ACCY111: Accounting Fundamentals in Society

Chapter 1: Decision Making and the Role of Accounting

Accounting – to provide and interpret financial information to aid decision making.

What is Accounting?

1. **Identification**
   - Transactions
2. **Measurement**
   - Quantification in monetary terms
3. **Recording**
   - Classification
   - Summarisation
4. **Communication**
   - Reports
   - Analysis
   - Interpretation

Users of Accounting

- **Internal** Stakeholders
  - Managers
- **External** Stakeholders
  - Investors
  - Lenders
  - Creditors
  - Customers
  - Government agencies

Types of Accounting

- **Management Accounting**
  - **Internal** focus
    - Planning
    - Controlling
    - Decision Making
  - **On-demand** reporting
    - Budgets
    - Forecasts
    - Performance reports
- **Financial Accounting**
  - **External** focus
    - Investing
    - Financing
    - Purchasing
  - **Regular interval** reporting
    - Balance sheet
    - Income statement
    - Statement of changes in equity
    - Statement of cash flows

The Income Statement / Profit or loss Statement

Income (Revenue) – increases in economic benefits during the accounting period in the form of inflows, enhancements of assets, or decreases of liabilities.

Expenses – decreases in economic benefits during the accounting period in the form of outflows, depletions of assets, or incurrences of liabilities.

MINH'S TV REPAIR Income Statement For the year ended 30 June 2016		
INCOME		
Repair income		$221 250
EXPENSES		
Advertising expense	$ 10 125	
Repair supplies expense	45 855	
Salaries and wages expense	63 900	
Rent expense	20 130	
Telephone expense	10 095	
Light and power expense	23 970	174 075
PROFIT		$47 175

- Reports **financial performance** over a specific **time period**
- Shows the **revenues and expenses of an entity** during a particular period
- Indicates a **profit or loss** over time period
  - **Income > Expenses = Profit**
  - **Income < Expenses = Loss**

The Statement of Changes in Equity/Capital

- **Process** of writing statement:
  - **Balance sheet** as at **beginning** of year and **income statement** for the period provide **E_1, Profit** and **Drawings**
  - Statement of **owner's equity for the period** is calculated
    - **E_1 + Profit – Drawings = E_2**
  - **Balance sheet** as at **end** of year uses **E_2**

MINH'S TV REPAIRS Statement of Changes in Equity For the year ended 30 June 2016	
Minh Vu, Capital - 1 July 2015	$185 170
Add: Profit for the year	47 175
	232 345
Less: Drawings	89 005
Minh Vu, Capital - 30 June 2016	$143 340

The Statement of Cash Flows

- Reports on the **cash inflows and outflows of the entity**
  - Divided into **operating, investing and financing activities**
- **Useful** in:
  - Helping users to **assess the sources and applications of cash**
  - The ability for the entity to **remain solvent**

MINH'S TV REPAIRS Statement of Cash Flows for the year ended 30 June 2019		
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$ 212 355	
Cash paid to suppliers and employees	(171 000)	
Net cash from operating activities		$ 41 355
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of land and buildings	(157 500)	
Purchase of repair equipment	(55 350)	
Net cash used in investing activities		(212 850)
CASH FLOWS FROM FINANCING ACTIVITIES		
Amount borrowed under mortgage	100 500	
Investment by owner	118 665	
Drawings by owner	(22 500)	
Net cash from financing activities		196 665
Net increase (decrease) in cash held		25 170
Cash at beginning of year		–
Cash at end of year		$ 25 170

Chapter 3: Recording Transactions

Types of Transactions

- **External Transactions**
  - Involve an **outside party**
  - **Exchange** of economic resources and/or obligations
  - e.g. sale of inventory, purchase of supplies
- **Internal Transactions**
  - **Transformation** of economic resources
  - e.g. use of office supplies and equipment to perform a service, change in value of assets
- **Non-Transactional Events**
  - **Not usually recorded** but may be in the future
  - e.g. receiving an order from a customer, hiring and employee, changing interest rates

Administrative Control Deficiencies

- **Too much trust** in employees and management
- **Improper segregation** of duties
- Employees in **financial difficulties**
- **Underpaying or poorly paying staff**
- Not ensuring staff regularly **take leave and vacations**
- **Poor relationship** between management and employees
- **No monitoring controls**

