ACCTG102 notes

# Chapter 1 – “Theory and concepts”

## What is accounting?

* The purpose of accounting is to **identify**, **record** and **communicate** the economic events of an **organisation** to **interested users**.

## Who uses accounting data?

* **Internal users:** Within the organisation – management, employees, various departments
* **External users:** Taxation authorities, customers, investors, creditors, suppliers
* Different entities have different needs for the information and access to information

## Laws regarding accounting

* NZ Financial Reporting Act of 1993
  + Set to be replaced by the Financial Reporting Bill by 2015.
* Who is involved in the rule-setting process?
  + International Accounting Standards Board (IASB) – 15 members
  + NZ External Reporting Board (XRB) – 9 members
  + NZ Accounting Standards Board (NZASB) – 10 members (committee of XRB)
* The XRB is responsible for setting auditing and accounting standards.
* Standard setting process
  + IASB: Research topic / discussion paper; due process (public comment); exposure draft; due process; issued if 9 of 15 members approve
  + NZASB: Received IASB standard; submitted to XRB for approval
  + NZASB has the power to come up with new NZ-specific FRS to supplement IFRS, but not often

## Generally accepted accounting practice (GAAP)

* GAAP includes IFRS, IASB interpretations of IFRS, NZ-specific FRS
* Currently, private “for-profit” entities must follow GAAP.
* In the FRB, only “publicly accountable” or “large” entities must follow GAAP.
  + Publicly accountable = majority of debt or equity instruments are traded on exchanges (shares or debentures traded publicly)
  + Large = $30m revenue and $60m assets **or** 10 shareholders
* If there is no standard:
  + Analogy (similar principles from another standard)
  + Conceptual Framework (see below)
* By following GAAP, it is presumed you have a true and fair view
  + If not, must follow standard and have footnotes explaining why it is not true and fair
* Two tiers of GAAP in NZ
  + Tier 1: Full IFRS
  + Tier 2: Reduced disclosure for non-publically accountable entities (must be elected to qualify for tier 2 – difference is a level of disclosure)

## Conceptual Framework

* The framework is not a standard – it is only a set of guidelines
* Three levels:
  + Basic objective of financial accounting (not management)
  + Qualitative characteristics, elements
  + Underlying assumptions (both explicit and implicit), measurement bases

### Objective of financial reporting

* To provide **general purpose** (for majority of external users) **financial reporting** about the reporting entity that is decision-useful to **primary users** of the entity’s financial reports.

### Qualitative characteristics

* **Fundamental** characteristics – if information is relevant and faithful, it is decision-useful.
  + Relevance– information is relevant if it is capable of influencing a decision
    - Materiality **–** by size or nature
  + Faithful representation
    - Complete – sufficient detail
    - Neutral – free from bias
    - Free from error – we still allow educated estimates
  + “Prudence is dead.”
* **Enhancing** characteristics
  + Comparability – both between entities and within an entity over time
  + Verifiability
  + Timeliness
  + Understandability – to those with reasonable background knowledge of business and economic activities.

### Elements

* Assets
  + Past event
  + Present control of a resource – we can limit use, not necessarily own
  + Probable future economic benefit
  + Reliable measurement
* Liabilities
  + Past event
  + Present obligation
  + Probable future outflow of resources
  + Reliable measurement
* Current assets/liabilities – within 12 months or one accounting period, whichever is longer
* Equity
  + Residual interest in assets after deducting all liabilities
* Income
  + Increases in economic benefits
  + From increases to total assets or decreases to total liabilities
  + Increase in equity, other than owner contributions
  + Dependent on measurement of assets/liabilities
* Expenses
  + Decreases in economic benefits
  + From decreases to total assets or increases to total liabilities
  + Decrease in equity, other than owner distributions
  + Dependent on measurement of assets/liabilities

### Assumptions

* Going concern – explicit
* Periodicity – implicit (comes under comparability and timeliness)
* Monetary unit – implicit
* Accrual accounting – not necessary (definition of elements)

### Measurement bases

* Historical cost
* Fair value (sell the asset for under current market conditions)
* Present value (time value of money)
* Liquidation value (if going concern fails, business will shut down)

## The accounting equation

* Assets – Liabilities = Equity + Income - Expenses
* Not all economic benefits are recorded in accounting records.
* Accounting transactions are exchanges of value between two separate entities – all recorded
* Other economic events might be recorded (revaluation, depreciation, inventory write-down)

## Residual analysis (some random crap made up by Glenn)

* Residual analysis uses the Conceptual Framework (definition of elements) to identify if an economic event has affected the accounting equation.
* Steps:
  + Have assets increased? Explain using definition
  + Have assets decreased? Only explain no future economic benefit.
  + Is equation in balance? If no, liabilities
  + Have liabilities increased? Explain using definition
  + Have liabilities decreased? Only explain no present obligation.
  + Is equation in balance? If no, equity
  + If net assets increased
    - Is this owner contribution?
    - If not, income.
  + If net assets decreased
    - Is this owner distribution?
    - If not, expense.
  + Ragequit.

