COMM 217 Chapter Notes - Financial Accounting

Financial Accounting (Concordia University)

COMM 217 Chapter Notes

Chapter 1: Financial Statements and Business Decisions

The Four Basic Financial Statements:

1) Statement of Financial Position (IFRS) and Balance Sheet (ASPE)

-The purpose of the statement of financial position (or balance sheet) is to report the financial position (amount of assets, liabilities and shareholder's equity) of an accounting equity, at a particular point in time.

- The SFP contains a **heading** where you'll find the name of the accounting entity (i.e. Canadian Tire Corporation), **title of statement** (i.e. Statement of Financial Position), **specific date** of the statement (i.e. at January 2, 2017), and **unit of measure** (i.e. in millions of dollars).

- The SFP is organized around: *Assets = Liabilities + Shareholder's Equity*

Assets: Assets are economic resources controlled by the entity. Assets have the potential to contribute cash to the entity in the future.

- All assets on the SFP is initially measured at total cost incurred to acquire it.

- Assets can be either debt-financed (i.e. liability), or financed by shareholder's (i.e. shareholder's equity).

- Generally listed in order of liquidity (highly liquid assets (cash, marketable securities) are listed first, meanwhile long-term assets are listed further down the balance sheet.) A liquid asset can be readily converted to cash.

Liabilities: The entity's obligations that result from past business events. They are essentially debts the entity owes to parties like creditors and suppliers. Liabilities are generally listed in terms of their order of maturity, where short-term debt (accounts payable) is listed first, and long-term debt (bonds payable) appears further down the SFP.

Shareholder's Equity: indicated the amount of financing provided by owners of the business, and reinvested earnings.

- S.E. is comprised of three things: 1) contributed capital: investments (e.g. cash, capital assets) made by the owners 2) retained earnings: amount of undistributed earnings reinvested in the business 3) other components: certain, specific equity transactions.

2) Statement of Comprehensive Income (IFRS) and Income Statement (ASPE)

- The SCI reports the change in shareholder's equity during an accounting period from business activities **excluding** exchanges with shareholders.
- The SCI comprises two components, companies have the option of reporting the two components in two different ways: 1) both components recorded in a single financial statement: the SCI. Or 2) Each component can be recorded in two separate statements- the statement of Earnings and the SCI reporting Additional Income and Expense Items.
- The first component provides a measure of a company's net earnings. Where Net Earnings = Revenue- Expenses
- The second component provides details on comprehensive income
- The S/E is composed of a heading, the title of the statement, **specific period** of time, and unit of measure.

- The S/E reports a company's revenues defined as: cash and promises received from delivery of goods and services.
- This means that revenues are considered **whether or not the customer has paid for the goods yet.**
- The S/E also provides an account of the companies expenses, the company recognizes all expenses (cash or credit), incurred during a specific accounting period, regardless of the timing of the cash payment.
- Common expenses: COGS, depreciation expense, salaries, income tax, etc.
- A loss is seen when Total Expenses > Total revenues.

- Important: net earnings won't always add up with total cash collections because revenue is reported when it is earned not when cash is collected.

3) Statement of Changes of Equity

- The SCE reports all changes to shareholders' equity during the accounting period.
- The SCE includes: heading, title of statement, unit of measure used, and also covers a **specific period of time**
- The SCE reports the opening and closing balance of these three components: 1) contributed capital 2) retained earnings 3) other components. (Recall these three accounts are seen on the SFP or B/S.
- The opening balance is retrieved from the SFP previous year's closing balance. Each of the three account opening balances are then adjusted.
- Net earnings are added to the opening retained earnings balance
- Distributed earnings (dividends) are deducted from the opening retained earnings.
- After these two transactions are taken into consideration, the closing balance of retained earnings is presented on the SCE.
- Transactions bearing on contributed capital are added or deducted to/from the opening balances (respectively) to derive the year end balances.
- Note: The closing balances of contributed capital, retained earnings and other components will be the same on both SCE and SFP.

4) Statement of Cash Flows:

- The SCF reports cash inflows and outflows that are related to operating, investing and financing activities during the accounting period.
- Financing activities include: borrowing or paying back money to lenders, receiving additional funds from shareholders, or paying them dividends.
- Investing Activities can include: buying or selling items, such as retail stores, buildings, and equipment used to distribute goods.

