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# Guide to the text

As you read this text you will find a number of features in every chapter to enhance your study of financial accounting and help you understand how the theory is applied in the real world.

## CHAPTER OPENING FEATURES

**Learning objectives** at the start of each chapter identify key concepts that will be covered. **Learning objective icons** appear throughout the chapter to identify where each objective is discussed.

### LO1 Beginning assumptions

The purpose of accounting is to identify, measure and communicate financial information about a particular entity to interested users. To do this, accountants make the following three basic assumptions: economic entity, accounting period and monetary unit.



**MINDTAP** Learn more by watching the animation: What is Accounting For?

### Learning Objectives

After studying the material in this chapter, you should be able to:

- LO1** Explain the three basic assumptions made when communicating accounting information.
- LO2** Describe the purpose and structure of an income statement and the terms and principles used to create it.
- LO3** Describe the purpose and structure of a balance sheet and the terms and principles used to create it.
- LO4** Describe the purpose of a statement of changes in equity and how it links the

## FEATURES WITHIN CHAPTERS

**CSL Analysis** boxes link to the CSL Annual Report extract provided in Appendix B of the textbook, providing an opportunity to apply financial accounting concepts to a real-world business.



### CSL Analysis

Look at CSL's balance sheet in this book's appendix. Write out in numbers the company's accounting equation ( $A = L + E$ ) as at 30 June 2020. How many different assets does the company disclose?

#### Analysis:

$A = L + E$   
 $9123 = 5989 + 3164$   
(rounded to the nearest million)  
Ten different assets are listed on CSL's balance sheet.

Important **key terms** are marked in bold in the text and defined in the margin when they are used in the text for the first time.

### Verifiability

**Verifiability** allows users to accept that the financial statements faithfully represent the business activity they claim to represent. Verifiability means that different

#### verifiability

Where information allows different independent observers to arrive at the same or similar outcomes.

**Making it Real** boxes present real-life financial accounting scenarios to demonstrate the chapter concepts in practice.



### Making it Real

#### GIFT CARDS

Although gift cards have existed for many years, the ever-growing popularity in recent times is causing some accounting issues for retailers due to the need to estimate when a customer's card is 'no longer expected to be redeemed' (i.e. when the revenue can be recognised because the card is unlikely to be used to purchase goods).

You might assume that retailers record

**NEW MindTap icons** indicate an opportunity to go online and access videos, quizzes and more. The highlighted text above each icon identifies the MindTap folder in which you can find it.



**MINDTAP** Review this material with the e-lecture.

**NEW**

# END-OF-CHAPTER FEATURES

At the end of each chapter you will find several tools to help you to review, practise and extend your knowledge of the key learning objectives.

Chapter tear-out cards at the back of the book provide a portable study tool, summarising each chapter for class preparation and revision.

### EXERCISES

**1 Assumptions** LO1

Of the three assumptions, which do you think is most important and why?

**2 Calculate profit or loss** LO2

Sarah's Science Service generated \$42 000 in revenue in the month of January. Salaries were \$10 500 for the month and supplies used were \$6000. Additionally, Sarah incurred \$1500 for advertising during the month.

**REQUIRED**

Calculate Sarah's profit or loss for the month of January.

**3 Calculate equity** LO3

A company reports assets of \$1 111 000 and liabilities of \$66 000.

**REQUIRED**

Calculate the company's equity.

**4 Identify accounting principles** LO4, 5

Each of the following statements is an application of the revenue recognition principle, the matching principle or the cost principle.

- A company records Equipment for the purchase price of \$10 000, although the suggested retail price was \$12 000.
- A company receives \$10 000 for a service to be performed, but records only \$5000 as Service Revenue because it earned only half in the current period.
- A company pays \$600 for insurance, but uses only \$400 during the period. Therefore, it records only \$400 as Insurance Expense.

**REQUIRED**

Identify which principle relates to each statement.

**5 Calculate retained earnings** LO4

At the beginning of the year, a company has retained earnings of \$185 000. During the year, the company earns \$120 000 of profits and distributes \$50 000 in dividends.

**REQUIRED**

Calculate the company's retained earnings at year end.

**6 Calculate cash flows** LO5

A company starts the year with \$45 000 in cash. During the year, the company generates \$240 000 from operations, uses

\$168 000 in investing activities and uses \$114 000 in financing activities.

**REQUIRED**

Calculate the company's cash balance at year end using a basic cash flow format.

