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CHAPTER 2

A FURTHER LOOK AT FINANCIAL STATEMENTS

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Learning Objectives

- Identify the sections of a classified statement of financial position.
- Identify and calculate ratios for analyzing a company's liquidity, solvency, and profitability.
- Describe the framework for the preparation and presentation of financial statements.

Statement of Financial Position

- presents a snapshot of the company's financial position (Assets, Liabilities and shareholders' equity) at a point in time.

- similar types of assets and liabilities are grouped together.

- order of presentation often used:
 - Liquidity order: From the most to the least liquid (North American companies).
 - Reverse liquidity order (international companies).

Statement of Financial Position Cont'd.

Assets

An asset is:

- a resource controlled by the company
- as a result of past events
- and from which future economic benefits are expected to flow to the company.

Assets are usually classified into:

- Current
- Non-current

Statement of Financial Position

Cont'd.

Current assets

- expected to be converted into cash, sold, or used up within one year of the company's financial statement date or its operating cycle, whichever is longer.

- include:
 - cash,
 - short-term investments,
 - receivables,
 - inventories,
 - supplies,
 - prepaid expenses.

Non current assets

- assets that are not classified as current assets.

- include:
 - Long term investments
 - Property, Plant and Equipment (also called tangible assets, capital assets, or fixed assets)
 - Intangible assets
 - Goodwill

Statement of Financial Position Cont'd.

Liabilities

- A liability is:
 - a present obligation of the company
 - arising from past events,
 - the settlement of which is expected to result in an outflow from the company of resources embodying economic benefits.

- Usually classified as current/non current.

Statement of Financial Position

Cont'd.

Current liabilities

- obligations that are to be paid or settled within one year of the company's financial statement date or its operating cycle, whichever is longer.

- include:
 - bank indebtedness,
 - accounts payable,
 - accrued liabilities (salaries payable, interest payable, income tax payable).
 - Notes payable,
 - current maturities of long-term debt.

Non current liabilities

- obligations expected to be paid or settled after one year.

- known as long-term debt.

- include:
 - notes payable (bank loan payable, bonds payable, mortgages payable).
 - lease liabilities,
 - pension and benefit obligations
 - deferred income tax.

Statement of Financial Position Cont'd.

Shareholders' Equity

- is the residual interest in the assets of an entity after deducting all its liabilities.

- It is composed of:
 1. Share capital
includes all class of shares issued.

 2. Retained earnings
= Accumulated profit - any losses - dividends paid.

 3. Other equity items
example: accumulated other comprehensive income (loss).

Statement of Financial Position Cont'd.

Presentation

Order of liquidity

- Current assets
- Non current assets
- Current liabilities
- Non current liabilities
- Shareholders' equity

Order of reverse liquidity

- Non current assets
- Current assets
- Shareholders' equity
- Non current liabilities
- Current liabilities



FRENETTE CORPORATION
Statement of Financial Position
October 31, 2012

Assets			
Current assets			
Cash		\$ 6,600	
Short-term investments		2,000	
Accounts receivable		7,000	
Merchandise inventory		4,000	
Supplies		2,100	
Prepaid insurance		<u>400</u>	
Total current assets			\$ 22,100
Long-term investments			
Debt investment		\$ 2,000	
Equity investment		<u>5,200</u>	
Total long-term investments			7,200
Property, plant, and equipment			
Land		\$40,000	
Buildings	\$75,000		
Less: Accumulated depreciation	<u>15,000</u>	60,000	
Equipment	<u>\$24,000</u>		
Less: Accumulated depreciation	<u>5,000</u>	<u>19,000</u>	
Total property, plant, and equipment			119,000
Goodwill			<u>3,100</u>
Total assets			<u>\$151,400</u>
	Liabilities and Shareholders' Equity		
Liabilities			
Current liabilities			
Accounts payable		\$ 2,100	
Salaries payable		1,600	
Interest payable		450	
Unearned revenue		900	
Bank loan payable		11,000	
Current portion of mortgage payable		<u>1,000</u>	
Total current liabilities			\$ 17,050
Non-current liabilities			
Mortgage payable		<u>\$10,300</u>	
Total non-current liabilities			<u>10,300</u>
Total liabilities			27,350
Shareholders' equity			
Common shares		\$74,000	
Retained earnings		<u>50,050</u>	
Total shareholders' equity			<u>124,050</u>
Total liabilities and shareholders' equity			<u>\$151,400</u>

Analyzing a Company's Financial Statement data

Three general types of ratios:

1. Liquidity ratios.
2. Solvency ratios.
3. Profitability ratios.

Analyzing a Company's Financial Statement data Cont'd.

