



ACC1100

Introduction to Financial Accounting

Lecture 2:

Introduction to Financial Statements, Accrual vs. Cash Accounting, Accounting Cycle, Transaction Analysis

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Reference: Financial Accounting Reporting, Analysis and Decision Making (5th Edition)

Chapter 1: pp. 20 - 48

Chapter 2: pp. 92 – 101

Chapter 3: pp. – 152 - 56

Chapter 11: pp. 642 – 650



Learning Objectives

1. Introduction to Financial Statements
2. Describe the characteristics of business transactions
3. Differentiate between a business transaction, a personal transaction and a business event
4. Distinguish between accrual accounting and cash accounting
5. Understand the accounting cycle and its different steps
6. Understand and apply the accounting equation and undertake transaction analysis

General Purpose Financial Reports

The key financial statements are:

- Balance Sheet (A.L and OE)
Measures financial position at a **point in time**
- Statement of Comprehensive Income / Income Statement (I.E)
Measures financial performance over a **period of time**
- Statement of Cash Flows (the Asset Cash)
Measures cash receipts and cash payments over a **period of time**
- Statement of Changes in Owners' Equity (OE)
Presents a summary of changes that occurred in the entity's equity **between two successive reporting dates**

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Balance Sheet

- The Balance Sheet summarises the financial position of an entity at a particular date
 - as at 30 June 2017
- An entity's financial position is divided into 3 categories:

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Assets

Assets can be categorised into current and non-current

- **Current Assets**

- Items converted to cash within one year
(e.g., inventory)

- Items consumed within one year
(e.g., office stationery)

- **Non-current Assets**

- Items intended to be held for longer than one year
(e.g., equipment, land and buildings, motor vehicles, long-term investments)

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Liabilities

Liabilities can be categorised into current and non-current

- **Current Liabilities**

- Obligations that are due to be repaid within one year
(e.g., creditors, bank overdraft, 6-month bank loan)

- **Non-current Liabilities**

- Obligations that are due for repayment after one year
(e.g., 5-year loan, mortgage)

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Owner's Equity

- It is the ***owner's investment*** in the entity
- It is the residual claim of the owners on the assets of the entity
- It is measured as the excess of assets over liabilities

$$\text{OWNER'S EQUITY} = \text{ASSETS} - \text{LIABILITIES}$$

$$\text{OE} = \text{A} - \text{L}$$

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Balance Sheet Example

S. Monash
Balance Sheet
As at 30 June 2017

ASSETS

Current Assets

Cash at bank	53,700	
Accounts receivable	<u>5,000</u>	58,700

Non-current Assets

Equipment		<u>4,500</u>
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Total Assets		\$63,200
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LIABILITIES

Current Liabilities

Accounts Payable		5,000
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Non-current Liabilities

Long-term loan		<u>15,000</u>
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Total liabilities		20,000
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OWNER'S EQUITY

Capital		30,000
Retained profits		<u>13,200</u>

Total owner's equity		<u>43,200</u>
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Total liabilities and owner's equity		<u>\$63,200</u>
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Income Statement

- Provides information on an entity's profitability for a period of time
 - E.g., for the period ended 30 June 2017
- Measures the difference between
 - **Revenues** earned during a period and **Expenses** incurred in earning the revenues

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Income Statement Example

S. Monash	
Income Statement	
For the period ended 30 June 2017	
Service Revenue	50,000
less Expenses	
Wages	(15,600)
Advertising	(10,800)
Total expenses	(26,400)
Profit	23,600

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Additional Income Statement Example

S. Monash

Income Statement

For the year ended 30 June 2017

Sales revenue	21 000	
LESS Cost of goods sold	<u>(8 000)</u>	
Gross profit	13 000	
LESS Operating expenses		
Salaries	(2500)	
Depreciation	(500)	
Electricity	(300)	
Travel	(300)	
Postage	<u>(400)</u>	<u>(4000)</u>
Profit before tax	9 000	
LESS Income tax expense	<u>(3 000)</u>	
Profit after tax	6 000	

