Part 1: Environment and Theoretical Structure of Accounting

Financial Accounting Review

ACG 6309
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Parts

• Part 2: Double Entry Accounting – its origins and significance
• Part 3: The Accounting Cycle, with emphasis on Ongoing Activities
• Part 4: The Accounting Cycle, with emphasis on End-of-Period Activities

Learning Outcomes

• After completing this Part, you should be able to describe and apply the
  – Function and primary focus of financial reporting
  – Cash basis versus accrual basis accounting
  – Objective and qualitative characteristics of accounting information
  – Four basic assumptions underlying GAAP
  – Recognition, measurement and disclosure concepts

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Part 1: Environment and Theoretical Structure of Accounting

**Accounting Basics**

- Accounting takes an enterprise’s financial data and converts it into financial information
  - Identification
  - Accumulation
  - Measurement
  - Communication
- Assets = Liabilities + Owners’ Equity.

**Cash versus Accrual Basis**

- Deals with recognition of revenue and expense – when an item appears in financial statements
- Cash Basis
  - Revenue recognized when received
  - Expense recognized when paid
- Accrual Basis
  - Revenue recognized when earned
  - Expense recognized when incurred.

**For Example**

- Carter Company has sales on account totaling $100,000 per year for three years. Carter collected $50,000 in the first year and $125,000 in the second and third years. The company prepaid $60,000 for three years’ rent in the first year. Utilities are $10,000 per year, but in the first year only $5,000 was paid. The remaining $5,000 plus $10,000 was paid in the second year; $10,000 was paid in the third year. Payments to employees are $50,000 per year.
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### Cash versus Accrual Basis

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash receipts</td>
<td>$50,000</td>
<td>$125,000</td>
<td>$125,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Cash payments:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>(60,000)</td>
<td>-</td>
<td>-</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Utilities</td>
<td>(5,000)</td>
<td>(15,000)</td>
<td>(10,000)</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Employees</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Net Cash Flow</td>
<td>$(65,000)</td>
<td>$60,000</td>
<td>$65,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Sales</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>(20,000)</td>
<td>(20,000)</td>
<td>(20,000)</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Utilities</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td>(30,000)</td>
</tr>
<tr>
<td>Employees</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Net Income</td>
<td>$20,000</td>
<td>$20,000</td>
<td>$20,000</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

### Objective

- Provide information:
  - Useful for decision making
    - Presupposes a reasonable understanding of business and economic activities
  - That helps predict amounts, timing and uncertainty of future cash flows
  - About economic resources, claims to those resources, and changes in resources and claims, i.e., assets, liabilities and equity.

### Primary Qualitative Characteristics

- Relevance – Makes a difference to the decision
  - Predictive value – ultimate outcome of past, present and future events
  - Confirmative value – confirm or correct prior expectations
  - Materiality – Omitting or misstating information could affect user’s decisions.
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Primary Qualitative Characteristics

• Faithful representation
  – Completeness – includes all information necessary for faithful representation of the economic phenomena that it purports to represent
  – Neutrality – free from bias
  – Free from error – no errors of omissions in the description of the amount or the process used to report the account.

Secondary Qualitative Characteristics

• Comparability (consistency) – similar measurements and reporting/same accounting treatment for similar events
• Verifiability – different knowledgeable and independent measurers would reach consensus about whether it is representationally faithful
• Timeliness – available to users before decision
• Understandability – users can comprehend it.

Basic Financial Statements

• Balance Sheet
• Income Statement
  – Companies must either provide a Statement of Other Comprehensive Income immediately following the Income Statement, or present a Combined Statement of Comprehensive Income that includes the information normally contained in both the Income Statement and the Statement of Other Comprehensive Income.
• Statement of Shareholders’ Equity
• Statement of Cash Flows
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Elements of Financial Statements

- Assets: Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events
- Liabilities: Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Elements of Financial Statements

- Equity: The residual interest in the assets of an entity that remains after deducting liabilities
- Assets – Liabilities = Equity

Elements of Financial Statements

- Revenues: Inflows or other enhancements of assets or settlement of liabilities from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major, or central operations.
- Notice that revenues are tied to increases in assets or decreases in liabilities.
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Elements of Financial Statements

- Expenses: Outflows or other using up of assets or incurrences of liabilities during a period from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.
- Notice that expenses are tied to decreases in assets or increases in liabilities.

Underlying Assumptions

- Economic Entity – economic events can be identified specifically with an economic entity.
- Going Concern – the business will continue to operate indefinitely.
- Periodicity – allows the life of a business to be divided into artificial time periods to provide timely information.
- Monetary Unit – financial statement elements should be measured in a particular monetary unit, i.e., $.

Recognition Concept

- Recognition means that an item should be presented in the financial statements when it meets the following criteria:
  - Definition
  - Measurability
  - Relevance
  - Reliability.
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Revenue Recognition: Realization

- Before revenue is recognized
  - Earnings process is judged to be complete or virtually complete
  - There is reasonable certainty as to the collectability of the asset to be received, which is usually cash.

Expense Recognition: Matching

- Expenses should be recognized in the period in which they produce revenue, i.e., match expense to the revenue
  - Direct: Cause and effect relationship, e.g., COGS
  - Indirect:
    - Focusing on specific time period, e.g., salary expense
    - Systematic and rational allocation, e.g., depreciation
    - Period incurred when period or periods of future revenue recognition will occur, e.g., advertising

Measurement Concept

- Measurement involves the two following choices:
  - The choice of the unit of measurement, e.g., the dollar
  - The choice of an attribute to be measured
    - Historical cost, e.g., land
    - Net realizable value, e.g., AR with bad debt
    - Current cost, e.g., some inventories
    - Present or discounted value of future cash flows, e.g., some investments
    - Fair value, e.g., bonds if option is elected
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Constraints to Relevance & Reliability

- Cost Benefit – Perceived benefit of information exceeds anticipated cost of producing information
- Materiality – Information is material if it has an effect on the decision
- Industry practices
- Conservatism – least likely to overstate assets or income.

Concluding Comments

- Function and primary focus of financial reporting
- Cash basis versus accrual basis accounting
- Objective and qualitative characteristics of accounting information
- Four basic assumptions underlying GAAP
- Recognition, measurement and disclosure concepts

The Next Step

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- Part 3: The Accounting Cycle, with emphasis on Ongoing Activities
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