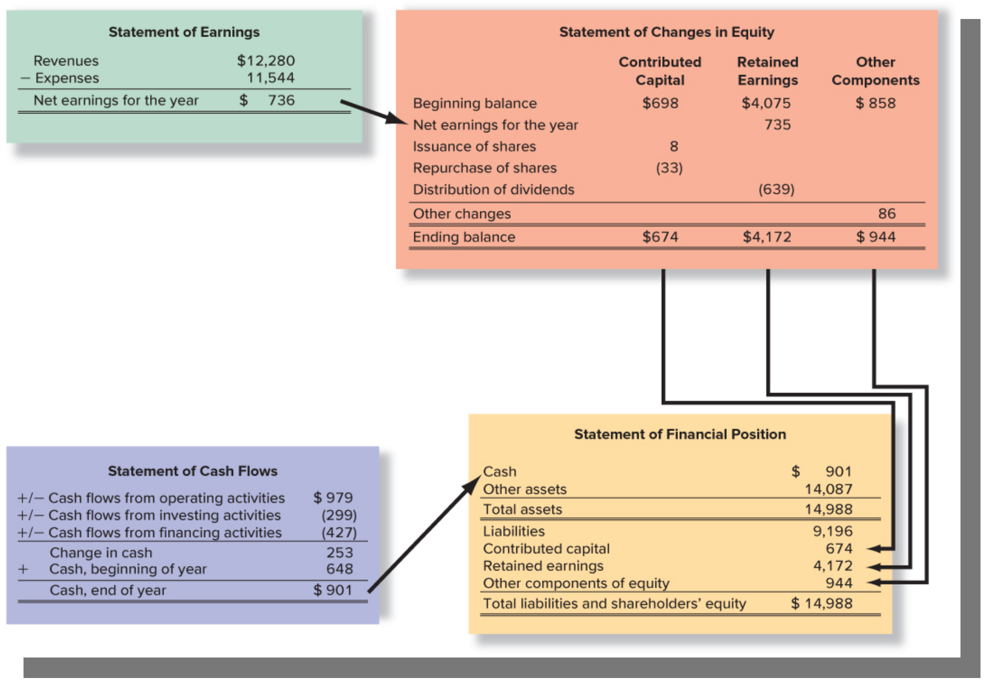
- Operating Activities include: the day-to-day process of obtaining products and services from suppliers, storing and delivering them to customers, collecting cash from clients and paying suppliers.
- In sum, SCF provides data on a company's cash payments and collections in terms of those three activities.
- The SCF conveys the opening and closing cash balances. The opening balance is taken from last year's closing cash balance on the SFP, and the closing cash balance is equal to the cash balance on the current year's SFP.

Relationships Among the Four Financial Statements:

- Net earnings are reported on the SE (or SCI), and then, net earnings are added to contributed capital on the SCE.

-The closing balance of contributed capital, retained earnings and other components of equity (respectively) are identical on both the SCE and SFP.

-The closing cash balance of the SFP is equal with the closing cash balance on the SCF.



Notes to Financial Statements

- Notes provide supplemental info about the financial condition of a company, without these the statements cannot be fully understood.

- 3 types of notes: 1) Description of rules 2) Additional data on line item (ex. Value of specific assets lumped together) 3) Disclosures about unlisted items (things that are important for investors to know but doesn't have to do with financials directly on the statement)

- IFRS = publicly traded corporations, ASPE = Private Companies.
- Sarbanes-Oxley Act 2002 (American): auditors who check if the statements are in accordance with IFRS.

Chapter 2: Investing and Financing Decisions and the Statement of Financial Position

Overview of Accounting Concepts:

Concepts Emphasized in Chapter 2:

Fundamental Qualitative Characteristics – Relevance and Faithful Representation

1) Relevance: Relevant info can influence users' decisions by helping them assess the economic effect of past activites or predict future events.
2) Faithful Representation: The information must be complete, neutral, and free from material error.

Enhancing Qualitative Characteristics

1) Comparability: Firms' accounting information is comparable when similar accounting methods have been applied to produce said information. Comparability decreases when different reporting standards are used in practice.
2) Verifiability: Information is verifiable if the independent accountants can agree on the nature and amount of the transactions reported in a firms financial statements.
3) Timeliness: Financial information is timely when it is available to decision makers when they can actually use it to make forecasts about firms.
4) Understandability: The quality of info that enables reasonable knowledgeable users to comprehend its meaning.

