

Lecture 1

Chapter 1: The Purpose and Use of Financial Statements

- **Accounting:** the info system that identifies and records the economic events of an **organization**, and then communicates them to interested **users**
 - the language of business
 - Global economic systems depend on reliable and accurate financial reporting
- Accounting does 3 things:
 - **Measures business activities**
 - **Process data into reports (financial statements)**
 - **Communicate results to decision makers**
- **Two categories of users:**
 - **Internal Users** – inside the company
 - Plan, organize, and run a business
 - Decisions:
 - **Pricing** – should we increase the price to sell more, etc.
 - **Strategic** – the vision of the organization, should we obtain this company, etc.
 - **Marketing** – what promos should we use (ads on TV, radio, gift certificates, etc.)
 - **Employee compensation** – rate of pay, bonuses (monetary, stocks, gifts), etc.
 - **Capital budgeting** – should we expand the factory, get new equipment, etc.
 - **Resource allocation** – if I have x amount of \$, should it go to training, R&D, etc.
 - Example Questions:
 - *Finance* – is there enough \$ to pay the bill?
 - *Marketing* – what price should we sell iPads at to maximize profits?
 - *HR* – how many employees can we afford to hire?
 - *Production* – which product line is most profitable?
 - **External Users** – outside the company
 - **Primary Users:**
 - **Investors / Shareholders** – buy, hold, or sell ownership interest
 - **Creditors / Lenders** – evaluate the risk of lending money (i.e. bankers)
 - **Others** – whether or not to grant credit to a customer
 - Tax authorities – does the company respect tax laws? (Canada Revenue)
 - Regulatory agencies – is the company operating within rules and laws?
 - Customers – support products and honour warranties
 - Labour unions – negotiate salaries
 - Economic planners
 - Communities
 - Example Questions:
 - *Investors* – is the company earning enough to give me a R.O.I.?
 - *Lenders and Other Creditors* – will the company be able to pay its debt?

Ethical Behaviour

- For accounting information to have value, preparers must have high ethical standards:
 - Actions are legal and responsible
 - Consider organization's interests
- Accountants and most companies have rules or codes of conduct to guide ethical behaviour
- Companies have rules of conduct
- Steps of analyzing ethical situations
 1. Recognize an ethical situation and the ethical issues involved
 2. Identify and analyze the main elements of the situation (i.e. *stakeholders*)
 3. Identify the alternatives and weigh the impact of each alternative on various stakeholders
- 53% of people trust their accountant and 88% say accountants aren't boring and 17% see job openings

Forms of Business Organizations

- **Reporting Entity Concept** – economic activity of the company is separate and distinct from activities of the owner

- **Three common forms:**
 - **Proprietorships**
 - **Partnerships**
 - **Corporations**

Proprietorships

- **Proprietorship – a business owner by one person** (“*sole*” – no partnership)
 - simple to setup and full control
 - small capital (money)
 - *Unlimited Liability* – receives profits, suffers losses, liable for all debts
 - life lasts as long as the owner's life
 - self-employment profits and owner taxed on personal income tax return
 - *Reporting Entity Concept* applies
 - Examples – mechanics, plumbers, hair salons, farms, local stores, etc.

Partnerships

- **Partnership – a business owned by more than one person**
 - Formalized in a written agreement
 - *Unlimited Liability* for both partners – can be forced to give up personal assets to pay the debt
 - self-employment profits and partners taxed on personal income tax return
 - *Reporting Entity Concept* applies

Corporations

- **Corporations – a business organized as a separate legal entity owned by shareholders**
- Shareholders invest money (i.e. on TSX)
- Indefinite life
- *Shares are easier to sell in a corp. than in a proprietorship or partnership*
- *Limited Liability* for shareholders

- **Public Corporations** – publicly traded shares and distribute financial statements to public parties
- **Private Corporations** – shares are issued but not available to the public on stock exchanges
- **Consolidated** – financial statements that include Company X and all companies owned or controlled by Company X

	Proprietorship	Partnership	Corporation
Ownership	One Individual	Two or more individuals	Many shareholders
Liability	Unlimited	Unlimited	Limited
Life	Limited	Limited	Indefinite
Ease of Raising Capital	Hard	Easier	Easiest
Income Tax	Paid by individual	Paid by individuals	Paid by entity

Types of Business

- **Manufacturing** – produce a good (Intel, Nike, etc.)
- **Merchandising** – sell a good (Staples, Amazon, etc.)
- **Service** – provide a service (Marriott, Bell, etc.)

