

ACCT10002

INTRODUCTORY FINANCIAL ACCOUNTING

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L1 - INTRODUCTION TO FINANCIAL REPORTING

Financial Reporting provides **financial information** about an entity that is useful to lenders, investors and creditors in **making decisions** about providing resources or interacting with the entity.

GPFR exists to provide information to a wide range of external users who cannot access internal information themselves.

Qualitative Characteristics of Relevance and Faithful Representation ensure that the reports contain useful information

Accounting Principles such as the monetary, entity, reporting period, going concern and cost and full disclosure principles also help to ensure information is useful.

Different types of entities have different reporting and disclosure requirements

- The **Conceptual Framework** acts as a guide to GPFR preparers.
- **Reporting Entities** are entities where it is reasonable to expect the existence of users dependent on GPFR for information. **Reporting entities must prepare GPFR.** Non-reporting entities have reduced reporting obligations.
- Reporting Entities will be classified as **Tier 1 or Tier 2** depending on the existence of public accountability, which will determine how they need to prepare their GPFR.
- **Disclosing Entities** are generally listed companies and are under Tier 1, along with stricter reporting requirements.

Small Private Companies may have reduced disclosure requirements if they are not publicly accountable. If they are not a reporting entity they may not need to produce GPFR.

Large Public Companies have over \$12.5m worth of assets, over \$25m gross operating revenue and/or more than 50 EFT employees, and therefore are more likely to be reporting entities and have public accountability.

Public Companies are non-private companies and may be disclosing entities if they are listed.

There are many regulators who monitor the reporting responsibilities in Australia

- **Financial Reporting Council** – oversee financial reporting
- **AASB** – develops conceptual framework and constructs accounting standards
- **ASX** – allows share trading
- **ASIC** – administers *Corporations Act 2001*
- **APESB** – Code of ethics for professional bodies

Ratio Analysis includes ROA, PM, WC and DR

-FINANCIAL REPORTING-

The **objective of financial reporting** is to provide **financial information about the entity** that is useful to existing and potential investors, ledgers and other creditors, in **making decisions** about providing resources to the entity, such as buying selling or holding equity/debt and providing or settling loans/credit.

-GENERAL PURPOSE FINANCIAL REPORTING (GPFR)-

GPFR exists to provide investors and lenders with general financial information because they cannot access internal information themselves. They are prepared by reporting entities which therefore means they are general in nature since they need to service the needs of a wide range of users. This fulfills a **stewardship** function as managers can prove to owners, who they act on behalf of, that they are managing resources well. GPFR are based on **estimates, judgements and choices** as reflected in the Conceptual Framework.

-THE CONCEPTUAL FRAMEWORK-

The **Conceptual Framework** consists of a set of concepts to be followed by preparers of financial statements and standard setters. The Conceptual Framework provides guidance to preparers of financial information by defining who is required to report and who the users are likely to be.

The **objective of GPFR** is to provide information to potential and existing investors, lenders and other creditors, therefore the conceptual framework needs to allow this provision of information to occur by ensuring the required information is communicated.

Reporting Entity – Entities where users exist that may depend on financial information and are therefore required to prepare GPFR to meet the information needs of users.

Qualitative Characteristics – aspect relating to the usefulness of the information presented.

Elements of financial statement – assets, liabilities, equity, revenues, expenses

-ACCOUNTING ELEMENTS-

-ASSETS-

Resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity (p. 4.4a)

- **Control** – is not exclusive to ownership
- **Past event** – resources to be purchased in the future are not yet assets.
- **Provide economic benefits** – contribute directly or indirectly to future cash flows or cash equivalents

RECOGNITION OF ASSETS – the process of incorporating assets into the financial statements

- **Probable** inflow of future economic benefits to the entity
- **Reliable measurement** of a cost of value can be allocated, including a reliable estimate.

-LIABILITIES-

A present obligation 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. (p 4.4b)

- **Present Obligation** – we must be obliged at this point in time
- **Past event** – liabilities do not include future obligations, such as wages for work not completed
- **Outflow of Economic Benefits** – will contribute directly or indirectly to future cash outflows

RECOGNITION OF LIABILITIES – the process of incorporating liabilities into the financial statements

- **Probable** outflow of future economic benefits from the settlement of the present obligation
- **Reliable measurement** of the amount of the settlement, including a reliable estimate

-EQUITIES-

The residual interest in the assets of the entity after deducting all its liabilities.