**7 Identify accounting assumptions and qualitative characteristics** LO4, 6

Consider the following independent scenarios:

- Peter's Pizza has been in business for 25 years. All of its operations are profitable, and the accountants believe that the company will continue to operate into the foreseeable future.
- A bank used the information presented in Fiona's financial statements to determine if it should extend a \$300 000 loan to Fiona. The information in the financial statements made a difference in the bank's lending decision.
- The manager of Attila's Antiques does not like to change accounting procedures because it hinders her ability to make year-to-year comparisons.
- Sarah, owner of Strathfield Shelter, informs her accountant that she does not want to review any accounting issue that is smaller than 1 per cent of profits.
- Matthew paid \$10 000 for inventory, which could now sell for only \$6000. He recognises this decrease while not recognising the increase in land from \$200 000 to \$300 000.
- Sue has two businesses. She keeps separate records for both businesses and does not combine them with her personal financial matters.

**REQUIRED**

Identify the accounting assumption or qualitative characteristic that relates to each scenario.

**8 Accounting terms** LO4, 5

Consider the following information:

Item	Appears on	Classified as
Salaries expense		
Equipment		
Cash		
Accounts payable		
Accounts receivable		
Buildings		
Contributed capital		
Retained earnings		
Interest revenue		
Advertising expense		
Salts		
Unearned revenue		

## REVIEW 1 FINANCIAL ACCOUNTING

LEARNING OBJECTIVES

### Key definitions

**accounting**  
The process of identifying, measuring and communicating economic information to permit informed judgements and decisions.

**expense**  
A decrease in resources resulting from the operation of a business.

**matching principle**  
The principle that expenses should be recorded in the period resources are used to generate revenues.

**economic entity assumption**  
The assumption made by accountants that the financial activities of a business can be separated from the financial activities of the business' owners(s).

**accounting period assumption**  
The assumption made by accountants that financial information can be meaningfully captured and communicated over short periods of time.

**asset**  
An economic resource that is objectively measurable, results from a prior transaction, and will provide future financial benefit.

**monetary unit assumption**  
An assumption made by accountants that the dollar is the most effective means to communicate economic activity.

**income statement (profit and loss statement)**  
The statement that reports a company's revenues and expenses and resulting profit or loss.

**revenue**  
An increase in resources resulting from the sale of goods or the provision of services.

**revenue recognition principle**  
The principle that revenue should be recorded when a resource has been earned and not just when the cash is received.

**LO1 Explain the three basic assumptions made when communicating accounting information.**

**LO2 Describe the purpose and structure of an income statement and the terms and principles used to create it.**

**LO3 Describe the purpose and structure of a balance sheet and the terms and principles used to create it.**

**LO4 Describe the purpose of a statement of changes in equity and how it links the income statement and the balance sheet.**

**LO5 Describe the purpose and structure of a statement of cash flow and the terms and principles used to create it.**

**LO6 Understand the objectives of financial reporting and qualitative characteristics that make accounting information useful.**

**LO7 Review the language of accounting.**

### Key formulas

**KEY FORMULA 1.1: INCOME STATEMENT**

Revenues – Expenses = Net Profit or Net Loss  
(or Income, more formally known as Total Comprehensive Income)

**KEY FORMULA 1.2: THE RELATIONSHIP BETWEEN ASSETS, LIABILITIES AND EQUITY**

Assets = Liabilities + Equity

**KEY FORMULA 1.3: STATEMENT OF CHANGES IN EQUITY (THE RETAINED EARNINGS PART)**

Retained Earnings, Beginning Balance  
+/- Net Profit/Loss  
– Dividends (Drawings)  
= Retained Earnings, Ending Balance

**KEY FORMULA 1.4: THE CASH FLOW STATEMENT**

Cash Flows Provided (Used) by Operating Activities  
+/- Cash Flows Provided (Used) by Investing Activities  
+/- Cash Flows Provided (Used) by Financing Activities  
= Net Increase (Decrease) in Cash  
+ Cash at the beginning  
= Cash at the end

# Guide to the online resources

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# FINANCIAL ACCOUNTING

Your school exams are over forever, and you are about to go on your 'gap' summer holidays. You decide to turn your love of drones into a business that you name Floating and Filming. With \$1000 of your own money and a \$2000 micro-enterprise loan from the bank, you purchase a \$2600 drone (with gimbal, camera and two spare rechargeable batteries), \$350 of spare propellers, SIM cards and other supplies. Floating and Filming has been featured on the regional SME (small-medium-enterprise) Facebook group, so you are off to a great start. During December, January and February, you have 28 filming jobs at an average of \$400 each job, you buy \$750 additional supplies and pay the bank \$50 interest. At the end of February, you still have the bank loan, you also have \$1940 in cash, \$100 of supplies and \$1200 owing to you from three customers.

