

ACCOUNTING FINAL EXAM – REFINED REFINED NOTES

Financial Accounting

- Preparing and presenting financial information for users to help them make informed decisions.

Management Accounting

- The role of management accounting is to provide information to internal users such as managers and owners
- The information provided is confidential and will not be available to external users

Financial Accounting

External
Half yearly or yearly
Historical focus
Highly summarised
Standard format

Primary users of the reports

Frequency of reports

Time frame focus

Content of reports

Format

Management Accounting

Internal
As frequently as required
Current and future focus
Very detailed
Tailor made

Internal Users

Managing Director
Financial Controller
Divisional Manager

External Users

Shareholders Creditors
Suppliers
Bank
Customers
Regulators

- ASSETS** are defined as 'resources controlled by the entity as a result of past events and from which future economic benefits are expected to

flow to the entity' Examples include Cash, car, textbooks, phone, jewellery & shares

- LIABILITY** is defined as 'present obligations 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' Examples include a mortgage, credit card, HECS debt, car loan, money owed to parents & a phone bill owing
- EQUITY** is defined as 'the residual interest in the assets of the entity after deducting its liabilities' therefore $ASSETS - LIABILITIES = EQUITY$. It relates to a business only.
- INCOME** is defined as 'increases in economic benefits during the accounting period 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' Examples include wages from a part time job, interest, government benefits.
- EXPENSES** are defined as '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'

Examples include staff wages, or personal examples include food and drink, university costs, clothes, rent, interest expense, electricity expenses etc.

An item may satisfy the definition of one of the elements, but it cannot be recorded in the accounting system unless it also satisfies two *recognition criteria*:

- **Probably occurrence** – it must be probable that the inflow or outflow has occurred (it has to be more than likely)
 - **Reliable measurement** - the item must have a cost or value that can be measured reliability
- **Business transactions** are occurrences — exchanges of resources between the entity and another entity or individual — that affect the assets, liabilities and owners' equity items in an entity.
 - **Entity concept** - it means that the owner of a business should not include any personal assets on the entity's balance sheet, as this statement must reflect the financial position of the business alone.
 - **Business Transactions** → involve an exchange of goods between an entity and another entity or individual
 - **Personal Transactions** → transactions of the owners, partners or shareholders that are UNRELATED to the operation of the business.
 - **Business Events** → occurrence's that have the potential to affect the entity in some way, but will not be recorded as business transactions until exchange of goods occurs between the entity and an outside entity or individual.

Balance sheet	Income statement
Assets (A) = Liabilities (L) + Equity (E)	Income (I) – Expenses (E)

Further:

Income (I) increases Equity (E)
Expenses (E) decrease Equity (E)

Therefore:

Assets (A) = Liabilities (L) + Opening Equity (E) + Income (I) – Expenses (E)

Income Statement

- Income and expenses form the income statement which reports operating performance
- It shows what income a business earned, less the expenses it incurred during a period of time
- The **income statement** reflects the accounting return for an entity for a specified time period. The accounting return is formally referred to as the profit or loss of the entity.
- Income comprises both revenue from the ordinary course of activities and gains

Presenting the Income Statement

- The appearance of the income statement differs depending on whether the statement is being prepared for internal or external reporting purposes, and whether the preparing entity is required to comply with accounting standards.
- The income statement for the previous reporting period in addition to the current reporting period is presented. Known as **comparative information**, it allows users to see

how the entity's financial performance in the current period differs from the previous period.

Debit & Credit Rules

- Each time a transaction or event is recorded, it will have a dual effect on the accounting records
- One part will cause a debit, the other will cause a credit
- Whenever a transaction occurs, it must be recorded in a way to ensure the extended accounting equation remains in balance

Balance sheet accounts						Income statement accounts		
ASSETS	=	Liabilities	+	Owner's Equity	+	Income	-	Expenses
+ \$5,000 (cash)				+ \$5,000 (capital)				
+ \$20,000 (motor vehicle)		+ \$20,000 (bank loan)						
- \$1,000 (cash)		- \$1,000 (bank loan)						
- \$800 (cash)								
+ \$800 (computer)								
- \$500 (cash)								+ \$500 (advertising)
+ \$350 (accounts receivable)						+ \$350 (service fees)		
\$23,850	=	\$19,000	+	\$5,000	+	\$350	-	\$500

Errors

- **Single Entry** - Where the effect of the transaction has only been recorded against one element, and the double entry has been forgotten creating an imbalance
- **Transposition** - Two digits are transposed E.g. Wages expense → Reduction in cash \$343 but in expenses it was recorded as \$434. Divisible by 9.
- **Incorrect entry** - Amount of transaction incorrectly added or subtracted on the wrong side

- The **duality** system of recording business transactions means that the business transactions have a dual effect on the accounting equation such that the equation remains in balance after the recording of each transaction. This is why a balance sheet, prepared as at any point in time, will always balance.

