

# Accounting for Business Decisions B

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## Non-current assets

### Describe non-current assets and how they are recorded, expensed, and reported

- Resource that is expected to be used in the normal course of operations for more than one year and is not intended for resale. E.g. land, buildings, equipment
- Recorded at the cost of acquiring them including taxes, delivery costs, insurance costs during transit
- If it does not say not-essential assume that the cost is essential
- A non-current asset converts to an expense as it is used or consumed
- The general form of the entry to record depreciation is: Debit depreciation expense (expense increasing) Credit accumulated depreciation (contra asset increasing)
- Depreciation is reported on the statement of comprehensive income often as a separate line item

### Calculate and compare depreciation expense using straight-line, reducing-balance and units-of-activity methods.

#### Straight-line method

- Spread depreciation evenly over the useful life of an asset.
- The depreciable cost of the asset is divided by the useful life of the asset (in years) to yield the amount of depreciation expense per period.
- Carrying amount is what the asset is worth after depreciation for the period

Year	Calculation	Depreciation expense	Accumulated depreciation	Carrying amount
			\$ 0	\$65 000
2013	$(\$65\,000 - \$15\,000) / 5$	\$10 000	\$10 000	\$55 000
2014	$(\$65\,000 - \$15\,000) / 5$	\$10 000	\$20 000	\$45 000
2015	$(\$65\,000 - \$15\,000) / 5$	\$10 000	\$30 000	\$35 000
2016	$(\$65\,000 - \$15\,000) / 5$	\$10 000	\$40 000	\$25 000
2017	$(\$65\,000 - \$15\,000) / 5$	\$10 000	\$50 000	\$15 000

#### Reducing-balance method

- Results in more depreciation expense in the early years of an assets life and less depreciation expense in the later years
- Matches expenses to revenues better than the straight-line method
- They provide larger expenses (and if used for tax purposes larger tax deductible expenses) in earlier years of a non-current asset's life.
- For simplicity we use 2 times the straight-line rate
- 1-(formula)  $\longrightarrow$   $1-n \sqrt{\frac{\text{Residual value}}{\text{Cost}}}$

- The formula gives the percentage which you then multiply by the carrying value of the asset
- This often means the last depreciation expense calculation is to reduce the book value to the residual value.
- $(\text{Straight line rate} \times 1.5) \times (\text{cost} - \text{accumulated depreciation})$
- Example on page 135

### Units-of-activity method

- Calculates depreciation based on use
- Limited to assets whose units of activity can be in some way determined
- Depreciation per unit of expected activity is the depreciable cost of the asset divided by the estimated units-of-activity over the life of the asset.

## Understand the effects of adjustments that may be made during a non-current asset's useful life.

### Adjustments for useful life

- Changes occur due to; changes in estimates, additional expenditures to improve the non-current asset, significant decline the asset's net realisable value

### Changes in depreciation estimates

- Matthew purchases a machine for \$90 000 on 1/7/2010, with a 10 year useful life and \$10 000 residual value. Using straight-line, Matthew records \$8 000 depreciation expense each year.
- Start of Year 5: Mathew estimates that the machine will now last only 8 years and have a residual value of \$6 000. The prospective revision (current and future) will not correct the first four years. What is the new annual depreciation?

<b>Step 1</b>	<u>Calculate carrying amount revision time</u> Cost of the asset, 1 July, 2010 Less: accumulated <u>depn.</u> for four years Carrying amount on 1 July, 2014	\$90 000 \$32 000 <u>\$58 000</u>
<b>Step 2</b>	<u>Calculate depreciable cost for future depreciation:</u> Net book value on 1 July, 2014 Less: estimated residual value Remaining depreciable cost	<u>\$58 000</u> \$6 000 <u>\$52 000</u>
<b>Step 3</b>	<u>Calculate revised depreciation expense:</u> <u>\$52 000 ÷ 4 remaining years = \$13 000 annual <u>depn.</u></u>	

### Expenditures after acquisition

- A capital expenditure increases the expected useful life or productivity of the asset. A revenue expenditure maintains the expected useful life or productivity of the asset.

