Slide 1

Elements and Assumptions and Principles

Financial statements are fundamental to understanding a business's performance and financial position; therefore, credit managers must thoroughly comprehend these documents.

To accurately interpret financial statements, it is crucial to understand their associated elements, as well as the underlying accounting assumptions and principles that govern their preparation.

Slide 2

The 10 Associated Elements in Financial Statements

Financial statements are structured around ten key elements that measure a business's performance and financial position.

These elements are:

Slide 3

Assets

These are all the resources owned, or in some cases controlled, by a company or a person.

Assets are expected to provide **future economic benefits** as a result of past transactions.

Examples include cash, inventory, property, plant, and equipment, as well as intangible assets (assets that lack physical substance, such as copyrights or trademarks).

Slide 4

Liabilities

These represent obligations, debts, and items owed by the business.

A liability requires a future sacrifice of assets, typically cash, to settle an obligation incurred from a past transaction.

Common examples include accounts payable, loans, notes payable, and accrued liabilities.

Slide 5

Equity

Also known as net assets or net worth.

It is the difference between a company's assets and its liabilities (Assets minus Liabilities).

It represents the remaining interest in the assets after subtracting liabilities.

For a corporation, owner's equity typically includes common stock and retained earnings.

Slide 6

Investment by Owners

This refers to an increase in the company's equity, which happens when something valuable, usually cash, is transferred to the business to gain or boost ownership interest.

Such investments directly raise the company's equity.

Slide 7

Distribution to Owners

This signifies a decrease in the equity of the business, occurring when assets, such as cash, are transferred to the owners.

This is essentially the opposite of owner investment, as it **reduces the company's equity**.

Slide 8

Comprehensive Income

This includes all changes in equity during a stated period, *except* those changes resulting from investments by owners or distributions to owners.

It typically encompasses net income plus certain "unrealized" gains and losses that do not flow through the income statement but directly affect equity, such as unrealized gains/losses on certain financial instruments or foreign currency transactions.

Slide 9

Revenues

These are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) derived from delivering or producing goods, rendering services, or other activities that constitute the entity's **ongoing major or central operations**.

When a company generates revenue, it typically increases its assets (e.g., cash or accounts receivable) or reduces liabilities, thereby increasing equity.

Examples include sales revenue for goods, tuition revenue for educational institutions, or advertising revenue for media companies.

Expenses: These represent the amount of assets or services spent or used. Expenses are decreases in assets or increases in liabilities incurred to generate revenue from the company's ongoing major or central operations. They include various costs necessary to run a business on a day-to-day basis, such as utilities, taxes, rent, wages, and the cost of goods sold.

Gains: These are increases in a company's equity resulting from **non-operating business transactions** and other occurrences, *except* those that stem from revenues or investments by owners. Unlike revenues, gains arise from peripheral or incidental transactions, such as the sale of an old warehouse by a company whose primary business is selling burgers.

Losses: These are decreases in a company's equity resulting from **non-operating business transactions** and other occurrences, *except* those that stem from expenses or distributions to owners. Losses are similar to expenses but arise from peripheral transactions, such as selling an asset for less than its cost.

Revenues, expenses, gains, and losses are combined to determine net income or net loss, which then contributes to comprehensive income and ultimately flows into the equity section of the balance sheet.

Core Accounting Assumptions and Principles

Financial accounting relies on several core assumptions and principles to ensure that financial statements provide a useful and accurate picture of a company's financial health.

Core Assumptions

1. **Economic Entity Assumption:** This assumption states that the activities of a business must be kept separate and distinct from the activities of its owners and any other entities. In other words, he business is treated as a separate "accounting entity" from its owners or other businesses for financial reporting purposes.

Key points:

- **Business ≠ Owner:** Personal transactions of owners should not be mixed with the business's transactions in the accounting records.
- **Applies to all entities:** This assumption applies to sole proprietorships, partnerships, corporations, and other organizations, regardless of their legal structure.
- **Ensures transparent financial reporting:** It allows users of financial statements (e.g., creditors, investors) to assess the financial performance and position of *the business itself* without being confused by the owners' personal finances or those of related entities.

Example:

If the owner of a sole proprietorship pays for a personal vacation from their own pocket, that expense is not recorded in the business's financial records, even though the business and the owner are legally the same entity.

2. **Going Concern Assumption:** It means that when preparing financial statements, we assume the business will continue to operate for the foreseeable future and has no intention or need to liquidate or significantly curtail its operations.

   Key points:

   The business is expected to keep running long enough to fulfill its objectives and commitments.

   Assets are reported at their historical cost, not at liquidation or fire-sale values, because we assume they will be used in the normal course of operations.

   Liabilities are reported as obligations that will be settled in the normal course of business.