Accounting Control Deficiencies

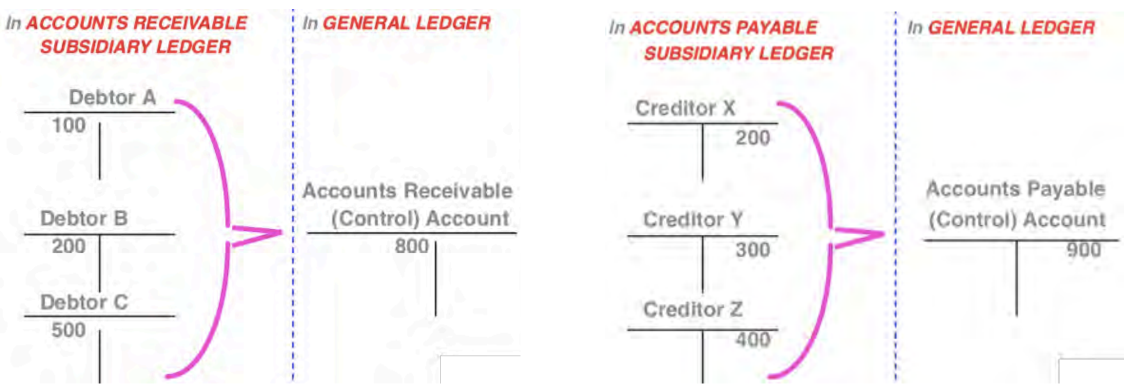
- **No or poor control of access to accounting records**
- **No approval authorities** or authority limits
- **No physical audits** of assets
- **Poor documentation** and handling of source documents
- **No trial balances** of the ledger
- **No reconciliations** of accounts
- **Inadequate investment in the accounting information system**
- A **lack of financial policies and procedures**

Red Flags for Cash Fraud

- **Increased costs**
- **Lower quality** of goods or services
- **Incomplete supplier information** on the invoice
- **Unusual supplier names and/or addresses** on the approved supplier list
- **Copies** of invoices and receipts, **not originals**
- **New unexplained wealth of employees**
- **Staff who have close relationships with suppliers**
- Goods that are **received but not ordered**, and goods **ordered but not received**
- **Unexplained or unusual trends in data**

Subsidiary Ledgers

- **Subsidiary ledgers and control accounts**
    - When a **large amount of repetitive and detailed information** is required **separate subsidiary ledgers are used**
    - The **total balance** of the related subsidiary ledgers is recorded in a **control account**
    - Often **used for a range of accounts** including:
        - Accounts receivable
        - Accounts payable
        - Inventory
        - Plant and equipment
        - Investments



Types of Ratio Analysis

- **Liquidity Ratios**
  - Measures the ability for a firm to **convert assets into cash**
  - Important to **bankers, suppliers and other short-term creditors**
  - **Current ratio:**
    - Measure the **short-term ability of an entity to pay its debts** and meet **unexpected needs for cash**
    - Satisfactory liquidity if **GREATER than 1.5:1**

$$\textbf{Current Ratio} = \frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$$

  - **Quick ratio (Acid test ratio):**
    - Measure of an **entity's immediate short-term liquidity**
    - **Excludes inventory and prepaid assets** which are the **least liquid** current assets
    - Satisfactory liquidity if **GREATER than 0.9:1**

$$\textbf{Quick Ratio} = \frac{\textbf{Cash} + \textbf{Marketable Securities} + \textbf{Net Receivables}}{\textbf{Current Liabilities}}$$

  - **Receivables turnover ratio:**
    - Indicates the **effectiveness of credit collection policies**
    - Measures the **number of times trade receivables are converted into cash** during the period
    - Satisfactory liquidity if **GREATER than 12 times per year**

$$\textbf{Receivables Turnover Ratio} = \frac{\textbf{Net Credit Sales Revenue}}{\textbf{Average Receivables}}$$

$$\textbf{Average Receivables} = \frac{\textbf{Starting Accounts Receivable} + \textbf{Final Accounts Receivable}}{\textbf{2}}$$

  - **Average collection period:**
    - Converts receivables turnover figure into a **measure of days for receivables collection**
    - Satisfactory liquidity if **LESS than 30 days**

$$\textbf{Average Collection Period} = \frac{\textbf{365}}{\textbf{Receivables Turnover Ratio}}$$

  - **Inventory turnover ratio:**
    - Reflects the **effectiveness of inventory management**
    - Satisfactory liquidity **depends on nature of industry and/or recent trends**

$$\textbf{Inventory Turnover Ratio} = \frac{\textbf{Cost of Goods Sold}}{\textbf{Average Inventory}}$$

$$\textbf{Average Inventory} = \frac{\textbf{Starting Inventory} + \textbf{Final Inventory}}{\textbf{2}}$$

  - **Average days in inventory:**
    - Converts inventory turnover into a **measure of days for inventory to be sold**
    - Satisfactory liquidity **depends on nature of industry and/or recent trends**

$$\textbf{Average Days in Inventory} = \frac{\textbf{365}}{\textbf{Inventory Turnover Ratio}}$$