### Capital expenditure

- A company purchases a non-current asset for \$50 000 on 1/1/2013, with a five-year life and no residual value. During the fifth and final year of the asset's life, the company incurs \$8 000 for upgrades that extend the asset's life to 7 years, from 5.

Date	Description	Debit	Credit
Year 5	Non-current asset	8 000	
	Cash		8 000
	(To record upgrade to asset)		

<b>Step 1</b>	<u>Calculate net book value after capital expenditure:</u>	
	Cost of the asset, 1 July, 2010	\$50 000
	Less: <u>Accum depn</u> for four years	\$40 000
	Net book value on 1 July, 2014	\$10 000
	Plus: Upgrades made in 2014	\$ 8 000
	Updated Carrying Amount for 2014	\$18 000
<b>Step 2</b>	<u>Calculate depreciable expense:</u>	
	Updated book value for 2014	\$18 000
	Less: Estimated salvage value	\$ 0
	Remaining depreciable cost	\$18 000
	Divided by remaining useful life	÷ 3
	Annual depreciation expense	\$ 6 000

### Revenue expenditure

- A company purchases a non-current asset for \$50 000 on 1/7/2010, with a five-year life and no residual (salvage) value. During the fifth and final year of the asset's life, the company incurs \$1 000 in ordinary maintenance.

#### General journal

Date	Description	Debit	Credit
Year five	Maintenance expense	1 000	
	Cash		1 000
	(To record normal maintenance)		

- No change is made to actual asset

### Asset impairment

- When a non-current asset's recoverable amount falls below its carrying amount, the asset is considered impaired.
- Under AASB 136 entities apply conservatism by writing these assets down from their carrying amount to their recoverable amount (through use or sale).
- Normally any loss on impairment is an expense.
- Special rules apply to impairment of assets previously revalued and reversal of impairments.

### Record the disposal of non-current assets.

- The accounting for the disposal of a non-current asset consists of the following three steps:
  1. Update depreciation on the asset.
  2. Calculate gain or loss on the disposal.
  3. Record the disposal.

### Rules for calculating the gain or loss on disposal (ACCT Financial Ch 8 – for a comprehensive worked example)

1. Record any necessary depreciation expense (possibly for a partial period) to update the accumulated depreciation account.
2. Calculate any gain or loss on the disposal by comparing the asset's carrying amount.
3. Prepare a journal entry that decreases the asset account and its related accumulated depreciation account.

- Record any gain or loss on the disposal.

## Describe intangible assets and how they are recorded, expensed, and reported

- An intangible asset is a resource that is used in operations for more than one year but has no physical substance. Examples include patents, trademarks, copyrights, franchises, and goodwill
- company holds a \$60 000 patent that has the maximum legal life of 20 years. The company estimates the patent will be useful for only 12 years and will then be worthless. How do we record amortization (depreciation)?  $\$60\,000 \div 12 = \$5\,000$  per year
- Debit Amortisation expense, Credit Patent
- Amortisation applies only to intangibles with limited lives like patents, assets with indefinite lives' like trademarks and goodwill are examined periodically to check for impairment

## Recording goodwill

- Suppose that Buyer Company purchases Seller Company for \$8 million when the value of Seller Company's net assets is \$6 million. How will this be recorded?

Description	Debit	Credit
Net assets of seller company	6 000 000	
Goodwill	2 000 000	
Cash		8 000 000

## Partnerships

### Describe the characteristics of the partnership form of business

- An association of two or more persons carrying on a business with a view to profit
- Social enterprise, third sector and not for profit entity's cannot structure as a partnership
- Characteristic: written agreement(deed of partnership), limited life, mutual agency, unlimited liability, co ownership of property, non-taxpaying entity

### Tests for determining the existence of a partnership

- Common law:** intention to be partners, agency: each party can make decisions on behalf of other parties, sharing profits
- Statutory rules:** joint ownership of property, sharing of gross returns, verbal agreements, receiving a share of partnership profits

### Accounting for partnerships

- Because a partnership is a pass-through entity, each partner reports his or her share of the partnership's income or loss as an individual. As a result, the accounting treatment is very much like a sole trader. To keep track of information, each partner will have (1) a capital account, and sometimes, (2) a drawing account.

