Comprehensive Study Notes for ACCT10001 [H1]
Subject Name: Accounting Reports & Analysis
Created Semester 1, 2021

Note: GREEN = Additional, non-examinable info to improve **holistic** understanding of accounting

Part 1: The scope of accounting

- **Accounting:** the process of identifying, measuring and communicating economic information about an entity to a variety of users for decision-making purposes
  - Identifying business transactions that affect a business' financial position
    - Must be reliably measured and recorded
  - Measuring business transactions
    - Involves grouping expenses, income, etc.
  - Communicating relevant information
    - Through accounting reports (e.g. statement of profit/loss)

1.1. Introducing the need for accounting

Uses for internal decision makers (owners and managers)

- Manage business operations such as price of goods and forecast profits
- Determine whether set targets have been met
- Help make the best investments

Uses for external decision makers (stakeholders)

- **Shareholders**
  - Have the managers been good stewards of the entity
  - Future profitability and cash flows for dividends
  - Possibility of capital growth for investment
- **Banks/Lenders/Suppliers**
  - Ability to repay debt
- **Employees**
  - Job security
  - Promotion opportunities
- **Consumers/Beneficiaries (e.g. taxpayers & community)**
  - Ability to provide goods and services in the future
- **Government authorities**
  - How much to tax
- **Regulatory bodies (ASIC, ASX, ATO)**
  - Is the entity abiding by regulations?
- **Community**
  - Positive contribution to the welfare of society
- **Special interest groups**
  - Has the entity considered environmental and social aspects?

Summary of information needs

Financial need	Non-financial need
▪ Profitability (the **rate** at which profits are generated, i.e. usage of resources to generate returns)	▪ (Good) corporate governance
▪ Efficiency (ability to generate cash flows, e.g. measure of turnover)	▪ Sustainability reporting is gaining traction
▪ Liquidity (ability to meet short-term debts)	
▪ Gearing or capital structure (the debt / equity mix) ○ The extent to which a company has used debt to finance its assets ○ Highly geared = higher proportion of debt	
▪ Market performance (share-based analysis)	

1.2. The two sides of the accounting coin

Financial accounting

- **Financial accounting** is the presentation and preparation of financial information to a variety of users
  - The historical costs/figures from the original transaction are used (e.g. price of property when it was bought)
  - Used for internal decision-making
- **General Purpose Financial Statements (GPFS)** are prepared for common users
- **Special Purpose Financial Statements** are prepared to meet specific needs to users who can command reports

Management accounting

- **Management accounting** provides economic information to internal users
- Involves planning and budgeting
  - Used for external decision making
- Management accounts are less formal, prepared in any period, to suit the needs of managers
  - E.g. a sales manager might ask for an account of the day's sale by the end of that day

Example of the interaction between both forms of accounting

- Large and diversified companies must report segment information
  - Management accounting determines the segments of the entity
  - Financial accounting reports this information to a variety of users
- ***More Info:*** https://www.graduatetutor.com/accounting-tutors/difference-between-financial-accounting-managerial-accounting/

1.3. Jobs in accounting

Part 3: Forms of business structures

- The **accounting entity concept** refers to how individuals are considered separate business entities from the entities they invest in, trade with and are employed by
- Thus, business transactions are recorded separately from personal transactions

3.1. What is a business entity?

- A **business** is an entity or organisation that engages in the trading of goods and/or services
- Not-for-profit entities (NFPs) do not have profit as their main objective
- For-profit entities have one of four structures
  - Sole trader
  - Partnership
  - Company
  - Trust
- These structures differ in terms of
  - Owner liability
  - Equity structure
  - Funding opportunities
  - Decision-making responsibilities
  - Taxation
- Most common business entity is the Small to Medium-Sized Enterprise (SME)
- SMEs do not have public accountability and publish GPFS for external users
  - ~97% of Australian businesses are SMEs
  - ~44% of the workforce is employed by SMEs
- Business entities focus on one or more of
  - Manufacturing of goods
  - Trading of goods to sell
  - Services

3.2. Sole Traders

- A **sole trader** is an individual who controls and manages a business
- Business is **not** a separate legal entity
- Owner is fully liable for all the business' debts
- Low costs and paperwork to establish a sole trader
- Sole trader must apply for an **Australian Business Number (ABN)**
  - An ABN is a identifying number for matters involving the ATO and other government agencies
  - It is an 11 digit number given by the ATO that helps with tax transactions
    - E.g. GST and the Fringe Benefits Tax (FBT)
    - Business must register for GST if the **turnover** is $75K or more
- Sole trader must have a tax file number
- Not bound by formal requirements such as accounting standards
- Examples: chefs, hairdressers, etc.

