

# CH 1 – The Financial Statements

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## Why Accounting is the Language of Business

- Financial statements are how businesses **communicate** performance & position to users (managers, investors, creditors, government, individuals, NPOs).
- Flow of information: **Transactions → Records → Reports → Decisions.**
- Two perspectives:
  - **Financial Accounting:** external + internal users; standardized (GAAP).
  - **Managerial Accounting:** internal; budgets, forecasts, decision support.

 **Tip** – When you read a company's filings, always identify **which statement** answers your question: performance (Income Statement), position (Balance Sheet), cash (SCF), or retained profits flow (RE).

## Organizing a Business: Legal Structures

| Type           | Ownership    | Liability                               | Taxation              | Notes   |
|----------------|--------------|---|-----------------------|---|
| Proprietorship | Single owner | Owner personally liable                 | Personal income       | Common for small retail & professional services |
| Partnership    | 2+ co-owners | Usually personally liable (LLP reduces) | Pass-through          | Shared control & risk                           |
| Corporation    | Shareholders | Separate legal entity                   | Corporate + dividends | Board governance; easier capital raising        |

 **Warning** – “Limited” in LLP/Corp refers to **owner liability**, not business obligation—the business still owes creditors; owners’ exposure is constrained by law/structure.

## GAAP & Statement Set (Order Matters)

- Standards:** GAAP via CPA Handbook; IFRS (publicly accountable) vs ASPE (private).
- Preparation order (conceptually):
  1. **Income Statement (IS)**
  2. **Statement of Retained Earnings (RE)**
  3. **Balance Sheet (BS)**
  4. **Statement of Cash Flows (SCF)**

The **output** of one statement is the **input** to another: IS → RE → BS → SCF reconciliation of ending cash.

## Income Statement (Performance over a Period)

**Core idea:** Revenues/Gains - Expenses/Losses = **Net Income (NI)** (or Net Loss).

Example:

**Mini-format** Company Name **Income Statement** For the Year Ended Dec 31, 20XX

Revenues (sales, service, etc.) Expenses (COGS, salaries, utilities, depreciation, ...) **Net Income**



**Tip** — Net income is **not** cash. Accrual: revenue is **earned**; expense is **incurred**—cash can happen before/after.

## Statement of Retained Earnings (RE Bridge)

**Tracks retained profits:** End RE = Beg RE + Net Income - Dividends

- NI **flows from IS**.
- End RE **flows to BS** (equity).

Example

If Beg RE = 24, NI = 6, Div = 2 → End RE = 28. That **28** must appear in BS under Shareholders' Equity.

## Balance Sheet (Position “As at” a Date)

**Equation:** Assets = Liabilities + Shareholders' Equity

- **Assets:** resources controlled (current vs non-current).
- **Liabilities:** obligations (current vs non-current).
- **Equity:** Common Shares + Retained Earnings.

| Category                | Examples  |
|-------------------------|---|
| Current Assets          | Cash, A/R, Inventory, Prepaids                                      |
| Non-Current Assets      | Land, Buildings, Equipment, Intangibles, Long-term Investments      |
| Current Liabilities     | A/P, Income taxes payable, Accrued expenses, Current portion of LTD |
| Non-Current Liabilities | Bonds payable, Long-term notes                                      |
| Equity                  | Common Shares, Retained Earnings                                    |



**Info** — “Current” means within a year (or the operating cycle, if longer). **Cash on BS** must equal **ending cash** on SCF.

## Statement of Cash Flows (SCF)

Explains **change in cash** over the period; reconciles to **ending BS cash**.

- **Operating:** cash from customers; cash paid to suppliers, employees, etc.
- **Investing:** buy/sell long-term assets & investments.
- **Financing:** issue shares/borrow; pay dividends/repay debt.

Example:

If Begin Cash = 10, Net Cash from O = +3, I = -5, F = +4 → Net ΔCash = +2 → End Cash = 12 (must match BS).

## Relationships Among Statements (Tight Coupling)

1. IS → RE: NI carries into RE.
2. RE → BS: End RE reported in equity section.
3. BS ↔ SCF: Ending Cash on SCF = Cash on BS.

 **Tip** – When numbers “don’t tie”, check **headings** (“For the Year Ended ...” vs “As at ...”) and **flows** (NI → RE, End RE → BS, End Cash ↔ BS).

## Notes to the Financial Statements

- Disclose **policies** (e.g., inventory method, depreciation), **assumptions**, and **judgments**.
- Must be read with the statements to interpret results properly.

 **Info** – Policy examples: FIFO vs Weighted Avg (inventory), straight-line vs declining-balance (depreciation). These choices change **timing** of expenses and therefore NI & equity.

## Underlying Concepts & Assumptions

| Concept/Assumption   | Explanation  |
|----------------------|--|
| Going Concern        | Entity expected to continue normal operations                |
| Separate Entity      | Business distinct from owners; keep records separately       |
| Historical Cost      | Record assets at purchase price (not current market)         |
| Stable Monetary Unit | Assumes currency purchasing power is stable in the short run |

Example:

Laptop bought for \$399 (market \$799). **Historical cost** → record \$399. If company is liquidating, **Going Concern** may not hold → valuation & presentation change (e.g., liquidation basis).

## Ethics & Decision Framework

- Good decisions are **economically sound, legal, ethical**.
- Ask: honest? fair? compassionate? community impact? greatest good? Golden Rule?
- **CPA Ontario** Code provides formal guidance for professional conduct.

 **Warning** – Technology amplifies mistakes: a flawed spreadsheet or missing data in AI/RPA can propagate incorrect balances.

## Quick Worked Examples (GCD-Style Steps)

### Example A – Build the Four Statements

**Given (period):** Sales 100, Expenses 70, Dividends 10, Beg RE 40, Share Issues 0, Begin Cash 12, Net cash O=+5, I=-3, F=-2.

**1) IS:** NI = 100 - 70 = **30** **2) RE:** End RE = 40 + 30 - 10 = **60** **3) BS (partial):** Equity includes **RE 60** (plus any common shares) **4) SCF:** Net ΔCash = 5 - 3 - 2 = **0** → End Cash = 12 (must match BS)

 **Tip** – Always compute **NI first**, then **RE**, then **BS**. Use SCF to justify the **BS cash** figure.

## Example B – Classify Accounts (Fast Drill)

| Item                | Class                            |
|---------------------|----------------------------------|
| Accounts Receivable | Asset (Current)                  |
| Bonds Payable       | Liability (Non-Current)          |
| Prepaid Insurance   | Asset (Current)                  |
| Dividends Declared  | Equity distribution (reduces RE) |
| Common Shares       | Equity                           |

## Mini Practice (Self-Check)

- **Linkage:** If NI increases by 8 and dividends are 3, by how much does **End RE** change? *Answer: +5*
- **SCF Tie:** Begin Cash 15; O=+4, I=-6, F=+5. What is End Cash, and where must you see it? *Answer: 18; BS Cash must equal SCF ending cash.*
- **Classification:** Cash equivalents mature in  $\leq$  3 months—BS or SCF category? *Answer: BS (Cash & cash equivalents); SCF still reconciles the total cash & equivalents.*

## One-Page Checklist (At a Glance)

| Question   | Answer                            |
|--|-----------------------------------|
| Which statement shows profitability?                               | Income Statement                  |
| Which statement carries NI forward?                                | Statement of Retained Earnings    |
| Which statement proves the accounting equation at a point in time? | Balance Sheet                     |
| Which reconciles beginning to ending cash?                         | Statement of Cash Flows           |
| Where do policy choices live?                                      | Notes to the Financial Statements |