How many employees can we afford to hire this year?



**Production**

Which product line is the most profitable?

► **Illustration 1-1**

Questions asked by internal users

To answer these and other questions, users need detailed accounting information on a timely basis; that is, it must be available when it is needed. For internal users, accounting provides a variety of internal reports, such as financial comparisons of operating alternatives, projections of profit from new sales campaigns, analyses of sales costs, and forecasts of cash needs. In addition, companies present summarized financial information in the form of financial statements for both internal and external use.

**Alternative Terminology**  
notes give synonyms that you may hear or see in the workplace and in this text.

## EXTERNAL USERS

There are several types of external users of accounting information. Investors use accounting information to make decisions to buy, hold, or sell their ownership interest. Lenders, such as bankers, use accounting information to evaluate the risks of lending money. Other creditors, such as suppliers, use accounting information to decide whether or not to grant credit (sell on account) to a customer. **Investors, lenders, and other creditors** are considered to be the primary users of accounting information.

**Alternative Terminology**  
*Investors* are also known as *shareholders* and *creditors* are also known as *lenders*.

Some questions that investors, lenders, and other creditors may ask about a company are shown in Illustration 1-2.



**Investors**

Should I purchase shares of this company?



**Lenders and Other Creditors**

Will the company be able to pay its debts as they come due?

► **Illustration 1-2**

Questions asked by external users

In addition to investors, lenders, and other creditors, there are many other external users with a variety of information needs and questions. For example, potential employees use annual reports to learn about the company and evaluate job prospects. Labour unions use financial information to bargain for better salaries and benefits. And taxing authorities, such as the Canada Revenue Agency, use financial statements to assess a company's income tax.

## ETHICAL BEHAVIOUR BY USERS

In order for financial information to have value to its users, whether internal or external, it must be prepared by individuals with high standards of ethical behaviour. Ethics in accounting is of the

utmost importance to accountants and the decision makers who rely on the financial information they produce.

Fortunately, most individuals in business are ethical. Their actions are both legal and responsible. They consider the organization's interests when they make decisions. Accountants and other professionals have extensive rules of conduct to guide their behaviour with each other and the public. In addition, many companies today have codes of conduct that outline their commitment to ethical behaviour in their internal and external relationships.

To sensitize you to ethical situations and give you practice at solving ethical dilemmas, we highlight the importance of ethics in different ways in this text:

1. A number of the feature stories and other parts of the text discuss the central importance of ethical behaviour to financial reporting.
2. Many of the *Accounting Matters* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Every chapter includes an *Ethics Case* in the end-of-chapter material that simulates a business situation and asks you to put yourself in the position of a key decision maker.

**Do It! exercises** prompt you to stop and practice the key points you have just studied before you go further in your reading of the text. *Related exercise material* tells you which Brief Exercises (BE) and Exercises (E) at the end of the chapter have similar study objectives.

### BEFORE YOU GO ON...

#### ► Do It! Users of Accounting Information

The following is a list of questions that may be asked by different users of accounting information:

1. Will I be able to obtain enough cash to finance this month's cash shortfall?
  2. Will the company be able to repay my loan when it comes due?
  3. What was the labour cost for the production of 1,000 board feet of lumber?
  4. Will the company stay in business long enough to service the products I buy from it?
  5. Will the company's share price go up or down in the near future?
- (a) Identify the type of user that would most likely ask each of the above questions from the following list of possible users: chief financial officer, customers, investors, lenders, or production manager.
- (b) Indicate whether the user you chose is an internal or external user.

#### Action Plan

- Understand the difference between internal and external users: Internal users work for the company; external users do not.
- Understand the types of information internal and external users require to make decisions.

#### Solution

| (a)                        | (b)                       |
|----------------------------|---------------------------|
| Type of User               | Internal or External User |
| 1. Chief financial officer | Internal                  |
| 2. Lenders                 | External                  |
| 3. Production manager      | Internal                  |
| 4. Customers               | External                  |
| 5. Investors               | External                  |

Related Exercise Material: **BE1-1** and **E1-1**.



# Forms of Business Organization

Businesses can be organized in different ways and the accounting standards they use can vary depending on the type of organization. There are three common forms of business organization: proprietorships, partnerships, and corporations.

## STUDY OBJECTIVE 2

Describe the primary forms of business organization.

