ACC1701x
AY22/23 Sem 2
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01. Financial Statements

Consolidated Financial Statements - Financial information about the group of companies including parent and subsidiaries
How does a parent company control subsidiary?

- Own a controlling interest of subsidiary's share
- Remaining shares are **Non controlling interest** - Separated, under book value

Associate Companies - Interest in shares outside group that wields significant influence

- Includes one-line partial consolidation of associate company in book value
- Recorded using equity method

Consolidated Balance Sheet

Purpose

- Report net worth of group **at specific date**

Fundamental Accounting Equation

$Assets = Liabilities + Equity$

Assets Resource controlled by company (eg. cash, accounts receivable, inventory, land, equipment, buildings)

Liabilities Amount owed to others leading to outflow of resources (eg. accounts payable, expenses)

Equity Owner's claim on residual interest after deducting liabilities

Problems

1. Not market value
   - Does not tell what the equity is worth in market
   - Market value = market share price * outstanding shares
2. Mixed measurement model - Mathematically dubious calculation
   - Property measured using **cost less depreciation** - amount originally paid less depreciation, OR current market value

Motivation

1. Comparing
   - Compare companies using **Market-to-book ratio** - $\frac{Market\ value}{Total\ equity}$
   - Why are they not the same?
     - Market takes into account future prospects not captured by book value
2. Details
   - Provides useful information

Statement of Changes in Equity

Lists impact of events on changes in equity

Factors

1. Contributions from shareholders
2. Distributions to shareholders
3. Business income/expenses
4. **Capital maintenance adjustments** - Remeasurement of asset/liability value

Statement of Comprehensive Income

- **Comprehensive Income** - Reflects changes of equity from non-owner sources and traditional income
- Show all operating and financial events that affect non-owners' interest in business
- Includes unrealised gains and losses

Income Statement

Includes information about business income and expenses for **the year**

Statement of Cash Flows

Accrual Basis - Record values when exchange of goods and services **NOT cash flows**

Subsections

- Operating activities
- Investing activities
- **Financing activities** - Borrowing or issuing shares (eg. repayments, share buybacks)

Item Breakdown

Current assets/liabilities Likely to be converted to cash/settled within a year

PPE Property, plant and equipment used in business

Right-of-use assets Rented premises for business (Asset)

Lease liabilities Outstanding rental payments wrt ROU assets

Trade Receivables Outstanding dues from **credit** customers

Cost of Goods Sold(COGS) Amount paid to suppliers for goods sold to customers

Gross Profit = COGS - Sales

Interest Income and expense Profit from investing and financing activities

02. Ratios

- Comparing companies as investment opportunities
- Comparing previous years to measure progress
- Overcome difference in scale

Profitability Ratios

- Measures performance of company over the year

Profit Margin $\frac{Net\ Profits}{Net\ sales\ (revenue)}$

Return on total assets $\frac{Net\ Profit}{Average\ Total\ Assets}$

Return on ordinary shareholders' equity $\frac{Net\ Profit}{Average\ total\ equity}$

Earnings per share $\frac{Ordinary\ shareholders\ profits - Pref\ Dividends}{Weighted\ average\ number\ of\ shares\ during\ year}$

Equity Categories

- **Share capital** - Amount collected when company originally issued shares
- **Retained earnings** - Accumulated profits - Amount paid as dividents

Liquidity and efficiency ratios

- Examine company capacity to meet short term debt obligation with current assets

Current ratio $\frac{Current\ assets}{Current\ liabilities}$

Acid Test ratio $\frac{Cash + Short\ term\ fin\ assets + Current\ receivables}{Current\ liabilities}$

Accounts receivable turnover $\frac{Net\ Sales}{Average\ accounts\ (Trade)\ receivables}$

- Receivables is **net** - Adjustment made for customers who may default

Inventory Turnover $\frac{Cost\ of\ goods\ sold}{Average\ inventory}$

Accounts payable turnover $\frac{Cost\ of\ goods\ sold}{Average\ accounts\ (trade)\ payable}$

Days' sales uncollected $\frac{Accounts\ (Trade)\ receivables,\ net}{Net\ sales} * 365$

Days' sales in inventory $\frac{Ending\ Inventory}{Cost\ of\ goods\ sold} * 365$

Days' purchases in accounts payable $\frac{Account\ (trade)\ payable}{Cost\ of\ goods\ sold} * 365$

Total Asset Turnover $\frac{Net\ sales}{Average\ total\ assets}$

Prepaid flows

- **Prepaid Expense** - Payments made for services not yet received (Assets)
- **Unearned Revenue** - Advanced payments received from customers (Liabilities)

Solvency Ratios

- Identify the company's risk of going bankrupt
- Gauge company chances of staying afloat

