Accounting Reports and Analysis

Week 1:

Primary users are investors, lenders, and suppliers
If we satisfy the needs of these groups of people, we would satisfy the needs of the rest
To produce a report in order to satisfy these needs, it is another way of considering risk, and thus the risk for other needs, such as employees.

Summary of information needs:

- ➔ Financial
  - Profitability: the utilisation of resources to generate returns
  - Efficiency: the ability to generate cash flow
  - Liquidity: the ability to meet short term debts
  - gearings/ capital structure: the debt/ equity mix
  - Market performance: share based analysis
- ➔ Non-financial
  - **Corporate governance**/ compliance
    - I.e. when employees expose business' for underpaying
    - Referring to the way that you conduct your business
  - Social and environmental impact (**sustainability reporting**)
    - Is it incompatible to be motivated by profit maximisation without caring about the environment or society
      - If you have to dispose raw materials, would it be the most cost efficient thing to simply flush it into the river or should you invest in practices to dispose of it responsibly
      - I.e. coles has a 'second bite' program, where instead of throwing out fresh produce into a dumpster, they give it to homeless people. However, it will cost some profit to pack and hand out This may influence customers to choose Coles, due their commitment to society
    - **Sustainability reporting** is looking at ways in which these companies can capture that information (programs such as 'second bite'), measure it, and tell customers about it

How accounting provides information

- ➔ Internal users
  - If you are **management**, you can easily have access to all sorts of data
    - I.e. knowing that a lot of students come at around 4m after school by looking at patterns of sales, and so you can efficiently prepare all the burgers

        - Preparing budgets: pulling out information from last year to prepare for the next year
        - **Management accounting**
- ➔ External Users
    - Lenders and stakeholders outside the entity
    - They do not have access to all the information so they are provided with general purpose financial reports every now and year
    - **Financial accounting**

Components of a General Purpose Financial Report (GPFR):

Notes to the Accounts: separates information into components

- I.e. the statement of financial position might have a single line item that says "property plant equipment $10,000,000,000". The notes will provide all sorts of data such as all the types of property plant equipment, how much they all cost, etc

Income statement/ statement of financial performance

- ➔ At the top of every report, there must be a who what and when
- ➔ Immediate past year figures are provided for comparison
- ➔ Calculates profit over a period of time
- ❖ Accounting profit measure "the excess of income over expenses for the period"

Balance sheet/ statement of financial position

- ➔ Financial position at a point in time

Statement of cash flows

- ➔ Also occurs over a period of time

Refers to the fact that the information conveyed is potentially valuable for a number of users

Corporations Act 2001 (CA 2001):

- ➔ Requires that FS and Notes must
    - Comply with accounting standards
    - Show a true and fair view of financial position and performance
        - **Fair**: a statement that is true but not misleading or ambiguous. Eg. saying you own a few companies which implies several.

The cost of Useful Information:

- ➔ For a large firm, an audit can cost several hundred thousand dollars, which reduces profit
    - Thus **good quality information** must be provided through a robust set of accounting standards
    - The information should lead to **better decisions**

- Then leads to **efficient capital markets**
    - If everyone is using quality information, then they make make assessments about how much a share is really worth
        - If their market is truly efficient, shares and companies will not be overvalued or under-valued, just valued.

➔ If you were thinking about lending money to an entity, you have to think about the risk.
- The higher you perceive the risk, you more interest you will charge
- <u>How to assess risk? The information</u>
- Quality information should reduce risk and therefore lower the interest rate, **lower the cost of capital**, and therefore **higher returns for investors**

Conceptual Framework for Financial Reporting:

➔ It establishes the broad and fundamental principles that allow us to think about accounting standards and thus prepares us for the more heavy and technical accounting standards

General Purpose Financial Reports:

➔ Provided by the balance sheet (ie. financial position)
- For those who cannot access it 24/7, like the manager (<u>internal user)</u>
    - They are referred to as a dependent user
- Another source regarding the information of the business is external data
    - I.e. global financial crisis, a disease that will restrict the profits of some companies and thus explain the data
- They can also provide data for finance reasons such as determining the value

