Accounting Reports and Analysis Notes

Lecture 1: The Nature & Purpose of Accounting

- Accounting – the process of **identifying, measuring and communicating economic information** about an entity to a variety of users for **decision making purposes.**
    - **Recording & Reporting for decision making**
    - **An information system**
- Users of accounting information
    - Resource providers – investors, members, donors, lenders, suppliers, employees
    - Recipients of goods and services – customers, beneficiaries e.g. taxpayers, community
    - Parties performing a review or oversight function – regulatory agencies (ASIC, ASX, ATO), analysts, unions, media, community groups
    - Management and governing bodies
- Information needs of users
    - **Investors** – risk and return ability to pay **dividends, potential for capital growth**
    - **Lenders** – ability to **repay debt, pay interest**
    - Suppliers – ability to pay debt, likelihood of ongoing customer
    - Employees – ability to provide benefits, ongoing employment
    - Customers / Beneficiaries – fair and reasonable prices / fees / taxes, capacity to provide ongoing supply
    - Regulatory agencies – compliance with reporting regulations, statistical data
    - Advisors and analysts – financial information for analysis
    - Community groups – social and environmental impact
- Information needs
    - ❖ Financial
    - **Profitability (utilisation of resources to generate returns)**
    - **Efficiency (the ability to generate cash flow)**
    - **Liquidity (the ability to meet short-term debts)**
    - **Gearing (the financial structure)**
    - **Market performance**
    - ❖ Non-financial
    - **Corporate governance / compliance**
    - **Social and environmental impact (CSR – Corporate Social Responsibility reporting)**
- **Management accounting**
    - For internal users – those involved in the day-to-day decision making and preparation of financial statements
- **Financial accounting**
    - For external users – stakeholders outside the entity
    - General Purpose Financial Reporting - To provide financial information about the reporting entity that is **useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity**.
- **General Purpose Financial Reports**
    - The set of financial statements containing the **Comprehensive Income Statement, Balance Sheet, Cash Flow Statement, Statement of Changes in Equity and Notes**
    - Designed to meet the information needs common to **external users** who are **unable to command the preparation of statements tailored to their needs**

- **Accrual accounting** - depicts the effects of transactions and other events and circumstances on a reporting entity's economic claims and resources in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period
- Fundamental Qualitative Characteristics – **Relevance & Faithful Representation**
- Enhancing Qualitative Characteristics – **Comparability, Understandability, Timeliness & Verifiability**
- **Relevance – capable of making a difference to decisions made by users**
  - Information is capable of making a difference if it has **predictive value** (but not necessarily a prediction), **confirmatory value** (feedback about previous evaluations or predictions) or both
- Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity – preparer makes the judgement
- Materiality is an entity-specific aspect of relevance based on **nature** and/or **magnitude**
- **Faithful representation – represents economic phenomena in words and numbers**
  - **Complete** – all necessary info including descriptions and explanations
  - **Neutral** – without bias, not manipulated to increase the probability that it will be received favourably or unfavourably
  - **Free from error** – does not mean accurate, means no errors or omissions in calculations, processes or descriptions; an estimate cannot be accurate, but it can be faithful
- **Comparability** – requires consistent application of accounting policies to be comparable between entities and reporting periods
- **Verifiability**
  - **Complete** – all necessary info including descriptions and explanations
  - **Neutral** – without bias, not manipulated to increase the probability that it will be received favourably or unfavourably
  - **Free from error** – does not mean accurate, means no errors or omissions in calculations, processes or descriptions; an estimate cannot be accurate, but it can be faithful
- **Timeliness**
  - having info available in time to be capable of influencing decisions
  - generally, the older the info, the less useful it is (exception – info used in trend analysis)
- **Understandability**
  - presenting clear and concise information
  - can't avoid some necessary complexities in FS
  - assumes users have reasonable knowledge or access to someone else who does
- Providing useful information comes at a cost which must be justifies by the benefits derived
- **Asset criteria**
  1. **Control – ability to direct the benefit; legal rights, including ownership, demonstrate control but ownership is not essential**
  2. **Past event**
  3. **Future economic benefit – potential to generate cash flow (or reduce cash outflow), contribute to productive capacity, or settle debts**
- **Liability criteria**
  1. **Present obligation – a duty or responsibility to act or perform in a certain way, may be legally enforceable or may arise from normal business practice**
  2. **Past events – acquisition of goods on credit, receipt of a loan**
  3. **Will result in an outflow of resources embodying economic benefits**

