Chapter 2: Investing and Financing Decisions and The Statement of Financial Position

CHAPTER SUMMARY

This chapter reviews the conceptual framework relevant to the Statement of Financial Position (the objective of external financial reporting, definitions of Statement of Financial Position elements, and the cost principle). The chapter discusses the accounting model and illustrates its application in the accounting system for a business. For accounting purposes, transactions are defined as (1) exchanges of assets and liabilities between the business and other individuals and organizations, and (2) certain events that do not occur between the business and other parties but exert a direct effect on the entity (such as recording adjustments to reflect the use of equipment in operations).

Application of the accounting model (Assets = Liabilities + Stockholders' Equity) is illustrated for Papa John's International. The application involves (1) transaction analysis, (2) journal entries, and (3) the accounts (T-account format). Each transaction causes at least two different accounts to be affected in terms of the accounting model. The model often is referred to as a double-entry system because each transaction has a dual effect. The process used in transaction analysis involves (1) identifying the accounts affected and classifying each as an asset, liability, or stockholders' equity account and (2) determining that the accounting equation remains in balance.

The transaction analysis model (built on the accounting model) and the mechanics of the debit-credit concepts in T-account format can be summarized as follows:

Transaction Analysis Model

Assets (A)		=	Liabilities (L)		=	Stockholders' Equity (SE)	
Increase Debit	Decrease Credit		Decrease Debit	Increase Credit		Decrease Debit	Increase Credit

T-Account Format

Assets (A)		Liabilities (L)		Stockholders' Equity (SE)	
Beg. Bal. Increase Debit	Decrease Credit	Decrease Debit	Beg. Bal. Increase Credit	Decrease Debit	Beg. Bal Increase Credit
End. Bal.			End. Bal		End. Bal.

CHAPTER OBJECTIVES

LO1 Define the objective of financial reporting, the elements of the Statement of Financial Position, and the related key accounting assumptions and principles.

LO2 Identify what constitutes a business transaction and recognize common Statement of Financial Position account titles used in business.

LO3 Apply transaction analysis to simple business transactions in terms of the accounting model: Assets = Liabilities + Stockholders' Equity.

LO4 Determine the impact of business transactions on the Statement of Financial Position using two basic tools, journal entries and T-accounts.

LO5 Prepare a simple classified Statement of Financial Position and analyze the company using the financial leverage ratio.

LO6 Identify investing and financing transactions and demonstrate how they are reported on the statement of cash flows.

<u>CHAPTER OUTLINE</u>

I. UNDERSTANDING THE BUSINESS

1. An understanding of a company's financial statements requires knowledge of business activities and their effects on account balances.
2. Financial statement analysis will allow the decision maker to arrive at decisions about a company. This evaluation can be used to compare one company to other companies.
3. Analysis of investing and financing activities of a business should be explored.
4. The concepts presented in Exhibit 2-1 are the framework of objectives, terms, concepts and principles used in financial accounting and reporting.

II. LO1 DEFINE THE OBJECTIVE OF FINANCIAL REPORTING, THE ELEMENTS OF THE STATEMENT OF FINANCIAL POSITION, AND THE RELATED KEY ACCOUNTING ASSUMPTIONS AND PRINCIPLES.

- **A.** Primary objective of financial reporting
  1. To provide useful economic information about a business to help external parties (investors and creditors) make sound financial decisions.
     - **a.** These decision makers are expected to have a reasonable understanding of accounting concepts and procedures.
     - **b.** Decision makers need to be able to use financial information to help them predict future cash flows related to investing and financing.

- **B.** Elements of the Statement of Financial Position
  1. Statement of Financial Position elements present the basic accounting equation (A = L + SE).
     - **a.** Assets: economic resources with probable future benefits owned by the entity as a result of past transactions.
       1. Listed on the Statement of Financial Position in the order of liquidity.
       2. Current assets are assets that will be used or turned into cash within one year.
       3. Historical cost principle: requires assets to be recorded at historical cost that, on the date of the transaction, is cash paid plus the current dollar value of all noncash consideration given in exchange.
     - **b.** Liabilities: are probable debts or obligations of the entity that result from past transactions, which will be paid with assets or services.
       1. Listed on Statement of Financial Position in the order of maturity dates.
       2. Current liabilities are obligations that will be paid in cash or other current assets or satisfied by providing cash, goods, or services within one year.
     - **c.** Stockholders equity (Owners Equity): the owners' residual interest in net assets (assets minus liabilities).
       Two categories:
       - a. Contributed capital
         - i. Results from owners' providing assets to the company in exchange for stock (evidence of ownership).
         - ii. The investments of the owners.
       - b. Retained earnings
         - i. The cumulative earnings that are not distributed to the owners and are reinvested in the business.
         - ii. Increased by net income and reduced by declared dividends.

