

Chapter

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ACCOUNTING FUNDAMENTALS

ACCOUNTING

- LANGUAGE OF BUSINESS
- *(Measures business activities, processes that information into reports and communicates the results to decision-makers)*

ACCOUNTING

- Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic events that is intended to be useful in making economic decisions. **(ACCOUNTING STANDARDS COUNCIL)**
- Accounting is an information system that measures, processes and communicates financial information about economic entity. **(FINANCIAL ACCOUNTING STANDARDS BOARD)**
- Accounting is an art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least of financial character, and interpreting the results thereof. **(AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS)**

3 Components of Accounting

1

IDENTIFYING: Analytical Component

-recognition or non-recognition of business activities as accountable events.

2

MEASURING: Technical Component

-assigning of peso amounts to the accountable economic transactions and events.

3

COMMUNICATING: Formal Component

-process of preparing and distributing accounting reports to potential users of accounting information.

Implicit in the Communication Process are:

Recording

-or JOURNALIZING is the process of systematically maintaining a record of all economic business transactions after they have been identified and measured.

Classifying

-is the sorting or grouping of similar and interrelated economic transactions into their respective classes.

Summarizing

-is the preparation of financial statements which include the statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows..

Objective of Accounting

-to provide quantitative financial information about a business that is useful to statement users particularly owners and creditors, in making economic decisions.

TYPES OF BUSINESS

- **SERVICE TYPE** - A service type of business provides intangible products (*products with no physical form*). Service type firms offer professional skills, expertise, advice, and other similar products. *Examples of service businesses are: schools, repair shops, hair salons, banks, accounting firms, and law firms.*
- **Merchandising Business** - This type of business buys products at wholesale price and sells the same at retail price. They are known as "buy and sell" businesses. They make profit by selling the products at prices higher than their purchase costs.

A merchandising business sells a product without changing its form.
Examples are: grocery stores, convenience stores, distributors, and other resellers.

TYPES OF BUSINESS (According to Activities)

- **Manufacturing Business** - Unlike a merchandising business, a manufacturing business buys products with the intention of using them as materials in making a new product. Thus, there is a transformation of the products purchased.

A manufacturing business combines *raw materials, labor, and factory overhead* in its production process. The manufactured goods will then be sold to customers.

Types of Business Operations

TYPE	ACTIVITY
1. SERVICE	<i>Selling people's time</i>
2. MERCHANDISING/TRADE	<i>Buying and selling products</i>
3. MANUFACTURING	<i>Conversion of raw materials into finished products</i>

FORMS OF BUSINESS

- **Sole Proprietorship** – This business organization has a single owner called the proprietor who generally is also the manager. The owner receives all profits, absorbs all losses and is solely responsible for all debts of the business.
- **Partnership** – Is a business owned and operated by two or more persons who bind themselves to contribute money, property and industry into the common fund with the intention of dividing profit among themselves.
- **Corporation** – Is a business owned by its stockholders. It is an artificial being created by operation of law, having the rights of succession and the powers, attributes and properties authorized by law or incident to its existence.

USERS OF FINANCIAL INFORMATION

- ✓ **Investors** – Needs information to help them determine whether they should buy, hold or sell.
- ✓ **Employees** – are interested in information about stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
- ✓ **Lenders** – are interested in information that enables them to determine whether their loans and the related interest will be paid when due.

USERS OF FINANCIAL INFORMATION

- ✓ **Suppliers and other trade creditors** – are interested in information that enables them to determine whether the amounts owing to them will be paid when due.
- ✓ **Customers** – have an interest in information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.
- ✓ **Government and their Agencies** – are interested in an allocation of resources and, therefore, the activities of the enterprise. They also require information in order to regulate the activities of the enterprise, determine taxation policies and as the bases for the national income and similar statistics.

GAAP

- Encompass the conventions, rules and procedures necessary to define accepted practice at a particular time.
- Developed on the basis of experience, reason, custom, usage and practical necessity.

FUNDAMENTAL CONCEPTS

- **Entity Concept** – An accounting entity is an organization that stands apart from other organizations and individuals as a separate economic unit. The transactions of different entities should not be accounted for together.
- **Periodicity Concept** – An entity's life can be meaningfully subdivided into equal time periods for reporting purposes. It will be aimless to wait for the actual last day of operations to perfectly measure the entity's net income.
- **Stable Monetary Unit Concept** – The Philippine peso is a reasonable unit of measure and that its purchasing power is relatively stable.