Given this information, can you tell what happened to your business over summer? While it has been fun it has also been hard work. Did you make enough money to make it worth continuing or would it have been financially more rewarding working at the local IGA store? How can you tell? Getting answers to such questions requires accounting, because ultimately you are filming to make money – no longer for the simple pleasure of filming with a drone or to provide an occasional shark-spotting community service. Working for yourself has certain advantages but also hassles, which may not come with being an employee, and these need to be balanced against the financial success of the business. All of us need money to live, eat, party and more.

## accounting

The process of identifying, measuring and communicating financial information to permit informed judgements and decisions.

**Accounting** is the process of identifying, measuring and communicating financial information to permit informed judgements and decisions. Put more simply, accounting is the language of business. When you want to know about the financial results of a

business, you must understand and speak the language of accounting. The purpose of this book is to help you learn, write and speak this language so that you can make socially responsible and financially sound business decisions.

With this overall purpose in mind, this chapter introduces the basic terms, principles and rules that comprise the 'spelling' and 'grammar' of the accounting language. It does so by creating the summer financial statements of the Floating and Filming (F&F) business, described above. At the end of the chapter, you should be familiar with the four main financial statements – income statement, balance sheet, statement of cash flow and statement of change in equity. Further, you should also have a working accounting vocabulary that will be expanded and refined in the following chapters.

## Learning Objectives

After studying the material in this chapter, you should be able to:

- L01** Explain the three basic assumptions made when communicating accounting information.
- L02** Describe the purpose and structure of an income statement and the terms and principles used to create it.
- L03** Describe the purpose and structure of a balance sheet and the terms and principles used to create it.
- L04** Describe the purpose of a statement of changes in equity and how it links the income statement and the balance sheet.
- L05** Describe the purpose and structure of a statement of cash flow and the terms and principles used to create it.
- L06** Understand the objectives of financial reporting and qualitative characteristics that make accounting information useful.
- L07** Review the language of accounting.

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Accounting, as the language of business, would describe this picture as a person using an asset (the drone) to generate revenue (the money she will be paid)

## LO1 Beginning assumptions

The purpose of accounting is to identify, measure and communicate financial information about a particular entity to interested users. To do this, accountants make the following three basic assumptions: economic entity, accounting period and monetary unit.



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### Economic entity assumption

#### economic entity assumption

The assumption made by accountants that the financial activities of a business can be separated from the financial activities of the business' owner(s).

The **economic entity assumption** states that the financial activities of a business can be separated from the financial activities of the business' owner(s) and from other business activities. This assumption allows a user to examine a company's (sole trader's or partnership's) accounting information without concern that

the information includes the personal affairs of the owner(s) or other business activities. For the Floating and Filming (F&F) example in the introduction, this means that the business is the reporting entity and your personal activities (such as the cost of Saturday evening out with friends) should not be included with business activities (such as buying new propellers for the drone). The definition of the 'reporting entity' can be complex and is covered in detail in the (Australian) *Financial Reporting Handbook* (the big book of rules

for accountants preparing financial statements) Statement of Accounting Concept SAC 1.

### Accounting period assumption

Business owners and other interested parties usually do not want to wait too long before they receive information about how a business is doing. They want periodic measurements of the business' financial success or failure. For many activities, be it a diet or sports training, it is useful to measure your performance at regular intervals to determine if you should change your strategy. In business, performance is measured primarily in financial terms. Accountants therefore assume that financial information can be meaningfully captured and communicated over short periods of time, even if those accounting periods are somewhat artificial, such as a month or a quarter (but no longer than a year). This is known as the **accounting period assumption** – the assumption made by accountants that financial information can be meaningfully captured and communicated over short periods of time. Although the measurement involves numbers, it usually requires judgements and estimates more than mathematical calculations.

#### accounting period assumption

The assumption made by accountants that financial information can be meaningfully captured and communicated over short periods of time.

Publicly traded companies such as CSL Limited are required to file financial statements with the Australian Securities Exchange (ASX) at least twice a year. For the F&F business example, the time period is the three months of summer.