Debt Ratio $\frac{Total\ liabilities}{Total\ assets}$

Equity Ratio $\frac{Total\ equity}{Total\ assets}$

Times interest earned $\frac{Profit\ before\ interest\ expense/tax}{Interes\ expense}$

Debt to equity ratio $\frac{Total\ Liabilities}{Total\ equity}$

Market prospects ratio

- Help compare share price to other investments

Price-earnings ratio $\frac{Market\ price\ per\ ordinary\ share}{Earnings\ per\ share}$

Divident yield $\frac{Annual\ cash\ dividents\ per\ share}{Market\ price\ per\ share}$

03. Accounting Equation

Sole Proprietorship - Business owned by a single party $\triangle Capital = Capital\ contributed + Income - Expenses + Withdrawals$

Concepts

- **Accrual accounting** - Revenue and expenses recorded when goods and services change hands
- **Income** - Increase in equity net from any contributions
- **Expense** - Decrease in equity net from withdrawals

1. Income statementRecords revenues, expenses and net profit
2. Statements of changes in equity
   - Records changes in a month
   - Includes contributions from owners and withdrawals
3. Balance sheet
   - Refers to a specific date so must specify date
   - Breakdown assets and liabilities
4. Statements of cash flow

   Differentiate the types of cash flows

   Operating Day-to-day operations of company

   Investing Cash used to buy/receive from sales of long lived assets used in business

   Financing Borrowing/lending or cash flows from owner

04. Debit and Credit

Represented via a T-account

Account Title	
Debit	Credit

- Every transaction there will be equal amounts listed
- Debit: Asset increase (eg. Withdrawals, Expenses)
- Credit: Liability, equity increase (eg. Revenue)

Permanent vs temporary accounts

Temporary Track accounts only during current period

Permanent Capital accounts that track equity long-term

Trade debtors Customer that has not paid for goods and services

Trade creditor Supplier who has sent your business goods/services but haven't paid

Journal entries - Convenient format for recording transactions

05. Adjusting and closing

Adjusting entries

Record of transactions happening during period that were unrecorded (Why unrecorded)

1. Frequent or continuous transactions - impractical to record
2. Earning revenue/incurring expenses do not happen during cash payments (Prepayments/ accrued revenues and expenses)
3. **Depreciation** - Adjustment for age of a long-lived asset used in business

   Accumulated Depreciation - Contra asset storing negative adjustment
   Goes up on credit side and down on debit side
   Carrying value - Remaining value of asset (cost - accumulated depreciation)

Closing entries

Clear the temporary accounts
Capital(post-closing) = Capital(pre-closing) + Revenues - Expenses - Withdrawals

Steps

1. Close revenue accounts to income summary (Debit revenue, credit income summary)
2. Close expense accounts to income summary (Credit expense, debit income summary)
3. Close income summary to capital
   - Debit $>$ Credit: Debit balance $\rightarrow$ Net loss (Credit income summary balance, debit capital)
   - Credit $>$ Debit: Credit balance $\rightarrow$ Net profit (Debit income summary balance, credit capital)
4. Close withdrawals account directly to Capital (Credit withdrawals, debit capital)

06. Inventory

Sales and cost of goods sold

Transactions

1. Earned revenue (Sales revenue and cash/accounts receievable increase)
2. Goods sold (Inventory and COGS expense decrease)

Perpetual System

- Tracks on every sale
- vs **Periodic** - Compare beginning + purchases and ending inventory

Shrinkage

Inventory is less than beginning (Unaccounted damage, loss)

Min(Cost, NRV)

Cost - Cost to acquire and make inventory available for sale

- Purchase price, NET of discounts or allowance
- Shipping cost (**Freight-in** - borne by the buyer)
- Taxes on purchase transaction (as long as not recoverable)

Net Realizable Value - Value that inventory can be sold, net reasonable cost to sell

Cash flow assumption

- **Specific identification** - Unique items that have to be tracked and use actual original cost of item
- **Interchangeable goods** - Indistinguishable goods, typically in bulk
  1. FIFO
  2. Weighted average cost - Cost of each good are the same at the time of sale

Midterm

Debits

Assets Cash, Account receivables. Supplies/inventory, **PREPAID** insurance/rent, equipment, land, buildings

Decrease in equity withdrawals, expenses(cost of goods sold)

Credits

Increase in equity Capital, revenue

Increase in liabilities Accounts payable, accumulated depreciation, borrowing

07. Cash and A/R

- Cash at hand
- Cash in bank
- Cash equivalents (liquid, in safe financial instruments)

Petty cash

- Fixed amount that companies holds, usually to meet day-to-day spending needs
- Credit "cash at bank" and debit "petty cash account" only when fund amount changes OR during setup/tear down

Cash over and short

- Account representing the gap between expected amount from receipts and actual amount in petty cash box
- Accidental mistakes eg. petty cashier returning the wrong amount of change
- Debited as minor expense

