CHAPTER 1

OVERVIEW OF CORPORATE FINANCIAL REPORTING

CHAPTER OVERVIEW

Whether you are performing day-to-day operations, borrowing money for a start-up or expansion, restructuring your organization, planning a new avenue of operations, or deciding to purchase or lease, you need to have accounting information that will help you make the best decisions.

**LEARNING OBJECTIVES**

1. Define financial accounting and understand its relationship to economic decision making.
2. Identify the main users of financial accounting information and explain how they use this information.
3. Describe the major forms of business organization and explain the key distinctions between each form.
4. Explain the three categories of business activities and identify examples of transactions related to each category.
5. Identify and explain the content and reporting objectives of the four basic financial statements and the notes to the financial statements.

**TEACHING TIPS FOR LEARNING OBJECTIVES**

***1. Define financial accounting and understand its relationship to economic decision making.***

Cover the definition of financial accounting from the textbook:

“Financial accounting is the process by which information on the transactions of an organization is captured, analyzed, and used to report to decision makers *outside* of the organization’s management team.”

Indicate the financial statements and related accounting information will be used by a variety of financial statement users with specific goals. Guidelines must therefore be set in order to make the information provided understandable and helpful to the various needs of their FS users.

Summarize the two main types of accounting information:

* Reports for **internal** use only (for use by management): This is known as managerial accounting. Its purpose is to inform decision making.
* Reports for **external** use (for use by others outside the organization): This is known as financial accounting. Its purpose is to help external users make decision and is the focus of this course.

***2. Identify the main users of financial accounting information and explain how they use this information.***

Describe the various users of financial information and discuss why the financial information is useful to each particular user.

Users of Financial Statement Information:

|  |  |
| --- | --- |
| **Internal users:** | **Purpose of Financial Statement Information** |
| Management | Decision making |
| **External users:** |  |
| Shareholders, the board of directors, and potential investors | Assess performance and stewardship of company’s management |
| Creditors (for example, financial institutions and suppliers) | Assessing credit worthiness |
| Regulators (for example, a stock exchange) | Ensuring compliance with regulations |
| Taxing authorities (for example, the Canada Revenue Agency) | Verify taxes paid |
| Other corporations, including competitors | Research and report competitive intelligence |
| Securities (stock) analysts | Analyze trends and assess the strengths and weaknesses of companies for investors |
| Credit-rating agencies | Report on a company’s credit worthiness |
| Labour unions – to help negotiate contracts for their members | Research to provide support in contract negotiations |
| Journalists – to validate and supplement information that is reported to readers | Validate and supplement information that is reported to readers |

You might decide to elaborate on the internal users described above. Different managers (i.e., HR, Marketing Executive, Finance Executive, Entrepreneur) would all be required to make decisions based on financial statements and the related information. For example, an HR director may need to decide if a bonus is paid out in a given year based on the performance of the company. The marketing department will try to evaluate the impact of an advertising campaign to decide if more advertising is necessary. Finance executives will make decisions on how to structure the company, to issue shares or issue more debt. The entrepreneur will need to understand the financial accounting information, as she or he will have to monitor the performance of the company and make critical business decisions based on such information.

***3. Describe the major forms of business organization and explain the key distinctions between each form.***

Use Exhibit 1.4 from the textbook to compare and contrast each type of business form.

**Exhibit 1.4** Key Distinctions between the Forms of Business

|  |  |  |  |
| --- | --- | --- | --- |
| **Distinguishing Feature** | **Corporation** | **Proprietorship** | **Partnership** |
| Number of owners | Can be a single owner or multiple owners | Single owner | Multiple owners |
| Separate legal entity? | Yes, personal assets of shareholders *are not* at risk in the event of legal action against company | No, personal assets of owner *are* at risk in the event of legal action | No, partners’ personal assets *are* at risk in the event of legal action |
| Owner(s) responsible for debts of the business? | Only to extent of investment | Yes | Yes |
| Taxed? | Yes, taxed separately | No, profits taxed in hands of owner | No, profits taxed in hands of owners |
| Costs to establish | Most expensive | Least expensive | Moderately expensive |
| Cost to maintain | Most expensive | Least expensive | Moderately expensive |