- Each partner may contribute different assets and liabilities and withdraw different amounts at different times. Each partner is given their own partnership capital account to keep track of this

### Account for a partner commencing a partnership

- The capital account for each partner records the fair value of the net assets contributed
- Accumulated depreciation is not brought into the accounts (books) of the new partnership. But 'provision for bad debts' is usually recorded because we know who owes what, but we do not know who will not pay.
- E.g. Assume Emily and Paul each contribute \$10 000 cash to commence a partnership

Date	Description	Debit	Credit
2013 1 July	Cash	20 000	
	Emily, capital		10 000
	Paul, capital		10 000

- Assume Emily contributes: cash \$194, accounts receivable \$120 (probably won't collect \$20 of this), equipment (net) \$205 and a note payable \$200. (Owners' equity is a credit)
- The capital is the net difference of her contributions

Date	Description	Debit	Credit
2013 1 July	Cash	194	
	Accounts receivable	120	
	Equipment	205	
	Allowance for BD		20
	Note payable		200
	Emily, capital		299

### Calculate the allocation of profits and losses to the partners

- E.g. A & B are partners they share the first \$100 000 based on service. "A" performs 70% of the total service. The next \$100 000 is shared based on capital, "A" contributed \$3m and "B" \$2m. Remaining profits (or losses) are shared equally.
- If nothing about losses in partnership then split losses evenly

### Assume a profit of \$300 (figures in thousands)

	A	B	Total
Total profit			300
Based on service	70	30	(100)
Based on capital (3:2)	60	40	(100)
Balance remaining			100
Remaining shared equally	50	50	(100)
Profits allocated to partners	180	120	(300)

### Assume a loss of 150 (figures in thousands)

IS IT ?	A	B	Total
Total Profit (Loss)			(150)
Based on service	70	30	(100)
Based on capital (3:2)	60	40	(100)
Balance remaining	(175)	(175)	(350)
Profits allocated to partners	-45	-105	(150)
OR IS IT ?	A	B	Total
Total Profit (Loss)			(150)
Balance remaining, shared equally	(75)	(75)	(150)
Profits allocated to partners	(75)	(75)	(150)

### Assume a profit of 180 (figures in thousands)

IS IT ?	A	B	Total
Total Profit (Loss)			180
Based on service	70	30	(100)
Based on capital (3:2)	48	32	(80)
Balance remaining			0
Profits allocated to partners	118	62	180
OR IS IT ?	A	B	Total
Total Profit (Loss)			180
Based on service	70	30	(100)
Based on capital (3:2)	60	40	(100)
Balance remaining, shared equally	(10)	(10)	(20)
Profits allocated to partners	120	60	180

## Account for a partner entering or leaving the partnership

### Buying out an existing partner

- When an existing partner sells their share in the partnership to a new partner, the price paid is a private matter between them. Whatever capital account balance is left of the old partners' is debited and the new partners' capital is credited.

#### General journal

Date	Description	Debit	Credit
31 Dec.	Capital old partner	250	
	Capital new partner		250

### Investing in a partnership

- If a new partner expands the partnership and receives capital equal to the net assets contributed, then assets are debited and capital credited.
- The complication arises when a new partner pays more or less than the capital received.
- If the new partner pays more than the capital received then it is a bonus to existing partners
- If the new partner pays less than the capital received then it is a bonus to the new partner
- Example on lecture 2 slide 24

### Withdrawal of a partner

- Assume the previous partnership with capital of \$600 (A = \$100 + \$60, B = \$200 + \$40, C = \$200)
- They have agreed to share profits 40% to A, 30% to B and 30% to C.
- B leaves taking \$310 cash (\$70 more than their capital balance which is shared 4:3 by A and B respectively)

