CHAPTER 2

A Further look at financial statements

Learning Objectives

1. Identify the sections of a classified statement of financial position.
2. Identify and calculate ratios for analyzing a company’s liquidity, solvency, and profitability.
3. Describe the framework for the preparation and presentation of financial statements.

Chapter Outline

**Learning Objective 1 – Identify the Sections of a Classified Statement of Financial Position**

In a classified statement of financial position (commonly known as the balance sheet), companies often group similar assets and similar liabilities together as they have similar economic characteristics. The groupings help users to determine (1) whether the company has enough assets to pay its debts as they come due and (2) the claims of short-and long-term lenders and other creditors on the company’s total assets.

A **classified** statement of financial position generally contains the following standard classifications:

* **Current Assets**
* Assets that are expected to be converted to cash or will be sold or used up within one year of the company’s financial statement date or its operating cycle, whichever is longer.
* The operating cycle of a company is the average period of time it takes for a business to pay cash to obtain products or services and then receive cash from customers for these products or services.
* Examples of current assets include: cash, held for trading investments, accounts receivables, notes receivable including loans receivable, inventory, supplies, and prepaid expenses.
* On the statement of financial position, current assets are normally listed in order of liquidity although some international companies use an order of reverse-liquidity.

Teaching suggestion – Ask students if a company can have too much cash? How can having too much cash be bad? Can a company have too much money tied up in inventory? Are there expenses incurred in carrying large amounts of inventory?

Teaching suggestion – (a) Discuss the difference between notes receivable and accounts receivable; different types of prepaid expenses; and the fact that inventory, supplies, and prepaid expenses will become expenses when they are used up. Explain why these assets are classified as current. (b) Discuss the concept of short-term investments.

* **Non-Current Assets**
* Assets that are not expected to be converted into cash, sold, or used up by the business within one year of the financial statement date or its operating cycle.
* Examples of non-current assets include: long-term investments, property, plant, and equipment, intangible assets, goodwill, and other assets.
* **Long-Term Investments**
* Multi-year investments in debt securities that management intends to hold to earn interest and equity securities of other companies that management plans to hold for many years to generate investment revenue or for strategic reasons.
* These assets are normally classified as non-current because they are not readily marketable or because management is not intending to see the investment and convert it into cash within one year.
* Examples are investments in shares, loans, notes, bonds or mortgages.

Teaching suggestion – Explain to students that in large companies there are individuals who do nothing but take care of long-term investments.

Discuss the difference between short-term and long-term investments in stocks and bonds of other corporations.

Example: A homebuilder has the following assets: (1) lots in a subdivision that are ready for sale to buyers; (2) land on which the corporate office building sits; and (3) land several miles north of town on which it plans a new subdivision in 5 years. Ask students where each of these parcels of land would go on a statement of financial position. This shows that the classification depends on the use by the company.

Also, ask students how they would classify a certificate of deposit that will mature in 5 years and be used to pay for the new subdivision.

* **Property, Plant, and Equipment**
* Assets with relatively long useful lives with physical substance (tangible).
* Assets used in operating the business.
* Examples include land, buildings, machinery, equipment, furniture, computers, and vehicles.
* Sometimes known as capital assets or fixed assets.
* Property, plant, and equipment are normally listed based on permanency, with land usually being the most permanent.

Teaching suggestion – Explain that items listed as property, plant, and equipment are recorded as assets and then depreciated (with the exception of land) over the life of the asset. It is possible to revalue the assets to current value using the revaluation model. The revaluation method will be discussed in Chapter 9.

Explain that depreciation is not a valuation of assets. It is the allocation of their cost over the periods in which they will benefit the business. Many students believe the statement of financial position shows the value of the business. Stress that accounting (with a few exceptions) records cost – not value.

* **Intangible Assets and Goodwill**
* Non-current assets.
* Assets which have no physical substance but represent a privilege or right granted to, or held by, a company that will result in a future economic benefit to the company.
* Examples are patents, copyrights, franchises, trademarks, trade names, and licences.
* Goodwill is an asset that can only result from the acquisition of another company, when the price paid to acquire the company is higher than the fair value of the purchased company’s net identifiable assets.
* Goodwill is similar to intangible assets in that it has no physical substance and will generate future value. It differs from intangible assets in that it cannot be separated from the company and sold.
* Goodwill is not amortized.
* Goodwill is usually reported separately from other intangible assets.