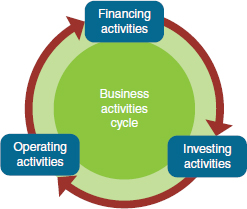
In-Class Exercise

* Prepare a list of fictitious companies such as the one below. Ask the students to indicate what type of corporation would be most fitting for the company described in the table. Ask students to prepare their answer and possibly allow them to discuss their answers within small groups. Ask students why they suggested a specific type of corporation. You can use this opportunity to review key features of the various types of corporations and explain why they are best suited in a specific scenario. *Note the table given to students should not include the grey cells. The grey cells are suggested solutions.*

|  |  |
| --- | --- |
| **Corporation and Description** | **Type of Corporation** |
| Mario’s Dry Cleaning: Mario owns a small dry-cleaning business in Ottawa. Mario is the founder of the business and he has 2 employees. | *Proprietorship*  *Possible reason: one owner, less expensive and complicated than a corporation* |
| Rogers Gibson Stein: A medium size accounting firm operating in Edmonton. John Rogers, Michelle Gibson and Simon Stein are the partners and they have 32 employees. | *Partnership*  *Possible reason: more than one owner, less expensive to form than a corporation* |
| Juniper Berries: An organic food company that specializes in frozen meals that are made from organic products. The business has been doing very well in Canada and the US. Leena, the founder, is looking to expand in Europe. | *Corporation*  *Possible reason: need to limit liability as a food producer, international growth* |
| Element Games: A large multinational video game design and production company that operates out of Montreal. They have 730 employees and have been successful internationally. | *Corporation*  *Possible reason: due to the size and international business* |
| Bumblebee Kids: Shannon operates a daycare from her home in Kelowna. Her sister works for her as an early childhood educator and there are 9 kids that attend the daycare. | *Proprietorship*  *Possible reason: one owner, less expensive than a corporation (note: some students may suggest a partnership due to the sister’s involvement, but since the sister works for Shannon, she is more an employee than a part owner).* |

***4. Explain the three categories of business activities and identify examples of transactions related to each category.***

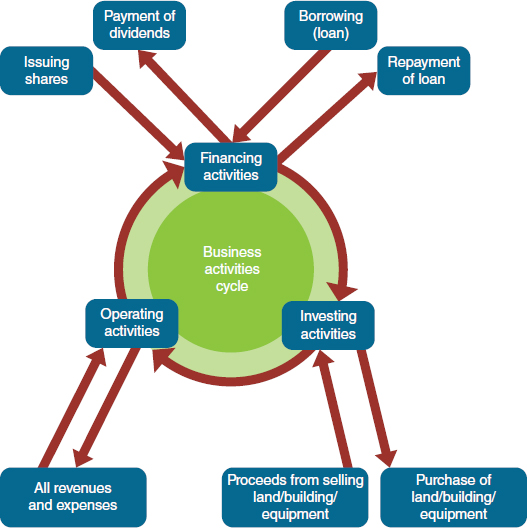
There are three types of business activities:



**Exhibit 1.5** The Three Categories of Business Activities

The activities that fall under these three types are as follows:

|  |  |
| --- | --- |
| **FINANCING ACTIVITIES** | |
| Inflows: | Borrowing money |
| Issuing shares |
| Outflows: | Repaying loan principal |
| Paying dividends |
| **INVESTING ACTIVITIES** | |
| Inflows: | Proceeds from the sale of property, plant, and equipment |
| Proceeds from the sale of shares of other companies |
| Outflows: | Purchase of property, plant, and equipment |
| Purchase of shares of other companies |
| **OPERATING ACTIVITIES** | |
| Inflows: | Sales to customers |
| Collections of amounts owed by customers |
| Outflows: | Purchases of inventory |
| Payments of amounts owed to suppliers |
| Payments of expenses such as wages, rent, and interest |
| Payments of taxes owed to the government |



**Exhibit 1.9** The Three Categories of Business Activities: Key Inflows and Outflows

**In-Class Exercise**

* Select a company and ask students what type of operating, financing and investing activities they would expect this company to have. Once you have gathered the suggestions from the students, present the cash flow statement of that company. The operating, financing and investing activities of that company will be found in the cash flow statement. This statement can be compared to the suggestions gathered from the students.
* Note: you might choose to look at Dollarama Inc. The cash flow statement is provided in Appendix A of the textbook.

