# CHAPTER 2

# INVESTING AND FINANCING DECISIONS AND THE STATEMENT OF FINANCIAL POSITION

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# CHAPTER LEARNING OBJECTIVES

1. Understand the objective of financial reporting, the qualitative characteristics of accounting information and the related key accounting assumptions and principles.

2. Define the elements of a classified statement of financial position.

3. Identify what constitutes a business transaction and recognize common account titles used in business.

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

5. Determine the impact of business transactions on the statement of financial position using two basic tools: journal entries and T-accounts.

6. Prepare a classified statement of financial position and analyze it using the current ratio.

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

# CHAPTER SUMMARY

***The text materials contain many useful exhibits for this chapter. In addition, other chapter features useful in the teaching of this text are contained in this manual.***

This chapter reviews the parts of the conceptual framework relevant to the statement of financial position (the objective of external financial reporting, definitions of the elements of the statement of financial position, and the cost principle). This chapter discusses the accounting model and illustrates its application in the accounting system for a business. For accounting purposes, transactions are defined as (a) exchanges of assets and liabilities between the business and other individuals and organizations, and (b) 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 + Equity ---- is illustrated for Sun-Rype (www.sunrype.com). 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 (a)

identifying the accounts affected and classifying each as an asset, liability, or shareholders' equity account and (b) 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) | | + | Equity (E) | |
|---|---|---|---|---|---|---|---|
| Increase Debit | Decrease Credit | | Decrease Debit | Increase Credit | | Decrease Debit | Increase Credit |

### T-Account Format

| Assets | | Liabilities | | Equity | |
|---|---|---|---|---|---|
| Increase Debit | Decrease Credit | Decrease Debit | Increase Credit | Decrease Debit | Increase Credit |
| Beg. Bal. | | | Beg. Bal. | | Beg. Bal. |
| End. Bal. | | | End. Bal. | | End. Bal. |

# CHAPTER LECTURE NOTES

## 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. Financial statements for Canadian companies contain estimates of financial value that are developed in accordance with generally accepted accounting principles (GAAP which can be IFRS or ASPE).
4. Financial statements are intended to communicate the economic facts, measured in monetary units in a standardized manner incorporating rules (standards) consistently without bias (faithful representation).
5. Analysis of investing (asset acquisition activities) activities and financing (activities around borrowing and equity transactions) activities of a business should be explored.
6. Financial statements communicate results or consequences of strategy by answering the following questions:

   i what type of business activities cause changes in the statement of financial position amounts from one period to the next?
   ii how do specific activities affect each of the statement of financial position amounts?
   iii how do companies keep track of these amounts

7. Once we have answered these questions, we will be able to use the information to
   i. Analyze and predict the effects of business decisions on the company's financial statements.
   ii. Identify and evaluate the financial activities that managers engaged in during the past period. This is a key task in financial statement analysis.

# II OVERVIEW OF ACCOUNTING CONCEPTS

The concepts presented in Exhibit 2-1 are the key concepts in the financial reporting framework of objectives, elements, qualitative characteristics, assumptions, principles and constraints.

## A. Concepts Emphasized in Chapter 2

1. The **primary objective of external financial reporting** is to provide financial information about a business to help external parties, primarily investors and creditors, make sound financial decisions in their capacity as capital providers. These decision makers need a reasonable understanding of accounting concepts and procedures. They need to be able to use financial information to help them predict future cash inflows and outflows both in terms of timing and uncertainty and financial values of assets and liabilities.

