

## Chapter 2- A Further Look At 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

- A classified statement of financial position generally contains the following standard classifications:
- Assets:
  - Current Assets
  - Investments
  - Property, Plant & Equipment
  - Intangible Assets
  - Goodwill
- Liabilities and Shareholders' Equity
- Current Liabilities
- Non-Current Liabilities
- Shareholder's Equity
  - Share Capital
  - Retained Earnings

### **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:** 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.
- **Non-current:** assets that are not classified as current assets.

### **Current Assets**

- Cash,
- Short-term investments, • receivables,
- Inventories,
- Supplies,
- Prepaid expenses,

No prescribed order (Order of liquidity in North America).

### **Non Current Assets**

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

### 1. Current Assets

- **Cash**: cash in hand and cash in bank or other financial institutions.
- **Short term investments (or trading investments)**: investments in debt securities or equity securities that are held in hope of generating interest income or gains from resale.
- **Receivables**: owed to the company by customers or others. Include accounts receivable and notes receivable.
- **Inventories**: finished and unfinished goods
- **Supplies**
- **Prepaid expenses**: represent the cost of things like rent and insurance paid in advance of use.

### 2. Long-Term Investments

- Multi-year investments in:
  - **Debt securities**: loans, notes, bonds, mortgages
  - **Equity securities**: shares of other companies.
- These assets are normally not intended to be sold (and converted to cash) within one year

### 3. Property, Plant and Equipment

- Tangible assets with relatively long useful lives.
- Used in operating the business.
- **Examples**: Land, Buildings, Equipment, Furniture
- Usually listed in order of permanency.
- The cost of property, plant, and equipment is allocated over its estimated useful life. This cost allocation is called **depreciation**.
- Assets that are depreciated should be reported at **carrying amount** (=cost- accumulated depreciation).
- The cost of long-lived assets with indefinite lives is not depreciated (e.g. land).

### 4. Intangible Assets

- Non-current assets that do not have physical substance and represent a privilege or a right held by the company
- Examples: Patents, copyrights, trademarks, licenses
- Generate a future value to the company.
- Amortized if they do not have an indefinite life.

### 5. Goodwill

- Results from the acquisition of another company.
- Is the difference between the price paid for the company and the fair value of the assets less the liabilities acquired from the purchased company.
- Not amortized.

### 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**: 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.
- **Non current**: obligations expected to be paid or settled after one year.

### **Current liabilities**

- Include:
- Bank indebtedness,
- Accounts payable,
- Accrued liabilities (salaries payable, interest payable, income tax payable).
- **Notes payable,**
- Current maturities of long- term debt.

*Often listed in the order in which they are expected to be paid.*

### **Non current liabilities**

- Include:
- Notes payable (bank loan
- Payable, bonds payable, mortgages payable)
- Lease liabilities,
- Pension and benefit
- Obligations
- Deferred income tax.

### **Current Liabilities**

- Bank indebtedness: short term loan from a bank (operating line of credit).
- Accounts payable: amounts owed by the company to suppliers for purchase made on credit (account).
- Accrued liabilities: amounts owed by the company for salaries, interest, rent,...
- Unearned revenue: cash received before revenue is earned.
- Notes payable: are amounts owed to banks but also to suppliers or others, that are supported by a written promise to repay. Can be current or non- current.
- Current maturities of long term debt: When a company has a long term loan, the portion of the payment that is due within the current year is classified as current maturities of long term debt.

### **Non Current Liabilities**

- Bonds payable: used by large corporations to borrow large sums of money.
- Mortgage payable: have property pledged as security for the loan.
- Lease obligations: 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.

### **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).

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

**Analyzing a Company's Financial Statement Data**

Three general types of ratios:

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

**Liquidity**

- Measure the short term ability to pay obligations as they become due.
- Two measures:

<p><b>Working capital</b> = <b>Current assets – Current liabilities</b></p>
<p><b>Current ratio</b> = <math>\frac{\text{Current assets}}{\text{Current liabilities}}</math></p>

### 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:

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

### 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

**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.

### Qualitative Characteristics

#### Fundamental

1. Relevance
2. Faithful Representation

#### Enhancing

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

## **Fundamental qualitative characteristics**

### **1. Relevance**

- The information has the ability to make a difference in a decision scenario.
- Relevant information may have:
  - Predictive value: if it helps users make predictions about the future
  - Confirmatory value: if it helps users confirm or correct their previous predictions or expectations
- Materiality is an important concept in relevance. Information is considered material if its omission or misstatement could influence the decision of users. Both materiality and relevance are defined in terms of what influences or makes a difference to a decision maker

### **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

## **Enhancing qualitative characteristics**

1. 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 or when companies with similar circumstances use the same accounting principles
  2. Verifiability: different knowledgeable and independent users can reach consensus that the information is faithfully represented.
  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 concisely.
- There is no prescribed order in applying these characteristics.

## **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

## **Elements of financial statements**

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

## **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

### 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.

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"> <li>• Predictive value</li> <li>• Confirmatory value</li> <li>• Materiality</li> </ul> 2. Faithful representation <ul style="list-style-type: none"> <li>• Complete</li> <li>• Neutral</li> <li>• Free from material error</li> </ul>	1. Comparability 2. Verifiability 3. Timeliness 4. Understandability	1. Cost
Underlying Assumption—Going Concern		
Elements of Financial Statements	Measurement of the Elements	
1. Assets 2. Liabilities 3. Equity 4. Revenue 5. Expenses	1. Historical cost 2. Fair value	

## 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