CHAPTER 1

An introduction to accounting

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1.1 explain the business context and the need for decision making

1.2 define accounting, describe the accounting process and define the diverse roles of accountants

1.3 explain the characteristics of the main forms of business organisation

1.4 understand the *Conceptual Framework* and the purpose of financial reporting

1.5 identify the users of financial reports and describe users' information needs

1.6 identify the elements of each of the four main financial statements

1.7 describe the financial reporting environment

1.8 explain the accounting assumptions, concepts, principles, qualitative characteristics and constraints underlying financial statements

1.9 calculate and interpret ratios for analysing an entity's profitability, liquidity and solvency.

Chapter preview

Welcome to the accounting journey, it is not just about recording numbers. Throughout this text you will explore the concepts and regulations that underlie the preparation of the accounting reports and the various decisions that need to be made in preparing the financial information and reports. As well, we will examine the decisions made using the accounting information as inputs into the decision-making process, both inside and outside the business organisation. Accounting information can help you understand a business entity's past performance and its current financial position, and provide some insight into its future prospects.

It is an exciting ever-changing business environment that keeps pace with the changes in technology and knowledge management. For example, Domino's Pizza Enterprises Ltd commenced as a single franchise in Australia and now is the largest franchisor of the US's largest pizza chain, with operations in Europe, Japan, Australia and New Zealand. How did this occur? Why did it embrace technologies such as online ordering, including a mobile phone app and Facebook? Domino's effectively obtains information from customers using this technology, which feeds into the sale growth predictions and the strategic future directions of the business.

In this chapter we introduce the business environment, including the role of accounting, the forms of business organisation, the regulatory environment, the financial statements, and some tools that can help you analyse financial statements for decision making. The content and organisation of this chapter are as follows.

An introduction to accounting

Introduction to accounting	Forms of business organisation	Introduction to the *Conceptual Framework*	Users and uses of financial information	Financial statements	The financial reporting environment	Assumptions, concepts, principles and qualitative characteristics	Analysing financial statements
• The business world • Accounting — the language of business • The accounting process • The diverse roles of accountants	• Sole proprietorship • Partnership • Company • Other forms of business organisation • Not-for-profit organisations	• The objective of general purpose financial reporting • The reporting entity	• Internal users • External users • Financing activities • Investing activities • Operating activities • Sustainability reporting	• Statement of profit or loss • Statement of changes in equity • Statement of financial position • Statement of cash flows • Inter-relationships between the statements	• Australian Securities and Investments Commission • Financial Reporting Council • Australian Accounting Standards Board • Australian Securities Exchange • Regulation in New Zealand • Professional accounting bodies	• Assumptions, concepts and principles • Qualitative characteristics	• Analysis and decision making • Profitability • Liquidity • Solvency

1.1 Introduction to accounting

LEARNING OBJECTIVE 1.1 Explain the business context and the need for decision making.

The business world

What's your favourite business? Apple, Google, Nike? Would you like to start your own business? How do you start a business? How do you make it grow and become widely recognised like Domino's? How do you determine whether your business is making or losing money? How do you manage your resources? When you need to expand your operations, where do you get money to finance the expansion — should you borrow, should you issue shares, should you use your own funds? How do you convince lenders to lend you money or investors to buy your shares? Success in business requires countless decisions, and decisions require financial and other information. A **decision** is a choice among alternative courses of action.

Architects use technical and structural knowledge of the building codes together with their creative ability to design a model or plan of a building. Just like architects, in order to start and run a business you need not only your creative ideas and marketing plan, but also information on the business environment in order to understand the context of your business. Accounting provides an economic model of the business world. It plays a key role in the provision of financial information for decisions made by people inside and outside a business. The continued growth of Domino's in both the European and the Australian and New Zealand markets required a variety of information including the past and current performance of the Domino's operations. Projections on future store sales growth and potential market share growth from opening new stores was also required in order to plan ahead and to help towards the achievement of targets. The provision of accounting information within the business entity is referred to as **management accounting**. **Financial accounting** is the term used to describe the preparation and presentation of financial reports for external users. However, both financial accounting and management accounting draw on the same information system used to record and summarise the financial implications of transactions and events. Businesses also need to provide information on the environment and the community within which the business operates. The concept of sustainability is explained later in this chapter.

The business environment is ever changing. Driven by technology, life cycles of businesses are shortening. New technologies, new processes, new products, faster information flows are driving changes. How often do you update your mobile phone? Everyone in society is affected by technology change. Computers provide the technology to process the information so more time is devoted to the analysis of the information to make the best informed decisions. Accountants work in businesses as part of management teams who analyse the information gathered to make decisions. So how do we go about the decision making?

The first step in the process of decision making is to identify the issue or the decision to be made. The next step is to gather the relevant information required for the analysis. Once gathered, you identify the tool or technique that will assist analysis of the issue so a decision can be made. The final step is to evaluate the results of the analysis and make the decision. The decision-making toolkit summarises this process.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Which film your friends wish to see	Cinema times and films showing Who are the lead actors Personal preferences	Eliminate unsuitable times and films Discuss which preferences are left and rank in popularity	Film most wish to see is the one chosen If none suitable, re-evaluate or select another social activity and start the decision process again.

Note: Each chapter presents useful information about how decision makers use financial statements. Decision-making toolkits summarise discussions of key decision-making contexts and techniques.

TECHNOLOGY VIGNETTE

Using big data to inform business decisions

The same steps in decision making in everyday life apply to business decisions. Big data is providing businesses with the opportunity to harness data to inform decisions and improve performance. Big data is not only available to major customer-facing businesses, but with the economical availability of Cloud-based solutions even small business can accumulate digital data about their customers.

Data is being used to inform fraud prevention, market segmentation, capacity planning, pricing strategies, and to optimise advertising and promotional expenditure. Examples of how big data is being used to implement changes across industry sectors are provided below. Other benefits to the business include:

- understanding customer needs and identifying opportunities to innovate
- improving process efficiency and product quality
- improving website design based on the behaviours of visitors to their site
- improving employee recruitment and retention.

However, to benefit from big data, businesses need to have the right data, be able to analyse it and have the skills to ensure that insights are applied to create value. This requires developing the skills of employees, spanning from technical ability to commercial acumen and include performance management and conformance to data management standards and policies (see figure1.1).

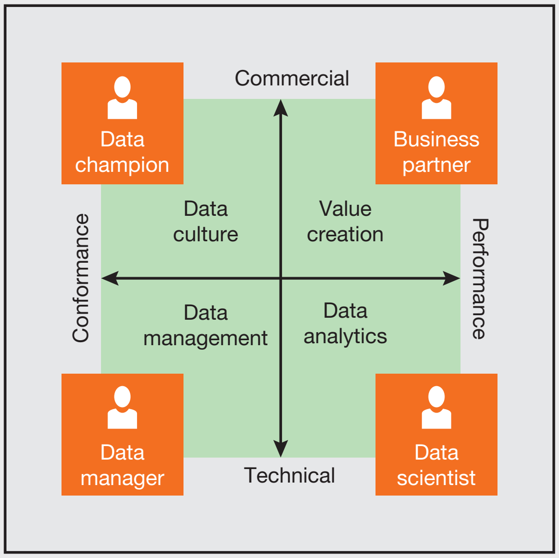
Due to the scale and complexity of big data sets now available, a data scientist may be required to conduct complex analysis using algorithms and predictive analytics to mine data. However, data visualisation tools may help businesses to analyse data using less advanced analysis tools.

Businesses need to ensure the integrity of data that they have captured and stored is maintained. Commercially sensitive data must be protected from cyberattacks and customers need to have confidence that their sensitive data is handled properly and maintained securely.

An appropriate data culture is required where data is valued as an important strategic asset that can enable new strategies and improve the competitive position of the business. To create value, analytical insights need to be translated into business opportunities where the best course of action is chosen. This requires collaboration between finance professionals, data scientists, IT professionals and business managers. However, according to Chartered Institute of Management Accountants (CIMA), management accountants are well placed to provide businesses with many of the skills required, especially as a finance business partner, data manager and data champion.

Source: Adapted from CIMA 2014.

FIGURE 1.1 Potential roles for management accountants



Source: CIMA 2014, p. 7.

For example, if you were wanting to choose which film a group of friends wish to watch, you would need information concerning each of your preferences for the genre and how flexible you are in your preferences, maybe who is in the leading roles and the times the movie is being shown. The tool would be to rank the films in order of preference starting with what is showing at the times your group is available, then reducing the alternatives to which films are showing, and then eliminating any alternative which one of your group didn't want to see. You may end up with no suitable film or you may go back and change the parameters, which may include looking for another social activity. Even with this analysis your group may not enjoy the film as it was a dud, but that is the risk you take. Decisions are future oriented and you need to make informed judgements.

Similar to the social activity decision, in the business world, even with all the information available, the final outcome of the decision may not be what was expected. Next, we are going to consider what accounting is and how it is used in the decision-making process in the business environment.

1.2 Accounting: the language of business

LEARNING OBJECTIVE 1.2 Define accounting, describe the accounting process and define the diverse roles of accountants.

The primary function of accounting is to provide reliable and relevant financial information for decision making. Accounting has been around for centuries and has developed significantly since its humble beginnings in ancient times when scribes recorded simple agreements between parties and other information on clay tablets. Today, almost every person engages in business transactions in relation to the financial aspects of life such as purchasing products and paying bills. This means that accounting plays a significant role in society.

Accounting can be referred to as the 'language of business' as it is a means of common communication where information flows from one party to others. In order for information to be effective it must be understood. Accounting, like many other professions, has its own terminology or jargon that is unique to the profession and can have alternative meanings in different contexts. Accounting terms, concepts and symbols are used to provide financial information to a variety of users including managers, shareholders and employees. You will need to learn these specialised terms and symbols in order to be able to prepare and use accounting information effectively. The definitions of key terms listed at the end of each chapter will support your learning. Providing reliable and relevant accounting information is a complex process.

The accounting process

Accounting is the process of identifying, measuring, recording and communicating the economic transactions and events of a business operation. Table 1.1 summarises these main steps.

TABLE 1.1 **The accounting process**

Identifying	Measuring	Recording	Communicating
Taking into consideration all transactions which affect the business entity	Quantifying in monetary terms	Analysing, recording, classifying and summarising the transactions	Preparing the accounting reports; analysing and interpreting

Identifying involves determining which economic events represent transactions. **Transactions** are economic activities relevant to a particular business and include, for example, the sale of a good to a customer or the purchase of office stationery from a supplier. Transactions are the basic inputs into the accounting process. **Measurement** is the process of quantifying transactions in monetary terms and must be completed in order to record transactions. The recording process results in a systematic record of all of the transactions of an entity and provides a history of business activities. To enhance the usefulness of the recorded information, it must be classified and summarised.

Classification allows for the reduction of thousands of transactions into meaningful groups and categories. For example, all transactions involving the sales of goods can be grouped as one total sales figure and all cash transactions can be grouped to keep track of the amount of money remaining in the business's bank account. The process of summarisation allows the classified economic data to be presented in financial reports for decision making by a variety of users. These reports summarise business information for a specific period of time such as a year, 6 months, one quarter or even a month. Domino's provides 6-monthly reports that are available to the general public via the securities exchange web site.

Communicating is the final stage in the accounting cycle. Communicating involves preparing accounting reports for potential users of the information. There are many reasons for maintaining accurate financial accounting records, including legal and other reporting requirements. The Australian Taxation Office (ATO) and the New Zealand Inland Revenue (NZIR) require businesses to provide a variety of financial information to comply with legal requirements. Users of financial information, both internal and external to the entity, will require financial information to make decisions in relation to the business. Once the users have acquired the information, they can use a variety of techniques to analyse and interpret the data. In most of the chapters, there are sections which demonstrate a variety of techniques that are useful for analysing and interpreting financial statements. These sections are intended to support the development of your skills in analysis and interpretation of financial information, and to enhance your understanding of accounting.

To recap this section, accounting provides an economic model of the business world and plays a key role in the provision of financial information for decision making. Accounting is the process of identifying, measuring, recording and communicating the economic transactions and events of a business operation to users of financial information. The first three activities of identifying, measuring and recording the business information are commonly referred to as **bookkeeping**. Bookkeeping forms the foundation of the activities underlying accounting and these processes are explained in detail in the early chapters of this text, using a manual accounting system. In the early part of the twentieth century, the role of the accountant did not extend much beyond this bookkeeping function. Today, however, the roles and responsibilities extend far beyond preparing accounting records.

The diverse roles of accountants

Accountants practise accounting in four main areas: commercial accounting, public accounting, government accounting and not-for-profit accounting.

Commercial accounting

Commercial accountants work in industry and commerce. Companies like Domino's and Qantas employ a number of accountants in different roles, such as management accounting and financial accounting. The accounting information system provides these accountants with the information they need for planning, decision making, and compiling reports for a range of users. The **chief financial officer (CFO)** is a senior manager in an organisation and directs the accounting operations. Financial accountants oversee the recording of all of the transactions and prepare reports for users external to the business entity, such as shareholders and creditors. Management accountants focus on providing information for internal decision making as they prepare specifically tailored reports for use by management. Commercial accountants are employed within organisations, and their work is directed by their employers. Public accountants, on the other hand, run their own businesses and are therefore more autonomous.

Public accounting

Public accountants, as the name suggests, provide their professional services to the public. They can practise in business organisations that range from small single-person-run offices to very large organisations with branches all over the world and thousands of employees. Public accountants tend to specialise in one or more areas of accounting when providing services to the public. Auditing is one of the primary services provided by large public accounting firms such as Deloitte and KPMG. An **audit** is an independent examination of the accounting data presented by an entity in order to provide an opinion as to whether the financial statements fairly present the results of the operations and the entity's financial position. Public accounting firms also provide a wide range of taxation services including advice for minimising an entity's tax liability, of course within the law, and preparation of tax returns, among other things. In more recent years, management advisory services have been a growing area for public accountants. Services include provision of advice on improving their clients' business efficiency and effectiveness, design and installation of accounting information systems, and assistance with strategic planning. Public accounting firms may also provide advisory services to government organisations or be employed by the government.

Government accounting

Government accountants, employed within government entities, engage in a variety of roles and activities, such as financial accounting and auditing. Local councils, state governments and federal government receive and pay out large amounts of funds each year and these activities need to be accounted for. Nowadays, many of the issues and decisions faced by government entities are the same as those in the commercial sector. As a result, these entities often follow accounting policies and practices similar to those in the private sector. Although most government entities are not-for-profit, some government departments, such as the Brisbane City Council, run profit-making businesses.

Not-for-profit accounting

Not-for-profit accountants, working in the not-for-profit sector, engage in many activities including planning, decision making, and preparing financial and management reports for both internal and external users. Management processes, accounting systems and operational methods are often similar between profit-making and not-for-profit entities. However, there is one major difference and that is the *profit motive*.

A **not-for-profit entity** focuses on successfully fulfilling its mission and administrative goals, rather than focusing on making a profit. Not-for-profit entities include public hospitals, clubs, some schools and charities. For example, the World Vision charity works with poor, marginalised people and communities to improve their lives and help them take control of their futures. Not-for-profit entities are exempt from income taxes on activities related to their exempt purpose and have fiduciary responsibilities to members, contributors and other constituents, and their activities may require reporting to supervising government entities.

In summary, accountants have many diverse roles and can work in different forms of organisation from small one-person businesses to large corporations with a worldwide presence. Once trained as an accountant, you can also work in organisations in non-traditional accounting roles or be better equipped to run your own business.

Would you like to run your own business? How would you decide how to structure your business and what resources would be required? In the next section, we explore the different forms of business organisation in more depth.

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What information would you require to set up and run your own business?
2. What is the primary objective of accounting?
3. Accountants practise accounting in four main areas. Describe these areas, with examples.

Note: *Review it* questions at the end of major text sections prompt you to stop and review the key points you have just studied. Sometimes these questions stand alone; other times they are accompanied by practice exercises called *Do it*.

1.3 Forms of business organisation

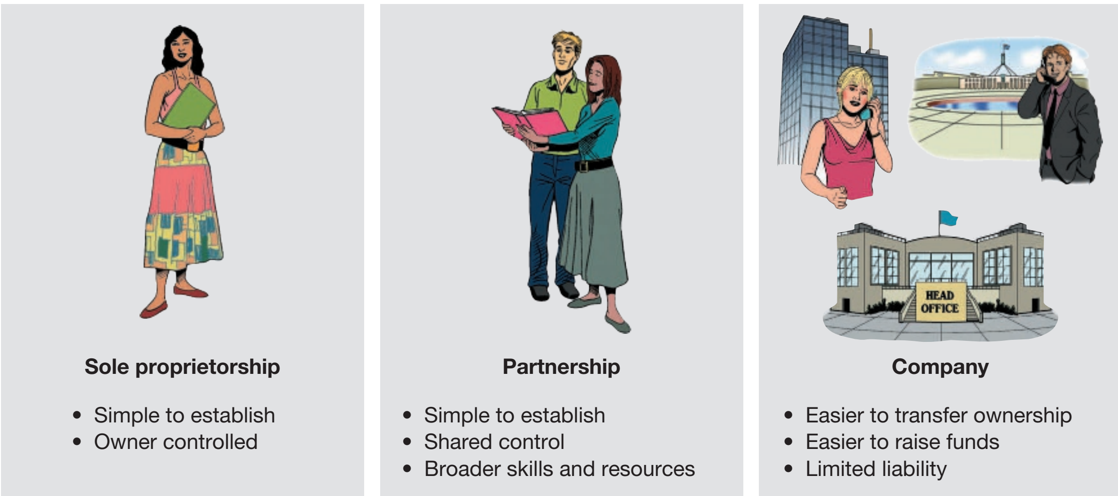
LEARNING OBJECTIVE 1.3 Explain the characteristics of the main forms of business organisation.

Business organisations can be classified into profit-oriented businesses such as sole proprietorship, partnership or company, and not-for-profit entities such as charities and government departments. Throughout this text, we concentrate on preparing financial reports for the profit sector. However, many of the concepts and regulations apply equally to the not-for-profit sector.

Suppose you graduate with a marketing degree and open your own marketing agency. One of the first important business decisions you will need to make is the organisational structure under which the business will operate. You have three choices: sole proprietorship, partnership or company. Figure 1.2 outlines the three main forms of business organisation. In selecting a suitable business structure, some of the factors to consider are:

- establishment fees and maintenance costs
- asset protection (business and personal assets)
- the type of business and how it impacts on your record keeping
- legitimate tax minimisation.

FIGURE 1.2 Characteristics of the main forms of business organisation



Sole proprietorship

A **sole proprietorship** is a business owned by one person. It is the simplest form of business structure and has very few legal formalities. It is quick and inexpensive to establish and inexpensive to wind down. Under this structure, the owner of the business has *no separate legal existence* from the business. You might choose the sole proprietorship form if you have a marketing agency. You would be referred to as a *sole trader*. As a sole trader, the business is fully owned by you and you have total autonomy over the business's strategic direction and all business decisions. The assets and profits completely belong to you. The business's income is treated as the business owner's individual income (hence, no separate legal existence). Sole traders pay the same tax as individual taxpayers, according to the marginal tax rates. Depending on the level of profits from the business, this could be a disadvantage. In the 2020 year, at an income level of around $140 000, the effective average tax rate of an individual is equal to the 27.5% company tax rate, so for any profits above this level the sole trader is paying more income tax than if the business was organised as a company. Other disadvantages are that the business is limited by the owner's skills, the funds available to invest, and the time available for running the business, as well as bearing full personal liability for the business's debts. Small owner-operated businesses such as restaurants, dentists and panel beaters are often sole proprietorships, as are farms and small retail shops.

Partnership

Another possibility for your new marketing agency is for you to join forces with other individuals to form a partnership, in which all partners share control. A **partnership** is a relationship or association between two or more entities carrying on a business in common with a view to making a profit. Entities forming the partnership may be individuals or companies.

There is little formality involved in creating a partnership. Partnerships are often formed because one individual does not have enough economic resources to initiate or expand the business, or because partners bring unique skills or resources to the partnership. You and your partner(s) should formalise your duties and contributions in a written partnership agreement. All partnerships should be formed on the basis of an agreement (which may be made in writing, verbally or by implication). In Australia, partnerships are governed on a state-by-state basis by the Partnership Act in each Australian state. In New Zealand, the *Partnership Act 1908* is the national legislation. Partners must also decide how profit (or losses) should be allocated among the partners. Accounting information is often used to determine each partner's share, as specified in the partnership agreement.

Traditionally, partnerships have not been incorporated. This means that, like a sole proprietorship structure, the business structure has **unlimited liability**, so each partner is personally liable for all the debts of the partnership even if they are caused by decisions made by other partners. More recently, changes to state and territory legislation have allowed for limited liability partnerships (LLPs). Similarly, New Zealand introduced limited partnerships in 2008. These are an emerging trend and are often used for raising venture capital for new businesses, such as a new mining venture. However, because *limited partnerships* are taxed as companies and the general partner still bears unlimited liability, this form of business structure is not very popular. Another disadvantage of a partnership structure is that a partnership has a limited life. If a partner wishes to sell or leave the partnership, or a partner dies, a new partnership agreement must be formed. The partnership agreement often has conditions on who can be admitted as a new partner in the event of a partner wishing to sell their share of the business. Finally, if there are disputes between the partners, it can be costly and damaging to the business, as well as to friendships.

Partnerships are often used to organise retail and service-type businesses, including professional services such as accounting, medical and legal practices.

Company

As a third alternative, a marketing agency can be organised as a company. A **company** or corporation is a separate legal entity formed under the *Corporations Act 2001* (Cwlth) in Australia or the New Zealand *Companies Act 1993* (Public Act). The process of setting up a company is called *incorporation*. The owners of a company are called **shareholders** (or *stockholders* in the US) and their ownership interests are represented by the number of shares they own in the company.

Under a company structure, the company can sue and be sued and enter into contracts in its own name. As a result, the shareholders of most companies have *limited liability*. **Limited liability** means the shareholders are liable for the debts of the business only to the extent of amounts unpaid on their shares. If a company breaches an agreement, it is generally solely liable — unless there is some misconduct by the directors or officers, such as misrepresentation or misleading or deceptive conduct. If misconduct or misrepresentation is proven, it is possible for the company directors to be held personally liable for debts. Another advantage of the corporate form is that a company has an indefinite life. The owners can more easily transfer their ownership interest by selling their shares in the company to other investors.

Companies vary in size from small privately owned and often family-run companies (proprietary limited companies — Pty Ltd) to large public companies listed on a securities exchange (limited companies — Ltd) managed by directors, with thousands of shareholders. If you use a company structure, there are establishment costs and ongoing fees and regulations to comply with. These make it more expensive to run than unincorporated business structures. We will discuss these issues in more depth in chapter 10.

When considering the business structure of your marketing agency, you need to decide on two factors: the decision-making structure you want for your business (sole trader, partnership or company) and the financial and legal ramifications of the structure you choose. Will the business be an incorporated or unincorporated business? A sole trader, for example, has all the decision-making power but also has full responsibility (is liable) for the actions of the business. A company, on the other hand, has limited liability but, if there is more than one director, the decision making is usually a shared responsibility. Thus, the decision to incorporate or to remain unincorporated has distinct legal and financial ramifications. Many businesses start as sole proprietorships or partnerships and eventually incorporate.

Other forms of business organisation

Although the sole proprietorship, partnership and company are the most common forms of business structure, others such as trusts, cooperatives and not-for-profit forms are discussed below.

Trusts

A **trust** is a relationship or association between two or more parties, whereby one party holds property in trust for the other, i.e. they are vested with the property. A trust, in its simple form, has:

- a settlor (who sets up the trust)
- a trustee (who is the legal owner and manages the trust property — investments, assets etc. — and pays out any net income for the benefit of the beneficiaries); and
- beneficiaries (the person or people who are the equitable owners and for whom the investments or assets are held and to whom income is paid).

The trustee has full control over the assets held by the trust, so it is important that the trustee be entirely trustworthy and able to manage all aspects of trust administration. Trusts may be made expressly in writing or implied from the circumstances. Trusts can range from relatively simplified structures to more complex structures. It is possible, for example, for a family member to act as a trustee for a family trust. It is very common in family-owned small businesses for a Pty Ltd company to be the trustee and the family members the beneficiaries, which means the business has the protection of limited liability for asset protection but profits can be split effectively for taxation. It is also possible for a company to trade as the trustee of a trust.

Cooperatives

A **cooperative** is a form of business organisation that is member-owned, controlled and used. It must consist of five or more people. Cooperatives are legislated at state level in Australia. They are distinctive for fostering a highly participative and democratic style of work, pooling resources to be more competitive and sharing skills. Cooperatives play an important role in the community. They supply goods and services to their members and to the general public in areas as diverse as retailing, recycling, manufacturing, labour hiring, printing and agriculture. Examples include Australian Forest Growers, South Gippsland Herd Improvement Association Inc., Ballina Fishermen's Co-operative Ltd and Bermagui Pre School Co-operative Society Limited.

Not-for-profit organisations

Not-for-profit is one of the more interesting forms of business organisation. This sector includes associations such as clubs, charities and the government sector.

Associations

Small non-profit, community-based groups often form **associations**. Associations can be, but are not always, incorporated. An incorporated association provides a relatively inexpensive and easier means of establishing a legal entity than forming a company. In other words, an association is an alternative to a company. An incorporated association has similar advantages to a company but is not as expensive to set up or maintain. An association can trade as a profit organisation, but this cannot be its main objective. Any profit from the trading must be put back into the association and not given to its members. Although associations tend to be small community groups, they can be specialist interest groups such as sports associations, industry associations, animal breeder associations and hobby associations. The Australian Medical Association and the Epilepsy Association of Australia are two examples of groups that are focused on a particular area.

Government

The government sector is also called the **public sector**. The distinguishing feature is that the organisations are owned by the government, whether it be federal, state or local. Within this sector there may be departments or segments which are operated as business enterprises and have a profit-making objective or aim to generate a return on the resources they control. Examples include public hospitals, public schools and the ATO.

Because the majority of business is transacted by companies, the emphasis in this text is on the corporate form of business structure. Generally, the techniques for recording transactions, the basic accounting equation, the principles underlying accounting and financial reporting, and the major financial statements are common to all business forms. Recall that the primary role of accounting is to provide financial information for decision making. How do accountants know what information to provide? The *Conceptual Framework for Financial Reporting*, referred to as the *Conceptual Framework* throughout this textbook, provides guidance to preparers of financial information by defining who is required to report and who the users are likely to be.

1.4 Introduction to the *Conceptual Framework*

LEARNING OBJECTIVE 1.4 Understand the *Conceptual Framework* and the purpose of financial reporting.

In this section we introduce the ***Conceptual Framework***. We will piece it together frame by frame throughout the chapter. A conceptual framework consists of a set of concepts to be followed by preparers of financial statements and standard setters. We will use the image of a window to present the *Conceptual Framework*, because a window is a lens through which we can view the world, in the same way as preparing external financial statements using a conceptual framework allows us to view the economic world in a particular way.

The *Conceptual Framework* has undergone an extensive review process over many years. In March 2018, the International Accounting Standards Board (IASB) issued a revised *Conceptual Framework for Financial Reporting* (*Conceptual Framework*). Throughout this text, the *Conceptual Framework* content is based on the 2018 version.

The *Conceptual Framework* consists of eight chapters. Chapter 1 is the objective of general purpose financial reporting, as represented in figure 1.3.

FIGURE 1.3 Building the *Conceptual Framework* — chapter 1

The objective of general purpose financial reporting

The objective of general purpose financial reporting forms the foundation of the *Conceptual Framework*. All the other elements flow from the objective. If we know why we need to report, then it follows we can determine who needs to report and what and how information is to be reported. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential equity investors, lenders and other creditors in making their decisions about providing resources to the entity. This definition highlights the primary users of **general purpose financial reports** to be existing and potential shareholders, lenders and other creditors. It also acknowledges that other groups may also be interested in the financial information. The management of the reporting entity is one such group, but it was decided that management does not need to rely on general purpose financial reports because it can obtain the financial information it needs internally. Other parties such as regulators and members of the public may also find general purpose financial reports useful.

