22747: Accounting for Managerial Decisions

Topic 1: Financial Accounting and the Financial Statements

Accounting: the process of identifying, measuring and communicating economic information to permit informed judgments and decisions. "the language of business".

Users of Accounting

- *Internal*
  - *management*
- *External*
  - *owners/shareholders, creditors, gvt*
  - *government/unions*

Assumptions made when preparing accounting information

1) Economic entity - financial activities of a business can be separated from those of the owners
2) Time period - economic information can be meaningfully captured and communicate over short periods of time
3) Monetary unit: accountants assure that the dollar is the most effective means to communicate economic activity
4) Going concern: accountants assume that a company will continue to operate into the forseeable future

Income Statement

- Reports a company's expenses and revenues over a specific period of time
  - e.g year ended June 30, 2017

expense: a decrease in resources associated with the sale of goods or services.
revenue: an increase in resources resulting from the sale of goods or services

Revenues - Expenses = Profit or Loss

Terms

Revenue recognition principle: a revenue should be recorded when a resource has been earned

e.g. cash received from your cleaning services

Expense recognition principle: an expense should be recorded when the resource is consumed.

e.g. fuel used in the month of January

matching principle: expenses should be recorded in the period resources are used to generate revenues.

sales revenue: the resources that a company generates during a period from selling its inventory.

cost of goods sold: the cost of the inventory sold during a period.

gross profit: the profit that a company generates when considering only the sale price and the cost of the product sold.

Balance Sheet

- Reported at a given time or date
  - e.g. at June 30, 2016

Assets = Liabilities + Equity

asset: an economic resource that is objectively measurable, that results from a prior transaction, and that will provide future economic benefits.

current asset: any asset that is reasonably expected to be converted to cash or consumed within one year of the balance sheet date.

- listed in order of their liquidity, which refers to the speed with which a resource can be converted to cash. Cash is listed first, followed by short-term investments, receivables, inventories and then finally other assets.

non current assets: are the resources that are used in a company's operations for more than one year and are not intended for resale. E.g. property, plant and equipment, intangible assets and deferred tax assets.

intangible asset: a resource that is used in operations for more than one year, it is not intended for resale, and has no physical substance. E.g. trademarks, patents, franchise rights, copyrights and goodwill.

historical cost principle: assets are recorded and reported at the cost paid to acquire them.

liability: an obligation of a business that results from a past transaction and will require the sacrifice of economic resources in the future.

current liability: an obligation that is reasonably expected to be satisfied within on year. E.g. accounts payable to suppliers, salaries payable to employees and taxes payable to taxing authorities.

non-current liability: an obligation that is not expected to be satisfied within one year.

equity: the difference between a company's assets and liabilities, representing the share of assets that is claimed by the company's owners.

contributed capital: the resources that investors contribute to a business in exchange for an ownership interest.

earned capital (retained earnings): the profit or loss generated each accounting period which has not been paid to shareholders as a dividend.

issued capital: the amount of equity a company generates throughout he sale of shares to investors.

retained earnings: the amount of equity a company generates by being profitable and retaining those profits in the business.

Net Assets = Assets - Liabilities

Statement of Changes in Equity

- Shows the change in a company's equity, we focus on the change in retained earnings over a specific period of time.

Basic structure of statement of changes in equity

Retained earnings, beginning balance
+/- Net income/loss
- Dividends
= Retained earnings, ending balance

** links the income statement and balance sheet together**

Statement of Cash Flows

The details of cash inflows and outflows for a business are reported on a statement of cash flows in the following three sections

1) Operating Activities
   - purchase of supplies
   - payment to employees
   - sale of product

2) Investing Activities
   - revenue generating assets

3) Financing Activities
   - borrowing money creditors
   - receiving contributions from investors

- Shows a businesses sources and uses of ash over a specific period of time. It's purpose is to inform users about how and why a business's cash changed during the period.

Key Formula

Cash flows provided (used) by operating activities
+/- cash flows provided (used) by investing activities
+/- cash flows provided (used) by financing activities
= Net increase (decrease) in cash

Information beyond the financial statements

Notes to the financial statements provide information that is useful to users which is not included on the statements. This includes

1) disclosure of the accounting methods used to prepare the financial statements
2) additional detail and explanations of account balances
3) information not recognised in the financial statements

Auditors reports

role of auditor : state an opinion on whether the financial statements present fairly in conformity with the Accounting Standards, the company's financial condition and results of the operations and cash flows.

Management Discussion and Analysis
provides managers comments on the company performance and its future strategies.

Accounting Standard Setting

- role of the Australian Accounting Standards Board (AASB)
- Australia adopts International Financial Reporting Standards issued by the International Accounting Standards Board (IASB)
- Compliance is the role of the Australian Securities and Investors Commission (ASIC)

Qualitative Characteristics of Accounting Information

Accounting information must possess certain characteristics to be considered useful.

understandability: the ability of accounting information to be "comprehensible to those who have a reasonable understanding of business… and are willing to study the information with reasonable diligence."

relevance: the capacity of accounting information to make a difference in decisions.

reliability: the extent to which accounting information can be depended upon to represent what it purports to represent, both in description and in number.

comparability: the ability to use accounting information to compare or contrast the financial activities of different companies.

consistency: the ability to use accounting information to compare or contrast the financial activities of the same entity over time.

materiality: the threshold at which a financial item begins to affect decision making.

conservatism: the manner in which accountants deal w/ uncertainty regarding economic situations.

<u>Horizontal Analysis</u>

A method of analysing a company's account balances over time. It is normally conducted on both the balance sheet and the income statement. The analysis calculates both the absolute and percentage change in each account balance on a financial statement.

Key Formula

Dollar change in account balance = current year balance - prior year balance

$$\text{percentage change in account balance} = \frac{\text{Dollar Change}}{\text{prior year balance}}$$