### Monetary unit assumption

The **monetary unit assumption** assumes that the dollar is the most effective means to communicate economic/financial activity – it is the 'attribute of interest'. The drone has many attributes: manufacturer, model, range, flying time and colour; but the attribute of interest in accounting is the cost in dollars. If an economic activity cannot be expressed in dollars, then it is not recorded in the accounting system. For F&F, paying for advertising on Facebook would be recorded as an expense, while a favourable story on the site would not be recorded in accounting as no money was exchanged. This is one of the limitations (but also strengths) of accounting. It assumes further that the dollar is a reasonably stable measure (the effect of inflation and deflation can be ignored).

#### monetary unit assumption

An assumption made by accountants that the dollar is the most effective means to communicate economic activity.

A more complex aspect of interpreting financial information, but at this stage not essential for a basic understanding of financial information is known as the going concern assumption. It takes as a given that a business will continue to operate into the foreseeable future, unless there is evidence to the contrary, most businesses are assumed to be going concerns. This can be important because it affects the dollar amount recorded with respect to the value of certain assets. Because F&F will continue beyond the summer, it is a going concern and we value the drone at what it is worth to the business, *not* the amount it might be sold for at the end of summer. With this we introduce the concept of judgement into accounting and the realisation accounting may not have the mathematical precision many often think it has.



### CSL Analysis

In this book's appendix, *CSL Annual Report 2019/2020*, you can find CSL's income statement, with the following three descriptions:

- 1 Consolidated Statement of Comprehensive Income
- 2 US\$m
- 3 For the year ended 30 June 2020.

Which assumption does each description best relate to?

#### Analysis:

- 1 Economic entity ('consolidated' refers to all the companies in the group being brought into one entity).
- 2 Monetary unit (for comparison with other biotech companies, CSL reports in US dollars; it does not affect the assumptions here).
- 3 Time period.

## L02 Reporting profitability: the income statement

The first question usually asked of a business is whether it is making any money. In accounting we would ask: Is the business profitable? Does it generate more resources than it uses? Accounting provides answers to these questions with a financial statement called the **income statement**

(sometimes called the **profit and loss statement**) or, to be technically correct, the *statement of comprehensive income*. This reports a company's *revenues* and *expenses* and the resulting *profit or loss* (*net income or total comprehensive income*).

When a company releases its annual report, the news headline is almost always the profit or loss number; for example, 'Commonwealth Bank Reports \$9.9 Billion Profits'.

#### income statement (profit and loss statement)

The statement that reports a company's revenues and expenses and resulting profit or loss.

## Revenues

A **revenue** is an increase in resources resulting from the sale of goods (sales revenue) or the provision of services (service revenue). Receiving \$400 for filming a surfing competition is an example of revenue. You have \$400 that you did not have before you provided the service.

Revenues are recorded according to the **revenue recognition principle**. The revenue recognition principle states that revenue should be recorded when a resource

#### revenue

An increase in resources resulting from the sale of goods or the provision of services.

#### revenue recognition principle

The principle that revenue should be recorded when a resource has been earned and not just when the cash is received.



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### Making it Real

#### IS THE BUSINESS A GOING CONCERN?

The Auditing Standard ASA 570 Going Concern suggests the following wording for the Auditor's report when a business has been unable to find sufficient funds:

#### Basis for qualified opinion

As discussed in Note yy, the Company's financing arrangements expire and amounts outstanding are payable on 19 August 202X. The Company has been unable to conclude renegotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial report does not adequately disclose this matter.<sup>1</sup>



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Jonathan Tyler

Revenues and expenses are measured in dollars

has been *earned*, regardless of when the cash is received. That is, you may ask to be paid before filming the surfer in a contest or you may decide not to bill her until after she has received her prize money. Regardless of when cash is received, revenue is earned when you do the filming (the provision of the service is substantially complete, and collection is reasonably assured). This is known as accrual-based accounting and is distinguished from cash-based accounting. The Australian Accounting Standard AASB 15 Revenue from Contracts with Customers provides much more detail on calculating the amount and determining the timing of revenue recognition.

Given these definitions, total revenue for summer for F&F is as follows: you have only one source of revenue – drone filming. Assuming that your customers will pay, your filming business earns revenue each time a filming job is undertaken. So, if you filmed 28 occasions at



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For F&F, selling surfing videos produces revenue

\$400 each, revenues total \$11 200 for the summer. Of those revenues, you have received cash for all but three (\$1200). The \$1200 has been earned (you have carried out the service and expect to be paid), although it has not been received in cash.

## Expenses

An **expense** is a decrease in resources resulting from the operation of a business. The replacement propellers and other supplies consumed (used up) while running the business are examples of expenses. Other expenses common to businesses are wages, taxes, advertising, rent, interest and utilities (i.e. electricity, water and gas).

