

## Busi 293 Notes

### Chapter Two

## Investing and Financing Decisions and the Statement of Financial Position

Chapter 2 introduces the Conceptual Framework for Accounting in Canada. This is covered in Section 1000 of the CICA Handbook (ASPE) and IASB Framework for the Preparation and Presentation of Financial Statements (IFRS) – Please refer to textbook Reference A which identifies the qualitative characteristics of Accounting Information.

The **qualitative characteristics** of financial information include:

#### Fundamental characteristics

**Relevance** – provides predictive and/or confirmatory value

**Faithful representation** – complete, neutral (unbiased) and free from material error. A material error is one which would affect the decision of a user.

#### Enhancing characteristics

**Comparability** – information is prepared on a consistent basis

**Verifiability** – able to be verified by independent accountants

**Timeliness** – timely information allows users to predict or confirm past values

**Understandability** – users are expected to have a reasonable understanding of business. Clear and concise information enhances its understanding.

**It is imperative to spend time understanding these concepts- they will be used in all accounting classes you take.**

The **assumptions** underlying the measurement and reporting of the Statement of Financial Position include:

**Separate-Entity** - include the assets and liabilities of the entity, not the personal assets and liabilities of the owners of the entity

**Unit-of-measure** - financial information is reported in terms of the national monetary unit – no adjustment for changes in purchasing power of that unit

**Continuity (Going Concern)** - the entity will continue operations in the future

The **Accounting Principles** include:

**Historical cost** - assets are recorded at the actual cost to the entity IFRS does allow for alternative measurement of assets. This will be discussed in Chapter 9.

## STATEMENT OF FINANCIAL POSITION

As noted in Chapter 1, assets are classified by liquidity. Please refer to textbook Reference B for an example of this statement.

Assets which are likely to be converted into cash within the next 12 months or liabilities which are likely to be satisfied within the next 12 months would be shown as “Current”. Items which do not meet these criteria would be shown lower on the Statement of Financial Position as Non-current assets or liabilities. Do you see that such information would be very relevant to creditors? A supplier who needs to be paid in the next 30 days is interested in the entity’s ability to pay short term rather than long term liabilities.

## Recording of transactions

An event is defined to be an item **which will have** an economic impact on an entity. A transaction, on the other hand, is an event which will have an immediate effect on an item in the accounting equation and therefore be recorded in the accounting process. **Only transactions** will be recorded in the financial statements. In order to produce complete financial statements, all transactions need to be recorded. Signing a contract will affect the future of the entity but would not be recorded unless there was an immediate effect on an asset, liability or equity account. (i.e. signing a contract for a sale which will take place in 6 months will not have an immediate effect on the Statement of Financial Position)

In the textbook they indicate transactions include external events which are exchanges of assets, goods or services by one party for assets, services or promises to pay (liabilities) by one or more other parties. Transactions also include certain events which are not exchanges between the business and other parties but nevertheless have a direct and measureable effect on the accounting entity.

An account is a standardized format that entities use to accumulate the effect of transactions. Entities create an account for each item they wish to track. A chart of accounts is a listing of all accounts which the entity has established to account for its transactions. A larger and more complex entity requires a longer the chart of accounts. Regardless of the size of the entity, the chart of accounts is usually presented in the following order:

- Assets
- Liabilities
- Shareholders' Equity
- Revenues
- Expenses

The starting point in any accounting system is the identification of all transactions which may affect the entity. **This means you need to understand the business, the transactions and then determine which accounts are affected.** Ask yourself: has an account increased or decreased? In the back of your mind remember the Accounting Equation (Assets = Liabilities + Shareholders' Equity). Please refer to textbook Reference C which provides many examples that I encourage you to work through.

It should be evident that the approach presented on these pages would be very time-consuming and cumbersome if an entity had thousands of transactions to record. In order to deal with this issue, accountants have developed a system to analyze and record transactions. This involves recording transactions as either debits or credits. **These are known as journal entries.**

**The rules of Debit (dr) and Credit (cr) which need to be clearly understood are as follows:**

- An increase in an asset is recorded by a debit
- A decrease in an asset is recorded by a credit
- An increase in a liability is recorded by a credit
- A decrease in a liability is recorded by a debit
- An increase in shareholders' equity is recorded by a credit
- A decrease in shareholders' equity is recorded by a debit
- An increase in revenue is recorded by a credit
- A decrease in revenue is recorded by a debit
- An increase in an expense is recorded by a debit
- A decrease in an expense is recorded by a credit
- A gain is recorded by a credit
- A loss is recorded by a debit

Remember that every transaction should be recorded by way of a journal entry and presented in the following format:

Date		Debit	Credit
	Debit Account name	XX	
	Debit Account name	XX	
	Credit Account name		XX
	Credit Account name		XX
	(Brief explanation of entry)		

### Important items to note:

- All Debits are always entered first; all credits then follow; note the indentation of the credits.
- Every entry must balance - debits must equal credits.
- Good journal entries always include a brief explanation of the entry. This is especially important for more complicated entries.

There is no need to add the words debit and credit beside each account name - I have done this for illustrative purposes only

Journal entries are entered into a journal (known as the book of original entry) in chronological order. At the end of the month, the accountant will transfer the amounts shown in each entry to the relevant Account. This process which is done automatically by computer program or by hand in a manual system is known as posting.

In this course we do not focus on the actual bookkeeping but use T-accounts to analyze the effect on various Accounts.

A useful tool in analyzing transactions is known as a **T- Account**. Each account has two sides - the left side known as a debit and the right side known as a credit. Don't think of debits and credits as good or bad, simply right or left!

## Example of a T-Account

Debit (Dr)	Credit (Cr)

Evaluate and understand your transaction; prepare the journal entry, and then post your journal entry to the T-Accounts. Remember to reference your journal entries by either a number or letter. Please refer to textbook Reference D for an example.

Don't forget to carefully review the examples of financial statements in the textbook. It is worthwhile Please refer to textbook Reference E. You are encouraged to look at the financial statement of other companies as you complete the course. It is interesting to see the variation in formats.

## Financial Statement Analysis

You will come to appreciate the importance of financial analysis. This includes ratio analysis - the comparison of different financial accounts within the financial statements. Ratios are introduced and discussed throughout the textbook.

The **Current ratio** is introduced at the end of chapter 2.

### Calculation

Current Assets/Current Liabilities

The ratio measures the ability of the entity to pay its short-term obligations with short-term assets.

## **Financial Statement Analysis** *continued*

Like all ratios, it provides information to users in making decisions but should not be the sole tool used in making such decisions. It is important to understand a ratio's limitations or the fact that management may be manipulating the components included in the ratio.