ACCT1006 Accounting and Financial Management

W1 An introduction to Accounting

Accounting

- Accounting is the process of identifying, measuring, recording and communicating the economic transactions and events of a business operation
  → Here, identifying, measuring, recording is referred to as 'bookkeeping'
- The primary function of accounting is to provide reliable and relevant financial information for decision making

GAAP (Generally Accepted Accounting Principles) – Accounting standards, CF, Accounting concepts and principles

GAAP consists of accounting standards, conceptual framework (CF) and accounting concepts and principles

*You do not need to know accounting standards in ACCT1006 but just be familiar with how it looks like as you will learn it in further accounting units

It is important to identify the order in which the various aspects of GAAP must be applied; first the Corporations Act, then accounting standards and interpretations are consulted, then CF and finally the underlying accounting concepts and principles

Conceptual Framework (CF)

- CF is a set of concepts defining the nature, purpose and content of general purpose financial reporting (GPFR) which is used by financial statement preparers and standard setters
- The purpose of CF is to
  - Assist in IASB (International Accounting Standards Board) to develop standards that are based on consistent concepts
  - Assist preparers to develop consistent activity policies when no standard applies to a particular transaction or event
  - Assist all parties to understand and interpret the standards
- CF is NOT a standard! But it provides guidelines in preparing the accounting standards

CF consists of 4 sections;

1. Objective of GPFR

- The objective of GPFR forms the foundation of the CF. All the other elements flow from the objective

- Objective of GPFR is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making economic decisions about the entity
- Useful information is based on ethical accounting practices by ethical accountants which typically possesses a number of qualitative characteristics
- Primary users of GPFR are resource providers; those who provide resources to the entity and therefore require information to make decisions about the provision of those resources

2. Reporting entity

- Reporting entity is any entity that prepares GPFR in accordance to accounting standards
- An entity for which it is reasonable to expect the existence of users who depend on GPFR in making economic decisions about the entity
- Not all businesses are classified as reporting entities
- 3 indicators of reporting entity
  1. Managed by individuals who are not owners of the entity (ownership separated from control)
  2. Politically or economically important
  3. Sizable in financial characteristics e.g. assets, borrowings, employees, customers, sales
- Reporting entities include public companies, some large private companies and government authorities
- It is important to determine whether an organisation is a reporting entity or not as reporting entities must prepare external GPFR that comply with the accounting standards. All other entities will prepare information for internal use.

3. Definitions of elements of financial statements – Assets, liability, equity, revenue, expense

*definition: **what** is to be recorded as A/L/E/rev/exp

*recognition criteria: **when** to recognise A/L/E/rev/exp

Asset

- Definition: Assets are resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity
  - Resource controlled by the entity: while control often means ownership of the asset, this is not always the case
  - E.g. finance lease: even though the legal ownership of the leased asset remains with the lessor, the finance lease is recorded as an asset in the lessee's statement of financial position as it satisfies the definition of an asset

- Result of past events: resources to be purchased in the future are not considered an asset until the exchange takes place
- Future economic benefits are potential: such that it can contribute directly or indirectly to the future cash flows or cash equivalents of the entity

*The definition of asset identifies its essential features but to be recognised and recorded, recognition criteria should also be met

- Recognition criteria: Asset is recognised when it is probable that the future economic benefits will flow to the entity and when the asset has a cost or value that can be measured reliably (recognition criteria)
  - To assess the degree of probability of future economic benefits, all the evidence available when the financial reports are prepared is used
- Assets are NOT recorded in the statement of financial position when
  - An item meets the definition of an asset but fails to meet the recognition criteria → here, the item should be disclosed in the 'notes to the financial statement' if it is considered to be relevant to user's decision making
  - It is considered improbable that economic benefits will flow to the entity beyond the current accounting period → if they do (probable), the cost is recorded as an asset e.g. prepaid insurance, but if not, the cost is recorded as an expense
- Current assets
  - Assets expected to be converted to cash or used in the business within a year or one operating cycle
  - E.g. cash, AR, marketable securities such as shares held as a short term investment, inventories, prepaid expenses
  - Current assets are important in assessing the ability of the business in paying short term debt
- Non-current assets
  - Assets that are not considered as current assets
  - Assets that are not expected to be converted into cash or consumed within a year or the operating cycle
  - E.g. property, plant and equipment (PP&E), intangible assets

