

Accounting Building Business Skills

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Chapter One: Introduction to Financial Statements

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Learning Objectives

- Describe the main forms of business organisation.
- Describe the financial reporting environment.
- Identify the types of users of accounting reports and their information needs.
- Explain the accounting assumptions, principles and qualitative characteristics underlying financial statements.

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Learning Objectives

- Describe the three main financial statements and the basic accounting equation relating to the statement of financial position.
- Identify the sections of a classified statement of financial position.
- Calculate ratios for analysing a company's profitability, liquidity and solvency.

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Forms of Business Organisation

- Sole Proprietorship - owned by one person
- Partnership - owned by more than one person
- Corporation - organised as a separate legal entity and owned by s stockholders

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The Financial Reporting Environment

- Australian Securities & Investment Commission
- Financial Reporting Council & Australian Accounting Standards Board
- Australian Accounting Research Foundation
- Australian Stock Exchange

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Users of Financial Information

- Internal Users – managers: production, marketing and directors
- External Users –
 - Resource providers
 - Recipients of goods and services
 - Reviewers – regulatory organisations, governments, trade unions, special interest groups

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Types of Business Activity

- Financing
- Investing
- Operating

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Financing Activities

- Outside sources of funds
 - Borrowing (debt funding) from banks or investors by debt securities
 - Selling shares to investors



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Investing Activities

- Acquisition of resources/assets needed to operate the business
- *Examples:*
 - Purchase or sale of property plant and equipment
 - Purchase of investments



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Operating Activities

- Results from activities undertaken to earn income
- Revenue – sale of goods, provision of services, return from investments
less
- Expenses – cost of resources/assets consumed or services used



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Accounting Assumptions & Principles

- monetary assumption
- accounting entity assumption
- period assumption
- going concern assumption
- historical cost
- full disclosure

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Qualitative Characteristics

- relevance
- reliability
- materiality test
- comparability
- understandability

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Financial Statements & Basic Accounting Equation

Basic Accounting Equation

$$\boxed{\text{Assets}} = \boxed{\text{Liabilities}} + \boxed{\text{Owners' equity}}$$

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Financial Statements & Basic Accounting Equation

- Statement of Financial Performance
 - Reports Revenues less Expenses for a particular period of time
- Statement of Financial Position
 - Reports assets and claims to those assets at a particular point in time
- Statement of Cash Flows
 - Information regarding cash receipts and cash payments for a particular period of time

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Statement of Financial Performance

WONG PTY LTD Statement of Financial Performance for the month ended 31 October 2003		
Service revenues		\$10 600
Expenses:		
Salaries expense	5 3200	
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
Net profit after tax		<u>\$ 2 860</u>

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Statement of Financial Performance (cont.)

WONG PTY LTD Statement of Financial Position as at 31 October 2003		
Assets		
Cash		\$15 200
Accounts receivable		200
Advertising supplies		1 000
Prepaid insurance		550
Office equipment		4 900
Total assets		<u>\$ 21 910</u>
Liabilities and owners' equity		
Liabilities		
Accounts payable	\$ 2 500	
Interest payable	50	
Revenue received in advance	800	
Salaries payable	5 000	
Bank loan	5 000	
Total liabilities		\$ 9 550
Owners' equity		
Share capital	10 000	
Retained profits 31/10/03	2 360	
Total owners' equity		<u>12 360</u>
		<u>\$ 21 910</u>
Calculation of retained profits		
Retained profits 1/10/03	\$ —	
Net profit after tax	2 860	
Less: Dividends	(500)	
Retained profits 31/10/03	2 360	

Statement of Financial Performance (cont.)

WONG PTY LTD Statement of Cash Flows for the month ended 31 October 2003		
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		<u>\$15 200</u>

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Interrelationship of Statements

- Change in financial position depends on result of Statement of Financial Performance
- Ending amount in Statement of Cash Flows is reported in the Statement of Financial Position

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Classified Statement of Financial Position

Assets	Liabilities
Cash assets	Payables
Receivables	Interest-bearing liabilities
Inventories	Tax liabilities
Investments in associates and joint venture entities	Provisions
Other financial assets	Equity
Property, plant and equipment	Contributed equity (capital)
Tax assets	Reserves
Intangible assets	Retained profits or accumulated losses

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Classified Statement of Financial Position

Current Assets – expected to be converted to cash or used in the business within 1 year

COLORADO GROUP LTD Statement of Financial Position (partial) (in thousands)	
Current assets	
Cash assets	\$17 758
Receivables	3 882
Other financial assets (cash on short term deposit)	14 000
Inventories	44 668
Other	1 654
Total current assets	<u>\$81 962</u>