Lecture 7: Financial Statement Analysis

- The objective of General Purpose Financial Reports is to **provide financial information** about the reporting entity **useful to existing and potential investors, lenders and other creditors in making decisions about providing resources**
- Users then evaluate how **efficiently** and **effectively** management has utilised the entity's resources to generate returns, and the financial position of the entity
- For a meaningful trend analysis, 3 to 5 periods of financial data is typically needed
- Analysis begins by expressing information in **relative terms** to enable **comparisons** various benchmarks (previous years, similar firms, industry averages, internal & external benchmarks)
- Throughout the analysis process, **consideration should be given to the accounting policies applied, the industry the entity operates in and the broad economic and political environment.**
- **Horizontal analysis compares changes in reported amounts from the previous year**

Horizontal analysis

- Compares reported amounts across different reporting periods to identify **magnitude** and **significance** of changes
- **Absolute change** calculated by:

$$= \text{Reported amount in } \textbf{current} \text{ reporting period} - \text{Reported amount in } \textbf{previous} \text{ reporting period}$$

- **Relative change (expressed as a %)** calculated by:

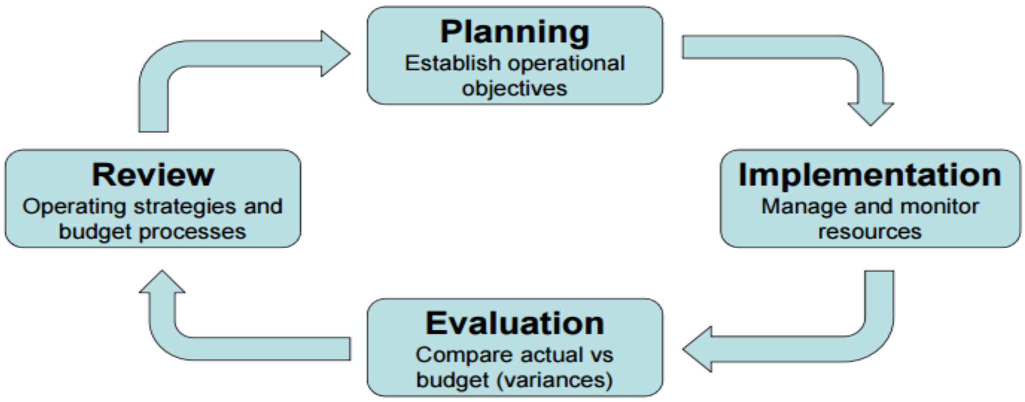
$$= \frac{\text{Reported amount in } \textbf{current} \text{ reporting period} - \text{Reported amount in } \textbf{previous} \text{ reporting period}}{\text{Reported amount in } \textbf{previous} \text{ reporting period}} \times 100$$

- **Trend analysis** uses time series data to analyse past performance by expressing **items relative to a selected base year.**
- **Vertical analysis** involves **comparing items** in a financial statement **to a base item** within the same statement, also knowns as **common size statements**
    - Income statement items are expressed as a % relative to **sales**
    - Balance sheet items are expressed as a % relative to **total assets**
- **Ratio analysis** compares **one line item** within the financial statements **relative to another**
- **Profitability (the entity's ability to generate profit)**
- **Efficiency (the entity's ability to generate cash flow)**
- **Liquidity (the entity's ability to meet short-term commitments)**
- **Gearing / leverage (the entity's capital structure and long- term stability)**
- **Market performance (most relevant to companies listed on a public exchange)**
- **Operating cycle – how long it takes to convert inventory into cash**
    - **Days inventory + Day receivables**
- **Cash cycle – the number of days between paying for inventory and receiving cash from selling it, or alternatively, how many days you have negative cash flow**
    - **Days inventory + Day receivables - Days payables**

Lecture 9: Budgeting

- The budgeting process is an integral part of **planning and control** for **management accounting.**
- **Strategic planning** is conducted by **senior management** and focusses on the **broad strategic direction** of the entity usually over a **3 to 5 year period** considering key issues such as **expansion and new product / service development**
- **Budgeting** focusses on the **short-term** (typically 12 months) **quantifying** financial (and non-financial) **goals and expectations** of management