Teaching suggestion – What is a patent? Encourage students to think about companies that have a lot of money invested in intangible assets. Sony Canada and Blackberry are companies that spend a great deal of money on patents.

ASPE comparison – Under IFRS, depreciation refers to the allocation of the cost of property, plant, and equipment over their useful lives while amortization refers to the allocation of cost of intangible assets over their useful lives. Under ASPE, amortization is used for the allocation of the cost for both tangible and intangible assets. Warn students that in practice, these terms are often used interchangeably.

* **Other assets**
* Other assets can include: non-current receivables, deferred income tax assets, and property held for sale.
* Deferred income tax assets arise due to differences between accounting and tax treatment and represent the income tax that is expected to be recovered in a subsequent period due to deductions that a company will be able to take when preparing its corporate income returns in future periods.
* Other assets are usually separately reported so that users can get a better idea of their nature and are accompanied by an explanatory note to the financial statements.
* **Liabilities** are obligations that result from past transactions and will result in the future transfer of an economic resource.
* **Current Liabilities**
* Obligations that are to be paid or settled within one year of the company’s statement date or its operating cycle, whichever is longer.
* Common examples are bank indebtedness, accounts payable, unearned revenue, notes payable including bank loans payable, and current maturities of long-term debt.
* Companies often list current liabilities in the order in which they are expected to be paid (order of liquidity by due date). However, some companies list current liabilities in a reverse order of liquidity.

Teaching suggestion – Discuss the different types of payables: bank indebtedness, accounts payable and accrued liabilities, salaries payable, interest payable, income tax payable, current maturities of non-current debt, etc. Discuss how notes payable can be current or long-term, depending on the maturity date.

* **Non-Current Liabilities**
* Obligations expected to be paid or settled after one year.
* Liabilities in this category include notes payable including bank loans payable, mortgage payable, bonds payable, lease obligations, pension and benefit obligations, and deferred income tax liabilities.
* Sometimes known as long-term liabilities.

Teaching suggestion – Bonds have been mentioned several times. Students need to understand the difference between notes payable and bonds payable. Also discuss the difference between interest payable and notes or bonds payable.

* **Shareholders’ Equity**
* A residual amount and is the difference between a company’s assets and its liabilities.
* Share capital – results when shares representing ownership in the business are sold to investors.
* Retained earnings – cumulative profits retained for use in the company.
* Note that other equity items (for example accumulated other comprehensive income (loss)) will be introduced in later chapters.

Teaching suggestion – Spend a few minutes discussing the statement of financial position of Frenette Corporation in Illustration 2-10. It might be useful to display this on your computer or on an overhead projector as many students don’t bring their textbook to class.

Teaching suggestion – Discuss with students the order of items in the statement of financial position using the North American order of liquidity and the international order of reverse-liquidity. Ask them if it makes a difference how accounts are ordered?

**Learning Objective 2 – Identify and Calculate Ratios for Analyzing a Company’s Liquidity, Solvency, and Profitability**

* **Ratio analysis** expresses the relationships between selected items of financial statement data. Ratios shed light on company performance
* **Intracompany** comparisons – covers two years for the same company
* **Intercompany** comparisons – based on comparisons with a competitor in the same industry
* **Industry-average** comparisons – based on average ratios for particular industries

Teaching suggestion – Discuss your preference for rounding. Explain how to compute percentages. Encourage students to use a spreadsheet for computations and presentation. Also encourage them to see if their answers are reasonable and to always reflect on what the computation means – not to just make the computation and then fail to understand what it tells a user.

Teaching suggestion – Discuss ways for students to find industry averages and ratios from sources on the web and in the library. Encourage them to start watching shows on the financial networks and reading business periodicals as well as the business section of newspapers. Ask them to share interesting information with the class.

* **Liquidity ratios** measure a company’s short-term ability to pay its maturing obligations (usually its current liabilities), and to meet unexpected needs for cash.
* **Working capital**
* Measure of short-term ability to pay obligations.
* Excess of current assets over current liabilities.
* Positive working capital indicates the likelihood for paying liabilities is favourable.

### Current ratio

* Measure of short-term ability to pay obligations.
* Calculated by dividing current assets by current liabilities.
* More dependable indicator of liquidity than working capital.
* Make sure students are cautious in interpreting this ratio because it does not take into account the composition of current assets and can be artificially high because of slow moving inventory and receivables.

Teaching suggestion – Explain that a 1.6:1 current ratio means that for every $1 in current liabilities, the company has $1.60 in current assets to pay the liabilities.