➤ Liquidity

- measure the ability to pay obligations as they become due.
- Two measures:

$$\text{Working capital} = \text{Current assets} - \text{Current liabilities}$$

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Analyzing a Company's Financial Statement data Cont'd.

➤ Solvency

- measure the ability to survive over a long period of time through paying interest as it comes due and repaying the face value of debt at maturity.
- measured by the Debt to Total Assets Ratio:

$$\text{Debt to total assets} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

Analyzing a Company's Financial Statement data Cont'd.

➤ Profitability

- Measure a company's operating success for a given period of time.
- Two measures:

$$\text{Earnings per share} = \frac{\text{Profit available to common shareholders}}{\text{Weighted average number of common shares}}$$

$$\text{Price-earnings ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

Framework for the Preparation and Presentation of Financial Statements

- Objective of financial reporting
- Qualitative characteristics of useful financial information
- Underlying assumptions
- Elements of financial statements
- Measurement of the elements of financial statements

Framework for the Preparation and Presentation of Financial Statements Cont'd.

The objective of financial reporting is to:

provide financial information useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company.

Framework for the Preparation and Presentation of Financial Statements Cont'd.

Qualitative characteristics

Fundamental

1. Relevance
2. Faithful representation.

Enhancing

1. Comparability,
2. Verifiability,
3. Timeliness,
4. Understandability.

Framework for the Preparation and Presentation of Financial Statements Cont'd.

Fundamental qualitative characteristics

1. Relevance

- The information has the ability to make a difference in a decision scenario.

- Relevant information may have:
 - Predictive value.
 - Confirmatory value.

- Materiality is an important concept in relevance.

Framework for the Preparation and Presentation of Financial Statements Cont'd.

2. Faithful representation

- The financial statements should reflect the economic reality of what really exists or has happened.

- Information must be:
 - complete,
 - neutral
 - free from material error

Framework for the Preparation and Presentation of Financial Statements Cont'd.

Enhancing qualitative characteristics

1. Comparability: results when users can identify and understand similarities in and differences among items.
2. Verifiability: different knowledgeable and independent users can reach consensus that the information is faithfully represented.

Framework for the Preparation and Presentation of Financial Statements Cont'd.

3. Timeliness: information must be available to decision makers before it loses its ability to influence decisions.

4. Understandability: the information is classified, characterized and presented clearly and consistently.

There is no prescribed order in applying these characteristics.

Framework for the Preparation and Presentation of Financial Statements Cont'd.

The cost constraint

- information will be presented only when the benefit associated with it exceeds the cost of providing it.

The going concern assumption

- the business will continue operating in the foreseeable future

Framework for the Preparation and Presentation of Financial Statements Cont'd.

Elements of financial statements

1. Elements relating to financial position
 - Assets
 - Liabilities
 - Equity
2. Elements relating to measuring performance
 - Income
 - Expenses

Framework for the Preparation and Presentation of Financial Statements

Cont'd.

Income

- involves increases in equity (other than from capital transactions with owners).
- Includes:
 - Revenue
 - Gain

Expenses

- involve decreases in equity (other than from capital transactions with owners).
- Includes:
 - Ordinary expenses
 - Losses

Framework for the Preparation and Presentation of Financial Statements Cont'd.

Measurement

- Quantifying items so that they can be presented in the body of the financial statements.

- Measurement basis:
 1. Historical cost: the amount of cash or cash equivalents paid or received in a transaction.
 2. Fair value: the price that would be received to sell an asset.
 - In choosing between these two, apply the concepts of relevance and representational faithfulness.

Comparing IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Terminology	The term <i>depreciation</i> refers to the allocation of the cost of depreciable tangible assets over their useful lives. The term <i>amortization</i> refers to the allocation of the cost of certain kinds of intangible assets over their useful lives.	The term <i>amortization</i> is used for the allocation of the cost of both depreciable tangible assets and certain kinds of intangible assets over their useful lives.
Earnings per share	Required to present in financial statements	Not required to present in financial statements
Conceptual framework for financial reporting	Still under development	Same general framework currently under development by international and U.S. standard setters anticipated to be applied to private enterprises when complete