➔ The information that a GPFR provide:
- Resources could be assets while claims could be the liabilities and the equity: **financial position**
- Changes: flows of inventory which give rise to increases and decreases in assets and liabilities: reflects **financial performance**

➔ **Accrual Accounting:** trying to measure economic reality. Trying to capture transactions and other economic phenomena in order to measure performance
- By selling or purchasing something on credit, regardless of whether cash was received, it is still considered as revenue or expense
    - Also includes depreciation

Qualitative characteristics of useful financial information:

Conceptual framework

➔ **Relevance (and materiality)**
- If the information is relevant to the decision making then it must be included
- **Materiality**: how significant is this piece of information. It is not material if it is not significant and therefore relevant

        - nature (the type of information) or magnitude ($100 to Bill Gates would be nothing- entity specific)
- ➔ **Faithful representation**
    - Not misleading or ambiguous
        - I.e. manipulating profit in order to receive a bonus
    - In order for information to be a faithful representation, it should be complete
- ➔ **Verifiability:**
    - Anything that you can't verify, you would still disclose
- ➔ **Understandability:**
    - Numbers aligned, brackets instead of negative signs, figures rounded to millions instead of having 8 figures, clear and concise, presentation issues
    - Aggregating things in a meaningful and useful way

Basis of Preparation:

Conceptual framework

- ➔ Reporting period
    - The life of the business is indefinite
    - Wanting information on a regular basis- annual reporting
    - <u>Referring to the segment of the life of the entity of which you are measuring performance and assessing financial position</u>
        - **Narrative reporting:** non-financial information
        - **Comparative reporting**: statements of financial position
- ➔ Going concern
    - We prepare financial statements on the presumption that this entity has no need nor any intention to wind up in the foreseeable future, that this business will continue into the foreseeable future
        - If you believe that your business is a going concern, then a relevant cost of the computer would be its cost.
        - But if you are not a going concern, then your perspective switches and you have to liquidate your assets. Thus a more **relevant** figure would be its recoverable amount (how much you think you can sell it for)

The Elements of Financial Statement:

<u>Definition of an Asset</u>:

- ➔ Something is an asset because it gives the owner rights, not because it has rights
    - Intellectual property: not all rights are physical assets, they could be intangible objects
        - Assets will embody a right of some sort
    - You can have two rights from one single asset
        - I.e. the right to use the house and the right to sell the house
- ➔ Potential to produce economic benefits

- You can't be certain that someone is going to pay you but you have a right to get that money

➔ Control
- If an asset has a future economic benefit, you need to be able to demonstrate that you can get that benefit, as well as prevent anyone else from getting it
  - If you don't control, it does not satisfy the definition of an asset
    - You can control an asset that you don't own
      - E.g. buying the house for half and borrowing the rest from the bank
      - Or you could be renting the house
  - Does not need to legally own

<u>Definition of a liability:</u>

➔ Transfer of an economic resource
- Not all contracts are necessarily formal
  - I.e. buying a coffee
- If you purchase a TV and would like to have it delivered to your house after paying, it has not been sold to you yet. The business has an obligation to deliver the TV.
- It is the transfer of goods not the transfer of cash that is the obligation

➔ Present obligation as a result of past events
- If you provide the goods but have not been paid yet, the other has an obligation to pay you
- There **must be a past event** to trigger the obligation
- may not occur at only one event or a single transaction
  - I.e. interest on loans
  - Even though a loan is not due for 30 days, it is still a present obligation

➔ Executory Contracts
- There are at least two parties involved in a transaction
- If you give someone the goods, the other has received their rights.
  - If the other has not performed their obligation then they have a liability.
  - Thus if you have performed your obligations but you haven't received the rights, you have an asset
  - <u>Whoever performs the obligation first gets the asset and the other gets the liability</u>

<u>Definition of Equity:</u>

➔ The residual interest between the assets and liabilities
- **Contributed equity**: when you give the company equity and the company gives you shares
  - <u>Issuing shares: contributed equity</u>
- Companies will invest your contributed equity, those assets will contribute to productive capacity which will produce profits

