L1 – THE NATURE AND PURPOSE OF ACCOUNTING REGULATORY AND CONCEPTUAL FRAMEWORKS

Accounting is the process of **identifying**, **measuring** and **communicating** financial information about an entity. The information can be communicated through **reports.**

The **purpose** of accounting is to provide **financial information** to a variety of internal and external **users** to help them with **decision making**, such as whether to invest or to lend.

Management accounting is concerned with communicating financial information about an entity to **internal** stakeholders, such as managers. Specific and sensitive information can be extracted from accounting records to create **Special Purpose Financial Reports.**

Financial Accounting involves communicating financial information about an entity to **external** stakeholders, such as customers and suppliers. Accountants prepare **General Purpose Financial Reports** which contain more general data and no insider information.

GPFR exist to provide information to external and potential stakeholders (investors and lenders) to help them make decisions about providing resources to the entity.

Sole Traders and **Partnerships** are simple and cheap to establish and are generally owned by those who establish and run the business. However, the owner/s are personally liable for the activities of the entity and have unlimited liability concerning any debt the entity may enter into.

Companies are owned by shareholders who purchase shares (ownership). Companies can be **public** (can have infinite shareholders) or **private** (can have less than 51 shareholders)

All entities must follow the **IFRS** accounting standards, as well as the **Corporations Act 2001. Reporting entities** are companies who have users who rely on GPFR to make decisions, and therefore these companies must prepare fully audited GPFR.

The **conceptual framework** dictates how GPFR need to be prepared and is the foundation for the creation of accounting standards. It acts as the building blocks of accounting.

Fundamental qualitative characteristics include Relevance and Faithful Representation
Enhancing qualitative characteristics include comparability, understandability, verifiability and timeliness.

The **elements of financial statements** are the categories that are used to measure financial position (A, L, Eq) and performance (I, Ex)

Recognition means reporting items that are **probable** and have a **reliable measurement.**

THE NATURE AND PURPOSE OF FINANCIAL REPORTING

Accounting is a 4-step process of Identifying, Measuring and Communicating financial information to provide information to users for decision making purposes.

IDENTIFY

- Identify transactions
- Transactions are events that change the elements in the balance sheet (A,L,OE - see L3/4)

MEASURE

- analyse - determine the effect on the accounting equation (A + L = OE)
- record - use a journal to write down the effect of the transaction
- classify - is it a cash transaction? is it a revenue/expense?

COMMUNICATE

- summarise the effect of transactions in financial reports
  * balance sheet
  * income statement
  * cash flow statement
  * statement of changes in equity

DECISION MAKING

- reports are analysed and decisions are made to change certain aspects of business operations

A range of users, both internal and external, need this information for financial (profitability, liquidity, efficiency, gearing market) and non-financial (corporate governance, corporate social responsibility) purposes.

Internal users are those that exist within a business (employees, managers, current investors) while **external** users are those that exist separate from the business (potential investors, suppliers, customers, competitors)

Management Accounting is accounting for the internal users of the business to help them with detailed planning and decision making. More customised and detailed reports are prepared for specific internal purposes that aren't bound by any requirements from the government.

Financial Accounting is accounting done for external users to help them make economic decisions about the business, since they can't access whatever information about the entity because they are not insiders. Financial accounting is bound by GAAP (Generally Accepted Accounting Principles), the reports produced are more 'general' to meet a wider range of uses and there is a time lag between when the business events occur and when they are reported.

TYPES OF BUSINESSES/CORPORATE STRUCTURES

Sole Traders and **Partnerships** are simple and cheap to establish, have a limited life, are the same legal entity as the owner/s but are separate reporting entities, have unlimited liability for the owner/s and the owner/s declare any profit earned as their own personal income.