## Financial statements

* Required: Statement of Comprehensive Income, Statement of Changes in Equity, Statement of Financial Position (Balance Sheet), Statement of Cash Flows
* Comparative information from previous period is generally required.
* Presentation should be similar between periods.
* Footnotes are required:
  + Statement of compliance
  + Summarise accounting policies used, and judgements made
  + Provide supporting information for items on the face of the statements

## Important notes for formatting statements

* Dollar signs to start a column and above a double-underline.
* Header: name of company; name of statement; date/period

### Statement of Comprehensive Income

* Bottom line:
  + If there is no CI: Profit and comprehensive income
  + If there is CI: Profit, *then* total comprehensive income
  + Other comprehensive income affects other reserves, not retained earnings

### Balance Sheet

* Current assets, non-current assets, current liabilities, non-current liabilities, net assets
* Equity

### Statement of Cash Flows

* Operating activities (generally income and expenses)
* Investing activities (generally non-current assets)
* Financing activities (generally liabilities and equity)
* Net change in cash, cash at beginning of period, cash at end of period

## Minimum disclosure requirements (Chapter 4/5 but w/e)

### Cash Flow Statement (I added this, but w/e)

* Everything that is cash is included in the cash flow statement
* No consideration for accrual accounting

### Balance Sheet

* Assets/liabilities are sorted by current/non-current (normal) or liquidity (rare)
* On the face
  + Cash and cash equivalents
  + Receivables
  + Inventories
  + Property, plant and equipment
  + Intangibles
  + Investment property
  + Trade and other payables
  + Provisions
  + Other financial liabilities
  + Contributed equity/share capital
  + Reserves – including retained earnings

### Statement of Comprehensive Income

* On the face
  + Revenue
  + Finance Costs
  + Discontinued operations
  + Income tax
  + Profit
  + Components of other comprehensive income
  + Total comprehensive income
  + Earnings per share
* On the face or in the notes
  + Auditor fees
  + Donations
  + Depreciation
  + Employee benefits
  + Any other material items

### Layout (chapter 5)

* + Gross sales revenue
* Less: Sales returns and allowances
* Less: Sales discounts
  + Net sales revenue
* Less: Cost of goods sold
  + Gross profit
* Less: Operating expenses
  + EBIT (earnings before interest and tax)
* Less: Finance costs
  + Profit before tax
* Less: Income tax expense
  + Profit (after tax)
* Other Comprehensive Income
  + Total Comprehensive Income

# Chapter 2 – Journals and ledgers

## General definitions

* Double entry system – each recordable event affects at least two accounts, total debits must equal total credits
* Normal balance
  + Assets (and expenses) have normal debit balances
  + Liabilities, (income) and equity have normal credit balances
  + Note: GST clearing does not have a normal balance
* Account - a record of increases and decreases in a specific element.
* Journal – book of original entry, which discloses complete effects of an event and provides a chronological record of events.
* Journalising
  + The \_\_\_\_\_\_ account has increased/decreased, which increases/decreases assets/liabilities/equity.
  + This increase to assets/liabilities/equity is recorded with a debit/credit.
  + Therefore, debit/credit the \_\_\_\_\_\_ account.
* Ledger - contains all accounts maintained by a business
* Chart of accounts – a list of all accounts with individual numbers
  + General rule – 1XX assets, 2XX liabilities, 3XX equity, 4XX income, 5XX expenses
* Posting – the process of transferring from the journal to the ledger
* Trial balance – a list of accounts and their balances at a given time

# Chapter 3 – Adjusting entries

## Accounting cycle

* Journalise, post to ledger
  + Unadjusted trial balance
* Adjusting entries, post to ledger
  + Adjusted trial balance
* **Financial statements**
* Closing journal entries, post to ledger
  + Post-closing trial balance
* Return to start

## Accounting period

* Accountants divide the economic life of a business into time periods
  + e.g. monthly, quarterly, semi-annually (includes interim), annually (generally not calendar year)

## Adjusting entries

* Adjusting entries NEVER include cash
* Make sure you check chart of accounts if provided for account names

### Why do we have them?

* Some events are not journalised daily for efficiency
* Some events are not reliably known until the end of the period
* Some events were not recorded as invoiced were not sent/received, but we still have to

### Examples

* Assets have been (partially) consumed - supplies, prepayments have been consumed
* Liabilities have been (partially) satisfied - unearned revenue may have been earned
* Revenue accruals – goods or services provided, but not billed or paid
* Expense accruals – goods or services received, but not billed or paid
* Expense recorded in full when cash paid, but some future benefit still exists
* Depreciation

