[ACCT1501]

Comprehensive Notes

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1. INTRODUCTION TO FINANCIAL ACCOUNTING

1.1 WHAT IS FINANCIAL ACCOUNTING?

Accounting: Is the process of *identifying, measuring, recording* and *communicating* economic information to assist users to make decisions

Some definitions:

- **Financial Performance:** is the generation of new resources from day-to-day operations over a period of time
- **Financial position:** is the enterprise's set of financial resources and obligations at a point in time
- **Financial statements:** are reports describing financial performance and position
- **Notes:** are part of a statement, adding explanations to the numbers

Financial accounting (wk. 1-10)	Managerial Accounting (wk. 11-12)
Financial accounting: focuses on the provision of information to users ***external*** to the enterprise. The focus is on **financial position** and **financial performance** - Externally focused - Aimed at investors, creditors, suppliers and customers - Must follow AASB reporting standards (GAAP)	**Management accounting:** focuses on the provision of information to users ***within*** the enterprise (to aid in operational planning and control decisions). - Internally focused - Aimed at managers throughout the organizations - No reporting standards

1.2 WHO USES FINANCIAL ACCOUNTING INFORMATION

Financial accounting is mainly used by:

Party	Reason for use
Stock market investors (market analysts)	Help decide whether to buy, sell or hold shares

Banks and other lenders/creditors	To decide whether or not to loan The likelihood of a company meeting its interest payment on time (and assets the company owns which can be seized and sold to pay loans)
Managers	Providing basic financial records for purposes of day-day management, control, insurance and fraud prevention (for analysis and evaluation of company performance)
Government bodies (such as the Australian Tax Office)	To monitor the actions of enterprises and assess things such as payable tax
Trade unions and employees	Profitability of the company and how it relates to employee pay and treatment. Important in wage negotiations. (also an analysis of job security)
Competing companies	To analyze the actions of a company in relation to their own
Potential partners	Other organizations such as suppliers may want to analyze financial statements to better understand a company before signing contracts to work together.
Any other party	It is important to remember that financial statements can be accessed by *anyone* and can be used in any means imaginable. Consider also journalists.

Note: Financial statements are used in junction with other documents such as **sustainability reports**

1.3 THE PEOPLE INVOLVED IN FINANCIAL ACCOUNTING

A user's main demand is for **credible** and **periodic** financial reports:

- **Credible:** demands information that is trustworthy
- **Periodic** demands high frequency releases of financial reports (quarterly, yearly etc.)

The two main groups responsible for preparing financial statements are:

- **Managers:** are responsible for running the enterprise thus also includes issuing accounting and other information
- **Accountants:** create financial statements by applying the principles of accounting to the enterprise's records under the direction of management.

As the information produced is also required third party may also be brought in; **Auditors** (credibility enhancers). Auditors have the task of verifying that financial statements have been prepared properly and in accordance with **accounting principles.**

Auditors may be internal (to enhance credibility) or external. Note that external auditors may not have any affiliation i.e. not be part of the board of directors, not own any shares such that they are completely independent from the company.

1.4 ACCRURAL ACCOUNTING

Accrual accounting: making an economically meaningful and comprehensive measurement of *performance* and *position* by recognising economic events (such as credit transactions) **regardless of when cash transactions happen**

Accrual Accounting: includes the impact of **transactions as the occur** rather than when cash is received
Cash Accounting: only accounts for the revenue and expenses when cash is paid or received

Example: A company makes cash sales of $10,000 and credit sales of $20,000 (all to be collected in July. Compare the monthly financial statements of the company under cash accounting and accrual accounting.