Expenses are recorded in the period they are incurred.

The **matching principle** states that expenses should be recorded in the period resources are used to generate revenues. For example, in summer the propellers are regularly replaced and should therefore be included in summer's expenses. The recording of revenues and expenses in the period they are earned and incurred should result in accurate matching and the calculation of a 'true and fair' profit or loss.

Given these definitions, total summer expenses for the business are as follows. While the business has only one source of revenue, the filming business has three sources of expenses. The first is supplies. From the given information, the amount of supplies used during summer can be calculated as follows:

Amount purchased at the beginning of summer	\$ 350
Plus amount purchased during summer	750
Less amount on hand at the end of summer	(100)
Amount used during summer	<u>\$1000</u>

Therefore, supplies expense in this period is \$1000.

The second expense relates to your borrowing. You paid the bank \$50 at the end of summer to compensate them for loaning you \$2000. Paying for the use of someone else's money is called interest. Therefore, interest expense is \$50.

The third expense relates to your equipment – the drone. Unlike supplies, which are used up and need to be regularly refilled, equipment that is used on an ongoing basis (although it will eventually deteriorate and may be of no monetary value to the business) needs to be expensed. Because this equipment was used in summer to generate revenues, the matching principle requires that some portion of the equipment's cost be expensed in summer. This is called depreciation expense. Chapter 8 will discuss the various methods for calculating

### expense

A decrease in resources resulting from the operation of a business.

### matching principle

The principle that expenses should be recorded in the period resources are used to generate revenues.

depreciation expense, but for now we will keep things simple. Assuming that the equipment will be used for another three seasons and then thrown away, it is reasonable to expense one-quarter of the equipment's cost each season. This equals \$650 for the drone (\$2600 cost divided by four seasons). Therefore, depreciation expense for summer is \$650.

## The income statement

Once a company's revenues and expenses are calculated, they are reported on the **income statement**. This is the financial statement that shows a business' revenues and expenses *over a specific period of time*. Its purpose is to demonstrate the financial success or failure of the business over that specific period. When revenues

exceed expenses, a company generates a profit. When expenses exceed revenues, a company incurs a loss. The basic structure of the statement is as follows:

### KEY FORMULA 1.1: INCOME STATEMENT

Revenues – Expenses = Net Profit or Net Loss  
(or Income, more formally known as Total Comprehensive Income)

Given the revenues and expenses determined previously, F&F's summer income statement would appear as shown in **Exhibit 1.1**. It contains the business name, the statement name (i.e. 'Income statement') and the time period, which for this example is the summer – the months of December, January and February. It also shows that the filming business generated \$9650 of profits during summer. This part of the statement is often called the 'profit and loss' section.

### Exhibit 1.1 INCOME STATEMENT FOR FLOATING AND FILMING

Floating and Filming Income statement for the three months ending 28 February		
Revenues		\$11200
Expenses:		
Supplies	\$1000	
Interest	50	
Depreciation	650	
Total expenses		\$ 1700
Profit		\$9500



## CSL Analysis

Look at CSL's income statement (Consolidated statement of comprehensive income) in this book's appendix. The statement contains five revenues (including 'Finance income' in the middle of the statement) and six expenses (including Cost of sales, Finance costs and Income tax expense).

- 1 Can you identify the others?
- 2 What was the company's Net profit for the period (after tax) for 2020?

### Analysis:

At this stage do not become too concerned over the particular profit figure used. CSL's financial statements in this book's appendix are an extract from its annual report, as required by Corporations Law, and are complex, especially for the first-time viewer.

- Revenues: Sales and service revenue; Influenza Pandemic Facility Reservation fees; Royalties and License revenue; and Other income. (We have ignored the Comprehensive income as it is not part of Profits.)
- Expenses: Research and development expenses; Selling and marketing expense; and General and expense.
- Net profit for the period (after income tax expense) for 2020 was \$2102.5 million. This was almost \$200 million more than 2019 (\$2102.5 – \$1918.7). In passing you may have noticed the dollars are US dollars (USD) not Australian dollars (AUD). At this stage this is not important, but will be explored further in later chapters.



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## LO3 Reporting financial position: the balance sheet

Another important issue for any business is its current financial position. What does the business own? What does it owe? Accounting provides answers to these questions with a financial statement called the **balance sheet** (sometimes called the *statement of financial position*), which reports a business' assets, liabilities and equity at a point in time.