Also, students need to be aware of the fact that the composition of the assets may be very important. For example, if a company had most of its current assets in cash it could be more certain of its liquidity position than a company with the majority of its current assets in inventory. What happens if the company cannot sell the inventory?

* **Solvency ratios** measure a company’s ability to survive over a long period of time by having enough assets to settle its liabilities as they fall due.
* **Debt to Total Assets Ratio**
* Measures the percentage of assets financed by lenders and other creditors rather than shareholders.
* The higher the percentage of debt financing, the riskier the business and the lower a company’s solvency.
* Calculated by dividing total debt (both current and non-current liabilities) by total assets.

Teaching suggestion – Compare ratios to tests performed by a doctor. Each test provides information. The doctor must ask the patient questions and then review the results of all tests before making a diagnosis. Students need to realize that ratios are indicators and must be analyzed properly before a decision can be made regarding the financial condition of a company. For example, a negative working capital does not always mean potential bankruptcy. The results of other ratios, as well as specific company information, must be analyzed. A discussion around very successful companies such as Dell and Amazon could be entertained, as these companies work with negative working capital, due to the fact that cash sales are collected from customers upfront before purchases have to be made.

Teaching suggestion – Help students calculate working capital, current ratio, and the debt to total assets ratio. Discuss whether a higher or lower ratio is better. You may also want to discuss the importance of comparing these ratios to the industry standards to inform the analysis.

Investors, lenders, and other creditors are interested in evaluating profitability. Profitability is frequently used as a test of management’s effectiveness.

* **Profitability ratios** – measure a company’s operating success for a given period of time.
* **Basic Earnings per Share**
* Measures the income earned on each common share.
* Calculated by dividing the income available to the common shareholders by the weighted average number of common shares issued during the year.
* Provides a useful perspective for determining investment return.

ASPE comparison – Under IFRS, earnings per share (EPS) is required to be presented in the financial statements, however ASPE does not require EPS to be included in the financial statements. Help students understand why this is the case.

Teaching suggestion – Ask students to watch one of the financial channels for at least 30 minutes and report on the references to basic earnings per share. If you use a discussion board, students can post their comments on it. This is an efficient way to share the information with the class without taking up too much classroom time.

* **Price-Earnings Ratio**
* Measures the ratio of the market price of each common share to its basic earnings per share.
* Calculated by dividing the market price per share by the basic earnings per share.

Teaching suggestion – Walk through the calculation of the price-earnings ratio for CT REIT and compare it to the industry average. Provide an explanation of what this ratio reveals – a general guideline in gauging share values.

**Learning Objective 3 – Describe the Framework for the Preparation and Presentation of Financial Statements**

* The **conceptual framework** is a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting statements.
* The basic **objective of financial reporting** is to provide financial information useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the company.
* The users identified in the conceptual framework are all external users and, as such, do not have access to the same financial information as internal users do and it is important that the financial information they do receive is as useful as possible.
* Financial statements are prepared using the **accrual basis of accounting**. Under the accrual basis of accounting, the effects of transactions on a company’s economic resources and claims are recorded in the period when a transaction occurs and not when cash is received or paid.
* In order to be useful, financial information should possess the following **fundamental qualitative characteristics**:
* **Relevance** – if knowledge of it will influence a user’s decision.
* Financial statements help predict future events thereby providing **predictive value**.
* Accounting information is also relevant to business decisions because it confirms or corrects prior predictions or expectations, thereby providing **confirmatory value**.
* Materiality is an important component of relevance because if an amount is too small to influence the decision, it may be omitted. Information is considered material if its omission or misstatement could influence the decision users.

Teaching suggestion – When you were trying to decide what to wear to class, did it matter whether you were going to an English class or an accounting class? No. That information was not relevant.

On the other hand, when you were making the decision, the outside temperature did make a difference. Therefore the temperature was a relevant factor.

Teaching suggestion – Materiality allows firms to modify GAAP. Assume a firm buys a new electric pencil sharpener that is expected to last for 6 years for $18. GAAP say that the pencil sharpener, because it is expected to last for 6 years, should be listed as an asset and depreciated—or charged off—over 6 years at a rate of $3 per year. The materiality constraint allows the firm to expense the pencil sharpener immediately because the $18 expense will not make a difference to the users of financial statements.