***5. Identify and explain the content and reporting objectives of the four basic financial statements and the notes to the financial statements.***

There are five components of financial statements:

|  |  |
| --- | --- |
| **COMPONENTS OF THE FINANCIAL STATEMENTS** | **Reporting Objective** |
| Statement of income | Measures the operating performance of a company over a period of time. |
| Statement of changes in equity | Measures the changes in the equity of the company over a period of time, differentiating between changes that result from transactions with shareholders and those resulting from the company’s operations. |
| Statement of financial position (Balance Sheet) | Measures the resources controlled by a company (assets) and the claims on those resources (by creditors and investors) at a given point in time. |
| Statement of cash flows | Measures the change in cash flow through operating, financing, and investing activities over a period of time. |
| Notes to the financial statements | Notes provide details and additional information that are left out of the main reports but are useful to users of financial information such as the various types of inventory held by the company and details on its long-term assets. |

Explore the statement of income and the statement of financial position in more detail.

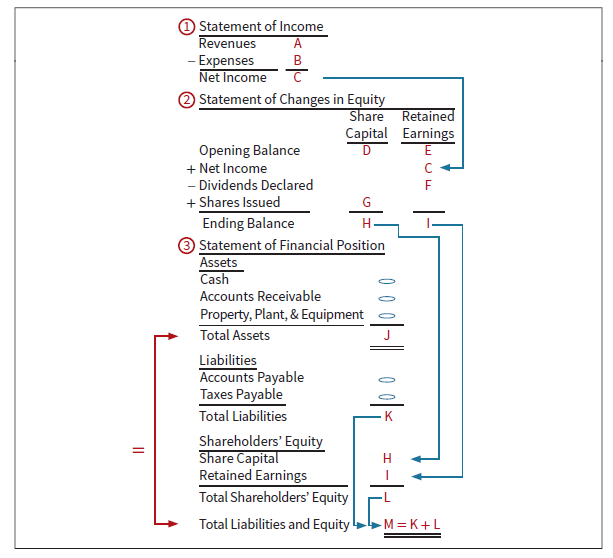
**Statement of Income**

|  |  |
| --- | --- |
| **COMMON STATEMENT OF INCOME ITEMS (Exhibit 1.12)** | |
| **Sales revenues** | The total amount of sales of goods and/or services for the period. |
| **Other income** | Various types of revenues or income to the company other than sales, including interest or rental income. |
| **Cost of goods sold** | The cost of the inventory that was sold during the period. |
| **Selling, general, and administrative expense** | The total amount of other expenses (such as salaries and rent) during the period that do not fit into any other category. |
| **Depreciation expense (amortization expense)** | The allocation of part of the cost of long-lived items such as equipment or a patent. |
| **Interest expense** | The amount of interest incurred on the company’s debt during the period. |
| **Income tax expense (provision for taxes)** | The taxes levied on the company’s profits during the period. |

**Statement of Financial Position**

|  |  |  |  |
| --- | --- | --- | --- |
| **COMMON ASSETS** | | | |
| **Current assets** | | **Cash** | The amount of currency that the company has, including amounts in bank accounts. |
| **Short-term investments** | Short-term investments in shares of other companies. |
| **Accounts receivable** | Amounts owed to the company by its customers as a result of credit sales. |
| **Inventory** | Goods held for resale to customers. |
| **Prepaid expenses and deposits** | Amounts that have been paid by the company but the underlying service has not yet been used. Common examples include insurance premiums or rent paid in advance. |
| **Non-current assets** | | **Property, plant, and equipment** | Land, buildings, equipment, vehicles, and so on that the company purchases to use to generate revenues in the future; they are *not* purchased to resell. |
| **Intangible assets** | Licences, patents, trademarks, copyrights, computer software, and other assets that lack physical form. These are also acquired to generate revenues in the future. |
| **Goodwill** | A premium that has been paid on the acquisition of another company related to factors such as management expertise and corporate reputation that will result in higher future earnings. |
| **COMMON LIABILITIES** | | | | |
| **Current liabilities** | | **Bank indebtedness** | | Amounts owed to the bank on short-term credit. |
| **Accounts payable (trade payables)** | | Amounts owed to suppliers from the purchase of goods on credit. |
| **Deferred revenue**  **(unearned revenue)** | | Amounts owed to customers for advance payments until the related goods or services have been provided. |
| **Dividends payable** | | Amounts owed to shareholders for dividends that have been declared by the board of directors. |
| **Accrued liabilities** | | Amounts owed related to expenses that are not yet due, such as interest and warranty expense. |
| **Income taxes payable** | | Amounts owed to taxing authorities. |
| **Non-current liabilities** | | **Notes payable** | | Amounts owed to a creditor (bank or supplier) that are represented by a formal agreement called a *note* (sometimes called a *promissory note*). Notes payable often have an interest component, whereas accounts payable usually do not. |
| **Long-term debt** | | Amounts owed to creditors due beyond one year. |
| **Deferred income taxes** | | Amounts representing probable future taxes the company will have to pay. |
| **COMMON SHAREHOLDERS’ EQUITY COMPONENTS** | | | | |
|  | | **Share capital** | | Represents the shares issued by the company, usually stated at an amount equal to what the company received from investors on the initial issuance of the shares. There can be different types of shares (common shares and preferred shares). There can also be different classes of shares; in other words, shares that have different rights and privileges. |
| **Retained earnings** | | The company’s earnings (as measured on the statement of income) that have been kept (retained) and not paid out as dividends. |

