UGBS 205
Fundamentals of Accounting Methods

Week 3 – Recognition and Measurement of Elements of Financial Statements

UNIVERSITY OF GHANA

College of Humanities

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Overview

- This session presents the various elements of financial statements and how they are recognized and measured. It further examines how the elements in financial statements relate to each other.

Learning Objectives

- At the end of this session, you should be able to
  - Identify the components of financial statements
  - Discuss the elements of financial statements
  - Explain the accounting equation
  - Determine the effects of transactions on the accounting equation
  - Explain the concept of double entry in accounting

Reading List

- Read Chapter 1 and 10 of Recommended Text –
  - Chapters 4 & 6 of Marfo-Yiadom, Asante & Tackie (2015)
  - Chapters 1 and 10 Wood, F. & Sangster, A. (2008). Frank Wood's Business Accounting 1. Volume 1. Pearson Education.

- Other Financial Accounting text books available to students

Classes of Financial Statements

- Do you recall the components of financial statements prepared by business organizations?

Classes of Financial Statements

Financial statements can be classified into;

- General Purpose Financial Statements
  - Information to wide range of users
- Special Purpose Financial Statements
  - Information to a particular user or group

Elements of Financial Statements

- Income
- Expenses
- Assets
- Liabilities and
- Equity
  – Are the elements of the financial statements
  – Hence they are the building blocks used in constructing financial statements

Elements of Financial Statements

Directly related to performance

- Income
- Expenses

Directly related to financial position

- Assets
- Liabilities
- Equity

Assets

Economic resources

Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events

Classification of Assets

Current Assets

- Assets from which future economic benefits are expected to flow to the entity in not more than a year after the reporting period
- The intention to turn them into cash within one year
- Examples; inventories/stock, trade receivables/debtors, accounts receivables/prepayments, bank, cash etc…

Non-Current Assets

- Assets from which future economic benefits are expected to flow to the entity in more than a year after the reporting period
- Acquired for continuing use within the business with a view to earning income or making profit from its use
- Not acquired for resale
- Examples; Land & building, plant & machinery, motor vehicles, fixtures and fittings, goodwill

Liabilities

Present obligations

Probable future sacrifices of economic benefits arising from present obligations to transfer assets or provide services to other entities in the future as a result of past transactions or events

Classification of Liabilities

Current liability

- Liability that is required to be settled in not more than a year after the reporting period
- Examples; Trade payables/creditors, accounts payable/accruals, bank overdraft, short-term loans etc…

Non-current liability

- Liability that is required to be settled in more than a year after the reporting period
- Examples; Long-term loan, debentures, bonds (issued)

Equity or Net assets

Stated Capital (Share Capital)

Owners contribution to the business in the form of assets, cash or other forms of contribution.

The residual interest in assets of the business after deducting all its liabilities.

Other reserves

Income Surplus (Retained Earnings)

Income

Increases in economic benefits which result in increase in equity

Occur in the form of

- Increase in assets
- Reduction in liabilities

Classification of Income

Revenue	• From delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations
Gains	• From peripheral or incidental transactions of an entity

Expenses

Expenses are decreases in economic benefits that result in decreases in equity

Occur in the form of

- Outflows or depletions of assets
- Incurrences of liabilities

Expenses and Losses

- Expenses and Losses lead to decrease in economic benefits that result in decreases in equity.
- However;
  - Expenses arise in the course of ordinary activities of a business
  - Losses arise from peripheral activities

Recognition and Measurement of Elements in Financial Statements

Recognition

What is meant by "recognition"?

The process of including in the financial statement an item that meets the definition of an element of financial statement and the fundamental recognition criteria

Fundamental Recognition Criteria

- For an element to be recognized in the financial statement, it must meet the fundamental recognition criteria;
  - Definition
  - Measurability
  - Relevance
  - Reliability

Fundamental Recognition Criteria

- Definitions
  - The item meets the definition of an element of financial statements.
- Measurability
  - The item has a relevant attribute measurable with sufficient reliability
- Relevance
  - The information about it is capable of making a difference in user decisions
- Reliability
  - The information about it is representationally faithful, verifiable, and neutral

Recognition of Elements

- Asset
  - Probable that future economic benefits will flow to the enterprise
  - Item has cost or value that can be measured reliably

- Liability
  - Probable outflow of resources embodying economic benefits from the settlement of obligation
  - Amount to be settled can be measured reliably

Recognition of Elements

- Income
  - When increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen and can be measured reliably

- Expense
  - When decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen and can be measured reliably

Measurement

What does “measurement” mean?

