Autumn 2018

22107 Accounting for Business Decisions A

University of Technology Sydney

Learning objectives:

- appraise the role of accountants and accounting information in the business environment
- apply accounting information in external and internal decision contexts of a business
- demonstrate analytical skills needed to process accounting information; prepare internal and external financial statements and be able to interpret accounting reports
- evaluate basic business information provided in the popular media.

Topics:

- The use of accounting information
- Financial accounting: Recording accounting transactions, adjusting entries, preparation and interpretation of financial statements
- Management accounting: cost behavior, CVP analysis, introduction to budgeting, relevant costing and decision making
- Ethics and accounting

WEEK ONE

Introduction to accounting - preparation week

- **Readings:** You are required to obtain a copy of the ACCT2 Financial 2nd Asia-Pacific Edition and ACCT2 Managerial 2nd Asia-Pacific Edition. You must read this subject outline.
- **Tutorial work:** (to be completed for the tutorial in the week following the lecture - the tutorial in week 2):

Financial Accounting:

- The recording of financial information which can be used to report to.
- Focus on external users

Management Accounting:

- The recording and predicting of financial information
- Focus on internal users (i.e managers)

WEEK TWO

Financial statements

- **Reading:**
    - ACCT Financial - Chapter 1 (pg 2 - 15), Chapter 2 (pg 20 - 36)
    - Law textbook - Chapter 4

Accounting assumptions:

Economic entity	Financial activities of a business can be separated from those of the business's owner, allowing one to examine a company's accounting information without consideration of the personal monetary position of the owner.
Time period	Economic information can be meaningfully captured and communicated over short periods of time. ● We need to measure performance from time to time to ensure that objectives are being achieved. ● Performance needs to measured consistency. ● Economic performance can be measured yearly, half yearly, monthly, etc.
Monetary unit	Accountants assume that the dollar is the most effective means to communicate economic activity, and if an economic activity is not able to be measured in dollars, it cannot be recorded. This means economic values do not adjust based on inflation.
Going concern	Accountants assume that a company will continue to operate into the foreseeable future. ● When you buy something, it's easy to put a dollar sign on it. ● For example, if you buy a pair of shoes for $100, there is a difference between the value of what you bought them for, and the value you can sell them for second hand. ● If you intend to keep the shoes, they are of $100 value to you, because if they got stolen you would have to pay $100 to replace them. However, if you planned on selling them, they may only be worth $5 to an op shop. ● The going concerns is something that helps us put a dollar amount besides assets and liabilities, but particularly assets. ● For a more business based example, if a lawn mowing business were to continuing operating throughout the summer, the lawnmower is valued based on what it is worth to the business rather than what it can be sold for.

GAAP:

- Generally Accepted Accounting Principles.
- Accounting standards developed by the Australian Accounting Standards Board (AASB) and enforced by ASIC.
- Financial statements should be presented fairly and provide a fair view.
- Australia has also adopted the International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB).
- Essentially the 'road rules' for accounting.

The income statement:

- Shows a businesses profitability during a specific period (e.g a month, year, etc.)
- Prepared under accrual basis of accounting
- *Revenue* = the increase in resources as a result of the sale of goods or services.
- *Expenses* = A decrease in resources resulting from the sale of goods or services
- *The income statement* = The company's revenues and expenses calculated and reported on a statement.
- *The profit figure* released in the income statement is the most important thing in the report by far, with the statistic telling you in one figure how well the business is doing.
- *Matching principle* says we try to match expenses with the revenue they earn.
- *Revenue recognition principle:* A revenue should be recorded when a resource has been earned. (reported for a specific period)
- *Total comprehensive incom*e = things that accountants recognise as being revenue and expenses that are not immediately obvious. The Accounting Standard allow them to be recorded separately or in the one statement
- *Gross profit* = only represents the profit generated when considering the sale price and cost of product sold.
- *Operating (other) expenses* = Expenses incurred by a company during normal operations.
- *Other comprehensive income* = not part of the realised gains or profits.