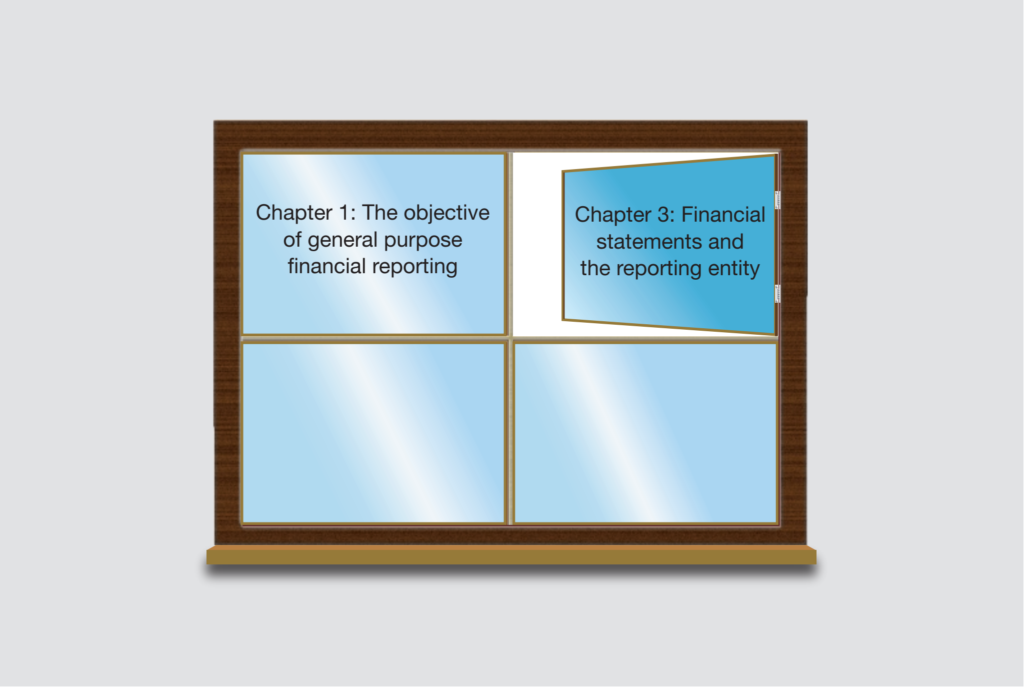
It is acknowledged that general purpose financial reports do not provide an evaluation of an entity but provide information that, together with other sources of information such as general economic conditions, political climate and industry conditions, allows primary users to estimate the value of the reporting entity.

Now that the objective of general purpose financial reporting has been discussed, the next step is to decide who needs to prepare general purpose financial reports.

The reporting entity

Another piece in the *Conceptual Framework* is represented in figure 1.4.

FIGURE 1.4 Building the *Conceptual Framework* — chapter 3



Prior to 2018, the *Conceptual Framework* did not include a section on the reporting entity and therefore Australian business entities and standard setters referred to that section from the previous Australian conceptual framework developed by the Australian Accounting Standards Board.

In the previous section, we described a number of different forms of business organisation. While each of these forms of business prepares some kind of information for a variety of users, not all businesses are classified as reporting entities. The **reporting entity** is discussed in paragraphs 3.10–3.14 of the *Conceptual Framework* (2018). Paragraph 3.10 states that 'a reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity. A reporting entity is not necessarily a legal entity'.

It is important to determine the boundary of the reporting entity. The information needs of the primary users of the reporting entity's financial statements are the driving factor. As previously stated, the primary users of general purpose financial statements are existing and potential investors, lenders and other creditors. These users require relevant information that 'faithfully represents' what it purports to represent. Faithful representation requires a reporting entity to maintain a complete set of economic activities resulting in neutral information (paragraph 3.14).

It is important to determine whether an organisation is a reporting entity as reporting entities must prepare *external* general purpose financial reports that comply with accounting standards. All other entities will prepare information for internal use.

Reporting entities tend to be larger organisations and the financial information provided in external general purpose financial reports tends to be quite condensed. Both reporting and non-reporting entities also prepare internal reports that contain more detailed information. Examples of both internal and external reports are provided in the latter part of this chapter. Possible new developments and differential reporting are explored in chapter 13.

The information arising from businesses, regardless of their structure, is useful to a variety of users. In the next section, we explore the users of financial statements and users' information needs.

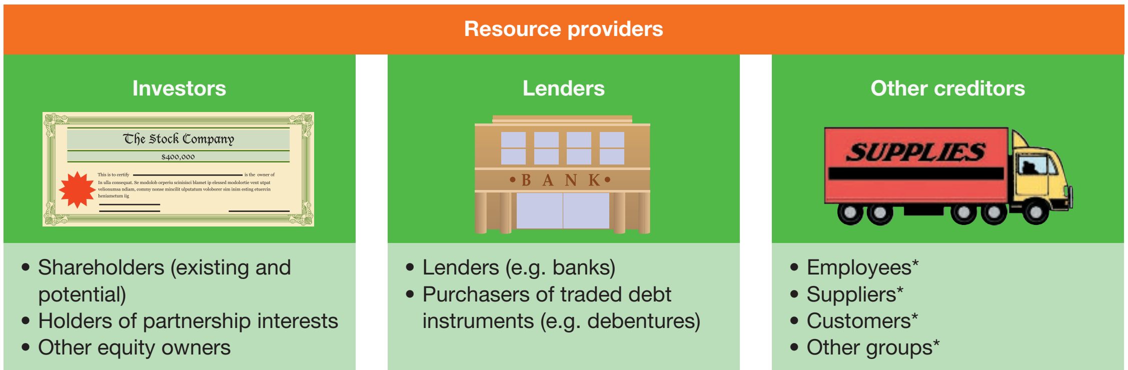
1.5 Users and uses of financial information

LEARNING OBJECTIVE 1.5 Identify the users of financial reports and describe users' information needs.

Now that we know which entities are required to prepare general purpose financial reports and the objective for financial reporting, let's take a closer look at the users of financial reports and their information needs. We begin with an exploration of the users and their information needs as outlined in the *Conceptual Framework* for financial reporting and then discuss other users of financial reporting.

Figure 1.5 sets out the primary users of the general purpose financial reports being those users who provide resources to the entity and therefore require information to make decisions concerning the provision of those resources.

FIGURE 1.5 Categories of primary users of general purpose financial reports



*Only in their capacity as resource providers, otherwise they are not considered primary users.

Investors contribute to the equity of an entity by investing resources (usually cash) for the purpose of receiving a return and include shareholders, holders of partnership interests and other equity owners. **Lenders** contribute to an entity by lending resources (usually cash) for the purpose of receiving a return in the form of interest. Some questions that may be asked by investors and creditors about a company include the following.

- Is the company earning satisfactory profit?
- How does the company compare in size and profitability with its competitors?
- Will the company be able to pay its debts as they fall due?
- Is the company paying regular dividends to its shareholders?

Other creditors may provide resources to an entity as a result of their relationship with the entity, even though they are not primarily resource providers. For example, suppliers extend credit to facilitate a sale, employees provide their services (human capital) in exchange for remuneration and customers may prepay for goods or services that are to be provided in the future. These parties are only considered resource providers to the extent that they provide the entity with resources in the form of credit, and they make decisions based on providing such resources. When they are not in this capacity they are referred to as other users.

Other users include government agencies, members of the public, suppliers, customers and employees (when not resource providers). While these other users have specialised information needs, they may find the financial information that meets the needs of resource providers useful. However, it is made clear that financial reporting is not primarily directed to other users but rather to resource providers. The information needs and questions of other external users vary considerably. For example, taxation authorities such as the ATO want to know whether the entity complies with the tax laws. Regulatory agencies such as the Australian Securities and Investments Commission (ASIC) or the Australian Competition and Consumer Commission (ACCC) want to know whether the entity is operating within prescribed rules. Table 1.2 provides a list of external users and examples of their information needs.

TABLE 1.2 **External users of accounting information and their information needs**

Users	Information needs
Investors	Information to determine whether to invest based on future profitability, return or capital growth
Creditors	Information to determine whether to grant credit based on risks and ability of the entity to repay debts
Customers	Information on whether an entity will continue to honour product warranties and support its product lines
Employees and trade unions	Information on whether the entity has the ability to pay increased wages and benefits, and offer job security
Government authorities	Information to calculate the amount of tax owing and whether the entity complies with tax laws
Regulatory agencies	Information to determine whether the entity is operating within prescribed rules

The common information needs of other users include an assessment of the entity's future cash flows (amount, timing and uncertainty) and evidence that management has discharged its responsibilities to use the entity's resources efficiently and effectively. Has management put in place systems to protect the entity's resources against the unfavourable effects of economic factors such as price and technology change? Has management complied with applicable laws, regulations and contractual commitments? This information concerning management's responsibilities is partly provided in an entity's financial report in the corporate governance statement.

Internal users

Internal users of accounting information are managers who plan, organise and run a business. They do not need to rely on general purpose financial reports as they can obtain the financial information they need internally. Internal users include marketing managers, production supervisors, directors and other managers. In running a business, managers of large companies like Domino's must answer many important questions, including the following.

- Is there sufficient cash to pay debts?
- What is the cost of manufacturing each unit of product?
- Can we afford to give employees pay rises this year?
- How should we finance our expansion into Europe?

To answer these and other questions, users need detailed information on a timely basis. For internal users, accounting provides internal reports, such as financial comparisons of alternative plans, projections of revenue from new sales campaigns, and forecasts of cash needs for the next year. In addition, internal users rely on summarised financial information presented in the form of financial statements.

External users

Although the needs of the various users differ, there are some common information needs that are intended to be met by external general purpose financial reports, i.e. the published financial statements of an entity prepared in accordance with applicable accounting standards.

External users have an interest in financial information about the three main types of activities — financing, investing and operating. These activities are common to all businesses. The accounting information system keeps track of the results of each of these business activities. Let's look in more detail at each type of business activity.

Financing activities

It takes money to make money. The two main sources of outside funds for companies are borrowing money from lenders and selling shares to investors. For example, Domino's may borrow money in a variety of ways. It can take out a loan at a bank or borrow from many lenders by issuing debt securities. Two types of debt securities are unsecured notes and debentures. The main difference is that debentures are secured by a charge over the issuer's assets. This means that specified assets can be sold to pay the debenture holders if the issuer defaults.

A company may also obtain funds by selling shares to investors. When a business initially becomes a company, shares are often issued to a small group of individuals who have an interest in starting the company. However, as the business grows, it becomes necessary to sell shares more broadly to obtain additional financing. **Share capital** is the term used to describe the total amount paid in by shareholders for the shares. The shareholders are the owners of the company.

Helpful hint: Companies may issue several types of shares, but the shares that represent the main ownership interest are called **ordinary shares**.

The claims of creditors differ from those of shareholders. If you lend money to a company, you are one of its creditors. In lending money, you specify a payment schedule (for example, payment at the end of 3 months). As a creditor, you have a legal right to be paid at the agreed time. In the event of non-payment, you may legally force the company to take action, such as selling its property to pay its debts. The law requires that creditors' claims be paid before ownership claims, i.e. owners have no claim on corporate resources until the claims of creditors are satisfied. If you buy a company's shares instead of lending it money, you have no right to expect any payments until all of its creditors are paid. However, many companies make payments to shareholders on a regular basis as long as they are solvent — that is, after the dividend is paid there are sufficient resources to cover expected payments to creditors. These payments to shareholders are called **dividends**. Dividends are a distribution of profit; they are not repayment of capital.

Investing activities

Investing activities involve purchasing the resources an entity needs in order to operate. During the early stages of an entity's life it must acquire many assets. For example, computers, delivery trucks, furniture and buildings are assets obtained from investing activities. Different types of assets are given different names. Domino's plant and equipment are referred to as *property, plant and equipment*, but can also be known as *fixed assets* or *non-current assets*.

While many of the entity's assets are purchased through investing activities, others result from operating activities. For example, if Domino's sells goods to a customer and does not receive cash immediately, it has a right to expect payment from that customer in the future. This right to receive money in the future is an asset called **accounts receivable**.

Operating activities

Once a business has the assets it needs to get started, it can begin its operations. Domino's is in the business of selling fast food. We call the results from the sale of these products *revenues*. **Revenues** are sales and other increases in equity that arise from the ordinary activities of an entity. For example, Domino's records revenue when it sells a pizza.

Revenues arise from different sources and are identified by various names depending on the nature of the business. For instance, Domino's main source of revenue is the sale of goods. However, it also generates store asset rental revenue and revenue from royalties. Sources of revenue common to many businesses are sales revenue, service revenue and interest revenue.

Before the business can sell a single pizza, it must purchase the ingredients to make the product. It also incurs costs such as salaries, rent and electricity. All these costs are necessary to sell the product. In accounting language, **expenses** are the cost of assets consumed or services used in the process of generating revenues.

Expenses take many forms and are identified by various names depending on the type of asset consumed or service used. For example, the business keeps track of these types of expenses: cost of sales, selling expenses (such as the costs associated with delivering pizzas), marketing expenses (such as the cost of advertising), administrative expenses (such as the salaries of administrative staff, and telephone and heating costs incurred in the office), and interest expense (amount of interest paid on various debts).

Domino's compares the revenues of a period with the expenses of that period to determine whether it has earned a profit. When revenues exceed expenses, a **profit** results. When expenses exceed revenues, a **loss** results.

Accountants today not only need to record the transactions and events that are then recognised and reported in the financial statements, but also need to be aware of sustainability issues for business and how to report them.

Sustainability reporting

It's constantly in the news; there have been many documentaries about it, numerous television programs, scientific research. What is IT? The environment and humanity's impact on it. While each of us makes an imprint on our environment with daily use of electricity, driving of cars and adding huge amounts of household waste to public waste facilities, businesses have the capacity to have an even larger effect on the environment.

Mining, deforestation, toxic wastes in rivers and oceans, and natural resource consumption are only some of the negative impacts that businesses all around the world have on our natural environment. It is not sufficient just to talk about it; it is more important to look at what we are doing to try to reduce the effects? Have you ever thought about your impact on the environment? Are you doing anything to reduce your environmental footprint?

Sustainability is about making sure the social, economic and environmental needs of our community are met and kept healthy for future generations. Sustainable development must not be only about economic growth, but also environmental quality and social equity. Measuring environmental impact is a difficult task. Accounting has traditionally measured business activities in dollar terms. How can accountants measure the impact that businesses have on the environment? How do we measure the impact of an open-cut mine on the landscape? How do we measure the effects of an oil spill that kills marine life? With the use of eXtensible Business Reporting Language (XBRL) we are attempting to standardise our measurements of financial information. Is it possible to standardise our measurement of environmental impacts?

Many companies disclose information on the impact of their business on the environment. Mostly this has been on a voluntary basis. Just access some large company web sites and you will find information on how they are trying to reduce their impact on the environment. However, we need to do more.

Currently, social and environmental disclosures are voluntary. However, there are increasing pressures on companies from shareholders and other stakeholders to measure, report on and reduce their environmental impact. There are also increasing pressures on governments to take appropriate actions. In order to improve the situation, we need reliable measurement systems. Can accountants meet the challenge?

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What are the three main forms of business organisation and the advantages of each?
2. What is the purpose of the *Conceptual Framework*?
3. Distinguish between internal and external users of financial information. Give examples of each.
4. Identify three categories of users identified by the *Conceptual Framework*. Give examples of each.
5. What are the three types of business activity?
6. What is meant by sustainability?

Do it

Classify the following activities as financing, investing or operating: (1) issuing shares, (2) purchasing a building, (3) selling pizza, and (4) repaying a loan.

Solution

(1) financing, (2) investing, (3) operating, and (4) financing.

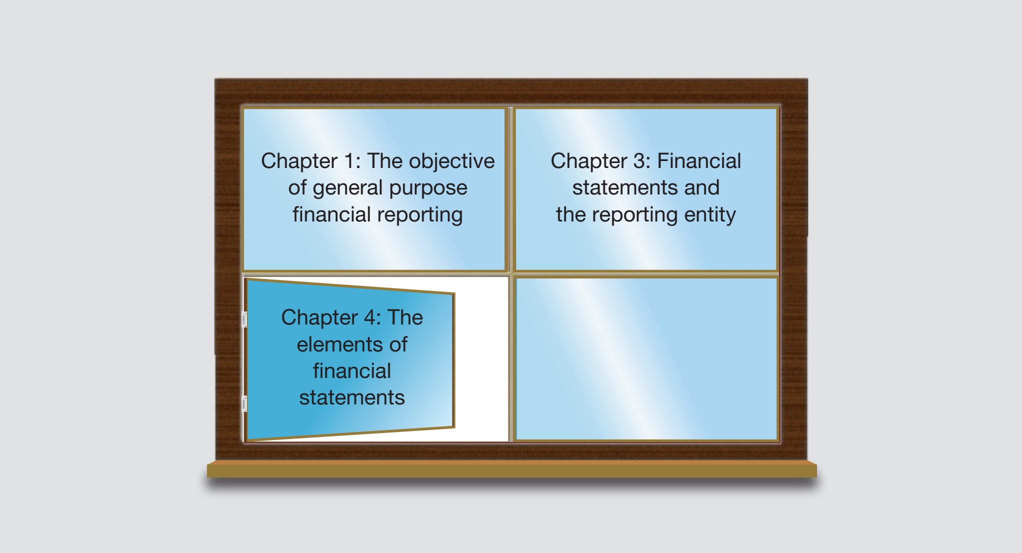
Note: Do it exercises, like the one here, ask you to put newly acquired knowledge to work. Sometimes, they outline the reasoning necessary to complete the exercise and show a solution.

1.6 Financial statements

LEARNING OBJECTIVE 1.6 Identify the elements of each of the four main financial statements.

Financial position, financial performance and cash flows are of interest to users of accounting information. How does an entity decide on the content of the financial statements? The definition of the elements of financial statements is another piece in the *Conceptual Framework* as represented in figure 1.6.

FIGURE 1.6 Building the *Conceptual Framework* — chapter 4



The *Conceptual Framework* defines the elements of financial statements. In this section, we explore the **financial statements** that provide vital information to users when making a variety of decisions. This information is presented in four main financial statements that form the backbone of financial accounting.

To present a picture at a point in time of what your business controls (its assets), what it owes (its liabilities) and the owner's investment in the business (equity), you would prepare a **statement of financial position**. **Assets** are formally defined in the *Conceptual Framework* as a 'present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits' (paragraphs 4.3 and 4.4). **Liabilities** are formally defined in the *Conceptual Framework* as a 'present obligation of the entity to transfer an economic resource as a result of past events' (paragraph 4.26). We will look at assets and liabilities in more detail in later chapters.

To show how successfully your business performed during a period of time, you would report its revenues and expenses in the *statement of profit or loss*. The **statement of changes in equity** explains all changes in equity during a period of time. **Equity** is defined in the *Conceptual Framework* as 'the residual interest in the assets of the entity after deducting all of its liabilities' (paragraph 4.63). Finally, of particular interest to bankers and other creditors is the **statement of cash flows**, which shows where the business obtained cash during a period of time and how that cash was used. The statement of cash flows is considered in more detail in chapter 11.

The next section of this chapter outlines and explains the regulation of external financial reporting in detail. To introduce you to the main financial statements, we have prepared the financial statements for a marketing agency, Wong Pty Ltd (figure 1.7). Take some time now to look at their general form and categories in preparation for the more detailed discussion that follows. Note that:

- a simplified statement of profit or loss is shown; a fully classified statement of profit or loss is provided in figure 4.6
- a simplified statement of financial position is shown; a fully classified statement of financial position is provided in figure 1.16
- Wong's financial statements are internal reports generated for internal use. External financial statements are presented in a different format as illustrated in the Giorgina's Pizza Limited statements later in the chapter.

FIGURE 1.7 Wong Pty Ltd's financial statements

WONG PTY LTD **Statement of profit or loss** for the month ended 31 October 2022		
Service revenues		$10 600
EXPENSES		
Salaries expense	$ 3 200	
Supplies expense	1 500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	5 740
Profit before tax		4 860
Tax expense		2 000
Profit		1 **$ 2 860**

WONG PTY LTD **Statement of financial position** as at 31 October 2022		
ASSETS		
Cash		**$15 200**
Accounts receivable		200
Advertising supplies		1 000
Prepaid insurance		550
Office equipment		4 960
Total assets		21 910
LIABILITIES		
Accounts payable	$ 2 500	
Interest payable	50	
Revenue received in advance	800	
Salaries payable	1 200	
Bank loan	5 000	
Total liabilities		9 550
Net assets		$12 360
EQUITY		
Share capital		$10 000
Retained earnings		**2 360**
Total equity		$12 360

WONG PTY LTD **Calculation of retained earnings** for the month ended 31 October 2022	
Retained earnings, 1 October 2022	$ –
Profit	**2 860**
Less: Dividends	(500)
Retained earnings, 31 October 2022	2 **$ 2 360**

WONG PTY LTD **Statement of cash flows** for the month ended 31 October 2022		
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from operating activities	$11 200	
Cash payments for operating activities	(5 500)	
Net cash provided by operating activities		$ 5 700
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchased office equipment	(5 000)	
Net cash used by investing activities		(5 000)

CASH FLOWS FROM FINANCING ACTIVITIES		
Issue of shares	10 000	
Proceeds from bank loan	5 000	
Payment of dividend	(500)	
Net cash provided by financing activities		14 500
Net increase in cash		15 200
Cash at beginning of period		–
Cash at end of period		**$15 200**

1 Note that final sums in the statements are double-underlined. Also note the interrelationships of the four financial statements as illustrated by the amounts in bold.

2 The calculation of retained earnings is part of the statement of changes in equity, but is usually shown as a note in the financial statements (see figure 1.15).

Statement of profit or loss

The purpose of the statement of profit or loss is to report the success or failure of the entity's operations for a period of time. To indicate that Wong's statement reports the results of operations for a period of time, the statement is dated 'for the month ended 31 October 2022'. The **statement of profit or loss** lists the entity's income (i.e. revenues and gains), followed by its expenses. Finally, the profit (or loss) is determined by deducting expenses from income. This result is the famed *bottom line* often referred to in business.

Why are financial statement users interested in the bottom line? We explain this using the 'decision-making toolkit' that follows. Resource providers (investors and lenders) use the statement of profit or loss to determine if the entity is profitable. If the revenues exceed the expenses, then a profit is reported; but if expenses exceed the revenues, then it is a loss. If investors believe that Wong Pty Ltd will be even more successful in the future, they may be willing to invest more funds. Investors are interested in an entity's past profit because it provides some information about future profit. Similarly, creditors also use the statement of profit or loss to predict future performance. When a bank lends money to an entity, it does so in the belief that it will be repaid in the future. If it didn't think it was going to be repaid, it wouldn't lend the money. Therefore, before making the loan, the bank loan officer will use the statement of profit or loss as a source of information to predict whether the entity will be profitable enough to repay its loan. Note also that managers allocate resources based on their beliefs about an entity's future performance.

The issue of shares and dividend distributions are not used in determining profit. For example, $10 000 of cash received from issuing new shares was not treated as revenue by Wong Pty Ltd, and dividends paid of $500 were not regarded as a business expense.

For external financial reports, the statement of profit or loss must also include all changes in equity other than owner/shareholder changes. This statement is called a 'statement of profit or loss and other comprehensive income'. The new standard permits an option of presenting one statement of profit or loss and other comprehensive income in two sections or two statements (a separate profit or loss section and a separate comprehensive income section). If a company does not have any additional items (such as asset revaluations), the statement of profit or loss and the statement of profit or loss and other comprehensive income are identical. The statement of profit or loss and other comprehensive income is illustrated in chapter 10.

Helpful hint: The heading of every statement of profit or loss includes the name of the entity, the name of the statement and the time period covered by the statement. Usually, another line is added to indicate the unit of measure; when it is used, this fourth line usually indicates that the data are presented 'in thousands' ($'000) or 'in millions'.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Are the entity's operations profitable?	Statement of profit or loss	The statement of profit or loss reports on the success or failure of the entity's operations by reporting its revenues and expenses.	If the entity's revenues exceed its expenses, it will report a profit; if expenses exceed revenues, it will report a loss.

Statement of changes in equity

The *statement of changes in equity* reports the total comprehensive income for the period and other changes in equity, such as adjustments to retained earnings (accumulated prior-year profits) for changes in accounting standards, changes in accounting policies and corrections of errors. The statement of changes in equity must also report details of transactions with the owners of the company (share capital movements and dividend payments) and, finally, a reconciliation of the movement in each component of equity. However, for simplicity we will illustrate only that part of the statement that reports on retained earnings; a full statement of changes in equity is illustrated later in this chapter using Giorgina's Pizza Limited. **Retained earnings** refers to the accumulated profit that has not been distributed as dividends to owners. This is an important part of the statement of changes in equity because it reports on dividends and explains the link between the statement of profit or loss and the statement of financial position.

As shown in figure 1.7, the statement of changes in equity shows the profit for the current period, which is the same as the amount reported in the statement of profit or loss. In this simple example, there are no other income or expense items or adjustments to retained earnings. The current period profit is the only item increasing retained earnings during the reporting period. The amount of retained earnings at the start of the period, which is nil for Wong Pty Ltd as it only commenced business at the beginning of the month, is added to profit.

Dividends reduce equity because they are a distribution to owners. In the Wong Pty Ltd example, dividends of $500 are deducted to calculate the closing amount of retained earnings. Note that this is equal to the amount of retained earnings reported in the statement of financial position.

Shareholders can see how much profit has been distributed as dividends by reading the statement of changes in equity. An entity could pay all of its profits for a period as dividends to shareholders. But few entities choose to do this. Why? Because they want to retain part of the profits to allow for further expansion. High-growth entities often choose to pay low or no dividends.

Statement of financial position

The *statement of financial position* reports assets and claims to those assets at a specific point in time. Claims are subdivided into two categories: claims of creditors and claims of owners. Claims of creditors are called *liabilities*. Claims of owners are called **equity** (or *shareholders' equity*). This relationship is shown in equation form in figure 1.8. This equation is referred to as the **basic accounting equation**.

FIGURE 1.8 Basic accounting equation

Assets = Liabilities + Equity

Assets must be in balance with the claims to the assets. As you can see from looking at Wong Pty Ltd's statement of financial position in figure 1.7, assets are listed first, followed by liabilities and equity. Equity comprises two parts: (1) share capital and (2) retained earnings and reserves. As noted earlier, share capital results when the entity issues shares. Wong Pty Ltd has share capital of $10 000. (Other names for share capital are *paid-up capital, issued capital* and *contributed equity*.)

Without any complex adjustments, which are considered in later chapters, the amount of retained earnings reported in the statement of financial position at the end of the period is the amount of retained earnings at the beginning of the period, plus profit after tax for the period, less any amount distributed as a dividend during the period.

Reserves also form part of equity. Some reserves are accumulated profit and result from transferring amounts from retained earnings to reserves. Other reserves result from the application of accounting standards involving, for example, asset revaluations.

Wong Pty Ltd has no reserves. The equity of Wong Pty Ltd is $12 360, consisting of share capital of $10 000 and retained earnings of $2360.

In figure 1.7 the statement of financial position is shown in a vertical format, which is the method used in the published financial statements of listed companies. An alternative format is the horizontal (or account) format shown in figure 1.9, where the layout of the statement of financial position is closely aligned to the basic accounting equation shown in figure 1.8.

FIGURE 1.9 Horizontal format of the statement of financial position

WONG PTY LTD Statement of financial position as at 31 October 2022			
ASSETS		LIABILITIES	
Cash	$15 200	Accounts payable	$ 2 500
Accounts receivable	200	Interest payable	50
Advertising supplies	1 000	Revenue received in advance	800
Prepaid insurance	550	Salaries payable	1 200
Office equipment	4 960	Bank loan	5 000
		Total liabilities	9 550
		EQUITY	
		Share capital	10 000
		Retained earnings	2 360
		Total equity	12 360
Total assets	**$21 910**	**Total liabilities and equity**	**$21 910**

Using the decision-making toolkit, creditors can use the statement of financial position as another source of information to determine the likelihood that they will be repaid. They carefully evaluate the nature of an entity's assets and liabilities. For example, does the entity have assets that could easily be sold to repay its debts? Managers use the statement of financial position with the statement of profit or loss to determine, for example, whether inventory is adequate to support future sales. The statement of financial position is also useful in assessing whether cash on hand is sufficient for immediate cash needs. The decision demonstrated in the toolkit looks at the relationship between debt (liabilities) and equity to determine whether the entity relies more on creditors or owners for its financing. Managers use this analysis to determine whether they have the best proportion of debt and equity financing.

