Week 1: Introduction to financial reporting

Ratio analysis

1. Profitability
    - ➢ **Return on Equity(ROE):** Measures the amount of net profit generated by each dollar invested by shareholder
        - **ROE** = Net profit / Average Equity
    - ➢ **Return on assets(ROA):** Measures the amount of EBIT generated by each dollar invested in assets
        - ROA = EBIT / Average total assets
        - Increased ROA = increased profitability(higher price/lower cost) / average total assets decreases

Financial reporting

2 users of financial report:

- ❖ Internal users:
    - ➢ Managers
- ❖ **3 External users: 上下外
    1. Resource providers (eg. investors, employees, lenders, creditors)
    2. Recipients of goods & services (eg. customers)
    3. External Parties with a review function (eg. governments, agencies, media)

General Purpose Financial Reports(GPFR)

4 things to know about GPFR:

1. Mainly provided for potential investors & lenders (Don't have direct access to info)
    - BUT it cannot provide all the information that they need → Info leakage
2. Designed to meet the needs of a wide range of users
3. Can be used to value the reporting entity
4. Largely based on estimations and judgements

Conceptual framework

- **Conceptual framework:** Define the elements of financial statements
    - **Aim:** To help the preparation of financial statements
- **5 elements of financial statements: (EXAM)
    - **Assets**
        - A resource controlled(no need to own) by the entity AND will bring future economic benefits(FEB)
    - **Liabilities**
        - A present obligation from past event AND will lead to future resource outflow
    - **Equity**: Asset - liability
        1. Contributed equity
        2. Retained earnings
        3. Reserves(eg. Revaluations surplus, other comprehensive incomes)
    - **Income**: Financial inflow that increases equity when assets ↑ / liabilities ↓
        - Vs. **Revenue**: Income earned by providing G/S
    - **Expenses**: Financial outflow that decreases equity when assets ↓ / liabilities ↑

5 things in a complete set of financial reports:

1. **Income statement:** Reports revenues less expenses for a particular period of time
2. **Balance Sheet:** Reports assets, liabilities and equity at a particular point of time
3. **Cash flow statement**: Reports cash receipts & payments for a particular period of time
4. **Statement of changes in equity:** Reports total comprehensive income + Transaction with owners
5. **Notes:** Reports a summary of significant accounting policies

**2 fundamental qualitative characteristics of financial information: (EXAM)

1. **Relevance**
    - Materiality → Information without which will affect the user's decision
    - **Materiality test**: Any material item must be recorded as assets for depreciation, any non-material item must be recorded as expense
2. **Faithful representation**
    - Complete, neutral & free form error

4 enhancing qualitative characteristics:

1. Comparability
    - ➢ Can be compared across time / with other entities
2. Verifiability
    - ➢ Can be verified by a third party
3. Understandability
    - ➢ Can be understood by a person who has reasonable business knowledge
4. Timeliness → Timely enough to help users on decision making

<u>6 Concepts and principles</u> AAMGCF

1. **Accounting entity concept**
    - ➢ Owner's transactions <u>must</u> be separated from the entity's transactions
2. **Accounting period concept**
    - ➢ The life of an entity can be divided into artificial periods
3. **Monetary principle**
    - ➢ All items included <u>must</u> be able to be expressed in monetary terms
4. **Going concern principle**
    - ➢ A business will remain in operation for the foreseeable future
5. **Cost principle**
    - ➢ All assets <u>must</u> be <u>**initially**</u> recorded at their original cost
    - ➢ BUT To provide useful info, entities can also use market valuation
6. **Full disclosure principle**
    - ➢ All items that may affect the user's decision <u>must</u> be disclosed in the financial statements

<u>Presentation of Financial Statement</u>

- ❖ **AASB 101 Presentation of Financial Statements:** Sets out the <u>presentation requirements</u> of financial statements
- ❖ ****2 Objectives of AASB 101:**
    1. To ensure <u>comparability</u> of a financial statement across time AND with other entities
    2. To ensure that info meets the needs of a <u>wide range of users</u>

2 AASB rules on classification: (NOT so important)

1. An entity <u>must</u> classify its balance sheet based on current and non-current assets and liabilities
    - ➢ UNLESS classification based on liquidity provides more reliable information
2. If an asset/liability category combines the amount that will be received/settled <u>after</u> 12 months with those <u>within</u> 12 months:
    - ➢ MUST separate the longer-term amount in <u>notes disclosure</u>

Sample formats of financial statements

Business Limited
Income Statement for the month ended 31 August 2010

Revenue		
Fees		4,200
less Expenses		
Wages	1,400	
Materials used	500	
Rent	300	
Bank Charges	100	2,300
Earnings before interest and tax		1,900
Interest Expense		200
Profit Before tax		1,700
Tax expense		510
Operating profit after tax		1,190
Retained profits at start		338
Profit available for distribution		1,528
less Dividends		400
Retained profits at end		1,128