Discuss the links between the financial statements by reviewing the exhibit in the chapter as shown below:



**Exhibit 1.23** Information Flows between the First Three Financial Statements

**In-Class Exercise**

Classify the following items according to where they would appear in the financial statements:

1. Debt owing to a supplier (accounts payable)
2. Sales revenue from sale of a product
3. Land and building used to produce the product
4. Short-term investment in the shares of another company
5. Property, plant, and equipment Unearned revenue
6. Payment of interest on a loan owed to a bank
7. Value of common shares issued
8. Loan payable in 5 years
9. Equipment used in production of product
10. Monthly cost for cell phone charges
11. Supplies used this month
12. Cash collections from customers that they owed on account
13. Dividends paid to shareholders

**Alternative class exercise**

Have students create “student financial statements”. Use the following formats for a statement of income and statement of financial position.

**Statement of Income**

|  |  |
| --- | --- |
| Income: Wages |  |
| Gifts |  |
| Other |  |
| Expenses: Rent |  |
| Tuition |  |
| Food |  |
| Other |  |
| Profit |  |

**Statement of Financial Position**

|  |  |
| --- | --- |
| Current assets: Cash in bank |  |
| Other assets lasting less than one year |  |
| Non-current assets: Computer |  |
| Car |  |
| Clothing |  |
| Other |  |
| Total assets |  |
| Current liabilities: Loans (less than one year) |  |
| Credit card debt |  |
| Non-current liabilities |  |
| Long-term liabilities: Student loans |  |
| Total liabilities |  |
| Shareholders’ equity (difference between assets and liabilities) |  |
| Total liabilities and shareholders’ equity |  |

You can ask the following questions to help students complete their financial statements:

1. What have you spent money on this year? *Students will give a variety of answers and many will represent expenses: Rent expense, food, entertainment, travelling etc. Be careful when students discuss spending money on things like tuition, clothing or computers. These would represent assets, as they are good for a longer period of time. These items would affect the balance sheet.*
2. What have you earned this year? *Summer jobs or part time jobs salary, Money from parents, gifts. Most of the answers here would represent revenues that affect the income statement.*
3. What do you own that has value? *The suggestions here should mostly relate to assets and the statement of financial position. Students will often suggest things like electronic goods, investments, cars (be careful that it is not a rental car), clothing, etc. These all represent assets. You can also ask students about their knowledge, skills and other things that will make them very valuable in the job market. This is an interesting way to introduce the concept of intangible asset. Although a full discussion on that topic is not suggested at this point, it should be noted that this is the type of challenge that accountants often face when it comes to capturing the value of certain things and representing them fairly in the FS. It can be noted that this topic will be covered in more depth later in the semester.*
4. Do you owe money to anyone? *The suggestions would mostly represent liabilities: credit card debt, student loans, loans from a friend.*
5. Has anyone given you money with no expectations of getting it back? *This question is meant to introduce the concept of equity. Parents may be paying for tuition or simply have given money and paid for expenses over the years. Scholarships can also be a good example. This represents someone investing in the student, hoping that they will be successful and provide a good return to society / parents.*

In order to conclude on this topic, you can show the full set of financial statements for Dollarama Inc. (available in Appendix A of the textbook). Demonstrate how the information flows between the various statements and how the information is classified. Take some time to indicate to students that the financial statements are only a small portion of the annual report. Scan through some of the notes to show how a lot of additional information can be found to complement the line items presented in the various statements.

**LEGAL NOTICE**

Copyright © 2018 by John Wiley & Sons Canada, Ltd. or related companies. All rights reserved.

Description: cid:image003.jpg@01CD4AF3.E17BD5B0

The data contained in these files are protected by copyright. This manual is furnished under licence and may be used only in accordance with the terms of such licence.

The material provided herein may not be downloaded, reproduced, stored in a retrieval system, modified, made available on a network, used to create derivative works, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise without the prior written permission of John Wiley & Sons Canada, Ltd.