

## Chapter 1 Accounting Communication – An Introduction

**Organization:** A collection of individuals pursuing the same goal or objective.

### Forms of Organizations

#### Business Entities

- Organized to earn an income(profit)
  
- 1) Sole Proprietorship
  - **Sole proprietorship:** A business with a single owner
  - **Economic entity concept:** The assumption that a single, identifiable unit must be accounted for in all situations
    - A business is often owned and operated by the same person, but the affairs of the business and the person must be kept separate
      - Unlike the distinction made for accounting purposes the Canada Revenue Agency does not recognized the separate entity between the proprietorship and it's owner; any income earned by the business is taxed on the tax return of the individual
  
- 2) Partnerships
  - **Partnerships:** A business owned by two or more individuals and with the characteristic of unlimited liability
  - A partnership is not a taxable entity; individual partners pay taxes on their proportionate shares of the income of the business
  
- 3) Corporations
  - **Corporation:** A form of entity organized under the laws of a particular province or the federal government; ownership evidenced by shares
  - A corporation is started by: filing for incorporation → approval by provincial/federal government → issuing of corporate charter → issue shares
    - **Shares:** A certificate that acts as ownership in a corporation
  - Advantages of running a corporation as oppose to a partnership:
    - Possible to raise a large amount of money in a short period of time
      - Through selling securities
        - Shares – ownership
        - Bonds: A certificate that represents a corporation's promise to repay a certain amount of money and interest in the future – loan
    - Ease of transfer of ownership
    - Limited liability of the shareholder – only liable for amount invested

### Non-Business Entities

- **Non-business entity:** Organization operated for some purpose other than to earn a profit
  - Exist to serve the needs of various segments of society
- Lack of identifiable owner – utilizes fund accounting

### The Nature of Business Activity

- A company obtains money from various types of financing activities, uses the money raised to invest in productive assets, and then provides goods and services to its customers
- 1) Financing Activities
    - All businesses start with financing; money is needed to start a business
    - **Liability:** An obligation of a business
      - I.e., Note payable = borrowed from bank, Bonds payable = sells bonds, Taxes payable = government taxes owed, Accounts payable
      - **Creditor:** Someone to whom a company or person has a debt
    - **Capital stock:** Indicates the owners' contributions to a corporation
      - Main difference from liabilities is that those to buy shares in a corporation takes ownership and becomes a shareholder as oppose to lending money
        - **Shareholder:** Someone who buys shares in a company
    - Includes issue and repurchase of common shares and long-term debt (liabilities)
  - 2) Investing Activities
    - Buying assets
      - **Asset:** A future economic benefit to an organization
    - Includes purchases of land, buildings, and equipment and purchases of other companies
  - 3) Operating Activities
    - Generating revenues (and income) via sales
    - **Revenue:** Inflows of assets resulting from the sale of products and services
    - **Expense:** Outflows of assets resulting from the sale of goods and services
    - Includes the sale of products/services, salaries and wages, payment for purchases of inventory, utility usages, taxes paid to the government

### What Is Accounting?

- **Accounting: The process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information**

## Users of Accounting Information and Their Needs

1. Internal Users
  - Managers of a company
  - **Management accounting:** The branch of accounting concerned with the preparation of financial statements for outsider uses
2. External Users
  - Those not involved directly in the operations of a business needs information that differs from that needed by internal users
  - Information is limited because outsiders rely on information presented by management – financial statements
  - **Financial accounting:** The branch of accounting concerned with the preparation of financial statements for outsider use
  - External users include: Shareholders and potential shareholders, bondholders, bankers, and other creditors (ability to repay loans), government agencies, suppliers, trade association, financial analysts

## Financial Statements: How Accountants Communicate

- **Net income on the income statement increases retained earnings on the statement of retained earnings. The ending balance in retained earnings is transferred to the balance sheet**
- 1) The Accounting Equation and the Balance Sheet
    - Assets = Liabilities + Owners' Equity
      - Foundation of the entire accounting system
    - **Owners' equity:** The owners' claims on the assets of an entity
    - **Shareholders' equity:** The owners' equity in a corporation
      - Capital stock
      - Retained earnings
    - **Balance sheet:** The financial statement that summarizes the assets, liabilities, and owners' equity at a specific point in time
      - Statement of financial position
  - 2) The Income Statement
    - Flow statement
    - **Income statement:** A statement that summarizes revenues and expenses
    - 3 largest items: revenues, operating expenses, and income tax expense
  - 3) The Statement of Retained Earnings
    - **Retained earnings:** The part of owners' equity that represents the income earned less dividends paid over the life of an entity  
(Accumulated earnings – D = RE)
    - **Dividends:** A distribution of the net income of a business to its owners

