Financial accounting 3 summary assignment

Business

CHAPTER 1: FINANCIAL STATEMENTS Financial Statement – the means by which the information accumulated and processed in financial accounting is periodically communicated. General purpose financial statements -PAS1 prescribes to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. -statements intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

Components of financial statements 1. Statement of financial position 2. Income statement 3. Statement of Comprehensive Income 4. Statement of Changes in Equity 5. Statement of Cash Flows 6. Notes comprising a summary of significant accounting policies and other explanatory information objectives of financial statements -to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.

General features of financial statements Going Concern An entity preparing PFRS financial statements is presumed to be a going concern. If management has significant concerns about the entity's ability to continue as a going concern, the uncertainties must be disclosed. If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis, in which case PAS1 requires a series of disclosures. Accrual Basis of Accounting

PAS1 requires that an entity prepare its financial statements, except for cash flow information, using the accrual basis of accounting. Materiality and

Aggregation Each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only if they are individually immaterial. Offsetting Assets and liabilities, and income and expense, may not offset unless required of permitted by a Standard or an Interpretation. Frequency of Reporting An entity shall present a complete set of financial statements at least annually.

Comparative Information PAS 1 requires that comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements, both face of financial statements and notes, unless another Standard permits or requires otherwise. Consistency of Presentation The presentation and classification of items in the financial statements shall be retained from one period to the next unless a change is justified either by a change in circumstances of requirement of a new PFRS. Measurement of elements process of determining the monetary amounts at which the elements of FS are recognized and carried in the statement of financial position and income statement. Measurement base on financial attributes 1. Historical cost- amount paid or the face value of the consideration given to acquire assets at the time of acquisition. 2. Current cost- amount that would have to be paid if the same or an equivalent asset was acquired currently. 3. Realizable value- amount that would currently be obtained by selling the asset in an orderly disposal. 4.

Present value- discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. CHAPTER 2: STATEMENT OF FINANCIAL POSITION The Statement of Financial Position Elements Asset An asset is a resource controlled by the entity as a result of

the past events and from which future economic benefits are expected to flow the entity. Liability A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Equity Equity is the residual interest in the assets of the entity after deducting all its liabilities. Statement of Financial Position Presentation An entity must normally present a classified statement of financial position, separating a current and noncurrent assets and liabilities. Only if a presentation based on liquidity provides information that is reliable and more relevant may the current/noncurrent split be omitted. In either case, if an asset (liability) category commingles amounts that will be received (settled) after 12 months, note disclosure is required that eparates the longer-term amounts from the 12-month amounts. An asset shall be classified as current when it satisfies any of the following criteria: * It is expected to be realized in, or is intended for sale or consumption, in the entity’s normal operating cycle; * It is held primarily for the purpose of being traded; * It is expected to be realized within 12 months after the reporting period; or * It is cash or a cash equivalent unless restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

All other assets shall be classified as noncurrent. A liability shall be classified as current when it satisfies any of the following criteria: * It is expected to be settled in the entity’s normal operating cycle; * It is held primarily for the purpose of being traded; * It is expected to be settled within 12 months after the reporting period; or * The entity does not have an unconditional right to defer settlement of the liability for at least 12 months after reporting period.

All other liabilities shall be classified as noncurrent. Long-term debt expected to be refinanced under an existing loan facility is noncurrent, even if due within 12 months. If a liability has become payable on demand because an entity has breached an undertaking under a long-term loan agreement on or before the balance sheet date, the liability is current, even if the lender has agreed, after the balance sheet date and before the authorization of the financial statements for issue, not to demand payment as a consequence of the breach.

However, the liability is classified as non-current if the lender agreed by the balance sheet date to provide a period of grace ending at least 12 months after the balance sheet date, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment. When an entity presents current and non-current assets and liabilities as separate classifications on the face of the BS, it shall not classify deferred tax assets (liabilities) as current assets. CHAPTER 6: ACCOUNTING CHANGES

Changes in accounting estimate A change in accounting estimate is a normal recurring correction or adjustment of an asset or liability which is the natural result of the use of an estimate. Examples of accounting estimate a. Bad debt b. Inventory obsolescence c. Useful life, residual value, and expected pattern of consumption of benefit of depreciable asset. d. Warranty cost e. Fair value of financial assets and financial liabilities Changes in accounting estimates are to be handled currently and prospectively, if necessary.

Prospective recognition of the effect of a change in accounting estimate means that the change is applied to transactions, other events and

conditions from the date of change in estimate. A change in depreciation method is accounted for as a change in accounting estimate. Accounting policies -are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. Changes in accounting policy A change in accounting policy shall be made only when: a. Required by an accounting standard or an interpretation of the standard. b.