Putting monetary amount on an element of financial statement

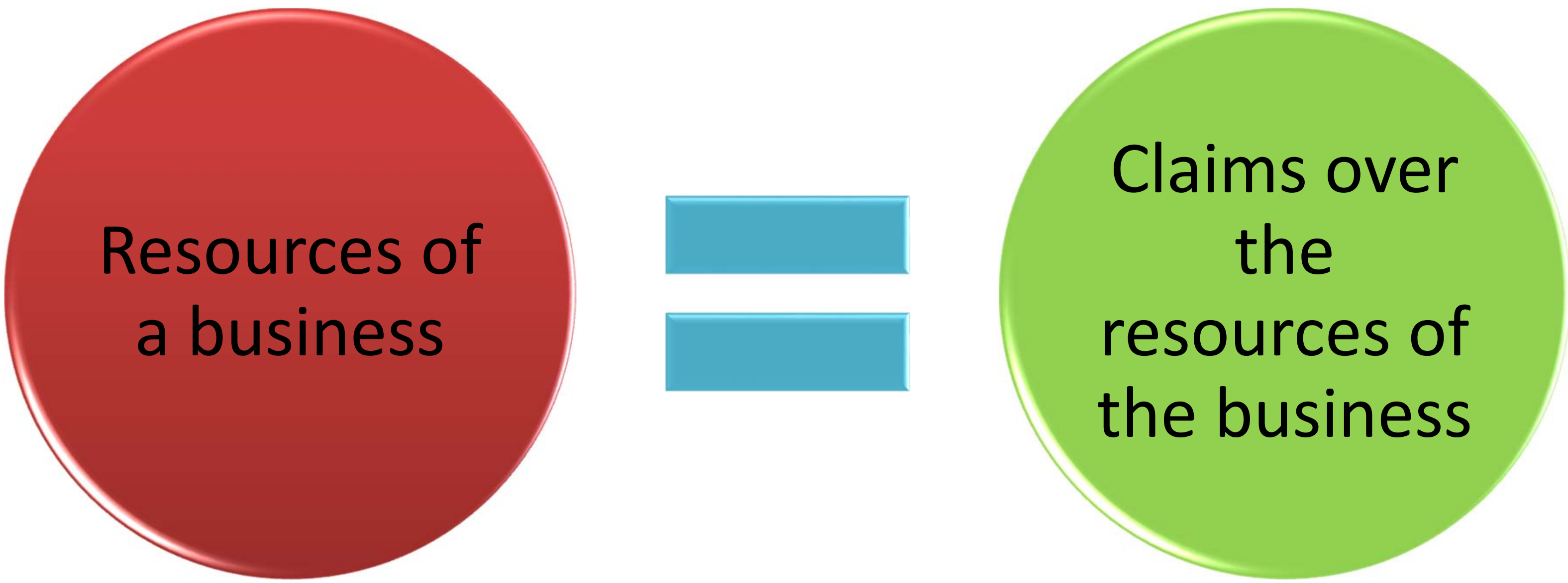
Bases of measurement

Historical Cost	• Based on acquisition cost or the original cost of the item
Current (Replacement) value	• Based on the cost that will be incurred in acquiring a similar item on the market in its current state
Net Realizable (Settlement) Value	• Based on the net amount that would be realized in the event of disposing off the item
Present (Discounted) Value	• Based on the discounted future cash flows associated with the usage of the item.