-INCOME-

Inflows of economic benefits, or reductions in outflows of economic benefits, that result in increases in assets, or decreases in liabilities that increases equity, other than those relating to contributions from equity providers.

-EXPENSES-

Outflows of economic benefits, or reductions in inflows of economic benefits, that result in decreases in assets, or increases in liabilities, other than those relating to distributions to equity providers.

-QUALITATIVE CHARACTERISTICS, CONCEPTS AND PRINCIPLES-

Qualitative Characteristics ensure that the information in GPFR is useful so users can make the best decisions based off it. Together these characteristics and principles are called GAAP.

Fundamental Qualitative Characteristics: allow information to be useful and fulfil the purpose of GPFR

- **Relevance** – Information must be capable of making a difference in decision making of users (materiality). It should have predictive value so users can use it to make decision about future activities.
- **Faithful Representation** – Information should be complete, neutral and free from error and should comply with the definitions and recognition criteria in the conceptual framework.

Different users may prefer either relevant or faithful information depending on their information needs.

Enhancing Qualitative Characteristics:

- **Comparability** – should be comparable across periods or with other entities
- **Understandability** – users with reasonable accounting knowledge should be able to comprehend
- **Verifiability** – backed up by evidence
- **Timeliness** – must be available in time to be useful for decision making

Other Qualitative Issues

- **Cost versus Benefit** – information should provide more benefits over the cost incurred to produce it

-Concepts and Principles-

- **Monetary Principle** – items included must be able to be expressed in monetary terms (\$)
- **Entity** – The owner and the business are separate entities and their transactions should be separate. All entities should be able to be identified and accounted for
- **Reporting Period** – We split the life of a business into artificial periods which allow us to prepare reports to track performance and progress
- **Going Concern** – the business' life is assumed to be indefinite
- **Cost Principle** – All assets are *initially* recorded at their historical/purchase price or cost. We can deviate from the cost principle to provide useful information (revaluation)
- **Full Disclosure** – All events that could make a difference to decisions made based on the reports should be *disclosed* in the financial statements, either in the reports or in the notes.

-FINANCIAL STATEMENTS-

AASB 101: Presentation of Financial Statements

The objective is to set the basis for presentation of GPFR to ensure comparability with other periods and other businesses, and allow the information to be useful for a wide range of users.

- how financial statements should be structured to optimise understandability
- the minimum requirements for their content and mandatory line items
- overriding concepts - going concern, accrual accounting, current and non-current classification

-A COMPLETE SET OF AUDITED GENERAL-PURPOSE FINANCIAL REPORTS CONTAINS: -

Statement of Financial Position

- Assets, Liabilities and Equity at a point in time.
- One must be provided for the previous period if an entity
 - has applied an accounting policy retrospectively
 - has had a retrospective restatement of items in the financial statements
 - has reclassified items in the financial statements (Paragraphs 40A – 40D)

Statement of Profit and Loss and OCI

- Profit and loss including revenues, realised gains, expenses and realised losses
- OCI including unrealised gains and losses.
- This measures the success of a business' operations over a period of time.

Statement of Changes in Equity

- Total Comprehensive Income for a period of time
- Other changes in equity, including changes in Share Capital, Retained Profits and Reserves.

Statement of Cash Flows

- Cash Receipts and Payments for a period of time.

Notes

- summarising significant policies used and choices made
- help shareholders better understand how performance is expressed in the statements

Comparative Information

- information relating to performance across multiple periods (paragraphs 38 and 38A)

Financial statements should be considered along with additional information such as the general economic conditions, political climate, industry trends, information from director's reports and media releases. These external factors may explain factors in the GPFR, such as decreases in sales, price increases, lower profits...

External users are those outside the business who have an interest in knowing about the activities of the entity as

- resource providers (suppliers, landlords, banks)
- recipients of goods/services (customers + other creditors)
- parties performing a review or oversight function (ASIC, ATO, trade unions)

-CURRENT AND NON-CURRENT CLASSIFICATION-

A statement of financial position must split current and non current assets and liabilities, or if not they must disclose the aggregation in the notes. A, L, OE can be reported separately or as a 'Net Asset' layout.