Lawn Service
Income statement
for the month ending 31 January

Revenues		$1 120
Expenses:		
Fuel	$80	
Interest	5	
Depreciation	70	
Total expenses		155
Profit		$ 965

- May be referred to as the profit and loss statement.

Single-step and multistep statements:

- Single step:
  - Calculates the total revenue and total expenses
  - Determines net income by subtracting total expenses from total revenues.
  - They are simple and present the income clearly.
- Multi-step:
  - Groups certain revenues and expenses and calculates multiple subtotals of income
  - This assists with providing information on different profitabilities in aspects of operations.
  - Most multi-step include some / all of the following:

- Total revenue
- Cost of sales
- Gross profit
- Expenses
- Profits before income tax expense
- Profits after income tax expense
- Other comprehensive income
- Total comprehensive income

The balance sheet:

- Shows a businesses financial position at the end of a specific date.
- The only financial statement which applies to a single point in time.
- Assets = liabilities + owner's equity

Assets:

Cost principle: what we paid for it is what it is recorded at

- Current Assets:
    - Assets that are expected to be converted into cash / consumed within a year
- Non-current Assets:
    - Resources not expected to be consumed within a year, such as property and equipment.
- Intangible Assets:
    - Non-physical assets used in operations for more than a year lik trademarks, copyrights and goodwill.

Liabilities:

- Current Liabilities:
    - Obligations to be paid within a year, such as money for creditors and tax
- Non-current Liabilities:
    - Obligations not expected to be paid within a year, such as interest-bearing liabilities.

Equity - the difference between assets and liabilities

- Contributed capital: the resources that investors contribute to a business in exchange for ownership interest.
- Retained earnings: earnings retained by the business - not paid out by dividends

The balance sheet = The financial statement that shows a businesses assets, liabilities and equity at a specific time.

The Accounting equation = Assets = Liabilities + Equity

Lawn Service
Balance sheet
at 31 January

Cash	$194	
Accounts receivable	120	
Supplies (petrol)	10	
Lawnmower	195	
Petrol can	15	
Total assets		$534
Note payable (to Mum)	$200	
Total liabilities		$200
Contributed capital	$100	
Retained earnings	234	
Total equity		334
Total liabilities and equity		$534

The statement in changes of equity:

- Shows the change in a company's equity, and the changes in retained earnings over a period of time.
- Retained earnings, Beginning balance +/- Net profit/loss - dividends = Retained earnings, Ending balance
- Unlike the income statement, each column int e statement of changes in equity reflects the activity in a specific equity amount rather than a period of time.

Lawn Service
Statement of changes in retained earnings
for the month ending 31 January

Retained earnings, 1 January	$ 0
+ Net income (or Net profits)	965
– Drawings (Dividends)	$ 731
Retained earnings, 31 January	$ 234

Linking the income statement and the balance sheet:

- The statement of changes in equity also links the income statement and the balance sheet.
- Businesses can't calculate retained earnings without factoring in the profit earned during the period.The statement of changes of retained earnings provides this link by including net profit or loss in the calculation of retained earnings, which is then reported on the balance sheet.
- For any business, statements must be prepared in the following order: income statement, statement of changes in equity, balance sheet

The cash flow statement:

- Reports a business' cash inflows and outflows from its operating, investing and financing activities
- *Financing activities* = The generating and repaying cash from creditors and investors. (Borrowing money from creditors and receiving contributions from investors)
- *Investing activities* = The buying and selling of revenue-generating assets (For example a lawn mower in a lawn mowing business)
- *Operating activities* = The purchase of supplies, payment of employees and sale of products.

Qualitative characteristics of accounting information:

- *Understandability* = the ability for accounting information the be understandable to those who have a general understanding of business activity.
- *Relevance* = How well the accounting information can influence business decisions
- *Reliability* = How dependable the information is
- *Compatibility* = The ability to use the accounting information to be weighed against the financial activities of other businesses
- *Consistency* = the ability to use the information to compare the financial activities of the same business over time
- *Materiality* = the threshold at which an item begins to affect decision making
- *Conservatism* = the manner in which accountants deal with uncertainty regarding economic situations.

