

The Classified Statement of Financial Position

- categorizing assets, liabilities and owners equity help:
 - determine whether the company has enough assets to pay its debts as they come due
 - determine the claims of short and long term creditors and lenders on the company's total assets

Assets

- are resources that company owns or controls that will provide future economic benefits
- includes those resources whose benefits will be realized within one year - Current Assets
- includes those resources whose benefits will be realized over more than one year - Non Current Assets

Current Assets

- assets expected to be converted into cash or will be sold/used up within one year of the company's financial statement date/operating cycle
- **operating cycle** is the average time it takes to go from cash to cash in producing revenue
 - in a merchandising business -> the time it takes to purchase inventory, pay cash to suppliers, sell inventory on account, collect cash
 - service business -> time it takes to pay employees, provide services on account, collect cash
 - operating cycle is less than a year
- Types of current assets
 - cash
 - short term investment - investments in debt securities or equity securities held in hopes of generating interest income or gains from profitable resale
 - accounts receivables - amounts owed to the company by customers who purchased products/services on credit or on account
 - accrued receivables - amounts owed to the company for interest, sales tax, rent
 - notes receivable, loans receivable - amounts owed to the

company by customers or others that are supported by a written promise to repay

- merchandise inventory - goods held for sale to customers, can be finished or unfinished goods
- supplies - includes consumable items like office supplies
- prepaid expenses - represents the costs of things like rent and insurance paid in advance of use - reflects unused benefits available for use during the year
- cash equivalents are very liquid investments in debt securities that can be easily converted to cash

Non Current Assets

- are assets not expected to be converted into cash, sold or used up by the business within one year of the financial statement date or its operating cycle
- Types of Non current assets
 - Long Term Investments - includes multi year investments in debt securities (loans, notes, bonds, mortgages) that management intends to hold to earn interest, equity securities (shares) of other companies that management plans to hold for many years to generate investment or revenue for strategic reasons
 - not readily marketable or respected to be converted into cash within a year
 - usually investments are assumed to be long term
 - Property, Plant and Equipment - tangible assets with relatively long useful lives that are currently being used in operating the business
 - includes land, building and equipment and furniture
 - **revaluation method** - when some companies choose to record assets at fair value
 - **depreciation** - when the cost of the asset is allocated over their estimated useful lives
 - **accumulated depreciation** shows the amount of depreciation taken so far over the life of the asset
 - cost of land is never depreciated
 - **Contra Asset Account** - accumulated depreciation is an example of a contra asset -> the value of the contra asset is subtracted from the balance it relates to
 - **carrying amount** - is the difference between cost and

- accumulated depreciation
- Intangible Assets - non current assets that do not have a physical substance and represents a privilege or a right granted to, or held by a company
 - patents, copyrights, franchises, trademarks, trade names, licenses
 - usually are divided into two groups
 - those with definite lives
 - those with indefinite lives
 - **amortization** refers to the allocation of the cost of certain kinds of intangible assets
 - goodwill - results from the acquisition of another company when the price paid for the company is higher than the fair value of the purchased company's net identifiable assets
 - is a calculated amount
 - the difference between the price paid for and the fair value of the assets acquired of the purchased company
 - has no physical substance but will generate future value
 - cannot be separated by the company and sold
 - not amortized, reported separately from intangibles

Liabilities

- are obligations that result from past transactions
- classified as current and non current

Current Liabilities

- obligations that are to be paid or settled within one year of the company's statement date or it's operating cycle
- Types of current liabilities
 - bank indebtedness - a short term loan from a bank, typically occurring when company uses an operating line of credit to cover cash shortfalls
 - Accounts Payable - represents amounts owed by the company to suppliers for purchases made on credit or on account
 - Accrued Liabilities - amounts owed by the company for salaries, interest, sales tax, rent, income tax
 - Notes Payable - amounts owed to banks or suppliers supported by a written promise to repay

- notes and loans can be referred to interchangeably
- can be current and non current
- long term - a portion of the loan or payable is repayable each year
- **current maturities of long term debt** the portion of the payment due to be made within the current year
- remainder of the loan is classified as a non current liability
- the relationship between current assets and current liabilities is important in evaluating a company's ability to pay its current liabilities

Non Current Liabilities

- obligations that are expected to be paid or settled after one year
- Types of non current liabilities
 - Notes payable, including bank loans payable, mortgage payable and bonds payable
 - mortgages payable - similar to long term notes but have property pledged as security for the loan
 - Bonds payable - used by large corporations and governments to borrow large sums of money
 - Lease obligations - includes amounts to be paid in the future on long term rental contracts used for equipment or other property
 - pension and benefit obligations - amounts companies owe past and current employees for retirement benefits
 - deferred income tax liabilities - represents income tax that is expected to be payable in a later year or years when a company prepares its future corporate income return
- non current liabilities stated on the statement of financial position -> are accompanied by extensive notes to financial statements
 - includes nature of the obligation