Liability

- Definition: Present obligation of the entity arising from past events, which is expected to result in an outflow of resources embodying economic benefits
  - Present obligation means that the entity has a duty to act or perform in a certain way in the future e.g. revenue received in advance (liability); entity has a present obligation to deliver goods or provide services at a future date e.g. mortgage; future obligation is a payment of cash to cover the principal and interest components for each repayment

    - Result of past event: generally, the obligation arises after the purchase or the asset has taken place
    - Result in an outflow of resources or economic benefits: e.g. liability can be settled by paying cash e.g. revenue received in advance (liability) can be discharged by providing goods or services e.g. AP can be discharged by issuing another liability such as notes payable
- Recognition criteria: Liability is recognised when the outflow of resources embodying the future economic benefits is <u>probable</u> and the amount at which the settlement will take place can be <u>measured reliably</u>
- Current liability
    - Obligations to be paid within the a year or the entity's operating cycle
    - E.g. AP, wages payable, bank loans payable, interest payable, tax payable
- Non-current liability
    - Obligations that are not classified as current liability
    - E.g. debentures payable, mortgages payable, unsecured notes payable, lease liabilities
- Contingent liabilities
    - Liabilities for which the amount of the future sacrifice is so uncertain that they cannot be measured reliably or do not satisfy the probability criterion
    - E.g. unsolved lawsuit → contingent liability
    - E.g. potential liability resulting from a tax audit in progress
    - Contingent liabilities are not reported in the financial reports as they are either not probable or they are not able to be measured reliably, or both
    - Must be disclosed in the 'notes to the financial statement'

Equity

- Definition: the residual value from assets of the entity after deducting all the liabilities
- In a corporate entity, equity can be classified into funds contributed by shareholders (share capital), retained earnings and reserves (representing appropriations of retained earnings)

Income

- Definition: Income is an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participant.
- Income encompasses both revenue and gains.
- Revenue definition: increase in economic benefits arising in the ordinary course of an entity

- Gains definition: other increases in economic benefits which do not arise in the ordinary course of business
- Recognition criteria: Income is recognised in the income statement when an increase in asset or decrease in liabilities become probable and can be measured reliably
- The recognition of income occurs simultaneously with the recognition of increases in assets or decrease in liabilities e.g. sale on credit results in an increase in AR (asset) and increase in sales revenue (income) e.g. for revenue received in advance, once the service has been provided there is a decrease in revenue received in advance (liability) and increase in sales revenue (income)

Expenses

- Definition: Expenses are decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants
- Expenses are decrease in economic benefit that arise in the ordinary activities of the entity e.g. cost of sales, wages and payments for rent
- Losses are expenses that do not necessarily arise in the ordinary course of business e.g. loss from a fire or flood, loss on the sale of non-current asset
- Recognition criteria: Expenses are recognised when the decrease in asset or increase in liabilities become probable and can be measured reliably

4. Qualitative characteristics; attributes that make information in financial statements useful

- Relevance (Fundamental characteristics)
    - Information is relevant if it can make a difference to the decision made by the users
    - Information that has predictive value and/or confirmatory value is considered to be relevant
        - Information is considered to have predictive value if it can be used to develop expectations for the future
        - Information is considered to have confirmatory value if it confirms or contests users' past or present expectations
    - Relevance and full disclosure principle is linked (interrelationships between accounting concepts and CF): The purpose of full disclosure principle is that all RELEVANT information that can make a difference to the decision made by the users should be fully disclosed
    - The relevance of the information is also affected by its materiality
        - Information is material if its omission or misstatement could affect users' decision

        - E.g. large companies rounding off the amounts in their financial statements to the nearest thousand dollars
        - Sometimes materiality has nothing to do with the size e.g. financial fraud would be considered material no matter what the amount is