2. The qualitative characteristics of accounting information contained in the conceptual framework provides guidance on the essential characteristics that determine the usefulness of accounting information. There are two fundamental qualitative characteristics:
   a. Relevance
      -information is considered to be relevant if it can influence users' decisions
      -relevant information has predictive and/or confirmatory value
   b. Faithful Representation
      -to be useful in decision making financial statements must be a faithful representation of the economic phenomena it is supposed to represent, thus reflecting the economic substance of a transaction which may differ from the legal form of the transaction

   The fundamental qualitative characteristics are supported by four enhancing qualitative characteristics:
   a. Comparability
      -the usefulness of accounting information is enhanced when similar accounting methods have been applied on a consistent basis
   b. Verifiability
      -assumes that accountants acting independent of each other can agree on the nature and amount of a transaction.
   c. Timeliness
      -information should be provided in a timeframe that enables users to make decisions
      -usefulness of financial information declines as time passes
   d. Understandability
      -users of financial information are expected to have a reasonable understanding of business and economic activities and be willing to analyze the information in a diligent manner

3. The **Cost Constraint of Accounting Measurement** suggests that information should be produced only if the perceived benefits of increased decision usefulness exceed the expected costs of providing that information.

4. **Underlying assumptions of accounting** help the decision maker to understand what accounting information purports as well as the inherent limitations of that information. Recall assumptions noted in Chapter 1:
   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. Periodicity assumptions-provides guidance on measuring and recognizing revenues and expenses. This assumption is covered in more detail in Chapter 3.

5. The **basic accounting principle, historical cost** provides that amounts shown on the statement of financial position represent the cash-equivalent cost at the date of acquisition.

## B. Elements of the Classified Statement of Financial Position

1. “Classified”, means sections of the statement of financial position broken down into Assets, Liabilities and Shareholders’ Equity. Within each section, further classifications are reflected. “Consolidated”, means that the classified elements of the Nestle (referred to as the parent company in this context) statement of financial position are *combined* with those of other companies under Nestle’s control (referred to as subsidiaries)
2. Statement of Financial Position (SFP) elements present the basic accounting equation (A = L + SE).
   a. Assets are economic resources controlled by an entity as a result of past transactions or events and from which economic benefits may be obtained. Assets on the SFP are listed in the order of liquidity between “current” (those economic resources that the entity will typically transform into cash or use within the next year or the operating business cycle of the entity, whichever is longer) and non-current.
      Current assets (short term) would include:
      a. Cash and Cash Equivalents
      b. Short term investments
      c. Trade and other receivables
      d. Inventories
      e. Prepayments
      f. Other current assets

      Non-current (long term) assets would include:
      a. Investments in Associates
      b. Property, plant and equipment (at cost less accumulated depreciation)
      c. Financial assets - Intangible assets
      d. Goodwill
      e. Intangible assets
      f. Other (miscellaneous) assets

   b. Liabilities (L) are debts or obligations of the entity that result from past transactions that will require the outflow of assets or services to the creditors in the future.

Liabilities are listed on the SFP in the order of maturity dates between current (expected to be repaid in one year or operating cycle whichever is longer) and non-current (maturities that extend beyond one year from the statement of financial position date).

Current liabilities would include:

a. Short-term borrowings
b. Trade payables
c. Accrued liabilities and provisions
d. Income taxes payable
e. Current portion of long-term debt
f. Other current liabilities

Non-current liabilities would include:

a. Long-term borrowings
b. Deferred income tax liabilities
c. Provisions
d. Other liabilities

c. Equity (E) is the residual interest in the net assets of the entity. It can be the result of financing provided to the corporation by both its owners and the operations of the business. There are two categories of Equity:
- Share capital (SC) results from owners providing assets to the company in exchange for shares (evidence of ownership). These are the investments of the owners. Contributed surplus which when combined with share capital is called contributed capital, is the result of certain prescribed transactions.
- Retained earnings (RE) result from undistributed earnings generated by the operations of the company. RE is reduced by declared dividends to date.
- The motives for owners to buy shares are to receive corporate distributions through dividends and/or enjoying capital gains upon the sale of their shares.

# III WHAT TYPE OF BUSINESS ACTIVITIES CAUSE CHANGES IN STATEMENT OF FINANCIAL POSITION AMOUNTS?

## A. Nature of Business Transactions

Transactions are certain recorded economic "events" which impact an entity. Transactions include two types of events:

1. External events: a direct exchange of assets/liabilities between a business and an <u>external</u> party. Examples: sales, borrowing, owner investments.