Helpful hint: The heading of a statement of financial position includes the name of the entity, the name of the statement and the date.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Does the entity rely mainly on debt or equity to finance its assets?	Statement of financial position	The statement of financial position reports the entity's resources and claims to those resources. There are two types of claims: liabilities and equity.	Compare the amount of liabilities (debt) with the amount of equity to determine whether the entity relies more on creditors or owners for its financing.

Statement of cash flows

The main purpose of a *statement of cash flows* is to provide financial information about the cash receipts and cash payments of a business for a specific period of time. To help investors, creditors and others in their analysis of an entity's cash position, the statement of cash flows reports the cash effects of an entity's: (1) operating activities, (2) investing activities and (3) financing activities. In addition, the statement of cash flows shows the net increase or decrease in cash during the period, and the cash amount at the end of the period.

Users are interested in the statement of cash flows because they want to know what is happening to an entity's most important resource. The statement of cash flows provides answers to the following simple but important questions.

- Where did cash come from during the period?
- How was cash used during the period?
- What was the change in the cash balance during the period?

The statement of cash flows for Wong Pty Ltd in figure 1.7 shows that cash increased by $15 200 during the year. This resulted because operating activities (services to clients) increased cash by $5700; financing activities increased cash by $14 500; and investing activities used $5000 cash for the purchase of equipment. The decision demonstrated in the decision-making toolkit is to determine if the entity is generating enough cash from its operations to fund its investing activities. Comparing the cash provided from operating activities with the amount of cash used in investing activities provides the answer.

If there is any deficiency, i.e. cash used by investing activities is greater than that generated from operating, then the funds must be provided from financing activities.

Helpful hint: The heading of a statement of cash flows must identify the entity, the type of statement and the time period covered by the statement.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Does the entity generate sufficient cash from operations to fund its investing activities?	Statement of cash flows	The statement of cash flows shows the amount of cash provided or used by operating activities, investing activities and financing activities.	Compare the amount of cash provided by operating activities with the amount of cash used by investing activities. Any deficiency in cash from operating and investing activities must be made up with cash from financing activities.

Interrelationships between the statements

Because the results on some statements are used as inputs to other statements, the statements are interrelated. These interrelationships are evident in Wong Pty Ltd's statements in figure 1.7.

1. The statement of financial position depends on the results of the statement of profit or loss and statement of changes in equity. Wong Pty Ltd reported profit of $2860 for the period. This amount is added to the beginning amount of retained earnings as part of the process of determining ending retained earnings.
2. The statement of cash flows and the statement of financial position are also interrelated. The statement of cash flows shows how the cash account changed during the period by showing the amount of cash at the beginning of the period, the sources and uses of cash during the period, and the $15 200 of cash at the end of the period. The ending amount of cash shown on the statement of cash flows is reflected in amounts reported on the statement of financial position.

Study these interrelationships carefully. To prepare financial statements you must understand the sequence in which these amounts are determined and how each statement affects the next.

The classified statement of financial position

As explained above, the statement of financial position shows a snapshot of an entity's financial position at a point in time. (Prior to periods commencing 1 January 2009, the statement of financial position was called a balance sheet.) To improve users' understanding of an entity's financial position, entities group similar assets and similar liabilities together. This is useful because it tells you that items within a group have similar economic characteristics. International accounting standard IAS 1/Australian accounting standard AASB 101 *Presentation of Financial Statements* prescribes minimum disclosures on the face of a classified statement of financial position. A **classified statement of financial position** is one in which assets and liabilities are classified as current and non-current (see figure 1.16). The most commonly reported items are listed in table 1.3.

TABLE 1.3 Minimum disclosures on the statement of financial position

Assets	Liabilities
Cash assets	Trade and other payables
Trade and other receivables	Financial liabilities
Other financial assets	Tax liabilities
Inventories	Provisions
Investment in property	**Equity**
Property, plant and equipment	Capital and reserves
Tax assets	Retained earnings or accumulated losses
Intangible assets	

Before we dive in, we need to explain three points.

1. To demonstrate a classified statement of financial position, we use a fictitious company, Giorgina's Pizza Limited.
2. Giorgina's Pizza Limited, like most entities, presents its financial statements for more than one year. This allows users to compare the business's financial position and performance for an accounting period with that of the previous period.
3. Note that numbers are reported in thousands on Giorgina's financial statements — i.e. numbers are rounded to the nearest thousand. Thus, the entity's total inventories for 2022 were $5 014 000 not $5014 (see figure 1.10).

FIGURE 1.10 Current assets section of Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED
Statement of financial position (partial)
as at 30 June 2022

	Note	2022 $'000	2021 $'000
CURRENT ASSETS			
Cash and cash equivalents	14	14 017	30 255
Trade and other receivables	15	19 809	15 764
Inventories	16	5 014	4 280
Current tax assets	17	143	–
Other current assets	22	5 701	4 673
		44 684	54 972
Assets held for sale	18	602	528
Total current assets		**45 286**	**55 500**

IAS 1/AASB 101 also requires that the assets and liabilities be classified as current and non-current, unless categorisation by liquidity provides more relevant information. Almost all entities, other than financial institutions and insurance companies, choose the current/non-current categories for presentation of the statement of financial position. Although not as informative as liquidity categories, the current/non-current categories provide a crude measure of: (1) whether the entity has enough assets to pay its debts as they come due, and (2) the claims of short-term and long-term creditors on the entity's total assets. This is discussed in more detail in the section on analysing financial statements (section 1.9). Current and non-current categories are used extensively for internal and external reporting. These categories can be seen in the statement of financial position for our example company, Giorgina's Pizza Limited. Each of the categories is explained next.

Helpful hint: Liquidity — the sooner an asset converts to cash, the more liquid it is said to be.

Current assets

Current assets include assets that are cash, held for the purpose of being traded, or expected to be converted to cash or used in the business within 1 year or within the operating cycle, whichever is longer. The **operating cycle** is the average time taken to acquire goods and services and convert them to cash in producing revenues. Giorgina's reported current assets of $45 286 000 in 2022. For most businesses the cut-off for classification as current assets is 1 year from the end of the reporting period. For example, accounts receivable are included in current assets because they will be converted to cash through collection within 1 year. Inventories are current assets because we expect that they will be used in the business within 1 year (hopefully, the raw materials sooner!).

Common types of current assets are: (1) cash, (2) marketable securities, such as shares held as a short-term investment, (3) receivables (notes receivable, accounts receivable and interest receivable), (4) inventories, and (5) prepaid expenses (insurance and supplies). Figure 1.10 shows the current assets that are reported in Giorgina's 2022 consolidated financial statements.

An entity's current assets are important in assessing its short-term debt-paying ability, as explained later in the chapter.

Non-current assets

Non-current assets are assets that are not expected to be consumed or sold within 1 year or the operating cycle. They encompass a diverse range of assets. The most common types of non-current assets include receivables that are due more than 1 year from the date of the statement of financial position; property, plant and equipment; and intangible assets. Figure 1.11 shows the non-current assets reported in Giorgina's 2022 financial statements.

FIGURE 1.11 Non-current assets section of Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED
Statement of financial position (partial)
as at 30 June 2022

	Note	2022 $'000	2021 $'000
NON-CURRENT ASSETS			
Property, plant & equipment	19	37 270	26 273
Deferred tax assets	17	30	622
Goodwill	20	42 835	35 195
Other intangible assets	21	13 070	9 607
Other non-current assets	22	3 821	4 294
Total non-current assets		**97 026**	**75 991**

Property, plant and equipment

Property, plant and equipment (sometimes called *fixed assets*) are assets with relatively long useful lives that are used in operating the business. This category includes land, buildings, machinery and equipment, delivery vehicles, and furniture. Giorgina's reported property, plant and equipment of $37 270 000, as shown in its statement of financial position in figure 1.11.

Depreciation is the practice of allocating the cost of assets to a number of periods, rather than simply expensing the full purchase price of the asset in the year of purchase. Assets that the entity depreciates should be reported on the statement of financial position at cost less accumulated depreciation. For example, Giorgina's reported accumulated depreciation of $17 069 000 for property, plant and equipment will be reported in the notes to the financial statements. The accumulated depreciation is the total amount of depreciation to date over the *life of the asset*.

Intangible assets

Many entities have assets, other than financial assets, that have no physical substance yet often are very valuable. These assets are referred to as **intangible assets**. They include patents, copyrights and trademarks or trade names that give the entity exclusive right of use for a specified period of time. Goodwill is included in intangible assets. Giorgina's reported goodwill of $42 835 000, as shown in figure 1.11. Non-current assets will be discussed further in chapter 8.

Current liabilities

In the liabilities section of the statement of financial position, the first grouping is current liabilities. **Current liabilities** are obligations that are to be paid within the coming year or the entity's operating cycle. Common examples are accounts payable, wages payable, bank loans payable, interest payable, taxes payable, and current maturities of long-term obligations (payments to be made within the next year on long-term obligations).

Within the current liabilities section of the statement of financial position, payables are usually listed first, followed by short-term borrowings, tax liabilities and provisions. Figure 1.12 shows the current liabilities reported in Giorgina's 2022 consolidated financial statements.

FIGURE 1.12 Current liabilities section of Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED
Statement of financial position (partial)
as at 30 June 2022

	Note	2022 $'000	2021 $'000
CURRENT LIABILITIES			
Trade and other payables	23	28 541	25 629
Borrowings—short term	24	5 312	8 651
Current tax liabilities	25	1 913	2 658
Provisions—short term	26	2 332	1 770
Other current liabilities	27	381	–
Total current liabilities		**38 479**	**38 708**

Non-current liabilities

Obligations that are not classified as current liabilities must be classified as **non-current liabilities**. Liabilities in this category include debentures payable, mortgages payable, unsecured notes payable and lease liabilities. Many entities report long-term borrowings maturing after 1 year as a single amount in the statement of financial position and show the details of the debt in notes to the financial statements. Others list the various types of long-term liabilities. In its statement of financial position, Giorgina's reported non-current liabilities as shown in figure 1.13. Liabilities will be discussed further in chapter 9.

FIGURE 1.13 Non-current liabilities section of Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED **Statement of financial position (partial)** as at 30 June 2022	Note	2022 $'000	2021 $'000
NON-CURRENT LIABILITIES			
Borrowings—long term	24	24 442	1 882
Provisions—long term	26	331	431
Deferred tax liabilities	25	1 796	2 324
Other non-current liabilities	27	330	365
Total non-current liabilities		**26 899**	**5 002**

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What are the major sections in a classified statement of financial position?
2. Explain the difference between current assets and non-current assets.
3. What was Giorgina's largest type of current asset at 30 June 2022? (The answer to this question is at the end of the chapter.)

Do it

The following information relates to Hoffman Ltd's statement of financial position at 30 June 2022. All receivables are due within 30 days.

Short-term investments	$ 2 300
Cash	800
Property, plant and equipment	10 700
Inventory	3 400
Accumulated depreciation	2 700
Accounts receivable	1 100

Prepare the assets section of a classified statement of financial position for Hoffman Ltd.

Reasoning

Assets are classified as current and non-current in a classified statement of financial position. Current assets are cash and other resources that are reasonably expected to be consumed in 1 year. Accumulated depreciation should be subtracted from property, plant and equipment to determine net property, plant and equipment.

Solution

HOFFMAN LTD **Statement of financial position (partial)** as at 30 June 2022		
ASSETS		
Current assets		
Cash	$ 800	
Accounts receivable	1 100	
Inventory	3 400	
Short-term investments	2 300	
Total current assets		$ 7 600
Non-current assets		
Property, plant and equipment	10 700	
Less: Accumulated depreciation	2 700	
Total non-current assets		8 000
Total assets		**$15 600**

A quick look at Giorgina's financial reports

So far, we have examined Giorgina's classified statement of financial position. Now let's put all the financial statements together. The same relationships that you observed among the internal financial statements of Wong Pty Ltd are evident in Giorgina's financial statements, which are presented in figures 1.14 to 1.19. We have simplified the financial statements to assist your learning — but they may look complicated anyway. Do not be alarmed by their apparent complexity. (If you could already read and understand them, there would be little reason to take this course!) By the end of this text, you'll have a great deal of experience in reading and understanding financial statements such as these.

Statement of profit or loss

Giorgina's statement of profit or loss is presented in figure 1.14. It reports total revenues and other gains in 2022 of $223 840 000 ($141 473 000 + $79 694 000 + $2 673 000). It then subtracts 11 types or categories of expenses to arrive at a profit of $21 400 000. This is a 5% decrease from the profit of $22 560 000 for the previous year.

FIGURE 1.14 Giorgina's statement of profit or loss (partial)

GIORGINA'S PIZZA LIMITED
Statement of profit or loss (partial)
for the year ended 30 June 2022

	Note	2022 $'000	2021 $'000
Sales revenue	3	141 473	126 350
Other revenue	4	79 694	72 316
Other gains and losses	5	2 673	2 371
Food and packaging expenses	8	(63 863)	(59 009)
Employee benefits expense	9	(57 195)	(44 954)
PPE maintenance expenses		(6 998)	(6 441)
Depreciation and amortisation expense	10	(9 594)	(7 522)
Rent expense		(6 827)	(5 878)
Finance expenses		(304)	(338)
Marketing expenses		(8 573)	(8 608)
Restaurant expenses		(5 387)	(4 415)
Telephone expenses		(4 763)	(5 002)
Other expenses	11	(29 764)	(26 642)
Profit before tax		**30 572**	**32 228**
Income tax expense	12	(9 172)	(9 668)
Profit from continuing operations	**13**	**21 400**	**22 560**

Note: Prior to 1 July 2012, the statement of profit or loss and other comprehensive income was called the statement of comprehensive income, and if the separate statement of profit or loss was presented it was called an income statement. Some companies still use the old terminology when labelling their external reports. See chapter 10 for further discussion.

Helpful hint: The percentage change in any amount from one year to the next is calculated as follows:

$$\frac{\text{Change during period}}{\text{Previous value}} \times \frac{100}{1}$$

Thus, the percentage change in profit is:

$$\frac{\text{Change in profit}}{\text{Previous year's profit}} \times \frac{100}{1}$$

Statement of changes in equity

To refresh your memory about this statement you might like to review the earlier 'Statement of changes in equity' section. Giorgina's presents information about its retained earnings in the notes to the financial statements in 2022 (figure 1.15). The amount of $47 784 000 reported as retained earnings at 30 June 2022 reflects the retained profits of $45 857 000 at the beginning of the reporting period, plus $21 400 000 profit for the year, less dividends of $19 473 000.

FIGURE 1.15 Note 30, Movement in retained earnings, from Giorgina's financial statements

GIORGINA'S PIZZA LIMITED **Notes to the financial statements** for the year ended 30 June 2022		
	2022 $'000	2021 $'000
30. RETAINED EARNINGS		
Balance at beginning of year	45 857	36 013
Profit	21 400	22 560
Payment of dividends (note 31)	(19 473)	(12 716)
Balance at end of year	**47 784**	**45 857**

Statement of financial position

Giorgina's statement of financial position is shown in figure 1.16. In the previous section, we examined the components of the statement of financial position separately. Now let's look at the full picture. The entity's total assets increased from $131 491 000 on 1 July 2021 to $142 312 000 on 30 June 2022. Its liabilities include trade and other payables as well as interest-bearing liabilities, such as borrowings.

FIGURE 1.16 Giorgina's statement of financial position

GIORGINA'S PIZZA LIMITED **Statement of financial position** as at 30 June 2022			
	Note	2022 $'000	2021 $'000
ASSETS			
Current assets			
Cash and cash equivalents	14	14 017	30 255
Trade and other receivables	15	19 809	15 764
Inventories	16	5 014	4 280
Current tax assets	17	143	–
Other current assets	22	5 701	4 673
Assets held for sale	18	602	528
Total current assets		45 286	55 500
Non-current assets			
Property, plant & equipment	19	37 270	26 273
Deferred tax assets	17	30	622
Goodwill	20	42 835	35 195
Intangible assets	21	13 070	9 607
Other non-current assets	22	3 821	4 294
Total non-current assets		97 026	75 991
Total assets		142 312	131 491
LIABILITIES			
Current liabilities			
Trade and other payables	23	28 541	25 629
Borrowing—short term	24	5 312	8 651
Current tax liabilities	25	1 913	2 658
Provisions—short term	26	2 332	1 770
Other current liabilities	27	381	–
Total current liabilities		38 479	38 708
Non-current liabilities			
Borrowing—long term	24	24 442	1 882
Provisions—long term	26	331	431
Deferred tax liabilities	25	1 796	2 324
Other non-current liabilities	27	330	365
Total non-current liabilities		26 899	5 002
Total liabilities		65 378	43 710
Net assets		**76 934**	**87 781**

EQUITY			
Capital and reserves			
Issued capital	28	30 640	52 404
Reserves	29	(1 490)	(10 480)
Retained earnings	30	47 784	45 857
Total equity		**76 934**	**87 781**

You can see that Giorgina's has slightly more equity financing than debt — 54% of its assets are financed by equity. As you learn more about financial statements, we will discuss how to interpret the relationships and changes in financial statement items.

Helpful hint: A statement of financial position which reports current and non-current categories for assets and liabilities is known as a fully classified statement of financial position.

Statement of cash flows

Giorgina's statement of cash flows is shown in figure 1.17. We can see that Giorgina's cash decreased by $17 836 000 during the year ended 30 June 2022. The reasons for this can be determined by examining the statement of cash flows in figure 1.17. The company generated $24 885 000 from its operating activities during the year. Its investing activities included capital expenditures (purchases of property, plant and equipment) as well as proceeds from the sale of non-current assets. The net effect of its investing activities was a decrease of cash of $22 797 000. Its financing activities involved the payment of cash dividends, repayment of borrowings, the return of share capital and proceeds from borrowings and share issues using net cash of $19 924 000. In all, the net effect of the cash generated from its operating activities, less the cash used in its investing and financing, plus the translation gain from cash held in foreign currencies was a decrease in cash of $16 238 000.

FIGURE 1.17 Giorgina's statement of cash flows

GIORGINA'S PIZZA LIMITED
Statement of cash flows
for the year ended 30 June 2022

	Note	2022 $'000	2021 $'000
CASH FLOWS FROM OPERATING ACTIVITIES			
Receipts from customers		245 357	221 324
Payments to suppliers and employees		(212 148)	(188 094)
Interest received		827	1 339
Interest paid		(304)	(338)
Income taxes paid		(8 847)	(5 972)
Net cash generated by operating activities	35	24 885	28 259
CASH FLOWS FROM INVESTING ACTIVITIES			
Payment for investment and business operations		(14 308)	(8 907)
Loans repaid by third parties		1 887	1 580
Payments for property, plant & equipment		(18 778)	(13 244)
Proceeds from sale of non-current assets		15 802	17 193
Payments for intangible assets		(7 400)	(5 606)
Net cash used in investing activities	36	(22 797)	(8 984)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from borrowings		32 791	–
Repayment of borrowings		(15 380)	(18)
Return of share capital		(22 532)	–
Dividends paid		(19 473)	(12 716)
Proceeds from issue of equity securities		4 670	4 012
Net cash used in financing activities	37	(19 924)	(8 722)
Net increase (decrease) in cash and cash equivalents		(17 836)	10 553
Cash and cash equivalents at the beginning of the year		30 255	21 064
Effects of changes in exchange rates on cash held in foreign currencies	38	1 598	(1 362)
Cash and cash equivalents at the end of the year	35	**14 017**	**30 255**

Note: The movement in cash is $17 836 000 less exchange rate differences of cash held in foreign currencies $1 598 000, a total net reduction of $16 238 000.

Other elements of an annual report

Companies that are publicly traded must provide their shareholders with an annual report each year. The **annual report** always includes the financial statements introduced in this chapter as well as other important sources of information such as notes to the financial statements, corporate governance statement the directors' report and an independent auditor's report. If the concise form of financial reporting is used to report to shareholders, a general discussion and analysis section must be included. This is instead of some of the notes to the financial statements, which are included in the full financial report. No analysis of an entity's financial situation and prospects is complete without a review of each of these items.

Notes to the financial statements

An entity's published financial statements are accompanied by explanatory notes and supporting schedules that form part of the statements. The **notes to the financial statements** clarify information presented in the financial statements, as well as expand on it where additional detail is needed. Information in the notes does not always have to be quantifiable (numeric). Examples of notes are descriptions of the accounting policies and methods used in preparing the statements, explanations of uncertainties and contingencies, and statistics and details too voluminous to be included in the statements. The notes are essential to understanding an entity's operating performance and financial position.

Figure 1.18 is an extract from the notes to Giorgina's financial statements for 2022. It describes the methods the company uses to account for revenues.

FIGURE 1.18 Extract from the notes to Giorgina's financial statements

GIORGINA'S PIZZA LIMITED
Notes to the financial statements (extract from Note 2.2)
for the year ended 30 June 2022

2.2 REVENUE RECOGNITION
Revenue is measured at the fair value of the consideration paid or to be received.

2.2.1 Sale of goods
Revenue from the sale of goods is recognised when the entity transfers to the purchaser the significant risks and rewards of ownership of the goods.

2.2.2 Other revenue
Dividend revenue from investments is recognised when it is established that the shareholders have the right to receive payment.

Interest revenue is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable.

Corporate governance statement

In 2002, the Australian Securities Exchange (ASX) established the ASX Corporate Governance Council, which produced a document entitled Principles of good corporate governance and best practice recommendations (released in March 2003). The guidelines were updated in 2007 (Corporate governance principles and recommendations, 2nd edition) and 2010 (Corporate governance principles and recommendations with 2010 amendments). In 2012, there was a comprehensive review and a third edition of the principles and recommendations was released. Since 2012, further comprehensive reviews have been performed and the fourth and latest edition of the principles and recommendations was released in February 2019. All Australian listed entities as part of the ASX listing requirements (LR4.10.3) are required to disclose the extent to which they have followed the ASX corporate governance recommendations, and, if they have not followed the recommendations, the reasons for adopting alternative governance practices. For some smaller listed entities, the **corporate governance statement** is part of the directors' report.

Directors' report

The **directors' report** section covers a number of issues which might affect users' interpretation of the financial statements. The contents of the report in Australia are governed by the Corporations Act, ss. 298–300. Information required to be disclosed in the report helps shareholders assess the performances of the entity and the directors. Among the things that must be included are a description of the business(es) undertaken by the entity; details of dividends; a description of anything important that has happened after the date of the financial statements (but before they were released); and various information about directors, including how many directors' meetings each one attended. In their report, directors will try to avoid disclosing things that might give competitors an advantage. Figure 1.19 presents a part of Giorgina's directors' report.

FIGURE 1.19 Extract from Giorgina's directors' report, 2022

GIORGINA'S PIZZA LIMITED
Directors' report (extract)

PRINCIPAL ACTIVITIES
The entity's principal activities in the course of the financial year were the operation of retail food outlets. During the financial year there were no significant changes in the nature of those activities.

REVIEW OF OPERATIONS
The result for the financial year ended 30 June 2022 was as follows:

	2022 $'000	2021 $'000
Profit before income tax expense	30 572	32 228
Income tax expense	(9 172)	(9 668)
Profit after income tax expense	**21 400**	**22 560**

Changes in state of affairs
There were no significant changes in the state of affairs of the entity that occurred during the financial year.

Future developments
The focus is on the opening of two additional stores, building our online business, and putting additional resources into staff development to maximise our efficiencies.

Dividends
In respect of the financial year ended 30 June 2021, as detailed in the Directors' Report for the financial year, a final dividend of 31.8 cents per share was paid to the holders of fully paid ordinary shares on 12 August 2021.

In respect of the financial year ended 30 June 2022, an interim dividend of 12.1 cents per share was paid to the holders of fully paid ordinary shares on 18 February 2022.

In respect of the financial year ended 30 June 2022, the Company will be paying a final dividend of 14.5 cents per share to the holders of fully paid ordinary shares on 21 October 2022.

Auditor's report

Another important source of information is the auditor's report. An **auditor** is an accountant who conducts an independent examination of the accounting data presented by an entity. Only accountants who are registered auditors may perform audits. If the auditor is satisfied that the financial statements present fairly the financial position, results of operations and cash flows in accordance with generally accepted accounting principles, then an unqualified opinion is expressed. If the auditor expresses anything other than an unqualified opinion, the financial statements should be used only with caution. That is, without an unqualified opinion, we cannot have complete confidence that the financial statements give an accurate picture of the entity's financial health.

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What are the content and purpose of each statement: statement of profit or loss, statement of changes in equity, statement of financial position and statement of cash flows?
2. The accounting equation is: Assets = Liabilities + Equity. Replacing words in the equation with dollar amounts, what is Giorgina's accounting equation at 30 June 2022? (*Hint:* Use comparative 2022 data in figure 1.16.) (The answer to this question is at the end of the chapter.)
3. Why are notes to the financial statements necessary? What kinds of items are included in these notes?
4. What is the purpose of the directors' report in the annual report?
5. What is the purpose of the auditor's report?

Do it

Pink Music Store Pty Ltd began operations on 1 July 2022. The following information is available for Pink Music Store on 30 June 2023: service revenue $17 000; accounts receivable $4000; accounts payable $2000; building rental expense $9000; bank loan $5000; share capital $10 000; retained earnings; equipment $16 000; insurance expense $1000; supplies (asset) $1800; supplies expense $200; cash $1500; dividends $500.

Prepare a statement of profit or loss, a statement of financial position and a calculation of retained earnings for Pink Music Store Pty Ltd using this information.

Reasoning

A statement of profit or loss reports the success or failure of an entity's operations for a period of time. A statement of financial position presents the assets, liabilities and equity of an entity at a specific point in time. The statement of changes in equity shows the items affecting each component of equity (in this case, retained earnings) during the period.

Solution

PINK MUSIC STORE PTY LTD **Statement of profit or loss** for the year ended 30 June 2023		
REVENUES		
Service revenue		$17 000
EXPENSES		
Rent expense	$9 000	
Insurance expense	1 000	
Supplies expense	200	
Total expenses		10 200
Profit		**$ 6 800**

PINK MUSIC STORE PTY LTD **Statement of financial position** as at 30 June 2023		
ASSETS		
Cash		$ 1 500
Accounts receivable		4 000
Supplies		1 800
Equipment		16 000
Total assets		23 300
LIABILITIES		
Accounts payable	$2 000	
Bank loan	5 000	
Total liabilities		7 000
Net assets		**$16 300**
EQUITY		
Share capital		$10 000
Retained earnings		6 300
Total equity		**$16 300**

PINK MUSIC STORE PTY LTD **Calculation of retained earnings** for the year ended 30 June 2023	
Retained earnings, 1 July 2022	$ –
Profit	6 800
Less: Dividends	(500)
Retained earnings, 30 June 2023	**$6 300**

1.7 The financial reporting environment

LEARNING OBJECTIVE 1.7 Describe the financial reporting environment.

Accounting has developed over time and the accounting rules have been developed to suit the needs of the ever-changing business environment. For example, as a result of the failure of many joint venture entities in the eighteenth century and loss of investors' funds, there arose a need for regulation to protect the investors and to encourage economic development. In most cases, until the mid-nineteenth century, an Act of Parliament was required to permit the raising of funds. The early *Companies Act 1856* set out rules for company formation, the roles of the directors, and rules protecting the distribution of the capital invested, but the accounting rules were left to the accountants. These rules and accounting practices were known as *generally accepted accounting principles (GAAP)* and the authority was derived from use by the business community and the accounting profession. However, as the business environment became more complex and the capital markets were globalised, there emerged many deviations in practice and the accounting profession recognised the need for standardised guidelines for accounting practices and procedures. The current GAAP in Australia is a combination of statutory rules (accounting standards) and interpretations as well as the assumptions, concepts and principles that have been developed over time.