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Statement of Comprehensive Income / Income Statement

- Under Australian accounting standards (AASB 101 *Presentation of Financial Statements*) an entity can report income and expenses as either:
 - A single statement called Statement of Comprehensive Income; or
 - Two separate statements called:
 - Income Statement; and
 - Statement of Other Comprehensive Income

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Statement of Comprehensive Income / Income Statement

Our **emphasis in ACC/F1100 is on the Income Statement** although note that 'other' comprehensive income can include:

- changes in the revaluation surplus for fixed assets
- gains and losses arising from the conversion of foreign operations
- fair value changes in available-for-sale financial assets

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What is a Statement of Cash Flows?

- AASB 107 *Cash Flow Statements* requires a statement of cash flows to be prepared in addition to the income statement and balance sheet and the statement of changes in owners' equity
- Shows the changes in the cash account
- Shows cash receipts and cash payments for a period of time
- A statement of cash flows reports the inflows and outflows of cash (and cash equivalents) under the headings of:
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Why is a Statement of Cash Flows Needed?

- Recognition of the overriding importance of liquidity to an entity
- To supplement the information provided by the income statement
 - Strong profit does not necessarily mean good liquidity
- To supplement the information provided by the balance sheet
 - Assess's the long-term financial structure i.e., gives an indication of the financing plan
- To evaluate entity's ability to generate future cash flows and provide an indication of the future solvency of the entity

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Classification of Cash Flow Transactions

- **Operating Cash Flows**
 - Principal revenue producing activities and activities that are
 - NOT investing and NOT financing
- **Investing Cash Flows**
 - Acquisition and disposal of long term assets and other investments (AASB107 para 6)
- **Financing Cash Flows**
 - Changes in the size and composition of equity and borrowings

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Operating Activities

- **Operating activities** are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities

Cash inflows include:

- receipts from customers/clients for providing goods/services
- interest received
- dividends received

Cash outflows include:

- payments to suppliers for goods/services provided
- payments to employees for services
- interest paid
- income taxes paid



Investing Activities

- **Investing activities** are the acquisition and disposal of long-term assets and other investments.

Cash inflows include:

- sale of property, plant and equipment (etc) for cash
- sale/redemption of shares/debentures of other entities for cash
- repayment of loans provided to other entities

Cash outflows to:

- purchase property, plant and equipment (etc) for cash
- purchase of shares/debentures of other entities for cash
- lend money to other entities



Financing Activities

- **Financing activities** are activities that result in changes in the size and composition of the contributed capital and borrowings of the entity

Cash inflows include:

- sale/issue of shares in the entity for cash
- issuing debentures or unsecured notes for cash
- obtaining a loan

Cash outflows include:

- payments to shareholders for share buy-backs
- dividends paid
- repayment of a loan



Classification of Cash Flow Transactions

Operating

Receipts from:

Sale of goods and services
Interest or dividends received

Payments for:

Purchase of inventory
Wages of employees
Taxes to governments
Interest to lenders

Investing

Receipts from:

Sales of property, plant and equipment
Repayment of loans by other entities
Sale of shares held as investments

Payments for:

Acquisition of property, plant and equipment
Acquisition of shares and debentures for investment purposes

Financing

Receipts from:

Issue of shares
Borrowings

Payments for:

Dividend distributions
Share buy-backs
Repayment of borrowings

Exclusions

The statement of cash flows *excludes* non-cash activities such as:

- Purchase of investments or property by incurring long-term debt
- Acquiring another business entity by issuing shares
- Conversions of liabilities to equity
- Revaluation of non-current assets
- Acquiring investments or property in exchange for other investments or property

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Separate Disclosure

- AASB 107 requires the separate disclosure of the following items:
 - Interest received
 - Interest paid
 - Income tax paid
 - Dividends received

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Presentation - Example

S. Monash
Statement of Cash Flows
For the year ended 30 June 2017

Cash Flows from Operating activities

Cash inflow from customers	120 500	
Cash outflow to suppliers	(76 000)	
Cash outflow on expenses	<u>(12 450)</u>	
Net cash flow from operations		32,050