Shareholder's Equity

- divided into two parts
 - share capital
 - retained earnings

Share Capital

- shareholders purchase shares in a company through investing cash -> or other assets
- investments are recorded as either common or preferred shares
- **Share Capital or Capital Stock** - total of all classes of shares issued is classified as share capital or capital stock

- companies usually have only one class of shares -> common shares

Retained Earnings

- **retained earnings** are the cumulative profits that have been retained for use in a company
- changes to retained earnings and share capital are detailed on the statement of changes in equity
- ending balances of share capital and retained earnings -> determined on the statement of changes in equity
 - combined and reported as shareholders' equity on the statement of financial position
 - common shares are also known as **ordinary shares**
- 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

Using the Financial Statements

- **ratio analysis** expresses the relationships between selected items of financial statement data
 - liquidity
 - solvency
 - profitability ratios are three general ratios used to analyze financial statements
- **liquidity ratio** measures a company's short term ability to pay its maturing obligations and to meet unexpected needs for cash
- **solvency ratio** measures a company's ability to survive over a long period of time
- **profitability ratio** measures a company's operating success for a given period of time
- ratios give clues about underlying conditions that may not be easy to

see when items are examined separately

- comparisons
 - **intracompany comparisons** covering two years for the same company
 - **intercompany comparisons** are based on comparisons with a competitor in the same industry
 - **industry average comparisons** based on average ratios for particular industries

Liquidity

- measures a company's short term ability to pay its maturing obligations and to meet unexpected needs for cash
- Two examples of liquidity measures
 - working capital
 - current ratio
- **Working capital** the difference between current assets and current liabilities
 - positive: greater likelihood the company will be able to pay its liabilities
 - negative: a company may have to borrow money
 - short term creditors may not be paid
 - **working capital = current assets - current liabilities**
- **Current Ratio** calculated by dividing current assets by current liabilities
 - is a more dependable indicator of liquidity than working capital
 - **Current Ratio = current assets / current liabilities**

Solvency

- measures a company's ability to survive over a long period of time
- **Debt to Total Assets** measures the percentage of assets that is financed by lenders and other creditors - rather than shareholders
- financing provided by lender and creditors is riskier than financing by shareholders
 - debt must be repaid at specific points in time
 - equity does not have to be repaid
 - **Debt to Total Assets = Total Liabilities/ Total Assets**
 - high ratio of debt to total assets is undesirable
 - from the lenders' and creditors' point of view
 - the higher the ratio, the lower the equity 'cushion' available to lenders and other creditors

Using the Income Statement

- reports how successful a company is at generating profit or net earnings from sales

Profitability

- **profitability ratios** measure a company's operating success for a specific period of time
- two examples of profitability ratios -> earnings per share, price earnings ratio
- **Earnings per Share** measures the profit earned on each common share
 - reported only for common shareholders
 - **EARNINGS PER SHARE = Profit available to Common Shareholders / Weighted Avg. Number of Common shares**
 - profit available to common shareholders will be the same as the profit reported on a company's income statement
 - unless company has preferred shares => preferred share dividends must be deducted from profit
 - are presented in financial statements for publicly traded companies
 - comparisons of earnings per share are not meaningful
- **Price Earnings Ratio**
 - can be compared across companies
 - measures the ratio of the stock market price of each common share to its earnings per share
 - **price earnings ratio = market price per share / earnings per share**
 - used by investors for valuation purposes
 - shows what investors expect of a company's future profitability

Framework for Preparation and Presentation of Financial Statements

Standard Setting Environment

- **conceptual framework** is a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and prescribes the nature, function and limits of financial accounting statements
 - guides decisions about what to present in financial statements, alternative ways of resorting economic events and appropriate ways of communicating information

Conceptual Framework for Financial Statements

- Objective Financial Reporting
- Qualitative characteristics of useful financial information
- underlying assumption
- elements of financial statements
- measurement of the elements of financial statements

Objective of Financial Reporting

- **objective of financial reporting** is to provide financial information about a company that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the company
 - decisions involve buying, selling or holding equity and debt instruments, providing or settling loans and other forms of credit
- financial info. about the company is provided by general purpose financial statements
 - provides info about a company's economic resources and claims against resources
 - provides info about effects of transactions and other events changing a company's economic resources and claims
- Financial statements are prepared using the **accrual basis of accounting**
 - effects of transactions a company's economic resources and claims are recorded in the period when a transaction occurs
 - not when cash is received or paid