        - Thus the profits end up in the equity, however it is distinct to your contributed equity as it was the company who put it there
    - **Paid-up capital:** amount of money a company has received from shareholders in exchange for shares of stock
    - **General reserve:** retained earnings of a company which are kept aside out of company's profits to meet future known/ unknown obligations
        - part of equity
    - **Dividends payable** is <u>NOT</u> part of equity
        - when declared payable to shareholders, decrease dividends, increase current liability

<u>Definition of Expense:</u>

- ➔ **Expenditure:** is the payment of money. You can incur an expense without paying any money.
    - You can have an expense without an expenditure
    - You can also have an expenditure without an expense
- ➔ **Cost:** it is not an expense.
    - I.e. if you incurred a cost for the watch and didn't pay for it, it's a cost but not an expenditure. If you did pay for it, it's a cost and an expenditure but not an expense

How recognition links the Elements:

The recognition process:

- ➔ You have to apply another criteria before you include things in the balance sheet: **the recognition criteria**
- ➔ Ultimately we put things into financial statements by describing them with a word and assigning a dollar value next to them
    - It is recognition because it ended up in the balance sheet
    - Need to consider whether these assets warrant inclusion in the balance sheet
- ➔ You could have something that is satisfying the definition, but not the recognition
- ➔ The amount at which an asset, liability or equity is recognised in the statement of financial position is referred to as its ***carrying amount***

Recognition Criteria:

- ➔ only items that meet the definition of an element can be recognised
- ➔ It is only recognised if
    - it provide users with useful information
        - Determining what is useful is a judgement by the preparer
    - It is a faithful representation of that asset or liability
    - It must be measured
        - Measurement that is subject to **estimation** gives rise to a level of **measurement uncertainty**
        - If the level of measurement uncertainty is high, consider:

- Applying the measure by explanatory notes
- Alternative measurement options
- Non-recognition accompanied by explanatory notes

➔ Recognition of an asset or liability may not relevant if:
- It is uncertain whether the asset or liability exists (**existence uncertainty**)
- The asset or liability exists, but the **probability** of an inflow or outflow of economic benefit is **low**

Derecognition:

➔ The removal of all or part of a recognised asset or liability

➔ For assets it occurs when:
- Is consumed
- Is collected, i.e. when a receivable pays you the amount owed
- Is transferred, i.e. when inventory is handed over to a customer
- Expires, i.e. when a 10 year lease of a building ends

➔ For liabilities it occurs when:
- Settled or fulfilled, i.e. the delivery of the TV

Measurement:

➔ Refers to assigning a monetary amount to an item when it is recognised

➔ Methods include:
- Historical cost
- Fair value
- Value in use: the present value of future cash flows generated from use and ultimate disposal. Determined by discounting future cash inflows and outflows, expressed as a net present value
- Current cost: replacement cost

Disclosure

- How a reporting entity communicates and presents information in financial statements
- Accounting standards prescribe / provide guidance regarding disclosure requirements
- Information needs to be relevant and contribute to a faithful representation
- Also enhance understandability and comparability
- Classifying information in a manner that groups similar items and separates dissimilar items
- The right balance: aggregate information in such a way that is not obscured either by unnecessary detail or by excessive aggregation (Notes can provide disaggregated information)

➔ *Week 2*

The Accounting Equation:

Assets - Liabilities = Equity -> made up of two broad components, contributed equity and retained earnings

- ➔ **Contributed Equity**: the equity that was put there by the shareholders and another component of equity that is a measure of their performance that has accumulated on their behalf since day one of the entity
- ➔ **Retained Earnings:** made up of profits that have been earned, which have been determined by income and expenses.
    - If the profit is distributed, the are referred to as **dividends** (for companies, for sole traders and partnerships they're called **drawings**)
        - Any of those dividends that are distributed are deducted from the accumulation of profit
        - Profit that are not distributed as dividends are retained in the business
            - They are reinvested on behalf of the shareholders
    - Thus retained earnings is the accumulation of every profit and every loss that has occurred in every reporting period since the entity began, less any dividends that have been distributed.

