Economics /Management 4
Financial Accounting

Financial Accounting’s Conceptual Foundations
A highly-stylized Information System

Basic Functions (all info systems):

1. Collection of transactions’ data
2. Measurement in dollar $
3. Classification into 7 Elements
4. Presentation in 3 Reports
Collection

Collect the quantitative information from commercial transactions with outsiders.

No transaction, no record.
Measurement

Transactions are recorded in $’s, or a local currency.

Not always easy. Think of trade-in’s.

Often “estimates” are required.
Classification

The numbers are given a name, actually two names ... and recorded twice.

This preserves the fundamental equation.

The fun begins with classification.
Classification is a Decision that starts a Process

- Amounts are recorded in two journals.
- Called double-entry book-keeping.
- Journals are individual accounts.
- Accounts are grouped by elements.
- There are five basic and two adjunct elements.
Classification into the *Elements of Accounting*

1. Asset
2. Liability
3. Equity
4. Revenue
5. Expense
6. Gain
7. Loss
Presentation

Into Financial Reports

1. Balance Sheet
2. Income Statement
4. Statement of Shareholder’s Equity
Terminology is Critical

- Earned Revenue v. Unearned Revenue.
- Pre-paid Expense v. Expense.
- Expense v. Accrued Expense.
- Goods Sold v. Inventory on Hand.
- Wholesale costs v. Retail prices

ADJECTIVES MATTER
Symmetry and Semantics

- Current vs. Non-Current
- Direct vs. Indirect
- Operating v. non-Operating
- Monetary vs. non-Monetary
- Right vs. Obligation
- Inflow vs. Outflow
- Primary vs. Adjunct
Profits are a *construct*, not a fact

The “fact” is … a good accountant can make profits anything that he/she wants them to be …

Profits = Revenue & Gains
        less Expenses & Losses

Thus, we will look very closely at what is meant by Revenue and Expense.
Two Methods of Accounting

Cash-basis

• Rules-oriented method. Only cash receipts or disbursements matter. And there is only one bottom-line.

Accrual

• Principles-based method. GAAP accounting. More useful but opens the way for judgment, thus manipulation. There are many possible bottom-lines.
the subjective meets the objective

- Opinion meets Evidence
- Quantitative meets Qualitative
- Romance meets Reality
- *Form* competes with *Substance*
Accrual concepts. Guidelines.

Useful doesn’t mean accurate!

Fiction is permitted in accounting; it’s just not called fiction, it’s called interpretation.

And, the line between lies and fiction is not a very bright one.

Principle’s-Based Reporting
Accounting Assumptions

• One **Entity**. You are separate from your company for accounting purposes.

• **Record-keeping** for a “**Period**” of time. Fiscal “FY” year comprised of 4 interim quarters of roughly 13 weeks each.

• **On-going** concern. Change accounting methods for bankrupt companies or for discontinued operations w/in a company.
The Accounting Period is a 12 month \textbf{fiscal year} 
With 4 Interim Periods.

<table>
<thead>
<tr>
<th>Most companies</th>
<th>Retailers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1\textsuperscript{st} Quarter</td>
<td>Jan-Mar</td>
</tr>
<tr>
<td>2\textsuperscript{nd} Quarter</td>
<td>Apr-June</td>
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<tr>
<td>3\textsuperscript{rd} Quarter</td>
<td>Jul-Sep</td>
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<tr>
<td>4\textsuperscript{th} Quarter</td>
<td>Oct-Dec</td>
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Accounting Principles

1. Cost
2. Realization
3. Matching
4. Disclosure
5. Objectivity
6. Materiality
7. Consistency
8. Conservatism
Accounting’s Principles

1. Cost – keep *historical* cost on-the-Books
2. Realization – “earned”. Three basic criteria define earning *Revenue Recognition*
3. Matching – outflows, i.e. *Expenses* w/ related inflows, i.e. *revenues* in fact or in time.
4. Disclosure – say it when you can’t measure it.
5. Objectivity – *independence* is provided by transactions that are *at arm’s length*
7. Materiality – level of detail; aggregate the small stuff
Principle’s-Based (financial) Reporting

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- Guidelines.
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