	June	July
Cash Accounting	$10,000	$30,000
Accrual Accounting	$30,000	$30,000

When using accrual accounting to prepare financial statements attempts are made to:

- Include all cash receipts and payments (everything under cash accounting)
- Future cash receipts and payments that should be expected based on existing transactions (such as credit transactions which will not be received until a later date)
- Measure of value of incomplete transactions
- Estimate figures when exact amounts are unknown
- Make economically meaningful assessment of awkward problems

1.5 THE KEY FINANCIAL STATEMENTS

Organizations are required to provide the following types of information:

- **Balance Sheet:** Showing the financial **position**
- **Income statement:** Showing the financial **performance**
- **Statement of cash flow:** shows the sources and uses of cash during the period

These will be explored in further weeks.

BALANCE SHEETS

A **Balance Sheet** will show an organization's resources and claims on resources (under accrual accounting) at a particular point in time.

The three main elements of a balance sheet are:

- **Assets:** What the organization owns
  - Cash at bank

- Accounts receivable – amount owed by customers
- Inventory
- Property, plant and equipment – real estate, machinery etc.

- **Liabilities:** What the organization owes others
  - Accounts payable – amounts owed to suppliers
  - Wages payable – amounts owed to employees
  - Provisions for employee entitlements
  - Other provisions – e.g. returns
  - Long-term loans
- **Shareholders' equity:** The difference between assets and liabilities
  - Share capital
  - Retained profits

Assets = Liabilities + Shareholders' equity

Comparative Balance Sheets: Balance sheets typically have data represented for 2 or more years to show the changes in assets, liabilities or shareholder's equity.

Note: **Consolidated Financial Statement:** Financial statements that factor the holding company's **subsidiaries** (company controlled by the parent company)

Retained Profits: Profits that will be put back into the business

INCOME STATEMENTS (AKA PROFIT AND LOSS STATEMENT)

The **income statement** a company's financial performance/profitability over a specific accounting period. Broadly speaking it covers:

- **Revenue:** increases in the firm's wealth arising from provision of goods and services to customers
- **Expenses:** decreases in the company's wealth due to costs
- **Profit:** The *net flow* of wealth the the company during the period
  Revenue > Expenses = net profit
  Revenue < Expenses = net loss

Note: revenues and expenses are recognized when an economically meaningful event occurs i.e. **accrual accounting** not cash accounting

Cost of goods sold: The cost of the good sold, takes into consideration the costs involved in purchasing/producing supplies.

Gross profit vs Net Profit:

- **Gross Profit:** Total revenue – cost of goods (amount it cost the company to produce the good or service; COGS)
- **Net Profit:** Gross profit – Other expenses

Revenue = Revenue + Expenses

STATEMENT OF CASH FLOW

Statement of cash flows provides details of a firm's **cash balance** *over a specific period of time.*

Cash flows are categorized as:

1. **Operating activities:** related to provision of gods and services
2. **Investing activities:** related to the acquisition of long term assets including property, plant and equipment
3. **Financing activities:** related to equity capital and borrowing

1.6 RELATIONSHIP BETWEEN FINANCIAL STATEMENTS

Within the overall balance sheet (see above) the differences in 'Cash' can be seen by analyzing the cash flow statements and the Income statements can be used to calculate the net profit, which is used to calculate the final retained profits.
(See Exhibit 1.4 P.17)

Income statements will shown changes in retained profits

1.7 DEMANDS ON THE QUALITY OF FINANCIAL ACCOUNTING

Fundamental qualitative characteristics:

- Relevance (related to the information presented and the frequency in which it Is published)
- Faithful representation (credibility)

Enhancing qualitative characteristics:

- Comparability
- Verifiability
- Timeliness
- Understandability

1.7 FINANCIAL STATEMENT ASSUMPTIONS

1. **Accrual basis:** Revenues and expenses are recognized at the time the occur rather than when cash is received or paid

2. **Accounting entity:** Activities of the entity are separate from those of its owners/members e.g. a company is separate from its shareholders, the owner has *limited liability*

3. **Accounting period:** The life of a business is divided into **discrete time periods of equal length** to evaluate performance for that period. → look at dates when analyzing financial statements
   Similar accounting period is easier to compare, and improved consistency

