Accounting and Financial Management 1A

LECTURE 1 NOTES

Accounting definition:

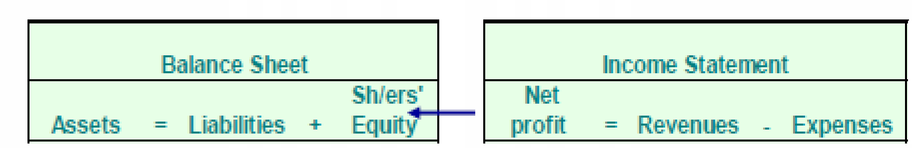
- Way in which organisations provide measure of financial position/performance. Conveys economic info. to decision makers > economic consequences of accounting (rise during the 60's and 70's) e.g. new corporate governance laws, collapse of companies e.g. Enron.
- Financial accounting – periodic financial statements provided to external entities e.g. investors i.e. buying or selling shares.
- Management accounting – internal decision makers providing basic financial records for management.

Double-entry book-keeping:

- Keeping track of where money comes from and where it goes.

Resources (Assets) = Sources (Liabilities and Shareholders' Equity (Capital)

Recorded in Balance Sheet



Net profit affects retained earnings a component of shareholder's equity.

Annual Report:

- Contains GPFR and company descriptions.

Concepts underpinning accounting:

- Going concern – presumption that company will continue operation (won't be liquidated).
- Unit of measurement – only $A transactions are recorded and the transactions are recorded to the original price of the entity.
- Accounting entity – the entity is separate from its owners.

Threshold Concept:

Matching Concept (Cash accounting) *vs.* *Accrual Concept*

All expenses to generate that period of revenue are deducted from revenues earned when receipts given.

Recognise revenue at point of sale but also expenses when they are incurred even though receipt comes later.

The cycle of business is divided into discrete time periods e.g. 1 yr/month to produce comparable financial statements.

Limitations of financial statements:

- Only quantitative data conveyed, no qualitative data e.g. value of the management team.
- Estimates e.g. warranty costs are used.
- Not adjusted for **inflation** and don't reflect the **opportunity cost**

General Purpose Financial Reports:

Objectives of GPFR:
- Provide useful information for evaluating/making decisions on resource allocation.
- Discharge accountability of managements and governing bodies.

Who uses GPFR?
- Resource providers compensated directly (employees, lenders, business entities) or indirectly (donors, members of public sector bodies i.e. taxpayers) for the resources they provide.
- Recipients of goods and services who benefit from the resource the reporting entity provide e.g. customers, beneficiaries.
- Parties providing a review/oversight function e.g. parliaments, government's employer groups.
- Management or governing bodies e.g. government enterprise.
- Owners (possibly shareholders) or proprietors as well as potential owners.

Preparers:
- Managers –need to avoid bias in their conflicting role of preparing but also understanding accounting data.

Auditors:
- Assess and ensure credibility of the financial statements.

Balance Sheets:

- Organisations resources +claims on resources at a point of time including:

    Assets (things or rights):
    - Accounts receivable (owing from customers for goods provided to them)
    - Inventory (stock on hand)
    - Investment Property
    - Inventory, plant, equipment
    - Tax Assets

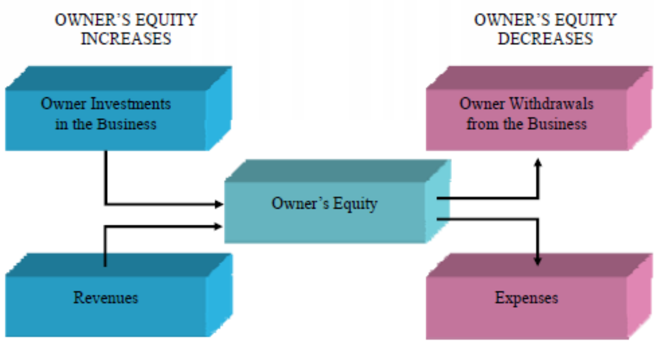
    Liabilities (anything other than an obligation to shareholders):
    - Accounts payable (owed to suppliers of goods)
    - Wages payable
    - Provision for employee entitlements e.g. sick leave or warranty for faulty products *not yet been paid*.
    - Tax liabilities (deferred tax liabilities where current reported accounting profit is > profit on tax return becoming a liability of income tax)

    Shareholder's equity:
    - Capital invested into the company
    - Retained profits distributed as dividends
    - Reserves

Which gives the equation > Assets + Liabilities = Shareholder's equity.

- Signals to companies the ability to pay LT loans and creditors and liquidity of assets.

Current assets – likely to be consumed over a period of 12 months within the operating cycle. Non-current assets – likely to remain with the company for a period of > 12 months.



Assets:
Defined as resources paid for by an organisation with a legal right. The resource must possess future economic benefit (FEB) and a reliable measurement of its value. Assets are only recorded where there is economic control i.e. employees are not owned and therefore not an asset.

Divided into **current** (most likely to last <12 months or consumed within the normal operating cycle of the company) and **non-current** (most likely to last > 12 months).

The realizable value of the asset if how much it could possibly sell for, while the present value defines how much could be made by using it.

An increase in the $ of an asset increases reserve, while a decrease increases liabilities.

Liabilities
Defined as obligations owed by an organisation – represent negative future cash flows. Not always paid back in cash but also G + S. Same concept with current and non-current liabilities.

