ACCT1501 Lecture 1

What is accounting?

- Accounting is the process of **identifying, measuring, recording** and **communicating** economic information to assist users to make decisions
- Accounting systems
  - Financial accounting system – focus on the provision of information to users external to the enterprise e.g. investors, creditors, also focuses on reporting financial position and financial performance
  - Managerial accounting system – detailed plans and continuous performance reports – used by internal decision makers e.g. managers to aid in operational planning and control decisions
- Users of accounting information
  - **Bankers** – the likelihood of the company meeting its interest/principal payment on time
  - **ASIC** – financial position and performance of a company issuing shares to the public for the first time
  - **Suppliers** – probability that the company will be able to pay for its purchases on time
  - **ATO** – profitability of company based on tax law
  - **Trade unions** – profitability of company since last contract with employees was signed
- The importance of accounting – used by
  - Management in making business decisions
  - Shareholders for decision making
  - Board of directors in takeover battles
  - Bankers and creditors in lending decisions
  - Boards in rewarding and removing executives
  - Management and unions in wage negotiations
  - Impacts communities
  - Impacts workers

What is an annual report?

- Magazine that contains a lot of descriptive information about the company and the general purpose financial statements

Key financial statements

Balance Sheet (Statement of financial position)

- Financial position of an enterprise **at a particular point of time**
- Financial position: enterprises set of financial resources and obligations at a point in time
- Used to assess financial structure and ability to pay debt
- Three main elements
  - Assets
    - Resources – they will benefit the company this year (current) or in future years (non-current)
    - E.g. cash, property, equipment, inventory
  - Liabilities
    - What the company owes
    - E.g. accounts payable, loan payable
  - Equity
    - What belongs to the owners, the residual, i.e. what is left after liabilities are taken care of e.g. share capital, retained profits
- Assets are due to debt or equity
- The balance sheet shows resources (assets), and claims on those resources (liabilities and equity) **at a point in time**
- Can be represented with the **accounting equation**

Assets = liabilities + equity

Income Statement (Profit and Loss Statement)

- Financial performance of an enterprise **over a period of time**
- Financial performance: generating new resources from operations over a period of time
- Shows the results of business operations over a specific time period
- Elements of income statement
  - Reports revenues earned, and any expenses incurred
  - Revenue: inflows of economic benefits that increase owner's equity e.g. sales revenue, service revenue
  - Expenses: use or loss of economic benefits that decrease owner's equity
    - Incurred when you use resources to generate revenue (matching principle)
  - If revenues are greater than expenses, there is a **net profit**
  - If revenues are less than expenses, there is a **net loss**
- Revenues and expenses are recognised when an economically meaningful event has occurred – accrual accounting (does not involve cash)

Cash Flow Statement

- Cash inflows and outflows **over a period of time**
- Provides details of movement in an entity's cash balance
- The cash flows are normally categorised into:
  - Operating activities: main revenue producing activities
  - Investing activities: acquisition and disposal of long term assets

    - Financing activities: equity capital and borrowing

Consolidated financial statement

- Financial statements that factor the holding company (parent company's) **subsidiaries** into its aggregated accounting figure
    - A subsidiary is a company controlled by parent company which has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities
    - **Intragroup balances**, and any unrealised gains and losses or income and expenses arising from **intragroup transactions**, are eliminated
- It shows how the holding company is doing as a group. The consolidated accounts should provide a true and fair view of the financial and operating conditions of the group

Accrual vs Cash Accounting

- An income statement reports revenues and expenses – accrual accounting
- A cash flow statement reports cash inflows and outflows – cash accounting
- **Accrual accounting**: includes the impact of transactions on the financial statements in the time periods where revenues and expenses occur rather than when the cash is received or paid
- **Cash accounting**: only accounts for revenues and expenses when cash is paid or received

Financial statement assumptions:

- Accrual basis – revenues and expenses are recognised at the time they occur rather than when the cash is received or paid
- Accounting entity – activities of the entity are separate from those of its owners/members, includes but not limited to, legal entities (e.g. consolidated entity)
    - Economic entity – a group of entities where the goals of the controlling entity are pursued e.g. companies, partnerships, funds
- Accounting period – life of a business is divided into discrete time periods of equal length to determine financial performance positions
- Monetary assumption – universally accepted medium of exchange, measure economic activity by a common denominator
- Historical cost assumption – transactions are initially recorded at their original cost. Treats assets in terms of their use rather than for resale
- Going concern assumption – assumes continued operation of accounting entity into foreseeable future, no intention or need to liquidate, produces demand for financial information during life of entity