Constraints of Accounting Management (Cost and Prudence)

1) Cost constraint: It is expensive to compile and disseminate financial information. Firms therefore, only distribute information to the extent its expected production costs are less than the expected benefits of the information to decision makers.

2) Prudence: Prudence suggests that care should be taken not to overstate assets and revenue or understate liabilities and expenses.

Financial Accounting is based on three assumptions:

1. *The separate-entity assumption* states that the activities of each business must be accounted for from the activities of its **owner.** A CEO's mortgage for example, does not appear on the corporations balance sheet.

2. *The stable monetary unit assumption* states that accounting information should be measured and reported in the national monetary unit without any adjustment for changes in purchasing power.

3. *The continuity (going-concern) assumption* states that businesses are assumed to continue to operate into the foreseeable future.

- Accountants use the *mixed-attribute measurement model* to measure a firm's assets and liabilities.
- In most cases, they are measured and recognized at **historical cost,** which is the price a firm paid to obtain control of the asset. A liabilities historical cost is a debts nominal value as assumed by the company on its transaction date.
- The historical cost of an asset or liability is sometimes adjusted in a reflection of their **fair value**.

Elements of the Classified Statement of Financial Position

- You will recall the SFP (of B/S) is a snapshot of a company's financial position. It details the extent to which assets are debt-financed (liability) or equity-financed (i.e. shareholder's equity).

- Equity financing is the process of raising capital through the sale of shares in an enterprise.
- Debt financing refers to funds borrowed by a business.
- Classified Balance sheets represent a more polished, finished product than unclassified balance sheets. They categorize assets and liabilities as either short or long term, and provide subtotals for each category.
- Consolidated Financial Statements: When large corporations control multiple subsidiaries, they (the parent company) must produce consolidated financial statements for the entire group.
- Current Assets: Assets that will be turned into cash normally within the year. Note: Inventory is always considered as current assets.
- Non-current assets: considered to be long tem because they will be used or turned into cash over a period longer than the next year (long-term receivables, long-term investments, property and equipment.)
- Recall liabilities are a company's debts – owed to creditors, lenders, suppliers, financial institutions, etc. They are often listed in terms of their *time-to-maturity.*
- Current liabilities: Short-term obligations that will be settled within the coming year by providing cash, goods, or other current assets. (Ex. Of current liabilities: accounts payable, short-term debt, current portion of long-term debt, income tax payable)
- Non-current liabilities: All of the company's obligations not classified as current-liabilities (i.e. long-term debt).
- Shareholder's equity represents the owner's residual ownhership interest in a company's assets. Shareholders assume risk when they invest in a company. Shareholders invest by buyinf shares of a company, and realize a return upon receipt of a dividend. Capital gain is selling your share for more than the purchased price.

<u>What types of business activities cause change in financial statement accounts?</u>

Bookkeeping is the practice of recording and classifying past transactions that bear on some aspect of the firm's performance and financial position. A transaction can either be

1) An *external event:* defined as an exchange between a business and one or more external parties to a business

2) *A measurable internal event:* measurable internal event, such as adjustments for the use of asset in operations.

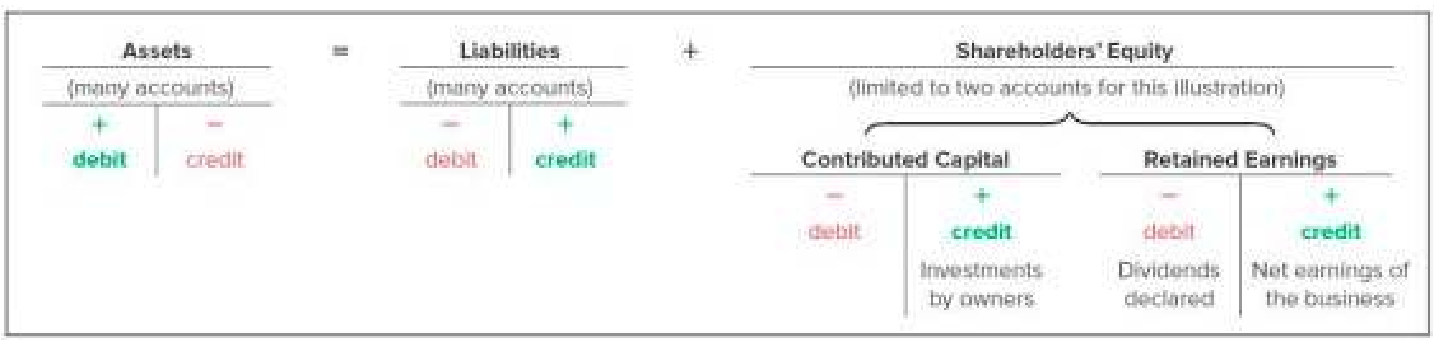
<u>How do Transactions affect Accounts?</u>

