✓ H1 ARA SUMMARY NOTES ✓

- Everything you need for **tutorials, tests, assignments, and exams.**

- **Concise, logical, easy** to understand and memorize. Even **color-coded!**

- Best for both **before AND after class**

- Digital and printing **friendly**

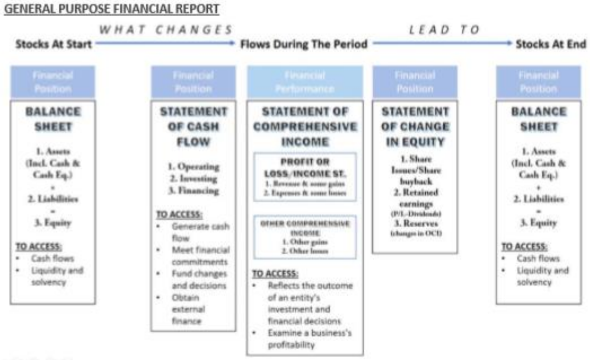
Best luck to you all!

Conceptual Framework & Financial Statements -Lec1&2

Tuesday, 20 June 2017 6:56 PM

- DEFINITION OF ACCOUNTING
  - A process of providing quality information to a variety of users for decision making.
  - A information system.
    - Process:
      - Identifying:
        - *Transactions that affect the entity's financial position i.e. material*
      - Measuring:
        - *Analysis, recording and classifying of business transactions*
      - Communicating:
        - *Through financial reports*
      - Decision making:
        - *By external and internal users*
    - Users: (TABLE ON textbook Pg.5)
      - External – Financial Accounting
        - i.e. Stakeholders e.g. employees, shareholders, suppliers, banks, government.
        - Main interests in the PERFORMANCE OF THE ENTITY, to make decisions about the entity.
        - Need the General Purpose Financial Reports (GPFR)
      - Internal – Management Accounting
        - i.e. owner or managers
        - Assist with decision-making activities.
        - Need details of all transactions and events, tailored reports generated from the accounting system
      - Summary of Information Needs:
        - Financial:
          - Profitability (utilization of resource to generate returns)
          - Efficiency (the ability to generate cash flow)
          - Liquidity (the ability to meet short-term debts)
          - Gearing (business structure)
          - Market performance (share price)
        - Non-financial
          - Corporate governance
          - Social and environmental impact

- GENERAL PURPOSE FINANCIAL REPORT



- Notes
  - Provides disaggregated information linked to the FS
  - ABOUT accounting policies (choices, judgements and estimations) used in preparing the FS and other non-financial information.
- Conceptual Framework
  - Which provides the fundamental principles and concepts to be applied in the formulation of accounting standards and preparation of a GPFR.
    - Definition: define the nature of the activity.
    - Recognition: filter the ones satisfied the recognition criteria.
    - Recorded: If can be defined and recognised
  - **Definition and Recognition Criteria of the Five Elements**

Elements	Definition	Recognition
Assets	-Past Event -Expect FEB -Control (Have legal right to obtain a benefit that we can direct)	-Probable inflow FEB -Cost or value that can be reliably measured.
Liability	-Past Event -Expect outflow FEB -Present obligation	-Probable outflow FEB -Cost or value that can reliably measured
Equity	Assets-liability	
Income/Revenue	-Increase in assets -Decrease in liabilities -Excl. owner' s contribution	-Must be earned
Expenses	-Decrease in assets -Decrease in liabilities -Excl. owner' s distribution	-Must be used

  - The Relationship of the 5 Elements
    - Business activities must be **classified** in to the **5 categories of accounting elements.**

BUSINESS ACTIVITIES	ASSETS • Cash (also reported in STATEMENT OF CASH FLOWS) • Other assets	Reported in BALANCE SHEET
	LIABILITIES	
	EQUITY	
	INCOME	Reported in INCOME STATEMENT
	EXPENSES	

    - Accounting Equation

REPORTED IN BALANCE SHEET

ASSETS-LIABILITIES=EQUITY – { Contributed Equity / Retained Earnings }

Retained Earnings = (Income-Expenses)-Dividends

(Income-Expenses) = Profit

REPORTED IN INCOME STATEMENT

  - The expanded accounting equation:
    - ASSETS=LIABILITIES+EQUITY+(INCOME-EXPENSES)
  - When assets FEB is used up, they become expenses (expect for trade receivables as they become cash)
  - **Net Profit vs Gross Profit**
    - Net profit = All revenues – All expenses
    - Gross profit = Sales – Cost of Sales (Excl. the cost of purchasing inventory that are not sold yet)
- **GPFR should exhibit the following qualitative characteristics to be useful:**
  - Relevance (which incorporates materiality)
    - If capable of making a difference to decisions
      - If has predictive value or/and confirmatory value
  - Faithful representation

- Complete, Neutral and Free from Error (x accurate)
- Comparability
  - Consistent application of accounting policies with other entities and reporting periods.
- Verifiability
  - Different independent observers could agree that it is a faithful representation.
- Timeliness
  - ASAP to be reasonable and relevant
- Understandability
  - However, assumes users have reasonable knowledge or access to someone else who does
- GPFR are mostly based on estimates, judgments and choices rather than exact depiction.
- **Accrual Accounting**
  - Cash is not the sole trigger for recording a transaction, but also credit and other economic events.