DOUBLE ENTRY AND ACCOUNTING EQUATION

Accounting Equation

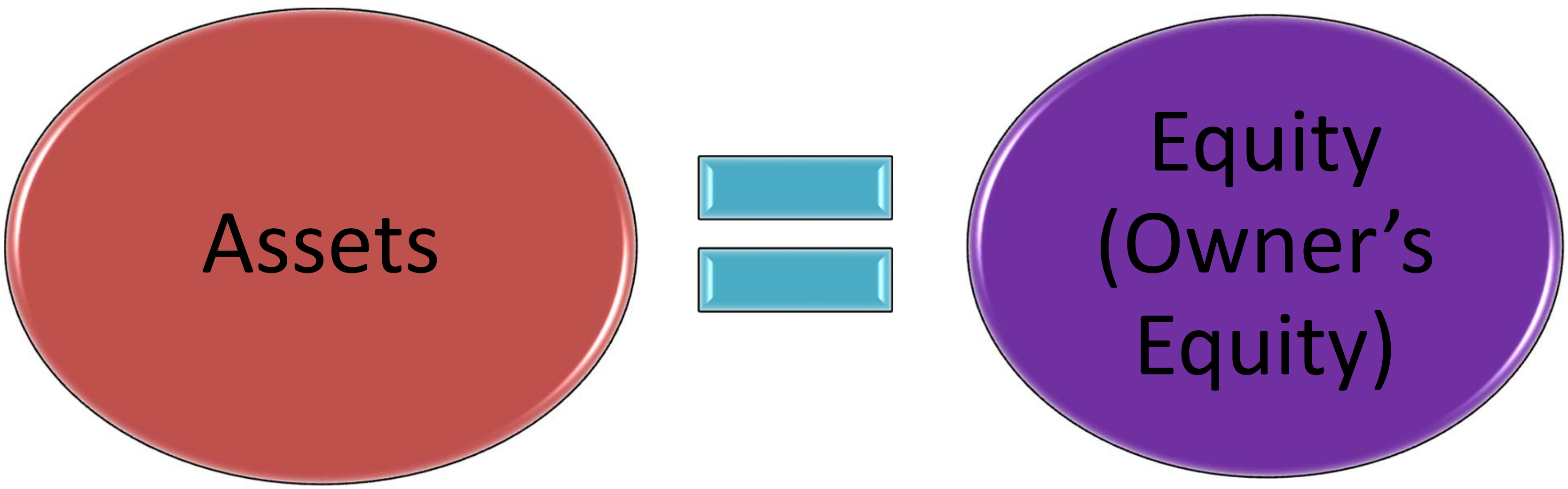
- Financial accounting is based upon a simple idea known as Accounting Equation