Business Activities

- **Main Terms:**
 - **Liabilities** – claims or amounts owed to lenders and creditors (debt and other obligations)
 - **Dividends** – payments to shareholders
 - **Assets** – resources that a company owns or controls
 - **Revenue** – amounts earned from the sale of goods
 - **Inventory** – items ready for future sale to customers
 - **Expenses** – the cost of assets that are consumed or services that are used in generating revenue
 - **Profit** – when revenues exceed expenses vs. **Loss** – expenses exceed revenues
- **Three types of Activities:**
 - **Financing**
 - **Investing**
 - **Operating**

Financing

- **Financing – obtaining (and repaying) funds to finance the operations of the business**
 - Borrowing money or repaying loans (debt)
 - Selling or repurchasing shares (equity)
 - Other Terms:
 - **Bank Indebtedness** – use of the operating line of credit to cover cash shortfalls and overdraws from bank account
 - **Loan/Note Payable** – money borrowed for short-term purchases
 - **Long-Term Debt** – debt borrowed for long periods of time
 - Includes mortgages payable, bonds payable, finance lease obligations, etc.
 - **Common Shares** – the amount paid by investors for shares of ownership in a company

Investing

- **Investing – obtaining the resources/assets needed to operate the business for the long term**
 - Purchase or sale of investments
 - Purchase or sale of long-lived assets (property, plant, equipment, and intangible assets)
 - Other Terms:
 - **Property, plant, and Equipment** – long-lived assets
 - Extra **cash = investments** in other corporations
 - ***Strong focus on long-term***

Operating

- **Operating – the main day-to-day activities of the business**
 - Other Terms
 - Types of revenue – *sales, service revenue, interest revenue, rent revenue*
 - **Accounts Receivable** – assets that will result in a future benefit (cash) once received
 - **Cost of Goods Sold** – the cost of inventory sold (expense)
 - Short-lived assets – short-term investments and accounts receivable
 - supplies, inventory, etc.
 - ***When an expense is incurred, an asset will increase or liability will decrease***
 - Types of Expenses:
 - production costs, admin expenses (salaries, advertising, etc.), depreciation expense and depletion expense (cost of using things), finance costs (interest on debts), & income tax
 - Short-term Liabilities:
 - **Accounts Payable** – obligations to pay for goods
 - **Interest Payable** – interest on amounts owed to lenders
 - **Dividends Payable** – shareholder profits
 - **Salaries Payable** – employee wages
 - **Property Tax Payable** – tax to the provincial government
 - **Sales Tax Payable** – tax to the provincial and federal governments
 - **Income Tax Payable / Deferred Tax Liabilities** – owed to the government

KEY 3 Commonalities

- **Financing – liabilities**
- **Investing – assets**
- **Operating – revenues & expenses**

Communicating with Users

- Arrange info into four financial statements
 - **Income Statement** – reports revenues and expenses to show company performance during a period of time
 - **Statement of Changes in Equity** – changes in each component of shareholders' equity, and total equity during a period of time
 - **Statement of Financial Position** – what the company owns (assets), what it owes (liabilities), and its net worth (shareholders' equity) at a specific point in time
 - **Statement of Cash Flows** – shows where a company obtained cash during a period of time and how that cash was used

- **Financial Statements** – business documents that companies use to report the results of their activities to various user groups
 - Publicly traded = produce quarterly and annually
 - **Fiscal Year** – an accounting time period of one year in length
 - *Fiscal Year Ends can vary (75% use December 31) but companies choose when their inventory or operations are low – need time from many workers and less costly to count low inventory*

Income Statement

- **Income Statement** – reports the results of operations for a specific period of time
 - **Revenues**
 - sale of product or service
 - inflow of assets
 - **Expenses**
 - costs of assets consumed or services used to generate revenues
 - **Net Earnings (or Loss) [aka Profit]**
= Revenues – Expenses

$$\textit{Profit or Loss} = \textit{Revenues} - \textit{Expenses}$$

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	9,758	
Profit before income tax		842
Income tax expense		200
Profit		\$ 642

Statement of Changes in Equity

- **Statement of Changes in Equity** – shows the changes in each component of shareholders' equity for the period
 - **Terms:**
 - **Shareholders' Equity** – claims or the ownership interest in a company by shareholders
 - **Share Capital** – amounts paid by shareholders in exchange for shares
 - **Retained Earnings/Deficit** – the cumulative profit retained by the corporation minus the dividends paid to shareholders
 - Shows:
 - A company's dividend payment practices
 - How many shares were issued or repurchased during the period

Total Equity = Issued Common Shares + Retained Earnings or Deficit

where, ***Retained Earnings or Defecit = Profit – Dividends***

	<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>\$10,000</u>	<u>\$142</u>	<u>\$10,142</u>

Statement of Financial Position (Balance Sheet)

- **Statement of Financial Position – reports assets and claims to those assets at a specific point in time**
- Assets = resources owned by a business
- Liabilities = obligations of the business to lenders/creditors
- Shareholders' Equity = share capital and retained earnings of shareholders

Accounting Equation:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

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

Statement of Cash Flows

- **Statement of Cash Flows – reports the cash receipts and payments for a specific period of time**
- Changes in cash should be categorized as one of the following activities
 - Operating
 - Investing
 - Financing
- Reconcile the change in cash to the beginning and ending cash balances
- Answers the following questions:
 - Where did cash come from during the period?
 - How was cash used during the period?
 - What was the change in cash balance during the period?
- Key points:
 - **Operating Activities – activities used to generate profits**
 - **should be a positive amount**
 - **Investing Activities – purchase/sale of long-lived assets or long-term investment securities**
 - **growing companies should have a negative amount**
 - **Financing Activities – borrow/repay money, issue/repurchase shares, or paying dividends**
 - **growing companies should have a positive amount**

$$\text{Cash at End of Period} = \text{Net Increase in Cash} - \text{Cash at Start of Period}$$

where,

Net Increase in Cash

$$= \text{Cash Provided by Operating} \pm \text{Cash Provided by Investing} \pm \text{Cash Provided by Financing}$$