## PROPRIETORSHIPS

When you graduate, you might decide to start your own business. If you do, you may choose to set up a proprietorship. A **proprietorship** is a business owned by one person. It is often called a “sole” proprietorship because the owner has no partners.

The proprietorship form of business organization is simple to set up and gives the owner control over the business. In most cases, only a relatively small amount of money (capital) is needed to start in business as a proprietorship. The owner (the proprietor) receives any profits, suffers any losses, and is personally liable (responsible) for all debts of the business. This is known as unlimited liability.

There is no legal distinction between the business as an economic unit and the owner. Accordingly, the life of the proprietorship is limited to the life of the owner. The business profits are reported as self-employment income and taxed on the owner's personal income tax return. However, for accounting purposes, the business records of the proprietorship must be kept separate from those related to the owner's personal activities.

The separation of business and personal records is known in its simplest form as the reporting entity concept. The **reporting entity concept** requires that the economic activity that can be identified with a particular company be kept separate and distinct from the activities of the owner and of all other economic entities. This concept applies not only to proprietorships, but also to partnerships and corporations, which are discussed in the next sections.

Small service businesses such as hair salons, plumbers, and mechanics are often proprietorships, as are many farms and small retail stores.

## PARTNERSHIPS

Another possibility after graduating would be for you to join forces with other individuals to form a partnership. A **partnership** is a business owned by more than one person. In most respects, a partnership is similar to a proprietorship except that there is more than one owner. Partnerships are often formed because one person does not have enough economic resources to start or expand the business, or because partners bring unique skills or other resources to the partnership.

Partnerships are normally formalized in a written partnership agreement that outlines the formation of the partnership, partners' contributions, how profits and losses are shared, provisions for withdrawals of assets and/or partners, dispute resolution, and partnership liquidation. Although there are advantages to working with others, there are also disadvantages. Each partner generally has unlimited liability for all debts of the partnership, even if one of the other partners created the debt. However, there are certain situations where partnerships can be formed with limited liability for selected partners.

Similar to a proprietorship, the profits of the partnership are reported as self-employment income and taxed on each partner's personal income tax return. In addition, the reporting entity concept requires that partnership records be kept separate from each partner's personal activities.

Partnerships are typically used to organize professional service businesses, such as the practices of lawyers, doctors, architects, engineers, and accountants.

## CORPORATIONS

As a third alternative after graduating, you might choose to form a business as a corporation. A **corporation** is a business organized as a separate legal entity owned by shareholders. Shoppers Drug Mart in our opening feature story is a corporation. As an investor in a corporation such as Shoppers

**Alternative Terminology**  
*Shares* are also known as *stock*.

Drug Mart, you receive shares to indicate your ownership claim. It is often possible for individuals to become owners of shares (shareholders) by investing relatively small amounts of money.

Suppose that you are one of Shoppers Drug Mart's shareholders. The amount of cash that you have in your personal bank account and the balance you owe on your personal car loan are not reported in Shoppers Drug Mart's financial statements. Similar to proprietorships and partnerships, you and the company are separate reporting entities under the reporting entity concept.

Since a corporation is a separate legal entity, its life is indefinite. That means it continues on regardless of who owns its shares. It is not affected by the withdrawal, death, or incapacity of an owner, as is the case in a proprietorship or partnership. Consequently, buying shares in a corporation, especially a large corporation, is often more attractive than investing in a proprietorship or partnership because shares are easier to sell.

There are other factors that need to be considered when deciding which organizational form of business to choose. As we discussed earlier, if you choose to organize as a proprietorship or partnership, you are personally liable for all debts of the business. Shareholders are not responsible for corporate debts unless they have personally guaranteed them. So most shareholders enjoy limited liability since they only risk losing the amount they have invested in the company's shares.

All of these advantages taken together—indefinite life, ease of transferring ownership, and limited liability—can make it easier for corporations, especially large corporations, to raise capital (cash) compared with proprietorships and partnerships.

Proprietors and partners pay personal income tax on their respective shares of the profits, while corporations pay income tax as separate legal entities on any corporate profits. Corporations may receive a more favourable income tax treatment than other forms of business organization. Because of the wide variety of income tax issues that apply to different companies in different jurisdictions, you would be wise to seek professional advice on taxation matters before choosing any form of business organization.