C. The Related Key Accounting Assumptions and Principles

1. Underlying assumptions of accounting help the decision maker to understand what accounting information reports as well as the inherent limitations.
2. Recall assumptions noted earlier in the text. There are four basic accounting assumptions, the first three relate directly to the Statement of Financial Position
   - **a.** Separate-entity assumption – "business" transactions are separate from "owner" transactions.
   - **b.** Unit-of-measure assumption – accounting information will be measured and reported in the national monetary unit of that company.
   - **c.** Continuity (going-concern) assumption – a business is expected to continue operations in the foreseeable future without forced liquidation.
   - **d.** Time period assumption
3. There are four basic accounting principles. The first directly relates to the Statement of Financial Position:
   - **a.** Historical Cost Principle: The historical cost principle states that the cash (or cash-equivalent cost) should be used to initially record financial statement elements. This historical cost amount is measured on the initial transaction date and does not typically reflect market value changes.
   - **b.** Revenue Recognition Principle
   - **c.** Matching Principle
   - **d.** Full Disclosure Principle

III. LO2 IDENTIFY WHAT CONSTITUTES A BUSINESS TRANSACTION AND RECOGNIZE COMMON STATEMENT OF FINANCIAL POSITION ACCOUNT TITLES USED IN BUSINESS.

A. Nature of business transactions

1. Transactions are certain recorded economic "events" which impact an entity.
   - **a.** External events: exchanges of assets, goods, or services by one party for assets, services, or a promise to pay (liability) by one or more other parties.
     Examples: sales, borrowing, owner investments.
   - **b.** Internal events: certain events that are not exchanges between the business and other parties but nevertheless have a direct and measurable effect on the entity.
     Example: Adjustments to record usage of assets (depreciation).
   - **c.** Some events are not reflected in the financial statements.
     Example: The signing of a contract.

B. Accounts

1. Account: a standardized format that organizations use to accumulate the dollar effects of transactions on each financial statement item.
2. Chart of accounts: a listing of the account titles and their unique numbers that a company uses to record the transactions of its business operations.
   - **a.** Each company has its own chart of accounts.
   - **b.** Statement of Financial Position accounts are listed first.
     1. Assets are listed first, in the order of their liquidity.
     2. Liabilities are listed next, in order of maturity.
     3. Stockholders' equity lists contributed capital and retained earnings.
     4. Revenues
     5. Expenses
   - **c.** In formal record keeping, unique numbers are used for each account listed in the Chart of Accounts.

C. Common Statement of Financial Position accounts:

  1. Assets:
    a. Cash
    b. Receivables are always assets.
    c. Prepaid Expenses is an asset because it represents amounts paid to others for future benefits.
    d. Buildings
    e. Land

  2. Liabilities:
    a. Accounts with "payable" in the title are always liabilities.
    b. Accounts with "unearned" in the title are liabilities. They are amounts paid in the past to the company by others expecting future goods or services from the company.

  3. Stockholders' Equity
    a. Common Stock, Preferred Stock
    b. Retained Earnings

IV. LO3 APPLY TRANSACTION ANALYSIS TO SIMPLE BUSINESS TRANSACTIONS IN TERMS OF THE ACCOUNTING MODEL:

ASSETS = LIABILITIES + STOCKHOLDERS' EQUITY.

A. Historical record keeping provides information to managers
  1. In order to evaluate the effects of past decisions and
  2. To plan for the future.
  3. Important for managers to understand how past transactions affect financial statement items (accounts) and how future events may impact those accounts.