Accounting Types:

- **Accrual accounting** is a system in which transactions are recorded in the period to which they relate, rather than in the period the entity receives or pays the cash related to the transaction. This means that the reported profit or loss based on the accrual system is the difference between income and expenses for the period. This is not synonymous with cash.
- A **cash accounting** system, in contrast, would determine cash profit or loss as the difference between the cash received in relation to income items and the cash paid for expenses for the period.

Accounting policy choices – depreciation:

- Employing **straight-line depreciation** (where the annual depreciation on the asset is the same each year), an expense of \$9000 would be recognised in the income statement for each of the next three reporting periods
- The **diminishing balance depreciation** method assumes that the economic benefits of using the asset will decrease over its useful life. Consequently, depreciation expense is higher in the asset's earlier years relative to later years.

- The **units of production depreciation** method charges depreciation expense based on the activity or output in the reporting period relative to the asset's total expected activity or output.

Gross Profit

Gross profit reflects the percentage by which an entity marks up the cost of its products to sell to its customers.

The statement of changes in equity

- Entities required to comply with accounting standards must present a **statement of changes in equity**. The statement shows the change in an entity's equity between two reporting periods.
- The purpose is to provide users with better information by requiring aggregation of items with similar characteristics and separation of items with different characteristics.
- Amount of equity at the start, and concludes with the amount of equity at the end of the accounting period.

Reporting Entity Concept:

- An entity is assessed as a reporting entity when there are users who depend on general-purpose financial statements for their decision-making.

Balance Sheet Format & Presentation:

- A T-format is often used by smaller entities, whereas a narrative format tends to be used by larger entities.
- A T-format lists the assets on one side (left-hand side), and the liabilities and equity on the other (right-hand side).
- T format follows the accounting formula $\rightarrow \text{ASSETS} = \text{LIABILITIES} + \text{OWNERS EQUITY}$
- A **narrative format** presents the assets, liabilities and equity down the page
- A narrative format follows the accounting formula $\rightarrow \text{ASSETS} - \text{LIABILITIES} = \text{OWNERS EQUITY}$
- The balance sheet shows the financial position of an entity (how well off it is at the time of reporting)
- The balance sheet outlines all of the businesses assets, what the business owes to liabilities, and what the owner's share of the business is.
- On the balance sheet, it is usual for an entity to show the total amounts for current assets, non-current assets, current liabilities and non-current liabilities.
- When preparing a balance sheet, assets and liabilities should be presented in a current/non-current format unless an alternative presentation, such as listing the assets and liabilities in order of their liquidity, provides information that is more relevant and reliable.
- The distinction between **current assets** and **non-current assets** is based on the timing of the future economic benefits. Similarly, the distinction between **current liabilities** and **non-current liabilities** is based on the timing of the expected future sacrifices.

Current Assets		Current Liabilities	
Bank	20,000	Accounts Payable	10,000
Accounts Receivable	6,000		
Prepayments	<u>900</u>	Non-Current Liabilities	
	26,900		
Non-Current Assets		Owner's Equity	21,400
Office Equipment	6,000		
Less Accum Dep'n	<u>(1,500)</u>		
	4,500		
	\$ 31,400		\$ 31,400

Statement of cash flows V Other general-purpose financial statements:

- The statement of cash flows was introduced because the income statement and balance sheet did not provide a complete picture of an entity's economic activities.
- Money received and spent during a period
- That is, an income statement summarized the entity's income and expense transactions but did not identify the flow of funds relating to those transactions; and a comparison of successive balance sheets would show the change in cash position from one point in time to another, but would not expose the cash flows associated with that change.
- **Cash flows** refer to the movement of cash resulting from transactions with external parties.
- The statement of cash flows also helps to identify changes in balance sheet items.

Cash V Profit:

- Based upon exchanges of cash only
- Report providing details about where cash came from and where it was spent
- Profits are also important and critical to the success of a business
- If a business can't pay their employees, suppliers and other creditors they may have to close their doors → This can still happen whilst a business is making profits
- Due to timing differences as to when revenue and expenses are recorded and when the actual cash is received and paid out, a business reporting profit may not have the physical cash needed to pay their bills
- This is why accrual accounting can be an inaccurate representation of an entity's financial position
- Statement of cash flows helps to identify possible future cash shortages and allowed the time needed to take corrective actions

Operating activities – relate to day-to-day revenue-generating activity, such as the provision of goods and services, including cash sales, interest receipts and creditor payments.