Accounting for Business Decisions A

Text(s): ACCT2 Financial, Fundamentals of Business Law, ACCT2 Managerial

Module 1 – Accounting in the world of business

Accounting is the process of identifying, measuring and communicating economic information to permit informed judgement and decisions.

Objective 1 *Examine the four assumptions made when communicating accounting information.*

The ***economic entity assumption*** states that the financial activities of a business can be separated from those of the business owner or owners.

- Allows financial information to be analysed without concern for the personal affairs of said owners
- Activities should be accounted for separately
- E.g. if you own a business and a house, those two things will be accounted for separately
    - Personal assets and liabilities are not included in the firm's accounting information

The ***time period assumption*** states that business owners and other relevant parties will desire periodic measurements of business performance

- Economic information can be meaningfully captured and communicated over short periods of time
    - It's useless to say "a business has a profit of $1000", what time period was it generated in?
- Accountants will thus assume that information can be meaningfully captured in short periods of time, even if they are arbitrarily defined (e.g. every month or quarter)

The ***monetary unit assumption*** states that the dollar is the most effective means to communicate economic activity

- If an activity cannot be expressed in dollar terms, it is not accounted for
- Assumes reasonable stability in terms of inflation and deflation such that a dollar earned in 1996 is assumed to be the same as a dollar earned in 2016

The ***going concern assumption*** assumes that a company will continue to operate into the foreseeable future

- If a firm is going concerns, it's operating and making a profit, otherwise it is in the process of liquidation
- An entity is assumed to be a going concern unless evidence suggests otherwise

Objective 2 *Describe the purpose and structure of an income statement and the terms and principles used to create it.*

The ***purpose of an income statement*** (technically known as a statement of comprehensive income or even a profit and loss statement) is to determine whether or not a company makes money

- It is a statement of revenues and expenses and the resulting net income over a period of time
- Demonstrates the financial success or failure of a company in that period of time

A ***revenue*** is an increase in resources resulting from the sale of goods or the provision of services

- Recorded according to the ***revenue recognition principle***, which states that revenue should be recorded when the resource is actually earned, this occurs when the sale of the good or service is substantially complete and collection is reasonably assured
    - AASB 118 Revenue provides detail on calculating the amount and timing of revenue recognition
    - E.g. If Nathan cleans a car and the client will pay in 6 months' time, the revenue will be recorded now rather than in 6 months
        - Revenue is earned when the obligation to the customer is met

An ***expense*** is a decrease in resources resulting from the sale of goods or provision of services

- Recorded according to the ***matching principle***, stating that expenses should be recorded in the period resources are used to generate revenues
    - E.g. If a lawn mowing business uses fuel to mow lawns in January then that is a January expense
- Not the same as a cost
- We just look at the expenses associated with generating revenue

Important: revenues and expenses are associated with goods and services, e.g. the sale of an asset would not be recognised as a revenue

Once revenues and expenses are calculated, they are reported on an ***income statement***, which will show the total comprehensive income (aka income aka net loss/profit)

$$Total\ comprehensive\ income\ = revenues - expenses$$

The income statement should contain the business' name, the statement name and the time period

Lawn Service
Income statement
for the month ending 31 January

Revenues		$1 120
Expenses:		
Fuel	$80	
Interest	5	
Depreciation	70	
Total expenses		155
Profit		$ 965

Objective 3 *Describe the purpose and structure of a balance sheet and the terms and principles used to create it.*

The ***balance sheet***, otherwise referred to as the ***statement of financial position***, reports a business' assets, liabilities and equity at a specific point in time

- Its ***purpose*** is to show a company's resources and its claims against those resources
- Often referred to as a snapshot of the business

An ***asset*** is an economic resource of a business that is objectively measurable and results from a prior transaction and will provide future economic benefit

- E.g. Cash: it is measurable as it can be counted, it is received through a transaction with someone else and it can be used to buy things in the future
- Can be intangible, e.g. copyright and trademarks
- Recorded according to the ***historical cost principle*** (also known simply as the ***cost principle***), which states that assets should be recorded and reported at the cost paid to acquire them
- However, it's important to note that this is subject to other factors, a lawnmower may have been purchased at $260, but could have required $50 in repairs over a time period, its cost becomes $210 (the costing of equipment will be explored more deeply in chapter 8)

A ***liability*** is an obligation of a business that results from a past transaction and will require the sacrifice of economic resources at some future date

- E.g. salaries payable to employees, taxes payable to governments, accounts payable to employers

Equity is the difference between a company's assets and liabilities, and represents the share of assets that are claimed by the business' owners