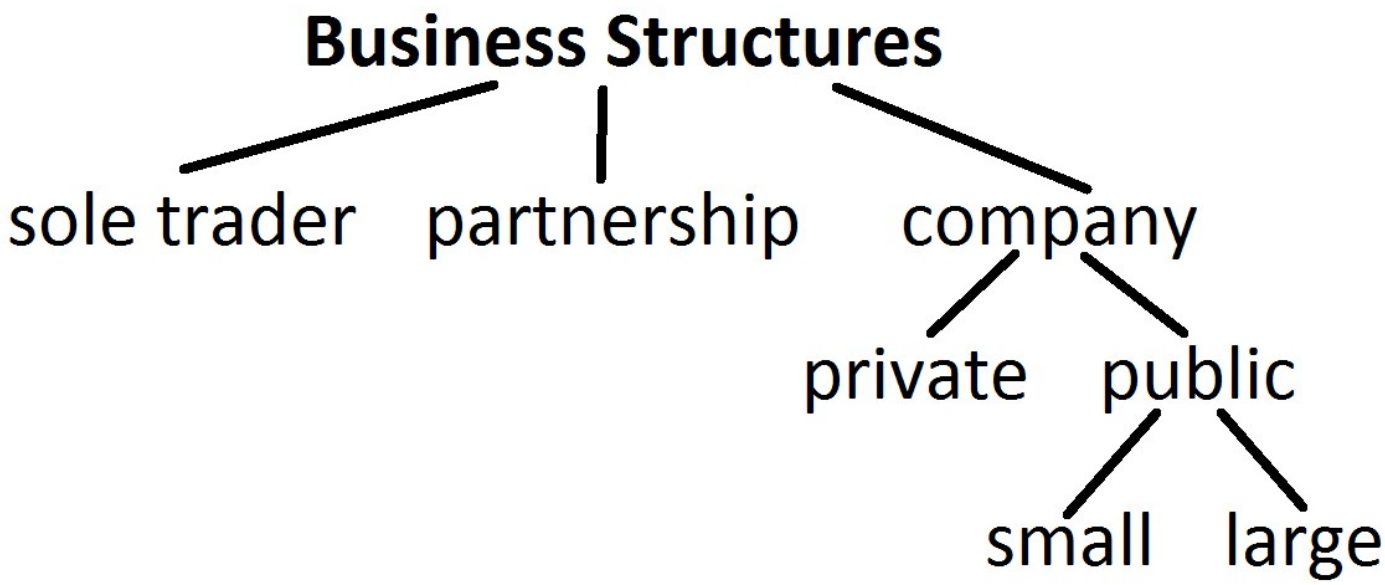
Companies are characterised by owners holding shares. Companies can be either **public** or **private**.

Public Companies have no maximum number of shareholders, no restrictions on raising capital from the public and no restrictions on transfer of ownership between shareholders. They have to prepare full, audited GPFR.

- **Public Limited –** "Ltd" company – there is limited liability
- **Limited by guarantee –** liability extends to an amount guaranteed by members
- **No – Liability –** for mining companies that want to encourage investment in risky business
- **Unlimited company –** liability can extend to personal assets for a business like an investment company where the owner needs to be wise in their investment

Proprietary/Private Companies have less than 51 shareholders and do have restrictions on raising capital and have restrictions on the transfer of ownership. They are classified as large if they meet 2 or more of:

- Operating Revenue of $25m
- Total assets of $12.5M
- 50 EFT Employees



We split them into Small and Large public companies because the Corporations Act 2001 imposes different external reporting requirements on the different types. **Small proprietary companies** have reduced external reporting requirements (i.e. differential reporting or reduced disclosure requirements) when preparing GPFR because they are not publicly accountable and do not have a large number of external users who are dependent on their information. **Large proprietary companies** have to prepare full, audited GPFR because there are a larger number of users dependent on information about the activities of the entity and this information needs to be publicly available in a clear format.

Regardless of the business structure, every entity must **report separate** to their owners. This means that the entity's financial activities are kept separate to the owner's financial activities. The house of the owner is not reported in the balance sheet of the business, and the revenue earned from business sales is not reported as the income of the owner. Any transactions between the owner and the business must be recorded, the same as if the business was to enter into a transaction with any other entity.

EXTERNAL REPORTING OBLIGATIONS APPLYING TO COMPANIES

A **reporting entity** is an entity that has users who rely on the information in GPFR to meet their information needs. This means that public and large proprietary companies are reporting entities and have to prepare full GPFR, whereas small proprietary companies are not reporting entities, so they are subject to differential reporting and have less reporting requirements. Both reporting and non-reporting entities still have to follow Accounting Standards.