- BUSINESS STRUCTURE
  - Common types:
    - Individual/sole trader
    - Partnership
    - Company
    - Trust
  - Features of the structures:

	Sole trader	Partnership	Company
Set up & administration	Simple	Relatively easy	Complex
Life of entity	Limited to life or desire of owner	Limited to life or desire of individual partners	Indefinite
Legal status relative to owners	Not separate	Not separate	Separate
Extent of owners' liability	Unlimited	Unlimited	Limited (with some exceptions)
Tax implications	Owner declares profit as income	Partner declares share of profit as income	Entity taxed on profit, shareholders declare dividends as income

- Companies typically offer the owners limited liability, so that their own assets are protected in the event that the company has any outstanding debts after all its assets have been liquidated.
- Legal status: How the law deal with the relationship of the owners and the entities. Notably, in accounting, the entity and the owners are separate reporting entities.
- **Companies:**
  - Divided into Public & Proprietary/Private by CA 2001 (Cooperation Act 2001)
  - Not all are listed on the ASX(Australian Security Exchange).
  - Public Companies:
    - Mostly 'Limited': liability limited to unpaid amounts on issued shares.
    - No restrictions on raising capital from public, therefore unlimited shareholders. (ASX)
    - No restrictions on transfer of ownership of shares. (ASX)
    - Some are 'Non-profit entities' and unlimited.
  - Proprietary Companies:
    - No more than 50 non-employee shareholders.
    - Restrictions on raising capital from public and transfer of ownership.
    - Small and Large companies:
      - Large if meets or exceeds two or more following thresholds, small if not:
        - Gross assets of $12.5m at end of FY
        - Gross operating revenue of $25m for the FY
        - 50 EFT employees at end of FY
- CA 2001
  - External reporting requirements according to the type of entity:
    - Full financial report for all public and large proprietary companies. Prepare financial reports annually and half-yearly for listed public companies.
    - Reduced reporting requirements for small proprietary companies.
  - Requires the FS and notes must:
    - Comply with accounting standards
      - Australian Accounting Standards (AASBs) are consistent with the International Financial Reporting Standards (IFRS) since 2015.
        - To create global consistency for the increase of foreign investors.
    - Show a true and fair view

Balance Sheet - Lec3&4

Tuesday, 20 June 2017 9:50 PM

BALANCE SHEET

- NATURE AND PURPOSE
  - Documents:
    - What an entity owns or controls at a particular date => ASSETS
    - External claims on the entity's assets => LIABILITIES
    - Internal claims on the entity's assets => EQUITY
  - Nature:
    - Duality: recorded in at least two accounts
    - With flexibility and discretion, given by IFRS (Agency Issues)
    - General guide for financial reporting
  - Purpose: to assess
    - Financial position
    - Cash flows
    - Liquidity and solvency
      - Liquidation: The company cannot pay its obligation when it come due.
      - Assets are divided up among creditors and shareholders, according to the priority of their claims.
    - Also assists profit driven entities:
      - Investing decision: what assets to acquire to increase value
      - Financial decision: how to raise funds to acquire these assets

- FORMAT AND PRESENTATION
  - Format
    - T format (above): for smaller entities
    - Narrative format (below): for larger entities
  - Presentation
    - Often present the current reporting period and the previous reporting period
      - Why?: As comparative information, which shows the changes of the entity's financial position
    - ★ Parent company (with control of other entities/voting rights) produces:
      - Financial reports for itself
      - Financial reports for the group i.e. consolidated financial statements/consolidation/group financial reports
        - Group:
          - Parent entity:
            - has over 50% of voting power of subsidiary entities
            - Losses are limited to subsidiary entities, and the parent entity is not directly liable
          - Subsidiary entity: being controlled

- ★ AGENCY THEORY
  - When shareholders appoint directors to run the company on their behalf
  - Shareholders judge the performance of the director based on financial statements
    - Therefore:
      - Directors have vested interest in the results (remuneration and re-election).
      - Preparers may be motivated by self-interest to manipulate results.
    - Overstating assets, understating liabilities
  - Whenever there is a choice, there could be an agency issue

- RECOGNITION, MEASUREMENT & DISCLOSURE
  - Recognition:
    - Definition: what is the item
    - Recognition: should it be included
  - Measurement:
    - Assign a monetary value => carrying amount/book amount
  - Disclosure:
    - Presentation
  - Notes provides:
    - Narrative description: methods used
    - Disaggregation of items
    - Other information that does not qualify for recognition

