MODULE 03: FINANCIAL ANALYSIS

Lecture 01: Accounting Concepts

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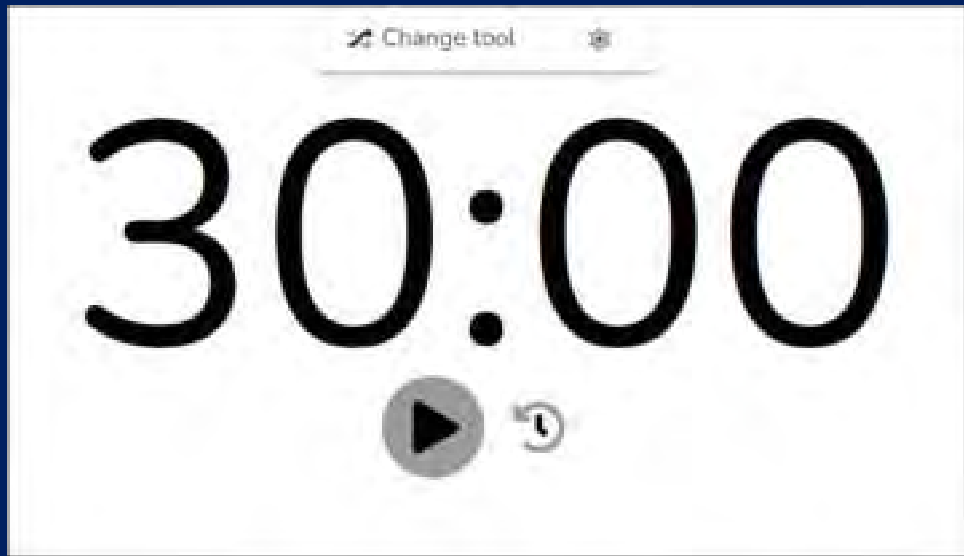
Module Outline

Introduction to Accounting Concepts	Financial Systems	Accountancy Techniques & Ratios	Short-Term vs Long-Term Decisions
Evaluation Financial Statements	Financial Forecasts	Group Presentations & Assignment	Tutorials

Today’s Agenda

- Self- Assessment – Part 1
- Accounting Principles & Concepts
- Accounting Theory
- Business Set-Ups and Formats
- Books of Account
- Financial Statements

Self-Assessment



Accounting Environment

Accounting Environment

- Accounting has been defined as the language of business
- Accounting enables organizations to determine how much profits or losses have been made in a particular period (financial year)
- Accounting provides statistical benchmarks against which an organization's overall performance is measured
- Accounting provides a universal explanation of the financial strength of an organization

History

- Double-entry bookkeeping was developed in the mercantile period of Europe
- To help rationalize commercial transactions and make trade more efficient
- It also helped merchants and bankers understand their costs and profits
- Some thinkers have argued that double-entry accounting was a key calculative technology responsible for the birth of capitalism

History

- The father of modern accounting is Italian Luca Pacioli, who in 1494 first described the system of double-entry bookkeeping used by Venetian merchants in his *Summa de Arithmetica, Geometria, Proportioni et Proportionalita*.

Book-Keeping…or Accounting ?

- Book-keeping focuses on recording and organizing financial data.
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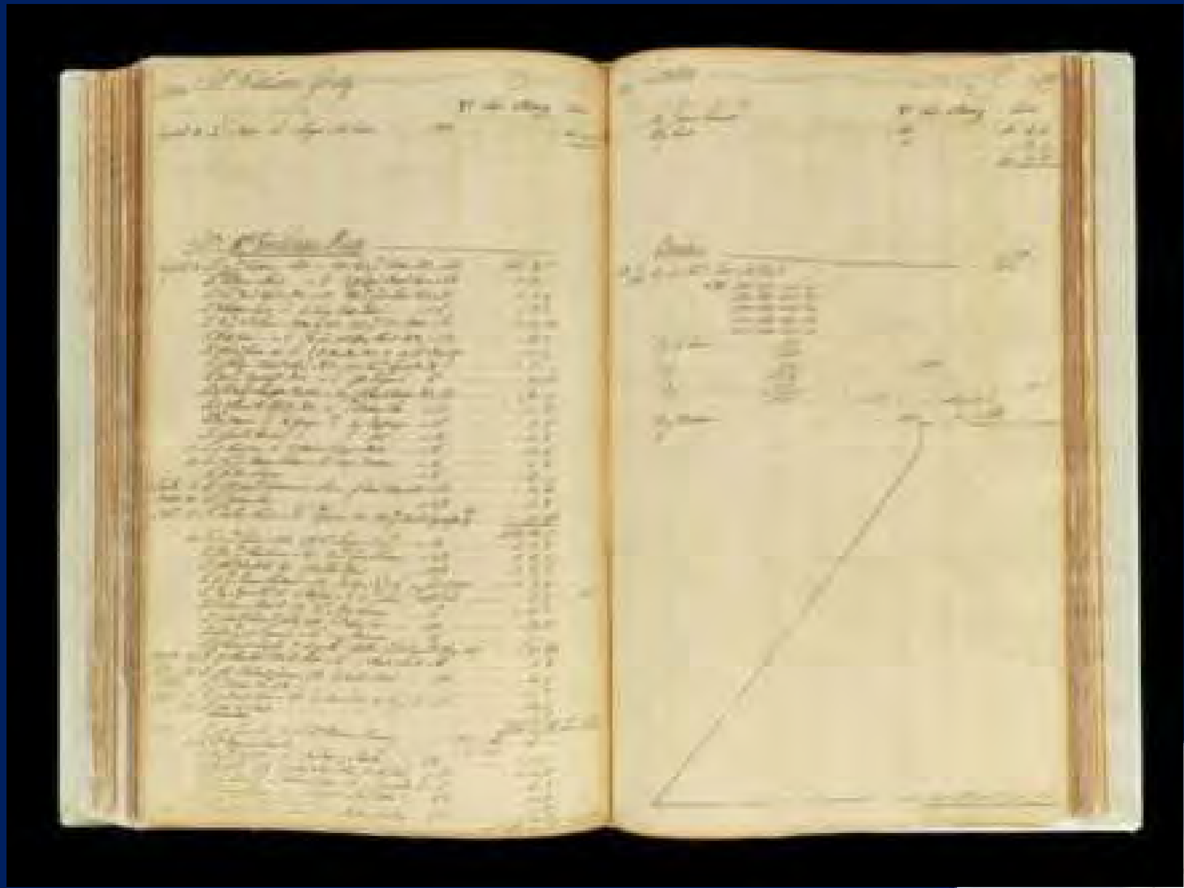
- Accounting is the interpretation and presentation of that data to business owners and investors.