Shareholder's equity
Defined as the amount of investments made by business owners. The residual interest in the entity assets after subtracting liabilities. The SE does not convey the market value of the whole business, only the historical cost of original capital etc. Examples include the purchase of shares by future owners recorded as share capital in the SE.

Balance sheet analysis:

- Debt-to-equity ratio: total liabilities / shareholder's equity. Indicates whether the business is financially sound if <1.
- Working capital ratio: Current assets/current liabilities. Indicates the ability to pay bills if >0.
- High amount of cash assets in the organisation indicates the leniency to declare a dividend for shareholders' of retained earnings/profits. However, a large amount of assets offers little leniency.
- By looking at the 'net' equipment asset of the balance sheet, we are able to account for depreciation of the equipment from its historical cost and identify which equipment may need replacement, where money is being lost.

Income statement:

- Information on organisation's profit or loss over a period of time of consideration. Also called statement of performance or operations.
- Profit = revenue – expenses

Revenue are increases in the company's wealth resulting from the provision of services or sale of goods to consumers, while **expenses** are the opposite resulting from operating costs or where long-term assets depreciate in value.

Income Statement accounts:

- Net sales – amount of revenue from sales less the amount of goods returned.
- Cost of goods sold – total cost of stock removed from inventory and sold.
- Gross profit – difference between net sales and cost of goods sold.
- Selling general and admin. expenses represents operating expenses of the entity.
- Interest expense – cost of using borrowed funds
- Income taxes – shown after all expenses, tax recorded on those expenses.
- Net profit per share.

Other features:

- Share of profit/loss from joint ventures or loss of associates.
- Employee benefits (**that have been paid!**).
- May include depreciation of non-current assets in notes or on the statement.

Income – increases in economic benefits during the accounting period that results in increases in equity. Income from revenue arises in the course of everyday activities, while income from gains is similar.

Expanding the basic accounting equation to include revenue + expenses:

A = L + SE

- SE = retained profits and capital
- Retained profits = accumulation of net profits (revenue – expenses) on the income statement – dividends paid out to owners.
- Profit is part of the **equity** component of the balance sheet.
- Overall positive net profit leads to either an increase in assets/decrease in liabilities or therefore an increase in equity.

Increases in SE:

- Contributions by owners increases cash and share capital > thus increasing assets and SE.
- $3000 interest payment on bank deposit increases cash and revenue > thus increasing assets and SE.
- **Dividends are not expense** simply a redistribution of profit to shareholders.

- Therefore A = L + CC (contributed capital) + RE (retained earnings) + R – E. This is the link between the BS and IS.

Income statement analysis:

- Announcements of profits whether they be pre-emptive or not, have a direct correlation with the value of share prices in the company.

Statement of cash flows

- Changes during a period in one balance sheet through operating, investing and financing activities.

Financial Accounting information needs to be:

- Relevant – time here is an issue.
- Reliable – the numbers should measure events neutrally without overstating an impact.
- Material – the assessment of whether an omission or non-disclosure of information would affect user decisions.
- Generally accepted accounting principles – based on past circumstances or situations the information needs to be believed for that organisation.
- Prudent – liabilities, losses should not be overstated.

Double Entry System

Transaction Analysis:

- Transactions are events that affect the operations and finances of an organisation.

Examples:

- Equipment worth 90000 purchased by paying 20000 cash and signing an agreement to pay the remainder in 90 days.

  Inventory + 90000 – 20000 cash assets = 70000 increase in assets.
  Increase in accounts payable +70000 = 70000 increase in liabilities.

- Shareholders invest 200000 in the business.

  Increase in cash asset = 200000 increase in assets
  Increase in share capital = 200000 increase in SE and liabilities

Expand the accounting equation:

Assets = Liabilities + Issued capital + opening retained profits + revenue – expenses (net profit) – dividends

Examples:

- Credit sales of $40000. Cost of goods sold 16000.

  Sales revenue increase by 40000, cost of goods sold increases by 16000 = 24000 increase in SE and liabilities
  Inventory decreases by 16000, accounts receivable increased by 40000 = 24000 increase in assets.

Recording transactions:

Account	Increase (+) results in	Decrease (-) results in
Assets	Debit	Credit
Liabilities	Credit	Debit
Share capital	Credit	Debit
Retained profits	Credit	Debit
Revenues	Credit	Debit
Expenses	Debit	Credit

Journal entries:

- Sum of debits = sum of credits.
- Shorthand version of transaction analysis.

Example:
500 tax owing. Decrease in cash an asset and decrease in taxes owing/payable.

		$
DR	Taxes Payable (liability)	500
CR	Cash (asset)	500

Example:
Shareholder given more shares for paying $1100 of the equipment cost. Increase in share capital and a decrease in the loan. Liabilities and SE cancel out.

	$
DR Loan (liability)	1100
CR Share capital (equity)	1100

Example:
Unsold food at the end of the year cost $550 and supplies on hand cost $1740. Food inventory must be reduced to $800 - $550 = $250 and supplies inventory to $2350 - $1740 = $610.

DR General Expenses (equity decreased)	250
CR Inventory of unsold food (assets decreased	250
DR General Expenses (equity decreased)	610
CR Inventory of supplies (assets decreased)	610

Account Classification:

- Current and noncurrent portions of noncurrent liabilities
- Bank overdrafts – The bank has allowed the company to remove more cash than in the account.
- Accumulated depreciation – can be shown as a liability or a separate “net” enclosure on the historical asset price.