**or** 2. Internal events: a measurable event <u>internal</u> to the business which is not a direct exchange. Examples: Losses from casualties and adjustments to record usage of assets previously purchased (depreciation).

Some "events" are external to the business but have not yet given rise to a transaction and are not subject to recording. Examples: signing a lease, taking a customer order, hiring a new employee. Each of these situations involves future promises but neither assets nor liabilities have been established in their regard.

A transaction is (1) an exchange between a business and one of more external parties to a business or (2) a measurable internal event, such as adjustments of the use of assets in operations.

### B. Accounts

1. An account is a standardized record that organizations use to accumulate the monetary effects of transactions on each financial statement item.
2. A chart of accounts (COA) is a listing of the accounts a company uses to record the transactions of its business operations. Every company creates its won chart of accounts to fit the nature of its business activities. The order of the COA listing facilitates the financial reporting for a company. For the statement of financial position focus, assets are listed first in order of liquidity. They are followed by liabilities in order of maturity. Next, equity lists share capital accounts and retained earnings. Finally, revenue and expense accounts follow. COA vary widely based on the industry of the company. In formal record keeping systems, unique numbers are used for each account listed in the COA.
3. More detailed listings are kept for several accounts. These are called subsidiary ledgers. Examples include accounts receivable, inventories, equipment, accounts payable, and notes payable. The total of a subsidiary ledger agrees to the related general ledger account balance.

## IV HOW DO TRANSACTIONS AFFECT ACCOUNTS?

1. Keeping historical records affecting accounts provides information to managers in order to evaluate the effects of past decisions and to plan for the future. Therefore, it is important for managers to understand how past transactions affect financial statement items (accounts) and how future events may impact those accounts.

### A. Principles of Transaction Analysis

1. This analysis involves studying a transaction to determine its economic effect on the entity in terms of the basic accounting equation (accounting model). This understanding is necessary to determine how transactions affect financial statement accounts.
2. Basic Accounting Equation: A = L + SE.
3. Principles of transaction analysis:
   a. Dual effects - each transaction affects at least two accounts. Identification of the appropriate accounts and the direction of the effects (increase or decrease) is key. 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. Whether a transaction is external (involves an exchange) or internal (involves an adjustment), the duality of effects results.
   b. Accounting equation - it must remain in balance. After each transaction, the accounting equation must be tested for equality. That is, A = L + SE must constantly be considered.
4. Transaction analysis process:
   a. Accounts and effects
      - Identify the accounts affected
      - Classify each account as A, L, or E
      - Determine the direction of the effect (increase or decrease) for each account
   b. Balancing
      - Prove that A = L+ E after the transaction
5. Analyzing Sun-Rype's Transactions

## V HOW DO COMPANIES KEEP TRACK OF ACCOUNT BALANCES?

1. The two tools to aid in reflecting the results of transaction analysis are journal entries and T-accounts (a simplified visual substitute for general ledger accounts).

### A. The Direction of Transaction Effects

1. It is important to understand which accounts increase and decrease because of a transaction.
2. By referencing T-accounts, increases are on the left for assets (which are on the left side of the t-account) and increases are on the right for liabilities and equity (which are on the right side of the t-account). Decreases work just the opposite.
3. Debit means the left side of an account while credit means the right side of an account.
4. By referencing the accounting equation, debits increase asset accounts and credits increase liability and equity accounts. Credits decrease asset accounts and debits decrease liability and shareholders' equity accounts.
5. The normal balance of an account is on the increase side. Therefore, asset accounts have debit balances while liability and equity accounts have credit balances.
6. Total debits must equal total credits in a transaction. This is necessary to keep the accounting equation in balance at all times.