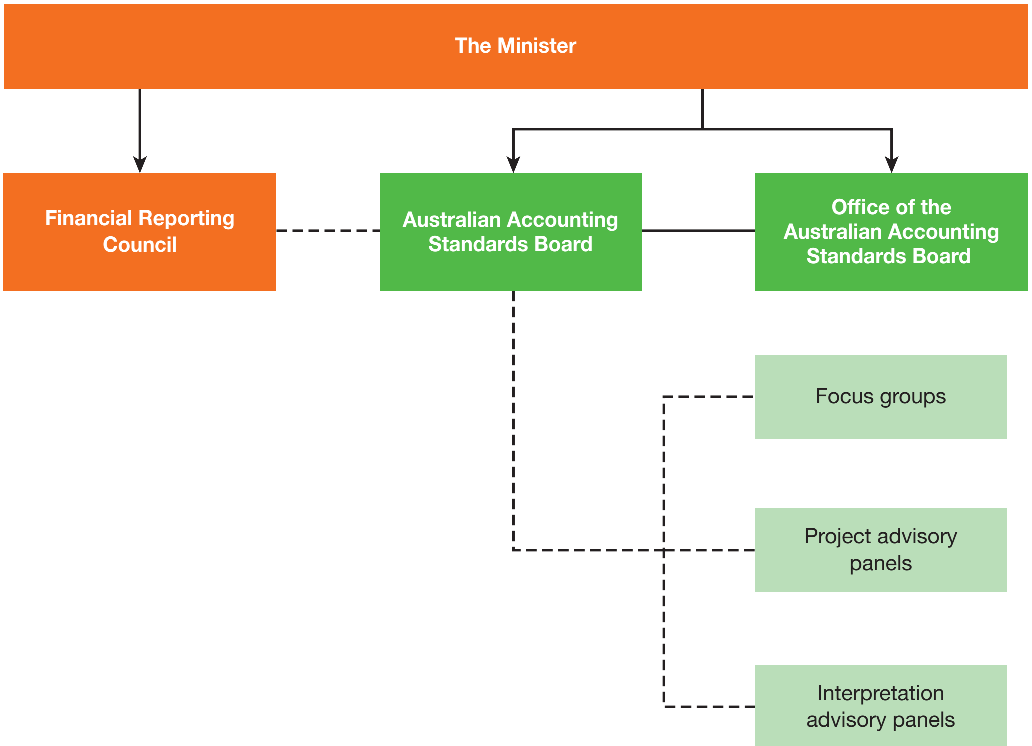
Companies registered in Australia must comply with the Corporations Act. This Act prescribes the preparation of external general purpose financial reports by certain categories of companies and this preparation is subject to regulations from several sources. The various users of financial information were discussed earlier in this chapter, where it was established that the provision of information is essential for decision making. However, there is a need for regulations and monitoring to ensure that the information provided to such users is reliable and unbiased. Let's take a closer look at each of these key players in the financial reporting environment, as well as a few others with whom they interact.

Australian Securities and Investments Commission

The **Australian Securities and Investments Commission (ASIC)** administers the Corporations Act. The Act requires certain companies, such as listed public companies, to prepare financial statements in accordance with Australian accounting standards. Among other functions, ASIC monitors compliance with accounting standards and the Corporations Act. This involves investigating companies that are suspected of not complying with the Act or of publishing financial reports that do not comply with accounting standards. The surveillance program of ASIC is assisted by auditors who access the internal records of companies and report on compliance. More details about ASIC can be found on its web site, www.asic.gov.au.

The structure of accounting standard setting is illustrated in figure 1.20, which refers to the two key bodies: the Financial Reporting Council and the Australian Accounting Standards Board. The roles of these bodies in regulating financial reporting are discussed below.

FIGURE 1.20 Structure of accounting standard setting



Source: Australian Accounting Standards Board web site, www.aasb.gov.au.

Financial Reporting Council

The **Financial Reporting Council (FRC)** is responsible for the broad oversight of the accounting standard-setting process for the private and public sectors. It comprises key stakeholders from the business community, the professional accounting bodies, governments and regulatory agencies. Members of the FRC are appointed by the treasurer. The FRC oversees the **Australian Accounting Standards Board (AASB)**, which is the organisation with authority to issue accounting standards in Australia, and the **Auditing and Assurance Standards Board (AUASB)**, which is the organisation with authority to issue auditing and assurance standards for use by auditors and providers of other assurance services. It advises the Commonwealth Government on the accounting standard-setting and auditing standard-setting processes. The FRC also monitors developments in international accounting standards and determines the AASB's broad strategic direction. The FRC may give the AASB directions, advice and feedback on matters of general policy and is responsible for approving its priorities, business plan, budget and staffing arrangements. However, the FRC cannot influence the AASB's technical deliberations and, hence, the content of particular accounting standards. More information about the FRC can be found on its web site, www.frc.gov.au.

Australian Accounting Standards Board

The AASB issues accounting standards for all types of reporting entities, business, not-for-profit and government (public) sectors. The members of the AASB are appointed by the FRC. In 2002, the FRC exercised its authority in determining the AASB's direction by endorsing Australia's convergence with international accounting standards from 1 January 2005. The standards issued by the AASB are consistent and include all options that currently exist under those issued by the International Accounting Standards Board. The **International Accounting Standards Board (IASB)** is the organisation with the authority to issue international financial reporting standards, commonly referred to as IFRS. The standards issued by the IASB are intended for the preparation of general purpose financial reports of profit-seeking entities, but in Australia and New Zealand (until recently) the same standards are applied to public sector entities and not-for-profit entities that prepare external general purpose financial reports. Where necessary, the AASB adds its own paragraphs to the international accounting standards only if they are considered particularly relevant in the Australian reporting environment, e.g. exclusions and alternatives to make the standards applicable to public sector entities. Not all entities need to comply with full accounting standards. AASB 1053 *Application of Tiers of Australian Accounting Standards* sets out the reduced disclosure requirements for some entities. More on this differential reporting regime will be covered in chapter 13.

Until 2004, in addition to setting standards, the AASB was developing a conceptual framework. The conceptual framework consisted of a set of concepts to be followed by preparers of financial statements and standard setters. It comprised statements of accounting concepts (SACs), which provided guidance but did not have mandatory status. The AASB had issued four statements of accounting concepts prior to the decision to converge with international accounting standards. The four statements addressed the scope and objective of general purpose financial reporting, qualitative characteristics, and the elements of financial statements. Some of the Australian conceptual framework differed from the IASB framework for presentation of financial statements. As part of the international convergence program, the AASB issued the *Framework*, which is equivalent to the *Conceptual Framework* issued by the IASB.

Between 2005 and 2019 the conceptual framework that was developed in Australia was no longer used in its entirety. The statements concerned with the objective (SAC 2) of general purpose financial reporting, qualitative characteristics (SAC 3) and the elements of financial statements (SAC 4) were encompassed in the framework. The statements that cover the scope (SAC 1) of general purpose financial reporting was temporarily retained, but the requirements of this statement have been incorporated into the 2019 version of the *Conceptual Framework*. The revised conceptual framework was released by the AASB in May 2019. The new requirements are explored in chapter 13. More information about the AASB can be found on its web site, www.aasb.gov.au.

Australian Securities Exchange

Another source of regulation for listed public companies is the Australian Securities Exchange (ASX). Listed entities must comply with the listing rules of the exchange or exchanges on which they are listed. The listing rules relating to financial reporting typically focus on disclosure of information. The ASX, through its Corporate Governance Council, publishes corporate governance guidelines for Australian listed entities. They also include industry-specific disclosure requirements. For example, the ASX requires listed companies operating in the mining industry to disclose details of mineral reserves. Details about the ASX can be found on its web site, www.asx.com.au.

Regulation in New Zealand

Accounting and auditing standards in New Zealand are set by the External Reporting Board. The **External Reporting Board (XRB)** is an independent Crown Entity, established under section 22 of the Financial Reporting Act 1993, and subject to the Crown Entities Act 2004. For more information about the XRB, refer to its web site, www.xrb.govt.nz.

In 2011, the New Zealand government announced changes to the financial reporting requirements for New Zealand entities. These changes are enacted in the *Financial Reporting Act 2013*. The main change is that many small and medium sized New Zealand companies will no longer need to prepare accounting reports using New Zealand generally accepted accounting practice (GAAP). Complementary to this, the XRB announced that, for financial reporting, New Zealand would change from a single set of sector neutral accounting standards to a multi-sector and standards approach. The full effect of these changes took place in 2016. Prior to these changes the reporting requirements between Australia and New Zealand were similar, particularly having sector-neutral accounting standards. Now, New Zealand is similar to the international standards where the for-profit publicly accountable entities will use New Zealand equivalents to the International Financial Reporting Standards (NZ IFRS) and public benefit entities (not-for-profit and government sector) will report using PBE standards, which are based primarily on International Public Sector Accounting Standards (IPSAS), modified as necessary for the New Zealand environment by the XRB. Also, within the two-sector reporting regime there are four tiers. Tier one in both sectors will use the full standards with fewer requirements as the tiers go down. More on this differential reporting regime will be covered in chapter 13.

Public companies listed on the New Zealand Stock Exchange (NZX) must also comply with NZX listing rules. The listing rules relating to financial reporting typically focus on disclosure of information. They also include industry-specific disclosure requirements. For example, the NZX requires listed companies operating in the mining industry to provide quarterly reports with full details of production, development and exploration activities. For more information about the NZX refer to its web site, www.nzx.com.

Professional accounting bodies

The three largest professional accounting bodies are CPA Australia, Chartered Accountants Australia and New Zealand, and the Institute of Public Accountants (IPA).

CPA Australia is the largest of the three professional bodies, with more than 166 000 members. The national office is in Melbourne with divisions throughout Australia and other countries, including Fiji, China (Hong Kong and Beijing), Indonesia, Malaysia, New Zealand, Papua New Guinea and Singapore. CPA Australia's web site, www.cpaaustralia.com.au, provides useful information for students of accounting. The web site provides information to its members and the public about accounting-related issues, such as financial planning including superannuation, financial reporting, changes in accounting standards, tax laws, auditing, finance and treasury, corporate governance, environmental and social reporting, business management and e-business. The web site also caters for students by providing information about study options in Australia and Asia, how to become a Certified Practising Accountant (CPA), business news and careers.

In 2013, the Australian and New Zealand chartered accounting associations voted to merge their associations. The new institute brand, Chartered Accountants Australia and New Zealand, was launched on 1 July 2014. Currently, there are more than 125 000 members. The Australian national office is in Sydney. There are regional offices throughout Australia and New Zealand with overseas members' groups in Hong Kong, Malaysia, Singapore, Switzerland and the United Kingdom. Further information on the combined professional accounting body can be found at www.charteredaccountantsanz.com.

The new professional accounting body has common admission programs for membership. The most common way is for a person to complete academic study (an undergraduate business degree), have practical experience and complete the professional competence program for Chartered Accountants (CA program).

CPAs and CAs are employed at all levels of government and the private sector, including not-for-profit entities, commerce and industry, and in public practice. CPAs and CAs working in commerce and industry may be chief financial officers (CFOs), specialists in financial reporting or management accounting, or do other specialised work in areas such as information technology, corporate treasury and internal auditing. Accountants in public practice engage in a variety of work, including taxation, financial planning, financial reporting, management, consulting, auditing and reviewing. In medium and large accounting firms, accountants usually specialise in one area.

The IPA caters for accounting practitioners who do not have a university degree in accounting. It also has a higher category of membership that requires completion of a degree as part of the professional qualification requirements. Like the two professional bodies discussed above, the IPA is a member of the International Federation of Accountants (IFAC). The IPA offers student membership and provides information about its membership categories and requirements, as well as developments in accounting, such as taxation and superannuation, on its web site, www.publicaccountants.org.au.

1.8 Assumptions, concepts, principles and qualitative characteristics

LEARNING OBJECTIVE 1.8 Explain the accounting assumptions, concepts, principles, qualitative characteristics and constraints underlying financial statements.

In the previous section the statutory regulation of accounting was outlined. Now let's examine the practices that underlie accounting.

Assumptions, concepts and principles

Monetary principle

In looking at Giorgina's financial statements you will notice that everything is stated in terms of dollars. The **monetary principle** requires that only those things that can be expressed in money be included in the accounting records. This might seem so obvious that it doesn't bear mentioning, but in fact it has important implications for financial reporting. Because the exchange of money is fundamental to business transactions, it makes sense that we measure a business in terms of money. However, it also means that certain important information needed by investors, creditors and managers is not reported in the financial statements. For example, customer satisfaction is important to every business, but it is not easily quantified in dollar terms, thus it is not reported in the financial statements.

Accounting entity concept

The **accounting entity concept** states that every entity can be separately identified and accounted for. For example, suppose you are a shareholder in Giorgina's, the amount of cash you have in your personal bank account and the balance owed on your personal car loan are not reported in the company's financial statements. The reason is that, for accounting purposes, you and the company are separate accounting entities. In order to accurately assess Giorgina's performance and financial position, it is important that you not confuse it with your personal transactions, or the transactions of any other entity. This is particularly important for sole proprietorships and partnerships as they are not separate legal entities. In addition, the business owners are often the managers of the business enterprises so it is easier to confuse the business and private transactions.

The accounting period concept

If you look at Giorgina's 2022 financial statements you will notice that the company reports on cash flows and performance for periods of 1 year, and on the financial position at the end of each period. Paragraph 3.4 of the *Conceptual Framework* states that financial statements are prepared for a specified period of time called the reporting period. The **end of the reporting period** for many Australian entities is 30 June and for many New Zealand entities is 31 March (NZ financial year-end). The **accounting period concept** states that the life of a business can be divided into artificial periods and that useful reports covering those periods can be prepared for the business. All entities report at least annually. Listed companies report at least every 6 months to shareholders and many prepare monthly statements for internal purposes.

Going concern assumption

The **going concern assumption** (*Conceptual Framework*, paragraph 3.9) states that the financial statements of the business are normally prepared on the basis that the reporting entity will remain in operation for the foreseeable future. Of course, many businesses do fail but, in general, it is reasonable to assume that the business will continue operating. Management must make an assessment of the validity of the going concern assumption when preparing financial statements in accordance with accounting standards. The going concern assumption underlies much of what we do in accounting. To give you just one example, if going concern is not assumed, then plant and equipment should be stated at their liquidation value (selling price less cost of disposal), not at their cost. The going concern assumption is inappropriate only when liquidation of the business appears likely.

Historical cost principle

The **historical cost principle** (*Conceptual Framework*, paragraphs 6.24 to 6.31) states that all assets are initially recorded in the accounts at their purchase price or cost. This is applied not only at the time the asset is purchased, but also over the time the asset is held. For example, if Giorgina's was to purchase land for \$500 000, it would initially be recorded at \$500 000. But what would the company do if, by the end of the next year, the land had increased in value to \$600 000? The answer is that under the historical cost principle the land would continue to be reported at \$500 000.

The use of cost for measurement of assets is often criticised as being irrelevant. Critics contend that market value would be more useful to financial decision makers. Proponents of cost measurement say that cost is the best measure because it can be verified easily from transactions between two parties, whereas market value is often subjective.

Helpful hint: Recently, some accounting rules have been changed, requiring that certain assets be measured at market value at the end of the reporting period.

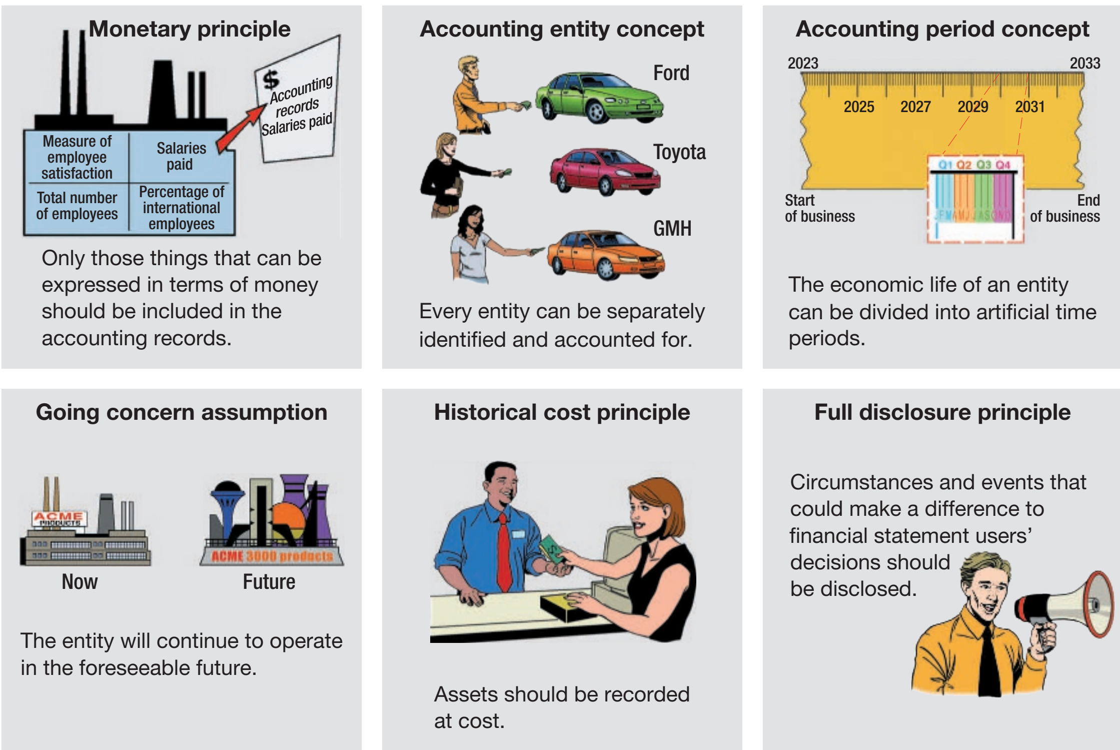
Numerous departures from the historical cost principle are permitted by accounting standards. For example, asset revaluations are permitted for most tangible non-current assets. Asset revaluations are discussed in chapter 8.

Full disclosure principle

Some important financial information is not easily reported on the face of the statements. For example, an entity might be sued by one of its customers. Investors and creditors might not know about this lawsuit. The **full disclosure principle** (*Conceptual Framework*, Chapter 7 — Presentation and Disclosure) requires that all circumstances and events that could make a difference to the decisions financial statement users might make be disclosed. If an important item cannot reasonably be reported directly in the financial statements, then it should be discussed in notes that accompany the statements.

The accounting assumptions, concepts and principles are shown graphically in figure 1.21.

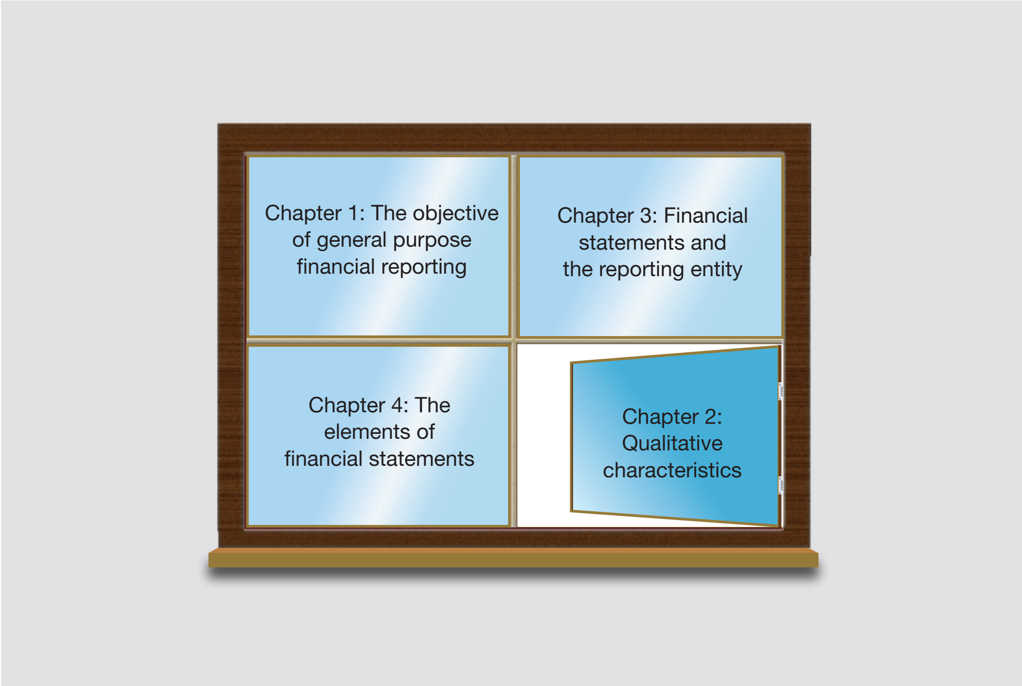
FIGURE 1.21 Accounting assumptions, concepts and principles



Qualitative characteristics

Now let's turn our attention to the needs of external users of accounting information. The *Conceptual Framework* identifies the *objective of general purpose financial reporting* as the provision of information to a wide range of users for making and evaluating decisions about the allocation of scarce resources. But how is that objective best served? In what format should financial information be presented? These questions are addressed by another piece of the *Conceptual Framework*. The *Conceptual Framework* provides guidance on the qualitative characteristics that information contained in general purpose financial reports should have in order to achieve the objective of providing useful information for decision making. Figure 1.22 below represents the final piece of the *Conceptual Framework* we introduce in this chapter.

FIGURE 1.22 Building the *Conceptual Framework* — chapter 2



While the objective of general purpose financial reporting is to provide useful information for decision making, the qualitative characteristics outline what it is about the financial information contained in the financial statements that primary users will find most useful. That is, the qualitative characteristics are the attributes that make the information in financial statements useful.

According to the *Conceptual Framework*, the qualitative characteristics are classified as either fundamental or enhancing depending on how they affect the usefulness of financial information. Enhancing qualitative characteristics and fundamental qualitative characteristics are complementary.

Fundamental qualitative characteristics

For the information in general purpose financial reports to be useful, it must be relevant and provide a faithful representation of the economic phenomena it represents. Relevance and faithful representation are therefore classified as fundamental qualitative characteristics.

Relevance

Information is considered **relevant** if it is capable of making a difference in the decisions made by users. Information that has predictive value and/or confirmatory value is considered to be relevant. Information is considered to have predictive value if it can be used to develop expectations for the future. Information is considered to have confirmatory value if it confirms or corrects users' past or present expectations. Information can often be both predictive and confirmatory (*Conceptual Framework*, paragraphs 2.6 to 2.10).

For example, when Giorgina's issues financial statements, the information in the statements is considered relevant because it provides a basis for forecasting future profits. Accounting information is also relevant to business decisions because it confirms or corrects previous expectations. Thus, Giorgina's financial statements help predict future events and provide feedback about previous expectations of the financial health of the company. The relevance of the information is affected by its **materiality** (*Conceptual Framework*, paragraph 2.11). Information is material if its omission or misstatement could affect users' decisions. Information that is immaterial need not be separately identified. Materiality can be measured in terms of size or importance. In a multi-million-dollar organisation a $10 000 error may not be considered material but would be material in a smaller organisation. So, what is considered to be material for one organisation might not be for another. For example, if Giorgina's purchased a stapler for $5 this would be considered immaterial; the purchase would be recorded in the accounting records as a business expense, although it would not be separately identified as an asset in the financial statements. However, if someone in an organisation was stealing money, then even small amounts would be considered material.

Faithful representation

Information is a **faithful representation** of the economic phenomena it purports to represent if it is complete, neutral and free from material error (*Conceptual Framework*, paragraphs 2.12 to 2.19). It is important that the information depicts the economic substance of the transactions, events or circumstances. At times, economic substance may not be the same as the legal form. To be complete, all the information needed to represent the economic phenomena faithfully is included and there is no omission that could make the information misleading. Hence, faithful representation is linked to the full disclosure principle.

Information that is considered to be neutral is free from bias. Information is biased if it is intended to attain or induce a particular behaviour or result. Some of the information in general purpose financial reports is measured using estimates in conditions of uncertainty. Hence, it is not reasonable to expect that reports will be completely error free. However, despite this limitation, faithful representation is achieved when the inputs used to make the judgements and estimates reflect the best available information at the time.

Relevance and faithful representation work together in enhancing the decision usefulness of information. Relevance is applied to determine which economic phenomena to represent and then faithful representation is applied to determine which depictions best represent the underlying economic phenomena.

Enhancing qualitative characteristics

Enhancing qualitative characteristics include **comparability**, **verifiability**, **timeliness** and **understandability** and are used to distinguish more useful information from less useful information. These characteristics are called enhancing characteristics as they enhance the decision usefulness of relevant information faithfully represented in financial statements.

Information that is comparable facilitates users identifying similarities and differences between different economic phenomena. Consistency refers to the use of the same accounting policies between entities, at the same point in time, or the same entity over time. Consistency supports the achievement of comparability (*Conceptual Framework*, paragraphs 2.24 to 2.29).

Information is verifiable if it represents the economic phenomena without bias or material error and has been prepared with appropriate recognition and measurement methods (*Conceptual Framework*, paragraphs 2.30 to 2.32).

Timeliness is measured by whether the information is available to users before it ceases to be relevant; that is, the information is received while it is still capable of influencing the decisions users make based on the information (*Conceptual Framework*, paragraph 2.33).

Understandability is the last of the enhancing qualitative characteristics and relates to the quality of information that assists users to understand the meaning of the information provided. It is important to recognise that understandability is highly dependent upon the capabilities of the users of the financial statements, and that users are assumed to have a reasonable knowledge of business activities and economic phenomena. However, classifying, characterising and presenting comparable information clearly and concisely will enhance understandability (*Conceptual Framework*, paragraphs 2.34 to 2.36).

While enhancing qualitative characteristics improve the usefulness of financial information and should be maximised where possible, they cannot make information decision useful if the information is irrelevant or not faithfully represented.

Constraint on financial reporting

Cost constraints limit the information provided by financial reporting (*Conceptual Framework*, paragraphs 2.39 to 2.43). Providing decision-useful information imposes costs, and the benefits of providing the information should outweigh the costs. Costs can include those associated with collecting, processing, verifying and disseminating information. Assessing whether benefits outweigh costs is usually more qualitative than quantitative and is often incomplete. In an attempt to ensure benefits outweigh costs, it is important to consider whether one or more enhancing qualitative characteristics may be sacrificed to reduce costs.

Table 1.4 summarises the fundamental and enhancing qualitative characteristics of financial information and the constraint of providing financial information in the *Conceptual Framework*.

TABLE 1.4 Fundamental and enhancing qualitative characteristics and constraint of financial information

Fundamental qualitative characteristics	Enhancing qualitative characteristics	Constraint of providing financial information
Relevance Faithful representation*	Comparability Verifiability Timeliness Understandability	Cost

*Complete, neutral, free from material error

The accounting assumptions, concepts and principles and the qualitative characteristics, together with accounting standards, are collectively referred to as Australian **generally accepted accounting principles (GAAP)**. Australian GAAP is different from GAAP in other countries, such as the United States. The differences arise mainly in the detailed prescriptions of accounting standards. Any differences are specified in the statement of conformity. Australian GAAP is almost identical to New Zealand's generally accepted accounting practices (GAAP). They include financial reporting standards, statements of accounting practice, exposure drafts, IASB exposure drafts, technical practice aids and research bulletins. Both Australia and New Zealand have introduced reduced reporting requirements depending on the type and size of the organisation. There will be more discussion of differential reporting in chapter 13.

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What are generally accepted accounting principles (GAAP)?
2. Describe the assumptions, concepts, principles and constraints underlying financial statements.
3. Explain the two main qualitative characteristics of information in general purpose financial reports.

1.9 Analysing financial statements

LEARNING OBJECTIVE 1.9 Calculate and interpret ratios for analysing an entity's profitability, liquidity and solvency.

So far, we have introduced the four main financial statements and discussed how these statements provide information about an entity's financial performance and position. As outlined in the *Conceptual Framework*, the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential equity investors, lenders and other creditors in making their decisions about providing resources to the entity. Now it is time to extend our discussion by showing you specific tools that can be used to analyse financial statements to make a more meaningful evaluation of an entity to assist investors and lenders' investment decisions. The analysis of financial statements is covered in more detail in chapter 12. For this section, we use the 2022 accounts of two furniture retailers: Original Furnishings Limited and Artistry Furniture Limited.