   Example:

If a company owns equipment with a useful life of 10 years, we depreciate it over 10 years (not assume it will be sold tomorrow), because we expect the company to continue operating.

When this assumption might not apply:

If there are significant doubts about a company's ability to continue (e.g., bankruptcy risk, severe financial distress), then financial statements must disclose this, and accountants may need to prepare the financials on a liquidation basis instead.

3. **Monetary Unit Assumption (Stable Measuring Unit Principle):** The **Monetary Unit Assumption** states that financial transactions and events are measured and reported in a **stable currency** (e.g., U.S. dollars) and that this unit of measure remains stable over time.

   Key points:

- **Only measurable in money:** Accounting records only transactions that can be quantified in monetary terms — things like employee morale or brand reputation are **not recorded** because they can't be reliably expressed in dollars.
- **Stable purchasing power:** This assumption ignores the effects of inflation or deflation, treating the dollar as if its purchasing power does not change significantly over time

   Example:

   If a company purchases inventory for $10,000, that amount is recorded at $10,000, even if inflation later reduces the purchasing power of that money.

   Implication:

   In economies with high inflation, this assumption may become unrealistic and financial statements may lose relevance unless adjustments for inflation are made.

4. **Periodicity Assumption:** The Periodicity Assumption (also called the Time Period Assumption) states that a business's ongoing life can be divided into artificial time periods — such as months, quarters, or years — for the purpose of preparing financial reports.

Key points:

- Even though business operations are continuous, we break time into **regular intervals** so financial performance can be measured and communicated.
- This allows users (investors, creditors, management) to evaluate performance over shorter time frames rather than waiting until the end of the company's life.
- Common periods:
  - **Monthly reports** for internal management

- **Quarterly reports** for external reporting (e.g., public companies)
- **Annual reports** for formal financial statements.

Example:

A company prepares financial statements every year ending December 31, even though it expects to operate indefinitely.

Why it matters:

This assumption underpins the accrual basis of accounting — revenues and expenses must be recognized in the correct period, even if cash is received or paid at a different time.

Core Principles

1. **Historical Cost Principle:** This principle is an accounting principle that requires assets to be recorded and reported at their original purchase price (cost) at the time of acquisition, rather than at their current market value.

   Key points:

   The historical cost includes all the costs necessary to acquire the asset and prepare it for use (e.g., purchase price, shipping, installation).

   This principle ensures that financial information is based on verifiable, objective evidence (actual transactions), providing reliability.

   Once recorded, the historical cost usually does not change over time, even if the asset's fair market value increases or decreases.

   Example:

   If a company purchases a machine for $50,000, it records the machine at $50,000 on the balance sheet — even if its market value later rises to $60,000 or falls to $40,000

   Limitations:

   While historical cost is reliable and objective, it may not always reflect the asset's current economic value, which is why some assets (like marketable securities) are reported at fair value under modern accounting standards.

2. **Revenue Recognition Principle (ASC 606):** This principle dictates when and how revenue should be recognized. The core principle of ASC 606 is to **"recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services"**. Under US GAAP, businesses must record revenues on their income statement in the period they were realized and earned, being reasonably sure they will receive the revenues upon completing an activity. The revenue recognition model typically involves five key steps:
    1. Identify the contract with a customer. A contract is an agreement creating enforceable rights and obligations. For a contract to be accounted for under ASC 606, it must meet specific criteria, including approvals and commitments from both parties, identifiable rights and payment terms, commercial substance, and probable collection of substantially all consideration.
    2. Identify the performance obligations in the contract.
    3. Determine the transaction price. This includes noncash consideration, variable consideration (subject to constraint), and significant financing components.
    4. Allocate the transaction price to the performance obligations.
    5. Recognize revenue when (or as) each performance obligation is satisfied. Revenue can be recognized over time or at a point in time, depending on specific criteria related to the transfer of control.
3. **Matching Principle:** This is a core idea in accrual accounting, also called the matching principle. It states that an expense should be recorded in the same period as the revenue it helped generate. For example, if a company sells t-shirts for $4,000 that cost $2,000, both the $4,000 revenue and the $2,000 expense (Cost of Goods Sold) need to be recognized in the same period. This principle helps give a clear and accurate view of a company's financial performance by directly linking costs to the revenues they produce.
4. **Full Disclosure Principle:** This principle requires companies to report their financial statements and disclose all material information that could significantly influence the reader's decision-making. Sharing all material financial data and related information about a company's performance helps prevent stakeholders from being misled. This includes management's perspective on risks and mitigating factors. The principle ensures that information relevant to equity holders, creditors, employees, and suppliers/vendors is shared, enabling adequately informed decisions. Although interpretation can be subjective, it is essential to disclose significant risks that might threaten the company's future.