We use the longer of either the '1 year' or 'operating cycle' measure to determine the boundaries for current/non current elements.

-TYPES OF ENTITIES-

Companies are **incorporated bodies** that are regulated by the *Corporations Act 2001* and are owned by shareholders with limited liability.

-PROPRIETARY “PTY” “PTY LTD” (PRIVATE) COMPANIES-

They are classified as large if they exceed 2 or more of the following thresholds, otherwise they are small:

- **Gross assets of \$12m** at the end of the Financial Year
- **Gross Operating Revenue of \$25m** for the Financial Year
- **50 EFT employees** at the end of the Financial Year

<i>REPORTING REQUIREMENTS OF ENTITIES</i>		
	<i>REPORTING ENTITY</i>	<i>TIER OF GPFR</i>
DISCLOSING ENTITY	✓	1 - FULL
PUBLIC COMPANY	✓	1 - FULL
LARGE PRIVATE	✓	1 - if public acc. 2 - if not
SMALL PRIVATE	✗	SPFR

We distinguish small and large private companies because we apply differential reporting since some companies will have more users in need of more comprehensive reports.

Small private companies generally don't have to prepare financial reports unless 5% or more of the shareholders OR ASIC request that a financial report be prepared

Large private companies generally have to prepare reports and have them audited

-PUBLIC COMPANIES-

A public company is any company that is not a proprietary company. It can be listed (“Ltd”) and can issue shares via a prospectus.

-FINANCIAL REPORTING REQUIREMENTS-

We have **differential reporting in Australia, where different classes of entities have different levels of reporting requirements.**

- Information Asymmetry means that some decision makers (managers) have more information than other decision makers (capital providers), therefore differential reporting allows those with information asymmetry to relieve this and provide information to all stakeholders.
- This allows insider trading to be minimised as insiders and outsiders will have the same information to base decisions on.

Conceptual Framework Statement of Accounting Concepts 1: Reporting Entities

Reporting Entity – Any entity where it is reasonable to expect the existence of users **dependent** on GPFR for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources

Dependent users may exist when there is

- **Separation of management** and/or owners from economic interest and there is information asymmetry
- **Economic of political influence** of the entity, meaning their legitimacy and ethics need to be reported
- **Significant financial characteristics** of an entity (sales, employees, assets, borrowings, customers, employees)

If an entity is a *reporting entity* then it must prepare **GPFR**, abiding by accounting standards.

If an entity is NOT a *reporting entity* then it has significantly lower financial reporting obligations.

AASB 1053: Application of Tiers of Australian Accounting Standards

Tier 1: All Australian Accounting Standards

Applies to *Publicly Accountable* entities

- where there are users who make economic decision but cannot access tailored information
- issue financial instruments in a public market.

Tier 2: All Australian Accounting Standards – Reduced Disclosure Requirements

Same recognition and measurement requirements but reduced disclosure requirements.

-DISCLOSING ENTITIES-

Corporations Act 2001: Disclosing Entities

- have their **securities listed on a licensed market** OR
- have securities issued via a prospectus to more than 100 holders OR
- require a trustee.

Disclosing Entities have the following extra obligations:

- They need to issue half yearly and full year accounting reports
- They must produce a Remuneration Report about their payments to directors
- They have continuous disclosure requirements
“Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity’s securities, **the entity must immediately tell ASX that information.**”

-REGULATORY ACCOUNTING FRAMEWORK-

Financial Reporting Council (FRC) – an advisory and overseeing body that is part of the accounting standard setting process. They oversee the AASB

Australian Accounting Standards Board (AASB) – reports to the FRC. They develop the conceptual framework, construct accounting standards and contribute to developing worldwide accounting standards with the ISAB. They also modify IFRS to suit the Australian accounting requirements (eg. 10% GST)

Australian Accounting Standards Board Interpretation Advisory Panels – panels are formed with AASB members and other experts and these panels pitch recommendations, alternate views and revision for accounting standards to the AASB.

International Accounting Standards Board (IASB) – entity that created IFRStandards.

Australian Securities Exchange – Public company that facilitates sharing trading to allow investors to have a level playing field. They influence disclosure through their listing rules.