The Budget Cycle



- The duration of the budgeted period should be manageable and relevant.
- Budgets can be prepared on a rolling basis as each month passes to ensure a better 12-month budget, rather than it remaining static for a whole year
- Budgets should be capable of adjustments as new information comes to light
- **Authoritarian style –** the budget is imposed on business from above
- **Participative style –** the budget is formulated through negotiation and feedback between senior management, business unit managers and employees
- **Incremental budgeting –** uses **previous years' results as a starting point** and justify increases or decreases for upcoming year
- **Zero-based approach – re-sets all budgets to zero** and then each figure is justified on a **cost-benefit basis**
- **Benefits of budgeting in the planning stage:**
    - Can **alert management to problems in advance** (resource constraints, cash shortages, financing needs)
    - Enables management to **apply strategy testing and sensitivity analysis and consider impact of these on results**
    - **Promotes coordination and communication** within the organisation
- A participative approach is more likely to result in
    - a budget that **better represents the economic reality** of a particular business unit
    - employees and managers being more accepting of budget targets
- Once the budget is implemented, it can **facilitate control** by:
    - Providing **defined financial objectives** and **enabling responsibility to be assigned** to all levels of management
    - **Motivating employees and managers to achieve targets** (may have incentive schemes in place)
    - Enabling **ongoing monitoring of performance throughout the period**

Lecture 10: CVP Analysis

- An important part of operating strategy is to **generate revenue, maximise profit and sustain operations**
- When setting price, management should consider its **costs** which must be covered to avoid losses, its **desired profit** if seeking a specific rate or return, **competition, demand** and the existence of **price controls** (price floor/ceiling)
- **Relevant range -** a **level of activity bounded by a minimum and maximum** within which the **relationships between revenue and expense** can be expected to **hold constant** (outside this range these relationships will differ)
- The distinction between **fixed** and **variable** costs is based on **how the cost responds** when there is a **change in the level of activity**.
- **Fixed costs** - costs that remain constant despite changes in the level of activity throughout the relevant range
- **Variable costs** - costs that change in direct proportion to a change in the level of activity throughout the relevant range
- **Mixed costs** - costs that contain a fixed portion that is incurred even when the activity level is zero and a variable portion that increases as the activity increase. E.g. mobile telephone bill, a salesperson's salary, etc.
- **Contribution margin = Sales Revenue – Total Variable Costs**
- The contribution margin calculates the amount by which total revenue exceeds total variable costs, and is the amount of revenue available to cover fixed costs and contribute to profit.
- **Contribution margin per unit (CMU) = Selling Price per unit – Variable Costs per unit**
- **CVP Analysis** is part of the **budgeting process**
- **Operational risk = Margin of safety**
- **Breakeven point -** The level of sales (in units or dollars) at which the entity covers its costs

$$\text{Breakeven point (in units)} = \frac{\text{Fixed costs}}{\text{Contribution margin } \textit{per unit}}$$

- **The contribution ratio** is useful in the **absence** of **volume or unit price/cost info**

$$\text{Contribution Margin ratio} = \frac{\text{CM per unit}}{\text{Selling price per unit}}$$

$$\text{Breakeven point (in \$ Sales)} = \frac{\text{Fixed costs}}{\text{Contribution margin ratio}}$$

- **Desired profit**

$$\text{Sales volume (units) to earn desired profit} = \frac{\text{Fixed costs + Desired profit}}{\text{Contribution margin per unit}}$$

$$\text{Volume} = (\text{FC} + \text{Profit}) / \text{CMU}$$

$$\text{Volume} \times \text{CMU} = \text{FC} + \text{Profit}$$

$$\text{Volume} \times (\text{SP/unit} - \text{VC/unit}) = \text{FC} + \text{Profit}$$

$$(\text{Vol} \times \text{SP/unit}) - (\text{Vol} \times \text{VC/unit}) = \text{FC} + \text{Profit}$$

$$\text{Sales revenue} - \text{Total VC} = \text{FC} + \text{Profit}$$

$$\text{Revenue} - \text{VC} - \text{FC} = \text{Profit}$$

$$\text{Revenue less Expenses} = \text{Profit}$$