

ACC1100

Introduction to Financial Accounting

TOPICS

- 1. Introduction to Accounting and Conceptual Framework**
- 2. The Recording Process**
- 3. Inventories**
- 4. Balance Day Adjustments**
- 5. Completing the Accounting Cycle**
- 6. Special Journals and Internal Controls**
- 7. Recording Inventory**
- 8. Non-Current Assets**
- 9. Liabilities**
- 10. Equity, Income and Expenses**
- 11. Cash Flow Statements**
- 12. Critical Analysis of Standards including Agriculture**

Week 1: Introduction to Accounting and the Conceptual Framework

Define: Accounting

Accounting is an information system or process that:

- Identifies economic transactions (events → exchanges of value)
- Records through summarising and classification
- Communicates information to users

Accounting is the economic events of an entity to permit informed judgements and decisions by interested users of the information

The Accounting Process

- (1) Identification - select economic events (transactions)
- (2) Recording – record, classify and summarise
- (3) Communication – prepare accounting reports – analyze and interpret reports for users

Why is accounting important?

Accounting information conveys information about business performance to others; decisions and judgements are then based on the information provided.

Poor accounting practices by a business can produce information that is inaccurate or misleading (must be ensured that information is free from bias and error). Poor accounting practices can lead to corporate collapses and financial ruins for people involved.

What is the role of accounting?

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

Identify the users of accounting information and the decisions they make

Internal Users

Managers, who plan, organize and run the business

Examples:

- Marketing managers (which areas to increase sales)
- Production supervisors (which products have high sales rate, low defect rate)
- Chief financial officers CFO's (how company is performing overall)
- Other employees

Detailed and frequent information is needed by these managers in order to make business decisions on a day-by-day basis. Need information more frequently than **external users**.

Users	Information needs
Investors	Information to determine whether to invest based on future profitability, return or capital growth
Creditors	Information to determine whether to grant credit based on risks and ability of the entity to repay debts
Customers	Information on whether an entity will continue to honour product warranties and support its product lines
Employees and trade unions	Information on whether the entity has the ability to pay increased wages and benefits, and offer job security
Government authorities	Information to calculate the amount of tax owing and whether the entity complies with tax laws
Regulatory agencies	Information to determine whether the entity is operating within prescribed rules

External Users

Vary in their nature and information they require

- Investors
E.g. shareholders – use information to make decisions to buy, hold or sell shares
- Creditors/ Lenders
E.g. suppliers, bankers – 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 organisations



- Sole Proprietorship
 - Owned by one person
 - Simplest form of business structure
 - Quick and inexpensive to establish
 - Disadvantages include that business is limited to owner's skills, owner's funds available to invest and they must bear full personal liability
 - E.g. restaurants, dentists....
- Partnership
 - Owned by more than one individual
 - All partners share control
 - Little formality involved in forming a partnership
 - Each partner is personally liable for all debts of the partnership irrelevant of which partner caused the debts
 - Can be a formal partnership with a written agreement/ informal
 - E.g. Accountants, solicitors, doctors....
- Company
 - Organized as a separate legal entity and owned by shareholder:
E.g., BHP, Westpac, RM Williams
 - Costly to set up
 - Shareholders have limited liability, you only owe the amount you put in

Regulating Accounting: Generally Accepted Accounting Principles (GAAP)

Australia has adopted standards that are consistent with those produced by the International Accounting Standards (IASB).

There exists an underlying 'conceptual framework' upon which the standards are based.

Conceptual Framework

- Considered the general principles of financial accounting
- Used as a basis for developing specific accounting rules and regulations
- Set of inner-related concepts which define the nature, subject and broad content of accounting

SAC 1: Statement of Accounting Concepts 1

- Defines a 'reporting entity' → WHO?

The AASB Framework

- Provides the objective of general purpose financial reporting
- Objective of financial reporting → WHY?

AND

- Explains the qualitative characteristics of information, the assumptions underlying financial reports and the five elements of accounting and criteria for their recognition
- What do we put into our information → WHAT?