Although the combined number of proprietorships and partnerships in Canada is more than the number of corporations, the revenue produced by corporations is far greater. Most of the largest companies in Canada—for example, Bombardier, Loblaw, Manulife Financial, Royal Bank, and Suncor—are corporations. Recently, the top 50 of Canada's largest corporations each reported annual revenues ranging from \$11 billion to \$51 billion.

Corporations such as these are publicly traded. That is, their shares are listed on Canadian, or other, stock exchanges such as the Toronto Stock Exchange (TSX). **Public corporations** are required to distribute their financial statements to investors, lenders, other creditors, other interested parties, and the general public. Shoppers Drug Mart is currently a public corporation. Its financial statements are readily available on its own website, as well as that of the System for Electronic Document Analysis and Retrieval (SEDAR), which posts financial statements for all public corporations in Canada. We have also included Shoppers Drug Mart's financial statements in Appendix A at the back of this textbook for your easy reference.

In addition to public corporations like Shoppers Drug Mart, there are **private corporations**. Private corporations also issue shares, but they do not make them available to the general public nor are they traded on public stock exchanges. These shares are often said to be "closely held." Consequently, many private corporations, especially small ones, do not have the same advantages of raising capital as do large corporations. For example, a small, local incorporated business would likely have as much difficulty raising funds as would a proprietorship or partnership.

There are some large private corporations, however, such as the Irving Group of Companies, the Jim Pattison Group, and McCain Foods. Some of these private corporations can equal the size of a public corporation. For example, Canada's top-earning private corporation reported annual revenue nearly equal to that of Canada's top-earning public corporation. Like proprietorships and partnerships, private companies almost never distribute their financial statements publicly. There is no requirement to do so as there is for public corporations, and most private corporations do not wish to disclose financial information to their competitors and the wider populace.

Many businesses start as proprietorships or partnerships and eventually incorporate. As the feature story pointed out, Shoppers Drug Mart began as a proprietorship in 1921 with two small operator-owned pharmacies in Toronto called Koffler Drug Stores. By 1962, the company had grown to 17 pharmacies and was renamed Shoppers Drug Mart. It subsequently became a private corporation and in 2001 became a public corporation. It is possible that Shoppers Drug Mart may

revert to a private corporation after it is acquired by Loblaw. At the time of writing, it is anticipated that this acquisition will be completed early in 2014.

Because most Canadian business is transacted by corporations, this book focuses on the corporate form of organization. We will discuss the accounting for both publicly traded and private corporations in this textbook.

## GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ORGANIZATIONS

How do businesses decide on the amount of financial information to disclose? In what format should financial information be presented? The answers to these questions can be found in accounting rules and practices that are recognized as a general guide for financial reporting purposes.

These rules and practices are referred to as **generally accepted accounting principles**, commonly abbreviated as GAAP. GAAP include broad policies and practices as well as rules and procedures that have substantive authoritative support and agreement about how to record and report economic events.

Generally accepted accounting principles can differ depending on the form of business organization. Publicly traded corporations must use International Financial Reporting Standards (IFRS), a set of global accounting standards developed by the International Accounting Standards Board. Private corporations, whose users can have different needs than publicly traded corporations, have a choice between using IFRS or Accounting Standards for Private Enterprises (ASPE), developed by the Canadian Accounting Standards Board.

Most private corporations choose to use ASPE, although there are exceptions. For example, McCain Foods Ltd. is a private company that chose to use IFRS instead of ASPE. It felt that IFRS was a more appropriate option for it given its size and global presence, as it has operations on six continents. We will learn more about IFRS and ASPE for corporations in Chapter 2.

As proprietorships and partnerships are private companies (even though they are not private corporations), these companies generally follow ASPE for external financial reporting purposes. However, proprietorships and partnerships often prepare financial statements only for the internal use of the owner(s), in which case they don't have to follow any particular set of accounting standards.

### Alternative Terminology

*Accounting principles* are also commonly known as *accounting standards* or *accounting policies*.



The ASPE icon indicates that there is a reporting difference for private companies following Accounting Standards for Private Enterprises, compared with those companies following IFRS.

The Accounting Matters! perspectives give examples of how accounting is used in various business situations.

