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