

Chapter 1- The Purpose and Use of Financial Statements

Users and Uses of Accounting

- Accounting is the **information system** that
 - identifies and records the economic events of an organization,
 - and communicates them to a wide variety of interested
 - users.
- It is “the language of business”.
- It helps users to make decisions.

Internal users

- Users within the organization.
- Accounting information helps to make decisions
 - Whether to purchase a new equipment,
 - Whether to hire new employees,
 - Determine the price to sell products

External users

- Users who are outside the organization.
- Accounting information helps to make decisions
 - Is the company earning enough to give me my required return on investment?
 - Will the company be able to repay its debts as the debts come due?

Forms of Business Organization

A business may be organized as:

1. Proprietorship: a business owned by one person.
2. Partnership: a business owned by two or more people.
3. Corporation: a separate legal entity owned by shareholders. Could be:
 - Public: list and trade their shares on public stock exchanges (Example: Bombardier, Research in motion)
 - Private: do not list or trade their shares on public stock exchange (Exp. McCain Foods)

Form	Advantages	Disadvantages
Proprietorship	<ul style="list-style-type: none"> • simple to establish • owner controlled 	<ul style="list-style-type: none"> • Unlimited liability • Financing may be difficult • Limited life.
Partnership	<ul style="list-style-type: none"> • simple to establish • broader skills and resources • shared financial resources and control 	<ul style="list-style-type: none"> • partners personally liable • transfer of ownership may be difficult. • Limited life
Corporation	<ul style="list-style-type: none"> • easy to sell or transfer ownership • greater capital raising potential • limited liability. • indefinite life. 	<ul style="list-style-type: none"> • more expensive and complex to set up • must file corporate income tax returns annually

Rules and practices for the preparation of financial statements

- **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**
 - Generally follow ASPE for external reporting
 - Not required to follow any particular standards for internal use

Types of Business Activity

Three types of business activity:

1. Financing activities
2. Investing activities
3. Operating activities

1. Financing activities

- Obtaining (and repaying) funds to finance the operations of the business.
- The two primary sources are:
 1. Debt: Borrowing money from lenders and other creditors which creates a **liability**.
 2. **Equity**: Issuing (selling) ownership interests in the corporation to shareholders.

2. Investing activities

- Obtaining resources or **assets** needed to operate the business.
- Examples:
 - Purchase or sale of long-term investments.
 - Purchase or sale of long-lived assets such as equipment.

3. Operating activities

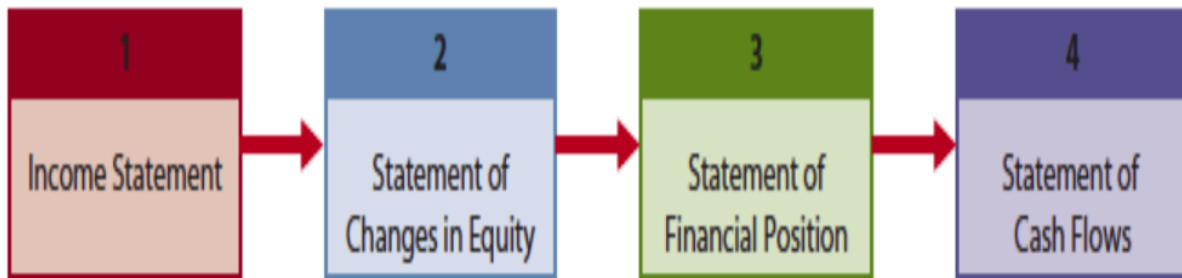
- Main day-to-day activities of the business which generate **revenues** and cause **expenses** to be incurred.
 - Examples:
 - Sale of merchandise.
 - Purchase of goods for resale.
 - Payments made to repair machines.
 - Short term investments.

Content and Purpose of the Financial Statements

Accountants communicate with users through four financial statements:

1. Income Statement
2. Statement of Changes in Equity
3. Statement of Financial Position
4. Statement of Cash Flows

Order of preparation of statements



1. Income Statement

- Reports success or failure of the company's operations **over** a specific period of time.
- Also commonly known as the statement of earnings or statement of profit and loss. Profit is also known as net income (especially for companies reporting under ASPE) or net earnings.
- Must be prepared first as profit is a required component to complete the statement of changes in equity.
- Summarizes all revenues and expenses for the period.
- **Revenues**
 - Arise from sales of products or services
- **Expenses**
 - Costs of assets consumed or services used to generate revenues
- **Profit (loss)**
 - = Revenues - Expenses

SIERRA CORPORATION
Income Statement, **Month** Ended October 31, 2012

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		<u>9,758</u>
Profit before income tax		842
Income tax expense		200
Profit		<u><u>\$ 642</u></u>

2. Statement of Changes in Equity

- Shows the amounts and causes of the changes in shareholders' equity for the period as well as changes in each component of shareholders' equity during the period.
- Shareholders' equity: share capital, retained earnings, other equity items.
- Covers a **period** of time (same as the income statement).
- Must be completed after the income statement and prior to the statement of financial position.

