Understanding Financial Statements

Session Plan
- Introduction
- Basic Concepts in Financial Accounting
- Generally Accepted Accounting Principles
- Financial Statements
- Financial Statement Analysis
- Case studies
- Conclusion

Introduction

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Course Objectives

SPPA workshop
Understanding Financial Statements

- Improve accounting concepts, principles and GAAP understanding
- Improve financial statement understanding
- Improve financial statement analysis skills

Basic Concepts in Financial Accounting

Basic Accounting: From Events to Decisions

Accounting Cycle

Accrual vs Cash Methods

Accrual method
- Revenues recorded when earned
- Expenses recorded when incurred

Cash method
- Revenues recorded when cashed
- Expenses recorded when paid

Basic Elements

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current &amp; Long term</td>
<td>Current &amp; Long term</td>
</tr>
<tr>
<td>Shareholders’ Equity</td>
<td>Net Assets</td>
</tr>
</tbody>
</table>

Revenues

Expenses
Basic Elements
Definitions

- **Assets**
  «An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.»

- **Liabilities**
  «A liability is defined as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.»

- **Equity**
  «Equity is the residual interest in the assets of the entity after deducting all its liabilities.»

- **Income (or revenue)**
  «Income is increases in economic benefit during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity other than those relating to contributions from equity participants.»

- **Expenses**
  «Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity other than those relating to distributions to equity participants.»

- **Profit oriented organizations**

- **Non-profit oriented organizations**

Types of Entities
- Publicly accountable enterprises
- Non-publicly accountable / private enterprises
- Not-for-profit organizations
- Public sector

Forms of Business Organization
- Sole Proprietorship
- Partnership
- Corporation

Source: CICA - IFRS CD1 (2008, p.3)
Types of Business

- Service
- Merchandising
  - Retailers
  - Wholesalers
- Manufacturing

Generally Accepted Accounting Principles

GAAP Accounting Postulates

- Accounting (Business) Entity Postulate
- Going-concern Postulate
- Unit of measure (stable-dollar) Postulate
- Accounting-period Postulate

GAAP Accounting Principles

- Objectivity (reliability, no bias) Principle
- Cost Principle
- Realization (revenue recognition) Principle
- Matching Principle
- Consistency and Uniformity (comparability) Principle
- Disclosure Principle
- Materiality Principle
- Conservatism Principle

Users and Users’ Needs

- Employees
- Non-executive directors
- Customers and suppliers
- Industry groups
- Labor unions
- Governmental departments
- Public
- Regulatory agencies
- Other companies

Users’ Needs

1. Assessing financial strength and stability
2. Assessing management quality
3. Estimating future prospects
4. Assessing financial strength and solvency
5. Assessing liquidity
6. Assessing risk and uncertainty
7. Assessing resource allocation
8. Making decisions
9. Making comparisons
10. Making valuation decisions
11. Assessing adaptability
12. Determining compliance with the law or regulation
13. Assessing contributions to society

GAAP Accounting Standards

- Canadian GAAP = CICA Handbook
- IFRS - International Financial Reporting Standards
  - Entities
    - publicly accountable enterprises
    - non-publicly accountable / private enterprises
    - not-for-profit organizations
    - public sector
  - Implementation between 2008 and 2011
Canadian Accounting Standards Timeline

Publicly accountable enterprises

January 2000
ActSI adoption

April 2008
Exposure Draft

March 2009
Exposure Draft

January 2010
Canadian GAAP

January 2011
Comparative EPS

IFRS disclosure

Private enterprises

January 2006
ActSI adoption of no convergence with IFRS

April 2008
Exposure Draft

April 2009
Invitation to comment and discussion paper

January 2010
Exposure draft (July 31)

January 2011
Made in Canada Privates standards

Canadian GAAP

Not-for-profit organizations

January 2000
ActSI adoption of no convergence with IFRS

December 2008
Canadian GAAP

January 2010
Made in Canada Private and NPO standards

January 2011
IFRS

Public sector

November 2007
PSAB decision

January 2010
PSAB decision

January 2011
PSAB decision

Federal, provincial, territorial & local government

CICA PSA Handbook

Made in Canada Public sector standards

Government business organizations

Made in Canada Private and NPO standards

Government NPO

CICA PSA Handbook

Public sector standards

Other government organizations

Made in Canada Private and NPO standards

Measurement Models

Measurement bases

- Process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement.