### balance sheet

A financial statement that reports a business' assets, liabilities and equity at a specific point in time.



## WHY DO WE HAVE FINANCIAL STATEMENTS?

### Dun & Bradstreet<sup>2</sup>

D&B is the world’s leading source of commercial information and insight on businesses, and the need of financial statements. This need shows that financial statements are not only important for students beginning their study of business, but also for use in a billion-dollar company, both inside and outside the company.

Before we start our review of financial statements, it is important to understand why they are put together in the first place. Management of any business requires a flow of information to make informed, intelligent decisions affecting the success or failure of its operations. Investors need statements to analyse investment potential. Banks require financial statements to decide whether or not to loan money, and many companies need statements to ascertain the risk involved in doing business with their customers and suppliers.

## Assets

### asset

An economic resource that is objectively measurable, results from a prior transaction, and will provide future financial benefit.

An **asset** is a resource of a business. More formally, it is an economic resource that is objectively measurable, that results from a prior transaction, and that will provide future financial benefit. Cash is a good example of an asset: it can be counted, it is received through a transaction with someone

else, and it can be used to buy things in the future. Other common assets include inventories, receivables, property, plant and equipment, and intangible assets (assets that have no physical form, such as trademarks and copyright). Money owed to the business is often called a receivable, but it is an asset because you expect to exchange it for cash when you are paid.

Assets are recorded and reported according to the historical cost principle, which is often shortened to

the cost principle. The **cost principle** states that assets should be recorded and reported at the cost paid to acquire them.

Given these definitions, F&F has several assets at the end of February:

- \$1940 of cash
- \$100 of remaining supplies
- \$1200 of receivables from customers.

You also have a used drone, but the value of this asset is calculated a little differently because it will continue to be used beyond this summer. The drone originally cost \$2600, but (as explained above) the matching principle requires us to expense \$650 of that cost in summer. This is called depreciation expense. As a result, the drone’s remaining value to the business is \$1950 (\$2600 – \$650). Again, Chapter 8 will discuss in much more detail the accounting for equipment and the related depreciation expense calculations.

### cost principle

The principle that assets should be recorded and reported at the cost paid to acquire them; sometimes referred to as the ‘historical cost principle’.

## Liabilities

A **liability** is an obligation of a business. More formally, it is a present obligation of a business that results from a past transaction and will require the sacrifice of resources at a future date. Examples of liabilities common to businesses include accounts payable to suppliers, salaries payable to employees and taxes payable to governments. The only liability of F&F at the end of summer is the \$2000 borrowed from the bank, which is considered a creditor. A creditor is a person or business who you owe money to. As will be explained below, the business does not have a liability for the \$1000 of your own money that was contributed to the business. You are the owner, not a creditor.

### liability

An obligation of a business that results from a past transaction and will require the sacrifice of resources at a future date.

## Equity

**Equity** is the difference between a business’ assets and liabilities and represents the share of assets that are claimed by the business’ owner(s). An example of equity with which you may be familiar is ‘home equity’. A homeowner’s equity refers to the difference between the value of the home and the amount owed to the bank. Equity in accounting is the same principle except that it usually refers to the difference between the value of the business’ assets and its liabilities.

### equity

The difference between a business’ assets and liabilities, representing the share of assets that is claimed by the business’ owner(s).

A business can generate equity in two ways. The first is through contributed capital.

**Contributed capital** is defined as the resources that investors put into a business in exchange for an ownership interest. The \$1000 that you, the owner, put into F&F is contributed

### contributed capital

The resources that investors contribute to a business in exchange for ownership interest.

capital. Note here that contributed capital is *not* revenue. The increase of \$1000 did not result from the filming business providing a service or selling a product. It came by contributing an ownership interest. The most common method that companies use to generate contributed capital is the issue (sale) of shares to investors. (Note that this is different from the daily buying and selling of shares on the securities exchange, where existing owners sell to new owners.)

The second way a business generates equity is through profitable operations. When a business generates profits, it can either distribute them to owner(s) or retain them to grow the business. Profits that are distributed to a company's owners

#### dividends

Profits that are distributed to owners (usually called drawings if the business is not a company).

#### retained earnings

Profits that are kept in the business.

(shareholders) are called **dividends**, or *drawings* for a non-company business (sole trader or partnership). Note here that dividends are not an expense of a company: they are simply a distribution of company assets to owners. Profits (earnings) that are retained in the business are called **retained earnings**. A company's retained earnings therefore represent

the equity generated from profitable operations that is kept in the company. Since F&F at the end of summer has less assets than the combined liabilities and contributed equity plus profits, there must have been some assets distributed to you. You obviously needed some 'spending money' over summer.