- Not an expense because they are a distribution of the income of the business to its shareholders
- **Statement of retained earnings:** The statement that summarizes the income earned and dividends paid over the life of a business

### The Conceptual Framework: Foundation for Financial Statements

- Primary assumptions accountants make:
  - Economic Entity Concept – requires that an identifiable, specific entity be the subject of a set of financial statements
  - **Cost Principle:** Assets are recorded at the cost to acquire them and continue to show this amount on all balance sheets until the company disposes of them
    - Companies carry assets at historical cost due to the subjective nature of market value
  - **Going Concern:** The assumption that an entity is not in the process of liquidation and that it will continue indefinitely
    - If the company is not in going concern it may be more relevant to follow market value than historical cost
  - **Monetary Unit** is Relatively Stable; the company's recognized medium of exchange
    - Monetary unit: The yardstick used to measure amounts in financial statements, the dollar
  - **Time Period:** Artificial segment on the calendar, used as the basis for preparing financial statements
    - Arbitrary time period (such as a year) that is shorter than the company's life span
- **Generally Accepted Accounting Principles (GAAP):** The various methods, rules, practices, and other procedures that have evolved over time in response to the need to regulate the preparation of financial statements
- In Canada accounting standards are set by: Accounting Standards Oversight Council → Accounting Standards Board (AcSB) → CAs, CMAs, CGAs
- In the United States standards are set by: the Securities and Exchange Commission (SEC) → **Financial Accounting Standards Board (FASB):** The group in the American private sector with authority to set accounting standards
- **International Accounting Standards Board (IASB):** The organization formed to develop worldwide accounting standards

### Ethics and Accounting

1. Recognize an ethical dilemma – likely to occur when a company is considering a decision about accounting methods or disclosures
2. Analyze the key elements in the situation
3. List alternatives and evaluate the impact of each of those affected

4. Select the best alternative

## Chapter 2 Financial Statements and the Annual Report

- The balance tells what obligations will be due in the near future and when assets will be available to satisfy them
- The income statement tells the revenues and expenses for a period of time
- The statement of cash flow tells where cash came from and how it was used during the period

### Objectives of Financial Reporting

- Overall objective – To communicate information to permit users of the information to make informed decisions
  - The purpose of financial reporting is to help the users reach their decisions in an informed manner
- Supporting objective – To reflect prospective cash receipts to investors and creditors
  - Future cash to be received from the investment
- Supporting objective – Reflect the management's stewardship of resources and claims to resources

### Qualitative Characteristics That Makes Accounting Information Useful

- Understandability: The quality of accounting information that makes it comprehensible to those willing to spend the necessary time
  - Usefulness & understandability
- Relevance: The capacity of information to make a difference in a decision
- Reliability: The quality that makes accounting information dependable in representing the events that it purports to represent
  - 4 Basic Characteristics
    - Verifiability
    - Representational faithfulness – information corresponds to an actual event
    - Neutrality
    - Conservatism – information that is uncertain should be presented so that assets and revenues are not overstated
- Comparability and Consistency
  - Comparability: For accounting information, the quality that allows a user to analyze two or more companies and look for similarities and differences
  - Consistency: For accounting information, the quality that allows a user to compare two or more accounting periods for a single company

- Materiality: The magnitude of an accounting information omission or misstatement that will affect the judgement of someone relying on the information
- Benefit versus Cost Constraint

#### The Classified Balance Sheet

- Operating Cycle: The period of time between the purchase of inventory and the collection of any receivable from the sale of the inventory
- Current asset: An asset that is expected to be realized in cash or sold or consumed during the operating cycle or within one year if the cycle is shorter than one year
- Non-current assets
  - Investments – securities that are not expected to be sold within the next year
  - Property, Plant, and Equipment – tangible productive assets used in the operation of a business
  - Intangibles – assets that lack physical substance (trademarks, copyrights, franchise rights, patents, and goodwill)
- Current liability: An obligation that will be satisfied within the next operating cycle or within one year if the cycle is shorter than one year
- Shareholders' Equity
  - Claims form from two sources:
    - Contributed capital – capital stock
    - Earned capital – retained earnings
- Creditors are interested in the balance sheet where they can evaluate the liquidity of the business
  - Liquidity: The ability of a company to pay its debts as they come due
- Working capital: Current assets – Current liabilities
- Current ratio: Current assets / Current liabilities

#### The Income Statement

- reports net income or net loss
- Single-step income statement: An income statement in which all expenses are added together and subtracted from all revenues
  - Adv – simplicity
  - Dis – no classification is made
- Profitability is measured by a company's profit margin / return on sales
  - Profit margin: Net income / Sales

#### The Statement of Retained Earnings

- Used to explain the changes in the components of owners' equity during the period

