ACCT1501 Notes

Chapter 1 - Introduction to financial accounting

- Financial accounting allows for the production of useful information which can be used in a variety of ways

1.2 Financial Accounting

- **Accounting** is the process of identifying, measuring, recording and communicating economic information to assist users to make informed decision
- **Financial accounting** - periodic financial statements provided to external decision makers (investors, creditors, customers)
    - Primarily measures **financial performance** (generating new resources from day to day operations *over a period of time)* and **financial position** (a firm's set of financial resources and obligations *at a point in time)*
    - Financial statements also contain notes, which provide an explanation of all the numbers
- Strong financial performance leads to a healthy financial position. Likewise, a healthy financial position facilitates strong performance (similar to the link between income and wealth)
- **Management accounting** - detailed plains and continuous performance reports provided to internal decision makers (managers) to help with operational planning and control decisions

1.3 Who uses financial accounting information?

- Board of Directors - to evaluate CEO performance
- Management - making business decisions
- Unions - wage negotiations
- Financial analysts/Shareholders - buy, sell or hold
- Bankers and creditors - to lend or not to lend
- Suppliers - Profitability of signing a contract with a firm

1.4 The people involved in financial accounting

- The main participants in financial accounting are:
    - Information users (decision-makers)
    - Information preparers
    - Auditors - enhance credibility of information, providing a professional opinion about the fairness and appropriateness of it
- A **user** is someone who makes decisions on the basis of financial statements. They require credible periodic financial statements (i.e. the information must be trustworthy and be provided regularly)
    - Examples of users: owners, potential owners, creditors, potential creditors, managers, employees, unions, regulators, financial and market analysts, competitors, customers, suppliers, ATO
- A **preparer** puts together financial statements
    - Examples of preparers: Managers, bookkeepers and clerks, accountants
- **Auditors** report on the credibility of financial statements. They must verify that these have been prepared fairly, competently and in line with accounting principles.

Their role came about to ensure that managers were not being self-serving, biased and untruthful in the preparation of financial statements. It is incredibly important that the external auditor is financially and ethically *independent* of the company, and so can be *objective.*

- **External auditors** report on financial statements on behalf of external users
- **Internal auditors** work within firms to support the credibility of information

1.5 Accrual accounting

Depreciation of assets???

- Under an **accrual accounting** approach, the impact of financial transactions are recorded as revenues and expenses occur rather than when cash is received or paid
    - It aims to include all cash flows that have already happened, incorporated expected future cash flows, measure the value of incomplete transactions (accounts receivable that will likely not be collected), estimate figures when exact amounts are unknown, assess awkward problems
    - There is a need for judgments to be made when preparing financial statements through an accrual accounting system. Therefore financial statements tend to be imprecise in reality, as they are dependent upon the quality and fairness of the judgments of managers, accountants and auditors
- **Cash accounting** records revenues and expenses at the time the cash is received or paid. While this reasonably precise, it experiences problems when the timing of the cash flow is in a different accounting period to the substance of the transaction.
    - For example, if a good is sold on credit, and the cash will not be received until a later accounting period

1.6 The key financial statements

Key financial statements provide information about a firm's financial position, financial performance, financing activities and investing activities.

- **Balance Sheets** show financial position at a point in time - they are used to assess financial structure and the ability to repay debts
- **Income statements** measure financial performance over a period of time
- **Statement of cash flows** show the sources and uses of cash over a period of time, highlighting financing and investing activities

Balance Sheet : A = L + OE

- The three main elements of a balance sheet are assets, liabilities and owners' equity
    - Assets: Resources that will benefit the company this year (current assets) or in future years (non-current assets)
        - E.g. Cash, accounts receivable, inventory, equipment
    - Liabilities: What the company owes
        - E.g. Accounts payable, wages payable, provision for employee entitlements, long term loans
    - Equity: What belongs to the owners - it is the residual claim of shareholders

on the excess of assets over liabilities

- E.g. Share capital (amount owners have invested), Retained profits (profits not distributed as dividends)

- The relationship between the elements of the balance sheet can be expressed through the accounting equation:
    - Assets = Liabilities + Owners Equity
        - This suggests that the resources of a firm are funded by either debt (liabilities) or equity (Owners equity)

Income Statement: Sales less COGS = Gross Profit --> less expenses = Operating profit before tax --> less tax = Operating profit after tax

- Provides information of a company's profitability by recording revenues earned and expenses incurred over a period of time
- Revenue: inflows of economic benefits that increase owners equity
    - E.g. Sales revenue, service revenue, fees earned
- Expenses: outflows of economic benefits that decrease owners equity
    - E.g. Operating expenses (salaries, electricity), Tax
- *The operating profit after tax is the connecting link between the balance sheet and the income statement.*
    - *Opening balance of retained profits (B/S) + Operating profit after tax (I/S) - Dividends = Closing balance of retained profits (B/S)*