B. Principles of Transaction Analysis
  1. Involves studying a transaction to determine its economic effect on the entity in terms of the basic accounting equation (A = L + SE).
  2. Principles of transaction analysis:
    a. Dual effect: each transaction affects at least two accounts.
      1. Identification of the appropriate accounts and the direction of the effects (increase or decrease) is key.
      2. The fact that every transaction has at least two effects on the basic accounting equation is the essence of the double-entry system of record keeping.
      3. Whether the transaction is external (involves an exchange) or internal (involves an adjustment), the duality of effects results.
    b. Accounting equation: must remain in balance after each transaction. After each transaction, the accounting equation must be tested for equality.

C. Analyze Papa John's transactions: In this chapter, several transactions are analyzed using the principles of the transaction analysis approach.

V. LO4 DETERMINE THE IMPACT OF BUSINESS TRANSACTIONS ON THE STATEMENT OF FINANCIAL POSITION USING TWO BASIC TOOLS, JOURNAL ENTRIES AND T-ACCOUNTS.

- Journal entries and T-accounts: the two tools to aid in reflecting the results of transaction analysis.
- Analyze → Journalize → Post

A. Analyze: The Direction of Transaction Effects
  1. It is important to understand which accounts increase and decrease because of a transaction.
  2. By referencing the accounting equation, increases are on the left for assets (which are on the left side of the accounting equation) and increase are on the right for liabilities and stockholders' equity (which are on the right side of the equation. Decrease work in the opposite manner.

B. Journalize
  1. Debit means the <u>left side</u> of an account; Credit means the <u>right side</u> of an account.
  2. By referencing the accounting equation, debits increase asset accounts and credits increase liability and stockholders' equity accounts.

3. The normal balance of an account is on the increase side; therefore, asset accounts normally have debit balances, and liability and stockholders' equity accounts usually have credit balances.
4. Total debits must equal total credits in a transaction. This is necessary to keep the accounting equation in balance at all times.

C. Post: Analytical Tool: The T-account.

1. Posting is the act of transferring journal entry amounts to the appropriate accounts in the ledger.
2. Journal entries show all of the accounts affected by a transaction, but do not provide account balances.
3. Account balances are found in the ledger (a group of accounts). The ledger is referred to as the "final" book of entry.
4. A T-account is a simplified version of a ledger account.
   - **a.** This tool allows for summarization of journal entry effects on an account. The balance of the account can be determined with T-accounts.
   - **b.** Important for managers to understand how past transactions affect financial statement items (accounts) and how future events may impact those accounts.

D. Transaction Analysis Illustrated

1. Use transaction analysis as well as the journal entry and T-account tools to process typical transactions.
2. There are beginning balances in many Statement of Financial Position accounts since the ending balances carry over to the new period.
3. It is essential to understand:
   - **a.** The accounting model
   - **b.** The transaction analysis process
   - **c.** Recording the dual effects of each transaction
   - **d.** The dual-balancing system

VI. LO5 PREPARE A SIMPLE CLASSIFIED STATEMENT OF FINANCIAL POSITION AND ANALYZE THE COMPANY USING THE FINANCIAL LEVERAGE RATIO

A. How is the Statement of Financial Position prepared?

1. Account balances for asset, liability, and stockholders' equity accounts are used to prepare a Statement of Financial Position.
2. If comparative Statement of Financial Positions are prepared, the most recent amounts are usually presented first (in the left column) with the older amounts to the right.
3. The Statement of Financial Position presents the accounting equation: A = L + SE
4. Account balances will change during the accounting period, but the accounting equation must still remain in balance.

B. Financial Leverage Ratio measures the relationship of assets to equity. The higher the portion of assets financed with stockholders' equity, the lower the ratio. The higher the ratio, the more debt financing. Debt financing is riskier.

$$\text{Financial Leverage Ratio} = \frac{\text{Average Total Assets}}{\text{Average Stockholders' Equity}}$$

VII. LO6 IDENTIFY INVESTING AND FINANCING TRANSACTIONS AND DEMONSTRATE HOW THEY ARE REPORTED ON THE STATEMENT OF CASH FLOWS.

A. Investing Activities:

1. Purchases/ sales of non-current assets.
2. Lending cash to others
3. Receiving principal payments on loans made to others

B. Financing Activities:

1. Borrowing and repaying debt.
2. Issuing and repurchasing stock.
3. Paying dividends.

C. Only report transactions where cash is involved.