ACCT10001 – Accounting Reports and Analysis

Study Notes

Contents

1 Nature and purpose of accounting

Accounting identifies, measures and communicates economic information so that people who cannot observe the entity from the inside can still decide whether to provide resources, and so that managers who *can* observe the entity can plan, control and choose among courses of action. The two settings share a language of assets, liabilities, equity, income, expenses and cash flows. They do not share the same primary audience, the same rules, or the same idea of what “useful” means.

Definition
The AASB *Conceptual Framework for Financial Reporting* states that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity. Those decisions include buying, selling or holding equity and debt instruments, providing or settling loans and other credit, and exercising rights to vote on, or otherwise influence, management’s actions.

Primary users cannot require the entity to hand them a private information pack. They rely on general purpose reports. Their expected returns (dividends, interest, principal, market-price changes) depend on the amount, timing and uncertainty of future net cash inflows, and on how management has discharged its *stewardship* of the entity’s economic resources. Reports therefore speak to two related questions: what resources and claims exist, and how efficiently those resources have been used.

General purpose reports do not, and cannot, provide everything a user needs. Users still have to bring in industry outlooks, macroeconomic conditions and their own forecasts. The reports are also not designed to show the value of the reporting entity. They supply information that helps users estimate that value. Much of what appears in the statements is estimated, not observed: useful financial information is produced with judgements and models, not only with counts of cash. The Framework’s primary users are existing and potential investors, lenders and other creditors. Employees, customers, governments and the public may also read the reports, but the Framework does not set out to meet every information need of those groups. A tax computation, an enterprise agreement, or a licence condition can require information the general purpose pack does not contain. That is a design choice: if the reports tried to serve every audience equally, they would serve the resource-providers who cannot command private information less well.

Two questions sit inside the objective and should not be ranked as rivals. First, what are the prospects for future net cash inflows (amount, timing, uncertainty)? Second, how efficiently and effectively has management discharged its responsibilities to use the entity’s economic resources? A lender pricing a covenant and a shareholder voting on directors are both using the same statements, for those two questions, with different weights.

Key concept
Stewardship information is not a separate, optional report. It is part of why general purpose reports exist. A user who reads profit only as an input to a valuation model, and never as evidence of how resources were used, is using half of the objective. A user who reads profit only as a scorecard for management, and never as a basis for forecasting cash, is using the other half.

1.1 Financial reporting and management accounting

Financial accounting produces information for parties outside the entity, under Australian Accounting Standards (which incorporate IFRS Standards with Australian-specific material). Management accounting produces information for parties inside the entity. Managers can obtain whatever internal information they need; they do not depend on the general purpose pack. The same transaction can therefore be measured one way for external reports and analysed another way for an internal decision, provided the external reports still comply with the Standards.

Feature	Financial accounting	Management accounting
Primary users	Investors, lenders and other creditors who cannot command information	Managers, team leaders, and the governing board in its planning role
Constraint	Australian Accounting Standards, the Corporations Act, and (if listed) ASX rules	Cost–benefit and relevance to the decision; no statutory format
Time focus	Past transactions and conditions, with estimates that look forward	Past, present and future: budgets, forecasts, and what-if analysis
Unit of reporting	The reporting entity, often a group	Product, job, customer, process, responsibility centre
Qualities prized	Comparability, verifiability, faithful representation	Timeliness, decision-fit, and the ability to change a plan

The subject's emphasis is the *use* of accounting information, not the bookkeeping craft of journals and ledgers. A user who cannot prepare a trial balance can still ask whether a reported asset meets the definition, whether a measurement basis is historical cost or current value, and whether a ratio is distorted by a policy choice. The cost constraint sits over both financial and management accounting. Producing information consumes preparer time, audit fees, system costs and, on the user side, the cost of reading. An extra disclosure that nobody can use is not "more transparent"; it is noise. The Framework's test is whether the benefits of reporting an item justify those costs, assessed by reference to primary users as a group, not to a single analyst's wish list.

1.2 Accrual accounting and cash

Key concept

Accrual accounting depicts the effects of transactions and other events on economic resources and claims in the periods in which those effects occur, even if the related cash receipts and payments fall in a different period. Cash accounting records receipts and payments when cash moves. Profit under accrual accounting is not a cash figure.

A credit sale recognised when control of the goods passes increases assets (a receivable) and income now; cash may arrive next month. Depreciation allocates the consumption of a machine across the periods that benefit from it; cash left when the machine was purchased. A user who treats profit as "cash in hand" will misread liquidity, solvency and the capacity to pay dividends.

Cash-flow information remains essential. It shows how the entity obtained and spent cash, including borrowing, repayment, and distributions to investors, and it helps users assess liquidity and solvency. The two depictions answer different questions. Accrual profit asks whether economic resources increased from operations. Cash flow asks whether cash increased, and from which activities.

Example: Accrual profit and cash from the same month

Given. Preston Lighting Pty Ltd, a wholesaler, records the following in May (exclusive of GST). Credit sales AUD 90,000; cash collected from customers AUD 72,000 (opening trade receivables AUD 21,000). Inventory purchases on credit AUD 48,000; cash paid to suppliers AUD 41,000; cost of sales AUD 44,000. Wages earned AUD 14,000, of which AUD 12,500 is paid in May. Quarterly rent of AUD 9,000 is paid on 1 May for May–July. A machine purchased for cash last year is depreciated AUD 2,000 for May. No other items.**Method.** Compute May profit under accrual accounting. Compute the May change in cash from these items. Reconcile receivables and explain why the two figures differ.**Working.** Accrual income: sales 90,000. Accrual expenses: cost of sales 44,000; wages 14,000; rent $9,000 \times \frac{1}{3} = 3,000$ (two months remain prepaid); depreciation 2,000. Profit $= 90,000 - 44,000 - 14,000 - 3,000 - 2,000 = 27,000$.

Cash from these items: $+72,000 - 41,000 - 12,500 - 9,000 = +9,500$ (the machine was paid last year).

Closing receivables: $21,000 + 90,000 - 72,000 = 39,000$. Closing prepayment: 6,000. Neither sits in cash.**Interpretation.** May's economic resources from trading rose by AUD 27,000 on the accrual depiction. Cash rose by only AUD 9,500, because credit customers and a rent prepayment absorbed cash, and because