* **Faithful Representation** – information is useful when it faithfully represents what really exists or happened. The information represents the economic reality of the situation. Financial reporting must present the economic substance of a transaction not just legal form. To be a faithful representation information must be:
* **Complete** –nothing important was omitted.
* **Neutral** – not biased toward one position or another.
* **Free from error** – it provides an accurate description and no errors were made in the process used to determine it.

Teaching suggestion – Financial statements must be a faithful representation to be of value. Securities regulators require companies listed on an organized stock exchange to have financial statements audited. The audit ensures a faithful representation; therefore, the public can feel more comfortable about information contained in audited financial statements.

* In addition to the two fundamental qualities of relevance and faithful representation, the conceptual framework also describes four enhancing qualities of useful information:
* **Comparability**
* Comparability – users can identify and understand similarities in, and differences among, items.
* Comparability enhances the usefulness of financial information because it allows users to compare results from the same company from one period to the next or compare results across different companies as they make investing or lending decisions.

Teaching suggestion – Ask students how comparability might be impacted by allowing public and private companies in Canada to utilize two different accounting standards – IFRS and ASPE.

* **Verifiability** – if different knowledgeable and independent users can reach consensus that the information is faithfully represented.
* In order to be relevant accounting information must have **timeliness**; therefore, it must be available to decision makers before it loses its ability to influence decisions.
* **Understandability** – classified, characterized, and presented clearly and concisely. Understandable information means that users with a reasonable knowledge of business can interpret the information and comprehend its meaning.

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| Teaching suggestion ‑ Identify the various levels of understanding that might exist among users of financial information. |

* + - * + **Cost constraint** ‑ the value of the information provided in financial reporting must exceed the cost of providing it.

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| Teaching suggestion – Try to think of accounting examples where the cost may exceed the benefit. For example, it wouldn’t make sense for a company to spend $30,000 to hire a security guard to protect $20,000 worth of inventory. |

* Going concern assumption – assumes that a company will continue in operation for the foreseeable future.

Teaching suggestion – Ask students what would happen to a company if users assumed it wasn’t going to survive past the current period? For example, all liabilities would become current and the original cost of an asset would not be relevant.

Teaching suggestion – Use this topic as a way to discuss some of the decisions the CPA must make about risk. What would be some of the factors that the CPA as an auditor would look for to support the going concern assumption?

* Financial statements portray the financial effects of transactions and other events by grouping them into broad categories or classes according to their economic characteristics. These broad classes are termed the **elements of financial statements**, which include assets, liabilities, equity, income (including gains), and expenses (including losses).
* Using the objective of financial reporting, the qualitative characteristics, and the underlying assumptions, standard setters developed foundational principles (GAAP) that describe which, when, and how the elements of financial statements should be recognized, measured, and reported.
* **Generally Accepted Accounting Principles (GAAP)** are widely recognized and have authoritative support through the Canadian and provincial business corporations acts and securities legislation.

Teaching suggestion – Remind students that financial statements consist of the income statement, statement of changes in equity, statement of financial position, and statement of cash flows. Again, it may be good to remind them that there are internal and external users.

* The historical cost basis of accounting requires assets and liabilities to be recorded at their cost at the time of acquisition, as cost is a faithful representation. Cost is objective, easily verifiable and is neutral.
* It continues to be applied until the asset is sold or until the going concern assumption no longer applies.

Teaching suggestion – Ask students to assume they just bought a delivery van for their business. The van had a sticker price of $18,000. A neighbour purchased an identical van last week for $16,500. The student gave $15,000 for the van. At which price should the van be recorded?

* The **current value basis of accounting** states that certain assets and liabilities should be recorded and reported at current value (the price that would be paid to purchase the same asset or paid to settle the same liability).

Teaching suggestion – Ask students to assume that they purchased shares at $10. At the end of the year the shares are now trading for $20. Which value is more relevant? The students should consider what would happen if they sold the shares today.

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 should an owner’s personal assets not be included with the assets of the company?
* Discuss why a business would want to produce financial statements more than once a year.
* Consider what types of companies would have assets that should be re-valued to current value on an annual basis?
* If the students owned a business, would they want to use the current value basis of accounting or the historical cost basis of accounting?
* Why should a classified statement of financial position be prepared? Wouldn’t totals for assets, liabilities, and equity be sufficient for users?
* Does it matter whether a classified statement of financial position is listed in order of liquidity or reverse-liquidity? Identify when each type of listing order might be useful to users.
* Is it possible to provide too much information within the financial statements? What would happen if competitors had access to this information?
* If you owned a business, would you want to use another company’s financial statements to compare your operating results to?