ACCT1501: Accounting and Financial Management 1A

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1.Introduction to Financial Accounting

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

Financial Accounting System

→ Periodic financial statements and related disclosures

- For *external* decision makers e.g. investors, creditors, customers, employees
- Reporting standards: AASB standards (GAAP)

Managerial Accounting System

→ Detailed plans and continuous performance reports for operational planning and control decisions

- For *internal* decision makers- mangers
- No reporting standards (less formal)

Users	Type of Information
- Management	Profitability of different decision e.g. payroll
- Bankers	Determine credit rating i.e. if loans can be paid back
- Shareholders	Prospect of future dividends i.e. if company is worth investing in
- Suppliers	Ability to pay them back in time
- Tax Office	Profit based on tax law (tax return to be prepared properly)
- Trade Unions	Profit since last enterprise agreement
- ASIC- Australian Securities and Investments Commissions	Agreeing listing price on stock exchange

The Annual Report

An Annual Report is a document which companies publish each year, containing the three key financial statements:-

- **Balance Sheet:** Shows the *financial position* of the business at a particular point in time
  - → Used to assess financial structure and their ability to pay debt
  - → "consolidated" BS = looking at a group of companies/brands e.g. Woolworths and Countdown
  - → Main elements: assets (A), liabilities (L), equity

- **Income Statement:** Shows the *financial performance* of a business over a period of time
  - → Shows how new resources are generated from operations
  - → Main elements: revenue, expenses
- **Cash Flow Statements:** Shows cash inflows and outflows over a period of time
  - → (not examined in ACCT1501)
- Annual Reports also contain additional information disclosed in notes (e.g. information on the depreciation method used for a particular asset, dividend policy, revaluations etc.)
  - → (not examined in ACCT1501)

Balance Sheet

- Shows resources (assets) and claims on those resources (liabilities and equity) at a point in time
  - → This is represented by the accounting equation:

Assets = Liabilities + Equity

Income Statement

- Shows the results of business operations over a specific time period; shows revenues earned and expenses incurred
- If revenue > expenses = net profit
- If revenue < expenses = net loss
- The income statement is prepared under **accrual accounting** (vs. the cash flow statement which is prepared under cash accounting)

Accrual vs. Cash Accounting

Accrual accounting: Includes the impact of transactions on the financial statement in the periods where revenues and expenses occur rather than when the cash is received or paid

Cash Accounting: Only accounts for revenues and expenses when cash is paid or received

E.g. In June 2019, a company makes credit sales of $100,000 that is to be collected in August 2019. What are the sales under cash and accrual accounting for the year end 30 June 2019?

- <u>Cash accounting:</u> Sales = $0 → no movement on cash for the year ended 30 June 2019

- <u>Accrual accounting:</u> Sales = $100,000 → although the cash is expected to be collected after the year ended, the sale was made during the reporting period, thus the $100,000 earned is included as sales

Qualitative Characteristics of Accounting

Fundamental Characteristics

- **Relevance:** the information provided in the statements are useful for decision making
- **Faithful Representation:** the information is free form bias

Enhancing Characteristics

- **Comparability:** useful for comparing between different entities (within the same industry)/ within the same entity over time
- **Verifiability:** numbers can be verified with documentation (and other sources)
- **Timeliness:** information is provided to users on time for decision making
- **Understandability:** users can understand the information
- **Materiality:** when the omission/misstatement of an item can influence decisions

Financial Statement Assumptions

1. **Accrual Basis:** revenue and expenses are recognised at the time they occur rather than when cash is received or paid (accrual accounting)
2. **Accounting Entity:** activities of the entity are separate from those of its owners/members
3. **Accounting Period:** life of the business is divided into discrete time period of equal lengths (this is used to determine financial performance and position)
4. **Going Concern**: assuming continued business operations into the foreseeable future
    - items are recorded at their going concern value rather than the liquidation value
5. **Historical Cost:** items are initially recorded at their original cost
6. **Monetary:** measures economic activity using a common and universally accepted medium of exchange (e.g. AUD$)

2. Measuring and Evaluating Financial Position and Financial Performance

The Balance Sheet

A statement that shows the financial position of a business at a particular point in time (hence title is "<u>as at</u>" a particular date)

- Title follows the format of: Balance Sheet of (Company Name) as at (Date)
- Contains three main elements: assets, liabilities, equity

Assets

A resource that is controlled (not necessarily owned) by an entity as a result of past events (e.g. a transaction) and from which future economic benefits are expected to flow to the entity

- **Recognition criteria:** probable of generating future economic benefits and the cost/value of the asset can be reliably measured
- *Non-current Assets:* expected to be owned by the business > one year e.g. Property, Plant and Equipment
- *Current Assets:* expected to be owned by the business < one year e.g. accounts receivable, inventory

Liabilities

A present obligation of the entity arising from past events where the settlement is expected to result in an outflow form the entity of resources embodying economic benefits (resulting in a decrease in economic benefits)

- **Recognition criteria:** probable of decreasing future economic benefits and the cost/value can be reliably measured
- *Non-current Liabilities:* expected to be owing by the business > one year e.g. long term loan
- *Current Liabilities:* expected to be owing by the business < one year e.g. accounts payable, bank overdraft

Equity

The net assets/ residual claim of an owner/ shareholder on the assets

RECALL: the accounting equation: assets = liabilities + equity
- Thus, equity are the net assets: equity = assets - liabilities

- *Share Capital:* the amount invested directly by the owners
- *Retained profits:* total cumulative amounts of profits retained in the business not yet distributed as dividends by owners

NOTE: Statement of Retained Profits shows how the balance of profit changes using the following equation:

Retained Profits = Net Profit – Dividends Paid/Declared

- This statement is included as a note to the Balance Sheet (in the Annual Report)

Income Statement

A statement (and temporary account) that shows the result of business operations over a specific time period, measures organisation efficiency

- Title follows the format of: Income Statement of (Company Name) for the period/year ended (Date)
- Relates to the accounting period assumption and uses <u>accrual</u> accounting
- Shows the revenue earned less expenses incurred, calculating the profit that may be available to shareholders

Revenue

The gross inflows of economic benefit during the period, arising in the ordinary activities of an entity when those inflows result in increases in equity other than those relating to contribution from equity participants

- Represents the increase in the wealth of the business
- Is recognised when <u>earned</u> (not when cash is received)

e.g. sales, dividends received, interest received

NOTE: Dividends paid/ declared = Expense
Dividends received = Revenue

Expenses

Represents decreases in the entity's wealth, they are incurred in order to earn revenue

- They do not include payments/returns to owners (dividends paid are considered to be "distributions" of net profit to owners)
- Is recognised when <u>incurred</u> (not when cash is paid)

e.g. rent, wages, depreciation

A cost is **capitalised** (i.e. is classified as an asset and becomes capital expenditure) instead of an expense if it satisfies the definition of an asset- in particular, if it provides future economic benefits (this is further explored in 9. Inventory and Non-Current Assets)

3. The Double Entry System

Transactions are events that affect the operation or finances of an organisation

- Accounting systems record these transactions
- Transactions are recorded under the **Double Entry System** where each transaction has an entry into at least two accounts and the accounting equation remains equal (A=L+E)