#### The Statement of Cash Flows

- Summarizes the cash flow effects of a company's operating, investing, and financing activities for the period

## Chapter 3 Processing Accounting Information

### Economic Events: The Basis for Recording Transactions

- Event: A happening of consequence to an entity
- External Event: An event involving interaction between an entity and its environment
- Internal event: An event occurring entirely within an entity
  - Never includes cash
- Transaction: Any event that is recognized in a set of financial statements
- An event must be measured to be recognized
- Source document: A piece of paper that is used as evidence to record a transaction

## Chapter 4 Accrual Accounting, Adjusting Entries, and Accounting Cycle

### Recognition and Measurement in Financial Statements

- Recognition: The process of including an item in the financial statements of an entity
  - How the accountant depicts, or describes the effects of economic events on the entity
- Measurement – attribute to be measures and scale of measurement/unit of measure must be decided
  - What attribute (characteristic) should be used – cost
    - Historical cost: The amount paid for an asset and used as a basis for recognizing it on the balance sheet and carrying it on later balance sheets – reliability
    - Realizable value: The amount of cash, or its equivalent, that could be received by selling an asset currently – relevance
  - Unit of Measure – money

### The Accrual Basis of Accounting

- Cash basis: A system of accounting in which revenues are recognized when cash is received and when cash is paid off
- Accrual basis: A system of accounting in which revenues are recognized when earned and expenses when incurred
- Adjusting entries: Journal entries made at the end of a period by a company using the accrual basis of accounting

- Depreciation: The process of allocating the cost of a long-term tangible asset over its useful life
  - Straight-line method: The assignment of an equal amount of depreciation to each period
  - Contra account: An account with a balance that is opposite that of a related account
- Deferred (prepaid) expense – Cash paid BEFORE expense is incurred
  - Prepaid expense: An asset resulting from the payment of cash before the incurrence of expense
  - Insurance policy, supplies, rent, buildings, equipment
  - DEPRECIATION
  - 1<sup>st</sup> Asset/Cash, 2<sup>nd</sup> Asset/Expense
- Deferred (unearned) revenue – Cash received BEFORE revenue is earned
  - Unearned revenue: A liability resulting from the receipt of cash before the recognition of revenue
  - Deposits, rent, subscriptions, gift certificates
  - 1<sup>st</sup> Cash/Liability, 2<sup>nd</sup> Liability/Revenue
- Accrued liability – Expense incurred before cash is paid
  - Accrued liability: A liability resulting from the recognition of an expense before the payment of cash
  - Salaries and wages, interest, taxes, rent
  - Interest = Principal X Annual rate of interest % X Time in years
  - 1<sup>st</sup> No Entry, 2<sup>nd</sup> Liability/Expense
- Accrued asset – Revenue earned before cash is received
  - An asset resulting from the recognition of a revenue before the receipt of cash
  - Interest, rent
  - 1<sup>st</sup> No Entry, 2<sup>nd</sup> Asset/Revenue

#### Summary of Adjusting Entries

1. It is an internal transaction
2. Never involves an increase/decrease of cash
3. B/S and I/S are involved

## Chapter 5 Income Measurement and the Income Statement

### The Revenue Recognition Principle

- Revenue: Increases in economic resources resulting from ordinary activities such as the sale of goods, the rendering of services, or the use by others of the entity's resources
- Revenue recognition principle: Revenues are recognized in the income statement when they are earned
  1. The performance is achieved

2. The amount is reasonably measurable
3. The collection of cash is reasonably assured

#### Applications of the Revenue Recognition Principle

- Time-of-sale method: The method used by merchandising and manufacturing industries to recognize revenue when goods are sold
- Percentage-of-completion method: The method used by contractors to recognize revenue before the completion of a long-term contract
- Franchises are usually recognized when an restaurant commences operations
- Production method: The method in which revenue is recognized when a commodity is produced rather than when it is sold
- Installment method: The method in which revenue is recognized at the time cash is collected

#### The Matching Principle and Expense Recognition

- Matching principle: The revenues for the period are associated with the costs of generating those revenues

#### The Format and Content of the Income Statement

- Single-step income statement: An income statement in which all expenses are added together and subtracted from all revenues
- Multi-step income statement: An income statement that shows classifications of revenues and expenses as well as important subtotals
  - Gross profit: Sales less costs of goods sold, also termed gross margin

Asset: A future economic benefit

Liability: An obligation of a business

Shareholders' Equity: The owners' equity in a corporation

Revenue: Increases in economic resources resulting from ordinary activities such as the sale of goods, the rendering of services, or the use by others of the entity's resources

Expense: Outflows of assets resulting from the sale of goods and services