4. **Monetary:** Measured by a common denominator i.e. common currency e.g. the Australian Dollar (AUD) → makes sure the values are relevant and ignores fluctuations in Australian value
   Note: This assumes the value of the dollar is constant over time, i.e. ignores inflation

5. **Historical Cost:** Transactions are initially recorded at their original value.
   Treats assets in terms of their use rather than for resale. Some assets can be revalued periodically
   An item may depreciate in value and this may affect its value in any way and is left to judgment

6. **Going Concern:** Assumes continued operation of accounting entity into foreseeable future
   No intention or need to liquidate
   produces demand for financial information during life of entity
   e.g. Liquidation value may be less if the business has going concern:
   note: Liquidation value (price for being sold within 24 hours) is less than the usage value

7. **Materiality:** Including what is important? E.g. do not count small transactions which will not make an impact (do not report a $10 purchase in a multi-million dollar firm)
   → usually auditors make these decision

2. MEASURING AND EVALUATING FINANCIAL POSITION AND FINANCIAL PERFORMANCE

2.1 INTRODUCTION TO THE BALANCE SHEET

Balance Sheet:

- Shows the **financial position** of an enterprise **at a particular point in time.**
  - What are the entity's resources and how they are financed?

IFRS: International **F**inancial **R**eporting **S**tandards

Aspects of a balance sheet:

- Title, date and currency
- Assets
- Liabilities
- Owner's Equity

Assets: Useful Financial Resources	Liabilities: Obligations to be paid ---------- Equity: Owner's investment

Assets: Useful Financial Resources
Liabilities: Obligations to be paid Equity: Owner's investment

2.2 EXPLANATIONS OF THE THREE BALANCE SHEET CATEGORIES: ASSETS, LIABILITIES AND EQUITY

Note: Current is used to describe an asset or liability executable within a yr.

ASSETS

Assets are resources controlled by the entity as a result of past events from which future economic benefits are expected. Assets need to satisfy three essential characteristics:

1) **Future economic benefit:** the assets are used to provide goods/services for exchange, with the objective of generating net cash flow
2) **Control by the entity:** The capacity of the entity to benefit from the asset in pursuing its objectives and to deny or regulate the access of others.
3) **Occurrence of past transaction or other past event:** means that the transaction or event must have occurred whereby the entity gains control over the future economic benefits of the asset

Note under this condition an 'employee' may not be considered an asset as the company does not have control over them

An asset can only be recognized on a balance sheet when:

a) It is probable that future economic benefits will occur
b) The asset possesses a cost or value that can be accurately measured

Note things such as market research has value but cannot be accurately measured (or even provide future benefits) cannot be listed in a balance sheet

Examples of assets include: Cash, accounts receivable, inventory, land and equipment

LIABILITIES

Liabilities are present obligations of the entity arising from past events, the result of which are expected to result in an outflow of economic benefits (can be paid in cash or with goods/supplies). There are two essential characteristics:

1) **A present obligation which involves settlement in the future:** via the sacrifice of future economic benefits
   - Usually legally enforceable
   - Imposed on the entity
   - Normal business transactions, custom or to maintain goodwill with customers/partners (e.g. non-compulsory maintenance/refunds)
2) **Adverse financial consequences:** The entity is obliged to sacrifice economic benefits to one or more entities

A liability is recognized on a balance sheet for the same reasons as an asset (see above)

Examples of liabilities include: Bank overdrafts, accounts payable and loans

Notes:

- A long term loan such as a mortgage that is paid in intervals can be split into current and non-current
  e.g. a $120,000 mortgage can list $20,000 under current and $100,000 under non-current
- The entity must have received the benefit for a liability to be listed
  e.g. an agreement to borrow before cash is received is not counted as a liability

EQUITY

Equity is the owner's interest in the enterprise:

- It can be derived from direct contributions of owners/shareholders
- It can be derived from retained profits (profits of the organizations not paid out as dividends)

As equity can be defined using the accounting equation as: E = A – L, the equity of the balance sheet is sometimes referred to as the **book value of the enterprise**.

