

Week 1 – Accounting Lecture

The role of accounting in decision making

Defining accounting

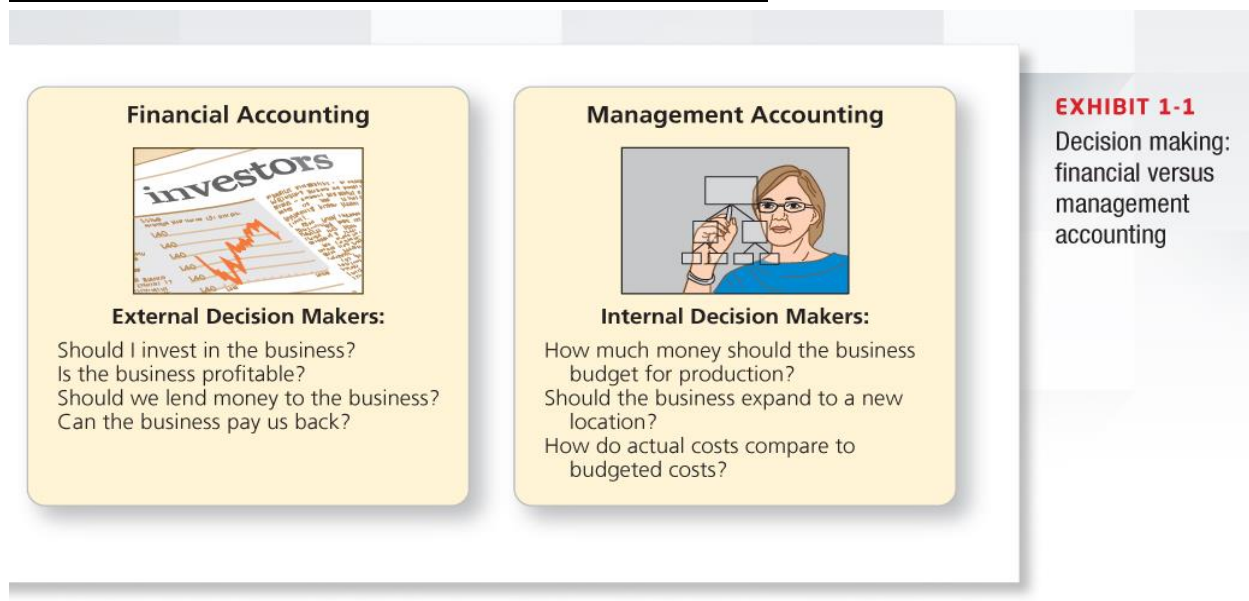
Accounting encompasses the information system that:

- measures business activities
- processes the data into reports
- communicates the results to decision makers

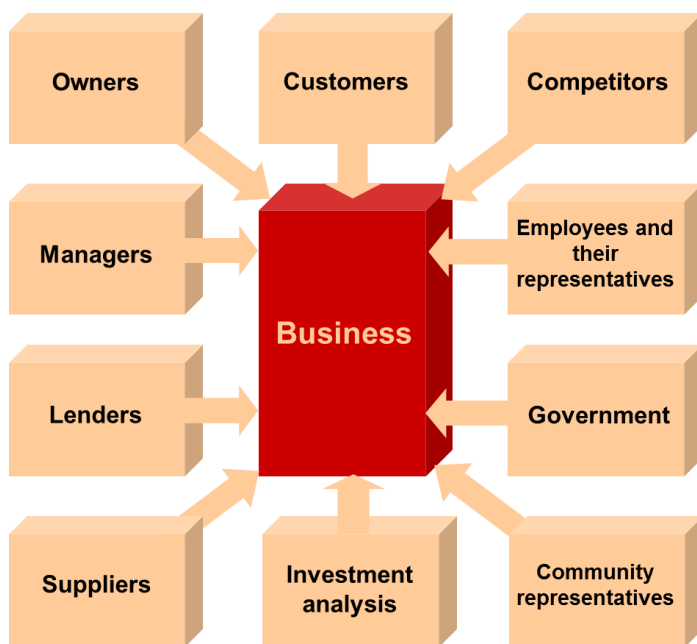
It is divided into two main types, namely:

- Financial accounting
- Managerial accounting

Decision making: financial versus management accounting



Users of accounting information



The accounting equation

- This measures the resources of a business and the claims to those resources.

- Equation always stays in balance.
- Each transaction affects at least two accounts, sometimes more.
- Some transactions affect only one side of the equation; some affect both sides.

Assets = Liabilities + Equity

Assets = Equity + Liabilities

Liabilities = Assets – Equity

Equity = Assets – Liabilities

Elements of the accounting equation

- **Assets** are resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity
- **Liabilities** are debts that are payable to outsiders called creditors
- **Equity** is the residual interest in the assets of the entity after deducting all of its liabilities
- **Revenue** arises from ordinary activities. Revenue, in the form of profit (revenues less expenses), and investment by owners increase equity.
- **Expenses** decrease equity by using up assets or increasing liabilities in order to deliver goods or services to customers

Current and non-current assets

- Current assets
 - cash
 - marketable securities
 - accounts receivable (debtors)
 - office supplies
 - inventory
 - prepaid items
- Non-current assets
 - land
 - building
 - machinery
 - motor vehicle
 - office equipment
- Intangible non-current assets
 - goodwill
 - patents
 - copyrights

Current and non-current liabilities

- Current liabilities
 - bank overdraft
 - accounts payable
 - accrued payments

- Non-current assets
- long term debts (mortgage)

Owner's Equity

Is what's left of your assets after you pay the liabilities.

