CHAPTER 1

THE PURPOSE AND USE OF FINANCIAL STATEMENTS

**LEARNING OBJECTIVES**

1. Identify the uses and users of accounting information.

2. Describe the primary forms of business organization.

3. Explain the three main types of business activity.

4. Describe the purpose and content of each of the financial statements.

**CHAPTER OUTLINE**

Learning Objective 1 – Identify the Uses and Users of Accounting information

Accountingis the information system that identifies and records the economic events of an organization, and then communicates them to a wide variety of interested users.

Teaching suggestion – Ask students to try to identify situations where accounting matters.

The users of financial information fall into two categories—internal users and external users.

* Internal users – users within the organization who have access to internal accounting information to help them make decisions required to run the company.
* External users – users who are outside the organization. These users are not involved in managing a company and do not have access to accounting information other than that which is available to the general public.
  + Investors (also known as shareholders)
  + Creditors such as bankers (also known as lenders) and suppliers
  + Others (i.e., Canada Revenue Agency, security commissions and other regulatory agencies, labour unions, potential employees, current employees not involved in managing a company, etc.)

Teaching suggestion – Ask students to assume they are managers of XYZ Corp., and consider questions they might have that could be answered using financial information (for example, the ability to earn income, generate future cash flows to meet obligations, produce satisfactory return on investment). Next, ask them to assume they are potential lenders or other creditors and think of questions they might have that could be answered using financial information.

Learning Objective 2 – Describe the Primary Forms of Business Organization

A business may be organized as **proprietorships**, **partnerships**, or **corporations**.

* Proprietorship or sole proprietorship – a business owned by one person
  + Advantages
* simple to establish
* owner controlled
* small amount of capital is needed
* owner receives any net income
  + Disadvantages
* proprietor personally liable
* financing may be difficult to obtain
* transfer of ownership may be difficult
* Partnership – a business owned by two or more people
  + Advantages
* simple to establish
* broader skills and resources
* shared financial resources
* shared control
  + Disadvantages
* partners personally liable
* transfer of ownership may be difficult
* Corporation – a separate legal entity owned by shareholders
  + Advantages
* easy to sell or transfer ownership
* greater capital raising potential
* legal liability limited to the net assets of the corporation
* some favourable income tax advantages
* indefinite life
  + Disadvantages
* more expensive and complex to set up
* must file corporate income tax returns annually
* Distinguish between public and private corporations
  + A public company lists and trades its shares on public stock exchanges
  + A private company does not make its shares available to the general public nor trade its shares on public stock exchanges
* Business records must be kept separate from those related to the proprietor’s, partners’, and shareholders’ personal activities in a proprietorship, partnership, and corporation, respectively. The reporting entity concept requires that the economic activity that can be identified with a company be kept separate and distinct from the activities of the owner(s) and of all other economic entities.
* Generally accepted accounting principles (GAAP) are the broad policies and practices as well as rules and procedures that have substantive authoritative support and agreement about how to record and report economic events. Principles are also commonly known as policies or standards.
* Publicly traded corporations must use international financial reporting standards (IFRS).

ASPE comparison – Private corporations can choose to follow ASPE (Accounting Standards for Private Enterprises) or IFRS. Once the selection has been made the accounting standards must be consistently applied.

Teaching suggestion – Provide some examples of local private companies and discuss whether it would make sense for the company to should follow ASPE or IFRS.

Learning Objective 3 – Explain the Three Main Types of Business Activity

There are three types of business activity: financing, investing, and operating. Stress to students that these will be covered in more detail later in the book when the statement of cash flows is discussed in Chapter 13.

* Financing activities – to start or expand a business, the company quite often needs cash from outside sources. The two primary sources are:
  + Debt: Borrowing money from lenders and other creditors which creates a liability
  + bank loan
  + debt securities (bonds)
* goods on credit from suppliers
  + Equity: Issuing (selling) ownership interests (shares) in the corporation to shareholders
  + Payment of interest borrowed on funds may be treated as a financing activity or an operating activity under IFRS. The payment of dividends may also be treated as financing activity or operating activity under IFRS. For the purposes of this text, interest will be treating as an operating expenses, dividends will be treated like a financing activity.
* Investing activities – purchasing (or selling) assets needed to operate the business (such as equipment, land, etc.) and purchasing or selling shares or debt securities (such as bonds) of other companies. (in long-term investments, for example).

Teaching suggestion – At this point, ask students to assume they have extra money to invest and ask them how they would prefer to invest the money. Would they consider loaning money to a corporation or would they rather buy shares in the company? Then ask students why they made the decision to lend or buy?

Teaching suggestion – Explain to students that investing does not just mean investments. For most companies, the vast majority of investing activities are normally related to the purchase and sale of long-term assets, rather than investments in shares or debt securities of other companies.

* Operating activities – comprise the primary activities for which the organization is in business.
  + Income results from increases in economic resources – normally an increase in an asset but sometimes a decrease in a liability – that result from the sale of a product or service in the normal course of business.

