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Regulatory Framework

An entity has the option of disclosing information (in the notes) that they did not recognise (in the financial statements)

Financial accounting vs management accounting

- Financial accounting:
    - Bounded by GAAP rules
    - Involves a time lag
    - Concise, with extra detail disclosed in the notes
    - Used by suppliers, consumers, banks, investors, regulatory bodies
- Management accounting:
    - Much less formal, tailored to the needs of management
    - No time lag as they are up to date
- Objective of measuring financial performance is to allow external users to judge profitability of the entity

Company regulation:

- All financial accounting is bounded by the rules of the Generally Accepted Accounting Principles (GAAP), which vary from country to country
    - Determines recognition, measurement and presentation of financial information
    - Life of the entity is arbitrarily divided into reporting periods
- International accounting standards board (IASB) create the International Financial Reporting Standards (IFRS), followed by most countries
    - Australia transitioned from following accounting standards developed by the Australian Accounting Standards Board (AASB) to IFRS in 2005
    - AASB is still responsible for developing and maintaining high quality financial standards in Australia, and contributing to IASB's operations
- Main source of company regulation is the Corporations Act (2001), administered by ASIC (Australian securities and investments commission)
    - Imposes annual reporting burdens according to the type of entity
- Accounting standards govern general presentation of statement of profit or loss for entities required to comply with them, prescribing line items that must be disclosed in the SofPos / in the notes
- users of financial statements must appreciate and be aware of accounting flexibility, discretion and incentives exist which may influence the preparer's choices, estimations and judgements

Conceptual framework:

- Assists preparation and presentation of financial statements, and helps users interpret information in financial statements
- Specifies objectives of financial statements, qualitative characteristics:
  - Relevance – capable of making a difference to decisions made by users (predictive / confirmatory value)
  - Faithful representation – complete, neutral, unbiased, free from error
  - Comparability – consistent application of accounting policies to facilitate comparison with other entities
  - Verifiability – independent observers could reach consensus about elements of the financial statement
  - Timeliness – having information available in time to be capable of influencing decisions (trade off with verifiability
  - Understandability – clear and concise
- Accrual vs cash accounting
  - Accrual: effects of transactions are recognised when they occur, not as cash is received / paid, meaning
  - Cash: payments are recorded when payments are made / received
- Limitations of accounting information:
  - Time lag between report production and distribution to users
  - Historical
  - Subjective
  - Costs of preparing and analysing

Financial statements:

- All financial statements must comply with accounting standards
- Must include:
  - Notes to the financial statements
  - Director's declaration about the financial statement and notes
  - Show a true and fair view of financial position and performance
- There are both costs and benefits of accounting and reporting requirements (eg cost of preparation & analysis, benefit of more efficient analysis and therefore more efficient capital markets)

Stock vs Flow items

- Stock items are taken at a particular date / point in time

- Flow items are considered for a period of time
- Issues can arise when comparing a flow item with a stock item (cannot compare a flow that has occurred during a year with another item calculated at a point in time)

Forms of business entities:

- 4 common types: sole trader, partnership, company, trust
  - All are separate reporting entities relative to the owners
  - Only the company is a separate legal entity (therefore only they can have limited liability – not in all cases though)
- Business entities can be for-profit or not-for-profit (usually limited by guarantee)
- Further types: manufacturing, trading, service

Sole trader

- Single owner, who fully controls and manages the business
- Pros:
  - They have low start-up costs and need minimal paperwork to commence – making it simple and cheap, admin is straight forward
  - Owner has total responsibility and autonomy for all business decisions
  - No formal guidelines for them to follow in terms of business reporting
  - They pay no company tax, as business profits or losses are included only in their individual tax return
- Cons:
  - Owner has unlimited liability for the debts & losses of the company as well as legal actions against the business, meaning personal assets may be at risk
  - Limited to life of owner

Partnership

- Association of two or more people/entities who run the business as partnership and share profits and losses according to their partnership agreement
- Partnership agreement must include partnership name, specific cash and asset contributions and profit and loss sharing arrangements
- Pros:
  - Set up is relatively easy, requiring minimal costs and resources

    - Benefit from combined skilled, talent and knowledge of more than two people
    - Partners are able to declare their share of profit as income (no company tax)
- Cons:
    - Unlimited liability of partners
    - Mutual agency
    - Automatic dissolution of partnership if one of the partners die / withdraws from partnership / irresolvable dispute

Company:

- Independent legal entity, normally characterised by the limited liability of its shareholders
- Pros:
    - Limited liability of shareholders for business debts
    - Access to additional capital from shareholders for business expansion
- Cons:
    - Establishing a company requires time and money
    - Complex regulatory requirements
    - Entity taxed on profit, with shareholders declaring dividends as income
- Types:
    - Private companies
    - Companies limited by shares
    - Companies limited by guarantee
    - No-liability companies
    - Unlimited companies

Comparing financial statements:

- Main difference lies in the distribution of profit to respective owners
- Sole trader: rights to any profits
- Partnership: partners must follow the partnership agreement, multiple partners must be states in SofPos
    - SofPos: capital account in statement of equity includes the multiples owners and their respective contributions
    - Undistributed profit included in each partner's current account
- Company: profit distributed to shareholders (owners) as dividends (with statement of equity stating capital contributions)

    - SofPos: capital account in statement of equity includes contributions of shareholders
    - Undistributed profits are classified as retained earnings
- Differential reporting: difference in requirements of reporting – AASB introduced reduced disclosure requirements for entities that are not publicly accountable (eg. unlisted public companies), providing an alternative to GPFS

Types of companies:

- Public company
    - Minimum of one shareholder, who have liability limited only to unpaid amounts on issued shares (plc / ltd – public limited company)
    - Public companies have no restrictions on raising capital from the public, besides requirement of a disclosure document
    - They may be listed on a local securities exchange
    - There are no restrictions on the transfer of ownership
    - Limited by guarantee
        - Liability extends to an amount guaranteed by members
        - Usually non-profits: clubs, charities
    - No liability companies
        - Concession afforded to mining companies in Australia
        - No liability even if unpaid amounts on shares
    - Unlimited companies
        - Liability can extend to personal assets
        - Generally restricted to investment companies
- Proprietary / private company (Pty ltd)
    - Must have less than 51 shareholders, otherwise it must go public
    - Have restrictions on raising capital from the public and the transfer of ownership, meaning they must target individual investors
    - Categorised as large / small depending on if they satisfy > 2 thresholds:
        - Revenue of $25m for the financial year
        - Gross assets of $12.5m at the end of FY
        - 50 EFT employees at the end of FY
- CA2001 imposes different reporting obligations depending on the type of entity
    - Public and large proprietary companies: full, audited financial report
    - Listed public companies (disclosing entities): additional half year financial reports – they have public accountability
    - Small proprietary companies have significantly less requirements