- Investments by owners (+)
- Revenues (+)
- Distributions to owners - drawings or dividends (-)
- Expenses (-)

Revenues

Are amounts received or to be received from customers for sales of products or services.

- Sales
- Performance of services
- Rent (received by the property owner)
- Interest (earned by the investor)

Expenses

Are amounts that have been paid or will be paid later for costs that have been incurred to earn revenue.

- Salaries and wages
- Electricity
- Rent (paid)
- Supplies used
- Advertising

Accounting for business transactions

- **Accounts** record the impact of events that are considered to affect the value of entities' assets, liabilities and equity
- A **transaction** is an event that involves at least two parties exchanging resources
 - Each transaction affects at least two accounts in the accounting equation
 - Some transactions affect only one side of the equation; some affect both sides
 - After each transaction, the accounting equation must be balanced

Rules for recording transactions

	DEBIT	CREDIT
ASSETS	+	-
LIABILITIES	-	+
CAPITAL	-	+
DRAWINGS	+	
REVENUES		+
EXPENSES	+	-

Example

Transaction 1: Starting the business

Transaction 2: Purchase of land

Transaction 3: Purchase of office supplies

Transaction 4: Earning of service revenue

Transaction 5: Earning of service revenue on credit

Transaction 6: Payment of expenses

Transaction 7: Payment of account

Transaction 8: Collection on account

Transaction 9: Sale of land

Transaction 10: Withdrawal of cash

Transaction 11: Personal transaction

Assets				Liabilities	Owners' equity
Cash	Land	Office supplies	Accounts receivable	Accounts payable	Sheena Bright, capital
(1) +30 000					(1) +30 000
(2) -20 000	(2) +20 000				
		(3) +500		(3) +500	
(4) +5 500					(4) -5 500
			(5) +3 000		(5) +3 000
(6) -3 300					(6) -3 300 *

Assets				Liabilities	Owners' equity
Cash	Land	Office supplies	Accounts receivable	Accounts payable	Sheena Bright, capital
(7) -300				(7) -300	
(9) +1 000			(9) -1 000		
(10) +9 000	(10) -9 000				
(11) -2 000					(11) -2 000

* Various expenses – rent, salaries, lease, electricity and gas

Financial Statements

Accounting reports, called **financial statements**, provide summarised information to the owner.

Statement of Financial Performance (Income statement) – A summary of the revenue and expenses for a specific period of time.

Statement of Financial Position (Balance sheet) – A list of the assets, liabilities, and owner's equity as of a specific date.

Statement of cash flows – A summary of the cash receipts and disbursements for a specific period of time.

Statement of owner's equity – A summary of the changes in the owner's equity that have occurred during a specific period of time.

Limitations of accounting information

- Accounting information is only a part of information to make decisions
- Time lag

- Historical information
- Subjectivity of information (use of judgments & estimates)

Accounting measurements: concepts and principles

- The primary objective of external financial reporting is to provide useful information that is relevant and provides a faithful representation of the company's financial status.
- When reports are prepared there is a set of general principles and detailed requirements (accounting standards) that are followed to ensure consistency between the financial statements
- Some of the basic concepts and principles that underpin the accounting standards are:
 - entity concept
 - accounting period concept
 - accrual accounting
 - going concern assumption
- The **entity concept** defines the entity for which accounting data is collected.
- The **accounting period concept** defines the unit of time for which accounting data is collected.
- The **accrual basis of accounting** adopts the view that profits from activities are recognised when revenues or gains are 'earned' regardless of when cash is paid.
- The **going concern assumption** assumes that the business as a whole will continue operating for the foreseeable future.

Qualitative characteristics of financial statements

- **Relevance** – financial information should be capable of making a difference in the decisions made by the users of the information
- **Faithful representation** – accounting information should be complete, unbiased or 'neutral', and free from error

plus

- Information should be:
 - comparable over time
 - verifiable
 - timely
 - understandable

Types of business organisation

EXHIBIT 1-6

Comparison of the three forms of business organisation

	Proprietorship	Partnership	Company
1 Owner(s)	Proprietor—there is one owner	Partners—there are two or more owners	Shareholders—there are generally many owners
2 Life of organisation	Limited by owner's choice or death	Limited by owners' choices or death	Indefinite
3 Personal liability of owner(s) for business debts	Proprietor is personally liable	Partners are personally liable	Shareholders are not personally liable
4 Accounting status	The proprietorship is separate from the proprietor	The partnership is separate from the partners	The company is separate from the shareholders

Ethics and professional conduct

- Financial reports prepared by accountants play a central part in informing financial decisions.
- The CAANZ and CPAA have a joint code of ethics for professional accountants as part of their professional standards
- **This code includes the following principles**
 - integrity
 - objectivity
 - professional competence and due care
 - confidentiality
 - professional behaviour

Summary: Chapter 1

- Accounting is typically divided into financial accounting and managerial accounting.
- Different users review a company's financial statements for different reasons.
- The accounting equation measures the resources of a business and the claims to those resources.
- Transactions are events involving at least two parties exchanging resources.
- A complete set of financial statements consists of four financial statements.
- There are several concepts and principles, including the entity concept, accounting period concept, accrual basis of accounting and the going concern assumption.