## The balance sheet

The balance sheet is the financial statement that shows a business' assets, liabilities and equity *at a specific point in time*. Its purpose is to show a business' resources and the claims against those resources. Because a balance sheet is reported at a moment in time, it is often referred to as a still photograph or snapshot of a business. The basic structure of the statement is as follows:

#### KEY FORMULA 1.2: THE RELATIONSHIP BETWEEN ASSETS, LIABILITIES AND EQUITY

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Given the assets, liabilities and equity determined previously, F&F's balance sheet would appear as shown in **Exhibit 1.2**. It contains the business name, the statement name and the time reference, which for this example is 28 February.

### Exhibit 1.2 BALANCE SHEET FOR FLOATING AND FILMING

Cash	\$ 1940	
Accounts receivable (money customers owe)	1200	
Supplies	100	
Drone	1950	
Total assets		<u>\$ 5 190</u>
Loan from bank	<u>\$2 000</u>	
Total liabilities		<u>\$2 000</u>
Contributed capital	\$1000	
Retained earnings	<u>2 190</u>	
Total equity		<u>\$ 3 190</u>
Total liabilities and equity		<u>\$ 5 190</u>

Notice that total assets equal total liabilities plus total equity (or assets minus liabilities equals net assets, which is equity). This will always be the case for any business. An entity's assets are always claimed by someone. Either they are owed to someone (in the filming business' case, the bank) or claimed by an owner (you). No asset of any business is ever unclaimed. This relationship between assets, liabilities and equity is represented by the following equation, known as the accounting equation or balance sheet equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

During summer you must have withdrawn \$7310 (\$9500 - \$7310 = \$2190), because even if you were not a good record keeper, we could calculate the amount of retained earnings simply by inserting the retained earnings dollar amount to make the accounting equation balance.



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### CSL Analysis

Look at CSL's balance sheet in this book's appendix. Write out in numbers the company's accounting equation ( $A = L + E$ ) as at 30 June 2020. How many different assets does the company disclose?

#### Analysis:

$$A = L + E$$

$$9123 = 5989 + 3164$$

(rounded to the nearest million)

Ten different assets are listed on CSL's balance sheet.

## LO4 Reporting equity: the statement of changes in equity

Business owners are usually interested in how their equity is growing as a result of profitable operations. They are also interested in how that equity is distributed in the form of dividends. Such information is reported on the **statement of changes in equity**. It shows the change in a business' equity, but most importantly, the *changes in retained earnings* over a specific period of time. The basic structure of the statement is as follows:

### statement of changes in equity

A financial statement that reports the change in a business' equity (contributed equity, reserves and retained earnings) over a specific period of time.

#### KEY FORMULA 1.3: STATEMENT OF CHANGES IN EQUITY (THE RETAINED EARNINGS PART)

Retained Earnings, Beginning Balance  
 +/- Net Profit/Loss  
 - Dividends (Drawings)  
 = Retained Earnings, Ending Balance



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The drone is the asset, which is being used by the business to earn revenue

F&F's statement of changes in equity (retained earnings) would appear as shown in **Exhibit 1.3**. It contains the name of the business, the statement name and the time period, which for this example is the summer. Note there are a number of acceptable ways to express the time or timing in financial statements.

Your business started with no retained earnings but generated profits of \$9500 over summer. Since \$7310 was distributed in dividends (or drawings), the business retained some of that money. Therefore, retained earnings increased from \$0 to \$2190.

### Exhibit 1.3 STATEMENT OF CHANGES IN RETAINED EARNINGS FOR FLOATING AND FILMING

Floating and Filming Statement of changes in retained earnings from 1 December to 28 February	
Retained earnings, 1 December	\$ 0
+ Net income (or Net profits)	9 500
- Drawings (Dividends)	7 310
Retained earnings, 28 February	<u>\$2 190</u>

## Linking the income statement and the balance sheet

In addition to showing the change in retained earnings, the changes in retained earnings part of the statement of changes in equity links the income statement and the balance sheet. A business cannot calculate its retained earnings balance at the end of the period without factoring in the profit earned during the period. The changes in retained earnings provide this link by including net profit or loss in the calculation of retained earnings, which is then reported on the balance sheet. This means that when preparing financial statements for any business, the income statement must be prepared first, followed by the statement of changes in equity and then the balance sheet. A depiction of these links is included in **Exhibit 1.4**.