This is an unreliable concept as it does not always show the market value of a company (recall going concern), as a business's value is derived from its performance, and potential for economic benefit, not just its current position

e.g. many tech companies invest heavily in their employees and/or knowledge base (intellectual property) which are not listed under assets and hence do not reflect in their company equity, yet are invaluable.

Note: *it is possible for shareholder's equity to be negative*, indicating that liabilities are greater than assets

Example of shareholder's equity are: share capital, retained profits

2.3 SOME PRELIMINARY ANALYSIS OF THE SOUND AND LIGHT BALANCE SHEET

Things to look at when analyzing a financial report:

- **How are they financed?** Consider the debt/equity ratio (L/E)
  Preferable if equity>liabilities
- **Ability to pay bills on time** Consider the liquidity of assets i.e. 'quick assets' would be things such as cash or accounts receivable, while inventory usually have low liquidity
  Consider the quick ratio (high liquidity assets/current liabilities)
- Current assets-current liabilities = **working capital**
  Note: All of these ratios are simply indicators and require more in depth analysis

- Equipment and depreciation:
  In calculating profit, accumulated depreciation counts as an expense
  Net book value of an equipment = cost of equipment – accumulated depreciation
  Accumulated depreciation is a negative asset
  This is an indicator of the useful life of the asset i.e. if is listed as half of its original value, then it is at roughly half cycle left.

2.4 A CLOSER LOOK AT THE BALANCE SHEET

COMPARATIVE BALANCE SHEETS

- Contains 2 or more periods to help users analyze changes
- By convention, the more recent accounting period is displayed on the left (closer to the writing)

NOTE: Many omissions and details are left to the 'notes' section, so always analyze these sections

ASSSETS - EXAMPLES

- **Cash and cash equivalent**
- **Investments:** are short term (current assets) which are intended to be converted into cash within the year
- **Prepayments:** are prepaid expenses that have been paid for, for which the benefits have not been received
- **Inventory:** Physical stock of goods
- **Property, plant and equipment:** real estate, equipment, machinery etc.
  Note: if (net) follows, then depreciation/appreciation has been taken into account
- **Accounts Receivable:** Money owed by customers
- **Intangible Assets:** are noncurrent assets that have no physical form such as copyrights, patents, trademarks, brand names and goodwill's.

LIABILITIES - EXAMPLES

- **Accounts payable**: amounts owed to suppliers
- **Wages payable:** amounts owed to employees
- **Provisions for employee entitlements:** Such as holiday leaves
- **Other provisions**: such as returns
- **Long-term loans**
- **Accrued expenses:** Expenses that have been incurred throughout the year but have not been paid at the time of the financial report
  e.g. electricity bills paid annually, report must account of cost of electricity up to the date of publication (can be current or non-current)

SHAREHOLDER'S EQUITY - EXAMPLES

- **Share Capital:** Money invested by shareholders
- **Retained Profits:** Profits invested back into the company (not paid to shareholders as dividends)

WHERE DO THE FIGURES COME FROM?

Accounting is generally a historical measurement system

- **Assets** are valued at the price they had when they were initially acquired
- **Liabilities** are valued at what was promised the time the obligations arose

In Australia certain assets may be revalued to market price

→ Deferred tax liabilities: estimates the amount of income tax to be paid in the next financial year

2.5 MAINTAINING THE ACCOUNTING EQUATION

Assets = Liabilities + Shareholder's equity

$$A_t = L_t + [SC_t + (RP_{t-1} + R + E - D)]$$

A_t = Assets
L_t = Liabilities
SC_t = Shareholder's Capital
RP_{t-1} = Retained Profits from previous period
R = Revenue
E = Expense
D = Dividends

Double entry system: Where accounting equation is always kept in balance

Assets	Liabilities + Equity
^Increase in assets	^Increase on L/E
^Increase in assets, v Decrease in assets	
	^Increase in L/E, v decrease in L/E

2.6 MANAGERS AND THE BALANCE SHEET

Balance sheets are important because it is what external users use to judge the company. It shows the company's financial position at a given point in time, providing a picture of the state of an organization.