Business Limited
Comprehensive Income

Profit attributable to owners		XXX
Other comprehensive income		
Increase in revaluation surplus	xxx	
Decrease in foreign currencies	xxx	
Total Comprehensive Income	xxxx	

Business Limited
Balance Sheet as at 31 August 2005

Current Assets		
Bank	29,833	
Accounts Receivable	4,120	
Materials on hand	450	
GST receivable	2,692	37,095
Non Current Assets		
Furniture & equipment		30,000
		67,095
Current Liabilities		
Accounts payable	375	
Dividend payable	400	
GST payable	1,130	
Accrued wages	150	
Provision for tax	912	
Loan	12,000	14,967
Non Current Liabilities		
Loan		12,000
		26,967
Shareholders' Equity		
Share capital	39,000	
Retained profits	1,128	40,128
		67,095

IMPORTANT!!!

1. On income statement → MUST **have gross profit** & **Income tax expense** = 30% x Profit before tax
2. '**Accumulated depreciation**' = contra asset account = a negative figure on BS's non-current asset
3. BUT '**depreciation expense**' = Operating expense
4. '**Revenue received in advance**' = a current liability
5. '**Prepaid expense**' = a current asset

Business Limited
Statement of Cash Flows
for the month ended 31 August 2010

Operating activities		
Receipts from customers	3,540	
Payments to suppliers	<900>	
Payments to employees	<1,350>	
Interest paid	<200>	
Net cash flow from Operating activities		1,090
Investing Activities		
Acquisitions of furniture & equipment	nil	
Net cash flow from Investing activities		nil
Financing Activities		
Proceeds from share issues	35,000	
Loan acquisitions	25,000	
Share buy-back payments	<8,000>	
Loan repayments	<24,000>	
Net cash flow from Financing activities		28,000
Net change in cash held		29,090
Cash at start		743
Cash at end		29,833

CA 2001: Types of companies

- ❖ **Company:** Corporation registered under Corporations Act 2001

2 types of companies:

1. **Proprietary company:** (private)
   - ➢ Have "Pty" in its name
   - ➢ Cannot have more than 50 non-employee shareholders (cannot do)
   - ➢ Cannot raise funds from the public (cannot do)
   - ➢ Can be small or large

     Large if satisfy **2 or more** conditions below: (12.5-25-50)
     1. Gross assets = **$12.5m** at end of FY
     2. Gross revenue = **$25m** for the FY
     3. **50** EFT(equivalent full time) employees at end of FY
2. **Public company:**
   - ➢ Can have unlimited number of shareholders (adv)
   - ➢ Can more raise funds from the public (adv)
   - ➢ Have limited liability
   - ➢ Can be listed or unlisted

****Reporting entities** (**EXAM**)

- ❖ **Reporting entity:** Entity that has dependent users on its GPFR
  (like demand-supply)
- ❖ An entity is likely to have dependent users on GPFR if it has:
  1. Separate management from economic interest (environment/safety committee)
  2. Strong economic or political influence
  3. *Strong financial characteristics
     - ➢ Large sales, customers, assets, liabilities
- ❖ **Requirement of reporting entity:** A reporting entity MUST prepare GPFR in compliance with accounting standards
  - ➢ Non-reporting entity has much lower reporting requirements

Why should there be **differential reporting**?

1. **Information asymmetry** exists between managers and the external resource providers
2. Large companies have an unlimited number of stakeholders

- ❖ Therefore, differential reporting efficiently resolved information asymmetry, especially in large companies

Tiers of Australian Accounting standards (NOT important)

- ❖ There are 2 tiers阶层 of accounting standards:
    1. **Tier 1:** All Australian accounting standards
    2. **Tier 2:** Australian accounting standards, with reduced disclosure requirements
- ❖ An entity is Tier 1 entity if it has
    - ➢ **Public accountability**:
        1. Has accountability to external resource providers
        2. Issues debt or equity securities in a public market

****Disclosing entities (EXAM)**

- ❖ An entity is a **disclosing entity,** if: (sell debt/equity securities想别人相信你)
    1. Its securities are listed on ASX OR
    2. Its securities are issued to more than 100 people OR
    3. It issues debentures AND requires the appointment of a trustee

A disclosing entity must have:

1. Submit financial report semiannually
2. A continuous disclosure scheme

Tutorial:

1. **Lower-of-cost-or-market rule:** Inventory must be recorded at the lower value between its original cost and market value
    - ➢ Usually only market price < cost when is damaged / obsolescent
2. 4 sources of information for users:
    - i. **GPFR** → for financial information
    - ii. **Sustainability reports** → for non-financial information
        - ■ To assess the company's Corporate social responsibility AND its social & legal legitimacy
    - iii. **Media release** → To assess the company's reputation, Customer loyalty and base to forecast future sales
    - iv. **Share market** → To assess the market's confidence towards the company (PER ratio)