Advantages

- <u>Fast and inexpensive to establish and wind down</u>

- Not subject to company regulation (e.g. the *Corporations Act 2001*)
- Sole trader does not pay separate income tax
- Owner has total autonomy over business decisions
- Owner claims all profit of the business and all after-tax gains if it is sold

Disadvantages
- Owner has **unlimited liability**, which is full responsibility for the business debts and legal actions
  - This risks personal assets if the business struggles
- Personal income tax rates are often higher than company tax rates
  - The sole trader entity pays no tax, because business profits and losses are included in the owner's individual tax return
- Sole trader is limited by their skill, time and investment
- The business ends if the owner decides to leave or passes away
- Government departments may be reluctant to do business with sole traders due to their non-legal status

3.3. Partnerships
- A **partnership** is an association of two or more persons or entities that carry on business as partners
- Partners share profits or losses according to ownership structures outlined in the partnership agreement
- Must register the business name and obtain an ABN
- Each Australian state has its own Partnership Act
  - Differ in areas such as partnership dissolution
- Suitable for many SMEs

The partnership agreement
- No legal requirement to have a written partnership agreement
  - However, in this case, the law assumes all profits were split equally amongst the partners
- The agreement should state
  - the name of the agreement
  - Cash and asset contributions by each partner
  - Profit/loss sharing agreement
  - Responsibilities and rights of each partner
  - The process of inducting a new partner, or what happens when a partner leaves

Advantages
- Easy and cheap to establish
- No formal requirements for partnership financial statements
- Partnership combines the skills and knowledge of multiple people, which reduces each partners workload and allows better decision making
- Partnership doesn't pay separate taxation
  - Partnership lodges an annual partnership income tax return
  - The return indicates each partner's income, which is taxed on the individual level

Reporting requirements

- Financial statements (as required by accounting standards)
    - Disclosing entities must apply Australian Accounting Standards to prepare their financial reports
    - For non-disclosing entities, auditors of the GPFS must apply the accounting standards
- Notes to financial statements
- Directors' declaration about the FS and notes
    - Offers opinion as to if FS and notes are complying with accounting standards and showing a true and fair view of info (**similar to auditor**)
    - Offers opinion as to if they think the company will be able to pay due debt

Part 4: Analysing Business Transactions

4.1. Recognising business transactions

- **Business transaction:** an occurrence that affects the assets, liabilities and equity accounts of an entity
- A business transaction should be recorded if there has been an exchange of resources between an entity and another entity or individual
    - The exchange must be reliably measurable in monetary terms and occur at an arm's length distance
    - **Arm's length distance** transaction: when parties with equal bargaining positions make a deal **and** neither is subject to the other's control
- **Drawings** are personal expenditures of the owner that involve the business entity's funds
- **Source documents:** the original documents verifying a business transaction
- Examples of transactions
    - Capital contribution by owners or withdrawal of capital
    - Payment of accounts payable
    - Payment for advertising

4.2. Business and personal transactions and business events

- **Personal transaction:** transactions of the owners, partners or shareholders that are unrelated to the operation of the business
    - If the owner withdraws business funds to buy something, it becomes a business transaction
        - Recorded as "drawings" and not part of "business expenses"
- **Business event:** an occurrence with the potential to affect the entity
    - E.g. negotiating a bank loan
- A business event becomes a business transaction after an exchange of goods or services occurs

4.3. The accounting equation

- **Accounting equation:** expresses the relationship between the assets of an entity and how the assets are financed
  - **Assets** are resources controlled by the entity
  - Assets can be **financed** by fund providers, and hence called **liabilities**
  - Assets can be **financed** by inside funds, and hence called **equity**
- Assets (A) = Liabilities (L) + Equity (E)

Concept of duality

- **Duality:** the idea that every business transaction has at least two effects on the accounting equation (to keep it balanced)
  - E.g. buying an office space with a loan increases both assets and liabilities
- The liabilities and equity represent the **claims against the entity's assets**

Statement of financial position	Statement of profit or loss
Assets (A) = Liabilities (L) + Equity (E)	Income (I) – Expenses (E)

Further:

Income (I) increases Equity (E)
Expenses (E) decrease Equity (E)