#### General journal

Date	Description	Debit	Credit
23 Mar.	Capital B	240	
	Capital A (4/7 x \$70)	40	
	Capital C (3/7 x \$70)	30	
	Cash		310

- Bonuses are shared among remaining partners in proportion to their profit sharing before the partner leaves.
- Assume the same partnership but B leaves taking \$100 cash (\$140 less than their Capital balance which is a bonus to remaining partners shared 4:3)

#### General journal

Date	Description	Debit	Credit
23 Mar.	Capital B	240	
	Capital A (4/7 x \$140)		80
	Capital C (3/7 x \$140)		60
	Cash		100

## Account for the liquidation of a partnership

- Sell off your assets into cash so the only assets is cash at bank

2. Pay off your liabilities by using cash
3. If you have any money left after paying of your debts return it to your owners

### Prepare the financial statements for a partnership.

- The major difference is that in the statement of financial position there is a capital account for each partner. Profits distributed to each partner may be shown at the bottom of the statement of comprehensive income
- Statement of changes in equity has a opening balance of each partner's capital

## Financial Statement Analysis

### Understand the nature of financial statement analysis

- The process of applying analytical tools to a company's financial statements to understand the company's financial health and requires; financial information, standards of comparison, analysis tools
- Common benchmarks include **intra-company** comparison which uses prior years of the same business as well as **intercompany** comparison that compares competitors.
- **Ratio analysis** is a comparison of different balances from the financial statements. Ratios are grouped together to assess a company's profitability, ability to pay debts, and survival in the long term,

### Calculate and interpret horizontal and vertical analysis

#### Horizontal analysis

- Calculates the change in an account balance from one period to the next
- **Current year- base year/ base year**

#### Vertical analysis

For the Balance Sheet	or	For the Income Statement
$\text{Percentage} = \frac{\text{Account balance}}{\text{Total Assets}}$		$\frac{\text{Account balance}}{\text{Net Sales or Revenue}}$

- States each account balance on a financial statement as a percentage of a base amount on the statement
- Expenses and income figures are stated as a percentage of sales or total revenue (set at 100%).

### Assess profitability through the calculation and interpretation of ratios.

#### Profit margin ratio

- Compares net income to net sales and measures the ability of a company to generate profits from sales
- A higher ratio indicates a greater ability to generate profits from sales
- **Profit margin=Total comprehensive income/ Net Sales**

### Return on equity

- Compares profits to the average balance in shareholders' equity, showing how effectively a company uses the funds provided by shareholders to generate additional equity for its owners
- **Return on equity= Total comprehensive income/Average shareholders' equity**
- **Average equity= Beginning equity + ending equity/2**

### Return on assets

- Compares income to average total assets
- Represents the ability to generate profit from entire resource base
- **Return on assets= Total comprehensive income/ Average total assets**
- **Average assets= Beginning assets+ ending assets/2**

### Earnings per share

- Compares a company's profits to the average number of shares
- It is the return on each share owned by an investor
- **Earnings per share= Total comprehensive income/ Average number of shares**
- **Average number of shares= Begging shares + ending shares/2**

### Price to earnings ratio

- Compares income to the current market price of the company's share, it is an investors perception of the company
- A price earnings ratio of 10 means that investors pay ten times current EPS share to buy one share.
- A higher price to earnings ratio generally indicates that investors are more optimistic about the future prospects of a company.
- **Price to earnings= Current market price of a share/Earnings per share**

### Assess liquidity through the calculation and interpretations of ratios

Liquidity ratios	Relationship
Current ratio	Current assets to current liabilities
Quick ratio	Cash-like assets to current liabilities
Receivables turnover ratio	Sales to account receivable
Inventory turnover ratio	Cost of goods sold to inventory

- Liquidity ratios assess the ability of a company to meet its immediate or short-term financial obligations. Failing to do so can result in additional expenses and, ultimately, bankruptcy.

### Current ratio

- It compares assets that should be turned into cash within one year to liabilities that should be paid within one year. A higher ratio indicates greater liquidity.
- **Current ratio= Current assets/ Current liabilities**