Statement of Accounting Concepts (SAC 1)

Define 'reporting entity' – Any entity in which it is reasonable to expect the existence of users who depend on general-purpose financial statements for information to enable them to make economic decisions

Dependant users – those people who need information but do not have the power to get it, you as a reporting entity should report to them

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

The ASSB Framework

Adapted from the IASB framework, it contains:

- Objective of financial reports
- Assumptions underlying financial reports
- Qualitative characteristics of financial reports
- Elements 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 for economic decision making
- To provide useful information for decision making (information about their financial position, financial performance and cash flow)
- Showing the results of accountability of management for the resources entrusted to it

Interrelationships between the statements

1. Statement of financial position depends on the results of profit or loss and statement of changes in equity
2. Statement of cash flows and statement of financial position are also interrelated as the ending amount of cash shown is reflected in the statement of financial position.

Assumptions underlying Financial Reports

Accrual Basis

- Records transactions when they occur rather than only when cash is received/paid (cash flow may occur earlier or later)

Going Concern

- Entity assumed to continue indefinitely
- Going concern assumes the business will run indefinitely into the future

Qualitative Characteristics of Financial Reports

Reliability	Free from material (major) error and bias, represent faithfully – figures must represent what's actually happening
Relevance	If it influences users' economic decisions through feedback or confirmatory value and comparability
Understandability	Readily understandable by users assumed to have reasonable business knowledge
Comparability	Must be able to compare financial statements over time and between entities- using same systems to acquire same information

ASSETS

Define: A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity

Definition criteria for Assets:

- (1) Future economic benefits (service potential)
 - Does it give us benefits (through use of asset or sale)
 - Potential to contribute, directly or indirectly, to the flow of cash to the entity
 - Generate cash flows through the sale of, or use of, the asset
- (2) Controlled by the entity
 - Do we get the benefits of the asset? Can we regulate access (stop others) from getting benefits of the asset?
 - Capacity of the entity to benefit from the asset and deny or regulate the access of others
 - Does not mean ownership (e.g., leases)
 - Does the entity control the resource?
- (3) Occurrence of past event
 - Transaction or other event giving the entity control of the asset must have occurred
 - E.g. Asset purchase or Non-reciprocal transfer (donation/grant), Leased asset

Recognition criteria for Assets:

Once the definition is satisfied, an asset should only be recognized (included) in the balance sheet if the recognition criteria are satisfied:

- (1) Probable future economic benefits
 - More likely than not
 - Greater than 50% chance of occurring
- (2) Reliable measurement
 - Transaction to verify the cost, must be able to give it a dollar value.
 - Reasonable estimate – consider reliable provided it is given by an expert in the valuation of that item
 - E.g., internally generated goodwill, brand names (Coke)?

Important Terms:

Recognized: Meets definition AND recognition criteria and is therefore included in the financial statements

Disclosed: Meets definition but NOT recognition criteria and therefore is not allowed within reports and thus is included as a note in the financial statements

LIABILITIES

Define: A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits

Definition criteria for Assets:

- (1) Future outflow of economic benefits
 - Settlement of the present obligation
 - E.g. Bank contract specifies future outflow
- (2) Present obligation
 - Legally enforceable obligations (consequences)
 - Contractual arrangements (bank loan) or Imposed on the entity (income tax payable)
 - Good business practice or equitable obligations (repairs)
 - Constructive obligation – based on a pattern of events (implied obligation: have given bonus for past 20 years → considered a liability)
- (3) Occurrence of past event
 - Transaction creating the present obligation must have occurred

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OWNER'S EQUITY

Define: The residual interest in the assets of the entity after deduction of its liabilities

$$A = L + OE$$

INCOME (REVENUE)

Define: Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants

Can never have an income without a change in A or L
Double entry accounting system
Owner's Equity (Capital Contribution) is not an income

Definition Criteria for Income

- (1) *Inflows (increases in assets or decreases in liabilities)*
 - i. Cash / credit sale (enhances debtors) / or forgiveness of debt (e.g., discount received)
- (2) *Resultant increase in equity*
 - i. Increase in net wealth (results in an increase in equity)
- (3) *Other than contributions by equity participants*
 - i. Income can not be capital contributed by owners