## ACCOUNTING MATTERS!

### What's in a Company Name?

How can you tell whether a company is a corporation or not? Corporations in Canada and the United States are identified by "Ltd." ("Ltée" in French), "Inc.," "Corp.," or in some cases, "Co." following their names. These abbreviations can also be spelled out. In Brazil and France, the letters used are "SA" (Sociedade Anonima, Société Anonyme); in Japan, "KK" (Kabushiki Kaisha); in the Netherlands, "NV" (Naamloze Vennootschap); in Italy, "SpA" (Società per Azioni); and in Sweden, "AB" (Aktiebolag).

In the United Kingdom, public corporations are identified by "plc" (public limited company), while private corporations are denoted by "Ltd." The same designations in Germany are "AG" (Aktiengesellschaft) for public corporations and "GmbH" (Gesellschaft mit beschränkter Haftung) for private corporations. There are no name distinctions between public and private corporations in Canada.

## BEFORE YOU GO ON...

### ► Do It! Business Organizations

In choosing the right organizational form for your business, you must consider the characteristics of each. Choose from the characteristics listed below for each of ownership, liability, life, ease of raising capital, and income tax, and match the characteristic with

(continued)

the form of business organization—proprietorship, partnership, or corporation—they are normally associated with:

- (a) Ownership: Choose among “one individual,” “two or more individuals,” or “many shareholders”
- (b) Liability: Choose between “limited” or “unlimited”
- (c) Life: Choose between “limited” or “indefinite”
- (d) Ease of raising capital: Choose among “hard,” “easier,” or “easiest”
- (e) Income tax: Choose between “paid by individual(s)” or “paid by entity”

**Action Plan**

- Understand the characteristics of each type of business organization.

**Solution**

|                             | Proprietorship     | Partnership                    | Corporation                  |
|-----------------------------|--------------------|--------------------------------|------------------------------|
| (a) Ownership               | One individual     | Two or more individuals        | Many individuals             |
| (b) Liability               | Unlimited          | Unlimited                      | Limited                      |
| (c) Life                    | Limited            | Limited                        | Indefinite                   |
| (d) Ease of raising capital | Hard               | Easier                         | Easiest                      |
| (e) Income tax              | Paid by individual | Paid by individuals (partners) | Paid by entity (corporation) |

Related Exercise Material: **BE1-2** and **E1-2**.



## Business Activities

**STUDY OBJECTIVE 3**

Explain the three main types of business activity.

All businesses are involved in three types of activity: financing, investing, and operating. For example, Shoppers Drug Mart needed **financing** in 2012 to expand its operations, so it borrowed money from outside sources. It then **invested** the cash in new drugstores, as well as expanding and remodelling others. This helped Shoppers increase its **operating** activities and improve sales.

Let's now look at these three types of business activity in more detail.

### FINANCING ACTIVITIES

It takes money to make money. The two primary ways of raising outside funds for corporations are (1) borrowing money (debt financing) and (2) issuing (selling) shares (equity financing) in exchange for cash.

Shoppers Drug Mart can borrow money in a variety of ways. The persons or companies that Shoppers owes money to are called lenders or creditors, one of the key user groups of accounting information. Amounts owed to lenders and other creditors—in the form of debt and other obligations—are called **liabilities**.

Specific names are given to different types of liabilities, depending on their source. For instance, Shoppers Drug Mart may have received funds from an operating line of credit with its bank. An operating line of credit is a pre-arranged bank loan for a maximum amount that allows a company to draw more money than there is on hand in its bank account. When a company uses its operating line of credit to cover cash shortfalls and overdraws its bank account, it results in a liability called **bank indebtedness**.

Shoppers Drug Mart may also have a short-term **loan payable** to a bank (also known as a note payable) for the money borrowed to purchase racks and display cabinets, for example. It may have

**long-term debt**, which can include **mortgages payable**, **bonds payable**, **finance lease obligations**, and other types of debt securities borrowed for longer periods of time.

A corporation may obtain equity financing by selling shares of ownership to investors. Shoppers Drug Mart first issued common shares to the general public in 2001 when it became a publicly traded corporation and listed its shares for sale on the TSX. **Common shares** is the term used to describe the amount paid by investors for shares of ownership in a company. Even if Shoppers becomes a private corporation after its acquisition by Loblaw, it will still have common shares. Its shares will, however, be owned by Loblaw rather than the general public. Common shares are just one class or type of shares (collectively known as **share capital**) that a company can issue.