Accounting Equation

Assets = Liabilities

Accounting Equation



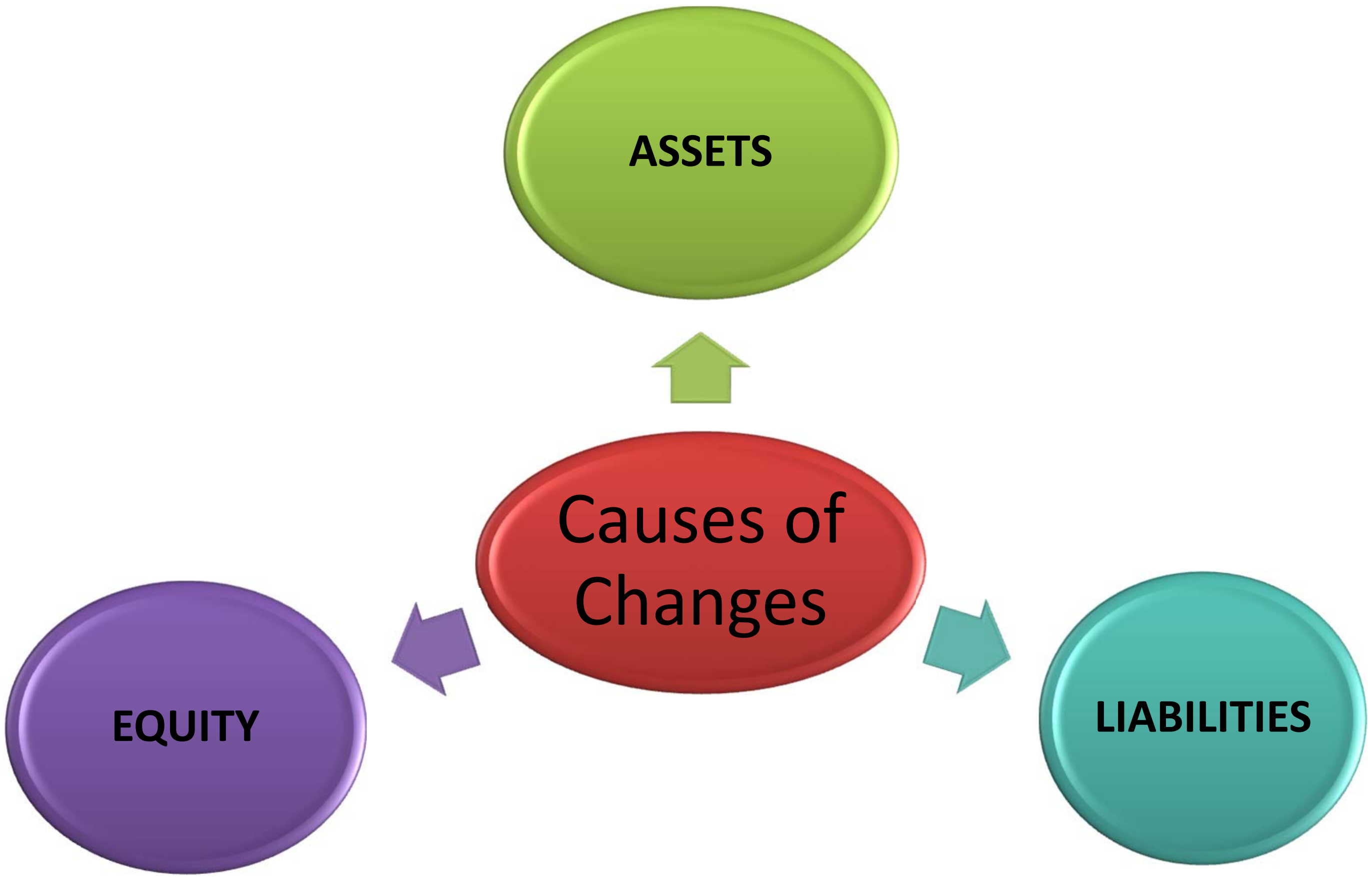
Accounting Equation

Assets = **Equity (Owner's Equity)** + **Liabilities**

Effects of Transactions on Accounting Equation

1. Identify the items involved in the transactions
2. Determine whether the item is an asset, a liability or capital (owner's equity)
3. Determine whether the item has increased or decreased as a result of the transaction
4. Explain the effect of the transaction on the accounting equation

CHANGES IN COMPONENTS OF ACCOUNTING EQUATION

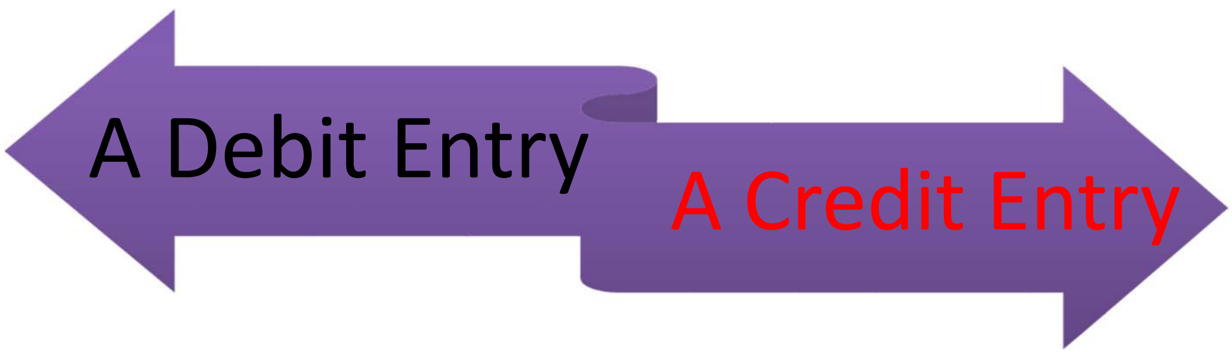


Double Entry Principle

- All transactions affect two items.
- Accounting shows the effect of the transactions on the two items by:

  a debit entry (left of a/c)

  a credit entry (right of a/c)
- Each transaction must have a debit and corresponding credit entry



Double Entry Principles Summarized

Accounts	To record	Entry in account
Asset	Increase Decrease	Debit Credit
Expense	Increase Decrease	Debit Credit
Liability	Increase Decrease	Credit Debit
Equity	Increase Decrease	Credit Debit
Revenue	Increase Decrease	Credit Debit

End of Session Questions

- What are the elements of financial statements?
- Show how each of the following transactions can affect the accounting equation (Statement of Financial Position)
  - Purchased goods on credit GH¢250,000 from Adwoa
  - Paid rent expenses for last month with cheque GH¢250
  - Sold goods costing GH¢50,000 on credit GH¢ 90,000 to Anas
  - Returned goods GH¢25,000 to Adwoa a trade payable