- Can be generated in two ways:
    - The first is through issued (also known as ***contributed***) capital, ***issued capital*** is defined as the resources that investors contribute to a business in exchange for an ownership interest
        - E.g. I put $100 into my lawn mowing service, this did not come from providing a service or selling a product but from a contribution of ownership interest
        - Commonly generated through shares
    - The other is through ***profitable operations***, whereby profit can be distributed to the owners or retained within the business
        - ***Dividends*** are paid to owners (they are not considered an expense but instead a distribution of company assets to owners)
        - ***Retained earnings*** are kept within the business and represent the equity generated and retained from profitable operations

$$Assets\ = liabilities + equity$$

Lawn Service
Balance sheet
at 31 January

Cash	$194	
Accounts receivable	120	
Supplies (petrol)	10	
Lawnmower	195	
Petrol can	15	
Total assets		$534
Note payable (to Mum)	$200	
Total liabilities		$200
Contributed capital	$100	
Retained earnings	234	
Total equity		334
Total liabilities and equity		$534

Objective 4 *Describe the purpose and structure of a statement of changes in equity and how it links the income statement and the balance sheet.*

A ***statement of changes in equity*** depicts how equity is growing as a result of profitable operations and how equity is distributed in the form of dividends as well as retained earnings all in a specific period of time.

Basic structure:

Lawn Service Statement of changes in retained earnings for the month ending 31 January	
Retained earnings, 1 January	$ 0
+ Net income (or Net profits)	965
– Drawings (Dividends)	$ 731
Retained earnings, 31 January	$ 234

$$Retained\ earnings\ (beginning\ balance) + net\ profit - dividends = retained\ earnings\ (ending\ balance)$$

The ***changes in retained earnings*** component of the statement of changes in equity links the income statement and the balance sheet

- A business can't calculate its retained earnings at the end of a time period without factoring in the profit earned during that period, the statement of changes in retained earnings provides this link by including a net profit or loss in the calculated of retained earnings, which is then reported on the balance sheet
- This means that an income statement must be prepared first when preparing financial statements, followed by the statement of changes in equity and then the balance sheet

These links are shown below:

Lawn Service	
Income statement	
Revenue	$1 120
– Expenses	155
Net income (or Profit)	$ 965
Statement of changes in equity (retained earnings)	
Retained earnings, 1 January	$ 0
+ Net income	965
– Drawings	731
Retained earnings, 31 January	$ 234
Balance sheet	
Total assets	$ 534
Liabilities	200
Issued (Contributed) capital	100
Retained earnings	234
Total liabilities and equity	$ 534

Objective 5 *Describe the purpose and structure of a cash flow statement and the terms and principles used to create it.*

A ***cash flow statement*** reports a business' cash inflows and outflows from its operating, investing and financing activities, it details the sources and uses of cash in a specific period of time and has the purpose of informing users about how and why cashflow changed during that time period

Financing can come in forms such as borrowing money from creditors and receiving contributions from investors

- E.g. Contributing $100 of your own money to the business
- Debt servicing, dividends etc

Once sufficient capital has been raised from creditors and investors, ***investing*** activities can be conducted through the purchasing and sale of revenue-generating assets

- E.g. Paying $200 for a new lawnmower would be a $200 cash outflow

Operating includes the purchase of supplies, the payment of employees and the sale of products

- E.g. $1000 in sales from mowing lawns and paying $100 for petrol would lead to a total inflow of $900
    - This inflow is not the same as profit!

$$\begin{aligned}&Cash\ flows\ provided\ or\ used\ by\ operating\ activites\\&\qquad + cash\ flows\ provided\ or\ used\ by\ investing\ activities\\&\qquad + cash\ flows\ provided\ or\ used\ by\ financing\ activities = net\ change\ in\ cash\end{aligned}$$

Example cash flow statement (Note that outflows are in brackets):

Lawn services
Cash flow statement
for the month ending 31 January

Operating activities		
Cash received from customers	$1000	
Cash paid for petrol	(90)	
Cash paid for interest	(5)	
Net cash provided by operating activities		$905
Investing activities		
Cash paid for lawnmower	$(260)	
Cash paid for petrol can	(20)	
Net cash used by investing activities		(280)
Financing activities		
Cash received from borrowing	$ 200	
Cash received from owner	100	
Drawings (dividend)	(731)	
Net cash used by financing activities		(431)
Net increase in cash		$194
Cash balance, 1 January		0
Cash balance, 31 January		$194

Objective 6 *Question the qualitative characteristics that make accounting information useful.*

Understandability refers to the ability of accounting information to be comprehensible to those who have a 'reasonable understanding of business and economic activities and accounting and a willingness to study the information with reasonable diligence'

Relevance refers to the capacity of accounting information to make a difference in decision making

- This occurs when it possesses ***feedback value*** (the ability to assess past performance) or ***predictive value*** (the ability to form expectations of future performance)
- It must also be timely

Reliability refers to the extent to which accounting information can be depended upon to represent what it purports to represent

- It must be ***verifiable*** (It can be proven to be free from error), have ***representation faithfulness*** (when the description of information corresponds to the underlying phenomenon, e.g. recording a petrol can purchase as an asset on a balance sheet is representationally faithful as the petrol can is treated as what it is – a resource) and ***neutral*** (non-bias reporting about the entity)