- Faithful representation (F)
    - Information is faithfully represented it is **complete, neutral (not biased), free from error (information does not contain any significant mistakes)**
    - For information to be complete, all the information needed to represent the economic phenomena faithfully should be included and there should be no omission which could make the information misleading → Hence, like relevance, faithful representation is also linked to the full disclosure principle
    - For information to be neutral, it should be free from bias
- Comparability (Enhancing characteristics)
    - Information is comparable if the users can identify the similarities and differences between financial statements in different period and across different reporting entities
        - Between different companies in the same time period
        - Between different years of the same company
    - Comparability is achieved when an entity uses consistent accounting principles each year and different entities use the same accounting principles in the same period → consistency enhances the comparability
    - E.g. inventory cost flow assumptions, depreciation methods, horizontal analysis
    - Using a different methods result in different amounts of profit and different amounts for assets which impacts comparability
    - To make comparisons across entities easier, each entity must disclose the changes in accounting methods. From these disclosures, the external user can determine whether the financial information is comparable and try to make adjustments.
- Verifiability (E) – Direct verifiability, Indirect verifiability
    - Information is verifiable if it faithfully represents the economic phenomena it is meant to represent and when independent observers could reach a consensus that a particular depiction is a faithful representation
    - Direct verifiability: direct observation e.g. counting cash to verify cash balance or counting inventory to determine quantities in stock
    - Indirect verifiability: techniques or calculations are used to check the representation e.g. verifying the ending inventory balance
- Timeliness (E)
    - Timeliness is measured by whether the information is available to the users before it ceases to be relevant
    - The older the information, the useless it is.

    - It depends on the user's need.
    - The application of timeliness is that the financial information is collected and prepared quickly so that it does not loses its relevance
- Understandability (E)
    - Relates to the quality of information that assists users to understand the meaning of the information provided
    - Information aids understandability if it is classified, characterised and presented clearly and concisely

*Although enhancing qualitative characteristics improve the usefulness of financial information and should be maximised where possible, it is important to note that they are only enhancing as they cannot make information decision-useful if the fundamental characteristics are not achieved

Constraint on financial reporting

Providing decision-useful information imposes costs, and the benefits of providing the information should outweigh the costs. Costs can include those associated with collecting, processing, verifying and disseminating information. Assessing whether benefits outweigh costs is usually more qualitative than quantitative and is often incomplete. It is important to consider whether one or more enhancing qualitative characteristics may be sacrificed to reduce costs

<u>Accounting concepts and principles</u>

It is important to know how to apply them and how important they are in preparing financial reports useful for decision making. It is also helpful to reflect on how accounting concepts and recognition criteria are interrelated.

①Accounting entity concept

- One of the most basic concept used in the preparation of financial statements
- Every entity can be separately identified and accounted for
- This is why owners are treated as claimants against their business although they are investing in their own business
- It is important that the owners should not confuse the entity's transactions with their personal transactions
- Applies to all accounting entities

②Accounting period concept

- The economic life of a business can be divided into artificial periods for reporting purposes
- This concept has an implication for recording transactions that affect more than one accounting period

- A firm has to report the financial results and accounting data over a certain time period (accounting period).
- Companies have different accounting periods
- In Australia, the most common annual accounting period is the financial year, from 1 July to 30 June of the following year → 30 June is end of the financial year
- **Accounting period concept** and the **expense recognition criteria** are interrelated e.g. insurance premium may cover more than one accounting period. Here, the portion that relates to this accounting period is recognised as an expense as decrease in future economic benefits is probable and can be measured reliably whereas the portion of the insurance payment that relates to the next accounting period is recognised as an asset (prepaid insurance)

③Going concern principle

- The business is assumed to continue operating for the foreseeable future (so that we can use historical cost) unless it ceases trading or goes into liquidation.
- If this assumption cannot be sustained due to liquidation (converting the assets into cash when the business stops), financial report should make this clear and value assets and liabilities on liquidation price
- If going concern principle is not assumed, the PPE assets should be stated at their liquidation value (selling price – cost of disposal) rather than their cost
- Closely related to cost principle

④Cost principle