Cash flows from investing activities

Cash outflow on premises		(\$5 000)
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Cash flows from financing activities

Repayment of Loan XYZ Ltd.	(21 600)	
Owners cash drawings	<u>(6 350)</u>	<u>(\$27 950)</u>
Net increase/decrease in cash held		(900)
Cash at beginning		<u>(15 000)</u>
Cash at end		<u>(15 900)</u>

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Apply it: classify the following cash flows as O, I or F

Owner contributed capital in cash	F	Paid cash to supplier	O
Paid staff wages	O	Paid GST owed to Government	O
Purchased computer in cash	I	Used cash to repay loan	F
Received cash from customer	O	Purchased furniture for cash	I
Received cash from new bank loan	F	Received cash from debtors	O
Paid interest on loan in cash	O	Paid rent one year in advance	O
Sold old equipment for cash	I	Paid cash dividend to shareholders	F
Owner took cash drawings	F	Loaned cash to related company	I

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Statement of Changes in Owner's Equity

- This statement shows all changes to owner's equity that occurred during the period.
- These changes could comprise
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Statement of Changes in Owner's Equity (Example)

S. Monash **Statement of Changes in Owner's Equity** **For the month ended June 30, 2017**

S Monash, capital, June 1, 2015	\$10,000
Owner's investment during the month	1,000
Profit for the month (I/S)	<u>3,000</u>
	14,000
Withdrawals during the month	<u>(2,000)</u>
S Monash, capital, June 30, 2016 (B/S)	\$12,000

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Cash and Accrual Accounting

- Entities need to record transactions and events that occur during a period to enable them to prepare financial statements.
- There are two methods of accounting that underlie the recording process:
 - cash accounting
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Cash versus Accrual Accounting

Cash Accounting

- Records revenues and expenses at the time the cash is *received* or *paid*
- The cash flow may be in a different period to when the original transaction occurred:
 - For example, Company A made credit sales of \$100,000 in June but the cash was received in July after the financial year end (June 30)
 - When is revenue recognised under cash accounting?

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Cash versus Accrual Accounting

Accrual Accounting

- Records revenues and expenses when transaction occurs
- Records income when it has been earned (regardless of whether the cash has been received).
- Records expenses when they have been incurred (regardless of whether the cash has been paid).
 - For example, Company A made credit sales of \$100,000 in June but the cash was received in July
 - When is revenue recognised under accrual accounting?
- Accrual accounting also includes non-cash expenses (depreciation; bad and doubtful debts) which will be discussed in Week 4.

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Cash versus Accrual Accounting

- Accounting information for users is generally prepared using the **accrual basis** rather than the **cash basis** of accounting!

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The Accounting Cycle

Identifying transactions

- Source documents (inputs)

Measuring/Recording transactions

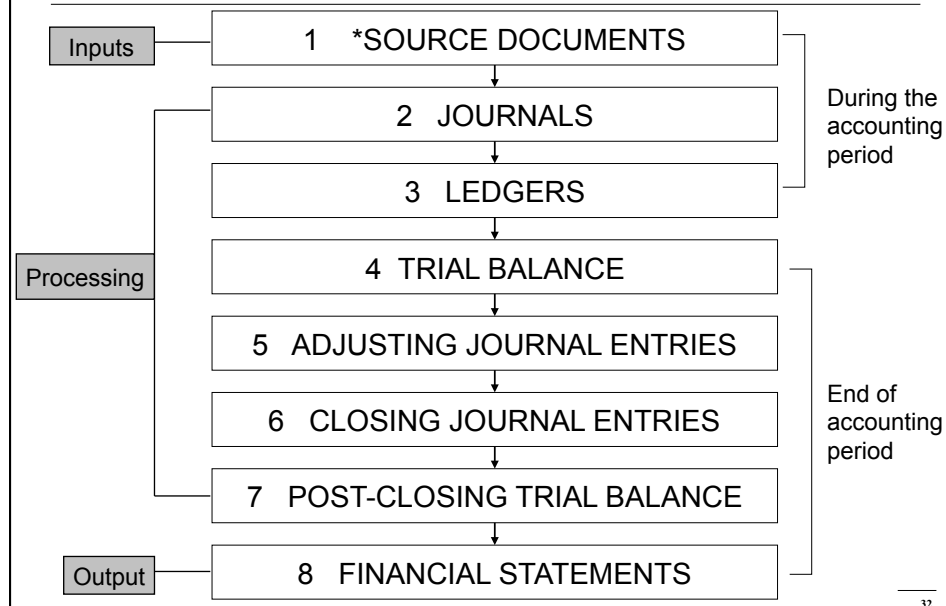
- Accounting books (processing)