- Measurement bases
  - Historical cost
  - Current cost
  - Realisable (settlement) value
  - Present value

Financial Statements
Balance Sheet
Statement of Financial Position

Assets
- Current term
- Long term

Liabilities
- Current term
- Long term

Equity

Non-profit - Fund Balances
- Invested in Capital Assets
- Externally Restricted
- Internally Restricted
- Unrestricted

Non-profit - Type of Funds
- Operating Fund
- Endowment Fund
- Acquisitions Fund
- Research Fund
- Capital Asset Fund

Income Statement
Statement of Operations

Revenues
Expenses

Net income
Excess of revenues over expenses

Revenues
Expenses

Net loss
Deficiency of revenues over expenses

Revenues
- Grants
  (Federal, Provincial, Municipal)
- Program service revenue
- Special events revenue
- Investment income
- Donations
Expenses

- Program expenses
- Fundraising expenses
- Administrative expenses

Statement of Retained Earnings

- Beginning balance
- + Net income
- - (Net loss)
- - Dividends paid
- Ending balance

Statement of Retained Earnings

Stat. of Changes in Net Assets

- Present changes for the period
  - in net assets
    - invested in capital assets
    - endowment
    - restricted net assets
    - unrestricted net assets
    - total net assets
  - in fund balances

Statement of Changes in Equity

Statement of Changes in Equity

For the year ended December 31, 20X2

<table>
<thead>
<tr>
<th>Share capital</th>
<th>Retained earnings</th>
<th>Translation of foreign operations</th>
<th>Available for sale financial assets</th>
<th>Revaluation surplus</th>
<th>Total equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At December 31, 20X1</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Changes in equity for 20X2</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Dividends</td>
<td>- (x)</td>
<td>-</td>
<td>-</td>
<td>(x)</td>
<td></td>
</tr>
<tr>
<td>Comprehensive income for the year</td>
<td>- x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Transfer to retained earnings</td>
<td>- x</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At December 31, 20X2</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

Source: CICA – IFRS CSI (2006, p.16)

Statement of Cash Flows

- Explanations of cash variations
  (Cash inflows and cash outflows)
- 5 components
  - Title
  - Activities
    - Operating
    - Investing
    - Financing
  - Net increase/decrease in cash

Notes to Financial Statements

- Supplementary explanations
- More information
- Accounting policies
Financial Statement Analysis

Determination of Disclosure Universe

Continuous Disclosure
- Earnings Guideance
- Press Releases containing Financial Information
- Material Change Reports
- Environmental, Health and Safety Reports
- Annual Information Form (AIF)
- Financial Statements MD&A
- Take Over Bid Disclosure
- Financial Statements
- Earnings Press Release
- Prospectuses
- Website

Information presented to Analysts, Credit Rating Agencies

Annual Report
- Annual Report
- Financial Statements

Users & Decisions
- Supplemental Information
- Management’s Responsibility Report
- Financial Statements
- Review of Operations
- Corporate Overview
- Highlights

Accountants’ Reports
- Auditor Report
- Notice to Reader
- Review Engagement Report

Methods
- Examination of Financial Statements
- Peer Benchmarking
- Common-Sizing Financial Statements (i.e. converting financial statements to %)
- Trend Analysis
- Comparisons in Relation to the Budget
- Financial Statements Ratios

Financial Statement Ratio Analysis
- Financial Return
- Liquidity
- Solvency
- Profitability
- Activity
- Productivity

Source: CICA (1993, p.27)
Role of Performance Assessment for NPO

User Community → The Organization
Decision about Support and Participation
Performance Assessment → Financial Disclosures → Oversight and Monitoring
Organizational Activities
Financial System

Questions Asked to Assess Financial Performance

1. Mission
   - What is your organizational mission?
   - Is the mission consistent with the stakeholder's values?
   - How does that translate into goals and objectives?
   - What is the business model/strategy?
   - What are present obstacles to fulfilling the mission?

Questions Asked to Assess Financial Performance

2. Service Delivery
   - What is the demand for these services?
   - What type, volume and quality of services are delivered?
   - Are these services compatible with mission?
   - Are they meeting goals and objectives?
   - What are present obstacles in service delivery?

Questions Asked to Assess Financial Performance

3. Organizational Management
   - What is the experience and expertise of management?
   - What is the quality of internal support systems?
   - What is the administrative efficiency?
   - What is the appropriateness of compensation?

Questions Asked to Assess Financial Performance

4. Organizational Funding
   - What cash funds are available?
   - What non-cash contributions (goods, services volunteers) are used and available?
   - How financial supportive are board and community?
   - How financial supportive are commercial activity?

Questions Asked to Assess Financial Performance

4. Organizational Funding
   - Is there continuity of support and diversity of income streams?
   - How compatible is the funding with the mission?
   - How efficiency is fundraising and development?
   - What are present obstacles in funding and support?
Questions Asked to Assess Financial Performance

5. Financial Health
   – What is the cash flow position?
   – How financially stable is the organization?
   – Does it have accumulated wealth to sustain it if funding is reduced?

Source: Keating and Frumkin (2001, p. 47)

Questions Asked to Assess Financial Performance

6. Financial Management
   – What is the quality of internal control system?
   – How prudent is the cash and investment management?
   – Are non-financial assets prudently managed?

Source: Keating and Frumkin (2001, p. 47)

Conclusion

- Basic concepts (elements, GAAP)
- Financial Statements
  - 5 main components
    • Statement of Financial Position / Balance Sheet
    • Income Statement / Statement of Operations
    • Statement of Changes in Equity / in Net Assets
    • Statement of Cash Flows
    • Notes to the Financial Statements
- Financial Statement Analysis

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