FINANCIAL STATEMENTS

Indicators of financial success are financial position (how wealthy the organisation is at a given point in time) and financial performance (how the organisation's wealth is changing over time). Financial statements detail financial position and performance.

Users of financial accounting information include accountants, investors, competitors, banks, corporate regulators, suppliers, the ATO, and trade unions.

Financial statements include:

Balance sheets

EXAMPLE LTD

BALANCE SHEET AS AT 30 JUNE 2016

Assets	$	Liabilities and shareholders' equity	$
Current assets		**Current liabilities**	
Cash	193 000	Accounts payable	210 000
Accounts receivable	400 000	Unearned revenue	120 000
Allowance for doubtful debts	(50 000)	Interest payable	40 000
Inventory	420 000	Income tax payable	780 000
Prepaid insurance	30 000		1 150 000
	993 000	**Noncurrent liabilities**	
Noncurrent assets		Long-term loan	770 000
Land	605 000		770 000
Equipment	2 030 000	**Total liabilities**	1 920 000
Accumulated depreciation	(690 000)	**Shareholders' equity**	
	1 945 000	Share capital	330 000
		Retained profits	688 000
		Total shareholders' equity	1 018 000
	2 938 000	**Total liabilities and shareholders' equity**	2 938 000

Balance sheets detail the financial position of a company at a given time. They summarise financial resources into assets, liabilities, and shareholders' equity. The accounting equation A = L + E summarises the relationship between the three.

Assets and liabilities must meet the definition criteria and recognition criteria to appear on the balance sheet (if the first is met but not the second, they will be disclosed in the notes of the financial statements).

The definition of an asset is "a resource that is *controlled* by an entity as a result of *past events*, and from which *future economic benefits* are expected to flow to the entity". The definition criteria are: control by the entity; occurrence of past events; future economic benefits.

The definition of a liability is "a *present obligation* of the entity arising from *past events*, the settlement of which is expected to result in an *outflow of future economic benefits* from the entity". The definition criteria are: a present obligation; occurrence of past events; outflow of future economic benefits.

The recognition criteria of assets and liabilities are:

- Prepare a post-closing trial balance.
- Prepare the financial statements.

Journal entries translate assets, liabilities, equity, revenues, and expenses into debits and credits. As a summary:

	Up	Down	Opening balance
Assets	Debit	Credit	Debit
Liabilities	Credit	Debit	Credit
Owner's equity	Credit	Debit	Credit
Revenues	Credit	Debit	-
Expenses	Debit	Credit	-

Financial statements are prepared from accounts. An account is the record of all dollar amounts comprising an asset, liability, equity, revenue, or expense. These amounts sum into a debit or credit (the balance of the account).

A ledger is a list of all journal entries for an account. The general ledger is a summary of all accounts, and subsidiary ledgers group similar accounts (such as accounts receivable). Note that the debits and credits of a subsidiary ledger are not equal, but instead have a net sum equal to the amount in the general ledger.

Common journal accounts include:

Cash – an asset account detailing actual cash used for payments.

Accounts receivable – an asset account detailing cash the enterprise is owed from credit payments.

Inventory – an asset account detailing inventory for sale (e.g. groceries, office supplies, drugs).

Land and buildings – An asset account detailing land and buildings. Sometimes just "land" or "buildings".

Equipment – An asset account detailing equipment used in whatever it is the enterprise does.

Interest receivable – An asset account detailing interest receivable by the enterprise.

Prepaid insurance/rent/etc. – An asset account detailing entitlement to goods and services that have been paid for but not received.

Unrecorded revenue – An asset account detailing revenues that have not been recorded.

Accumulated depreciation – A contra asset account showing the accumulated depreciation of a tangible asset.

Accumulated amortisation – A contra asset account showing the accumulated amortisation of an intangible asset.

Loan payable – A liability account detailing long-term loans of the enterprise.

Accounts payable – A liability account detailing cash the enterprise owes for credit payments.

Wages payable – A liability account detailing cash the enterprise owes for wage payments.

Unearned revenue – A liability account detailing revenue that has been received but not yet earned.

- Outstanding cheques: Cheques written by a business that have not been presented to the bank.
- Non-sufficient funds (NSF) cheques: Customer cheques deposited but returned because of lack of funds.
- Bank charges.
- Electronic funds transfer transactions: particularly receipts from customers that have not been recorded by the company.
- Interest earned on the account.

A bank reconciliation looks like this:

SYDNEY CITY BANK

BANK RECONCILIATION

	$
Ending balance per bank statement	485 000
Add: Receipts/increases entered on company records but not reported on the bank statement	20 000
Deduct: Disbursements/decreases entered on company records but not reported on the bank statement	(5 000)
Adjusted cash balance: bank	500 000
Ending balance per company records	505 000
Add: Receipts/increases reported on the bank statement but not entered in company records	5 000
Deduct: Disbursements/decreases reported on the bank statement but not entered in company records	(10 000)
Adjusted cash balance: company records	500 000

Note that the entries must be *specific* – e.g. deposits in transit, bank charges, outstanding cheques, cheque recording error.