The change will result in more relevant or reliable information about the financial position, financial performance and cash flows of the entity. Examples of change in accounting policy a. Change in the method of inventory pricing from the FIFO to weighted average method b. Change in the method of accounting for long term construction contract. c. The initial adoption of policy to carry assets at revalued amount d. Change from cost model to fair value model in measuring investment property and property, plant and equipment e. Change to a new policy resulting from the requirement

A change in accounting policy required by a standard or an interpretation shall be applied in accordance with the transitional provisions therein. If the standard or interpretation or transitional provisions or if an accounting policy is changed voluntarily, the change shall be applied retrospectively. Retrospective application means that any resulting adjustment from the change in accounting policy shall be reported as an adjustment to the opening balance of retained earnings. The amount of the adjustment is determined as of the beginning of the year.

Prospective application means that the new accounting policy is applied to events and transactions occurring after the date of change. Change in reporting entity A change in reporting entity is a change whereby entities change their nature and report their operations in such a way that the financial statements are in effect those of a different reporting entity. CHAPTER 7: INTERIM FINANCIAL REPORTING Interim report is a financial reporting period shorter than one financial year. Components of an interim financial report a. Condensed statement of financial position . Condensed income statement c. Condensed statement of comprehensive income d. Condensed statement of cash flows e. Selected explanatory notes Under PAS 34, paragraph 28, the general rule in preparing interim financial statements is that costs and expenses that clearly benefit more than one interim period are allocated to the interim periods affected. Inventory loss from market decline is reported in the interim period in which the decline occurs. Recovery of such loss on the same inventory in later interim period is recognized as gain in the later interim period.

However, any gain on reversal of inventory writedown is limited only to the amount of loss previously recognized. The effects of a disposal of segment of business are reported separately in the interim periods in which they occur. PAS 34, paragraph 39, provides that cost incurred unevenly during a financial year shall be anticipated or deferred for interim purposes only if it is also appropriate to anticipate or defer such cost at the end of the financial year. Gains should be recognized in the interim period in which they are realized.

The cumulative effect of change in accounting policy is shown in the statement of retained earnings, not in the income statement. CHAPTER 8: OPERATING SEGMENT Under PFRS 8, an entity shall disclose information about an operating segment that meets any of the following quantitative thresholds: 1. The segment revenue, including both sales to external customers and intersegment sales or transfers, is 10% or more of the combined revenue, internal and external, of all operating segments. 2. The segment profit or loss is 10% or more of the greater of the following: a.

The combined profit of all operating segments with profit b. The combined loss of all operating segments with loss 3. The assets of the segment are 10% or more of the combined assets of all operating segments. Under PFRS 8, paragraph 13, segment revenue includes sales to external customers and intersegment sales of operating segments engaged solely in manufacturing. Revenue includes both sales to unaffiliated customers and intersegment sales. Under PFRS 8, paragraph 15, the total external revenue attributable to reportable operating segments must be at least 75% of the total entity external revenue.

General corporate expenses are not allocated to operating segments as a measure of profit or loss. If the total external revenue attributable to reportable segments constitutes less than 75% of the entity external revenue, additional segments shall be identified even they do not meet the 10% quantitative threshold until 75% of the entity external revenue is included in reportable segments. Moreover, reportable segments that are below the10% threshold can be aggregated as one segment if they have

similar economic characteristics and share a majority of the five aggregation criteria as follows: a.

Nature of product b. Nature of production process c. Class of customer d. Method of distributing product e. Regulated environment CHAPTER 9: CASH AND ACCRUAL BASIS Method of Accounting. 1. Cash Basis- Income is recognized when received regardless of when earned, and expense is recognized when paid regardless of when incurred. 2. Accrual Basis- Income is recognized when earned regardless of when received, and expenses are recognized when incurred regardless of when paid. Computation of sales under accrual basis Cash Sales XX

Sales on account: Trade accounts and notes receivable XX Collection of Trade accounts and notes receivable XX Sales returns, allowances and discounts XX Accounts and notes receivable write off XX Trade notes receivable discounted XX Total XX Less: trade accounts and notes receivable, beg XX Total Sales XX Computation of Purchases under Accrual Basis Cash Purchases XX Purchases on account XX Trade accounts and notes payable, end XX

Payment of Trade accts and Notes payable XX Purchases return, discounts & allowances XX Total XX Less: Trade accts and notes payable, beg XX Total purchases XX Income other than sales Income received XX Add: Deferred income- beg XX Accrued income- end XX Total XX Less: Deferred income- endXX Accrued income- begXX XX Income for the current year XX Expenses in general Expenses paid XX Add: prepaid expenses- beg XX Accrued expenses- end XX

