



École de gestion

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CHAPTER 1

THE PURPOSE AND USE OF FINANCIAL STATEMENTS

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Learning Objectives

- Identify the users and uses of accounting.
- Describe the primary forms of business organization.
- Explain the three main types of business activity.
- Describe the content and purpose of each of the financial statements.

Users and Uses of Accounting

- Accounting is the **information system** that
 - identifies and records the economic events of an organization,
 - and communicates them to a wide variety of interested users.

- It is “the language of business”.

- It helps users to make decisions.

Users and Uses of Accounting

Internal users

- ❑ Users within the organization.
- ❑ Accounting information helps to make decisions
 - Whether to purchase a new equipment,
 - Whether to hire new employees,
 - Determine the price to sell products

External users

- ❑ Users who are outside the organization.
- ❑ Accounting information helps to make decisions
 - Is the company earning enough to give me my required return on investment?
 - Will the company be able to repay its debts as the debts come due?



Forms of Business Organization

A business may be organized as:

1. Proprietorship: a business owned by one person.
2. Partnership: a business owned by two or more people.
3. Corporation: a separate legal entity owned by shareholders (exp: Bombardier, Loblaw,...).

Forms of Business Organization Cont'd.

1. Proprietorship

- Advantages
 - simple to establish
 - owner controlled

- Disadvantages
 - Unlimited liability (proprietor personally liable for all debts of the business)
 - Financing may be difficult
 - Limited life.

- The proprietor pays personal income tax on the company's profits. Depending on the circumstances, this may be an advantage or disadvantage.

Forms of Business Organization Cont'd.

2. Partnership

- Advantages
 - simple to establish
 - broader skills and resources
 - shared financial resources
 - shared control

- Disadvantages
 - partners personally liable
 - transfer of ownership may be difficult.

- Partners pay personal income tax on their share of profits. Depending on the circumstances this may be an advantage or disadvantage.

Forms of Business Organization

Cont'd.

3. Corporation

- Advantages
 - easy to sell or transfer ownership
 - greater capital raising potential
 - legal liability limited to the net assets of the corporation
 - Indefinite life.

- Disadvantages
 - more expensive and complex to set up
 - must file corporate income tax returns annually

- Corporations are taxed as a separate legal entity. This may be an advantage or a disadvantage.

Forms of Business Organization

Cont'd.

Public corporations

- list and trade their shares on public stock exchanges
- GAAP: IFRS.
- broad group of users of financial statements.
- Example: Bombardier, Research in motion.

Private corporations

- do not list or trade their shares on public stock ex.
- GAAP: ASPE or IFRS. Once the selection has been made, it must be consistently applied.
- small group of users of financial statements.
- More than 2 million private corporations in Canada (Exp. McCain Foods)



Types of Business Activity

Three types of business activity:

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

Types of Business Activity Cont'd.

1. Financing activities

- Obtaining (and repaying) funds to finance the operations of the business.

- The two primary sources are:
 1. Debt: Borrowing money from lenders and other creditors which creates a liability.

 2. Equity: Issuing (selling) ownership interests in the corporation to shareholders.

Types of Business Activity Cont'd.

2. Investing activities

- Obtaining resources or assets needed to operate the business.

- Examples:
 - Purchase or sale of long-term investments.

 - Purchase or sale of long-lived assets such as equipment.

Types of Business Activity Cont'd.

3. Operating activities

- main day-to-day activities of the business.

- Examples:
 - Sale of merchandise.

 - Purchase of goods for resale.

 - Payments made to repair machines.

 - Short term investments.

Content and Purpose of the Financial Statements

Accountants communicate with users through four financial statements:

1. Income Statement
2. Statement of Changes in Equity
3. Statement of Financial Position
4. Statement of Cash Flows

Content and Purpose of the Financial Statements Cont'd.

1. Income Statement

- Reports success or failure of the company's operations over a specific period of time.
- Summarizes all revenues and expenses for the period.
- Also commonly known as the statement of earnings or statement of profit and loss.
- Profit is also known as net income (especially for companies reporting under ASPE) or net earnings.
- Must be prepared first as profit is a required component to complete the statement of changes in equity.

Content and Purpose of the Financial Statements Cont'd.