Comparability refers to the ability of information to be weighed against or contrasted to the financial activities of other businesses

- Allows a firm to assess its market position, gauge success against competitors and set future goals based on industry standards
- Despite comparability being desired, standards across firms are not uniform, as a result it is required that entities disclose the accounting methods used to allow for comparability

Consistency refers to the ability to use accounting information to compare or contrast the financial activities of the same entity over time

- It is highest when the same accounting methods are used year after year
- Changes to accounting methods hinder consistency and thus must be disclosed so that concerned parties can compensate for these changes

Materiality is similar to relevance – it refers to a threshold at which an item begins to affect decision making, items meeting or exceeding this threshold are said to be ***material***, other items are ***immaterial***

- The threshold is often set at some percentage of assets or sales

Conservatism refers to the manner in which accountants deal with uncertainty regarding economic situations

- When uncertain scenarios arise, conservatism dictates that accounting methods that are least likely to overstate the company's assets and revenues

Objective 7 *Study the conceptual framework of accounting.*

Terms used to identify and describe economic information		
Term	**Definition**	**Reported on the**
Asset	A resource of a business.	Balance sheet

Terms used to identify and describe economic information		
Term	**Definition**	**Reported on the**
Liability	An obligation of a business.	Balance sheet
Equity	The difference between assets and liabilities.	Balance sheet
Issued (contributed) capital	Equity resulting from contributions from owners (often from issuing ordinary shares).	Balance sheet
Retained earnings	Equity resulting from profitable operations.	Balance sheet and statement of changes in equity
Revenue	An increase in assets resulting from selling a good or providing a service.	Income statement
Expense	A decrease in assets resulting from selling a good or providing a service.	Income statement
Dividend (Drawings)	A distribution of profits to owners.	Statement of changes in equity

Principles used to measure economic information		
Principle	**Definition**	**Ramification**
Revenue recognition	Revenues are recorded when they are earned.	The receipt of cash is not required to record a revenue.
Matching	Expenses are recorded in the time period when they are incurred to generate revenues.	For many assets, the cost of the asset must be spread over the periods when it is used.
Cost	Assets are recorded and maintained at their historical costs.	Except in a few cases, market values are not used for reporting asset values.

Assumptions made when communicating economic information		
Assumption	**Definition**	**Ramification**
Economic entity	The financial activities of a business can be accounted for separately from the business ’ owners.	We do not have to worry that the financial information of the owner is mixed with the financial information of the business.
Monetary unit	The dollar, unadjusted for inflation, is the best means of communicating accounting information in Australia and New Zealand.	All transactions in foreign currencies are converted to dollars.
Time period	Accounting information can be communicated effectively over short periods of time.	Most businesses prepare half-yearly and annual financial statements.
Going concern	The company for which we are accounting will continue its operations indefinitely.	If an entity is not selling its assets, then the cost principle is appropriate.

Qualitative characteristics that make accounting information useful		
Term	**Definition**	**Ramification**
Understandability	Accounting information should be comprehensible by those willing to spend a reasonable amount of time studying it.	Users must spend a reasonable amount of time studying accounting information for it to be understandable.
Relevance	Accounting information should have the capacity to affect decisions.	Information should have predictive or feedback value and should be timely.
Reliability	Accounting information should be dependable to represent what it purports to represent.	Information should be free from error, a faithful representation and neutral.
Comparability	Accounting information should be comparable across different businesses.	Entities must disclose the accounting methods that they use so that comparisons across companies can be made.
Consistency	Accounting information should be comparable across different time periods within a business.	An entity should use the same accounting methods year after year and disclose when they change methods.
Materiality	The threshold over which an item could begin to affect decisions.	When an amount is small enough, normal accounting procedures are not always followed.
Conservatism	When uncertainty exists, accounting information should present the least optimistic alternative.	An entity should choose accounting techniques that guard against overstating revenues or assets.

Financial statements used to communicate economic information			
Statement	**Purpose**	**Structure**	**Links to other statements**
Income statement	Shows a company's revenues and expenses over a specific period of time.	Revenue – Expenses = Net Profit/Loss	Net profit goes to the statement of changes in equity to calculate retained earnings.
Balance sheet	Shows a company's assets, liabilities and equity at a specific point in time.	Assets = Liabilities + Equity	The balance in retained earnings comes from the statement of changes in equity. The balance in cash should agree with the ending cash balance on the cash flow statement.
Statement of changes in equity	Shows the changes in a company's retained earnings over a specific period of time.	Beginning Retained Earnings + Profits (or – Losses) – Dividends = Ending Retained Earnings	Ending retained earnings goes to the balance sheet.

Financial statements used to communicate economic information			
Statement	**Purpose**	**Structure**	**Links to other statements**
Cash flow statement	Shows a company's inflows and outflows of cash over a specific period of time.	Operating Cash Flows +/– Investing Cash Flows +/– Financing Cash Flows = Net Change in Cash	The ending cash balance on the cash flow statement should agree with the balance in cash on the balance sheet.