A **disclosing entity** is an entity that issues securities that are quoted on a stock market or made available to the public via a prospectus. This will include some public companies that have decided to list, and if so, they have to prepare half yearly reports as well.

The **International Financial Reporting Standards (IFRS)** are developed by the International Accounting Standards Board (IASB). The accounting standards are a reporting obligation that businesses have to follow that provides the rules about how to disclose the effect of transactions in the financial statements. In Australia we use a modified version of IFRS called the **Australian Accounting Standards (AAS)**, which include Australia-specific sections such as our 10% GST.

The main source of **company regulation** is the Corporations Act 2001 which is overseen by the ASIC. There are also the listing rules of the ASX, and the regulations set by professional accounting associations.

CONCEPTUAL FRAMEWORK

The **Conceptual Framework** is the guide on how to prepare GPFR, including the objective of GPFR, their desired qualitative characteristics and the definition and recognition criteria of elements. They are the overall underlying rules that provide the basis for the development of accounting standards.

The **objective of GPFR** is to *provide financial information about the entity that is useful to investors, lenders and other creditors in making decisions about providing resources to the entity*. **GPFR exist because** external stakeholders who need to know about the business' activities for investment/ lending purposes can't access their own information from inside the business, but still need the business to communicate important financial information to them. GPFR forces businesses to report generic financial performance and position to these external stakeholders to satisfy their information needs. However GPFR are based on estimates, choices and judgements meaning that they do not necessarily reflect the true value or worth of an entity, but rather the view that the entity wants external users to see.

GPFR give information concerning financial position (the economic resources and claims at a point in time) and financial performance (the changes in economic resources and claims over a period of time).

The **limitations of GPFR** include the time lag between when events occur and when they are reported, the historical nature of the data that doesn't necessarily represent future data, the costs associated with providing the information and the possible disadvantages the business is put in due to releasing this information, such as disclosing information about a competitive advantage to competitors.

Qualitative Characteristics are the qualities that information in the reports should possess to be useful.

The **fundamental qualitative characteristics** are relevance (materiality) and faithful representation

- **Relevance –** information is relevant if it is capable of making a difference to decisions made by users. If it has predictive value or confirmatory value then it will be useful for decision making.
    - Information should also be **material**, meaning it is significant enough that if it was mistaken or omitted then decisions made on its basis may be changed. The decision of materiality is based on both the nature and magnitude of the item.
- **Faithful representation –** information should represent what is aims to represent is the closest manner
    - **Complete –** contains all necessary descriptions and explanations, including extra information in the notes.
    - **Neutral –** isn't manipulated to appear in a certain manner and isn't biased
    - **Error free –** there are no calculation errors and nothing is omitted

The **enhancing qualitative characteristics** include comparability, understandability, verifiability and timeliness.

- **Comparability –** information should be internally (against other periods) and externally (against other businesses) comparable due to the following of AAS.
- **Understandability –** Information should be presented in a clear and concise manner that uses simple language and explanations. It is assumed that users will have reasonable knowledge of accounting to understand reports.
- **Verifiability –** A range of independent and knowledgeable people could reach consensus that an item/range is a faithful representation. If it can't be verified then assumptions should be disclosed.
- **Timeliness –** information should be available in time to be capable of influencing decisions (3 months)

The **elements of financial statements** are the categories that are used to measure the business' financial position (**A**ssets, **L**iabilities, **Eq**uity) and financial performance (**I**ncome, **Ex**penses).

Assets – *a resource controlled by the entity as a result of past events which are expected to result in an inflow of economic benefits to the entity.*

- Control – the business must be able to direct the benefits and have legal control over it.
- Past Events – the business must have done something already to gain control – you cannot recognise something that will become an asset in the future as an asset at the current point in time.
- Future Economic Benefits – it has the potential to generate cash inflow (or reduce cash outflow), contribute to productive capacity or be exchanged for goods/services

Current assets are those that will be realised, sold or consumed in the normal operating cycle (12 months) or are cash and cash equivalents. All other assets are non-current as they will last past 12 months from reporting.