Analysis and decision making

Ratios are a valuable source of information when making resource allocation decisions. A **ratio** expresses the mathematical relationship between one quantity and another. **Ratio analysis** therefore expresses the relationship among selected items of financial statement data found in general purpose financial statements. The relationship between financial data points is expressed in terms of a percentage, a rate or a simple proportion. To illustrate, in 2022 Original Furnishings Limited had current assets of $187 470 000 and current liabilities of $123 975 000. The relationship between these accounts is determined by dividing current assets by current liabilities to get 1.51. The alternative means of expression are:

Percentage: Current assets are 151% of current liabilities.
Rate: Current assets are 1.51 times as great as current liabilities.
Proportion: The relationship of current assets to current liabilities is 1.51:1.

For analysis of the main financial statements, ratios can be classified as shown in figure 1.23.

FIGURE 1.23 Financial ratio classifications

Profitability ratios

Measures of the operating success of a company for a given period of time

Liquidity ratios

Measures of short-term ability of the company to pay its maturing obligations and to meet unexpected needs for cash

Solvency ratios

Measures of the ability of the company to survive over a long period of time

When making a decision to lend money or to invest in an entity, users of general purpose financial statements find it helpful to use ratios. Ratios can provide clues as to underlying conditions that may not be apparent from simply inspecting the individual components of a particular ratio as provided in the financial statements. The ratios can be classified into profitability ratios, liquidity ratios and solvency ratios, which we discuss in detail below with reference to furniture retailers Artistry Furniture Limited and Original Furnishings Limited. While ratios are useful inputs into resource allocation decisions, a single ratio by itself is not very meaningful. Accordingly, in this and the following chapters we will augment ratios with data and information from a wide variety of sources including:

1. *intracompany comparisons* covering two years for the same entity
2. *intercompany comparisons* based on comparisons with a competitor in the same industry
3. *other relevant information* such as general economic conditions, industry trends or averages, information from directors' reports and media releases.

Profitability

Original Furnishings aims to generate a profit for its shareholders by manufacturing and selling furniture. Artistry Furniture aims to generate profits for its shareholders as a furniture retailer. The statement of profit or loss for Artistry Furniture reports how successful it is at generating a profit from its sales and other revenue. The statement reports the revenue for the period and the expenses incurred during the period. Figures relating to profitability are taken from Artistry Furniture's statement of profit or loss for the year ended 30 June 2022 and summarised in figure 1.24.

FIGURE 1.24 Extract from Artistry Furniture Limited's statement of profit or loss

ARTISTRY FURNITURE LIMITED
Statement of profit or loss (extract)
for the year ended 30 June 2022

	2022 $'000	2021 $'000
Revenues	135 000	112 000
Expenses	(113 600)	(98 500)
Profit before income tax	**21 400**	**13 500**
Income tax expense	(4 800)	(4 050)
Profit	**16 600**	**9 450**

Before we begin the analysis, it is important to note that, when identifying the numbers to be used in ratio calculations, a close examination of the notes to the financial statements is required. For example, Artistry Furniture reports profit after tax for the year ended 30 June 2022 as $21 900 000. However, this figure includes a one-off item in other income that needs to be excluded from the ratio calculations. Artistry Furniture received a one-off compensation benefit of $5 300 000 (net of tax) from the State Government. This income does not represent income generated by the day-to-day operations of the business and is unlikely to be received in the future, hence it should be excluded in calculating profitability for the company. Users of financial information make decisions about current and future profitability based on past data using trends over time. Removing items that distort trends and hinder users' assessments of the true earning capacity of the company assists in the analysis of the company and improves the decision-making process. This is discussed further in chapter 10 in section 10.6 'Earning power and irregular items' and in chapter 12 under the section headed 'Atypical data'.

In figure 1.24 we can see that Artistry Furniture's revenues increased during the year from $112 000 000 in 2021 to $135 000 000 in 2022. This has resulted in an increase in the adjusted profit figure (net of other income) from $9 450 000 in 2021 to $16 600 000 in 2022 because the increase in the company's expenses was relatively smaller than the increase in its revenues. That is, sales have increased 20.5% on the 2021 sales and operating expenses as a percentage of sales have decreased by 3.8%, resulting in an increase in profit. How was this great result achieved by the company? Insights can be found in the financial statement notes, which could explain that the increase in sales revenue was driven by the opening of new stores as well as growth in sales in the existing stores. Further, the notes could explain that operating expenses had decreased as a percentage of sales due to management's success in managing costs.

Given retailers are affected by the changing general economic conditions, employment levels, inflation and interest rates, investing and lending decisions are enhanced when company information is explored in its wider context. To achieve this, we need further information about the furniture industry specifically, as well as the economy and business environment generally. One helpful source is the company's annual report; other sources include media releases in the press, data on competitors and the company's web site. For example, let's assume that these furniture retailers have been operating in difficult retail conditions due to subdued consumer spending on discretionary items. Being aware of this difficulty in the business environment would prompt the decision makers to evaluate an increase in sales as even more impressive than first thought from the figures alone.

To evaluate the profitability of Artistry Furniture further, ratio analysis would be used. **Profitability ratios** measure the operating success of an entity for a given period of time. We will look at two examples of profitability ratios: return on assets and profit margin.

Return on assets

An overall measure of profitability is the **return on assets (ROA)**. This ratio is calculated by dividing profit by average assets. (Average assets are commonly calculated by adding the beginning and ending values of assets and dividing by 2.) Profit refers to profit after income tax unless stated otherwise. The return on assets indicates the amount of profit generated by each dollar invested in assets. Thus, the higher the return on assets, the more profitable the entity. Selected figures from the 2022 statement of profit or loss for Artistry Furniture are presented in figure 1.24. The 2022 and 2021 return on assets of Original Furnishings and Artistry Furniture Limited (entities operating in the same industry) are presented in figure 1.25.

FIGURE 1.25 Return on assets

$$\text{Return on assets} = \frac{\text{Profit}}{\text{Average total assets}}$$

($'000)	2022	2021
Original Furnishings	$\frac{\$35\,900}{(\$287\,370 + \$233\,280)/2} = 0.138{:}1 \text{ or } 13.8\%$	$\frac{\$38\,875}{(\$233\,280 + \$255\,050)/2} = 0.159{:}1 \text{ or } 15.9\%$
Artistry Furniture	$\frac{\$16\,600}{(\$65\,250 + \$51\,840)/2^*} = 0.284{:}1 \text{ or } 28.4\%$	$\frac{\$9\,450}{(\$51\,840 + \$41\,472)/2^*} = 0.203{:}1 \text{ or } 20.3\%$

*Amounts used to calculate average assets are taken from the statement of financial position (see figure 1.27). Total assets in 2020 were $41 472 000. Also note that amounts in the ratio calculations have been rounded to the nearest thousand.

We can evaluate Original Furnishings' 2022 and 2021 return on assets in a number of ways. First, we can compare the ratio across time. That is, did its performance improve? The decrease from 15.9% in 2021 to 13.8% in 2022 suggests a decline in profitability. The ratio tells us that in 2021 Original Furnishings generated 15.9 cents on every dollar invested in assets and in 2022 it generated 13.8 cents on every dollar invested in assets. Then we can compare the ratios with those of another operator in the industry, Artistry Furniture. In both 2021 and 2022, Original Furnishings' return on assets is below that of Artistry Furniture's. Thus, based on the return on assets, Original Furnishings' profitability appears weaker than Artistry Furniture's. In 2021, Artistry Furniture has a higher return on assets because it generated almost one-quarter of the amount of profits in dollar terms compared with Original Furnishings' profits, whilst using about one-fifth of the assets used by Original Furnishings. In 2022, Artistry Furniture has a larger return on assets because it generated around one-half of profits in dollar terms compared with Original Furnishings' profits, but Original Furnishings has around four and a half times the assets used by Artistry Furniture. In other words, put simply, Artistry Furniture was able to generate more profits using fewer assets.

Profit margin

The **profit margin** measures the percentage of each dollar of sales that results in profit. It is calculated by dividing profit by net sales (revenue) for the period. Businesses with high turnover, such as supermarkets and grocers (Coles or Woolworths) and discount stores (The Reject Shop or Crazy Prices) generally experience low profit margins. Low-turnover businesses, such as jewellery stores (Tiffany's) or shipbuilders (Australian Defence Industries), usually have high profit margins. Profit margins for Original Furnishings and Artistry Furniture are shown in figure 1.26. The figure for sales revenue used in calculating the profit margin is the same as total revenue reported in the statement of profit or loss. For simplicity it is assumed that all revenue is sales revenue.

FIGURE 1.26 Profit margin

$$\text{Profit margin} = \frac{\text{Profit}}{\text{Net sales}}$$

(\$'000)	2022	2021
Original Furnishings	$\frac{\$35\,900}{\$562\,500} = 0.064$ or 6.4%	$\frac{\$38\,875}{\$510\,300} = 0.076$ or 7.6%
Artistry Furniture	$\frac{\$16\,600}{\$135\,000} = 0.123$ or 12.3%	$\frac{\$9\,450}{\$112\,000} = 0.084$ or 8.4%

Original Furnishing's profit margin decreased from 7.6% in 2021 to 6.4% in 2022. This means that in 2022 the company generated 6.4 cents on each dollar of sales and in 2021 it generated 7.6 cents on each dollar of sales. As we said earlier, single numbers have more meaning when they are combined with other data. Let's start by evaluating Original Furnishings' results by comparing them to those of its competitor, Artistry Furniture. Original Furnishings' profit margin was lower than Artistry Furniture's in both years. What could explain the difference in mark-up between businesses in the same industry? To answer this, we need to know a little more about the two companies. In 2022, Original Furnishings has 75 stores, with 55 of those being their Fun Furniture stores. A plausible explanation is that Original Furnishings has established itself in the marketplace as 'best value' and therefore sets a lower mark-up. Artistry Furniture, on the other hand, has 20 stores, with only 4 stores in the 'best value' market. Artistry Furniture branded stores may be perceived by the marketplace as 'better quality' and the company is therefore able to command a higher mark-up on its furniture sales.

In addition to the structure of the store holdings, further information provided in the financial statements and results presentations for each of these companies (available on the company web sites) sheds further light on the difference in mark-up. Artistry Furniture purchases its stock from overseas and was able to maintain its profit margin as supplier increases were offset by a stronger Australian dollar resulting in larger buying power. On the other hand, Original Furnishings explained that its profit margin was down due to its strategy of discounting its stock to clear excessive inventory. Furthermore, Artistry Furniture noted that it had decreased its expenses as a percentage of sales, illustrating management's focus on managing its operating costs. Original Furnishings reported quite a different story, claiming that its cost of business actually increased with higher property costs, higher employment costs and increased depreciation, as well as the development of an e-commerce platform.

As you can see, there is a lot of information users can draw upon to analyse, evaluate and make decisions about an entity. The decision-making and analysis processes are summarised in the decision-making toolkit below. In subsequent chapters you will learn more about evaluating an entity and the various forms of analysis for evaluating an entity's profitability, as introduced in this section.

Potential investors, shareholders, lenders and other users are interested in evaluating a company's profitability when making decisions about providing resources to a company. As you can imagine, potential investors and lenders feel more confident investing resources in a company that is profitable rather than one that is unprofitable. Calculating the return on assets ratio using profit and average total assets data from financial reports and then interpreting the results using multiple sources of information assists users in answering questions like: is the entity using its assets effectively? Recall that a higher value for the ratio indicates a better or more efficient use of assets, as was seen for Artistry Furniture when compared with Original Furnishings.

Another question decision makers might like to answer when making resource allocation decisions includes: is the entity maintaining an adequate margin between sales and expenses? By calculating the profit margin ratio using the profit and net sales figures from the statement of profit or loss, resource providers can evaluate whether the entity has a sufficient mark-up on its inventory and whether it is managing its operating costs effectively. All other things being equal, the higher the value of the ratio, the more favourable the return on each dollar of sales; thus the more attractive the company is to investors and the safer it is to lenders.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Is the entity using its assets effectively?	Profit and average assets	$\text{Return on assets} = \dfrac{\text{Profit}}{\text{Average total assets}}$	Higher value suggests efficient use of assets.
Is the entity maintaining an adequate margin between sales and expenses?	Profit and net sales	$\text{Profit margin} = \dfrac{\text{Profit}}{\text{Net sales}}$	Higher value suggests favourable return on each dollar of sales.

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What are the three ways that ratios can be expressed?
2. What is the purpose of profitability ratios? Explain the return on assets and the profit margin ratios and how they inform the decisions that users make about resource allocations.

Liquidity

Profitability ratios are helpful in evaluating and making decisions about an entity. However, these ratios do not provide users of financial information with a complete picture of the entity to support their resource allocation decisions, so including liquidity and solvency ratios is helpful. **Liquidity ratios** measure the short-term ability of the entity to pay its maturing obligations and to meet unexpected needs for cash.

You can learn a lot about an entity's financial health by evaluating the relationship between its various assets and liabilities. However, any analysis of liquidity is incomplete without looking at cash flows. In this section, we will look at some ratios that use numbers from the statement of financial position of Artistry Furniture (figure 1.27). This will be followed by cash flow analysis.

FIGURE 1.27 Artistry Furniture statement of financial position

ARTISTRY FURNITURE LIMITED
Statement of financial position (extract)
as at 30 June 2022

	2022 $'000	2021 $'000
ASSETS		
Current assets		
Cash	24 000	19 800
Trade and other receivables	4 420	2 700
Inventories	12 500	10 300
Other financial assets	520	100
Other assets	210	540
Total current assets	41 650	33 440
Non-current assets		
Deferred tax assets	2 100	2 400
Property, plant & equipment	19 500	14 000
Intangible assets	2 000	2 000
Total non-current assets	23 600	18 400
Total assets	65 250	51 840

LIABILITIES		
Current liabilities		
Trade and other payables	23 150	16 300
Current tax liabilities	4 800	4 050
Provisions	1 180	900
Total current liabilities	29 130	21 250
Non-current liabilities		
Deferred tax liabilities	270	20
Provisions	1 940	2 610
Borrowings	7 800	5 200
Total non-current liabilities	10 010	7 830
Total liabilities	39 140	29 080
Net assets	**26 110**	**22 760**
EQUITY		
Issued capital	2 000	2 000
Reserves	680	15
Retained earnings	23 430	20 745
Total equity	**26 110**	**22 760**

Suppose you are a banker considering lending money to Artistry Furniture, or you are a computer manufacturer interested in selling computers to the company. You would be concerned about Artistry Furniture's **liquidity** — its ability to pay obligations that are expected to become due within the next year or operating cycle. You would look closely at the relationship of its current assets to current liabilities before lending the entity money or supplying the entity with goods or services on credit.

Working capital

One measure of liquidity is **working capital**, which is the difference between the amounts of current assets and current liabilities.

$$\text{Working capital} = \text{Current assets} - \text{Current liabilities}$$

When working capital is positive, there is greater likelihood that the entity will be able to pay its liabilities. When working capital is negative, the entity will be unable to pay short-term creditors from existing current assets. Short-term creditors may not be paid unless the entity can draw on other sources of cash, and the entity may ultimately be forced into liquidation. Artistry Furniture had a positive working capital in 2022 of $12 520 000 ($41 650 000 - $29 130 000) and is therefore in a good position to pay its short-term debts as they fall due.

Current ratio

One liquidity ratio is the **current ratio**, which is calculated by dividing current assets by current liabilities.

The current ratio is a more dependable indicator of liquidity than working capital. Two entities with the same amount of working capital may have significantly different current ratios. The 2022 and 2021 current ratios for Original Furnishings and Artistry Furniture are shown in figure 1.28.

FIGURE 1.28 Current ratios of Original Furnishings and Artistry Furniture

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

($'000)	2022	2021
Original Furnishings	$\frac{\$187\,470}{\$123\,975}$ = 1.51:1 or $1.51	$\frac{\$150\,480}{\$95\,625}$ = 1.57:1 or $1.57
Artistry Furniture	$\frac{\$41\,650}{\$29\,130}$ = 1.43:1 or $1.43	$\frac{\$33\,440}{\$21\,250}$ = 1.57:1 or $1.57

Calculating the ratio is only the first step in the analysis process when making a decision. It is important to take the time to *interpret* the data. Decision makers need to answer the question 'what does this ratio actually mean?' Original Furnishings' 2022 current ratio of 1.51:1 means that, for every dollar of current liabilities, it has $1.51 of current assets. This indicates that the company will have funds available to pay debts as they fall due. Original Furnishings' current ratio decreased slightly from 1.57 in 2021 to

1.51 in 2022, decreasing its liquidity. However, compared with Artistry Furniture's 2022 current ratio of 1.43:1, Original Furnishings appears to have better liquidity.

What is considered to be an *acceptable* ratio varies from industry to industry. However, between 1:1 and 1.5:1 is generally considered to be an acceptable current ratio for most industries. In this case both Original Furnishings' and Artistry Furniture's liquidity ratios are well above the *acceptable* ratio. These results would become *part* of the information resource providers use to make resource allocation decisions. For example, these ratios increase a lender's confidence that the companies will be able to repay any funds lent to them.

The current ratio is only one measure of liquidity. It does not take into account the *composition* of the current assets. For example, a satisfactory current ratio does not disclose whether a portion of the current assets is tied up in slow-moving inventory, i.e. inventory that is held in stock for a long period of time and is difficult to sell. The composition of the assets matters because a dollar of *cash* is more readily available to pay the bills than is a dollar of inventory. Inventory generally will be converted into cash in time, which will then be available to pay debts; however, only *after* the item is sold *and* the cash has been collected from the customer. This can take days, weeks, months or years depending on how quickly inventories sell.

Explaining why examining the composition of current assets is so important is best demonstrated using an example. Suppose an entity's cash balance declined while its inventory increased substantially. If inventory increased because the entity was having difficulty selling its products, then even though the current ratio might increase, the current ratio might not fully reflect the reduction in the entity's liquidity. In a later chapter you will learn about other measures of liquidity and how to analyse the liquidity of certain assets using turnover ratios.

Using the statement of cash flows

The statement of cash flows provides financial information about the sources and uses of an entity's cash. Investors, creditors and others want to know what is happening to an entity's most liquid resource — its cash. In fact, it is often said that 'cash is king' because if an entity can't generate cash, it won't survive, and for this reason cash is often referred to as the life blood of the business. To aid in the analysis of cash, the statement of cash flows reports the cash effects of: (1) an entity's *operating activities*, (2) its *investing activities* and (3) its *financing activities*.

The sources of cash matter. For example, you would feel much better about an entity's health if you knew that its cash was generated from the operations of the business rather than borrowed from the bank. The statement of cash flows for Artistry Furniture for the year ended 30 June 2022 is provided in figure 1.29.

FIGURE 1.29 Artistry Furniture Limited cash flows

ARTISTRY FURNITURE LIMITED
Statement of cash flows
for the year ended 30 June 2022

	2022 $'000	2021 $'000
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers	137 200	121 500
Payments to suppliers and employees	(115 300)	(106 400)
Interest received	950	900
Income taxes paid	(4 050)	(3 450)
Net cash flows from operating activities	18 800	12 550
CASH FLOWS FROM INVESTING ACTIVITIES		
Payments for property, plant & equipment	(9 000)	(2 000)
Net cash used in investing activities	(9 000)	(2 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends paid	(8 200)	(7 200)
Proceeds from borrowings	3 400	–
Interest paid	(800)	(225)
Net cash used in financing activities	(5 600)	(7 425)
Net increase/(decrease) in cash held	4 200	3 125
Cash at the beginning of the year	19 800	16 675
Cash at the end of the year	**24 000**	**19 800**

In the long term, it is generally desirable that an entity be able to generate enough cash from its operating activities to pay dividends and finance its investing needs. This information is important when potential investors and creditors are deciding whether to provide resources to the entity. Cash flows from operations needs to be assessed over a number of years because the timing of major capital investment expenditures and, to a lesser extent, cash paid for operating activities can cause considerable variation in the relationship between operating and investing cash flows from year to year.

To illustrate, let's consider Artistry Furniture's operating cash flows. Cash generated by operating activities for 2022 was $18 800 000 compared with $12 550 000 for 2021. There was an increase in cash receipts, and payments to suppliers and employees increased at a lesser rate. This resulted in an increase in net cash from operations of $6 250 000. Net cash spent on investing activities, which consisted solely of purchases of property, plant and equipment in 2022, was $9 000 000 compared with $2 000 000 in 2021. The funds for investing activities were provided partly from operating activities and partly by the proceeds from borrowings; you can see this in the investing and financing sections of the statement of cash flows. The outflow of cash for property, plant and equipment was largely due to a $6 500 000 purchase of property. No additional funds were obtained from new share issues during 2021 or 2022. Dividends accounted for the main outflow of funds for 2022 and 2021 financing activities in the amounts of $8 200 000 and $7 200 000 respectively.

Earlier we introduced you to the current ratio. The statement of cash flows can also be used to calculate additional measures of liquidity. The **current cash debt coverage** is a measure of liquidity that is calculated as *net cash provided by operating activities* divided by *average current liabilities*. It indicates the entity's ability to generate sufficient cash to meet its short-term needs. Cash debt coverage is the best measure of liquidity given it shows whether the cash generated by operating activities is sufficient to cover the current liabilities as they fall due. Statement of financial position measures of liquidity, such as the current ratio, include items in the calculation that are not yet cash, such as receivables or inventories. Inventories and receivables cannot be used to pay liabilities until the cash is collected, which can take time. While the acceptable level for the current cash debt coverage will vary between industries, in general a value below 0.40 times is considered cause for additional investigation of an entity's liquidity. Figure 1.30 shows the current cash debt coverage for Original Furnishings and Artistry Furniture for 2022 and 2021.

FIGURE 1.30 Current cash debt coverage

$$\textbf{Current cash debt coverage} = \frac{\textbf{Net cash provided by operating activities}}{\textbf{Average current liabilities}}$$

($'000)	2022	2021
Original Furnishings	$\frac{\$79\,425}{(\$123\,975 + \$95\,625)/2} = 0.72{:}1 \text{ or } 0.72$	$\frac{\$56\,475}{(\$95\,625 + \$71\,720)/2} = 0.68{:}1 \text{ or } 0.68$
Artistry Furniture	$\frac{\$18\,800}{(\$29\,130 + \$21\,250)/2^{*}} = 0.75{:}1 \text{ or } 0.75$	$\frac{\$12\,550}{(\$21\,250 + \$17\,000)/2^{*}} = 0.66{:}1 \text{ or } 0.66$

*Amounts used to calculate average current liabilities are taken from the statement of financial position (figure 1.27). Current liabilities at year-end 2020 were $17 000. Also note that amounts in the ratio calculations have been rounded to the nearest thousand.

We can use these cash measures of liquidity to supplement the analysis of liquidity using the statement of financial position figures. Original Furnishings' current cash debt coverage of 0.72 in 2022 is higher than in 2021.

The recommended minimum level for current cash debt coverage is 0.40. This is a general guide that decision makers can use when making resource allocation decisions. A current debt coverage of greater than 0.40 gives potential investors and creditors more confidence in the company than a ratio below 0.40. 'Can the entity meet its short-term obligations?' is the primary question decision makers ask about liquidity, as outlined in the decision-making toolkit. By drawing on information from the statement of financial position (current assets and current liabilities) as well as information from the statement of cash flows (cash flows from operating activities) decision makers can calculate the current ratio and cash debt coverage ratio to assess liquidity. In both cases, a higher ratio indicates more favourable liquidity. Recall liquidity is the entity's ability to repay current obligations as they fall due. If the entity can't pay its obligations, then it could be forced into liquidation, which might result in the resource providers (e.g. lenders, suppliers or investors) losing money. Let's explore cash measures of liquidity using the data from Original Furnishings' and Artistry Furniture's financial statements.

As at June 2022, Artistry Furniture's current liabilities were covered 0.75 by cash flows from operations. This result is almost twice the general guide used to evaluate an entity's liquidity for the current cash debt coverage ratio, indicating more favourable liquidity for the company. Both companies' current cash debt coverage ratios are above 0.40, which indicates the companies have a favourable liquidity position and should be able to generate sufficient cash flows from operations to meet current liabilities as they fall due. The steps in the decision-making process are summarised in the decision-making toolkit next.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Can the entity meet its short-term obligations?	Current assets and current liabilities	$\text{Current ratio} = \dfrac{\text{Current assets}}{\text{Current liabilities}}$	Higher ratio indicates more favourable liquidity.
Can the entity meet its short-term obligations?	Current liabilities and cash provided by operating activities	$\text{Current cash debt coverage} = \dfrac{\text{Cash provided by operations}}{\text{Average current liabilities}}$	A higher value indicates more favourable liquidity.

Solvency

When deciding how to allocate resources, decision makers need to consider how the entity will fare in the short term as well as the long term. Now suppose that instead of being a short-term creditor, you are interested in either buying Artistry Furniture's shares or extending the company a long-term loan. Long-term creditors and shareholders are interested in an entity's long-term **solvency** — its ability to pay interest as it comes due and to repay the debt at maturity. **Solvency ratios** measure the ability of the business to survive over a long period of time. The debt to total assets ratio is one source of information about long-term debt-paying ability. Cash flow ratios, such as the cash debt coverage, are also useful tools of analysis. By looking at an entity's profitability, liquidity and solvency with other data like general economic and business information, decision makers can construct a more complete picture of the entity's performance and position when analysing and making decisions about lending or investing their funds.

Helpful hint: Some users evaluate solvency using a ratio of liabilities divided by equity. The higher this ratio, the lower an entity's solvency.

Debt to total assets ratio

Recall that Assets = Liabilities + Equity. This equation shows that the assets can either be funded through equity or debt. The **debt to total assets ratio** measures the percentage of assets financed by creditors rather than shareholders. Debt financing is riskier than equity financing because debt must be repaid at specific points in time, whether the entity is performing well or not. Thus, the higher the percentage of debt financing, the riskier the entity. What risk means in this instance is that, all other things being equal, the higher the debt is, the more interest that needs to be repaid each period and the greater the principal to be repaid at the end of the loan period. In practical terms, the company has to generate sufficient profits to repay the interest and debt, and if it cannot and the company goes into liquidation, existing resource providers (lenders or investors) may not be able to claim their investment or loan from the company if it has insufficient funds. Thus, the higher the debt is, the riskier it is for resource providers.

The debt to total assets ratio is calculated by dividing total debt (both current and non-current liabilities) by total assets. The information for this ratio is taken from the statement of financial position. Calculating this ratio is a tool that helps users of financial information assess whether the entity can meet its long-term obligations, as summarised in the decision-making toolkit above. The higher the percentage of total liabilities (debt) to total assets, the greater the risk that the entity may be unable to pay its debts as they become due. The ratios of debt to total assets for Original Furnishings and Artistry Furniture for 2022 and 2021 are presented in figure 1.31.

FIGURE 1.31 Debt to total assets ratio

$$\text{Debt to total assets ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

($'000)	2022	2021
Original Furnishings	$\frac{\$170\,235}{\$287\,370}$ = 0.59:1 or 0.59	$\frac{\$130\,860}{\$233\,280}$ = 0.56:1 or 0.56
Artistry Furniture	$\frac{\$39\,140}{\$65\,250}$ = 0.60:1 or 0.60	$\frac{\$29\,080}{\$51\,840}$ = 0.56:1 or 0.56

The 2022 ratio of 59% means that 59 cents of every dollar invested in assets by Original Furnishings has been provided by its creditors. The 2022 ratio of 60% means that 60 cents of every dollar invested in assets by Artistry Furniture has been provided by its creditors. The higher the ratio, the lower the equity 'buffer' available to creditors if the company becomes insolvent, i.e. the less chance the creditors might have their debts repaid out of shareholders' funds if the company goes into liquidation. Thus, from a lender's or creditor's point of view, a high ratio of debt to total assets is undesirable. Based on the 2022 data, Original Furnishings is slightly more solvent than Artistry Furniture. Examination of the statement of financial position indicates that Artistry Furniture has less long-term debt than Original Furnishings.