Therefore:

Assets (A) = Liabilities (L) + Opening Equity (E) + Income (I) – Expenses (E)

4.4. Analysis of business transactions

- Cash transactions are business transactions with an exchange of cash
- Credit transactions are business transactions where the amount will be received at a later date

Examples

1. **Capital contribution** – depositing money into the bank

Assets (A) = Liabilities (L) + Equity (E)
↑ Cash $20 000 = $0 + ↑ Capital $20 000

2. **Asset purchase -** buying an iPad for the business

Assets (A) = Liabilities (L) + Equity (E)
↓ Cash $500
↑ Office equipment $500

3. **Income earned** – earning $3000 in a credit transaction

Assets (A) = Liabilities (L) + Equity (E) + Income (I) – Expenses (E)	
↑ Accounts receivable $3000	↑ Coaching fees $3000

- Principle amount repaid is written under loans
- Interest paid is written as an expense (the 1 year time to repay the loan has been used up)

- PPE is an asset because its future benefit is to contribute to the revenue generating process of the business
    - Estimation is used to identify the **useful life** of the PPE to measure the cost over time
    - E.g. 50K worth of PPE lasts 10 years, so the asset decreases and expenses are 5000 per year

Gross profit

- Service firms generate revenue by providing a service
- Trading firms generate revenue by buying and selling goods
- Manufacturing firms generate revenue by producing and selling goods
- **Profit (net profit):** measures the difference between **all revenue** and **all expenses**
- **Gross profit:** measures the difference between the revenue generated from selling goods **(sales)** and the cost of that inventory sold **(cost of sales)**
    - Cost price happens from past event
    - Sale price is determined from a future event, the sale

Part 5: The Statement of financial position (SoFPos)

Three elements of SoFPos

- The **resources** the entity **controls**
- The **claims** against those resources
- The **residual** interest (claims by owners)

Measuring assets

- Most assets are recognised at their cost
- Economic benefits could be
    - A realisable value: an expected cash inflow
    - A fair value: the market value (price of sale)
    - A value-in-use: the Net Present Value (NPV) of all the future net cash flows linked with the asset over its useful life
- **Recoverable amount (RA)**
    - This is just the realisable value for most assets
    - For others, such as PPE, it is the higher of its
        - Fair value minus costs to sell and
        - Value-in-use

Overstating the carrying amount is not a faithful representation

- An assets CA **must not** exceed its RA
- If RA < CA => the asset is **impaired** and the CA must be **written down** to the RA

5.1. Presenting & Disclosing elements in the SoFPos

Current and non-current assets and liabilities

- **Current asset/liability:**
  - If the flow of resources is expected to be realised within the next reporting period, i.e. assumed to be 12 months
  - **Or** is **cash/cash equivalent**
  - If the asset is expected to be realised within an entity's operating cycle
  - If the asset is held primarily for the purpose of trading
- Comparing current assets with current liabilities helps to assess an entity's liquidity
- **Operating cycle:** the time lapse between the purchasing of an asset and the realisation of its economic benefit (vice versa for a liability)
  - Machinery is a non-current asset because it's benefits last beyond a year
  - The portion of a loan due within the next year is a current liability, with the remainder a non-current liability

Presentation and disclosure of assets, liabilities and equity

- Assets are classified by their **nature** or **function**
  - Liquidity
    - 1. Cash and cash equivalents
    - 2. Trade and other receivables
    - 3. Inventory (however, not always current, e.g. wine being preserved for several years before being sold)
    - 4. Other current assets
  - Marketability
  - Physical characteristics
  - Expected timing of future economic benefits
  - Purpose
- Liabilities and equity are classified by their **nature**
  - Liquidity
  - Level of security or guarantee
  - Expected timing of the future sacrifice
  - Source
  - Conditions attached to the liabilities
- Classification of equity items can be based on either source (owner contributions or retained earnings) and/or the rights attached to the item
- **Class** refers to the type of asset, liability or equity items
  - Small entities often list their elements individually
  - Large entities aggregate their assets by class and add greater details in the notes of the accounts

Asset classes

- **Cash and cash equivalents [P]**
  - Includes cash at bank, on hand, in transit and on short-term deposit
  - Expect this class to be small because it generates low returns relative to productive assets
  - Cash equivalents are held to meet **short-term cash commitments**

