

Chapter 1: The Financial Statements

- **Financial statements** - business documents that companies use to report the results of their activities to groups like managers, investors, creditors, and regulatory agencies.

Accounting is the Language of Business

- **Accounting** - an information system
 - Measures business activities, processes data into reports, and communicates results to decision makers
 - Produces financial statements
 - **Financial statements** - measure performance and shows where a business is financially
 - Bookkeeping is the mechanical part of accounting

Who uses accounting information

- Individuals - to make decisions on renting/buying, budgeting, etc
- Investors / creditors - to decide how much income to invest and how/ when a company will pay them back
- Regulatory bodies - businesses are required to pay taxes to the body. SEC requires companies whose stock is traded publicly to release statements periodically
- Nonprofit organizations - base operating decisions on statements

Financial vs. Managerial

- **Financial accounting** - provides info for decision makers outside of the company
- **Managerial accounting** - provides info for decision makers inside the company (managers)
 - Kept separate for confidentiality reasons

Organizing a business

- **Proprietorship** - 1 owner
 - Accepts all liability personally
 - In accounting a proprietorship is separate from owner
- **Partnership** - 2 + owners
 - General partnership all general partners are personally liable
 - risky
 - Limited-liability partnership only the general partner is liable
 - Limited partners are only liable up to his/ her investment plus their proportionate share of liabilities
 - Partnership doesn't pay taxes, it flows through each owner
- **Limited-liability Company (LLC)** - members
 - Members are not liable, the LLC is
 - Members pay tax at their rate for income, LLC not taxed
- **Corporation** - stockholders/ shareholders
 - Stockholders not liable
 - Corporation is separate entity with many rights
 - Formed under state law
 - Corp pays taxes & shareholders pay taxes - double taxation of distributed profits
 - Shareholders are taxed on their dividends

- Stockholders elect board of directors - CEO, COO, CFO

Underlying Accounting Concepts

- **Generally accepted accounting principals (GAAP)** - guidelines for measurement and disclosure of financial information
 - Formulated by the **financial accounting standards board (FASB)**
- **International accounting standards board** - sets International financial reporting standards (IFRS)
- Fundamental qualitative characteristics
 - Relevance
 - Must be capable of making a difference to decision maker
 - Must be **material** - important enough to user so that if it were omitted it would make a difference to users decisions
 - Only info that is material needs to be separately disclosed (discussed) in statements
 - Faithful representation
 - Info must be complete, free from bias, and without material error
 - Must focus on economic substance of transaction, event, etc
 - Makes info reliable
- Enhancing qualitative characteristics
 - Comparability
 - Must be capable of being compared with info from another company in the same period
 - Must be consistent with similar info for that company from previous periods
 - Verifiability
 - Info is capable of being checked for accuracy, completeness, and reliability
 - Verifying info is done by auditors
 - Enhances reliability
 - Timeliness
 - Must be made available to users early enough to make decisions
 - Understandability
 - Transparent so it makes sense and can reasonably inform users
- Constrains
 - Cost
 - Cost of disclosure should not exceed expected benefit to users
 - Management must weigh costs

The Entity Assumption

- **Entity**- any organization that stands apart as a separate economic unit
- Most basic accounting assumption
- Managers need accounting information for each entity (division) in the company

The Continuity (Going -Concern) Assumption

- **Going - concern assumption** - Assume the entity will exist long enough to use all existing assets for its intended purposes
 - Should stay in long enough to recover the cost of assets by allocation that cost through depreciation to business operations over the assets' economic lives

- Opposite = quitting concern
 - Most relevant measure of the value of assets is their current fair **market value** - amount the company would receive if assets were sold

The Historic Cost Principle

- **Historic cost principle** - assets should be recorded at their actual cost, measured on the date of the purchase
 - amount of cash paid plus the dollar value of all non-cash consideration given in exchange (privileges, rights, etc)
- Holds value of assets at measured price for as long as the business holds asset (same with continuity)
- Historic cost is most relevant, verifiable, & faithful representation of its carrying value
- If asset is later sold at different price, the new value is established
- **Fair value** - amount the business could sell the asset for or amount business could pay to settle liability
- IFRS are more liberal with fair values than GAAP

The Stable-Monetary-Unit Assumption

- **Stable-Monetary-Unit Assumption** - assume the dollar's purchasing power will be stable over time
 - Done so that each year's statements will not have to be converted to new dollar amount
- **Inflation** - rise in general price level

IFRS

- SEC has announced plan to adopt some version of IFRS in 2015
- GAAP will probably be used where IFRS is vague
- Most common accounting principles are same for both
- IFRS allows for more flexibility and professional judgment
 - Allows fair value approach

The Accounting Equation

Assets & Liability

- $Assets = Liability + Owners\ Equity$
- $Liability = Assets - Owners\ equity$
- $Owners\ equity = Assets - Liability$
- **Assets** - economic resources that are expected to produce a benefit in the future
 - **Cash** - liquid assets that are the medium of exchange
 - Ex: inventory
 - **Fixed assets** - long lived assets the company uses to do business
 - Ex: property, plant, equipment
- **Liability** - "outside claim"; debts payable to outsiders (creditors)
 - **Payables** - always liability
 - Ex: accounts payable, taxes payable
 - Accounts payable are typically paid within year or operating cycle
 - **Long-term debt** - liability payable beyond a year
 - Current portion of long-term debt is amount due within next year and must be disclosed separately