Recognition Criteria for Income

Once the definition is satisfied, income should only be recognised (included) in the income statement if the recognition criteria are satisfied

The recognition criteria are the same for assets, liabilities, income and expenses

PROBABLE + RELIABLE

Probability that inflow will occur

EXPENSES

Define: Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants

Definition criteria for Expenses

- (1) *Outflows (decrease in assets or increase in liabilities)*
 - Salaries paid or owed
- (2) *Resultant decrease in equity*
 - Reduction in net worth
- (3) *Other than distributions to equity participants*
 - Not dividends or withdrawals (drawings) by owner

Template for answering questions

Table shows if you have left a box empty – avoid missing aspects

Definition	
Future Economic Benefits	
Control	
Past Event	
Recognition Criteria	
Probable	
Reliable Measurement	
Conclusion	

GENERAL PURPOSE FINANCIAL REPORTS

The key financial statements are:

- Balance Sheet (A,L and OE)
Measures financial position at a point in time
Date always written, as at _____
- Statement of Comprehensive Income / Income Statement (I,E)
Measures financial performance over a period of time
Profit/ Loss summary
- Statement of Cash Flows (the Asset Cash)
Measures cash receipts and cash payments over a period of time
How has cash come in/out – final cash balance (will match cash asset in balance sheet)
- Statement of Changes in Owners' Equity (OE)
Presents a summary of changes that occurred in the entity's equity between two successive reporting dates
What has happened to the wealth of a business over periods

Balance Sheet

Summarises the financial position of an entity at a particular date

- As at 30 June 2016

An entity's financial position is divided into 3 categories:

- Assets
Current assets – converted to cash within one year/ consumed within one year
Non current Assets – held for longer than one year
- Liabilities
Current Liabilities – obligations that are due to be repaid within one year
Non Current Liabilities – due for repayment after one year
- Owner's Equity – owners investment in the entity

Balance Sheet as at 30 June 2016		
ASSETS		
Current Assets		
Cash at bank	53,700	
Accounts receivable	<u>5,000</u>	58,700
Non-current Assets		
Equipment		<u>4,500</u>
Total Assets		\$63,200
LIABILITIES		
Current Liabilities		
Accounts Payable		5,000
Non-current Liabilities		
Long-term loan		<u>15,000</u>
Total liabilities		20,000
OWNER'S EQUITY		
Capital		30,000
Retained profits		<u>13,200</u>
Total owner's equity		43,200
Total liabilities and owner's equity		\$63,200

Income Statement

Provides information on an entity's profitability for a period of time

- For the period ended 30 June 2016
- Measures the difference between revenue earned during the period and expenses incurred in earning those revenues

Income Statement Example:

Income Statement for the year ended 30 June 2016		
Sales revenue	21 000	
LESS Cost of goods sold	<u>(8 000)</u>	
Gross profit		13 000
LESS Operating expenses		
Salaries	(2500)	
Depreciation	(500)	
Electricity	(300)	
Travel	(300)	
Postage	<u>(400)</u>	<u>(4000)</u>
Profit before tax		9 000
LESS Income tax expense		<u>(3 000)</u>
Profit after tax		6 000

Under Australian Accounting Standards (AASB 101, Presentation of Financial Statements) an entity can report income and expenses as either:

- A single statement called Statement of Comprehensive Income
OR
- Two separate statements called:
 - Income statement; and
 - Statement of Other Comprehensive Income

'Other' comprehensive income can include:

- Changes in the revaluation surplus for fixed assets
- Gains and losses arising from the conversion of foreign operation
- Fair value changes in available-for-sale financial assets

Statement of Cash Flows

- Shows the change in the cash account
- Shows cash receipts and cash payments for a period of time
- Cash transactions are split into 3 categories
 - Operating activities (day-to-day operations)
 - Investing activities (acquisition and disposal of NCAs)
 - Financing activities (changes in financial structure)