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Classified Statement of Financial Position

Non-Current Assets – not expected to be consumed or sold within 1 year

COLORADO GROUP LTD Statement of Financial Position (partial) (in thousands)	
Non-current assets	
Property, plant and equipment	\$33 197
Intangibles	13 217
Deferred tax assets	6 188
Total non-current assets	<u>\$52 602</u>

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Classified Statement of Financial Position

Intangible Assets – non-financial assets that have no physical substance
e.g. Patents, copyrights

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Classified Statement of Financial Position

- Current Liabilities – obligations that will be paid within 1 year

COLORADO GROUP LTD Statement of Financial Position (partial) (in thousands)	
Current liabilities	
Payables	\$18 239
Interest-bearing liabilities	6 760
Current tax liabilities	6 285
Provisions	15 405
Total current liabilities	<u>\$46 689</u>

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Classified Statement of Financial Position

Non-Current Liabilities – obligations expected to be paid after 1 year

COLORADO GROUP LTD Statement of Financial Position (partial) (in thousands)	
Non-current liabilities	
Interest-bearing liabilities	\$15 040
Deferred tax liabilities	1 675
Provisions	320
Total non-current liabilities	<u>\$17 035</u>

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Analysing Financial Statements

Ratio analysis

- relationships between items of financial statement data
- expresses the mathematical relationship between two different quantities
- Expressed as percentages, rates, proportions

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Financial ratio classifications

What do ratios show?

1. Profitability – measures the operating success
2. Liquidity – measures short-term ability to pay obligations as they fall due
3. Solvency – measures ability to survive over a long term



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Profitability ratios

Return on assets – amount of net profit generated by each \$ invested in assets

$$\frac{\text{Net profit}}{\text{Average Total Assets}}$$

	2001	2000
Fantastic Furniture (\$ in thousands)	$\frac{\$4025}{(\$21\,745 + \$16\,044)/2^*} = 21.3\%$	$\frac{\$4018}{(\$16\,044 + \$9026)/2^*} = 32.1\%$
Freedom Group	3.5% **	1.8%

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Profitability ratios

Profit margin – percentage each sales \$ that results in net profit

$$\frac{\text{Net Profit}}{\text{Net Sales}}$$

	2001	2000
Fantastic Furniture (\$ in thousands)	$\frac{\$4025}{\$69299} = 5.8\%$	$\frac{\$4018}{\$57460} = 7.0\%$
Freedom Group	2.3%	0.8%

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Liquidity ratios

Working capital –
Current Assets – Current Liabilities

Fantastic Furniture – year ending 30 June 2001
 $\$15,581,623 - \$8,997,094 = \$6,584,529$

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Liquidity ratios

Current ratio – measures short ability to meet
Current obligations

	2001	2000
Fantastic Furniture (\$ in thousands)	$\frac{\$15581}{\$8997} = 1.73:1$	$\frac{\$12458}{\$6478} = 1.92:1$
Freedom Group	1.51:1	1.43:1

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Liquidity ratios

Using the Statement of Cash Flows

Current cash Debt coverage ratio – indicates the ability to generate sufficient cash to meet short term needs

$$\frac{\text{Cash provided by operations}}{\text{Average Current Liabilities}}$$

	2001	2000
Fantastic Furniture (\$ in thousands)	Not calculated	$\frac{\$2836}{(\$6478 + \$4643)/2} = 0.51$ times
Freedom Group	0.25 times**	0.016 times

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Solvency ratios

Debt to Total Assets ratio – percentage of assets financed by creditors

$$\frac{\text{Total Liabilities}}{\text{Total Assets}}$$

	2001	2000
Fantastic Furniture (\$ in thousands)	$\frac{\$9323}{\$21745} = 43\%$	$\frac{\$6822}{\$16044} = 43\%$
Freedom Group	39%	44%

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Solvency ratios

Cash Debt coverage ratio – indicates ability to generate sufficient cash to meet long term needs

$$\frac{\text{Cash provided by operations}}{\text{Average total liabilities}}$$

	2001	2000
Fantastic Furniture (\$ in thousands)	Not calculated	$\frac{\$2836}{(\$6822 + \$4643)/2} = 0.49$ times
Freedom Group	0.25 times	0.18 times

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Decision toolkit

- Are the business operations profitable?
- Does the business rely mainly on debt or shareholder's equity to finance its assets?
- Does the business generate sufficient cash from operations to fund its investing activities?
- Is the company using its assets effectively?
- Is the company maintaining an adequate margin between sales and expenses?

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Decision toolkit

- Can the company meet its short-term obligations?
- Can the company meet its long-term obligations?

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