# Chapter 4 – Completing the accounting cycle (closing entries)

## Nature and purpose

* Nature: Transfer temporary accounts to permanent accounts
  + Temporary accounts – income, expenses, dividends – only relate to one accounting period
  + Permanent accounts – assets, liabilities, share capital/reserves (balance sheet  
    equity) – carried forward into future accounting periods
* Purpose: Update reserve balances, give temporary accounts a ‘fresh start’

## The closing process

* Debit revenues and gains that affect profit, credit income summary
* Credit expenses and losses, debit income summary
* If profit, debit income summary, credit retained earnings (if loss, reverse)
* Credit dividends, debit retained earnings (directly, not to income summary)
* Debit other comprehensive income, credit other reserves (in general)

## Correcting entries

* If you’ve screwed up…
* Correcting entries are made whenever an error is discovered
* They must be posted before closing entries occur
* If an income or expense is incorrectly stated
  + If the error is found during the period, correct them to their income or expense account
  + If the error is found after the period, correct them to retained earnings (as we have already closed them for the period)

**Disclosure requirements listed under Chapter 2**

# Chapter 5 – Inventory

## Definitions of inventory

* Inventories are current assets held:
  + For sale in the ordinary course of business (finished goods)
  + In the process of production for such sale (work in progress)
  + In the form of materials or supplies to be consumed in the production process (raw materials)

## Inventory systems

### Periodic

* Not commonly used
* No running record of inventory, cost of goods sold

### Perpetual

* Commonly used, technology helps
* Merchandise inventory and cost of goods sold are updated as transactions occur
* Periodic inventory counts are still needed to check inventory levels (calculate thefts, errors etc.)

## Freight costs

### FOB (freight on board) shipping point

* When the seller gives goods to the carrier, control is given to the buyer
* Buyer pays the freight costs, which are considered part of merchandise inventory cost
* Buyer is responsible for insurance

### FOB Destination

* Seller has control of the goods while in shipment - buyer only gains control when goods arrive
* Seller pays for freight costs, freight-out expense

## Purchase returns and allowances / discounts

* Return – inventory is returned
* Allowance – inventory is not returned, but a discount is allowed
* For the buyer, returns reduce the cost of merchandise inventory (credited)
* For the seller, returns increase ‘sales returns and allowances’ or ‘sales discount’ account – contra-revenue accounts
* All costs incurred before the asset is **ready for intended use** are part of the cost of the asset.

**Statement of Comprehensive Income format listed under Chapter 2**

# Chapter 5½ - GST (clearing)

## General rules

* GST is a domestic consumption (only within New Zealand [not a tax on exports, but including imports]), value-added tax.
* In general, most businesses:
  + Collect GST from customers when they sell their products; this amount is due to the government (current payable)
  + Pay GST to suppliers for most assets and expenses (including prepayments); this amount may be claimed back from the government (current receivable)
* Effectively, the tax is only levied on the **value added** by a business.
* Effectively, the consumer pays the entire amount of GST.
* GST rate in New Zealand is 15%
* GST is neither an expense or a revenue – it is a current asset or liability
* Most assets/liabilities/expenses/revenues are stated net of GST – exceptions are accounts receivable and accounts payable
* “*GST clearing*” does not have a normal debit/credit balance
* If a business is not GST registered, then assets and expenses are more costly – cannot claim back GST

## Calculations

* If the invoice is GST inclusive, then divide by 1.15 to get GST exclusive price, difference is GST value
* If the invoice is GST exclusive, multiply by 0.15 to get the GST value, or multiply by 1.15 to get GST inclusive price

## Exceptions

* If a business has turnover less than $60,000 a year, they do not have register for GST.
  + They do not have to pay GST, but cannot claim it back either.
* Some goods are services are exempt:
  + Financial transactions – loans and interest, securities (debentures, share transactions), dividends, bank fees
  + “Zero-rated” activities – e.g. exports
  + Wages (there are P.A.Y.E. taxes) – does not include independent contractors
  + Non-accrual adjusting journal entries – depreciation, inventory write-down

# Chapter 5¾ - ratios

## Earnings per share

* **Required on the SOCI**
* Formula = (Profit after tax – Dividends) ÷ Number of ordinary shares

## Gross profit ratio

* Formula = Gross profit ÷ net sales

## Operating expenses ratio

* Formula = Operating expenses ÷ net sales

## Profit margin ratio

* Formula = Profit after tax ÷ net sales

## Return on assets

* Formula = EBIT ÷ average assets

**Note:**

* Net sales = Gross sales – sales returns/allowances/discounts
* Gross profit = Net sales – cost of goods sold
* Operating expenses – does not include finance costs or tax
* EBIT = Gross profit – operating expenses
* Average assets = (Total assets start of period + total assets end of period) ÷ 2

# Chapter 6 – Inventory Part 2

* Can’t be bothered yet. LERL