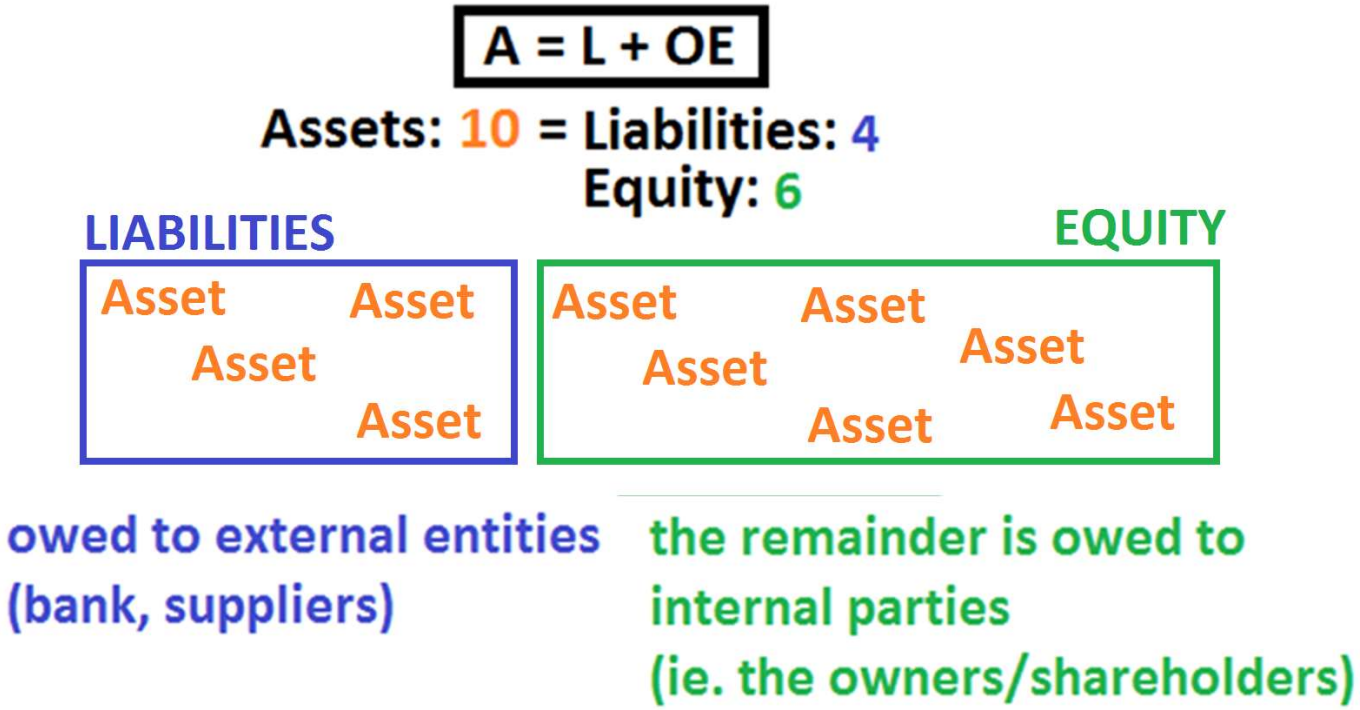
Liabilities – *a present obligation of the entity as a result of past events, the settlement of which is expected to result in a probable outflow of economic benefits.*

- Present Obligation – a duty or responsibility to act in a certain way. Future commitments are not present obligations
- Past Events – there must have been an event already to trigger a liability.
- Outflow of economic benefits – liabilities require settlement through an outflow of FEB.

Current Liabilities are those that are expected to be settled in the entity's normal operating cycle (12 months), while non-current liabilities will be settled after 12 months from the reporting date.

Equity – *The residual interest in the assets of the entity after deducting all its liabilities.* **Equity = A – L.** Equity is essentially the assets that the business owes to the owners. Once all of the assets owed to external parties (liabilities) are distributed then the remaining assets belong to the owners, hence 'equity'. There are 2 types of equity:

- Contributed Equity – equity contributed by investors, such as the owners contributing cash in exchange for shares.
- Retained Profits (a specific type of reserve) – profits earned by the business that have been reinvested, kept in the business and not spent.