SIERRA CORPORATION

Income Statement, Month Ended October 31, 2012

Revenues		
Service revenue		\$10,600
Expenses		
Salaries expense	\$7,200	
Supplies expense	1,500	
Rent expense	900	
Depreciation expense	83	
Insurance expense	50	
Interest expense	25	
Total expenses	<u>9,758</u>	
Profit before income tax		<u>842</u>
Income tax expense		<u>200</u>
Profit		<u><u>\$ 642</u></u>

Content and Purpose of the Financial Statements Cont'd.

2. Statement of Changes in Equity

- Shows the amounts and causes of the changes in shareholders' equity for the period as well as changes in each component of shareholders' equity during the period (share capital, retained earnings, other equity items).
- Covers a *period* of time (same as the income statement).
- Must be completed after the income statement and prior to the statement of financial position.

Content and Purpose of the Financial Statements Cont'd.

SIERRA CORPORATION

Statement of Changes in Equity, Month Ended October 31, 2012

	<u>Common Shares</u>	<u>Retained Earnings</u>	<u>Total Equity</u>
Balance, October 1	\$ 0	\$ 0	\$ 0
Issued common shares	10,000		10,000
Profit		642	642
Dividends		(500)	(500)
Balance, October 31	<u><u>\$10,000</u></u>	<u><u>\$142</u></u>	<u><u>\$10,142</u></u>

Content and Purpose of the Financial Statements Cont'd.

ASPE/IFRS comparison:

- Under ASPE, the statement of retained earnings shows the change in only one component – the retained earnings – of shareholders' equity.
- Under IFRS, the statement of changes in equity shows changes in all components of shareholders' equity including share capital and retained earnings, and any other equity items.

Content and Purpose of the Financial Statements Cont'd.

3. Statement of Financial Position

- shows what the business owns (its assets) and what it owes (its liabilities) and its net worth (its shareholders' equity).
- prepared as at a specific point in time.
- $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$ (The accounting equation).
- Also commonly known as the balance sheet (especially for companies reporting under ASPE).

Content and Purpose of the Financial Statements Cont'd.

SIERRA CORPORATION

Statement of Financial Position, October 31, 2012

	Assets	
Cash		\$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment		4,917
Total assets		<u>\$21,867</u>

Content and Purpose of the Financial Statements Cont'd.

SIERRA CORPORATION

Statement of Financial Position, October 31, 2012

Liabilities and Shareholders' Equity

Liabilities

Accounts payable	\$ 2,500
Salaries payable	3,200
Interest payable	25
Income tax payable	200
Unearned revenue	800
Notes payable	5,000
Total liabilities	<u>11,725</u>

Shareholders' equity

Common shares	10,000
Retained earnings	142
Total shareholders' equity	<u>10,142</u>

Total liabilities and shareholders' equity	<u><u>\$21,867</u></u>
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Content and Purpose of the Financial Statements Cont'd.

4. Statement of Cash Flows

- Reports the cash effects (receipts and payments) of a company's activities for a period of time.
- Shows cash increases and decreases from operating, investing, and financing activities.
- Indicates net increase or decrease in cash during the period as well as ending cash balance.
- Covers the same period of time as the income statement and statement of changes in equity.
- Ending cash in this statement agrees to the ending cash reported in the statement of financial position.

Content and Purpose of the Financial Statements Cont'd.

