Chapter 1 – Financial Accounting

Beginning Assumptions

Economic Entity Assumption states that the financial activities of a business can be separated from the financial activities of the business's owners. This allows a user to examine a company's accounting information without concern that the information includes personal affairs of the owners or other business activities.

Time Period Assumption is when accountants assume that economic information can be meaningfully captured and communicated over a short period of time.

Monetary Unit Assumption assumes that the dollar is the most effective means to communicate economic activity.

Going Concern Assumption takes as a given that a company will continue to operate into the foreseeable future. It allows accountants to use certain techniques.

Reporting Profitability: The Income Statement

Revenues are the increase in resources resulting from the sale of goods or provision of services. Revenues are recorded according to the revenue recognition principle that states that a revenue should be recorded when a resource has been earned. A resource is earned when either the sale of the good or the provision of the service is substantially complete, and collection is reasonably assured.

Expenses are the decrease in resources resulting from the sale of goods or provision of services. Expenses are recorded to the matching principle that states that expenses should be recorded in the period resources are used to generate revenues.

The Income Statement is the financial statement that shows a company's revenues and expenses over a specific period of time.

$$Revenue - Expenses = Net\ Profit\ or\ Net\ Loss$$

Reporting Financial Position: The Balance Sheet

Assets are resources of the business, such as cash. Intangible assets have no physical form such as trademarks or copyrights. Assets are recorded and reported according to the historical cost principle, which is often shortened to the cost principle that states assets should be recorded and reported at the cost paid to acquire them.

Liabilities are an obligation of the business that results from a past transaction and will require the sacrifice of economic resources at a future date.

Equity is the difference between a company's assets and liabilities and represents the share of assets that are claimed by business owners. Issued capital is defined as the resources that investors contribute to a business in exchange for an ownership interest, dividends are profits distributed to owners and is usually called drawings. Profits that are retained in the business are called retained earnings.

The Balance Sheet is the financial statement that shows a business's assets, liabilities and equity at a specific point in time.

$$Assets = Liabilities + Equity$$

Reporting the Equity: The Statement of Changes in Equity

Owners are usually interested in how their equity is growing as a result of profitable operations. They are also interested in how that equity is distributed in the form of dividends. Such information is reported on the statement of changes in equity. It shows the change in a company's equity and retained earnings over a period of time.

$$Retained\ Earnings, Beginning\ Balance$$

$$+\ Net\ Profit/-\ Loss$$

$$-\ Dividends$$

$$=\ Retained\ Earnings, Ending\ Balance$$

Linking the Income Statement and the Balance Sheet – Statement of changes in equity links the income statement and balance sheet. A business cannot calculate its retained earnings balance at the end of the period without factoring the profit earned during the period. The statement of changes in retained earnings provides this link by including net profit or loss in the calculation of retained earnings, which is then reported on the balance sheet.

Reporting Cash Flows: The Cash Flow Statement

Financing Activities – Most businesses must raise funds to begin. Borrowing money from creditors and receiving contributions from investors that are both ways to finance a business's operations. Therefore, generating and repaying cash from creditors and investors are considered financing activities.

Investing Activities – Once a company has raised sufficient capital from creditors and investors, it usually acquires the revenue-generating assets that it needs for operations. The buying and selling of such assets are considered investing activities.

Operating Activities – After the proper equipment is required, a business can begin operations. Operating a business includes the purchase of supplies, the payment of employees and the sales of products. These transactions are considered operating activities.

The Cash Flow Statement – The details of cash inflows and outflows for a business are reported on a cash flow statement which shows a business's sources and uses of cash over a specific period of time. Its purpose is to inform users about how and why a business's cash changed during the period.

$$Cash\ Flows\ Provided\ (Used)\ by\ Operating\ Activities$$

$$+/-\ Cash\ Flows\ Provided\ (Used)\ \ by\ Investing\ \ Activities$$

$$+/-Cash\ Flows\ \ Provided\ (Used)\ by\ Financing\ Activities$$

$$=\ Net\ Increase\ (Decreased)\ in\ Cash$$

Qualitative Characteristics of Accounting Information

Understandability refers to the ability of accounting information to be comprehensible to those who have a 'reasonable understanding of business and economic activities and accounting and a willingness to study the information with reasonable diligence'.

Relevance refers to the capacity of accounting information to make a difference in decisions. Accounting information has this capacity when it possesses feedback value or predictive value. Feedback value refers to the ability to assess past performance, while predictive value refers to the ability to form expectations of future performance.

Reliability refers to the extent to which accounting information can be depended upon to represent what it purports to represent, both in description and in number. Information is verifiable if it can be proven to be free from error. Information has representational faithfulness when the description corresponds to the underlying phenomenon.

Comparability refers to the ability to use accounting information to be weighed against or contrasted to the financial activities of different businesses. This allows an entity to assess its market position within an industry, to gauge its success against a competitor and to set future goals based on industry standards. It does not imply uniformity.

Consistency refers to the ability to use accounting information to compare or contrast the financial activities of the same entity over time. It is the highest when an entity uses the same accounting methods every year. They can compare and reveal trends that helps generate expectations.

Materiality is a concept that is closely related to relevance. Items meeting or exceeding the threshold are said to be material – that is, they are large enough to possibly affect decision making. Items below the threshold are said to be immaterial – that is, they are small enough that they will not affect decision making.

Conservatism refers to the manner in which accountants deal with uncertainty regarding economic situations. When accountants are faced with uncertainty about how to account for or report a particular transaction or situation, conservatism dictates that they use the accounting that is least likely to overstate the company's assets and revenues or to understate the company's liabilities and expenses.

The Conceptual Framework of accounting is the collection of concepts that guide the manner in which accounting is practised. The conceptual framework is the grammar, punctuation, spelling and sentence structure of the financial accounting language.

Principles used to Measure Economic Information

Principle	Definition	Ramification
Revenue Recognition	Revenues are recorded when they are earned.	The receipt of cash is not required to record a revenue.
Matching	Expenses are recorded in the time period when they are incurred to generate revenues.	For many assets, the cost of the asset must be spread over the periods when it is used.
Cost	Assets are recorded and maintained at their historical cost.	Except in a few cases, market values are not used for reporting asset values.