Total XX Less: Deferred income- endXX Accrued income- beg XX XX Income for the current year XX Prepaid expenses are expenses paid in advance but not yet incurred. These are assets. Accrued expenses are expenses already incurred but not yet paid. These are liabilities. CHAPTER 10: SINGLE ENTRY Single Entry System A system of record keeping in which transactions are not analyzed and recorded in the double entry framework is called a single entry system when the records are said to be incomplete. CHAPTER 11: ERROR CORRECTION Prior Period Errors

Prior period errors are omissions from, and misstatements in, an entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that was available and could reasonably be expected to have been obtained and taken into account in preparing those statements. Such error result from mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretation of facts, and fraud. Prior period error shall be corrected by retrospective restatement, meaning, if comparative statements are presented, the prior year statements are restated to correct the error.

Types of Errors a. Statement of financial position errors *affect the statement of financial position and real accounts only, meaning, the improper classification of an asset, liability and capital account. b. Income Statement errors * affect the income statement or nominal accounts only, meaning, the improper classification of revenue and expense account c. Combined statement of financial position and Income statement errors * affect both the statement of financial position and income statement ecause they result in a misstatement of net income If it is impracticable to determine the period

specific effect of an error on comparative information for one or more prior periods presented, the entity must restate the opening balances of assets, liabilities, and equity for the earliest period for which retrospective statement is practicable (which may be the current period) Further, if it is impracticable to determine the cumulative effect, at the beginning of the current periods, the entity must restate the comparative information to correct the error prospectively from the earliest date practicable.

CHAPTER 12: STATEMENT OF CASH FLOW Cash comprises cash on hand and demand deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Cash flows are inflows and outflows of cash and cash equivalents. Operating Activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalent.

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. *Interest and dividends received and paid may be classified as operating, investing, or financing cash flows, provided that they are classified consistently from period to period. Interest paid ??? usually operating; alternatively financing Interest received ??? usually operating; alternatively financing Dividends received ??? usually operating; alternatively financing Dividends paid ??? usually financing; alternatively operating FINANCIAL STATEMENT ANALYSIS

THE BASIC FINANCIAL STATEMENT ANALYSIS 1. HORIZONTAL OR COMPARATIVE ANALYSIS -represents the differences in absolute amount and in percentage between two periods (i. e. years, quarters, etc.), two companies, actual and budgeted date, and other bases analyses. Percentage of changes= Amount of change/Base 2. TREND ANALYSIS It extends beyond two years. The purpose of trend analysis is to track down what happened in the past and provide a pattern on what may happen in the coming years. It uses indexes and ratios to simplify the visible complications of numbers contained in financial reports. . THE VERTICAL ANALYSIS (OR COMMON-SIZE ANALYSIS) It gets the proportional component of each of the variables in the financial statements in relation to a chosen base 4. THE FINANCIAL MIX RATIO CLASSIFICATION OF FINANCIAL MIX RATIOS a. Profitability Ratios It measures the ability of the business to generate profit in relation to sales, investments, assets, equities, or common shares outstanding. ??? RETURN ON SALE = Net Income Net sales ??? GROSS PROFIT RATE = Gross Profit Net Sales ??? RETURN ON TOTAL ASSETS = Net income + Interest expense, net of tax/ average total assets RETURN ON SHE = Net income Ave. SHE b. Growth Ratios -Are indicative of the organization's potential and attractiveness as an investment option. EARNINGS PER SHARE = Net income – Pref. dividend Ave. common shares outstanding BOOK VALUE PER SHARE = Shareholder's Equity Ave. shares outstanding c. Liquidity Ratios Liquidity refers to the ability of the business to pay its obligations in cash as they mature. OPERATING TURNOVER = collection period + inventory days INVENTORY TURNOVER = COGS Ave. inventory INVENTORY DAYS = 360/ inventory days

RECEIVABLE TURNOVER = Net credit Sales Ave. Trade receivables COLLECTION PERIOD = 360/ ARTO PAYABLE TURNOVER = Net credit purchases Ave. Trade payables PAYABLES DAYS = 360/ payable turnover NET WORKING CAPITAL = Current Assets-Current Liabilities CURRENT RATIO = Current asset/ Current Liabilities QUICK RATIO = Quick Assets/ Current Liabilities d. Leverage Ratios Financial leverage is a measure of risk. DEBT to EQUITY RATIO = total debt Net SHE DEBT to ASSET = Total debt total assets TIME INTEREST EARNED = EBIT interest expense