### B. Analytical Tool: The Journal Entry

1. A general journal is part of the bookkeeping system of a company. It contains a chronological listing of journal entries. It is referred to as the “original” book of entry.
2. A journal entry expresses the effects of a transaction on accounts in a "debit=credit" format. Its source is a business document. A journal entry should include a transaction date.
3. A simple entry affects two accounts. A compound entry affects more than two accounts.
4. In a journal entry, debit accounts and amounts should be listed first followed by credits. Credit accounts and amounts are indented below the debit portion(s) of the journal entry.

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

1. Journal entries, per se, do not provide account balances. Account balances are found in the ledger (a group of accounts). The ledger is referred to as the “final” book of entry.
2. Posting is the act of transferring journal entry amounts to the appropriate accounts in the ledger.
3. A T-account is a simplified version of a ledger account. This tool allows for summarization of journal entry effects on an account. The balance of the account can be determined with T-accounts.

### D. Transaction Analysis Illustrated

1. Use transaction analysis as well as the journal entry and T-account tools to process typical monthly 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

Note: Practice is important in order to grasp these critical concepts.

## VI HOW IS THE STATEMENT OF FINANCIAL POSITION PREPARED?

1. Account balances for asset, liability, and equity accounts are used to prepare a statement of financial position. Balances from T-accounts are used in this chapter for that purpose.
2. If a comparative statement of financial position is 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 + E
   Several account balances change during the accounting period, but the accounting equation must still remain in balance.

### A. Some Misconceptions

1. Bookkeeping does not equal accounting. Rather, bookkeeping is an important part (a subset) of accounting.
   a. Bookkeeping is the routine, clerical function of recording and posting journal entries. A basic knowledge of accounting is necessary to perform these bookkeeping tasks.
   b. Accounting involves the design of accounting systems, analysis of complex transactions, the interpretation of financial data, financial reporting, auditing, taxation, and management consulting. A high degree of knowledge, professional judgment, and experience are needed to perform these accounting functions.
2. The results of the accounting processes do not reflect "exact" information.
   a. Many estimates are used that influence account balances.
   b. Generally, the amounts on financial statements do not represent current market values. They typically present historical cost amounts.
   c. It is important to gain an understanding of what financial statements do and do not reflect. The user needs to understand financial statement limitations.
3. Accounting is not inflexible nor is it a “cut and dried” subject. Instead, it is a dynamic and creative area of study that requires considerable judgement. It requires dedicated involvement for the users of financial statements as well as the preparers of those statements. Problem solving and communication skills are ***extremely important*** in accounting.

# ADDITIONAL TEACHING NOTES

1. Point out that most decision makers are neither ignorant nor superhuman. They often are average investors (or creditors). However, they are expected to have the tools to evaluate what goes on in the business world. Some of your students may already be investors or creditors.

2. Distinguish between "going concern" and "liquidation" valuations.

3. Point out that some companies present amounts on the statement of financial position in dollars, thousands of dollars, etc. The student should be sure to reference the statement of financial position heading for this information.

4. Note that the chart of accounts for assets and liabilities often differs widely for industries and companies.

5. Distinguish between historical costs recorded in the accounts and current fair market values.

6. Owners are "external" to a company because of the separate-entity concept. There should be no commingling of assets or liabilities of owners and companies.

7. Briefly mention how subsidiary ledgers support the details of general ledger accounts such as accounts receivable, accounts payable, and equipment.

8. This chapter presents an excellent experience with several cash transactions that have effects on the cash flow statement. There are references to cash flows throughout the text. Comprehensive coverage of the cash flow statement is in chapter 13.

9. Emphasize the "misconceptions" at the end of the text materials.

10. T-accounts are great visual learning devices. Encourage students to use them throughout the course.

11. It is quite important that students identify accounts as (A), (L), or (E) when doing transaction analysis and preparing journal entries. It typically makes the analysis process clearer and the journal entry preparation easier for them at this stage of learning.