Companies can also use cash for financing activities, such as repaying debt or repurchasing shares from investors. Shoppers Drug Mart did both in 2012. The claims of lenders and other creditors differ from those of shareholders. If you loan money to a company, you are one of its lenders or other creditors. In loaning money, you specify a repayment schedule; for example, payment at the end of each month. In addition, interest is normally added to the amount due or overdue. As a lender or other creditor, you have a legal right to be paid at the agreed time. In the event of nonpayment, you may force the company to sell assets to pay its debts.

Shareholders have no claim to corporate resources until the claims of lenders and other creditors are satisfied. If you buy a company's shares instead of loaning it money, you have no legal right to expect any payments until all of its lenders and other creditors are paid. Also, once shares are issued, the company has no obligation to buy them back, although it may choose to do so. On the other hand, debt obligations must be repaid.

Many companies pay shareholders a return on their investment on a regular basis, as long as there is enough cash to cover required payments to lenders and other creditors. Payments to shareholders are called **dividends** and are normally in the form of cash, although they can also take other forms. Shoppers Drug Mart paid a dividend of \$1.06 per share to its shareholders in 2012.

## INVESTING ACTIVITIES

After a company raises money through financing activities, it then uses that money for investing activities. Investing activities involve the purchase (or sale) of long-lived assets that a company needs in order to operate. **Assets** are resources that a company owns or controls. Every asset is capable of providing future economic benefits that can be short- or long-lived. Investing activities generally involve long-lived assets. For example, furniture, equipment, computers, vehicles, buildings, and land are all examples of long-lived assets that result from investing activities. Together, they are referred to as **property, plant, and equipment**, or "property and equipment," as Shoppers Drug Mart calls this asset category.

Other examples of long-lived assets include goodwill and intangible assets. **Goodwill** results from the acquisition of another company when the price paid is higher than the value of the purchased company's net identifiable assets. **Intangible assets** are assets that do not have any physical substance themselves but represent a privilege or a right granted to, or held by, a company. Examples of intangible assets include patents, copyrights, and trademarks.

**Cash** is one of the more important assets owned by Shoppers Drug Mart, or any other business. If a company has excess cash that it does not need in the short term, it might choose to invest it in debt securities (such as bonds) or equity securities (such as shares) of other corporations or organizations—these are called **investments**. Many students misunderstand the term *investing activities*, thinking the term means "investments" only. However, in the context of a business activity, investing activities means investing in the long-lived assets necessary to run the company and not just purchasing an investment on which to earn a return for the long term, such as interest or dividends.

## OPERATING ACTIVITIES

Once a business has the finances and has made the investments it needs to get started, it can begin its operations. For example, Shoppers Drug Mart sells prescription and non-prescription drugs, as well as health and beauty aids and household products. We call the amounts earned from the sale of these goods **revenue**. In accounting language, revenues are increases in economic benefits—normally an increase in an asset but sometimes a decrease in a liability—that result from the sale of a product or service in the normal course of business.

### Alternative Terminology

*Property, plant, and equipment* is also known as *capital assets* or *fixed assets*.

### Alternative Terminology

*Revenue* is also known as *income*.

**Alternative Terminology**

*Interest revenue* is also known as *finance income*.

Revenues come from different sources and are identified by various names. For instance, Shoppers Drug Mart's main source of revenue is the money it earns from the sale of prescription and other products to consumers—it calls this revenue “sales.” However, companies may also earn interest revenue on excess cash held as investments and rental income from unused space. Sources of revenue that are common to many businesses are **sales revenue**, **service revenue**, **interest revenue**, and **rent revenue**.

When Shoppers Drug Mart sells a prescription to a customer who has a drug plan, such as Blue Cross, it does not immediately receive all of the cash for the sale. Instead, it must send a bill to Blue Cross for the amount covered by the drug plan and then wait for Blue Cross to pay the amount owed. This right to receive money in the future is called an **account receivable**. Accounts receivable are assets because they will result in a future benefit—cash—when the amounts owed are eventually collected.

We first mentioned the term *assets* in the investing activities section above. A company's long-lived assets, such as property, plant, and equipment, are purchased through investing activities. Other assets—typically with shorter lives—result from operating activities, such as short-term trading investments and accounts receivable. Companies also have other types of receivables, such as interest receivable, rent receivable, and income tax receivable (also known as “deferred tax assets”) that is due from the federal government.