SIERRA CORPORATION

Statement of Cash Flows, Month Ended October 31, 2012

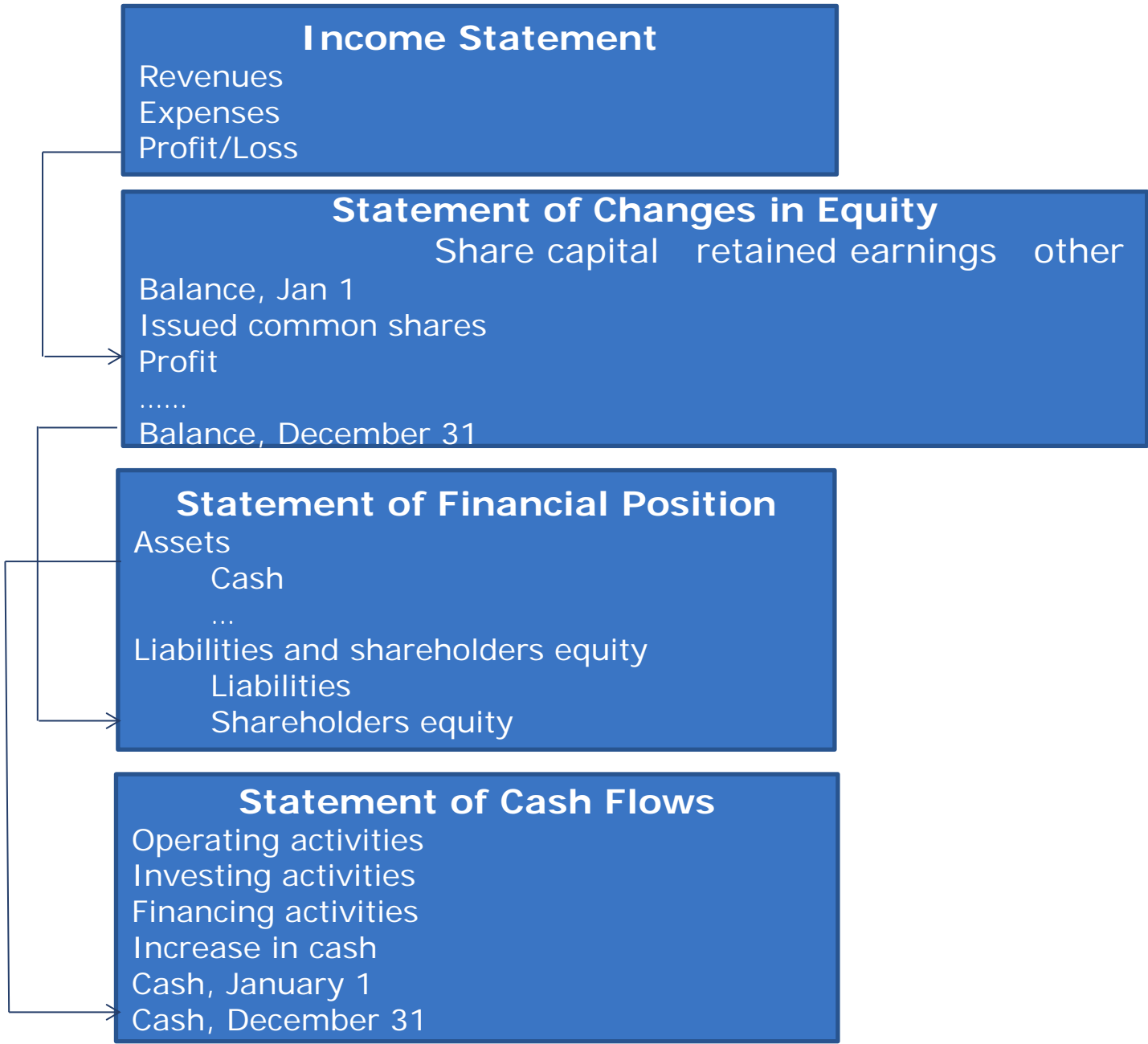
Operating activities		
Cash receipts from operating activities	\$11,200	
Cash payments for operating activities	<u>(5,500)</u>	
Net cash provided by operating activities		\$ 5,700
Investing activities		
Purchase of equipment	<u>\$(5,000)</u>	
Net cash used by investing activities		(5,000)
Financing activities		
Issue of common shares	\$10,000	
Issue of notes payable	5,000	
Payment of dividend	<u>(500)</u>	
Net cash provided by financing activities		<u>14,500</u>
Net increase in cash		15,200
Cash, October 1		<u>0</u>
Cash, October 31		<u><u>\$15,200</u></u>

Content and Purpose of the Financial Statements Cont'd.

Relationships between Statements

Results from some statements are used as data in other statements.

- Profit (loss) from income statement is reported in statement of changes in equity.
- Ending balances of each component of shareholders' equity from statement of change in equity is reported in statement of financial position.
- Cash balance reported in the statement of financial position agrees to ending cash balance on statement of cash flows.



Annual Report

- Publicly traded companies must prepare an annual report each year.
- It includes financial and nonfinancial information about the company:
 - Financial: management discussion and analysis (“MD&A”), statement of management responsibility, auditors’ report, financial statements and notes.
 - Nonfinancial: company’s mission and goals, products, people.
- Example:
http://ir.bombardier.com/var/data/gallery/document/47/33/43/64/13/Bombardier-AR2012_March2013_en.pdf