Note that the adjusted cash balances must balance. If they do not, it is likely that a record-keeping error has been made, either by the company or by the bank.

Bank reconciliation statements are prepared using the following steps:

1. Tick off items in last month's bank reconciliation statement that were outstanding then and appear in the bank statement.
2. Tick off items in the bank statement and cash journals that appear in both places.
3. If you find errors, inform the bank of their error (if they are responsible) or correct the relevant cash journal (if the company is responsible).
4. Go through the bank statements and enter the unticked amounts into the relevant cash journal, and then tick them in the bank statement and cash journals.
5. Go through the cash journals and enter the unticked amounts (outstanding deposits and outstanding cheques) into the cash balance.
6. Total the cash receipts journal and cash payments journal and post them to the bank ledger account.
7. Write the bank reconciliation statement.

FINANCIAL REPORTING PRINCIPLES, ACCOUNTING STANDARDS, AND AUDITING

Days in inventory	The average number of days inventory is held before being sold.
Debtors turnover	The credit sales volume per dollar of accounts receivable.
Days in debtors	The average number of days the company waits for debts to be paid.
Liquidity ratios	
Current ratio	The financial stability of the company and its ability to cover short-term debts.
Quick ratio	The ability of the company to cover short-term debts without selling inventory.
Interest coverage ratio	The degree to which financial commitments are covered by the company's ability to generate profit.
Financial structure ratios	
Debt-to-equity ratio	The proportion of borrowing to owner's investment (the company policy on financing of assets).
Debt-to-assets ratio	The proportion of borrowing to owner's investment (the company policy on financing of assets).
Leverage ratio	The proportion of borrowing to owner's investment (the company policy on financing of assets).
Cash flow sufficiency ratios	
Cash flow adequacy	Ability to generate cash to cover primary cash requirements.
Long-term debt payment	Adequacy measure for contractual payments.
Dividend payout	Payout ratio measure for discretionary distributions.
Reinvestment	Outlay ratio measure for discretionary investments.
Debt coverage	Coverage – used as payback – how many years, at current flows, it will take to retire debt
Depreciation – amortisation impact	Ratio of non-cash items to cash from operations.
Cash flow efficiency ratios	
Cash flow to sales	Ratio of sales dollar realised as cash from operations.
Operations index	Measures cash-generating productivity of continuing operations.
Cash flow return on assets	Measures return on assets on cash generation basis.

INTERNAL CONTROL

There are three objectives to internal control:

- Effectiveness and efficiency in operations relating to the entity's business objectives.
- Reliability of internal and external financial and non-financial reporting.
- Compliance with relevant laws and regulations.

For these objectives to be reached, it is required that management and the board of directors have reasonable assurance that:

- They understand the extent to which the organisation's objectives are being achieved.
- Financial statements are being prepared reliably.
- There is compliance with relevant laws and regulations.

There are five concepts underpinning internal control:

Revaluation increment (increase):

DR Land 1 000 000

CR Revaluation surplus 1 000 000

Revaluation decrement (decrease):

DR Loss on devaluation of land 1 000 000

CR Land 1 000 000

MANAGEMENT ACCOUNTING

Management accounting is accounting done by an organisation's management to assist the organisation.

The objective of management accounting is to help managers increase stakeholder value.

Management accounting is more flexible than financial accounting as it is not subject to generally accepted accounting principles, and generally focuses on relevance, timeliness, and comparability over faithful representation, understandability, or verifiability.

Two basic strategic models exist for managers: cost leadership (competing in a market by having a lower price than competitors, often used by organisations with high sales turnover and high level of economic scale) and product differentiation (competing in a market by differentiating their product from competitors, by brand image, quality or innovation, or additional services provided).

Definitions of cost:

- Cost is the cash or cash equivalent sacrificed for goods and services. Costs expire when they are used up in the production of revenues.
- Expenses are expired costs.
- Assets are non-expired costs.
- The opportunity cost of an action is the value of the next best alternative sacrificed to perform that action.
- A differential cost is the difference in cost between two or more alternatives.
- A sunk cost is a cost that cannot be retrieved.
- Controllable costs are costs a manager has influence over.
- Non-controllable costs are costs a manager has no significant influence over.
- A cost object is an item or activity to which costs are assigned.
- Direct costs are costs associated with a single cost object.
- Indirect costs are costs common to several cost objects, which are difficult to associate with any particular one.
- Period costs are costs expensed in the period in which they are incurred (including all selling and administrative costs and some manufacturing costs).
- Product costs are costs expensed in a different period to the one in which they were incurred (including most manufacturing costs).
- The unit product cost is the product cost of producing one unit of a product.
- The comprehensive unit cost is the product and period costs of producing one unit of a product.
- Prime costs are the sum of all direct costs.