Accounting for Business Decisions A- Chapter 1
Financial Accounting

Accounting- is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions. It is the language of business.

To accomplish the process of accounting, accountants use four assumptions;

- Economic entity assumption- states that the financial activities of a business can be separated from the financial activities of the business owner(s).
- Time period assumption- accountants assume that economic information can be meaningfully captured and communicated over short periods of time. This can be for one month, quarterly, or even yearly.
- Monetary unit assumption- assumes that the dollar ($) is the most effective means to communicate economic activity. If an economic activity cannot be expressed in dollars, then it is not recorded in the accounting system.
- Going concern assumption- accountants assume that a company will continue to operate into the foreseeable future. Most companies are assumed to be going concerns, those that are not, are often in the process of liquidation.

Reporting profitability: the statement of comprehensive income

This statement answers the crucial question of “is this business profitable?”.

It reports a company’s revenues and expenses over a specific period of time.

Revenue- is an increase in resources (money) resulting from the sale of goods or the provision of services.

Revenues are recorded according to the revenue recognition principle. It states that a revenue should be recorded when a resource has been earned.

Expenses- is a decrease in resources resulting from the sale of goods or the provision of services. Example, petrol used while mowing lawns.

Matching principle- states that expenses should be recorded in the period resources are used to generate revenue.

The purpose of the statement of comprehensive income is to demonstrate the financial success or failure of the company over that specific period of time.

Revenues – Expenses = Net profit or Net loss

Reporting financial position: the statement of financial position

A statement of financial business shows what the organisation both owns and owes. It reports a business’s assets, liabilities and equity at a specific point in time.

Asset- is a resource of a business. It results from a prior transaction and will produce future economic benefit. Can also be intangible (trademarks or copyright).

Cost principle- the principle that assets should be recorded according to their historical cost (cost paid to acquire them).

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

Equity- the difference between a company's assets and liabilities, representing the share of assets that is claimed by the company's owners.

A company can generate equity in two ways.

- Contributed capital: the resources that investors contribute to a business in exchange for ownership interest.
- Profitable operations: when a company generates profits, it can either distribute them to owners, or retain them in the business to grow the business (retained earnings).

The purpose of this statement is to show, at any given time, a company's resources and its claims against those resources.

The accounting equation: Assets= Liabilities + Equity

Reporting equity: the statement of changes in equity

A financial statement that reports the change in a company's retained earnings (contributed capital and retained earnings) over a specific period of time.

Retained Earnings/ Opening Balance

+/- Net Profit/Loss

- Dividends

= Retained Earnings/ Closing Balance

Linking the statement of comprehensive income and the statement of financial position

A business cannot calculate its retained earnings balance at the end of the period without factoring in the profit earned during the period. The statement of changes in equity provides this link by including net profit/loss in the calculation of retained earnings, which is then reported on the statement of financial position.

This means, when preparing financial statements for any business, the statement of comprehensive income must be prepared first, followed by the statement of changes in equity and then the statement of financial position.

Reporting cash flows: the cash flow statement

A financial statement that reports a business's cash inflows and outflows from its operating, financing and investing activities, over a specific period of time.

Financing activities- includes borrowing money from creditors and receiving contributions are both ways of financing a business's operations. Drawings (dividends) is another example.

Investing activities- buying and selling of assets are the main examples. Investing money in a lawnmower for example.

Operating activities- includes the purchase of supplies, payment of employees and sale of products.

The basic structure of the cash flow statement is as follows;

Cash flows provided (used) by operating activities

+/- Cash flows provided (used by investing activities

+/- Cash flows provided (used) by financing activities

= Net increase (decrease) in cash

Qualitative characteristics of accounting information

Accounting information must possess certain qualitative characteristics to be considered useful.

Understandability- The ability of accounting information to be comprehensible to those who have a reasonable understanding of business and are willing to study the information with reasonable diligence.

Relevance- refers to the capacity of accounting information to make a difference in decisions. Financial statements must be relevant to our decision making on the month it was created for and also to generate expectations for the following month. Information must also be timely.

Reliability- refers to the extent to which accounting information can be depended upon to represent what it purports to represent. To be considered reliable, accounting information should be verifiable (free from error), should have representational faithfulness and should be neutral.

Comparability- the ability to use accounting information to compare or contrast the financial activities of different businesses.

Consistency- refers to the ability to use accounting information to compare or contrast the financial activities of the same entity over time.

Materiality- the threshold at which an item begins to affect decision making. Items meeting or exceeding the threshold are said to be material- that is, they are large enough to possibly affect decision making. The alternative is immaterial- below the threshold and don't affect decisions.

Conservatism- refers to the manner in which accountants deal with uncertainty regarding economic decisions. When uncertainty exists, accounting information should present the least optimistic alternative.

The conceptual framework of accounting

It is the collection of concepts that guide the manner in which accounting is practiced.

These concepts include terms, principles, assumptions and qualitative characteristics that are necessary to communicate the financial activities and position of a business.