Based on these ratios, Original Furnishings appears to be solvent in that its assets exceed its liabilities. Artistry Furniture, on the other hand, is only near solvent given its debt to total assets ratio of 0.60:1. However, the adequacy of this ratio is often judged in the light of the entity's profits, cash flows and ability to pay interest when it falls due. Generally, entities with relatively stable profit can support higher debt to total assets ratios than can cyclical entities with widely fluctuating profits, such as many high-tech companies. The profitability, liquidity and solvency ratios calculated thus far, as well as the other information on the company's management, suggest that Artistry Furniture is a safe investment for potential shareholders and lenders.

The **cash debt coverage** is another measure of solvency that is calculated as cash provided by operating activities divided by average total liabilities. It indicates the entity's ability to generate sufficient cash to meet its long-term needs. Figure 1.32 presents the cash debt coverage for Original Furnishings and Artistry Furniture for 2022 and 2021. Although what is considered an acceptable ratio varies between industries, a general rule of thumb is that a ratio below 0.20 is considered cause for additional investigation.

FIGURE 1.32 Cash debt coverage

$$\text{Cash debt coverage} = \frac{\text{Net cash provided by operating activities}}{\text{Average total liabilities}}$$

($'000)	2022	2021
Original Furnishings	$\frac{\$79\,425}{(\$170\,235 + \$130\,860)/2}$ = 0.53:1 or 0.53	$\frac{\$56\,475}{(\$130\,860 + \$98\,147)/2}$ = 0.49:1 or 0.49
Artistry Furniture	$\frac{\$18\,800}{(\$39\,140 + \$29\,080)/2^*}$ = 0.55:1 or 0.55	$\frac{\$12\,550}{(\$29\,080 + \$23\,264)/2^*}$ = 0.48:1 or 0.48

*Amounts used to calculate average total liabilities are taken from Artistry Furniture's statement of financial position (figure 1.27). Total liabilities at year-end 2020 were $23 264 (in thousands). Also note that amounts in the ratio calculations have been rounded to the nearest thousand.

Original Furnishings' cash debt coverage of 0.53 in 2022 is well above the recommended minimum level of 0.20, suggesting it is solvent consistent with the results of the debt to total assets ratio. Note the differences between the current debt coverage and the cash debt coverage for both Original Furnishings and Artistry Furniture. This difference reflects the levels of non-current liabilities. Artistry Furniture experienced a substantial increase in cash debt coverage in 2022, whereas Original Furnishings experienced only a slight increase. However, while Artistry Furniture maintained higher cash debt coverage in 2022, both companies are above the minimum level of 0.20, indicating they are both solvent. We will investigate other measures of liquidity and solvency in later chapters.

The decision-making toolkit below summarises the decision-making processes for determining whether an entity can meet its long-term obligations. Calculating the cash debt coverage ratio is a useful tool for users of financial statements when making decisions about lending money to an entity or purchasing shares. A higher ratio indicates better solvency because the entity is generating cash to meet its long-term needs.

The solvency ratios for both Original Furnishings and Artistry Furniture indicate that the entities are solvent and therefore low risk for investors and creditors.

In this section, we have explored some of the decision-making processes users of general purpose financial statements undertake when making choices about whether to lend money or to invest in an entity. We saw that ratios could provide clues as to underlying conditions that may not be apparent from simply inspecting the individual figures provided in financial statements. The ratios were classified into profitability ratios, liquidity ratios and solvency ratios, which were employed to conduct an in-depth analysis of two companies, Artistry Furniture Limited and Original Furnishings Limited. By now you can clearly see that, while ratios are useful inputs into resource allocation decisions, a single ratio by itself is not very meaningful. Augmenting ratios with data and information from a wide variety of sources makes the data more meaningful and gives the analysis some context. Recall that *intracompany comparisons* (covering two years for the same entity), *intercompany comparisons* (based on comparisons with a competitor in the same industry) and *other relevant information* such as general economic conditions, industry trends or averages, and information from directors' reports and media releases provided great insights for interpreting the data.

You may find it helpful to consolidate your knowledge by taking some time now to work through the decision-making toolkit activity. Then, review the steps in the decision-making toolkit summary to ensure you understand how to calculate and evaluate profitability, liquidity and solvency ratios.

DECISION-MAKING TOOLKIT

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Can the entity meet its long-term obligations?	Total liabilities and total assets	Debt to total assets ratio $= \frac{\text{Total liabilities}}{\text{Total assets}}$	A higher ratio indicates solvency risk because the entity has fewer assets available for creditors.
Can the entity meet its long-term obligations?	Total liabilities and cash provided by operating activities	Cash debt coverage $= \frac{\text{Cash provided by operations}}{\text{Average total liabilities}}$	A higher ratio indicates better solvency as the entity is generating cash to meet its long-term needs.

LEARNING REFLECTION AND CONSOLIDATION

Review it

1. What is liquidity? How can it be measured using a classified statement of financial position?
2. What is solvency? How can it be measured using (a) a statement of financial position? (b) a statement of cash flows?
3. What information does the statement of cash flows provide that is not available in a statement of profit or loss or statement of financial position?
4. What does the current cash debt coverage measure? What does the cash debt coverage measure?

Do it

Selected financial data for Drummond Ltd at 30 June 2022 are as follows: cash \$60 000; receivables (net) \$80 000; inventory \$70 000; total assets \$540 000; current liabilities \$140 000; and total liabilities \$270 000. Calculate the current ratio and debt to total assets ratio.

Reasoning

The formula for the current ratio is: Current assets ÷ Current liabilities. The formula for the debt to total assets ratio is: Total liabilities ÷ Total assets.

Solution

The current ratio is 1.5:1 (\$210 000 ÷ \$140 000). The debt to total assets ratio is 0.5:1 (\$270 000 ÷ \$540 000).

DECISION-MAKING TOOLKIT — A SUMMARY

Decision/issue	Info needed for analysis	Tool or technique to use for decision	How to evaluate results to make decision
Are the entity's operations profitable?	Statement of profit or loss	The statement of profit or loss reports on the success or failure of the entity's operations by reporting its revenues and expenses.	If the entity's revenues exceed its expenses, it will report profit; if expenses exceed revenues, it will report a loss.
Does the entity rely mainly on debt or equity to finance its assets?	Statement of financial position	The statement of financial position reports the entity's resources and claims to those resources. There are two types of claims: liabilities and equity.	Compare the amount of liabilities (debt) with the amount of equity to determine whether the entity relies more on creditors or owners for its financing.
Does the entity generate sufficient cash from operations to fund its investing activities?	Statement of cash flows	The statement of cash flows shows the amount of cash provided or used by operating activities, investing activities and financing activities.	Compare the amount of cash provided by operating activities with the amount of cash used by investing activities. Any deficiency in cash from operating and investing activities must be made up with cash from financing activities.
Is the entity using its assets effectively?	Profit and average assets	$\text{Return on assets} = \dfrac{\text{Profit}}{\text{Average total assets}}$	Higher value suggests efficient use of assets.
Is the entity maintaining an adequate margin between sales and expenses?	Profit and net sales	$\text{Profit margin} = \dfrac{\text{Profit}}{\text{Net sales}}$	Higher value suggests favourable return on each dollar of sales.
Can the entity meet its short-term obligations?	Current assets and current liabilities	$\text{Current ratio} = \dfrac{\text{Current assets}}{\text{Current liabilities}}$	Higher ratio indicates more favourable liquidity.
Can the entity meet its short-term obligations?	Current liabilities and cash provided by operating activities	$\text{Current cash debt coverage} = \dfrac{\text{Cash provided by operations}}{\text{Average current liabilities}}$	A higher value indicates more favourable liquidity.
Can the entity meet its long-term obligations?	Total liabilities and total assets	$\text{Debt to total assets ratio} = \dfrac{\text{Total liabilities}}{\text{Total assets}}$	A higher ratio indicates solvency risk because the entity has fewer assets available for creditors.
Can the entity meet its long-term obligations?	Total liabilities and cash provided by operating activities	$\text{Cash debt coverage} = \dfrac{\text{Cash provided by operations}}{\text{Average current liabilities}}$	A higher ratio indicates better solvency as the entity is generating cash to meet its long-term needs.

USING THE DECISION-MAKING TOOLKIT

Roaming Limited operates in the travel and leisure industry. Assume that you are considering the purchase of shares in Roaming.

Required

Answer these questions related to your decision whether to invest.

(a) What financial statements should you be interested in?

(b) What should these financial statements tell you?

(c) Should you request audited financial statements? Explain.
(d) Will the financial statements show the market value of Roaming's assets? Explain.
(e) Compare Roaming's profit for 2022 with its profit for 2021. The statement of profit or loss with comparative 2021 figures is provided in figure 1.33.

FIGURE 1.33 Roaming's statement of profit or loss

ROAMING LIMITED
Statement of profit or loss (extract)
for the year ended 30 June 2022

	Consolidated	
	2022 $'000	2021 $'000
REVENUE FROM CONTINUING OPERATIONS		
Revenue from the sale of travel services	778 950	695 491
Other revenue from ordinary activities	20 000	15 200
Total for revenue from continuing operations	798 950	710 691
OTHER INCOME	3 230	1 470
EXPENSES		
Selling expenses	(611 670)	(554 240)
Administration/support expenses	(85 457)	(58 278)
Finance costs	(13 282)	(13 585)
Share of loss of joint venture accounted for using the equity method	(463)	(415)
Profit before income tax expense	**91 308**	**85 643**
Income tax expense	(27 392)	(25 693)
Profit attributable to members of Roaming Limited	**63 916**	**59 950**

(f) How much of Roaming's assets were financed by creditors at 30 June 2022? Roaming's statement of financial position is shown in figure 1.34.

FIGURE 1.34 Roaming's statement of financial position

ROAMING LIMITED
Statement of financial position (extract)
as at 30 June 2022

	Consolidated	
	2022 $'000	2021 $'000
ASSETS		
Current assets		
Cash and cash equivalents	261 843	240 357
Available for sale financial assets	204 831	—
Receivables	244 987	211 200
Other financial assets	—	192 738
Current tax receivables	5 596	—
Assets of disposal group classified as held for sale	12 179	—
Total current assets	729 436	644 295
Non-current assets		
Property, plant and equipment	78 486	91 239
Intangible assets	207 431	165 671
Deferred tax assets	13 206	15 998
Other financial assets	—	—
Investments accounted for using the equity method	2 248	2 750
Total non-current assets	301 371	275 658
Total assets	1 030 807	919 953

LIABILITIES		
Current liabilities		
Payables	465 000	424 942
Borrowings	43 662	37 793
Provisions	3 400	3 116
Current tax liabilities	2 533	3 144
Total current liabilities	514 595	468 995
Non-current liabilities		
Payables	34 682	17 844
Borrowings	27 000	15 000
Deferred tax liabilities	378	1 025
Provisions	8 442	8 729
Total non-current liabilities	70 502	42 598
Total liabilities	585 097	511 593
Net assets	**445 710**	**408 360**
EQUITY		
Share capital	260 000	260 000
Reserves	7 770	4 940
Retained earnings	177 940	143 420
Total equity	**445 710**	**408 360**

(g) Did Roaming generate sufficient cash flows from its operating activities to finance its investing activities in 2022? A simplified statement of cash flows is provided in figure 1.35.

FIGURE 1.35 Roaming's statement of cash flows

ROAMING LIMITED
Statement of cash flows
for the year ended 30 June 2022

	2022 $'000	2021 $'000
Net cash inflow from operating activities	122 974	117 596
Net cash (outflow) from investing activities	(62 497)	(22 970)
Net cash (outflow) from financing activities	(38 991)	(97 433)
Net increase (decrease) in cash held	**21 486**	**(2 807)**

(h) Calculate Roaming's return on assets for 2022 and profit margin for 2022 and 2021. Has profitability improved in the 2-year period?
(i) Calculate Roaming's current ratio for 2022 and 2021 and the current cash debt coverage for 2022. Does Roaming have liquidity problems?
(j) Calculate Roaming's debt ratio for 2022 and 2021 and the cash debt coverage for 2022. Has solvency improved since 2021?
(k) What other information would be useful to review when looking at Roaming's operations?

(*Using the decision-making toolkit* exercises ask you to use information from financial statements to make financial decisions. We encourage you to think through the questions related to the decision before you study the solution.)

Solution

(a) Before you invest, you should investigate the statement of profit or loss, statement of financial position and statement of cash flows.
(b) You would probably be most interested in the statement of profit or loss because it tells about past performance and thus gives an indication of future performance. The statement of cash flows reveals where the entity is getting and spending its cash. This is especially important for an entity that wants to grow. Finally, the statement of financial position reveals the types of assets and liabilities and the relationship between assets and liabilities.
(c) You would want audited financial statements — statements that an independent accountant has examined and expressed the opinion that the statements present fairly the entity's financial position and results of operations. Investors and creditors should not make decisions without studying audited financial statements of entities required to appoint auditors.
(d) The financial statements will not show the market value of all of the entity's assets. One important principle of accounting is the historical cost principle, which states that assets should be recorded at historical cost. Historical cost has an important advantage over other valuations: it is objective and reliable.

(e) Roaming's profit for 2022 is $63 916 000, an increase of $3 966 000 on the 2021 profit of $59 950 000. This is a 6.6% increase. Revenue from the sale of travel services increased 12%, but during the year there was an expansion in the corporate travel service network to internationalise the business and added costs came with this expansion. The future aims are to reduce global costs and improve the profit margin.

(f) Roaming's debt ratio at 30 June 2022 was 0.57:1 or 57%, indicating that 57 cents of every dollar of assets was financed by creditors. The debt ratio is calculated as total liabilities divided by total assets ($585 097 000/$1 030 807 000).

(g) Roaming generated net cash flows of $122 974 000 from its operations in 2022 and spent $62 497 000 (net) on investing activities that year, so there were sufficient cash flows from operations to finance the investing activities.

(h) The return on assets for 2022 is 0.066 or 6.6% [$63 916 000/($1 030 807 000 + $919 953 000)/2]. The profit margin for 2022 was 0.08 or 8% ($63 916 000/$798 950 000) and for 2021 it was 0.084 or 8.49% ($59 950 000/$710 691 000). Thus, profitability decreased marginally in 2022.

(i) Roaming's current ratio was 1.42:1 ($729 436 000/$514 595 000) in 2022 and 1.37:1 ($644 295 000/$468 995 000) in 2021. The current cash debt coverage for 2022 was 0.25 or 25% [$122 974 000/($514 595 000 + $468 995 000)/2]. Roaming generated positive net cash flows from operating activities in 2022 and 2021. The current ratio improved only slightly during the year. The improvement was because of a growth in cash and trade receivables. However, the current cash coverage is only 0.25, which is below the general rule of thumb of 0.40, so the actual liquidity should be investigated.

(j) Roaming's debt ratio for 2022 was 57%, as calculated in part (f), and 0.556 or 55.6% for 2021 ($511 593 000/ $919 953 000). This indicates that solvency hasn't changed from 2021 to 2022. The cash debt coverage for 2022 was 0.224 or 22.4% [$122 974 000/($585 097 000 + $511 593 000)/2]. A ratio of 0.20 times is the bare minimum, so the cash debt coverage indicates barely adequate solvency and should be monitored, as most of the liabilities are current (short term).

(k) Other useful information would be information from the company such as directors' reports and media releases; intercompany comparisons with a competitor in the same industry; information on general economic conditions; and industry trends or averages.

SUMMARY

1.1 Explain the business context and the need for decision making.

Accounting provides an economic model of the business world. It plays a key role in the provision of financial information for decisions made by people inside and outside the business. The process of decision making is first to identify the issue or the decision to be made. The next step is to gather the relevant information required for the analysis. Once gathered, you then identify the tool or technique that can provide the analysis of the issue so a decision may be made. The final step is to evaluate the results of the analysis and make the decision.

1.2 Define accounting, describe the accounting process and define the diverse roles of accountants.

Accounting is the process of identifying, measuring, recording and communicating the economic transactions and events of a business operation to provide reliable and relevant financial information for decision making. Accountants practise accounting in four main areas: commercial accounting, public accounting, government and not-for-profit accounting.

1.3 Explain the characteristics of the main forms of business organisation.

A sole proprietorship is a business owned by one person. A partnership is a business owned by two or more people. A company is a separate legal entity for which evidence of ownership is provided by shares. Other forms include trusts, cooperatives and not-for-profit forms. A trust is a relationship or association between two or more parties whereby one party holds property in trust for the other. A cooperative is a form of business organisation which is member-owned, controlled and used. It must consist of five or more people. The not-for-profit sector includes clubs, charities and the government sector.

1.4 Understand the *Conceptual Framework* and the purpose of financial reporting.

The *Conceptual Framework* consists of a set of concepts to be followed by preparers of financial statements and standard setters. A reporting entity is defined as an entity for which it is reasonable to expect the existence of users who depend on general purpose financial reports for information to enable them to make economic decisions. It is important to determine whether an organisation is a reporting entity as reporting entities must prepare external general purpose financial reports that comply with accounting standards. Reporting entities tend to be larger organisations and the financial information provided in external general purpose financial reports tends to be quite condensed. Both reporting and non-reporting entities also prepare internal reports which have more detailed information. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential equity investors, lenders and other creditors in making their decisions about providing resources to the entity.

1.5 Identify the users of financial reports and describe users' information needs.

Internal users are managers who need accounting information for planning, controlling and evaluating business operations. The main external users are investors and creditors. Investors (shareholders) use accounting information to help them decide whether to buy, hold or sell shares. Creditors (suppliers and bankers) use accounting information to assess the risk of granting credit or lending money to a business. Other groups who have an indirect interest in a business are customers and regulatory agencies. Users of financial reports are interested in information about financing activities, which involve collecting the necessary funds to support the business; investing activities, which involve acquiring the resources necessary to run the business; and operating activities, which involve putting the resources of the business into action to generate a profit.

1.6 Identify the elements of each of the four main financial statements.

A statement of profit or loss presents the income (revenues and gains) and expenses of an entity for a specific period of time. A statement of changes in equity reports the amount of comprehensive income for the period and other changes in equity. A statement of financial position reports the assets, liabilities and equity of a business at a specific date. A statement of cash flows summarises information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.

1.7 Describe the financial reporting environment.

The Corporations Act regulates the activities of companies. ASIC administers the Corporations Act. The financial reporting regulations are contained in the Australian accounting standards. The FRC oversees the AASB and advises the Commonwealth Government on the standard-setting process and developments in international standard setting. The AASB issues accounting standards that certain entities, such as listed companies, must apply when preparing published financial statements. Listed companies must also comply with additional financial reporting requirements of the Australian Securities Exchange. Key professional bodies include CPA Australia, Chartered Accountants Australia and New Zealand and IPA. The accounting standards issued by both the Australian and New Zealand standard-setting bodies are consistent with those issued by IASB and are commonly referred to as IFRS.

1.8 Explain the accounting assumptions, concepts, principles, qualitative characteristics and constraints underlying financial statements.

The basic accounting assumptions, concepts and principles are the monetary principle, the accounting entity concept, the accounting period concept, the going concern assumption, the historical cost principle and the full disclosure principle. The *Conceptual Framework* states that for information included in general purpose financial reports to be useful it must be relevant and provide a faithful representation of the economic phenomena it represents. Relevance and faithful representation are therefore classified as fundamental qualitative characteristics. Enhancing qualitative characteristics include comparability, verifiability, timeliness and understandability and are used to distinguish more useful information from less useful information. Cost is the constraint that limits the information provided by financial reporting.

1.9 Calculate and interpret ratios for analysing an entity's profitability, liquidity and solvency.

Profitability ratios, such as profit margin and return on assets, measure different aspects of the operating success of an entity for a given period of time. Liquidity ratios, such as the current ratio, measure an entity's short-term ability to pay its maturing obligations and to meet unexpected needs for cash. The current cash debt coverage is another measure of an entity's liquidity. Solvency ratios, such as the debt to total assets ratio and the cash debt coverage, measure an entity's ability to survive in the long term.

KEY TERMS

accounting The process of identifying, measuring, recording and communicating the economic transactions and events of a business operation.

accounting entity concept A concept that every entity can be separately identified and accounted for. Economic events can be identified with a particular unit of accountability, so that financial statements are prepared from the perspective of the entity, not its owners or other parties.

accounting period concept An accounting concept that the economic life of an entity can be divided into discrete periods of time and that useful reports covering those periods can be prepared by the entity.

accounts receivable Amounts due from customers for the sale of goods or services on credit. Also called debtors or trade debtors.

annual report A report prepared by corporate management that presents financial information including financial statements, notes and the directors' report.

assets Present economic resources controlled by an entity as a result of past events. An economic resource is the right that has the potential to produce economic benefits.

associations Small, non-profit, community-based groups. Associations can be, but are not always, incorporated as an alternative to a company. An incorporated association has similar advantages to a company but is not as expensive to set up or maintain. An association can trade as a profit organisation, but this cannot be its main objective.

audit An audit is an independent examination of the accounting data presented by an entity in order to provide an opinion as to whether the financial statements fairly present the results of the operation and the entity's financial position.

Auditing and Assurance Standards Board (AUASB) The organisation with authority to issue auditing and assurance standards for use by auditors and providers of other assurance services.

auditor An accountant who conducts an independent examination of the accounting data presented by the entity and expresses an opinion as to the fairness of the presentation of an entity's financial position and results of operations, and the entity's conformance with accounting standards.

Australian Accounting Standards Board (AASB) The organisation with authority to issue accounting standards in Australia.

Australian Securities and Investments Commission (ASIC) The body that administers the Corporations Act.

basic accounting equation Assets = Liabilities + Equity.

bookkeeping The activities of identifying, measuring and recording the business information are commonly referred to as bookkeeping. Bookkeeping forms the foundation of the activities underlying accounting.

cash debt coverage A cash-basis ratio used to evaluate solvency, calculated as net cash provided by operating activities divided by average total liabilities.

chief financial officer (CFO) A senior manager in an organisation who directs the accounting operations.

classified statement of financial position A statement of financial position in which assets and liabilities are classified as current and non-current.

commercial accountants Commercial accountants work in industry and commerce in different roles such as management accounting and financial accounting.

company A company or corporation is a separate legal entity formed under the Corporations Act. The process of setting up a company is called incorporation. The owners of a company are called shareholders.

comparability Ability to compare the accounting information of different entities or the same entity over time because the same accounting measurement and principles are used.

Conceptual Framework The conceptual framework consists of a set of concepts to be followed by the preparers of financial statements and standard setters.

cooperative A form of business organisation which is member-owned, controlled and used. It must consist of five or more people. Cooperatives are legislated at state level. They are distinctive for fostering a highly participative and democratic style of work, pooling resources to be more competitive and sharing skills.

corporate governance statement A separate section of a company's annual report containing disclosures relating to the extent to which the company has followed the ASX's corporate governance principles and recommendations.

cost constraints A constraint on the pursuit of qualitative characteristics of financial reporting so that the costs of preparing and reporting financial information does not exceed the benefits to users.

current assets Cash and other assets that are reasonably expected to be converted to cash or used in the business within 1 year or the operating cycle, whichever is longer.

current cash debt coverage A cash-basis ratio used to evaluate liquidity, calculated as net cash provided by operating activities divided by average current liabilities.

current liabilities Obligations reasonably expected to be paid within the next year or operating cycle, whichever is longer, e.g. wages payable or loan payable.

current ratio A measure used to evaluate an entity's liquidity and short-term debt-paying ability, calculated as current assets divided by current liabilities.

debt to total assets ratio Measures the percentage of total financing provided by creditors; calculated as total liabilities divided by total assets.

decision A choice among alternative courses of action.

directors' report A section of the annual report that provides information about the directors and their views on the company's performance.

dividends A distribution of profits by a company to its shareholders in an amount proportional to each shareholder's percentage ownership. The most common form is a cash distribution.

end of the reporting period The last date of each reporting period.

equity The residual interest in the assets of the entity after deducting all its liabilities; also known as shareholders' or owners' equity.

expenses Assets consumed or services used in the process of generating revenues, and losses incurred.

External Reporting Board (XRB) An independent New Zealand Crown Entity that sets accounting and auditing standards in New Zealand.

faithful representation Information is a faithful representation of the economic phenomena it purports to represent if it is complete, neutral and free from material error.

financial accounting The preparation and presentation of financial reports for external users.

Financial Reporting Council (FRC) Body that oversees the AASB.

financial statements Section in the annual report that contains the summarised financial information of an entity prepared in accordance with applicable accounting standards.

full disclosure principle Accounting principle dictating that circumstances and events that make a difference to financial statement users should be disclosed.

general purpose financial reports Financial reports intended to meet the information needs of users who are unable to command reports to suit their specific needs.

generally accepted accounting principles (GAAP) A set of rules and practices, having substantial authoritative support, that are recognised as a general guide for financial reporting purposes. In New Zealand GAAP stands for generally accepted accounting *practices*.

going concern assumption States that the financial statements are prepared on a going concern basis unless management either intends to or must liquidate the business or cease trading.

government accountants Are employed within government enterprises and engage in a variety of roles and activities, such as financial accounting and auditing.

historical cost principle All assets are initially recorded in the accounts at their purchase price or cost.

intangible assets Identifiable non-monetary assets that have no physical substance (e.g. patents and copyrights).

International Accounting Standards Board (IASB) The organisation with the authority to issue international financial reporting standards (IFRS).

investors People who make decisions to buy, hold or sell shares.

lenders Suppliers, bankers and others who grant credit or lend money.

liabilities Present obligations of the entity to transfer economic resources as a result of past events.

limited liability The limit of liability of owners of a company to any unpaid amount of capital.

liquidity The ability of an entity to pay obligations that are expected to become due within the next year or operating cycle.

liquidity ratios Measures of the short-term ability of an entity to pay its maturing obligations and to meet unexpected needs for cash.

loss The amount by which expenses exceed revenues and gains.

management accounting A field of accounting that provides economic and financial information for managers and other internal users.

materiality The condition on reporting information if its omission or misstatement could influence the decisions of users of financial reports.

measurement The process of determining the monetary amounts at which the elements of the financial reports are to be recognised and carried in the statement of financial position and the statement of profit or loss.

monetary principle A principle stating that the items included in an entity's accounting records must be able to be expressed in monetary terms.

non-current assets Assets that are not expected to be consumed or sold within 1 year or the operating cycle and have not been purchased for trading purposes.

non-current liabilities Liabilities that are not expected to be paid within 1 year or the operating cycle, e.g. mortgage payable.

not-for-profit accountants Accountants working in the not-for-profit sector who engage in many activities including planning, decision making, and preparing financial and management reports for both internal and external users.

not-for-profit entity A not-for-profit entity focuses on successfully fulfilling its mission and administrative goals, rather than focusing on making a profit. Not-for-profit entities include public hospitals, clubs, some schools and charities.

notes to the financial statements Notes that clarify information presented in the financial statements, as well as expand on information where additional detail is needed.

operating cycle The length of time it takes for a business to acquire goods, sell them to customers and collect the cash from the sale.

ordinary shares Shares representing the residual ownership interests in a company.

partnership A business relationship or association between two or more people or entities carrying on a business in common with a view to making a profit.

profit The amount by which revenues and gains exceed expenses.

profit margin A measure of the profit generated by each dollar of sales, calculated as profit divided by net sales.

profitability ratios Measures of the profit or operating success of an entity for a given period of time.

property, plant and equipment Tangible assets that have physical substance, are used in the operations of the business for more than one period, and are not intended for sale to customers (e.g. land and buildings).

public accountants Accountants who provide their professional services to the public. They can practise in business organisations that range from small, single-person run offices to very large organisations, with branches all over the world and thousands of employees.

public sector The public sector is also called the government sector. The distinguishing feature is that the organisations are owned by the government, whether it be federal, state or local.

ratio An expression of the mathematical relationship between one quantity and another; may be expressed as a percentage, a rate or a proportion.

ratio analysis A technique for evaluating financial statements that expresses the relationship among selected financial statement data.

relevant Accounting information is considered to be relevant if the information makes a difference to a decision.

reporting entity An entity in which it is reasonable to expect the existence of users who depend on general purpose financial reports for information to enable them to make economic decisions.

retained earnings The accumulated profit from the current and previous accounting periods that has not been distributed to owners.

return on assets (ROA) An overall measure of profitability, calculated as profit divided by average total assets.

revenues Sales and other increases in equity that arise from the ordinary activities of an entity.

share capital The total amount paid in by shareholders for shares in the company. Alternative terminology includes: paid-up capital, issued capital and contributed equity.

shareholders The owners of a company are called shareholders and their ownership interests are represented by the number of shares they own in the company.

sole proprietorship A business owned by one person.

solvency An entity's ability to pay interest as it comes due and to repay the face value of debt at maturity.

solvency ratios Measures of the ability of the entity to survive over a long period of time.

statement of cash flows A basic financial statement that provides information about the cash receipts and cash payments of an entity during a period, classified as operating, investing and financing activities, in a format that reconciles the beginning and ending cash balances.

statement of changes in equity A statement that reports the amount of total comprehensive income for the period and all other changes in equity.

statement of financial position A statement that reports on the assets, liabilities and equity of an entity at a specific date.

statement of profit or loss A statement that reports revenues, gains and expenses, and the resulting profit or loss; previously known as the statement of financial performance or the profit and loss statement.

sustainability Making sure social, economic and environmental factors are considered and kept healthy for future generations.

timeliness Whether the communication of financial information is in the time frame within which decisions are made.

transactions Economic activities relevant to a particular business, such as the sale of a good to a customer or the purchase of office stationery from a supplier. Transactions are the basic inputs into the accounting process.

trust A relationship or association between two or more parties whereby one party holds property in trust for the other, i.e. they are vested with the property.

understandability The extent to which information can be understood by proficient users.

unlimited liability Like a sole proprietorship structure, a partnership has unlimited liability, so each partner is personally liable for all the debts of the partnership even if they are caused by decisions made by other partners.

verifiability The extent to which independent observers could reach a consensus that a particular depiction is a faithful representation of the economic phenomena it is meant to represent.

working capital The difference between the amounts of current assets and current liabilities.