Transaction analysis is based on two conditions:

1) Every transaction affects at least two account balances

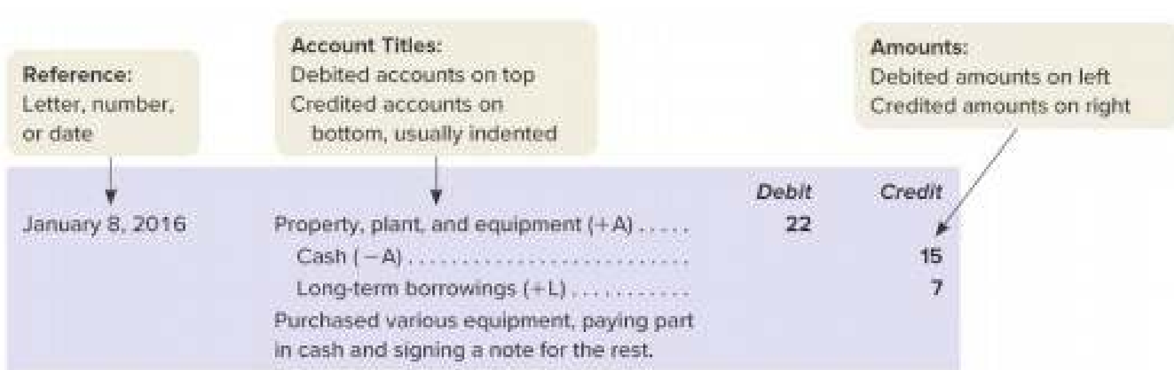
2) The accounting transaction must remain in balance after each transaction.

- Transactions can either increase or decrease a particular account balance
- A single transaction changes no LESS than two account balances
- The T-account is a tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company.
- Each T-account has two sides: a left side, known as the debit side, and a right side known as the credit side. (+/- side)



- Assets are located on the left side of the accounting equation. The left side of an Asset T-account represents its positive side. The amount any transaction increases the value of an asset it added to the **left side.**
- The right side of the asset T-account is its negative side. If a transaction decreases the value of an asset is appears on the right side.

- You debit an asset to increase its balance, and credit an asset to decrease its balance.
- Liabilities and Shareholder’s Equity is located on the right side of the accounting equation (everything is reversed).
- The left side of these accounts is negative while the right side is positive
- The amount by which any transaction increases a liability or S.E. account is added to the **right-hand side** of the pertinent T-account.
- Conversely, the amount by which any transaction decreases the value of a liability or shareholder’s equity account is deducted from the **left-hand side** of the pertinent T-account.
- You **credit** liability and S.E. accounts to **increase their balances.** You debit them to **decrease** their associated balances.
- Transactions also impract revenue and expense accounts
- Expense accounts: Increases appear on the left side of an expense t-account, whereas deductions appear on the left side. You debit an expense account **increase** its balance, and **credit** the account to **decrease** its balance.
- Revenue Accounts: Increases appear on the right side of a revenue T-account, deduction on the left side. You debit a revenue account to decrease its balance, you credit it to **increase** its balance.
- Journal Entries: are made to adjust account balances in a reflection of past transactions. Every journal entry impacts no **less than** two separate accounts. Example of three journal entries:



How is the SFP prepared and analyzed?

- A trial balance is prepared before year end to check the equality of the debits and credits
- Lists the titles of the "accounts" I none column, usually in order: Assets, liabilities, S.E., revenues, and expenses. Each accounts associated balance is listed in one of two adjacent columns. Debits 1st column, credits 2nd column and balances come from the general ledger.

Applicable Ratios

- *Tests of profitability* are used to compare net earnings with one or more primary activities.
- *Tests of Liquidity* are sued to gauge a company's capacity to meet its currently maturing obligations (i.e. current-liabilities) over the operating cycle
- *Tests of solvency* are rations that measures a company's ability to meet its long-term obligations.

** **Current Ratio = Current Assets / Current Liabilities**

This ratio is a test of liquidity.