- Changes in shares

$$\boxed{\text{Common shares, beginning of period}} + \boxed{\text{Common shares issued (sold)}} - \boxed{\text{Common shares repurchased}} = \boxed{\text{Common shares, end of period}}$$

- Changes in retained earnings

$$\begin{array}{c} \boxed{\text{Revenues}} \\ - \\ \boxed{\text{Expenses}} \\ = \\ \boxed{\text{Profit (or - Loss)}} \end{array} + \boxed{\text{Retained earnings, beginning of period}} - \boxed{\text{Dividends}} = \boxed{\text{Retained earnings, end of period}}$$

	<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>

3. Statement of Financial Position

- Shows what the business:
 - 1. owns (assets)
 - 2. owes (liabilities)
 - 3. net worth (shareholders' equity).
- **Assets = Liabilities + Shareholders' Equity** (The accounting equation).
- Prepared as **at a specific point** in time.
- Also commonly known as the balance sheet (especially for companies reporting under ASPE).

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

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><u>\$21,867</u></u>

4. Statement of Cash Flows

- Shows cash increases and decreases from:
 - 1. Operating activities,
 - 2. Investing activities,
 - 3. Financing activities.
- Indicates net increase or decrease in cash during the period as well as ending cash balance.
- Ending cash in this statement agrees to the ending cash reported in the statement of financial position.

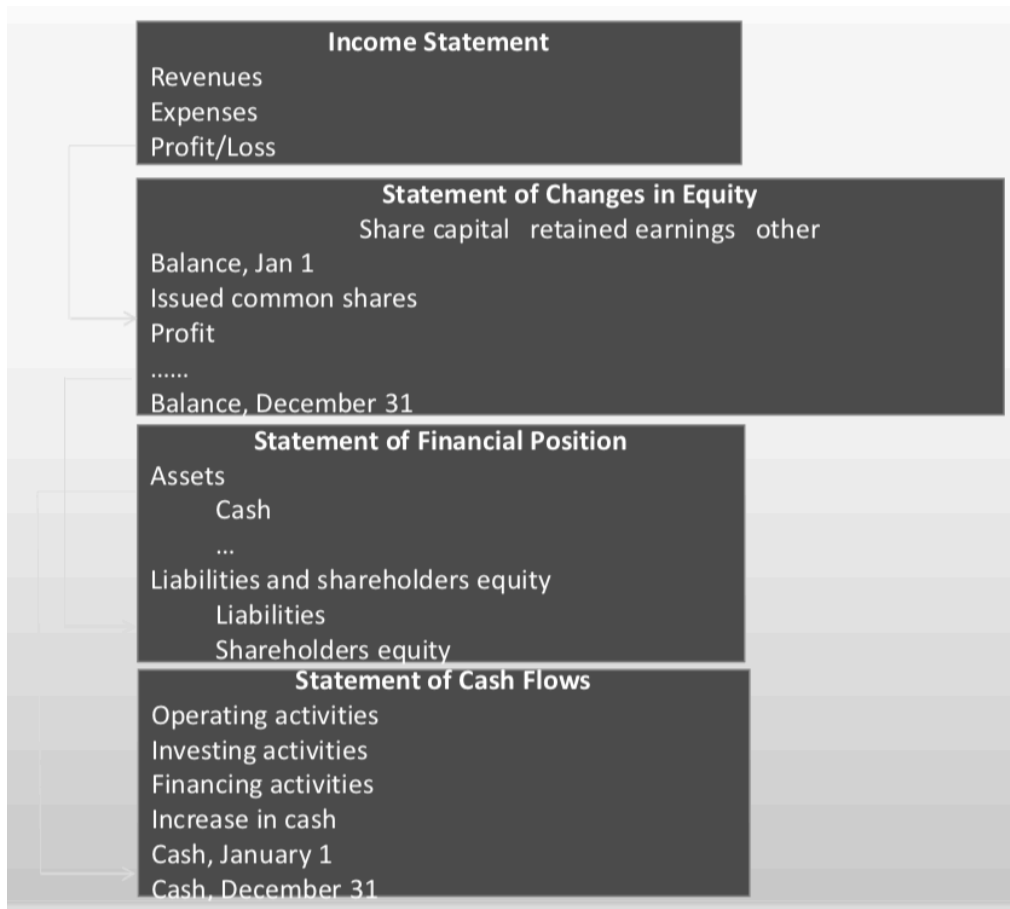
Operating activities		
Cash receipts from operating activities	\$11,200	
Cash payments for operating activities	<u>(5,500)</u>	
Net cash provided by operating activities		\$ 5,700
Investing activities		
Purchase of equipment	<u>\$(5,000)</u>	
Net cash used by investing activities		(5,000)
Financing activities		
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>

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Relationships between Statements

- Profit (loss) from income statement is reported in statement of changes in equity.
- Ending balances of each component of shareholders' equity from statement of change in equity is reported in statement of financial position.

- Cash balance reported in the statement of financial position agrees to ending cash balance on statement of cash flows.



Annual Report

- Publicly traded companies must prepare an annual report each year.
- It includes financial and non financial information about the company:
 - Financial: management discussion and analysis (“MD&A”), statement of management responsibility, auditors’ report, financial statements and notes.
- Non financial: company’s mission and goals, products, people.

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. Proprietorships and partnerships generally follow ASPE.
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 (for example, 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.