DEMONSTRATION PROBLEM

Jeff Andringa, a former Aussie Rules player, quit his job and started Footy Camp, a football camp for children aged 8 to 17. Eventually he would like to open football camps nationwide. Jeff has asked you to help him prepare financial statements at the end of his first year of operations. He relates the following facts about his business activities.

In order to get the business off the ground, he decided to incorporate. He issued shares in Footy Camp Pty Ltd to a few close friends, as well as buying some of the shares himself. He initially raised $75 000 through the issue of these shares. In addition, the company took out a $100 000 loan at a local bank. A bus for transporting children was purchased for $40 000 cash. Balls and other miscellaneous equipment were purchased with $3000 cash. The company earned camp fees during the year of $200 000, but had collected only $140 000 of this amount. Thus, at the end of the year it was still owed $60 000. The company rents time at a local school oval for $150 per day. Total oval rental costs during the year were $8000, insurance was $20 000, salary expense was $45 000, and administrative expenses totalled $15 700, all of which were paid in cash. The company incurred $2000 in interest expense on the bank loan; the interest was still owed at the end of the year.

The company paid dividends during the year of $16 000 cash. The balance in the company's bank account at the end of the year, 30 June 2022, was $167 300.

Required

Using the format of Wong Pty Ltd's statements, prepare a statement of profit or loss, a statement of changes in equity (retained earnings section only), a statement of financial position and a statement of cash flows. (*Hint:* Prepare statements in this order to take advantage of the flow of information from one statement to the next — see figure 1.7.) Ignore depreciation and tax for this problem.

(*Demonstration problems* are a final review before you begin homework. Problem-solving strategies that appear before the solution give you tips about how to approach the problem and the solution provided illustrates both the form and content of complete answers.)

PROBLEM-SOLVING STRATEGIES

From the information given you need to identify which reports the items are entered in to.

1. The statement of profit or loss shows revenues and expenses for a period of time. Revenues are reported when billed or the invoice is prepared.
2. The statement of changes in equity reports the amount of profit for a period of time and other changes in equity. The calculation of the movement in retained earnings was required here and the ending balance is entered into the equity section of the statement of financial position together with the shares issued at the beginning of the period.
3. The statement of financial position reports assets, liabilities and equity at a specific date.
4. The statement of cash flows reports sources and uses of cash from operating, investing and financing activities for a period of time. This statement reports only the actual cash flows and the ending balance of the cash is also reported in the statement of financial position.

SOLUTION TO DEMONSTRATION PROBLEM

FOOTY CAMP PTY LTD
Statement of profit or loss
for the year ended 30 June 2022

REVENUES		
Camp fees revenue		$200 000
EXPENSES		
Salaries expense	$45 000	
Insurance expense	20 000	
Administrative expenses	15 700	
Oval rental expense	8 000	
Interest expense	2 000	
Total expenses		90 700
Profit		**$109 300**

FOOTY CAMP PTY LTD **Calculation of retained earnings** for the year ended 30 June 2022	
Retained earnings, 1 July 2021	$ —
Profit	109 300
Less: Dividends	(16 000)
Retained earnings, 30 June 2022	**$ 93 300**

FOOTY CAMP PTY LTD **Statement of financial position** as at 30 June 2022		
ASSETS		
Cash		$167 300
Accounts receivable		60 000
Bus		40 000
Equipment		3 000
Total assets		270 300
LIABILITIES		
Bank loan payable	$100 000	
Interest payable	2 000	
Total liabilities		102 000
Net assets		**$168 300**
EQUITY		
Share capital		$ 75 000
Retained profits		93 300
Total equity		**$168 300**

FOOTY CAMP PTY LTD **Statement of cash flows** for the year ended 30 June 2022		
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts from operating activities	$140 000	
Cash payments for operating activities	(88 700)	
Net cash provided by operating activities		$ 51 300
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of bus	(40 000)	
Purchase of equipment	(3 000)	
Net cash used by investing activities		(43 000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from bank loan	100 000	
Issue of shares	75 000	
Dividends paid	(16 000)	
Net cash provided by financing activities		159 000
Net increase in cash		167 300
Cash at beginning of period		—
Cash at end of period		**$167 300**

SELF-STUDY QUESTIONS

1.1 The steps, in order, in the decision-making process are: **LO1**
(a) identify issue; analyse information; gather information; identify decision-making tool; evaluate results; make a decision.
(b) gather information; identify decision-making tool; identify issue; evaluate results; analyse information; make a decision.
(c) identify issue; gather information; identify decision-making tool; analyse information; evaluate results; make a decision.
(d) gather information; identify issue; identify decision-making tool; evaluate results; analyse; make a decision.

1.2 Accounting is the process of: **LO2**
(a) recognising, measuring, recording and communicating.
(b) identifying, measuring, recording and communicating.
(c) identifying, recording, classifying and communicating.
(d) analysing, identifying, recording and interpreting.

1.3 Which of the following is not a typical accountant's role? **LO2**
(a) A financial controller.
(b) A marketing manager.
(c) An auditor.
(d) All of the above are roles of an accountant.

1.4 Which is not one of the three main forms of business organisation? **LO3**
(a) Sole proprietorship.
(b) Unincorporated trust.
(c) Partnership.
(d) Company.

1.5 Which is an advantage of companies relative to partnerships and sole proprietorships from the perspective of owners? **LO3**
(a) Separation of ownership and control.
(b) Harder to transfer ownership.
(c) Reduced legal liability.
(d) Most common form of organisation.

1.6 Which is *not* an indicator that the entity is a reporting entity? **LO4**
(a) Separation of ownership from management.
(b) It has substantial borrowings.
(c) It trades overseas.
(d) It is economically important.

1.7 Which of the following statements concerning general purpose financial reports is correct? **LO5**
(a) General purpose financial reports are more detailed than the internal reports.
(b) General purpose financial reports are prepared in accordance with accounting standards.
(c) General purpose financial reports are the only accounting reports entities prepare.
(d) Government enterprises do not need to prepare general purpose financial reports.

1.8 Which is *not* one of the three main business activities? **LO5**
(a) Financing.
(b) Operating.
(c) Advertising.
(d) Investing.

1.9 Which statement about users of accounting information is *incorrect*? **LO6**
(a) Management is considered an internal user.
(b) Taxing authorities are considered external users.
(c) Present creditors are considered external users.
(d) Regulatory authorities are considered internal users.

1.10 Profit will result when: **LO6**
(a) assets exceed liabilities.
(b) assets exceed revenues.
(c) expenses exceed revenues.
(d) revenues exceed expenses.

1.11 What section of a statement of cash flows indicates the cash spent on new equipment during the past accounting period? **LO6**
(a) The investing section.
(b) The operating section.
(c) The financing section.
(d) The statement of cash flows does not give this information.

1.12 Which financial statement reports income and expenses? **LO6**
(a) Statement of changes in equity.
(b) Statement of profit or loss.
(c) Statement of financial position.
(d) Statement of cash flows.

1.13 The amount of retained earnings is not affected by: **LO6**
(a) profit.
(b) loss.
(c) the issue of shares.
(d) dividends.

1.14 In a classified statement of financial position, liabilities are usually classified as: **LO6**
(a) current liabilities and overdraft.
(b) current liabilities, non-current liabilities and equity.
(c) current liabilities and non-current liabilities.
(d) current liabilities and intangible liabilities.

1.15 As of 31 December 2021, Smithers Pty Ltd has assets of \$7500 and equity of \$3000. What are the liabilities for Smithers Pty Ltd as of 31 December 2021? **LO5**
(a) \$10 500.
(b) \$4500.
(c) \$7500.
(d) \$3000.

1.16 The AASB is overseen by: **LO7**
(a) ASIC.
(b) the IASB.
(c) the FRC.
(d) the ASX.

1.17 Generally accepted accounting principles are: **LO7**
(a) a set of standards and rules that are recognised as a general guide for financial reporting.
(b) usually established by the Australian Taxation Office.
(c) the guidelines used to resolve ethical dilemmas.
(d) fundamental truths that can be derived from the laws of nature.

1.18 What organisation issues Australian accounting standards? **LO7**
(a) Australian Accounting Standards Board.
(b) External Reporting Board.
(c) Australian Securities and Investments Commission.
(d) None of the above.

1.19 What organisation issues New Zealand accounting standards? **LO7**
(a) New Zealand Institute of Chartered Accountants.
(b) New Zealand Inland Revenue.
(c) External Reporting Board.
(d) None of the above.

1.20 Which of the following is a main qualitative characteristic of information reported in financial statements in accordance with the *Conceptual Framework*? **LO8**
(a) Comparability.
(b) Understandability.
(c) Relevance.
(d) Confidentiality.

1.21 Cost measurement means that: **LO8**
(a) assets should be recorded at cost and adjusted when the market value changes.
(b) activities of an entity should be kept separate and distinct from its owner.
(c) assets should be recorded at their cost.
(d) only transaction data capable of being expressed in terms of money should be included in the accounting records.

1.22 Valuing assets at their market value rather than at their cost is inconsistent with the: **LO8**
(a) accounting period concept.
(b) accounting entity concept.
(c) historical cost principle.
(d) All of the above.

1.23 Which is *not* an indicator of profitability? **LO9**
(a) Current ratio.
(b) Profit margin.
(c) Profit.
(d) Return on assets.

1.24 For 2022 Carman Ltd reported profit $48 000; net sales $400 000; and average assets $800 000. What was the 2022 profit margin? **LO9**
(a) 6%.
(b) 12%.
(c) 40%.
(d) 200%.

1.25 Which of these measures is an evaluation of an entity's ability to pay current liabilities? **LO9**
(a) Profit margin.
(b) Current ratio.
(c) Both (a) and (b).
(d) None of the above.

QUESTIONS

1.1 Describe the decision-making process.
1.2 What are some of the financial decisions owners need to make when running a new business?
1.3 What are some of the financial decisions owners need to make when running a new business?
1.4 Who are the external users of accounting data? Give examples.
1.5 Listed here are some items found in the financial statements of Ruth Weber Ltd. Indicate in which financial statement(s) each item would appear.
(a) Sales revenue.
(b) Office equipment.
(c) Accounts receivable.
(d) Interest expense.
(e) Share capital.
(f) Loan payable.
1.6 What is a conceptual framework and what purpose does it serve?
1.7 Why is it important to determine if a business entity is a reporting entity? Outline the three main indicators that determine if an entity is a reporting entity.
1.8 What are the three main categories of the statement of cash flows? Why do you think these categories were chosen?
1.9 What is retained earnings? What items increase the balance in retained earnings? What items decrease the balance in retained earnings?
1.10 What purpose does the going concern assumption serve?
1.11 Shirl Lee, the managing director of Whitegoods Pty Ltd, is pleased. Whitegoods substantially increased its profit in 2021 while keeping its unit inventory relatively the same. Rose Ena, chief accountant, cautions Shirl Lee, explaining that since Whitegoods changed its method of inventory valuation, there is a comparability problem and it is difficult to determine whether Whitegoods is better off. Is Rose correct? Why or why not?
1.12 What is meant by the term *operating cycle*?
1.13 (a) Tia Kim believes that the analysis of financial statements is directed at two characteristics of an entity: liquidity and profitability. Is Tia correct? Explain.
(b) Are short-term creditors, long-term creditors, and shareholders mainly interested in the same characteristics of an entity? Explain.
1.14 Holding all other factors constant, indicate whether each of the following signals generally good or bad news about an entity.
(a) Increase in the profit margin.
(b) Increase in the current ratio.
(c) Decrease in the debt to total assets ratio.
(d) Increase in the current cash debt coverage.

BRIEF EXERCISES

BE1.1 Explain the characteristics of the main forms of business organisation. LO3
Match each of the following forms of business organisation with a set of characteristics: sole proprietorship (SP), partnership (P), company (C).
(a) ______________ Shared control, increased skills and resources.
(b) ______________ Simple to set up and maintains control with founder.
(c) ______________ Easier to transfer ownership and raise funds, no personal liability.

BE1.2 Describe the financial reporting environment. LO7
Indicate whether each statement is *true* or *false*.
(a) Accounting standards are set by the Financial Reporting Council.
(b) The ASX Listing Rules are only applicable to entities listed on the ASX.
(c) The Corporations Act is administered by the ATO.

BE1.3 Identify users of accounting financial reports and describe their information needs. LO5
Match each of the following types of evaluation with one of the listed users of accounting information.
1. Trying to determine whether the company complied with the Corporations Act.
2. Trying to determine whether the entity can pay its obligations.
3. Trying to determine whether a major investment proposal will be cost-effective.
4. Trying to determine whether the company's profit will result in a share price increase.
5. Trying to determine whether the entity should use debt or equity financing.

(a) ___________Executive directors.
(b) ___________Bank managers.
(c) ___________Shareholders.
(d) ___________Chief financial officer.
(e) ___________Australian Securities and Investments Commission.

BE1.4 Prepare a statement of financial position. LO6
In alphabetical order below are items for ABC Pty Ltd at 31 December 2021. Prepare a statement of financial position following the format of figure 1.7.

Accounts payable	$ 32 500
Accounts receivable	10 000
Cash	30 000
Inventory	7 500
Share capital	15 000

BE1.5 Determine the proper financial statement. **LO6**
Indicate which statement you would examine to find each of the following items: statement of financial position (SFP), statement of profit or loss (P/L) or statement of cash flows (SCF).
(a) Revenues during the period.
(b) Accounts receivable at the end of the year.
(c) Cash received from borrowing during the period.
(d) Cash payments for the purchase of property, plant and equipment.

BE1.6 Prepare the assets section of a classified statement of financial position. **LO6**
A list of financial statement items for Swift Ltd includes the following: accounts receivable $15 000; prepaid rent $1000; cash $4500; supplies $2000; short-term investments $12 000; property, plant and equipment $40 000. Prepare the asset section of the statement of financial position, showing appropriate classifications.

BE1.7 Calculate return on assets and profit margin. **LO9**
The following information is available for Ware Ltd for 2021: sales revenue $7 840 000; cost of sales $3 528 000; profit $1 176 000; total equity $2 233 300; average total assets $5 113 000. Calculate the return on assets and profit margin for Ware Ltd for 2021.

EXERCISES

E1.1 Match items with descriptions. **LO1, 3, 5, 6**
Here is a list of words or phrases discussed in this chapter.
1. Auditor's opinion
2. Accounts payable
3. Accounts receivable
4. Sole trader
5. Partnership
6. Decision
7. Company
8. Equity investors
9. Share capital

Required
Match each word or phrase with the best description of it.
_______________ (a) An expression about whether financial statements are presented in a reasonable fashion.
_______________ (b) Obligations to suppliers of goods.
_______________ (c) The portion of equity that results from contributions from investors.
_______________ (d) An entity that raises money by issuing shares.
_______________ (e) Amounts due from customers.
_______________ (f) People who make decisions to buy, hold, or sell shares.
_______________ (g) A person operating and owning a business with no other owners.
_______________ (h) A business that is owned jointly by two or more individuals but that does not issue shares.
_______________ (i) A choice among alternative courses of action.

E1.2 Prepare a statement of profit or loss and a calculation of retained earnings. **LO6**
This information relates to Ray's Rentals Pty Ltd for the year 2021.

Retained earnings, 1 January 2021	$45 000
Advertising expense	1 800
Dividends paid during 2021	7 000
Rent expense	10 400
Hire revenue	70 000
Electricity expense	2 400
Wages expense	28 000
Share capital	40 000

Required
After analysing the data, prepare a statement of profit or loss and a calculation of retained earnings for the year ending 31 December 2021.

E1.3 Correct an incorrectly prepared statement of financial position. **LO6**
Deanna Veale is the bookkeeper for Quality Products Ltd. Deanna has been trying to make the statement of financial position of Quality Products Ltd balance. It is finally balanced, but now she's not sure it is correct.

QUALITY PRODUCTS LTD
Statement of financial position
as at 30 June 2021

ASSETS		LIABILITIES AND EQUITY	
Cash	$15 000	Accounts payable	$15 000
Supplies	5 600	Accounts receivable	(6 000)
Inventory	28 400	Share capital	25 000
Dividends	3 000	Retained earnings	18 000
Total assets	**$52 000**	**Total liabilities and equity**	**$52 000**

Required
Prepare a correct statement of financial position.

E1.4 Identify financial statement components and calculate profit. **LO6**

The following items were taken from White Ltd's financial statements for 2021. (All dollars are in thousands.)

______________	Retained earnings	$ 2 000	______________	Non-current borrowings	$ 22 000
______________	Cost of sales	55 700	______________	Inventories	4 500
______________	Wages expense	18 300	______________	Sales revenue	144 000
______________	Cash	11 200	______________	Accounts receivable	12 000
______________	Current payables	14 500	______________	Reserves	8 000
______________	Interest expense	8 000	______________	Income tax expense	13 700
______________	Other expense	10 300	______________	Contributed equity	30 000
______________	Depreciation	1 800	______________	Property and equipment	20 000

Required

Perform each of the following.

(a) In each case identify whether the item is an asset (A), liability (L), equity (Eq), revenue (R) or expense (Ex).

(b) Calculate profit for White Ltd for the year ended 30 June 2021.

E1.5 Calculate missing amounts. **LO6**

Here are incomplete financial statements for Road Ltd.

ROAD LTD **Statement of financial position**			
ASSETS		LIABILITIES AND EQUITY	
Cash	$ 10 500	Liabilities	
Inventory	15 500	Accounts payable	$ 26 000
Property	80 000	Equity	
		Contributed equity	(a)
		Retained earnings	(b)
Total assets	**$106 000**	**Total liabilities and equity**	**$106 000**

Statement of profit or loss	
Revenues	$200 000
Cost of sales	(c)
Administrative expenses, including tax	14 000
Profit	**$ (d)**

Statement of changes in equity	
Beginning retained earnings	$12 000
Profit	(e)
Less: Dividends	(8 000)
Ending retained earnings	**$45 000**

Required

Calculate the missing amounts.

E1.6 Identify the concept or principle that has been violated. **LO8**

Cheong Pty Ltd had three major business transactions during 2021.

(a) Merchandise inventory with a cost of $68 000 is reported at its market value of $100 000.

(b) The owner of Cheong Pty Ltd, Cheong Kong, purchased a computer for personal use and charged it to his expense account.

(c) Cheong Pty Ltd wanted to make its 2021 profit look better, so it added in sales that occurred on the first two days of 2022.

Required

In each situation, identify the assumption or principle that has been violated, if any, and discuss what should have been done.

E1.7 Classify items as current or non-current, and prepare assets section of statement of financial position. **LO6**

The following items were taken from the 30 June 2022 consolidated statement of financial position of Maximum Energy Limited. (All dollars are in millions.)

Inventories—current	$ 199.5	Intangibles	$4 724.1
Receivables—due after 30 June 2023	70.9	Other current assets	586.6
Oil and gas assets (non-current)	742.6	Property, plant and equipment	7 997.4
Investments (long term)	49.6	Cash and cash equivalents	421.5
Other long-term financial assets	507.7	Current receivables	2 766.0
Other financial assets (short term)	280.3	Other non-current assets	41.1
Deferred tax assets (non-current)	1 093.8	Exploration and evaluation assets (non-current)	523.5
		Inventories (non-current)	43.8

Required

Prepare the assets section of a classified statement of financial position.

E1.8 Classify items as current or non-current, and prepare the assets section of the statement of financial position. **LO6**

The following items were taken from the 30 June 2022 consolidated statement of financial position of Field Limited. (All dollars are in millions.)

Inventories	$ 138.9	Other current assets	$ 16.6
Trade and other receivables	182.9	Deferred tax assets (non-current)	57.1
Property, plant and equipment	521.5	Cash and cash equivalents	603.1
Other non-current assets	1.0	Current tax receivable	8.1
Intangible assets	1 410.5	Derivative financial instruments (current)	0.1
Investments in jointly controlled entities (non-current)	6.5	Receivable (non-current)	0.9
Assets held for sale (current)	1.9		

Required

Prepare the assets section of a classified statement of financial position.

E1.9 Prepare financial statements. **LO6**

These financial statement items are for Wellington Wall Coverings Pty Ltd at year-end, 31 July 2021.

Cost of sales	$ 60 000
Salaries expense	40 000
Other expenses	38 000
Building	140 000
Accounts payable	11 000
Sales revenue	100 000
Rent revenue	50 000
Rent revenue received in advance	2 000
Share capital	160 000
Cash	25 000
Bank loan	110 000
Accumulated depreciation	14 000
Land	120 000
Depreciation expense	7 000
Retained earnings (beginning of the year)	3 000
Inventory	20 000

Required

(a) Prepare a statement of profit or loss for the year.
(b) Prepare a classified statement of financial position at 31 July 2021.

E1.10 Identify financial statement components and calculate profit. **LO6**

These financial statement items are for Bear Pty Ltd at year-end, 30 June 2023.

Cost of sales	$ 84 000
Salaries expense	56 000
Other expenses	53 200
Building	196 000
Accounts payable	15 400
Sales revenue	140 000
Rent revenue	70 000
Rent revenue received in advance	2 800
Share capital	224 000
Cash	35 000
Bank loan	154 000
Accumulated depreciation	19 600
Land	168 000
Depreciation expense	9 800
Retained earnings (beginning of the year)	4 200
Inventory	28 000

Required

(a) Prepare a statement of profit or loss for the year.
(b) Prepare a calculation of retained earnings for the year.
(c) Prepare a classified statement of financial position at 30 June 2023.

E1.11 Calculate liquidity ratios and compare results. **LO9**

Retail Ltd operates stores in numerous states. Selected financial statement data (in thousands of dollars) for the year ended 30 June 2022 are as follows.

	End of year	Beginning of year
Cash	$ 8 995	$ 17 807
Receivables (net)	10 711	15 992
Merchandise inventory	184 872	187 890
Other current assets	3 848	1 624
Total current assets	$208 426	$223 313
Total current liabilities	$129 941	$169 549

For the year, net sales revenue was $1 109 934 and cost of sales was $628 197 (in thousands).

Required

(a) Calculate the working capital and current ratio at the beginning of the year and at the end of the current year.
(b) Did Retail Ltd's liquidity improve or worsen during the year?

E1.12 Calculate and interpret solvency ratios. **LO9**

The following data were taken from the 2022 financial statements of Energy Limited. (All dollars in millions.)

	2022	2021
Current assets	$ 2 838.0	$ 4 231.9
Total assets	13 367.8	15 738.4
Current liabilities	2 291.8	7 609.8
Total liabilities	9 026.8	8 605.5
Total equity	8 339.0	8 132.9
Cash provided by operating activities	621.8	467.5
Cash generated by (used in) investing activities	(559.6)	(532.3)

Required

Perform each of the following.

(a) Calculate the debt to assets ratio for each year.
(b) Calculate the cash debt coverage for each year. (Note: Total liabilities at year-end 2020 were $7804 million.)
(c) Discuss Energy Limited's solvency in 2022 versus 2021.
(d) Discuss Energy Limited's ability to finance its investment activities with cash provided by operating activities, and how any deficiency would be met.

E1.13 Calculate and interpret solvency ratios. **LO9**

The following data were taken from the 2022 financial statements of Oldfield Limited. (All dollars in millions.)

	2022	2021
Current assets	$ 726.4	$ 719.8
Total assets	2 756.8	2 694.8
Current liabilities	392.8	534.1
Total liabilities	1 324.5	1 328.7
Total equity	1 652.3	1 376.1
Cash provided by operating activities	188.7	130.0
Cash generated by (used in) investing activities	158.9	(85.6)

Required

Perform each of the following.

(a) Calculate the debt to assets ratio for each year.
(b) Calculate the cash debt coverage for each year. (Note: Total liabilities at year-end 2020 were $1405 million.)
(c) Discuss Oldfield Limited's solvency in 2022 versus 2021.
(d) Discuss Oldfield Limited's ability to finance its investment activities with cash provided by operating activities, and how any deficiency would be met.

PROBLEM SET A

PSA1.1 Determine forms of business organisation. **LO3**

Presented below are five independent situations.

(a) Three information systems lecturers have formed a business to improve the speed of information transfer over the internet for securities exchange transactions. Each has contributed an equal amount of cash and knowledge to the venture. Although their approach looks promising, they are concerned about the legal liabilities that their business might confront.
(b) Sarah and Andrew wish to purchase a taxi licence. One has a suitable motor vehicle and the other has enough cash to buy the licence.
(c) Robert Steven and Tom Cheng each owned separate shoe manufacturing businesses. They have decided to combine their businesses. They expect that within the coming year they will need significant funds to expand their operations.

(d) Darcy Becker, Ellen Sweet and Meg Dwyer recently graduated with marketing degrees. They have been friends since childhood. They have decided to start a consulting business focused on marketing sporting goods over the internet.
(e) Anthony Troy wants to rent CD players and CDs in airports across the country. His idea is that customers will be able to rent equipment and CDs at one airport, listen to the CDs on their flights, and return the equipment and CDs at their destination airport. Of course, this will require a substantial investment in equipment and CDs, as well as employees and locations in each airport. Anthony has no savings or personal assets. He wants to maintain control over the business.

Required

In each case explain what form of organisation the business is likely to take — sole proprietorship, partnership or company. Give reasons for your choice.

PSA1.2 Identify users and uses of financial statements. LO5

Financial decisions often place heavier emphasis on one type of financial statement over the others. Consider each of the following hypothetical situations independently.

(a) North Sales Ltd is considering extending credit to a new customer. The terms of the credit would require the customer to pay within 30 days of receipt of goods.
(b) An investor is considering purchasing shares in Giorgina's. The investor plans to hold the investment for at least 5 years.
(c) Otago Bank is considering extending a loan to a small company. The company would be required to make interest payments at the end of each year for 5 years, and to repay the loan at the end of the fifth year.
(d) The finance director of Pacific Pipes Ltd is trying to determine whether the company is generating enough cash to increase the amount of dividends paid to investors in this and future years, and still have enough cash to buy plant and machinery as needed.

Required

Although the decision makers should refer to all financial statements, for each situation, state whether the decision maker would be most likely to place the main emphasis on information provided by the statement of profit or loss, statement of financial position or statement of cash flows. In each case provide a brief justification for your choice. Choose only one financial statement in each case.

PSA1.3 Comment on proper accounting treatment and prepare a corrected statement of financial position. LO6, 8

Ultimo Travel Goods Pty Ltd was formed on 1 July 2021. At 30 June 2022, Mark Austin, the managing director and major shareholder, decided to prepare a statement of financial position, which appeared as follows.

