

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):
 - Income Statement** (IS)
 - Statement of Retained Earnings** (RE)
 - Balance Sheet** (BS)
 - 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 \rightarrow RE: **NI** carries into RE.
2. RE \rightarrow BS: **End RE** reported in equity section.
3. BS \leftrightarrow 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 \rightarrow RE, End RE \rightarrow BS, End Cash \leftrightarrow 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** \rightarrow record \$399. If company is liquidating, **Going Concern** may not hold \rightarrow 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 Δ Cash = $5 - 3 - 2 = 0 \rightarrow$ 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 ≤ 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