Table of Contents

Week 1: Introduction to Accounting and the Conceptual Framework

Learning objectives

1. Define what accounting is
2. Identify the users of accounting information and the decisions they make
3. Introduce Accounting Standards and the Conceptual Framework
4. Explain the nature of a reporting entity
5. Define assets, liabilities, income, expenses and owner's equity
6. Understand the two recognition criteria that must be met before an item can be included in the financial statements
7. Apply the definitions and recognition criteria to an unusual transaction
8. Explain the basic concepts of the four key financial statements and describe their purpose

Accounting is the process of identifying, measuring, recording and communicating the economic transactions and events of a business operation to interested users (internal or external).

identifying → measuring → recording →communicating

- **Identification**: taking into consideration all transactions which affect the business entity
- **Measuring**: quantifying in monetary terms
- **Recording**: analysing, recording, classifying and summarizing the transactions
- **Communicating**: preparing the accounting reports; analysing and interpreting

Why is accounting important?

- Accounting information conveys information about business performances to others.
    - Decisions are made based on the information provided.
- Poor accounting practices by businesses can produce information that is inaccurate or misleading.
    - This can lead to corporate collapses and financial ruin for many people involved.

The role of accountants

- To **assist people in making decisions** about the allocation of scarce resources
- Accounting **measures business activity**, and processes it into **reports** to enable **communication** of the information to **users** who are internal or external to the entity.

Internal users: Managers who plan, organize, and run the business. Detailed and frequent information is needed by these managers to make business decision on a day-by-day basis.

e.g. marketing managers, Chief Financial Officers, production supervisors

External users: vary in their nature and information requirements. They have an interest in the activities of financing, investing and operating

- Investors (shareholders) – use information to make decisions; i.e. buy, hold or sell shares
- Creditors/ lenders – e.g. suppliers, bankers that use information to evaluate risks of giving credit and lending money
- Government and regulatory bodies – e.g. ATO, ASIC use information to determine an entity's compliance with rules and regulations

Forms of business organizations

Sole proprietorship (sole trader): is a business owned by **one person**. Simplest form of business structure, and has very few legal formalities. The business has *no separate legal existence* from the business

- Simple to establish
- Owner controlled
- Examples include: restaurants, dentists, panel beaters

Pros	Cons
Owner has full autonomy over business Simple to establish	Business is limited by the owner's skills, the funds available to invest, and time available for running a business.
Assets and profits belong to the owner	Owner must bear full personal liability for the business' debts.

Partnership: owned by more than one individual; all partners share control. Entities forming the partnership may be individuals or companies. The roles of each partner is formalized in an agreement (writing, verbally or by implication).

- Simple to establish
- Shared control
- Broader skills and resources

Examples include:

- Accountants, solicitors, doctors

Pros	Cons
Gain of economic resources to initiate or expand the business	**Unlimited liability** – each partner is personally liable for all the debts of the partnership, even if caused by other members of the partnership.
Partners bring unique skills or resources	*Limited partnerships* are taxed as companies. Thus, the general partner still bears unlimited liability.
	Limited lifespan

	If a partner wishes to leave, or sell, or dies a new partnership agreement must be formed.
	Disputes between partners may be costly and damaging to the business, and friendships.

Company: organized as a separate legal entity and owned by shareholders.
Examples include: BHP, CSR, Westpac

- Easier to transfer ownership
- Easier to raise funds
- Limited liability
- Indefinite lifespan

Incorporation: process of setting up a company

Shareholders: owners of a company. Ownership interests are represented by the number of shares they own in the company. As an owner of a company, you have limited liability as per shares.

Limited liability: shareholders are liable for the debts of the business only to the extent of amounts unpaid on their shares.

History of Regulating of Accounting

- Over time, **Generally Accepted Accounting Principles (GAAP)** have developed to guide the practice of accounting.
- accounting standards are mandatory for many entities to follow in the preparation of financial statements.
- Australia has adopted standards that are consistent with the **International Accounting Standards Board (IASB)**
- There is an underlying conceptual framework upon which the accounting standards are based.
    - This framework attempts to derive a general theory for determining the information to be provide in financial statements.

Conceptual Framework (2 components)

- Regarded as the **general principles of financial reporting**
- Used as the basis for developing specific accounting rules and regulations
- Set of **inter-related concepts** which define the **nature, subject and broad content** for accounting

Statement of accounting concepts 1 (SAC 1)

- Defines a 'reporting entity' (**Who?**)

Reporting entity: **any entity** in which it is reasonable to expect the existence of **dependent users** who depend on general-purpose **financial statements** for information to enable them to make economic decisions.

- If an entity meets this definition, it must prepare financial reports

Dependent users: those that need the information but do not have the power to get it

The AASB Framework

Adopted from the IASB framework and contains the following

- Objective and elements of financial reports
- Assumptions underlying financial reports
- **Qualitative characteristics** of financial reports
- **Recognition criteria** for the elements of financial statements.

Objective of Financial statements

To provide information:

- About the financial position, performance and cash flows of an entity that is **useful** in making economic decisions.
- Showing the results of accountability of management for the resources entrusted to it.

Accrual Basis

- Records transactions when they occur rather than only when cash is received/ paid
  - Regardless of whether associated with cash
  - Record transactions when they occur

Consistency

- Once an entity adopts an accounting principle or method, continue to follow it consistently in future accounting periods.
- Only change an **accounting** principle or method if the new version in some way improves reported financial results.

Conservatism

- Rather over-estimate a loss than under-estimate
- Rather under-estimate a profit than over-estimate
  - Don't recognize a revenue until it has been received
  - Recognize a loss as soon as it is expected to happen

Historical Cost

- Record info at its purchase price (historical cost)
  - Using original evaluation
  - Verifiable by a sourced document

Entity

- The owner(s) of the business are separate from the business

Reporting Period

- Life of the business cab be divided into artificial periods of time that must be less than or equal to a year at its maximum, to allow the creation of accounting reports
  - Allows to see how a business is doing (static measure – at one exact)

Going concern

- Entity assumed to continue indefinitely

Qualitative Characteristics of Financial Reports

Qualitative characteristics: attributes that make the information provided in financial statements useful to users

4 characteristics

1. Understandability: readily **understandable** by users assumed to have a **reasonable business knowledge**
2. Relevance: if it **influences users' economic decisions** through feedback or confirmatory value and comparability
3. Reliability: free from material error (major errors) and bias, **represent faithfully** (cannot record larger profits without actual events); figures have to represent the current state of the entity
4. Comparability: must be able to **compare financial statements over time** and between entities. Using the **same system to reach the same figures**, Rules cannot be changed over time, unless people are notified. Hence, comparable over time.

Elements of Financial statements

Assets: "… a resource **controlled** by the entity as a result of **past events** and from which **economic benefits** are expected to **flow** to the entity"

3 Essential Characteristics

1. **Provides future economic benefits (service potential)**
    a. Potential to contribute, directly or indirectly, to the flow of cash to the entity
        i. Generate cash flows through the sale or use of the asset
2. **Controlled by the entity**
    a. Capacity of the entity to benefit from the asset and deny or regulate the access of others
    b. Does not mean ownership (e.g. leases)
3. **Occurrence of past event**
    a. Transaction or other event giving the entity control of the asset must have occurred
        i. E.g. asset purchase or non-reciprocal transfer (donation/ grant)

Ask yourself:

- Does this thing give us benefits?
- Can we regulate the benefits to prevent others from receiving it?
- Is there a past event that reflects a form of control of the asset?

If it passes each criteria, it is an asset