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>

The Accounting Equation

$$\text{Economic Resources} = \text{Claims to Economic Resources}$$

OR

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

- **Assets** – the economic resources of a business that are expected to produce a benefit in the future
- **Liabilities** – “outsider claims” or economic obligations payable to outsiders
- **Shareholders' (Owners') Equity** – “insider claims” of a business

- **For corporations, Shareholders' Equity is divided into two main categories**
 - **Share Capital** – the amount invested in the corporation by its owners
 - the basic component of contributed capital is common shares
 - **Retained Earnings** – the amount earned by income-producing activities and kept for use in the business

Therefore,

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

OR

$$\text{Assets} = \text{Liabilities} + \text{Share Capital} + \text{Retained Earnings}$$

- **Net Income**
 - **Revenues** – increases in retained earnings from delivering goods or services to customers
 - **Expenses** – decreases in retained earnings that result from operations

Components of Retained Earnings (for the period)

$$\text{Start Balance of R. E.} \pm \text{Net Income} - \text{Dividends} = \text{End Balance of R. E.}$$

where,

$$\text{Net Income} = \text{Revenue} - \text{Expenses}$$

Expansion of the Accounting Equation

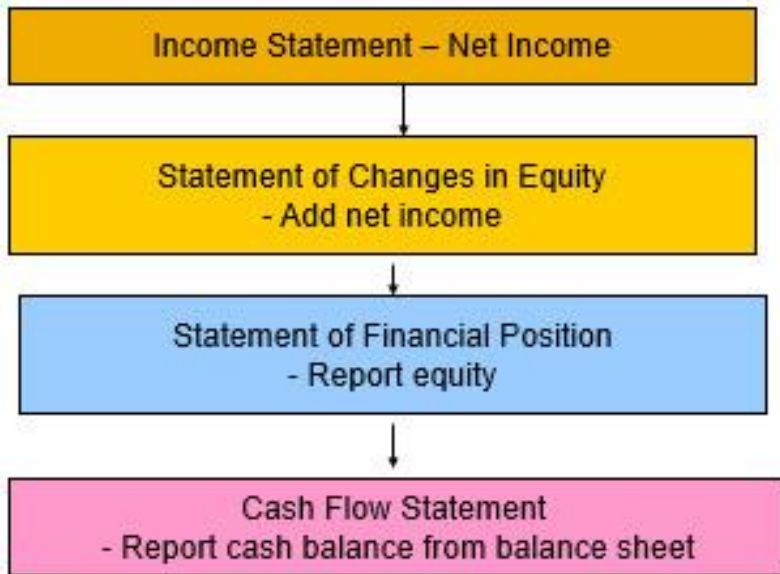
$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

where,

$$\text{Shareholders' Equity} = \text{Shares} + \text{Retained Earnings} - \text{Dividends} + \text{Revenues} - \text{Expenses}$$

Relationship Among the Financial Statements

- Financial Statements...
 - are a picture of the company in financial terms
 - relate to a specific date or covers a particular period



Question	Answer	Financial Statement
1. How well did the company perform (or operate) during the period?	$\text{Net Income} = \text{Revenues} - \text{Expenses}$	Income Statement
2. Why did the company's retained earnings change during the period?	$\text{Ending R. E.} = \text{Starting R. E.} \pm \text{Net Income} - \text{Dividends}$	Statement of Changes in Equity
3. What is the company's financial position at the end of the period?	$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$	Statement of Financial Position
4. How much cash did the company generate and spend during the period?	$\text{Increase or Decrease in Cash} = \text{Oper.} + \text{Inv.} + \text{Finan.}$	Cash Flow Statement

Annual Report

- Publicly traded companies must prepare an annual report each year
- Includes financial and nonfinancial info 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

Generally Accepted Accounting Principles (GAAP)

- Rules and practices for the preparation of financial statements
- Different for publicly-traded and private corporations:
 - Publicly-traded corporations use International Financial Reporting Standards (IFRS)
 - Private corporations may use IFRS or Accounting Standards for Private Enterprises (ASPE)
- Proprietorships and partnerships do not have to use IFRS or ASPE as statements are prepared for internal users only

Comparing IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Accounting standards	Publicly traded corporations must use IFRS; private corporations can choose to use IFRS or ASPE.	Private corporations can choose to use IFRS or ASPE. Once the choice is made, it must be applied consistently.
Terminology	The balance sheet is more commonly known as the statement of financial position and net income as profit under IFRS.	The statement of financial position is more commonly known as the balance sheet and profit as net income under ASPE.
Statement of changes in equity vs. statement of retained earnings	A statement of changes in equity must be presented that shows the changes in all components of shareholders’ equity (e.g., share capital and retained earnings).	A statement of retained earnings is presented that shows the change in only one component—retained earnings—of shareholders’ equity.