    - Accruals
    - Provisions
- Judgements
    - Remote vs possible vs probable
    - Preference shares classified as debt or equity
- Preparers biggest risk: **understating carrying amounts**

Part 6: Statement of profit or loss and statement of changes in equity

6.1. Income

Income vs revenue

- Income includes
    - **Revenue** from ordinary activities
        - Principle revenue creating activities e.g. sales and fees (core business)
        - Other revenue e.g. interest, royalties, rent, dividends
    - **Gains** that are defined as income and may/may not be from ordinary activities
        - **Realised gains:** from disposals of NCA
        - **Unrealised gains:** from increase in FV of NCA

Recognition of income

- Coincides with the recognition of an asset or the derecognition of a liability
- Performance obligation must be fulfilled for income to be earned

Measurement of income

- Based on amount of cash received or value of an invoice
- Estimations: using a pro rata allocation e.g. accrued revenue, using a market valuation

Disclosure of income

- Separately disclose all material items
- Prescribed line item: **revenue**
- Revenue recognition policies

Revenue from principal activities

- Recognition
    - At the time when goods or services are provided
    - Coincides with the recognition of **cash** or **trade receivables** or the derecognition of **unearned revenue**
- Measurement
    - Agreed value at point of sales
- Disclosure
    - Line item: **sales revenue, service/fees revenue**

For companies earning cash before providing the good/service

- E.g. magazines give monthly editions, gyms give annual subscriptions

- This depends on the size and nature of the item, and if non-disclosure could affect a user's decision-making
- Disclosure can occur in notes or in the statement of profit or loss
- Material items of income/expense can result from disposals of PPE, asset impairments and restructurings

Part 7: Statement of cash flows

Note: this statement has the minimum recognition and measurement risks

7.1. the components

Operating activities [Revenue, expenses, CA, CL]

- Cash from core principal money-generating business activities
- Accrual approach
- Cash inflows – **receipts** from sales of g&s, including non-core sources
  - E.g. royalties, fees, commissions
- Cash outflows – **payments** to suppliers of g&s
  - Payments for employee entitlements
  - Net GST paid or received
- Disclosure:
  - **Receipts from customers**
  - **Payments to suppliers and employees**
  - Optional: **cash generated from operations** = receipts - payments
- We want: positive NCF to signal a sustainable entity

Investing activities [NCA]

- Cash flows from investing activities
  - **Payments** to invest
  - **Proceeds** (not the gain!) from disposals or maturity
- Disclosure
  - **Payments to acquire**
  - **Proceeds from disposal of**
- We want: negative NCF to signal an expanding entity

Free cash flow = NCF operating activities – investing activities
Positive free cash flow indicates the entity holds enough to repay debt, give dividends and scale up operations

Financing activities [Interest Bearing Liabilities, Contributed equity]

- Disclosure
  - **Proceeds from issuing shares**
  - **Payments to acquire shares from owners**
  - **Proceeds from borrowings or issuing debt**
  - **Repayments of principal related to borrowings or debt**
- We want:

Restructuring

- A restructuring is a program that changes either
  - The scope of the entity's business
  - Manner in which the business is conducted

Part 8: Financial Analysis

8.1. Analysing financial statements

- Information must be compared to a benchmark
  - Past periods
  - Similar firms and industry averages
  - External benchmarks (different forms of investment)
  - Internal benchmarks (budget forecasts, bonus triggers, investors' required rates of return)

Horizontal analysis

- Comparing amounts to previous periods, i.e. % changes
- Interpret both the % change and dollar amount change

Vertical analysis

- Compare line items to a base item, typically of highest magnitude
  - Profit/loss line items expressed as a % of sales or revenue
  - SoFPos line items expressed as a % of total assets
- Financial statements expressed this way are called **common size statements**

Ratio analysis

- Comparing two line items
- If numerator and denominator increase by same amount,
  - Ratio <u>increases</u> if it is less than 1
  - Ratio <u>decreases</u> if it is more than 1
- There is no consensus on the classifications and formulas for ratios
- Ratios assist users in deciding an entity's
  - Profitability – ability to generate profits
  - Efficiency – ability to generate cash flows
  - Liquidity – ability to meet short term commitments
  - Gearing or leverage – capital structure
  - Market performance

8.2. Profitability ratios

Return on Equity (ROE)

- Shows return to <u>ordinary shareholders</u>
- Captures profitability, efficiency and capital structure
- Uses profit after-tax
- Excludes any non-controlling interests
- Equity includes contributed equity, reserves and retained profits