This however does not show how well the company is performing, this aspect is left to the income statement.

2.7 THE INCOME STATEMENT

Income Statement:

- **Financial performance** of an enterprise **over a period of time** (using accrual accounting)
  - Has the entity used its resources efficiently and effectively?
  - → Sometimes referred to as the **Profit and Loss Statement (P&L)**

The income statement has three parts:

- Revenue
- Expense
- Profit

REVENUES

Revenue: increases in the company's wealth arising from the provision of goods/services. Wealth increases because:

- Customers pay cash for goods/services
- Customers promise to pay cash (accounts receivable)
- Customers pay in other forms such as providing other assets or forgoing debts to the company
- Interest and dividends

Revenue is recognized *if the good/service has been rendered* (as this creates a liability for the other party which can then be considered an increase in company assets i.e. cash or accounts receivable)

EXPENSES

Expenses: Decreases in the company's wealth incurred in order to earn revenue. Wealth decreases because:

- Operating costs
- Customers must be given goods they have paid for
- Long-term assets wear out as they are used to earn revenue (depreciating assets)
- Liabilities are incurred as part of the process

Cost of goods sold: what the enterprise pays to provide/produce the goods.

Hence a transaction with a customer must have two aspects:

1) The enterprise is better off because of the revenue gained
2) The enterprise is worse off because of the cost of the goods that the customers takes away

The sale of an asset is listed as both a source of revenue and an expense. Cash received is revenue (1) while the loss of the asset during the transaction is the expense. (2)

Consider the basic journal entry:
Dr Cash
Cr Revenue

Dr Cost of goods sold
Cr Inventory

The first entry acknowledges revenue and the gain of cash (1)
The second entry acknowledges the expense and the loss of inventory (2)

Note: in the double entry system, when a product is produced, the is an increase in assets (inventory) and increase in liabilities (cost of goods sold). When sold the profit becomes cash (or accounts receivable) and is also listed in shareholder's equity.

Note: Expenses include tax, but do NOT include dividends (see retained profits below)

PROFIT

Profit is the net inflow of wealth that a company incurs within a period. The net profit is the difference between revenue and expenses:

Net Profit = Revenue - Expenses

- **Net profit** if revenue > expenses
- **Net loss** if revenue < expenses

Gross Profit = Revenue – Cost of Goods Sold
Net Profit = Revenue-Expenses

THE RELATIONSHIP OF PROFIT FOR THE PERIOD TO RETAINED PROFITS

The retained profits are the sum of past net profits (measured since the company began), minus dividends declared (even if not yet paid) to owners since the beginning of the company. Hence retained profits are *increased by net profit* in that period and *decreased by dividends* in that period.

Retained profit of the period = Net Profit – Dividends

Or

Retained profit = Retained Profit (beginning of period) + Net Profit (for the period) – Dividends (for the period)

When dividends are declared, the amount is deducted from the retained profits at the time. At that point, the company has a liability to the owners which it pays off by sending owners promised cash. This follows two principles of financial accounting:

1) Transaction with owners in the form of dividends (not an expense)
2) Owners can be creditors too if they are owed dividends, lent the company money or have shares

2.8 CONNECTING BALANCE SHEETS AND INCOME STATEMENTS

An income statement is used to find retained profits, which is then added into the existing account of retained profits on the balance sheet

2.9 A CLOSER LOOK AT THE INCOME STATEMENT

- Income statement covers a period of time (shown at the top of the income statement)
- When calculating retained profits, use profit after tax (net profit)

2.10 CAPITAL MARKETS, MANAGERS AND PERFORMANCE EVALUATION

The profit figures disclosed by an income statement are very important as they impact a manager's salary, promotion, career and reputation:

- Focus is placed on profit, and mostly ignored non-financial performance
- The income statement often shows earnings per share (EPS) hence is directly related stock value…
- Stock value often moves in the direction as the financial statement
- Manager's performance is measured in the income statement