Australian Securities & Investments Commission (ASIC) – administers and enforces corporations legislation (directors and companies, financial markets, financial services etc...). Aims to ensure fair and transparent markets. They enforce the *Corporations Act 2001*.

Accounting Professional and Ethical Standards Board (APESB) – independent body that sets ethical standards for the 3 professional accounting bodies (CPAA, CAANZ, IPA)

-ANALYSING FINANCIAL STATEMENTS-

-PROFITABILITY -

Measures the operating success of a company

Return on Assets (ROA) – measures the net profit generated from each dollar invested in assets.

Profit Margin – percentage of each sales dollar that results in profit

$$\text{ROA} = \frac{\text{Net Profit/EBIT}}{\text{Average Total Assets}}$$

$$\text{PM} = \frac{\text{Gross Profit/Net Profit}}{\text{Net Sales}}$$

-LIQUIDITY-

The ability to meet short term obligations and meet unexpected needs for cash

Working Capital – measures short term ability to may obligations and meet unexpected cash needs.

$$\text{Working Capital} = \text{Cur Assets} - \text{Cur Liabilities}$$

-SOLVENCY-

The ability of a company to survive over a long period of time.

Debt Ratio – measures percentage of assets financed by creditors rather than shareholders which indicated the ability of an entity to survive over a long period of time.

$$\text{DR} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

L2 – DOUBLE ENTRY

Transactions are exchanges of items of value between two entities, whereas **Events** are occurrences that don't directly change the financial position but might change how the business operates and performs.

The **Double Entry System** is used to recognise the dual effect of transactions.

The **Recording Process** is

1. Determine the effect on the accounting equation
2. Record in a **Journal**
3. Post the journal to the **General Ledger**

A pre-adjustment **Trial Balance** is created to ensure that Dr = Cr after the journals have been posted to the ledgers so the accounting equation remains true.

Equity is made up of:

- **Retained Earnings** – the retained profit + profit (- loss) – dividend distributions
 - **Reserves** are retained profits held for a particular purpose, not for distribution
- **Share Capital** – the investment from shareholders.

-TRANSACTIONS AND EVENTS-

Transactions – External exchanges of something of value between two or more entities that change the financial position of the business.

Events – activities undertaken by the business that change how it performs but doesn't directly change the financial position of the entity, such as hiring employees or changing the mark up.

-DOUBLE ENTRY SYSTEM-

Double Entry System – System that recognised the dual effect of transactions by recording each transaction in at least 2 accounts and total debits must equal total credits, resulting in a balanced accounting equation.

T-ACCOUNT FORM

DR	CR
10 000	4000
5 000	900

RUNNING BALANCE ACCOUNT FORM

DR	CR	BALANCE
10 000		10 000
	4000	6 000
	900	5 100
5 000		10 100

A	R
D	OE
E	L

$$\mathbf{A = L + E}$$

-RECORDING PROCESS-

1. DETERMINE THE EFFECT OF THE TRANSACTION ON THE ACCOUNTING EQUATION
2. ENTER TRANSACTION INFORMATION INTO A JOURNAL

Journals are chronological records of all transactions. The general journal means the entire effect of a transaction is recorded in one place which helps to compare Dr and CR entries to detect and eliminate errors.

3. POST JOURNAL INFORMATION TO ACCOUNTS IN THE GENERAL LEDGER

The **General Ledger** contains all the asset, liability and equity accounts. It accumulates all of the information about changes in specific account balances to allow specific elements of the business to be analysed.

Posting is the process of transferring journal entries to ledger accounts

-TRIAL BALANCE-

A **Trial Balance** is a list of all the accounts and their balances at a given time, listed in order as they appear in the general ledger. It is used to ensure that debits and credits equal after posting from the journals. Financial statements are created based upon the values in the post-adjustment trial balance.