Teaching suggestion – Stress the fact that just because a business is earning income it is no reason to assume that the business has a lot of cash in the bank. Focus students’ attention on the three types of business activity and let them think about what could have happened to the money the business has made. You might also ask students how a business reporting a loss could have money in the bank.

Teaching suggestion – Ask students to think about some of the ‘dotcom’ businesses. Many of these companies received large amounts of cash from stockholders and creditors (financing activities). The cash was spent on salaries, advertising, entertainment, equipment and other expenses and assets (investing and operating activities). Unfortunately, many of these businesses were unable to generate sufficient revenues. When the cash ran out, many of the businesses went under. Many shareholders lost their investments and many creditors were unable to collect on debts.

Learning Objective 4 – Describe the Purpose and Content of Each of the Financial Statements

Accountants communicate with users through four **financial statements**:

* Statement of Income
  + Reports success or failure of the company’s operations over a specific period of time.
  + Summarizes all revenue and expenses for the period—month, quarter, or year. If revenues exceed expenses, the result is a net income. If expenses exceed revenues, the result is a net loss.
  + Also commonly known as the statement of earnings or statement of profit and loss. Net income is also known as profit, or net earnings.
  + Must be prepared first as net income is a required component to complete the statement of changes in equity.
* Statement of Changes in Equity
  + Shows the amounts and causes of the changes in total shareholders’ equity for the period as well as changes in each component of shareholders’ equity during the period.
  + Reconciles changes in share capital, retained earnings and any other equity accounts (such as accumulated other comprehensive income) from the beginning to the end of the period.
  + Covers the same period of time as the statement of income.
  + Must be completed after the statement of income and prior to the statement of financial position as ending shareholders’ equity is a required component of the statement of financial position.

ASPE comparison – A statement of retained earnings is presented that shows the change in only one component – the retained earnings – of shareholders’ equity. Under IFRS the statement of changes in equity shows changes in all components of shareholders’ equity including share capital and retained earnings, and any other equity items.

* Statement of Financial Position
  + Shows the relationship between assets, liabilities and equities on a particular date at the end of a period, rather than for a period of time.
  + Assets = Liabilities + Shareholders’ Equity.
  + Also commonly known as the balance sheet (especially for companies reporting under ASPE).

Teaching suggestion – Give examples of assets (i.e. cash, accounts receivable, inventories, furniture and fixtures, and equipment). Explain the difference between accounts receivable and notes receivable.

Teaching suggestion – Discuss the concept that assets are the resources that are used by the firm to create more money than what was paid for the assets. Liabilities and shareholders’ equity is how the assets were acquired by the business.

* Statement of Cash Flows
  + Reports the cash effects (receipts and payments or inflows and outflows) of a company’s activities for a period of time.
  + Shows cash increases and decreases for each business activity; operating, investing, and financing activities.
  + Indicates net increase or decrease in cash during the period as well as ending cash balance.
  + Covers the same period of time as the statement of income and statement of changes in equity.
  + Ending cash in this statement agrees to the ending cash reported in the statement of financial position.

Teaching suggestion – Using the statements in the North West Company illustration, show the interrelationships between the financial statements and the sequence of preparation. (Note: the arrows in the example help to illustrate this.)

1. Statement of income (net income to statement of changes in equity).
2. Statement of changes in equity (net income from income statement added to retained earnings account. Ending shareholders’ equity for each account and in total from statement of changes in equity to shareholders’ equity section of statement of financial position).
3. Statement of financial position (ending shareholders’ equity for each account and in total from statement of changes in equity).
4. Statement of cash flows (ending cash agrees with cash shown on statement of financial position).

Teaching suggestion – Ask students to open their books to the “Sierra Corporation” financial statements found in the text. Follow the example to illustrate how the statements link together.

Teaching suggestion – Ask students to prepare selected financial statements including the statement of income, statement of changes in equity, statement of financial position, and/or statement of cash flows. This is an activity that can kindle thinking. In addition, students may be pleasantly surprised to find that cash outflows they previously thought of as expenses are actually investment activities (such as payments to purchase a car).

**SUGGESTED TOPICS TO GENERATE CLASS DISCUSSION**

The following list of topics is provided as ideas to help professors generate class discussion. We hope you find one or more suggestions useful. Suggested solutions are not included as answers can be expected to vary widely.

* Why does Canada have different accounting standards for different types of corporations?
* Shouldn’t all companies follow the same set of accounting standards?
* Why would a private company decide to adopt ASPE instead of IFRS?
* If you had a private company, what accounting standard—ASPE or IFRS—would you select?
* Why are there different terms to describe the same concept?
* Do you think that a business needs a code of ethics?
* If you were setting up a business, how would you structure the business?
* Why would two businesses structure their companies in different ways?
* Why would a bank require financial information when examining whether to loan your company money? Should the bank consider your personal, as well as business, information in the determination of whether to offer your business a loan?
* Is “business ethics” an oxymoron?