ACCOUNTING FOR BUSINESS DECISIONS B STUDY NOTES

LECTURE 1 – NON-CURRENT ASSETS

- Asset → a resource controlled by an entity as a result of past events and from which future economic benefits are expected to arise – have to control it and have some ownership
- Non-current asset → used in normal course of operations for more than one year and not intended for resale
- On balance sheet

RECORDING NON-CURRENT ASSETS

- Should be recorded at the cost of acquiring them → not an easy number to determine
- Costs include
  - All necessary costs incurrent to be delivered, installed and ready to use
  - Not just purchase price
  - Includes → taxes, delivery costs, postage, installation costs
  - All necessary to bring asset to its intended purpose
- Example
  - 'Non-compulsory insurance' → not included in recorded cost because it is not compulsory – not essential to bring the truck to its intended purpose
  - Costs = 65,000, even though purchase price is 60,000

EXPENSING NON-CURRENT ASSETS

- Converting an asset to an expense → depreciation
- Depreciation NOT about market value → making a NCA to get it to market value
- Depreciation → about the matching principle
  - Want to match expenses with the period which revenues are earned as a result of incurring those expenses
  - Process of spreading cost of a NCA over its useful life → based on USE not market value
  - About equity and being fair → so that profit and loss of each year is what it deserves to be
- Not market value → because you are not selling it on earlier years – that's why costs are spread

RECORDING DEPRECIATION

- Depreciation expense is calculated at the end of an accounting period and recorded with an adjusting journal entry
- General journal entry

  DR Depreciation Expense (expense increasing)

  CR Accumulated Depreciation (contra asset increasing)
- Accumulated depreciation = contra asset account → accumulating balance is subtracted from the asset account to yield the carry amount of the non-current asset – carrying amount gets lower over time

WHERE IS DEPRECIATION REPORTED?

- Depreciation expense → Statement of comprehensive income (profit and loss statement)
- Accumulated depreciation → balance sheet

CALCULATING DEPRECATION EXPENSE

- Must calculate depreciation each period
- Needs the following information
  - Cost
  - Residual value / salvage value
  - Useful life
  - Depreciation method
- Three methods to calculate depreciation
  - Straight line method
  - Reducing balance method
  - Units of activity method
  - Pick the method that marries the way you are going to use the NCA

STRAIGHT LINE DEPRECIATION

- Spreads depreciation evenly over the life of an asset
- Depreciable cost → Divided by the useful life of the asset (in years) to yield the amount of depreciation per expense period
- Difference between straight line and depreciation method → the carrying value
- If asset is not used evenly throughout different years → do NOT use straight line depreciation method – not very accurate
- Formula
    - Depreciation Expense = $\frac{\text{Cost – Residual Value}}{\text{Useful Life}}$

CARRYING AMOUNT

- Carrying amount = cost – accumulated depreciation

REDUCING BALANCE DEPRECIATION

- Aka two-time straight line method
- Results in more depreciation earlier in an assets life and less later
- Accelerated method that results in more depreciation expense in early years of an assets life and less depreciation expense in the later years
- As assets depreciate more and more, carrying amount gets less and less
- Formula
    - Depreciation expense 2 x (1/useful life) x carrying amount

UNITS-OF-ACTIVITY METHOD

- Calculates depreciation based on use
- Limited to assets where units of activity can be measured
- The more used → the more depreciation
- Formula
    - Depreciation expense per unit = (Cost – Salvage Value) / Useful life in units
    - Depreciation expense = depreciation expense per unit x actual units of activity

ADJUSTMENTS FOR USEFUL LIFE

- Adjustments are needed when
    - Estimates change
    - Additional expenses
    - Significant declines in realisable value → new assets / technology

EXPENDITURES AFTER ACQUISITION

- Capital expenditure
    - Increases expected useful life or productivity of the asset
    - Does not only improve current condition but it must be beyond what it was when it was acquired
    - Beyond what it had when you started
    - Increases asset value
- Revenue expenditure
    - Maintains the useful life of the asset
    - Increases expense amount
    - Doesn’t add to the asset value of the car

ASSET IMPAIRMENT

- Conservatism → must devalue/impair your asset to an amount lower than it is on paper
- Impairment → expense that lowers the value of a non-current asset

DISPOSALS

- Update depreciation at time of sale
- Calculate fain or loss
- Record disposal

PROFITABILITY

- Critical for long term survival
- Total comprehensive income → tells little about the efficiency and effectiveness of profits
  - Efficiency → how much money did you invest to make that profit?
  - Need to know how that profit was made and how efficiently they made the profit
- Large profits are not necessarily successful
  - Compare to previous performance
  - Compare to competitors
- Who uses profitability ratios
  - Creditors → want to make sure you pay back loans on time
  - Shareholders → investing in a business means you want the business to grow
  - Managers → evaluate their own performance based on profitability ratios
- First four ratios → net profit divided by something – name gives it away in a lot of cases

PROFIT MARGIN RATIO

- Formula
  - Profit Margin = $\frac{\text{Net Profit}}{\text{Net Sales}}$
- Compares net income to net sales and measures the ability of a company to generate profit from its sales
- Higher ratio → greater ability to generate profits from sales
- Can still be a successful business with a low profit margin
  - Apple → high profit margin
    - Differentiate their products
    - Sell similar products higher than other companies
  - Coles / Woolies → low profit margins
    - Low prices to attract lots of customers
    - High turnovers

RETURN ON EQUITY

- Formula
  - Return on Equity = $\frac{\text{Total Comprehensive Income}}{\text{Average Shareholder's Equity}}$
  - Average Shareholder's Equity = $\frac{\text{Beginning Equity + Ending Equity}}{2}$
- Compares profits to the average balance in shareholder's equity, showing how effectively a company uses funds provided by shareholders during the year to generate additional equity for its owners
- Australian companies ROE averages 8% – 10%
- High return on equity = good
  - Except in certain circumstances → if indicates you've taken on a lot of risk
- Borrowing money can increase return on equity → also increases risk
- As you borrow more money → leverage / gearing – increases chance of losses
- High ROE good but does not capture risk taken by the company
- Compares what you actually earned to what you invested into the business

RETURN ON ASSETS

- Formula
  - Return on Assets = $\frac{\text{Net Profit}}{\text{Average Total Assets}}$
  - Average Assets = $\frac{\text{Beginning Assets + Ending Assets}}{2}$
- Similar to return on equity → compares income to average total assets
- Represents ability to generate profits from its entire resource base → not just those provided by its owners
- Look at how many assets have been purchased by the business to make a profit
- Borrowing money influences the return on equity, return on assets number is consistent based on amount you've purchased
- Difference between ROE and ROA
  - ROE → can be bias if you've borrowed lots of money