BACKGROUND: SOLE TRADERS, PARTNERSHIPS, COMPANIES AND FINANCING

A2.1 FOUR KINDS OF BUSINESS ORGANIZATIONS

There are two types of equity:

- **Directly contributed equity:** Owners have provided money or other assets to the enterprise
- **Indirectly contributed equity:** Owners allowed profits to remain to help earn profits in the future e.g. retained profits

There are four main kinds of business organizations: Sole trader, Partnership, Company and corporate groups

SOLE TRADER

- A business owned by one person (the proprietor)
- The business and the owner exist as one single entity and are hence indistinguishable
- Owner's equity and retained profits are considered one entity hence the equity section of the balance sheet will show:

<u>Owner's equity</u>
Owner's capital: XXX

PARTNERSHIP

- More than one owner
- Also unincorporated
- All partners are collectively responsible for the company (usually terms are set out privately)
- Similar to sole trader legally, hence:

Owner's equity
Partner's Capital:

Partner A XXX
Partner B XXX
Partner C XXX

Total Capital: XXX

COMPANY

Companies ae legal entities established under corporate law:

- Company's capital is divided into shares, and owners are called shareholders
- Companies are separate entities from their owners, hence limited liability (Ltd.) meaning if it fails, the shareholders only lose the capital invested into the company
- Shares are considered 'personal' assets and can be passed on or sold without any effect on company activity
- Companies may issue debentures or unsecured notes (latter for larger more stable companies)
- Debts may be secured over floating charge or company assets
- Public companies can invite the public to buy shares (listing the company on the stock exchange
- Private companies (Pty Ltd) do not invite the public, and have a maximum of 50 shareholders, and restrictions on the transferability of shares

Forms of share capital:

When shares are first issued, money is received as share capital**,** the share can then be sold and exchanged freely as a private 'asset' and does not affect company activity or accounting

There are two classes of shares:

- **Ordinary shares** where owners are able to vote, the ones who decide who will be on the board of directors that manage the company for the owners and declares dividends to owners
- **Preference shares** where the owners do not vote, but have certain rights such as receiving a fixed dividend, and in some cases preference in asset distribution if the company liquidates
- restrictions on the transferability of shares

Retained Profits:

Profits of the company can be paid to owners in the form of dividends or retained within the company balance sheet (as explored previously)

Owner's equity
Share Capital

Class A Shares	XXX
Class B Shares	XXX
Total issued capital	XXX

Retained Profits	XXX
Total Shareholder's equity:	XXX

IN SUMMATION: THE FOUR BUSINESS ORGANIZATIONS

Kind	Legality	Owner(s)	Equity Concerns
Sole Trader	Not Separate from owner	One proprietor	Capital and retained profits are combined
Partnership	Not Separate from owner	Two or more partners	Capital and retained profits are combined but each partner's total is calculated separately
Company	Separate from owner	Usually several or many shareholders	Legal share capital is disclosed separately from retained profits
Corporate group	Consists of legally separate companies	Usually several or many shareholders	Legal share capital of parent company is disclosed separately from retained profits

A2.2 BUSINESS FINANCING

Current Liabilities:

- Loans from banks due on demand
- Financing provided by suppliers and other trade creditors by allowing Co. to obtain credit for its purchases and pay for them later
- Wages payable
- Provisions for employee benefits (executable within the year)

- Estimates for owing for things such as power, interest charges, legal costs
- Income and other taxes owed
- Dividends owed by the enterprise (declared but not yet paid)
- Short-term portions of longer debts

Non-Current Liabilities

- Mortgages and other debts extended over several years
- Certain long-term liabilities such as special loans, long-term tax, estimates and estimated liabilities/provisions for employee benefits

Owner's Equity:

- For a sole trader: Owner's capital
- For a partnership: Owners' capital
- For a company: Share capital received for each kind of share plus retained profits