FUNDAMENTAL CONCEPTS

- Conservatism – This requires understanding rather than overstating (income) and expenses amounts that have a degree of uncertainty. The rule is to recognize revenue when it is reasonably certain and recognize expense as soon as they are reasonably possible.
- Matching – To avoid overstatement of income in any one period, the matching principles requires that revenues and related expenses be recorded in the same accounting period.

BASIC PRINCIPLES

- **Objectivity Principle** – Accounting records and statements should be based on the most reliable data available so that they will be as accurate and as useful as possible.
- **Historical Cost** – states that acquired assets should be recorded at their actual cost and not at what management thinks they are worth as at reporting date.
- **Revenue Recognition Principle** – revenues are to be recognized in the accounting period when goods are delivered or services rendered or performed.

BASIC PRINCIPLES

- **Expense Recognition Principle** – expenses should be recognized in the accounting period in which goods and services are used to produce revenue and not when the entity pays for those goods or services.
- **Adequate Disclosure** – requires that all relevant information that would affect the user's understanding and assessment of the accounting entity be disclosed in the financial statements.

BASIC PRINCIPLES

- **Materiality** – Financial reporting is only concerned with information that is significant enough to affect evaluations and decisions.
- **Consistency Principle** – the firm should use the same accounting method from period to period to achieve comparability over time within the single enterprise. However, changes are permitted if justifiable and disclosed in the financial statements.

CONCEPTUAL FRAMEWORK

- describes the basic concepts that underlie the preparation and presentation of financial statements for external users.
- Framework is not PFRS and hence does not define standards for any particular measurement or disclosure issue.
- In those cases where there is a conflict, the requirement of the PFRS prevail over those of the framework.

Scope

The Conceptual Framework addresses:

1. The objective of financial reporting
2. The qualitative characteristics of useful financial information
3. The reporting entity
4. The definition, recognition and measurement of the elements from which financial statements are constructed
5. Concepts of capital and capital maintenance

1. OBJECTIVE OF FINANCIAL REPORTING

-to provide financial information about the reporting entity that is useful to present and potential investors, lenders and other creditors in making decisions in their capacity as capital providers.

- ✓ Fundamental
- ✓ Enhancing

QUALITATIVE CHARACTERISTICS

- **FUNDAMENTAL QUALITATIVE CHARACTERISTICS**
- **ENHANCING QUALITATIVE CHARACTERISTICS**

✓ **FUNDAMENTAL QUALITATIVE CHARACTERISTICS**

-contribute to decision usefulness of financial reporting information.

- a. RELEVANCE- capable of making a difference in decision made by users.
 - 1. Predictive Value- influences the economic decisions of users by helping them evaluate past, present and future events.
 - 2. Confirmatory Value (Feedback Value)- confirming or correcting their past evaluation..

✓ **FUNDAMENTAL QUALITATIVE CHARACTERISTICS**

b. FAITHFUL REPRESENTATION- to be useful, financial information must not only be relevant, it must also represent faithfully the phenomena it purports to represent.

1. Completeness- information must be complete but within the bounds of materiality and cost.
2. Neutrality- free from bias toward predetermined result.
3. Free from error- absence of material error.

*Substance over form- if information is to represent faithfully the transactions and other events it purports to represent, it is necessary that they are accounted in accordance with their substance and reality and not merely their legal form.

✓ **ENHANCING QUALITATIVE CHARACTERISTICS (VCUT)**

a. VERIFIABILITY- means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is faithful representation.

b. COMPARABILITY- can be compared with a similar information about other entities and with similar information about the same entity for another period or another date.

- Intercomparability- between and across entities
- Intracomparability- within the entity

✓ **ENHANCING QUALITATIVE CHARACTERISTICS (VCUT)**

c. UNDERSTANDABILITY- classifying, characterizing and presenting information clearly and concisely makes it understandable.

d. TIMELINESS- means that information is available to decision-makers in time to be capable of influencing their decisions.

Relating to Financial Position:

- b. LIABILITY- present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- c. EQUITY- the residual interest in the asset of the entity after deducting all its liabilities.

Relating to Performance:

- a. INCOME- increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

*Encompasses both revenue and gains.

REVENUE- arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

Relating to Performance:

b. EXPENSE- decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

*Encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity.

Recognition- process of incorporating in the financial statements an item that meets the definition of an element and satisfies the following criteria for recognition:

- **Asset Recognition Principle**- asset is recognized in the balance sheet when it is **probable** that the future economic benefits will flow to the entity and the asset has a cost or value that **can be measured reliably**.
- **Liability Recognition Principle**- liability is recognized in the balance sheet when it is **probable** that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place **can be measured reliably**.