Qualitative Characteristics of Useful Financial Information

- identifies the types of information that are likely to be most useful to existing and potential investors, lenders, other creditors in making their decisions
- **Fundamental Qualitative Characteristics** - there are two fundamental qualitative characteristics of useful financial information
 - Relevance
 - Faithful Representation
- accounting information has relevance if it makes a difference in users' decisions
 - may have predictive value, confirmatory value, or both
- **predictive value** - financial information has predictive value if it helps users make predictions about future events
- **confirmatory value** - financial information has confirmatory value if it

helps users confirm or correct their previous predictions or expectations

- **materiality** - information is considered material if its omission or misstatement could influence the decisions of users
 - materiality and relevance are both defined in terms of what influences or makes a difference to a decision maker
- faithful representation - for accounting information to be useful, it must be relevant and represent economic reality
 - complete - nothing important was omitted
 - neutral - is not biased toward one position or another
 - free from material error
- **Enhancing Qualitative Characteristics** there are four enhancing qualities of useful information
 - comparability
 - verifiability
 - timeliness
 - understandability
- **comparability** results when users can identify and understand similarities in and differences among items
 - consistency aids comparability when a company uses the same accounting principles and methods from year to year
 - when reported consistently, financial statements can be used for a meaningful analysis of trends within the company
- **verifiability** if different knowledgeable and independent users can reach consensus that information is faithfully represented
 - determined by verifying an amount directly - counting cash
 - determined by checking inputs to a formula and recalculating the outputs
- **timeliness** when accounting information is relevant it should be available to decision makers before it loses its ability to influence decisions
- **understandability** when information is classified, characterized and presented clearly and concisely
 - means reasonably informed users can interpret the information and comprehend its meaning

Cost Constraint on Useful Financial Reporting

- **cost constraint** is a pervasive constraint ensuring that the value of the

information provided in financial reporting is greater than the cost of providing it

- benefits of financial reporting information should justify costs of providing and using it
- providing additional information increases costs,
 - benefits may be less than the costs

Underlying Assumption

- **going concern assumption** assumes that a company will continue in operation for the foreseeable future
- if a company is assumed to be going concern, reporting assets at their cost may be more appropriate than reporting land at fair value

Elements of Financial Statements

- elements include assets, liabilities, equity, income, expenses
- financial statements portray financial effects of transactions and events through grouping them into broad categories or classes according to their economic characteristics
- elements should be precisely defined and universally measured

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.

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.

Equity Equity is the residual interest in the assets of the company after deducting all its liabilities.

Income Income includes both revenue and gains. Revenue arises in the course of the ordinary activities of the company while gains may or may not arise from ordinary activities. Income is the increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Expenses Expenses include losses as well as those expenses that arise from ordinary activities of the company. Losses may or may not arise from ordinary activities. Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Measurement of the Elements of Financial Statements

- two measurement costs
 - historical costs
 - fair value
- **Historical Cost**
 - **cost basis of accounting** states that assets and liabilities

- should be recorded at their cost at the time of acquisition
- true for when the item is purchased and when asset/liability is held
- cost is the most relevant value -> because land is intended for use in the business -> not being held for resale
 - land will continue to be reported at cost until it is sold
 - or if the going concern assumption is no longer valid

- **Fair Value**

- **fair value basis of accounting** states that certain assets and liabilities should be recorded and reported at fair value
 - the price that would be received to sell an asset
- cost and fair value are generally the same
 - values diverge as time passes - fair value becomes more useful than cost for certain types of assets and liabilities
 - two fundamental qualitative characteristics -> that make financial information useful for decision making
 - relevance
 - faithful representation

Summary of Conceptual Framework for Financial Reporting

- financial information is provided by general purpose financial statements that are prepared using the accrual basis of accounting
 - qualitative characteristics ensure information provided in these statements are useful
- key assumption: going concern assumption
 - underlies the preparation of financial statements
- objective of financial reporting - to provide financial information that is useful for decision making

Objective of Financial Reporting

Qualitative Characteristics of Useful Financial Information

Fundamental Qualitative Characteristics	Enhancing Qualitative Characteristics	Constraint
1. Relevance <ul style="list-style-type: none"> • Predictive value • Confirmatory value • Material 2. Faithful representation <ul style="list-style-type: none"> • Complete • Neutral • Free from material error 	1. Comparability 2. Verifiability 3. Timeliness 4. Understandability	1. Cost

Underlying Assumption—Going Concern

Elements	Measurement of the Elements
1. Assets 2. Liabilities 3. Equity 4. Revenue 5. Expenses	1. Historical cost 2. Fair value