Statement of Cash Flows:

- Provides details of movements in an entity's cash balance. Categorised as:
    - Operating activities: relating to the provision of goods and services
    - Investing activities: relating to the acquisition and disposal of certain non current assets (property, plant and equipment)
    - Financing activities: related to changing the size and composition of the financial structure of the entity (equity, certain borrowings)

1.7 Relationships between the financial statements

Users of financial information have certain expectations regarding the quality of financial accounting information:

- Relevance - information should assist users in making decisions about the allocation of scarce resources
- Timeliness - information must be provided early enough to allow for decisions to be made
- Reliability - information should be unbiased, objective, and not mislead users
- Materiality (significance) - assessing whether the omission, misstatement or non disclosure of information would affect users. Information that is material is significant, while information that is non-material is not
- GAAP (generally accepted accounting principles) - information is prepared in accordance with GAAP
- Prudence - the need to be cautious: in the presence of uncertainty, assets, revenues and profits should not be overstated, and liabilites, expenses and losses should not be understated
- Disclosure - notes and account descriptions are provided to increase the clarity of financial statements

- Understandability - Reports should be prepared having regard to the ability of users to interpret the information
- Comparability
- Consistency - keeping the same accounting methods over time

There exists certain trade-offs among accounting principles. Examples include:

- Prudence is a bias that interferes with reliability
- Following new accounting methods being issued will compromise consistency
- Inverse relationship between reliability and timeliness

1.8 Financial statement assumptions

Some basic assumptions underly current accounting practices and the preparation of financial statements

- Accounting entity assumption - activities of the entity are separate from those of its owners
- Accounting period assumption - life of a business is divided into discrete time periods of equal length to evaluate performance (producing regular, comparable financial statements)
- Monetary assumption - accounting transactions are measured in a common denominator (AUD)
- Historical cost assumption - transactions/assets are recorded at their original cost
- Going concern assumption - financial statements are prepared on the premise that the organisation will continue operations in the foreseeable future, with no intention or need to liquidate
- Materiality assumption
- Accrual basis - financial reports are prepared on the accrual basis of accounting

1.9 Is accounting really important?

- Used by
  - management in making business decisions
  - shareholders for decision making purposes
  - board of directors in takeover battles
  - bankers and creditors in lending decisions
  - corporated boards in rewarding and removing excecutives
  - unions and management in wage negotiations
- Impacts
  - economy and employment
  - community and consumers
  - employees

Chapter 2: Measuring and evaluating financial position and performance

2.1 Introduction to the balance sheet

The balance sheet is a statement that summarises the financial position of an enterprise at a particular point in time. It provides information about:

- Financial structure: mix of debt and equity

- Liquidity: ease of converting assets to cash in normal course of business (short-term focus)
- Solvency: ability to pay debts when they fall due (longer-term focus)

Essential components of the balance sheet are:

- Name of the entity
- Type of financial statement
- Date
- Currency

2.2 Explanation of three balance sheet categories

Not all assets and liabilities are recorded on the balance. They must meet the definition and the recognition criteria

- Assets: a resource that is controlled by an entity as a result of past events, and from which future economic benefits are expected to flow to the entity:
    - Definition Criteria:
        - Future economic benefit: assets are used to provide goods or services with the objective of generating net cash flows
        - Control by the entity: capacity of an entity to benefit from the asset in pursuing its objectives and to deny or regulate the access of others
        - Occurrence of past transactions or other past events: the transaction or event giving the entity control over the future economic benefits must have occurred
    - Recognition Criteria:
        - Probable that any future economic benefit associated with the item will flow to the entity
        - Item has a cost or value that can be measured reliably
    - Assets can be:
        - Current: expect to realise benefits within the year
        - Non current: expected to have benefits for more than a year into the future
- Liabilities: a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
  Note: an expectation to pay later is not a liability if the transaction bringing the benefit has not happened
    - Definition criteria:
        - Present obligation exists and the obligation involves settlement in the future
        - It has adverse financial consequences for the entity in that the entity is obligated to sacrifice economic benefits to one or more other entities
        - Occurrence of past transactions or other past events
    - Recognition Criteria:
        - Probable that any future economic benefit associated with the item will flow to the entity
        - Item has a cost or value that can be measured reliably
    - Liabilities can be:
        - Current: will be paid off within the year
        - Non current: will remain liabilities for more than a year