Preparing financial Statements:

- ➔ While the **corporation act** does not impose a general purpose financial statement on them, the bank requires them in order to track that the business is credit worthy
    - It is called a **debt covenant**
    - If not they will demand all the money back
- ➔ By applying **accounting standards** each year, you will ensure that they will:
    - look similar so that it is comparable
    - It will also allow **comparability** with other entities because they are using the same accounting standards so it makes the information useful
- ➔ FEB: future economic benefit

Week 3

Asset Classification:

- ➔ I.e. a piece of equipment that has a 5 year life. This is a non-current asset because that benefit will extend beyond the next 12 months
    - After four years when there is only one year left of benefit of that asset
        - That asset remains non-current because even tho there is only 12 months of benefit remaining, the benefit extended over five years, four of which already occurred
            - Always remains non-current

- **Classes of assets:** refers to the aggregation of assets that have similar or like economic characteristics
    - I.e. anyone who owes us money is a receivable
        - "Trade and other receivables"

Recognition, Measurement and Disclosure:

- **Recognition:** The minute you record anything in any box, it is recognised
    - As a result, the number in that box is going to reflect the total and thus be reported in the statement of financial position
- **Measurement:** the basis upon which we quantity the economic effect of the inflow of this asset
    - Carrying amount: the number that is ultimately going to be reported for that asset
    - I.e. the amount we expect to receive as a cash inflow
- **Disclosure:** how we communicate that information, can take various forms
    - I.e. if you disclose something as a line item in a financial statement, or disclosing information in the notes
        - Does not necessarily have to be in the financial statements
    - Disclosure and recognition are not the same thing.
        - You could recognise something and therefore its numerical impact is embedded in a line item and a total
            - Recognition is just the fact that the number changes
            - But if it's not the material, you might not disclose anything about it
        - You could also disclose things that are not recognised

Measuring Assets:

- When it comes to measuring economic benefit, we might measure it based on a realisable value
    - It is an amount we expect as a direct cash inflow from that asset
        - I.e. receivables
- **Fair value:** market value
- **A value in use:** you take an asset and you consider all of the cash flows associated with that asset
        - the inflows that we can link based on its future economic benefit that we expect to flow in,
            - any cash flow associated with that asset, and the scrap/ residual value at the end of the asset's life
            - Based on its estimated useful life
        - We apply a technique where we discount it back to a single net present figure
        - A value in use is intended to assign a dollar value to the net benefits we expect to accrue from this asset through using it

- ➔ **Recoverable amount:** if a business is motivated by profit maximisation, a business would choose to either sell the asset or hold it and use it in order to generate the greatest return
    - The recoverable amount of an asset is whichever of those two things is higher
        - The recoverable amount of a receivable would be the realisable value- the expected cash inflow from what someone owes you
        - The recoverable amount of an asset is how much you sell it for
- ➔ **The general principle of GPFR:** if you do not write it down to its RA, you risk overstating
    - You must write down assets that you identify as impaired and you must write it down

Cash and Cash Equivalents:

- ➔ A <u>demand deposit</u> is essentially a bank account
- ➔ If you put money in a term deposit, you get interest on that account and in theory you won't touch the money until it reaches the end of the term
    - However if you desperately need the money, you would be required to forfeit any interest and incur some kind of penalty for withdrawal
    - Is **not cash equivalent** because there is a risk of change in value
- ➔ Short term or long term: based on personal judgement
    - Refrains from nominating a time threshold
    - It is important to distinguish this because it will impact on how users perceive or measure the liquidity of our entity
    - Most entities would determine that short term is 3-6 months
        - Not a rule, just a common threshold
- ➔ **Bank overdraft:** you can withdraw an amount up to x amount of overdraft so it creates a line of credit
    - Same logic as a credit card- it allows you to spend $3000 you do not have.
    - I.e. you can have an account with $100, another with $50, and an overdraft of $25- what are your cash and cash equivalents:
        - Two views:
            - $100 + $50 - $25
                - You are balancing the overdraft against the $150. Thus your cash and cash equivalents would be $125
            - The overdraft could be viewed as a liability so $150 of cash and cash equivalents
- ➔ A business can have too much cash
    - Cash is the least productive asset if you have millions sitting there doing nothing
    - A better use would be to use it to:
        - pay off interest bearing debt
        - invest it in a NCA that would generate some productive capacity
        - Give it back to your shareholders
- ➔ They have a <u>maturity of 3 months or less</u>