Business Pty Ltd Trial Balance as at 31 Oct 2018			A	R
No.	Account Title	Debit	D	O
			E	L
100	Cash	15 200		
110	Advertising Supplies	2 500		
112	Prepaid Advertising	600		
130	Office Equipment	5 000		
200	Accounts Payable			2 500
213	Accrued Revenue			1 200
230	Bank Loans			5 000
300	Share Capital			10 000
320	Dividends	500		
400	Service Revenue			1 000
500	Salaries Expense	4 000		
510	Rent Expense	900		
		28 700		28 700

The trial balance doesn't detect these errors

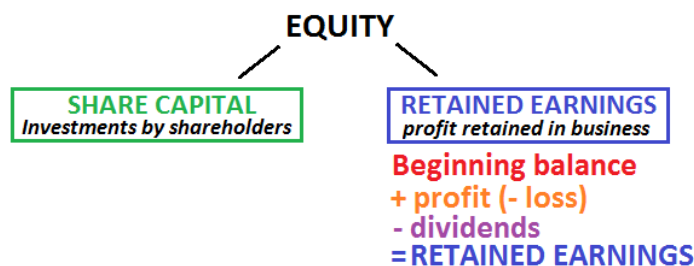
- Transaction wasn't recorded
- Transaction wasn't posted
- Journal entry posted to ledgers twice
- Incorrect amount debited and credited
- Incorrect accounts titles recorded
- Dr and Cr are reversed
- Two errors that have cancelled each other out

The numbers used here are the codes used in the **Chart of Accounts** which is a list of all the ledger accounts in order according to their type.

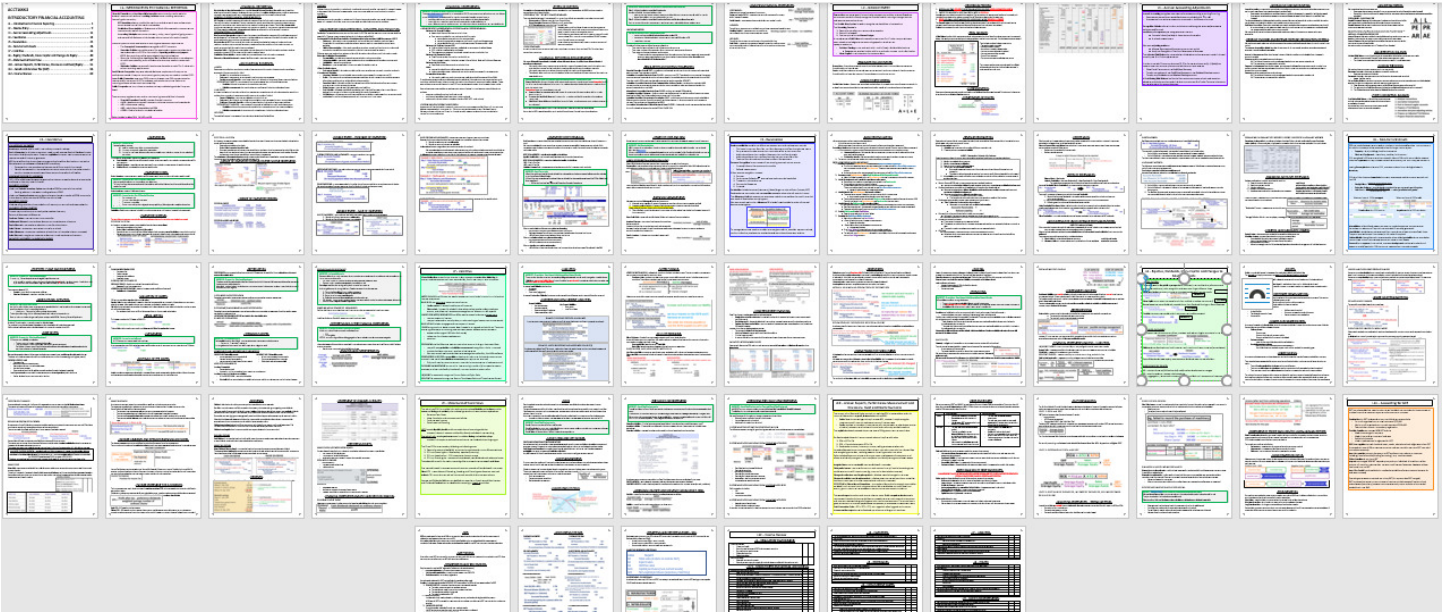
-CLOSING ENTRIES-

Revenue and expense accounts need to be closed to the **Profit and Loss Summary Account**. The balance of this account is transferred to the **Retained Earnings** account.

-COMPONENTS OF EQUITY-



Preview of the entire document



It is 62 pages with the narrow margins used, however it would be 82 pages if the regular margin size was used.