

Busi 293 Notes

Chapter One

Financial Statements & Business Decisions

Objective of Financial Statements

Communicate financial information to 3rd parties (Users) for decision-making

Financial Statements include:

Statement of Financial position or Balance Sheet – presented at a point in time.

Statement of Comprehensive Income – presented for a period of time.

Statement of Changes in Equity – presented for a period of time.

Statement of Cash Flows – presented for a period of time.

Users

Often identified as either internal or external and categorized as follows:

- Owners
- Potential investors
- Creditors
- Government agencies

As the objectives of users vary widely; it is very difficult to satisfy the needs of all users in a single set of financial statements.

Economic Environment

Important to understand the entity – competitive environment, products/services sold or rendered, the users and their needs. An effective accountant must be aware changes in the environment so the effect on the financial statements can be considered.

Accounting System

A system that collects and processes financial information about an organization and reports that information to decision makers.

Our focus will be on external decision making. Managerial accounting is that branch of accounting deal with internal decision-making.

Accounting Equation

Assets = Liabilities + Shareholders' Equity

Remember this equation must always be in balance. It is important to keep this in mind when analyzing accounting transactions.

Statement of Financial Position

Listing of assets, liabilities and Shareholders' Equity at a point in time.

Refer to textbook Reference A.

Assets must meet the following three criteria:

Economic resources controlled by the entity.

Arose from past transactions.

Future economic benefits can be obtained.

Assets are usually classified by category and are usually presented from most liquid to least liquid. (i.e. convertible into cash)

The **cost principle** records assets at their cost - the amount paid to acquire the asset. Although assets are not recorded at market value, there is a trend to value certain assets at market value for public companies - e.g. marketable securities.

Liabilities must meet the following criteria:

- Represent a present obligation.
- Arose from past transactions.
- Require future outflow of economic resources.

Shareholders' Equity consists of the following three components:

Contributed Capital (Share Capital) – represents permanent investments by shareholders – disclosure of the number of shares outstanding and the amount received for those shares is required.

Retained Earnings - the amount of earnings retained by the entity since inception. (i.e. the amount which has been earned but not yet distributed to the shareholders via dividends).

Other components – essentially reflect the changes in the values of assets and liabilities over time.

Statement of Comprehensive Income

This statement reports the change in shareholders' equity during a period of time from business activities other than investments by shareholders or distributions to shareholders. The first part of the statement reports the revenues earned less the expenses incurred to generate the reported revenue. The difference is the Net Earnings

(Loss) for the period. It reports how well the entity performed during the period. (This part is often referred to as the Statement of Earnings). Please refer textbook Reference B.

The second part reports comprehensive income which comprises income and expense items not recognized in the Statement of Earnings in accordance with International Financial Reporting Standards. This component will be discussed in greater detail in your intermediate accounting courses.

Statement of Changes in Equity

This statement reconciles the opening balance of each of the three components of shareholders' equity – contributed capital, retained earnings and other components to the ending figure. Please refer to textbook Reference C.

You can see that a reconciliation of retained earnings (the accumulated earnings/loss retained by the entity) is prepared as follows:

Opening Retained Earnings- Must agree to amount shown as Retained Earnings on the Balance Sheet at the start of the period.

+ Net Earnings for the period - Must agree to the Statement of Earnings for the period.

- Dividends declared in the period – Amount declared by the Board of Directors in the period

= Ending Retained Earnings – Must agree to amount shown as Retained Earnings on the Statement of Financial Position at the end of the period.

Statement of Cash Flows

Please refer to textbook Reference D for a Statement of Cash Flows prepared under the direct method. In Chapter 5 we will look at the direct method but concentrate on the indirect method. **You will only be responsible for the indirect method on the final examination.** This statement reports the sources and uses of cash for a period.

This statement is presented in three components:

Operating activities – cash used or generated from normal operating activities.

Investing activities – where or how cash was invested by management.

Financing activities – how management financed the entity.

This statement is often difficult for students and investors to understand. Remember an entity must generate sufficient cash to remain in business.

Please refer to textbook Reference E for a summary of the financial statements.

Notes to the Financial Statements

Necessary to provide detailed information on items included in the above noted Financial Statements.

Note presentation is usually very extensive and usually addresses:

Accounting policies adopted by the entity.

Additional detail concerning balances in the financial statements including disclosure of circumstances (e.g. lawsuits) which may be important to users.

RULES FOR PREPARATION OF FINANCIAL STATEMENTS IN CANADA.

Financial Statements in Canada must comply with Generally Accepted Accounting Principles (GAAP).

Based on:

- Ontario Securities Commission (Canada)

- Input from interested parties -

- Handbook published by the Canadian Institute of Chartered Accountants - Accounting Standards Board (AcSB)

Standards are formed with the input of many different groups in the community – it is a political process.

Standards are required to:

- Provide practitioners with guidance to ensure consistency is achieved in the preparation of financial statements.

- Ensure/encourage the production of high quality information.

- Minimize manipulation of financial information.

- Ensure protection of the public.

There is a thrust to harmonize Accounting Standards throughout the world for publicly accountable entities - those whose shares on a recognized stock exchange. Canada has adopted International Financial Reporting Standards (IFRS) for such entities. The financial statements presented in this chapter comply with IFRS.

Canadian Private Enterprises on the other hand may use accounting standards that deviate from IFRS. These standards, known as Accounting Standards for Private Enterprises (ASPE), recognize the information needs of external users of these financial statements differ from the users of publically accountable entities. Private enterprises

do not include the many individual investors that typically purchase shares of publically accountable entities. **Private companies would not prepare a statement of comprehensive income or a statement of changes in equity.**

Management's responsibility for Financial Statements

Management is responsible to ensure that financial information is complete and a faithful representation of the underlying transactions. As many estimates are used in preparing financial statements, it is important to appreciate the risk associated with a published set of financial statements.

To reduce this risk, Publically Accountable Entities must have their financial statements audited by an independent auditor. An example of an Independent Auditors' Report can be found in textbook Reference F. Remember an opinion is not a certification of fact. The opinion does however provide users with some comfort that the financial statements have been presented fairly. Further discussion of this area will be discussed in Busi 455 Principles of Auditing.

Types of Businesses (Please refer to textbook Reference G.)

In your careers, you are likely to encounter three forms of business organizations:

Proprietorship - owned by one individual, easy to form, unlimited liability

Partnership – 2 or more partners, easy to form, unlimited liability

Corporation – most commonly encountered, separate legal entity from its owners, limited liability

Types of Businesses (Please refer to textbook Reference G.) *continued*

While financial statements are prepared for all forms of organizations, there are differences in the preparation of individual statements. (e.g. a corporation has share capital while proprietorships and partnerships do not; a corporation has retained earnings while proprietorships and partnerships do not - they have capital balances.

Ethics in Accounting

Ethics is a cornerstone of the Accounting Profession. The Rules of Professional Conduct provide guidance for members and protection for the public.

All professional accountants in Canada are bound by a code of ethics
Some of the more important rules include:

Confidentiality – respecting the information of their clients

Competence – ensuring they are knowledgeable on the engagements they are completing

Adhering to the CICA Handbook and its recommendations

Not associating with information they know or should know is false and misleading

Upholding the reputation of the profession

Despite this being your first accounting class, it is important to be aware and abide by these important foundations of our profession.