Earnings per share (EPS) / Diluted EPS

- Diluted EPS uses the no. Of shares if all convertible securities were implemented
- **Formula:** profit available to ordinary shareholders / WAVE no. Of ordinary shares on issue
- **Can also use NOCF instead of earnings in the numerator**

Dividend payout ratio

- Formula: dividends / profit

Price/Earnings ratio

- Shows the number of years of earnings it would take to earn back the share cost

8.7. Further analysis techniques

Trend analysis

- Use time series data to analyse past performance and try to predict future performance
- Technique expresses line items relative to a base year
  - Don't use an atypical year
  - Assign a value of 100
  - Express other years as a relative %

DuPont analysis

$$\text{ROE} = \text{Int \& tax impact} \times \overbrace{\text{EBIT PM} \times \text{ATO}}^{\text{ROA}} \times \text{Leverage}$$

$$\frac{\text{Profit}}{\text{Equity}} = \frac{\text{Profit}}{\cancel{\text{EBIT}}} \times \frac{\cancel{\text{EBIT}}}{\cancel{\text{Sales}}} \times \frac{\cancel{\text{Sales}}}{\cancel{\text{TA}}} \times \frac{\cancel{\text{TA}}}{\text{Equity}}$$

Part 9: Budgeting

Strategic planning and budgeting

- Senior management conduct strategic planning to plan for long-term (3-5yrs)
- **Budgets** operationalise the strategic planning by quantifying goals for the short-term (1yr)
- **Balanced scorecards** quantify non-financial goals

- **Cash outflows**
  - To suppliers and employees (using purchases and expense budget)
  - Relating to PPE (using capital expenditure budget)
  - For planned dividends
- The net expected cash position (from operating and investing activities) determines if funding is required
  - Budgeted profit/loss statement is completed after determining the **interest** and **tax expenses**
  - Cash budget is complete after accounting for the financing cash flows
- Cash budget should be prepared month-by-month

Budgeted statement of financial position
- Combined last years' one with the other budgets

Planning and control: analysing the cash budget
- Can pinpoint timings of projected cash shortages
  - Seek additional finance
  - Increase projected inflows (liquidate assets, investments)
    - Note: you can't just sell more, as you need to know the price elasticity of demand
  - Decrease projected outflows (defer capital expenditure, leverage trade credit terms)
- Can leverage excess cash situations by investing in short-term deposits

9.3. Evaluation: variance reports
- Completed at the end of the period to determine variances between actual results and budget forecasts
- Variances are identified as favourable (F) or unfavourable (U)
- Management applies a materiality threshold to identify significant variances (relative to its own guidelines)
- Management seeks explanations and considers corrective action (e.g. changing operations or bonuses)

Part 10: CVP Analysis

Sales and marketing decisions
- Sales budget: volume (units) of sales x selling price per unit
- Issues considered
  - What to sell
  - Quantity and price
  - How to promote it
  - How to distribute it
  - Offer cash/credit

Costing and pricing decisions
- Factors to consider when setting prices

FINAL Part 11: Sustainability

11.1 What is sustainability?

- **Sustainability:** economic activity that is socially and environmentally responsible for the medium/longer term (doing stuff better)
  - Intergenerational sustainability
- **Shared value:** the opportunities arising to become more sustainable (doing better stuff)
  - Innovative business modals and investment

Dimensions of sustainability (Corporate Sustainability Responsibility CSR)

- **Economics element**
  - Not compromising quality of life
- **Environmental element**
- **Social element**
  - Access to basic resources (food, water, etc.)
  - Embracing social investment (e.g. philanthropy)

There are incentives supporting the "business case" for sustainability

11.2 Theories explaining why businesses strive to be sustainable

Agency theory

- Companies' contracts with their executives to incentivise specific behaviour
- Contractual details are specified in terms of earnings targets, as well as <u>sustainability targets</u>
- Other associated costs and benefits
  - Minimal costs (e.g. avoid sugar tax or carbon tax)
  - Maximum benefits (e.g. environmental project approvals)

Stakeholder theory

- Organisation responds to interests of broader stakeholders such as environmental committees
- Can't explain differences between companies

Legitimacy theory

- Organisations continually strive to be seen as legitimate
- The "social" contract is the right customers give to companies to view their operations as legitimate
- Else customers can just leave or protest!

Institution-based arguments

- Institutions strive to be like companies they see as "leaders"