**Supplies** are another example of a short-term asset used in day-to-day operations, as is inventory, which is described next. Before Shoppers Drug Mart can sell products to its customers, it must first buy prescription drugs, health-care aids, cosmetics, household items, and other goods. Items such as these that are held for future sale to customers result in an asset called inventory or **merchandise inventory**. When the goods (inventory) are sold, they are no longer an asset with future benefits but an expense. More specifically, the cost of the inventory sold is an expense called cost of goods sold. In accounting language, **expenses** are the costs of assets that are consumed or services that are used in the process of generating revenues. As we will learn in Chapter 4, expenses are related to assets and liabilities. When an expense is incurred, an asset will decrease or a liability will increase.

**Alternative Terminology**

*Interest expense* is commonly known as *finance costs*.

There are many kinds of expenses and they are identified by various names, depending on the type of asset consumed or service used. For example, Shoppers Drug Mart keeps track of these types of expenses: **cost of goods sold**, **operating and administrative expenses**, **interest expense**, and **income tax expense**. Shoppers' operating and administrative expenses item is a summary of individual expense accounts such as salaries, advertising, utilities, professional fees, rent, depreciation (the allocation of the cost of using property and equipment), amortization (the allocation of the cost of intangible assets), and other costs associated with running the business.

Short-term liabilities may result from some of these expenses. This occurs, for example, when Shoppers Drug Mart purchases drugs on credit (on account) from pharmaceutical companies (suppliers). The obligations to pay for these goods are called **accounts payable**. It may also have **interest payable** on the outstanding (unpaid) liability amounts owed to various lenders and other creditors, **dividends payable** to shareholders, **salaries payable** to employees, **property tax payable** to the municipal and/or provincial governments, and **sales tax payable** to the provincial and federal governments. **Income tax payable** (also known as “deferred tax liabilities”) is an example of another liability that is payable to the government.

To determine whether it earned a profit, Shoppers Drug Mart compares the revenues earned in a period with the expenses incurred in that same period. The goal of every business is to sell a good or service for a price that is greater than the cost of producing or purchasing the good or providing the service, plus the cost of operating the business. This means that revenues should, ideally, be greater than the expenses incurred to generate the revenue. When revenues are more than expenses, a **profit** results, as shown in Illustration 1-3. Profit is also commonly known as *net earnings* or *net income*. In particular, companies following ASPE tend to use the term *net income*.



**Illustration 1-3**  
Determination of profit (loss)

$$\text{Revenues} - \text{Expenses} = \text{Profit (Loss)}$$

Shoppers Drug Mart's revenues exceeded its expenses and it reported a profit of \$608,481 thousand for the year ended December 29, 2012. When the opposite happens—that is, when expenses exceed revenues—a **loss** (also known as a net loss) results.

## SUMMARY OF BUSINESS ACTIVITIES

To summarize our discussion in this section, there are three types of business activities that companies engage in: (1) financing, (2) investing, and (3) operating, as shown in Illustration 1-4.



► Illustration 1-4  
Business activities

1. **Financing activities** include borrowing cash from lenders by issuing debt, or conversely, using cash to repay debt. Cash can also be raised from shareholders by issuing shares, or paid to shareholders by repurchasing shares or distributing dividends.
2. **Investing activities** include purchasing and disposing of long-lived assets such as property, plant, and equipment and purchasing and selling long-term investments.
3. **Operating activities** result from day-to-day operations and include revenues and expenses and related accounts such as receivables, supplies, inventory, and payables.

### BEFORE YOU GO ON...

#### ► Do It! Business Activities

Classify each of the following items as (a) a financing, investing, or operating activity, and (b) an asset, liability, share capital, revenue, or expense.

1. An amount paid to an employee for work performed
2. An amount earned from providing a service
3. An issue of common shares
4. A truck that is purchased
5. An amount owed to a bank

#### Action Plan

- Classify each item based on its economic characteristics.
- Understand the differences among financing, investing, and operating activities.
- Understand the distinctions among assets, liabilities, share capital, revenues, and expenses.

#### Solution

- | (a)                   | (b)  |
|-----------------------|--|
| 1. Operating activity | Expense (salary expense)                     |
| 2. Operating activity | Revenue (service revenue)                    |
| 3. Financing activity | Share capital (common shares)                |
| 4. Investing activity | Asset (truck—property, plant, and equipment) |
| 5. Financing activity | Liability (bank loan payable)                |

Related Exercise Material: BE1-3, BE1-4, E1-3, and E1-4.