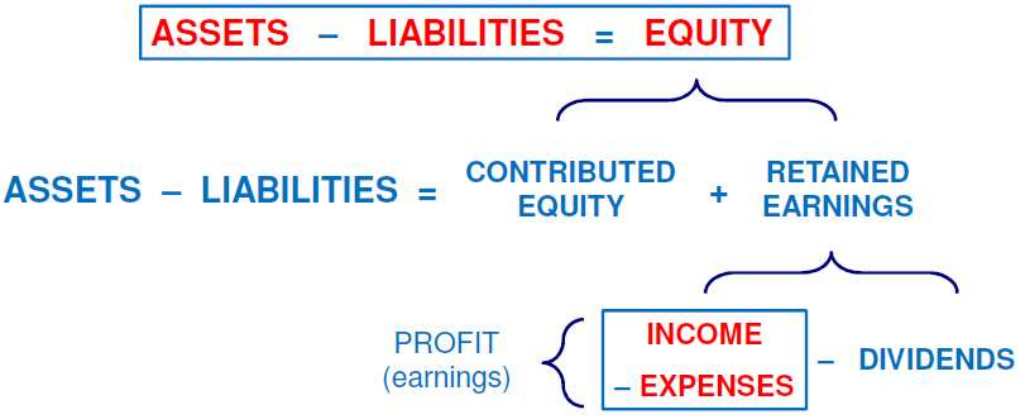
Income – *inflows of economic benefits (or decreases in outflows) that result in increases in assets (or decreases in liabilities) the increase equity, except for contributions from equity participants.*

- Income must be earned because the entity provides a good/service/resource (sales, feed, rest revenue, interest revenue)

Expense – *Outflows of economic benefits (or decreases in inflows) that decrease assets (or increase liabilities) that reduce owner's equity except for distributions to equity participants.*

- A resource must be used because inventory disappears, labour is utilised, part of an asset is used

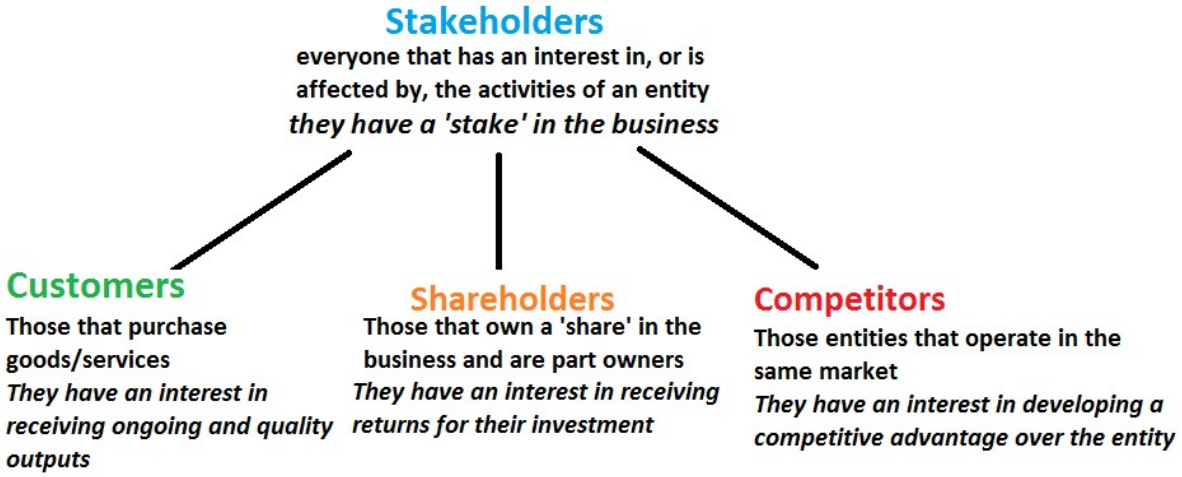
Income less expenses will give you the profit (or loss) for a period. This amount then makes up part of retained earnings, making it a part of equity.



Recognition is the process of incorporating an item that meets the definition of an accounting element into the reports. The recognition criteria of Assets, Liabilities and Owner's Equity are:

- It is **probable** that any future economic benefit associated with the item will flow to or from the entity. Probable does not mean certain, however if there is no reason to assume it wouldn't happen then it is probable.
- The item has a cost/value that can be **reliably measured.** If not even a reliable estimate can be made then the item should not be recognised but should still be disclosed in the notes.

GENERAL TERMINOLOGY NOTE: STAKEHOLDERS VS SHAREHOLDERS



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