Example:

Statement of cash flows for the year ended 30 June 2016	
Cash flows from operating activities	
Receipts from customers	17 000
Payments to suppliers	(7 700)
Payment to employees	(2 300)
Cash operating costs	<u>(4 500)</u>
<i>Net cash flows from operating activities</i>	2 500
Cash flows from investing activities	
Purchase of machinery	(2 300)
<i>Net cash flows from investing activities</i>	(2 300)
Cash flows from financing activities	
Issue of shares	4 000
Bank loan	<u>(3 600)</u>
<i>Net cash flows from financing activities</i>	<u>400</u>
Total net cash flows	600
Cash: 1 July 2015 (opening balance)	<u>1 400</u>
Cash: 30 June 2016 (closing balance)	2 000

Statement of Changes in Owner's Equity

Shows all changes to owner's equity that occurred during the period

These changes could comprise:

- Capital
- Profit
- Drawings/ Dividends

Statement of Changes in Owner's Equity for S Monash for the month ended June 30, 2016	
S Monash, capital, June 1, 2015	\$10,000
Owner's investment during the month	1,000
Profit for the month (I/S)	3,000
	14,000
Withdrawals during the month	(2,000)
S Monash, capital, June 30, 2016 (B/S)	\$12,000

CONCEPTS AND PRINCIPLES

Accounting Entity Concept

States that every entity can be separately identified and accounted for. It is important that business transactions are not confused with personal accounts, as they are separate accounting entities

Accounting Period Concept

States that the life of the business be divided into artificial periods so that useful reports covering those periods can be prepared for the business. All entities report at least annually

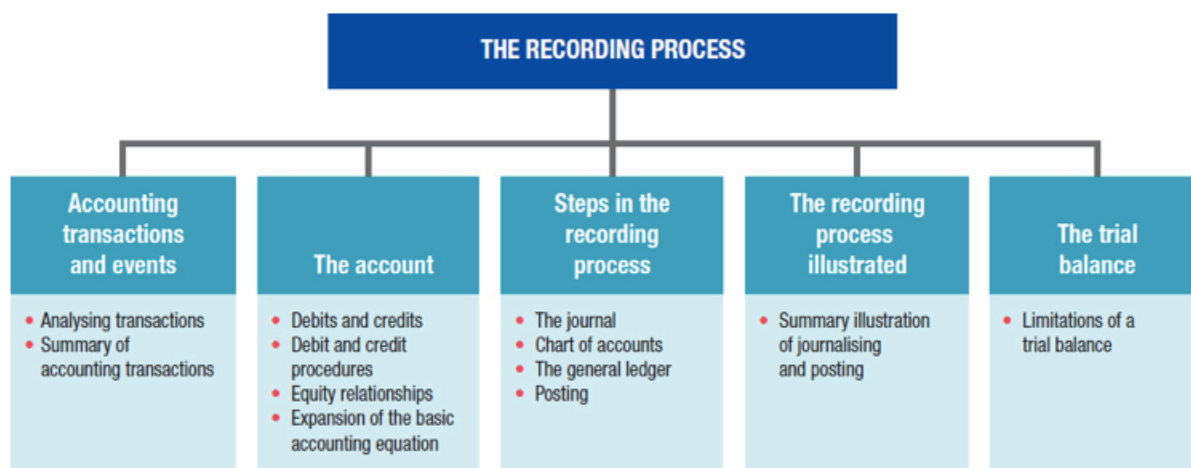
Cost Principle

States that all assets are initially recorded in the accounts at their purchase price or cost. This is applied not only at the time of purchase, but also over the time the asset is held.

Full Disclosure Principle

Some important financial information is not easily reported on the face of statements. Full disclosure principle requires that all circumstances and events that could alter decisions users might make, be disclosed.

Week 2: The Recording Process



Cash and Accrual Accounting

Entities need to record transactions and events that occur during a period to enable them to prepare financial statements

There are two methods of accounting that underpin the recording process

- Cash Accounting
- Accrual Accounting