Changing fund amount

- Record replenishment and amount to increase[debit]/decrease[credit] fund to petty cash

Bank reconciliation

- Updating cash at bank records and book records (deposits and withdrawals)

Causes

Deposits in transit Company received and recorded cheques and deposited in bank but bank has not cleared/recorded deposit **add to bank**

Outstanding cheques Payment made via cheques but payee has not deposited cheques/still being processed

- Bank has not deducted from account but book records payments when cheques were sent - **subtract from bank**

Non-sufficient funds(NSF) Receive cheques that recorded as cash receipt and deposited but bounced because not enough money in payer bank account

- Book incorrectly add amount **subtract from book**

Bank charges Expense from commission fees and penalties deducted from account - **subtract from books**

Interest received Commercial bank giving interest to account **add to book**

Collections on behalf Bank directly collect outstanding dues on behalf **add to book**

Bad debts

Accrual accounting at the end of the year

- Expected loss from customers not paying when selling goods on credit
- Recorded as *loss allowance* or *allowance for bad debts*
- Contra-asset representing a negative adjustment to trade receivables
- Goes up on credit side and down on debit side
- Coupled with *expected credit loss* or *bad debt expense*

When customer defaults

- Reduce allowance to "write off" trade receivable amount
- Can reverse write off (customer pays up despite giving up hope)
  - Credit allowance and debit trade receivables

Dr Loss allowance	xxx	
Cr Trade receivables		xxx

08. Notes and Warranty

- Current liability
  - Notes payable
  - Warranty liability

Notes payable/receivable

- Formal document where a borrower promises to pay a fixed sum of money (principal) after a fixed period from date note is signed (issue date)
- Current asset (less than a year)
- Stronger than accounts payable/receivables
- **Maturity/settlement date** - Note due date
- **Interest** - Additional amount borrower must return on top of principal (accrued interest + principal lumpsum)
- Note that interest is recorded in a separate account with adjusting journal entries

Calculations

- Months
  - Taken from the same day of the month
  - eg. Borrowing on 2/1/2023 + 3 months = 2/4/2023
- Days
  - Taken from the day after issue date
  - eg. Borrow on 2/1/2023 + 30 days = 1/2/2023
- Record non-payments against an established allowance

Provisions liabilities

- Liabilities where timing and amount are uncertain and needs to be estimated
- eg. **embedded warranty** - Warranty automatically gotten when purchasing goods(included in sale price)
- vs **extended warranty** - Extra charge for additional warranty counted under unearned revenue
- **Warranty expense** - Balancing figure when creating/increasing provision
- **Warranty liability** - Anticipated future claims decrease when actual warranty claim occurs (cash/asset goes down concurrently)

Contingent liabilities

- Possible uncertain liabilities that do not satisfy the criteria to be stated as provisions

09.PPE

- Tangible long-lived assets used in business to generate profits
- Life is more than a year (non-current asset)

Accounting

- Initially recorded at acquisition cost

1. Cost approach
   - Asset recorded at **carrying amount** - cost less accumulated depreciation
   - Recorded by 2 accounts (PPE at cost and accumulated depreciation on PPE)
2. Revaluation approach
   - Periodically revalued to current market value
   - Record the difference in value as accumulated depreciation

Acquisition cost

- Includes all cost necessary to acquire asset, bring to location of use and install it
- Additional cost accrued as initial acquisition cost of asset
- Includes future cost of dismantling/clean-up of assets
- All related liability is non-current

Capital vs Revenue expenditure

Cost incurred after installation

Capital expenditure

- Addition or improvement of assets
- Provides additional functionality and extends life
- Increase in asset at cost amount

Revenue expenditure

- Routine repair, maintenance/cleaning cost to maintain in proper working conditions
- Recorded as expense

Depreciation

- Estimate of the wear and tear that assets suffers during life

Straight-line depreciation

$$\frac{Acquisition\ cost - Residual\ value\ if\ any}{life\ in\ years}$$

Partial-year depreciation

- Acquired during a year so depreciation is prorated at a fraction of a year (rounded to nearest month)
- **15-day rule** - Before 15 start counting from that month, after 15th start counting from next month

Revising assumptions

Estimate of depreciation changes

- Revised estimates **prospectively** over the remaining recalculated life of asset
- Not **retrospectively** - Changing past estimates
- Revised depreciation expense =
- $\frac{carrying\ amount\ at\ beginning\ of\ year - Revised\ residual\ value}{Revised\ remaining\ life\ from\ start\ of\ year}$

PPE disposal

Selling PPE

Steps:

1. Credit PPE asset **at cost** to 0
2. Debit accumulated depreciation of PPE asset to make it 0
3. Debit proceeds from sale to cash/receivable
4. Gain [Credit] or loss[debit] on disposal
   - Proceeds from sale of PPE - carrying amount of PPE at sale date