ULTIMO TRAVEL GOODS PTY LTD
Statement of financial position
as at 30 June 2022

ASSETS		LIABILITIES AND EQUITY	
Cash	$ 20 000	Accounts payable	$ 40 000
Accounts receivable	55 000	Notes payable	15 000
Inventory	30 000	Bank loan	160 000
Villa	300 000	Equity	55 000

Mark willingly admits that he is not an accountant by training. He is concerned that his statement of financial position might not be correct. He has provided you with the following additional information:

1. The villa is on the Gold Coast and actually belongs to Mark, not to Ultimo Travel Goods Pty Ltd. However, because he thinks he might allow executives to use it sometimes, he decided to list it as an asset of the company. To be consistent he also listed as a liability of the company his personal loan that he took out at the bank to buy the villa.
2. The inventory was originally purchased for $10 000, but due to a surge in demand Mark now thinks he could sell it for $30 000. He thought it would be best to record it at $30 000.
3. Included in the accounts payable balance is $5000 that Mark owes for his personal telephone account. Mark included this in the accounts payable of Ultimo Travel Goods Pty Ltd because he will probably use company funds to pay for it.

Required

(a) Comment on the proper accounting treatment of the three items above.
(b) Provide a corrected statement of financial position for Ultimo Travel Goods Pty Ltd. (*Hint:* To get the statement of financial position to balance, adjust equity.)

PSA1.4 Prepare financial statements. LO6

CSI Pty Ltd was started on 1 October with an investment of $45 000 cash. Following are the assets and liabilities of the company on 31 October 2021, and the revenues and expenses for the month of October, its first month of operations.

Cash	$ 7 800	Bank loan	$30 000
Accounts receivable	11 400	Rent expense	1 500
Equipment	60 000	Repair expense	500
Service revenue	10 000	Fuel expense	3 400
Advertising expense	900	Insurance expense	400
Accounts payable	2 400		

No further shares were issued in October, but a dividend of $1500 in cash was paid.

Required

Prepare a statement of profit or loss and a calculation of retained earnings for the month of October, and prepare a statement of financial position as at 31 October 2021.

PSA1.5 Determine items included in a statement of cash flows and prepare the statement. **LO6**

Presented below are selected financial statement items for Daisy Ltd for 31 December 2021.

Inventory	$ 32 000
Cash paid to suppliers	195 000
Building	400 000
Share capital	20 000
Share issued for cash this current year	10 000
Cash dividends paid	15 000
Cash paid to purchase equipment	35 000
Equipment	40 000
Revenues	300 000
Cash received from customers	264 000

Required

Determine which items should be included in a statement of cash flows, and then prepare the statement for Daisy Ltd.

PSA1.6 Prepare financial statements. **LO6**

Ultra Pty Ltd was started on 1 May with an investment of $75 000 cash. Following are the assets and liabilities of the company on 31 May 2022, and the revenues and expenses for the month of May, its first month of operations.

Cash	$30 500	Bank loan	$40 000
Accounts receivable	25 400	Rent expense	12 500
Equipment	87 000	Repair expense	1 800
Service revenue	42 800	Fuel expense	3 600
Advertising expense	800	Insurance expense	2 600
Accounts payable	8 400		

No further shares were issued in May, but a dividend of $2000 in cash was paid.

Required

Prepare a statement of profit or loss and statement of changes in equity for the month of May, and prepare a statement of financial position as at 31 May 2022.

PSA1.7 Determine items included in a statement of cash flows and prepare the statement. **LO6**

Presented below are selected financial statement items for Pod Ltd for 30 June 2022.

Inventory	$ 80 000
Cash	203 000
Cash paid to suppliers	170 000
Building	640 000
Share capital	50 000
Cash dividends paid	18 000
Cash paid to purchase equipment	50 000
Equipment	70 000
Revenues	320 000
Cash received from customers	296 000

Required

Determine which items should be included in a statement of cash flows, and then prepare the statement for Pod Ltd.

PSA1.8 Prepare a classified statement of financial position. **LO6**

The following items are taken from the 30 June 2022 statement of financial position of Cement Ltd (in millions).

Cash on deposit (short term)	$ 80.6
Issued capital	2 533.8
Property, plant and equipment	3 367.1
Payables (short term)	761.1
Intangible assets	859.9
Non-controlling interests (part of equity)	99.3
Current tax liabilities	29.1
Other non-current assets	58.5
Other current assets	32.8
Investments accounted for using the equity method (non-current assets)	44.6
Deferred tax assets (non-current)	153.7
Other financial assets (current)	21.6
Other financial liabilities (non-current)	35.5
Other long-term financial assets	13.5
Receivables (short term)	877.8
Other financial liabilities (current)	66.1
Receivables due after 30 June 2023	26.8

Retained earnings	588.0
Cash and cash equivalents	249.9
Loans and borrowings	1 639.6
Provisions (short term)	242.1
Inventories (current)	620.0
Payables (long term)	8.4
Reserves	75.4
Loans and borrowings (due before June 2023)	136.9
Deferred tax liabilities (non-current)	58.6
Provisions (long term)	146.5
Inventories (non-current)	13.6

Required

Prepare a statement of financial position, appropriately classified, for Cement Ltd as at 30 June 2022.

PSA1.9 Calculate liquidity, solvency and profitability ratios. **LO9**

Here are the comparative statements of City Sales Pty Ltd.

CITY SALES PTY LTD
Statement of profit or loss
for the year ended 30 June 2022

	2022	2021
Net sales	$2 200 000	$2 000 000
Cost of sales	1 120 000	996 000
Selling and administrative expense	830 000	824 000
Interest expense	31 000	30 000
Income tax expense	104 000	50 000
Profit	**$ 115 000**	**$ 100 000**

CITY SALES PTY LTD
Statement of financial position
as at 30 June 2022

	2022	2021
ASSETS		
Current assets		
Cash	$ 100 500	$ 60 000
Short-term investments	90 000	50 000
Accounts receivable (net)	139 000	125 000
Inventory	145 000	115 500
Total current assets	474 500	350 500
Property, plant and equipment (net)	540 300	440 300
Total assets	1 014 800	790 800
LIABILITIES		
Current liabilities		
Accounts payable	146 000	65 400
Income taxes payable	104 000	34 600
Total current liabilities	250 000	100 000
Debentures payable	210 000	200 000
Total liabilities	460 000	300 000
Net assets	**$ 554 800**	**$ 490 800**
EQUITY		
Contributed equity	$ 350 000	$ 300 000
Retained earnings	204 800	190 800
Total equity	**$ 554 800**	**$ 490 800**

The cash provided by operating activities for 2022 was $260 000.

Required

Calculate these values and ratios for 2022:

(a) Working capital.
(b) Current ratio.
(c) Current cash debt coverage.
(d) Debt to total assets ratio.
(e) Cash debt coverage.
(f) Profit margin.
(g) Return on assets.

PSA1.10 Calculate ratios and compare liquidity, solvency and profitability for two entities. **LO9**

Selected financial data (in thousands) of two competitors, AKA Ltd and UFO Ltd, for 2021 are presented here.

	AKA Ltd	UFO Ltd
	Selected statement of profit or loss data for year	
Net sales	$120 000	$100 000
Cost of sales	65 000	51 000
Borrowing costs (interest expense)	10 500	30 000
Income tax expense	14 000	4 000
Profit	16 000	5 000
	Condensed statement of financial position (end of year)	
Current assets	$ 33 000	$ 20 000
Non-current assets	127 000	175 000
Total assets	**$160 000**	**$195 000**
Current liabilities	$ 15 000	$ 10 000
Non-current liabilities	70 000	160 000
Total equity	75 000	25 000
Total liabilities and equity	**$160 000**	**$195 000**
	Beginning-of-year balances	
Total assets	$140 000	$155 000

Required

For each entity, calculate these values and ratios:

(a) Working capital.
(b) Current ratio.
(c) Debt to total assets ratio.
(d) Return on assets.
(e) Profit margin.
(f) Compare the liquidity, solvency and profitability of the two entities.

PROBLEM SET B

PSB1.1 Determine forms of business organisation. **LO3**

Presented below are five independent situations.

(a) Fiona has just graduated with a media and communications degree and wants to start an events management business. She has some savings and her family is willing to support her in her endeavours. Although she has had offers to work for several established businesses, Fiona wants to try it on her own and she wants to maintain control over the business.
(b) Mark has been operating as a sole trader for a number of years. Profits are slowly increasing and he expects his gross profit before income tax this year to be around $200 000. Mark also has an opportunity to expand operations and will need to borrow larger sums from a bank or similar financial institution.
(c) Maurice, Jacob and Emily have all just graduated with commerce degrees, one in accounting, another in IT and the third in marketing. They want to combine their skills and start a business selling goods over the internet.
(d) Amanda and Jessica have been friends since school and want to make a go of their hobby of jewellery making. They already have fashion stores interested in stocking their product, plus they have a web site and sell goods over the internet.
(e) Michael Murphy and Steve Elks each own separate printing businesses. They have decided to combine their businesses. They expect that within the coming year they will need significant funds to expand their operations.

Required

In each case explain what form of organisation the business is likely to take — sole proprietorship, partnership or company. Give reasons for your choice.

PSB1.2 Identify users and uses of financial statements. **LO5**

Financial decisions often place heavier emphasis on one type of financial statement over the others. Consider each of the following hypothetical situations independently.

(a) The finance director of Organic Products Ltd is trying to determine whether the company is generating enough cash to buy new equipment for the business without borrowing and still have enough left to pay dividends to investors.
(b) An investor is considering purchasing shares in Woolworths Limited. The investor plans to hold the investment for at least 4 years.
(c) Datt Ltd is considering extending credit to a new customer. The terms of the credit would require the customer to pay within 30 days of receipt of the goods.
(d) Intrigue Finance is considering extending a loan to a company. The company would be required to make interest payments at the end of each year for 8 years, and to repay the loan at the end of the eighth year.

Required

Although the decision makers should refer to all financial statements, for each situation, state whether the decision maker would be most likely to place the main emphasis on information provided by the statement of profit or loss, statement of financial position or statement of cash flows. In each case provide a brief justification for your choice. Choose only one financial statement in each case.

PSB1.3 Comment on proper accounting treatment and prepare a corrected statement of financial position. LO6, 8

Saturn Pty Ltd was formed on 1 July 2021. At 30 June 2022, Mary Eagle, the managing director and major shareholder, decided to prepare a statement of financial position, which appeared as follows.

SATURN PTY LTD
Statement of financial position
as at 30 June 2022

ASSETS		LIABILITIES AND EQUITY	
Cash	$ 112 000	Accounts payable	$130 000
Accounts receivable	168 000	Notes payable	60 000
Inventory	150 000	Bank loan	640 000
Villa	1 000 000	Equity	144 000

Mary willingly admits that she is not an accountant by training. She is concerned that her statement of financial position might not be correct. She has provided you with the following additional information.

1. The villa is in Foster and actually belongs to Mary, not Saturn Pty Ltd. However, because she thinks she might allow executives to use it sometimes, she decided to list it as an asset of the company. To be consistent, she also listed, as a liability of the company, her personal loan that she took out at the bank to buy the villa.
2. The inventory was originally purchased for $50 000, but due to a surge in demand Mary now thinks she could sell it for $150 000. She thought it would be best to record it at $150 000.
3. Included in the accounts payable balance is $4000 that Mary owes for her personal electricity account. Mary included this in the accounts payable of Saturn Pty Ltd because she will probably use company funds to pay for it.

Required

(a) Comment on the proper accounting treatment of the three items above.
(b) Provide a corrected statement of financial position for Saturn Pty Ltd.

PSB1.4 Prepare financial statements. LO6

Evans Ltd was started on 1 July 2021 with an investment of $150 000 cash. Following are the assets and liabilities of the company on 30 June 2022, and the revenues and expenses for the year of operations.

Cash	$155 100	Bank loan	$90 000
Accounts receivable	43 000	Rent expense	37 500
Equipment (net)	120 000	Repair expense	700
Service revenue	250 000	Office expense	68 000
Advertising expense	16 500	Depreciation expense	30 000
Accounts payable	24 800	Insurance expense	24 000

No further shares were issued during the year, but a dividend of $20 000 in cash was paid.

Required

Prepare a statement of profit or loss, a calculation of retained earnings for the year, and a statement of financial position as at 30 June 2022.

PSB1.5 Determine items included in a statement of cash flows and prepare the statement. LO6

Presented below are selected financial statement items for Buzzy Bee Ltd for 31 December 2021.

Inventory	$ 80 000
Cash paid to suppliers	301 500
Building	1 800 000
Share capital	200 000
Cash received—issue of shares	50 000
Cash dividends paid	15 000
Cash paid to purchase equipment	210 000
Equipment	240 000
Revenues	560 000
Cash received from customers	509 200

Required

Determine which items should be included in a statement of cash flows, and then prepare the statement for Buzzy Bee Ltd.

PSB1.6 Prepare financial statements. LO6

Frankie Ltd was started on 1 May 2022 with an investment of $120 000 cash. Following are the assets and liabilities of the company on 31 May 2022, and the revenues and expenses for the month of May, its first month of operation.

Cash	$ 76 700	Bank loan	$80 000
Accounts receivable	29 600	Rent expense	7 600
Equipment	126 000	Repair expense	1 200
Service revenue	60 000	Office expense	16 400
Advertising expense	4 000	Insurance expense	2 400
Accounts payable	5 400		

No further shares were issued in May, but a dividend of $1500 in cash was paid.

Required

Prepare a statement of profit or loss and calculate retained earnings for the month of May and prepare a statement of financial position as at 31 May 2022.

PSB1.7 Determine items included in a statement of cash flows and prepare the statement. **LO6**

Presented below are selected financial statement items for Spoon Ltd as at 30 June 2022.

Inventory	$ 65 000
Cash	270 000
Cash paid to suppliers	205 000
Building	640 000
Share capital	50 000
Cash dividends paid	77 000
Cash paid to purchase equipment	105 000
Equipment	140 000
Revenues	605 000
Cash received from customers	515 000

Required

Determine which items should be included in a statement of cash flows, and then prepare the statement for Spoon Ltd.

PSB1.8 Prepare financial statements. **LO6**

An extract from the general ledger of Retail Limited for the year ended 30 June 2021 appears as follows.

Item	$	Item	$
Accounts payable	3 300	Inventory	21 500
Accounts receivable	8 320	Other expenses	6 250
Advertising expense	5 000	Rent expense	2 500
Bank loan	15 000	Repairs expense	15 000
Cash	24 250	Opening retained earnings	12 500
Cost of sales	82 000	Salaries expense	35 000
Equipment	83 000	Sales	167 420
Insurance expense	1 300	Share capital	100 000
Intangibles	6 300	Dividends paid	7 800

Additional information:

- Cash paid to suppliers $84 500
- All other expenses were paid in cash
- Cash received from customers $172 350
- Cash paid to purchase equipment $36 000
- The bank loan was taken out in the current year and is repayable in May 2023.

Required

(a) Prepare a statement of profit or loss for the year ended 30 June 2021.
(b) Prepare a calculation of retained earnings for the year ended 30 June 2021.
(c) Prepare a statement of financial position as at 30 June 2021.
(d) Prepare a statement of cash flows for the year ended 30 June 2021.
(e) Calculate the cash account balance at 1 July 2020 (i.e. the opening balance).

PSB1.9 Calculate liquidity, solvency and profitability ratios. **LO9**

Here are the comparative statements of Nixon Pty Ltd.

NIXON PTY LTD
Statement of profit or loss
for the year ended 30 June 2022

	2022	2021
Net sales	$3 300 000	$3 000 000
Cost of sales	1 680 000	1 494 000
Selling and administrative expense	1 245 000	1 236 000
Interest expense	46 500	45 000
Income tax expense	156 000	75 000
Profit after tax	**$ 172 500**	**$ 150 000**

NIXON PTY LTD Statement of financial position as at 30 June 2022	2022	2021
ASSETS		
Current assets		
Cash	$ 150 750	$ 90 000
Short-term investments	135 000	75 000
Accounts receivable (net)	208 500	187 500
Inventory	217 500	173 250
Total current assets	711 750	525 750
Property, plant and equipment (net)	810 450	660 450
Total assets	1 522 200	1 186 200
LIABILITIES		
Current liabilities		
Accounts payable	219 000	98 100
Income taxes payable	156 000	51 900
Total current liabilities	375 000	150 000
Debentures payable	315 000	300 000
Total liabilities	690 000	450 000
Net assets	**$ 832 200**	**$ 736 200**
EQUITY		
Contributed equity	525 000	450 000
Retained earnings	307 200	286 200
Total equity	**$ 832 200**	**$ 736 200**

The cash provided by operating activities for 2022 was $375 000.

Required

Calculate these values and ratios for 2022:

(a) Working capital.
(b) Current ratio.
(c) Current cash debt coverage.
(d) Debt to total assets ratio.
(e) Cash debt coverage.
(f) Profit margin.
(g) Return on assets.

PSB1.10 Calculate ratios and compare liquidity, solvency and profitability for two entities. LO9

Selected financial data (in thousands) of two competitors, NEW Ltd and OLD Ltd, for 2021 are presented here.

	NEW Ltd	**OLD Ltd**
	Selected statement of profit or loss data for year	
Net sales	$420 000	$350 000
Cost of sales	227 500	178 500
Borrowing costs (interest expense)	36 750	105 000
Income tax expense	49 000	14 000
Profit	56 000	17 500
	Condensed statement of financial position (end of year)	
Current assets	$115 500	$ 70 000
Non-current assets	444 500	612 500
Total assets	**$560 000**	**$682 500**
Current liabilities	$ 52 500	$ 35 000
Non-current liabilities	245 000	560 000
Total equity	262 500	87 500
Total liabilities and equity	**$560 000**	**$682 500**
	Beginning-of-year balances	
Total assets	$490 000	$542 500

Required

For each entity, calculate these values and ratios:

(a) Working capital.
(b) Current ratio.
(c) Debt to total assets ratio.
(d) Return on assets.
(e) Profit margin.
(f) Compare the liquidity, solvency and profitability of the two entities.

BUILDING BUSINESS SKILLS

FINANCIAL REPORTING AND ANALYSIS

Financial reporting problem: Giorgina's Pizza Limited

BBS1.1 Giorgina's 2022 financial statements were provided earlier in this chapter in figures 1.14, 1.16 and 1.17.

Required

Use Giorgina's financial data to answer these questions:

(a) What were Giorgina's total assets at 30 June 2022? 1 July 2021?
(b) How much inventory did Giorgina's have on 30 June 2022?
(c) What amount of accounts payable (payables) did Giorgina's report on 30 June 2022? on 1 July 2021?
(d) What were Giorgina's sales in 2022? in 2021?
(e) What is the amount of the change in profit before tax from 2021 to 2022?
(f) The accounting equation is: Assets = Liabilities + Equity. Replacing the words in that equation with dollar amounts, give Giorgina's accounting equation at 30 June 2022.
(g) What were the current liabilities on 1 July 2021?

Comparative analysis problem: Giorgina's Pizza Limited vs. Classic Food Ltd

BBS1.2 Extracts from the 2022 financial statements of Classic Food Ltd (a hypothetical company) are presented below, and Giorgina's 2022 financial statements are in figures 1.14, 1.16 and 1.17.

CLASSIC FOOD LTD
Statement of profit or loss (extract)
for the year ended 30 June 2022

	2022 $'000	2021 $'000
Revenue	650 738	237 735
Borrowing costs expense	(4 463)	(574)
Profit from ordinary activities before income tax expense	37 265	19 330
Income tax expense	(13 713)	(7 078)
Profit from ordinary activities after income tax expense	23 552	12 252

CLASSIC FOOD LTD
Statement of financial position
as at 30 June 2022

	2022 $'000	2021 $'000
Current assets		
Cash	25 000	5 220
Receivables	7 842	4 112
Inventories	139 412	70 055
Other	2 446	1 951
Total current assets	174 700	81 338
Non-current assets		
Property, plant and equipment	86 158	40 729
Deferred tax assets	6 900	3 205
Intangible assets	96 085	44 530
Other	384	494
Total non-current assets	189 527	88 958
Total assets	364 227	170 296
Current liabilities		
Payables	139 500	60 797
Interest-bearing liabilities	35 016	17 895
Current tax liabilities	6 743	5 623
Provisions	13 741	8 522
Total current liabilities	195 000	92 837
Non-current liabilities		
Interest-bearing liabilities	60 891	31 634
Deferred tax liabilities	1 712	1 421
Provisions	6 917	5 105
Total non-current liabilities	69 520	38 160
Total liabilities	264 520	130 997
Net assets	**99 707**	**39 299**
EQUITY		
Contributed equity	77 663	31 442
Retained earnings	22 044	7 857
Total equity	**99 707**	**39 299**

Required

(a) For each entity calculate the return on assets and profit margin.
(b) Which entity appears to have stronger profitability?
(c) For each entity calculate working capital and the current ratio.
(d) Which entity appears to have stronger liquidity?
(e) What additional information would you require to make a better decision about the future profitability and liquidity of the two companies?

Interpreting financial statements

BBS1.3 Tick Tock Technology Ltd launched its latest wireless communications product in 2022. The company spent much of 2021 developing and testing software so that its equipment could operate seamlessly in the public switched telephone network. Information from the company's statement of cash flows for the year ended 31 December 2022 follows.

	2022	2021
Cash received from customers	—	—
Cash generated (used) by operating activities	$(8 700 703)	$(11 265 540)
Cash generated (used) by investing activities	183 160	(42 968)
Cash provided (used) by financing activities	8 489 104	11 226 587
Net change in cash	**$ (28 439)**	**$ (81 921)**

The most significant source of cash generation was borrowing in 2021 and share issues in 2022. Despite delays, management has expressed confidence that the company is now positioned with a considerable competitive advantage.

Required

Use the information provided to answer each of the following.

(a) If you were a creditor of Tick Tock Technology, what reaction might you have to the 2021 and 2022 statements of cash flows?
(b) If you were a shareholder of Tick Tock Technology, what reaction might you have to the cash flows in 2022?
(c) If you were evaluating the company as either a creditor or a shareholder, what other information would you be interested in reviewing?

Financial analysis on the web

BBS1.4 **Purpose:** This exercise is an introduction to some large accounting firms.

Addresses:

Deloitte	www2.deloitte.com/au or www2.deloitte.com/nz
Ernst & Young	www.ey.com/au/en/home
KPMG	www.kpmg.com.au
PricewaterhouseCoopers	www.pwc.com.au or www.pwc.co.nz

Steps: Go to the homepage of a firm that is of interest to you.

Required

Answer the following questions.

(a) Name two services provided by the firm.
(b) What countries or regions does it operate in?
(c) Does it provide information for students? If so, briefly describe the type of information.
(d) Summarise one recent news item discussed on the firm's web site.

CRITICAL THINKING

Group decision case

BBS1.5 Permanent Press provides laundry services to hotels and hospitals. In a recent annual report, Permanent Press chronicled its contributions to community services over the past 10 years. The following excerpts illustrate the variety of services provided.

1. At a local festival, Permanent Press sponsored the event by providing T-shirts, stationery and office decorations featuring the company's name and logo.
2. In support of the 'Clean Up Australia' campaign in 2020, the company donated, and its employees planted, grevillea gardens in cities across Australia.
3. The company held a competition in which customers throughout Australia and New Zealand nominated their favourite children's charities. Winning charities in the draw received a monetary donation from Permanent Press in the name of the customer.
4. Permanent Press executives often volunteer their time and resources to serve as role models and mentors to young people in Auckland.

Required

With the class divided into groups, answer the following.

(a) The entity assumption requires that a company keep the personal expenses of its employees separate from business expenses. Which of the activities listed above were expenses of the business, and which were personal expenses of the employees? Be specific. If part of the donation is business and part is personal, note which part is each.
(b) For those items that were business expenses, state whether the expense was probably categorised as an advertising expense, employee wages expense, grounds maintenance expense, or charitable contribution expense. You may use any or all of the categories. Explain your answer.

Communication activity

BBS1.6 Stefani Leotta is the trainee accountant for GaGa Fashions Ltd. Stefani has finally got the company's statement of financial position to balance, but as she's still completing her business degree, she isn't sure that it's correct. Before sending the statement to the board of directors, she asks you to check it and prepare a report.

GAGA FASHIONS LTD
Statement of financial position
for the month ended 30 June 2022

ASSETS		LIABILITIES AND EQUITY	
Equipment	$36 900	Contributed equity	$48 000
Cash	14 400	Accounts receivable	(30 000)
Supplies	1 680	Inventory	(7 200)
Dividends	4 200	Accounts payable	25 980
		Retained earnings	20 400
Total assets	**$57 180**	**Total liabilities and equity**	**$57 180**

Required

Unfortunately, Stefani has made some fundamental errors. Prepare a report for Stefani using the following structure.

Part (a) An explanation of the purpose and structure of your report and an overview of the initial findings.

Part (b) A discussion of the purpose of a statement of financial position and definitions for each of the elements.

Part (c) The identification of each of the errors in the statement of financial position with an explanation of why they are incorrect and how they can be corrected.

Part (d) A correct statement of financial position

Part (e) A discussion of why it is important that the statement of financial position is faithfully represented.

Part (f) Provide examples of decisions users make, based on the information in general purpose financial statements.

Sustainability

BBS1.7 The following is an extract from the AGL Energy Limited web site.

> At AGL, sustainability means thinking about our long-term responsibilities towards our customers, our people, our investors and to our community, and to the environment in which we all work and live.
>
> We're focused on delivering affordable, reliable, lower-carbon and innovative energy solutions for all of our customers, including those experiencing financial hardship.
>
> To accomplish this, we need to support our people and the communities in which we live and work. We do this by reinvesting in the communities we operate in, and by celebrating and developing our safe, diverse and inclusive workforce. As an essential service provider in a highly regulated industry, we have a responsibility to engage with governments at all levels on energy and related policies.
>
> We are also committed to taking a conscientious approach to the environment by actively working to reduce greenhouse gas emissions and manage our environmental footprint.
>
> These complex issues — and the actions we are taking — shape our sustainability strategy.
>
> We're always listening, learning and reviewing our approach, and measure our performance through our transparent sustainability reporting.
>
> ***Source:*** AGL Energy Limited, www.agl.com.au/about-agl/sustainability.

Required

What is meant by the term sustainability?

Access AGL Energy Limited's latest sustainability responsibility report and:

1. outline the company's approach to sustainability
2. summarise AGL's achievements in health and safety and the environment for the current period. Include a discussion of how these achievements are measured.

Ethics case

BBS1.8 As the chief financial officer of Mobile Phones Pty Ltd, you discover a significant misstatement that overstated assets in this year's financial statements. The misleading financial statements are contained in the company's annual report, which is about to be issued to banks and other creditors. After much thought about the consequences of telling the managing director, Jack Frost, about this misstatement, you gather your courage to tell him. Jack says, 'What they don't know won't hurt them. But just so we set the record straight, we'll adjust next year's financial statements for this year's misstatement. We can fix it next year when we make more profit. Just don't make that kind of mistake again.'

Required

(a) Who are the stakeholders in this situation?
(b) What are the ethical issues?
(c) What would you do as the chief financial officer?

ANSWERS

Answers to self-study questions

1.1 (c) 1.2 (b) 1.3 (b) 1.4 (b) 1.5 (c) 1.6 (c) 1.7 (b) 1.8 (c) 1.9 (d) 1.10 (d) 1.11 (a) 1.12 (b) 1.13 (c) 1.14 (c) 1.15 (b) 1.16 (c) 1.17 (a) 1.18 (a) 1.19 (c) 1.20 (c) 1.21 (c) 1.22 (c) 1.23 (a) 1.24 (b) 1.25 (b)

Answer to review it questions

Question 3, section 1.6: Trade and other receivables (from figure 1.10)
Question 2, section 1.6: Assets $142 312 000 = Liabilities $65 378 000 + Equity $76 934 000

REFERENCE

Chartered Institute of Management Accountants (CIMA) 2014, 'Big data: readying business for big data revolution', CGMA briefing, November, www.cgma.org/content/dam/cgma/resources/reports/downloadabledocuments/cgma-briefing-big-data.pdf.

ACKNOWLEDGEMENTS

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