- **Income Recognition Principle-** income is recognized in the income statement when an increase in future economic benefit related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.
- **Expense Recognition Principle-** expense is recognized in the income statement when a decrease in future economic benefit related to a decrease in an asset or a increase of a liability has arisen that can be measured reliably
 - **Cause & Effect Association**
 - **Systematic & Rational Allocation**
 - **Immediate Recognition**

ELEMENTS OF FINANCIAL STATEMENTS

- **Assets** - are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
- **Liabilities** - are 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.
- **Equity** - or net assets, called shareholders' equity or stockholders' equity for a corporation, is the residual interest in the assets of an entity that remains after deducting liabilities.

ELEMENTS OF FINANCIAL STATEMENTS

- **Revenues** - are inflows or other enhancements of assets or settlements of liabilities from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major, or central, operations.
- **Expenses** - are 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.

Measurement of the Elements of FS

- **Historical costs** – assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.
- **Current Cost** – assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent was acquired currently.
- **Present Value** – assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in a normal course of business.

NORMAL BALANCE OF AN ACCOUNT

Account Category	Increases Recorded by		Normal Balance	
	Debit	Credit	Debit	Credit
ASSET	✓		✓	
LIABILITIES		✓		✓
OWNER'S EQUITY:				
OWNER'S CAPITAL		✓		✓
WITHDRAWALS	✓		✓	
INCOME		✓		✓
EXPENSES	✓		✓	

ACCOUNTING EVENTS AND TRANSACTIONS

ACCOUNTING EVENT- is an economic occurrence that causes changes in an enterprise's assets, liabilities, and/or equity.

TRANSACTION- is a particular event that involves the transfer of something of value between two entities.

ACCOUNTING CYCLE

- a series of steps taken in gathering, processing and summarizing data so as to produce meaningful information which are communicated to statement users by way of financial reports.

Chapter

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|---|---------------------------------|
| 1. Analyzing (Identification of events to be recorded) | Recording phase |
| 2. Recording (Transactions are recorded in the journal) | |
| 3. Posting (Journal entries are posted to the ledger) | |
| 4. Unadjusted Trial Balance (Preparation of a Trial Balance) | Summarizing/
Reporting phase |
| 5. Adjusting Entries (Preparation of worksheet including adjusting entries) | |
| 6. Financial Statements (Preparation of Financial Statements) | |
| 7. Adjusted Trial Balance (Adjusting journal entries are journalized and posted) | |
| 8. Closing Entries (Closing journal entries are journalized and posted) | Optional steps |
| 9. Post-Closing Trial Balance (Preparation of Post-closing Trial Balance) | |
| 10. Reversing Entries (Reversing journal entries are journalized and posted) | |

Basic Areas Of Finance

- Corporate finance
- Investments
- Financial institutions
- International finance

Investments

- Work with financial assets such as stocks and bonds
- Value of financial assets, risk versus return, and asset allocation
- Job opportunities
 - Stockbroker or financial advisor
 - Portfolio manager
 - Security analyst



Financial Institutions

- Companies that specialize in financial matters
 - Banks – commercial and investment, credit unions, savings and loans
 - Insurance companies
 - Brokerage firms
- Job opportunities



International Finance

- This is an area of specialization within each of the areas discussed so far
- It may allow you to work in other countries or at least travel on a regular basis
- Need to be familiar with exchange rates and political risk
- Need to understand the customs of other countries; speaking a foreign language fluently is also helpful

Why Study Finance?

- Marketing

- Budgets, marketing research, marketing financial products

- Accounting

- Dual accounting and finance function, preparation of financial statements

- Management

- Strategic thinking, job performance, profitability

- Personal finance

- Budgeting, retirement planning, college planning, day-to-day cash flow issues

Business Finance

- Some important questions that are answered using finance
 - What long-term investments should the firm take on?
 - Where will we get the long-term financing to pay for the investments?
 - How will we manage the everyday financial activities of the firm?

Financial Manager

- Financial managers try to answer some, or all, of these questions
- The top financial manager within a firm is usually the Chief Financial Officer (CFO)
 - Treasurer – oversees cash management, credit management, capital expenditures, and financial planning
 - Controller – oversees taxes, cost accounting, financial accounting, and data processing

Financial Management Decisions

- Capital budgeting
 - What long-term investments or projects should the business take on?
- Capital structure
 - How should we pay for our assets?
 - Should we use debt or equity?
- Working capital management
 - How do we manage the day-to-day finances of the firm?

Goal Of Financial Management

- What should be the goal of a corporation?
 - Maximize profit?
 - Minimize costs?
 - Maximize market share?
 - Maximize the current value of the company's stock?
- Does this mean we should do anything and everything to maximize owner wealth?
- Sarbanes-Oxley Act