Communicating financial information

- Financial statements (output)

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The Accounting Cycle



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Step 1: Source Documents

Evidence that a transaction has occurred

Necessary as a starting point for recording transactions

Examples include:

- EFT receipts
- Suppliers' invoice
- Cheque butts
- Sales invoice duplicates
- Cash register records

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Step 2: Journal Entries

- Based on the relevant source documents, transactions are recorded by preparing journal entries
- We are going to use **Transaction Analysis** to help us understand how to prepare journal entries
- *Please note: Businesses don't use transaction analysis to record transactions. They use journal entries to record transactions!*

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The Accounting Equation

- The basic version of the accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

- This equation expresses the relationship between the assets of the entity and how the assets are financed.

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The Accounting Equation (continued)

- If an entity has \$960,000 worth of assets, and currently owes \$400,000 for various liabilities, the accounting equation determines that the owner's equity must be:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

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Balancing the Accounting Equation

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

- This equation must always stay balanced.
- In order for this to occur, there needs to be a minimum of TWO effects.
- When transactions are recorded in the accounting system, the accounting equation maintains its **balance** at all times.

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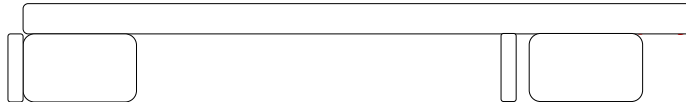
Transactions

- Exchanges between two or more parties
- May affect the business along with customers, suppliers, banks, other parties
- May affect the business owner
- Where the transaction relates to the owner but not the business, it is a personal transaction
- Where the transaction relates to the owner and the business, or the business and an external party, it is a business transaction
- ONLY business transactions should be recorded in the accounting system of the business under the 'entity' concept

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Transaction Analysis

- An owner provides \$50,000 in cash funds to start the business



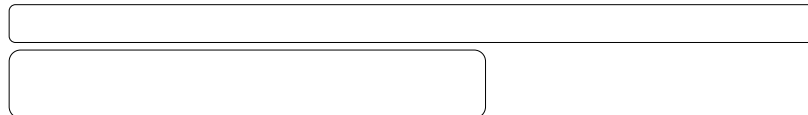
- Thus increasing both assets and owners equity.
- Notice that both sides of the accounting equation increase, and it remains balanced.

Clue – Identify the 2 things that change

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Transaction Analysis

- The company purchases a \$19,000 motor vehicle and funds it by borrowing using a bank loan



- This increases both assets (the vehicle) and liabilities (the bank loan).
- Again, both sides of the accounting equation increase, and remains balanced.

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Transaction Analysis

- Some transactions cause decreases in the elements, such as a \$3,500 part repayment of the loan principal (liability) with cash (asset).

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

- Despite a reduction in both elements, the equation once again remains in balance.

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Transaction Analysis

- Changes do not always take place on both sides of the equation.
- If cash was used to purchase a computer, one asset would increase while the other decreases.

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

- The overall balances of the equation remain the same. It is only the type of assets that have changed.

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Expanded Accounting Equation – Part 1

- So far we have only considered transactions involving assets, liabilities and equity.
- Transactions involving income and expenses must also be managed by the accounting equation.
- Since income less expenses equals profit (or loss), and profit (or loss) relate to owner's equity, these last two elements can be incorporated into the accounting equation.