Vertical analysis issues

- Compares a business's account balances within one year
- Completed on both the income statement and balance sheet
- Calculated by dividing each account balance by a base amount, yielding a percentage.
- The base account is total assets for balance sheet accounts and sales or total revenues for income statement accounts.

	For the balance sheet	For the income statement
Percentage	$\frac{\text{Account Balance}}{\text{Total Assets}}$	$\frac{\text{Account Balance}}{\text{Net Sales or Revene}}$

- The results of a vertical analysis is a common-size financial statement, where all accounts have been standardised by the overall size of the company.
- Divides each inventory balance by total assets for that year.

Horizontal analysis issues

- A method of analysing a businesses account balances over time.
- Completed on both the income statement and balance sheet
- Calculates the absolute and percentage change in each account balance on a financial statement
- Can identity promising / troubling trends in a business
- Horizontal refers to the calculations compared across the columns of yearly data
- Completed first by determining the dollar change in an account, as defined as the current year balance less then divided by the prior year balance to yield a percentage change. (seen in the equation below:

$$\text{Dollar Change in Account Balance} = \text{Current Year Balance} - \text{Prior Year Balance}$$

$$\text{Percentage Change in Account Balance} = \frac{\text{Dollar Change}}{\text{Prior Year Balance}}$$

Common-size statements

- Allow financial statement users to determine the importance of each account to the overall companand compare this importance to other businesses.
- Statements where all items are replaced by percentages of the whole in order to compare two very different business sizes.

Notes to the financial statement:

- Disclose accounting methods used
- Disclose additional details and explanations of account balances
- Provides information not recognised in the financial statements

Auditor's report:

- All annual reports contain an independent auditor's report.
- It is an opinion of the fairness of the financial statement not about the quality of the company

Business forms:

- *Sole proprietorship:*
  - Owned by one person who maintains and controls all aspects of the business
  - May employ staff to help run the business, but makes all business decisions
  - Advantages:
    - Formation - no lengthy documents
    - Control - the sole trader retains all control over the business, and can make all decisions
    - Profits - The sole trader retains all profits, and does not need to split them with anyone
    - Taxation - an advantage if profits are low
    - Dissolution - If the trader wants to end his business, he does not need to comply with formalities

- Disadvantages:
    - Management - It can be a lot for one person to manage
    - Expertise - there are only the expertise of one person available, as opposed to a partnership where the range of insight from various people can be beneficial
    - Capital - It can be financially strenuous to raise capital on your own
    - Liability - a trader has unlimited liability, and personal assets can be used
    - Limitations of business life - The business is not separate from its owner, and dies when the owner does
    - Taxation - only an issue if taxes are large
- *Partnership:*
  - Two or more proprietors own a business, and spread financial risk and gain among all owners
  - Advantages:
    - Formation - Easier to form in a partnership, and no formal matters need to be tended to
    - Management - It is easier to manage a business with more than one trader, as life events such as illness and holidays can be covered
    - Flexibility - Not restricted by the business
    - Profits and taxes - the profits belong to owners, and partners are taxed individually
  - Disadvantages:
    - Liability of partners - Liability is unlimited
    - Lack of permanence - Not separate from its members, with death or bankruptcy ending the partnership
    - Size - Maximum of 20 partners permitted
    - Capital - Limited capital due to the savings of the partners.
- *Company:*
  - A separate legal entity that is established by registering the company with ASIC.
  - Sells shares.
  - Can be either public or private
    - Public involves ownership being available to the public through the purchase of shares on the Australian Securities Exchange (ASX)
    - A private company does not involve any type of available ownership to the general public, and is owned by whoever started the business.

WEEK THREE

NO CLASS