ASSETS

- ASSET CLASSIFICATION
  - Current & Non-current

- Relates to the acquisition and disposal of long-term assets and other investments not included in cash equivalents
- Extent to which expenditures have been made for resources intended to generate FBE and cash flows -> i.e. non-current assets
- Examples:
  - Inflow:
    - Proceeds from Non-c assets Disposal
    - Withdrawals from Long-term Interest-bearing Deposits
    - Proceeds from Disposing of Shares in Other Companies
    - Receiving Principal Relating to Loans to Employees or Other Entities
  - Outflow:
    - Payments to Acquire or Construct PPE, Intangibles or Other Long-term Assets
    - Payments into Long-term Interest-bearing Deposits
    - Payments to Acquire Shares in Other Companies/Subsidiaries
    - Lending Money to Employees or Other Entities

  Corresponding
- Expectation: -ve result
  - Signal the entity is expanding
    - New sources of inflow of FEB
  - If -ve: Signal of contraction

★ 3. **Financing Activities**
- Definition:
  - Cash flows that result in changes in the size and composition of the contributed equity and borrowings of the entity -> non-c liabilities
- Purpose:
  - To predict claims on future cash flows by providers of capital (i.e. debt and equity) to the entity
- Examples:
  - Inflow:
    - Proceeds from Issuing Shares
    - Proceeds from Borrowings or Issuing Debt
  - Outflow:
    - Payments to Acquire Shares from Owners (i.e. buy-backs)
    - Repayments of Principle Relate to Borrowings or Debt
- Expectations:
  - -ve:
    - Paying off interest-bearing debt => Being able to repay

    OR
  - +ve because:
    - Using long-term finance for long-term investment
      - Signal: +ve net financial cash flow & -ve net investing cash low
    - IF NOT:
      - 'propping up' poor NCF from operating activities

★ Special Cases: Non-Cash Financing and Investing Activities
- e.g. Acquiring non-current assets through borrowings
  - Acquiring a business by exchange of shares
  - Converting debt into equity (convertible shares into ordinary shares)
- Excluded from CFS
- Disclosed in Notes with detailed information

Special Cases: Interest and Dividends:
- Choice of the preparers:

Interest	→ Operating Activity	**Inflow:** Expense determining profit or loss **Outflow:** Expense determining profit or loss
	→ Investing Activity	**Inflow:** Returns on investment
	→ Financing Activity	**Outflow:** A cost of obtaining financing

Dividend	→ Operating Activity	**Inflow:** Revenue determining profit or loss **Outflow:** A distribution of profits
	→ Investing Activity	**Inflow:** Returns on investment
	→ Financing Activity	**Outflow:** Changes the composition of equity (decrease in retained earnings)

- OVERVIEW AND RELATIONSHIP TO OTHER STATEMENTS

- Sample Statement of Cash Flow

Paul's Guitar Shop
Statement of Cash Flows
For the Year Ended December 31, 2015

CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from customers	$ 51,300
Cash paid for merchandise	(15,000)
Cash paid to employees	(10,000)
Cash paid for interest	(500)
Cash paid for income taxes	(1,500)
NET CASH PROVIDED BY OPERATING ACTIVITIES	24,300
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of property and equipment	(101,000)
NET CASH USED IN INVESTING ACTIVITIES	(101,000)
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from line of credit	-
Payments on line of credit	10,000
Proceeds from long-term debt	99,500
Payments on long-term debt	-
NET CASH PROVIDED (USED) IN FINANCING ACTIVITIES	109,500
NET INCREASE (DECREASE) IN CASH	32,800
BEGINNING CASH BALANCE	-
ENDING CASH BALANCE	$ 32,800

→ Should be the largest

→ Sum of NCF

→ Reconciles to Balance Sheet
- Cash and Cash Equivalents

- Cash Flow Patterns

	HEALTHY	DECLINE/WARNING	DESPAIR	DEATH
Operating	+	-	-	-
Investing	-	0 (∵no cash from operating)	+ (Selling non-c assets)	0
Financing	-/+*	- (Financing)	0	0

- Also positive indicators:
  - Adequate but no excessive levels of C&CE
  - Receipt from customers > Payment to suppliers -> Generating profit
  - NOCF = Profit -> High earnings quality
- Reconciling Cash and Cash Equivalents
  - Should reconciled except causing by:
    - ? Overdraft of several bank accounts
    - Accrual vs Cash
      - Timing: recognised in different financial period
      - Some revenue ≠ Cash receipts
        - Credit sales
        - Accrued revenue
        - Receipt from receivables
        - Receipt from unearned revenue
      - Some expense ≠ Cash payments
        - Accrued expenses
        - Depreciation and amortisation
        - Payments to accounts payable
        - Payments of prepaid expenses
- Reconciliation of Net Operating Cash Flow to Profit or Loss (AUS specific requirement)
  - [Profit]±[Depreciation, Amortisation & Net Accruals]=[Net Operating Cash Flows]
    - Must be disclosed in notes -> AUS-specific requirement
  - The bigger the gap between [Profit] and [NOCF], the more [Depreciation, Amortisation & Net Accruals]
  - Purpose
    - Allows users to see changes in operating accounts brought about by use of accrual versus cash basis of accounting
    - The greater the disparity between [Profit] and [NOCF], the greater indication of earnings management -> manipulate profit