# CHART OF END OF CHAPTER MATERIALS

| LEARNING OBJECTIVE | EXERCISES | PROBLEMS | ALTERNATE PROBLEMS | CASES & PROJECTS |
|---|---|---|---|---|
| 1 | 1,2 | | | 1,2,5,7 |
| 2 | 1 | 1 | 1 | 1,2,5,7, |
| 3 | 1,3,4,5 | 2 | 2 | 1,2,3,8,9,10 |
| 4 | 1,6,7,8,11 | 2 | 2 | 1,2,8 |
| 5 | 5,9,10,11,12, 13,14,15,16 | 1,5,8 | 1,3,5,8 | |
| 6 | 14 | 3,5,7,8 | 3,5,7,8 | 4,5,6,7,8 |
| 7 | 17,18 | 4,6 | 4,6 | 1,2,3,10 |

*NOTE TO INSTRUCTORS: ALL TEST BANK CONTENT AVAILABLE ONLINE THROUGH EZ-TEST AND ON CONNECT CAN BE SORTED BY LEARNING OBJECTIVE, QUESTION TYPE, AND LEVEL OF DIFFICULTY.

# GUIDE TO OTHER CHAPTER FEATURES

Focus Company used for Primary Illustrations/Management Decision Setting
Sun-Rype Products Ltd. www.sunrype.com

Financial Analysis Titles
Analysis of Changes in Inventory and Accounts Receivable
Unrecorded but Valuable Assets
Analysis of Change in Trade Payables
Inferring Business Activities from T-Accounts

Focus on Cash Flows
Investing and Financing Activities

Question of Accountablility
Environmental Liabilities-The Greening of Accounting Standards

International Perspective
Understanding Financial Statements of Foreign Companies

Key Ratio Analysis
The Current Ratio

Self Study Quiz Summary

1. Determine the classification of assets and liabilities as current or non-current

2. Complete the transaction analysis

3. Determine the normal balance for the given accounts as either Dr or Cr.

4. Complete the missing information

5. Classify transactions as either financing or investing activity and whether the Transaction will increase or decrease cash flow

Demonstration Case Summary
Setup T-accounts
Analyze transactions, prepare journal entries, and determine account balances
Prepare a classified statement of financial position
Prepare the investing and financing sections of the cash flow statement

Chapter Take Aways
Chapter summary by learning objective

# SUPPLEMENTAL ENRICHMENT ACTIVITIES

***Note: Many of these activities would be suitable for individual or group applications.***

## IN THE CLASSROOM

"Who Owns What" Game:

Some of your students may work (or have worked) in financial institutions. Explain that there are two sides to every transaction. Working in groups for this game would probably get the best results. Have some students be depositors and others be bank tellers. Use playing cards or "play" money for the transactions. Have each "side" determine if the deposits are assets or liabilities to them. The same thing can be done with borrowing from the bank for a car or home loan. This will reinforce the definition of assets and liabilities for all parties to a transaction. These transactions will "hit close-to-home" for many students.

"Chart of Accounts" Exercise:

It would be beneficial for students to see a variety of charts of accounts (COA) for various industries. You may have had consulting experience with particular industries not presented in the text. Some examples for consideration could be newspapers, banks, pet stores, or other companies that students may find interesting. Have the students "develop" a COA for a company you select for them. They can compare and contrast their account selections with other groups orally in class or in a written report.

"Liquidity" Exercise:

Start with either listings of COAs or those which students developed in the "Chart of Accounts" Exercise above. Have the students develop the order of liquidity for assets and the order of maturity for liabilities. This should reinforce the order of accounts in an accounting system's general ledger.

## OUTSIDE THE CLASSROOM

LIBRARY PROJECTS:

Company Update Project:
Students could locate and read articles about Nestle Inc. They could prepare written or oral reports on their research.

Literature Reference Project:
Students could read the articles footnoted in the chapter in their entirety. Students could report additional insights they derived about the companies or subject matter.