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Extended Accounting Equation - Part 1

Assets = Liabilities + Owner's Equity

- Revenue (Income) is shown as a positive addition to owner's equity, since revenue contributes to profit.
- Assets = Liabilities + Owner's Equity +
- Expenses are shown as a subtraction from owner's equity, since expenses reduce profit.
- Assets = Liabilities + Owner's Equity + Income –
- We can now consider how transactions involving these two elements can be analysed.

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Transaction Analysis

- The recording of a \$220 cash sale would:
 - Increase assets (cash) and increase revenue (sales).
- $$\text{Assets} = \text{Liabilities} + \text{Owner's Equity} + \text{Income} - \text{Expenses}$$

Here, both sides of the equation increase due to a rise in assets and owner's equity.

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Transaction Analysis

- If staff worked for an entity, but had not yet been paid, there would be both an increase and decrease on the right hand side of the equation.

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity} + \text{Income} - \text{Expenses}$$

- Despite owner's equity decreasing due to an expense, liabilities increase causing no overall change in the balance of the equation.

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Extended Accounting Equation - Part 2

Assets = Liabilities + Owner's Equity + Income - Expenses

- Additional capital is shown as a positive addition to owner's equity.
- Assets = Liabilities + Owner's Equity + Income – Expenses +
- Drawings are shown as a subtraction from owner's equity
- Assets = Liabilities + Owner's Equity + I – E + Add. Capital –
- This is the fully expanded accounting equation that we will be using.
- We can now consider how transactions involving these additional elements can be analysed.

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Transaction Analysis

- Let's now consider an additional contribution of capital and its effect on the equation.

Assets = Liabilities + Owner's + Income - Expenses + Additional - Drawings
Equity Capital

- Both asset and owner's equity increase.

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Transaction Analysis

- This time, the owner takes cash drawings to spend on personal items. Drawings, the opposite to a contribution, result in a decrease in owner's equity.

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity} + \text{Income} - \text{Expenses} + \text{Additional Capital} - \text{Drawings}$$

- Both equity and assets decrease thus the equation is still in balance.

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Reminder

- Think of the accounting equation in its simplest form:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

- Income and additional contributions of capital increase owner's equity, so should be added.
- Expenses and owner's drawings decrease owner's equity, so should be subtracted.

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Transaction analysis via a simple worksheet

- While not part of formal recording, transaction analysis can assist in understanding the rules relating to transactions.
- Your task will be to identify and understand the impact of transactions on the elements of accounting via a simple worksheet:

Balance sheet accounts						Income statement accounts		
Assets	=	Liabilities	+	Owner's Equity	+	Income	-	Expenses

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Apply it: Transaction analysis via a simple worksheet

Record the following transactions in the simple worksheet:

1. An owner contributes \$5,000 cash to start a small business as a mobile tutor.
2. She buys a car for the business via a bank loan for \$15,000.
3. She buys some flowers to brighten up her house.
4. She purchases stationery supplies for the business on credit for \$200 from a supplier.
5. She purchases a laptop for the business worth \$1,000 in cash.
6. She provides tutoring to students for a total of \$350 cash.
7. She pays \$100 cash for advertising in local school newsletters.
8. She pays \$60 cash for fuel used.

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Simple worksheet

Balance sheet accounts					Income statement accounts			
Assets	=	Liabilities	+	Owner's Equity	+	Income	-	Expenses

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The Recording Process

- While transaction analysis is useful, it cannot realistically record thousands of transactions.
- Instead, entities use 'journals' and 'ledger accounts' to record transactions on a regular basis.
- **This will be the focus of next week's lecture!**

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Learning Objectives

1. Introduction to Financial Statements
2. Describe the characteristics of business transactions;
3. Differentiate between a business transaction and a personal transaction;
4. Distinguish between accrual accounting and cash accounting
5. Understand the accounting cycle and its different steps
6. Understand and apply the accounting equation and undertake transaction analysis