### Exhibit 1.4 RELATIONSHIP BETWEEN THE FINANCIAL STATEMENTS

Floating and Filming	
<b>(Simple) Income statement</b>	
Revenue	\$11 200
- Expenses	<u>1 700</u>
Net income (or Profit)	<u>\$9 500</u>
<b>Statement of changes in equity (retained earnings)</b>	
Retained earnings, 1 December	\$ 0
+ Net income (from above)	9 500
- Drawings	<u>7 310</u>
Retained earnings, 28 February	<u>\$ 2 190</u>
<b>(Abbreviated) Balance sheet</b>	
Total assets	\$ 5 190
Liabilities	2 000
Contributed capital	1 000
Retained earnings (from above)	<u>2 190</u>
Total liabilities and equity	<u>\$ 5 190</u>



## CSL Analysis

Look at CSL's statement of changes in equity (Consolidated statement of changes in equity) in this book's appendix.

- 1 Which column of the statement contains the changes in retained earnings?
- 2 For 2020, is the amount of profit after income tax expense for the period the same as profit after tax on the income statement?
- 3 Is the balance in retained earnings the same as the balance on the balance sheet? (Hint: look at the numbers in bold, as they are for 2020.)

### Analysis:

- 1 The statement of changes in equity has five double (2020, 2019) columns of numerical data. The fourth column (headed Retained earnings) is CSL's statement of changes in retained earnings.
- 2 In 2020, the amount of profit after tax (Profit for the period) is \$2102.5 million, which is the number shown on the income statement.
- 3 The total retained earnings at the end of the period are \$10 752.3 million, which is the same balance shown on the Balance sheet.



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## LO5 Reporting cash flows: the cash flow statement

Another important issue for any business is the management of cash. Where does a company get its cash? Where does its cash go? Will there be enough cash to pay the employees? Accounting provides answers to these questions with a financial statement called a cash flow statement. A cash flow statement reports a business' cash inflows and outflows from its *operating, investing* and *financing activities*, but lets us look at them in reverse order because the first thing a business needs to do is obtain some money before it starts operations. Remember F&F started with \$1000 of the owners and \$2000 borrowed.

### Financing activities

Most businesses must raise funds to begin. Borrowing money from creditors and receiving contributions from investors are both ways to finance a business' operations. Therefore, generating and repaying cash from creditors and investors are considered *financing*

*activities*. In the filming business, you contributed \$1000 of your own money and borrowed \$2000. Both of these inflows are from financing activities. Therefore, the cash inflow in summer from financing activities is \$3000. You withdrew \$7310 – this is a cash outflow from financing activities.

### Investing activities

Once a company has raised sufficient capital from creditors and investors, it usually acquires the revenue-generating assets that it needs for operations. The buying and selling of such assets are considered *investing activities*. In the filming business, you paid \$2600 for the drone. Therefore, the cash flows from investing activities were negative \$2600. In other words, F&F experienced a cash outflow of \$2600 in summer from investing activities.

### Operating activities

After the proper equipment is acquired, a business can begin operations. Operating a business may include the purchase of supplies, the payment of employees and the sale of products. These transactions are considered *operating activities*. For F&F, cash flows from operations over summer included \$10 000 received from customers for filming, \$1100 paid for supplies and \$50 paid to the bank in interest. As a result, the net cash inflow from operating activities for the month was \$8850 ( $\$10\,000 - \$1100 - \$50 = \$8850$ ). Note: this is not the same as profits, because revenue included the \$1200 you are owed; expenses included depreciation but not the cost of unused supplies.

## The cash flow statement

The details of cash inflows and outflows for a business are reported on a **cash flow statement**. The cash flow statement is a financial statement that shows a business' sources and uses of cash over a specific period of time. Its purpose is to inform users about how and why a business' cash changed during the period. The basic structure of the statement is as follows:

#### cash flow statement

A financial statement that reports a business' sources and uses of cash over a specific period of time.

#### KEY FORMULA 1.4: THE CASH FLOW STATEMENT

$$\begin{aligned}
 &\text{Cash Flows Provided (Used) by Operating Activities} \\
 &\quad +/ - \text{Cash Flows Provided (Used) by Investing Activities} \\
 &\quad +/ - \text{Cash Flows Provided (Used) by Financing Activities} \\
 &= \text{Net Increase (Decrease) in Cash} \\
 &\quad + \text{Cash at the beginning} \\
 &= \text{Cash at the end}
 \end{aligned}$$