Book-Keeping…or Accounting ?

Book-keeping typically consists of:

- invoicing
- receipts and bills
- recording business transactions
- payroll

Book-Keeping...or Accounting ?

Accounting typically consists of:

- financial statements and reports
- budgets
- tax returns
- analyzing business performance

Book-Keeping...or Accounting ?

The tasks that book-keepers and accountants do vary between businesses.

Book-keepers working for smaller businesses might do some basic accounting duties.

There's often overlap, and the duties may change a lot from one business to another.

Users of Accounting Information

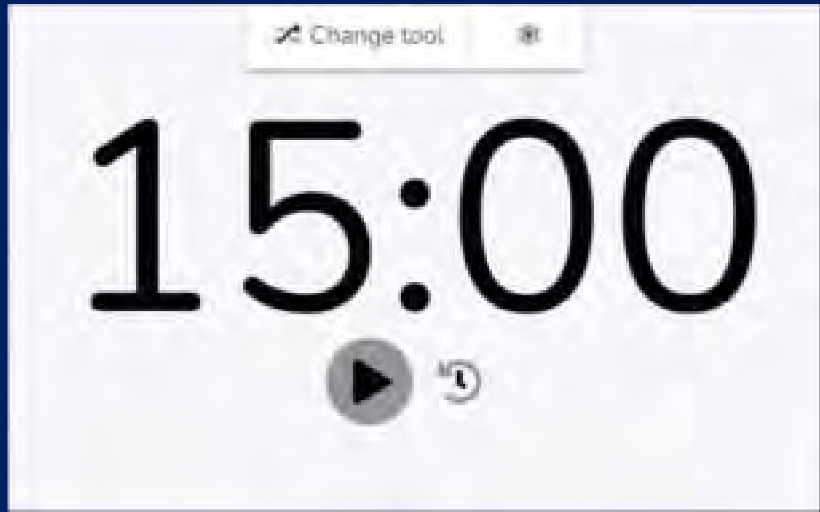
- Owners / Shareholders / Partners
  - (Current Profitability, Capital Growth, Dividend Returns)
- Investors
  - (Future Profitability, Risks of Investment)
- Government
  - (Profitability, Taxation payments)

Users of Accounting Information

- Creditors/Suppliers
  - (Liquidity, Ability to repay debts, Time taken to pay debts)
- Employees
  - (Profitability, Organisation Growth, Organisational Stability, Security of Employment)
- Management
  - (Profitability, Return on Capital, Capital Growth, Owners' Satisfaction)
- General Public
  - (Profitability, Organisational Stability and Growth, Market Share)

Sources of Financial Information

- Financial Information is provided to different users from the annual published accounts
- These accounts are derived primarily from the accounting records and the annual financial statements
- Other sources of information include market surveys, company research information, share market prices, financial estimates and other relevant data that may be made available to users of accounting information



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Accounting Principles

Accounting Principles

- All users will see the same financial statements

- Principles – to provide consistent usable financial statements
  - Relevance
  - Reliability
  - Comparability
  - Understandability

Accounting Principles

- **Relevance**
  - Financial information is considered relevant if it affects the business decision

Any other decision outside of the business cycle is ……….

Accounting Principles

- **Reliability**
  - Information should be free from significant errors, bias and independently verified.

Auditors

Internal

External

Opinions

Accounting Principles

- **Comparability**
  - Can be compared with other periods and similar businesses.

Like with Like

Accounting Principles

- **Understandability**
  - The Financial Statements must be capable of being understood by the users of the report

Various users

Internal vs External

Name some …….

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Accounting Theory

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The Accounting Theory

Business Set-Ups

Business Organisations

- Self-Employed – Sole Trader
- Self-Employed – With employees
- Partnership
- Limited Liability Company
- Public Company
- Government & Parastatal
- Group Structure
- VOs and Associations
- Trusts

Self-Employed

- A sole trader or practitioner
- Can work from home or mobile environment
- May have employees
- The benefits of being self-employed include:
  - being your own boss
  - creating your own schedule
  - flexibility
  - working towards your own dreams
  - taking enjoyment in the challenges of starting something from scratch
  - choosing the people you work with
  - creating your own work environment

Partnership

Advantages

- Two heads (or more) are better than one
- Your business is easy to establish
- Start-up costs are low
- More capital is available for the business
- Greater borrowing capacity
- High-calibre employees can be made partners
- Opportunity for income splitting, an advantage of particular importance due to resultant tax savings
- Partners’ business affairs are private
- Limited external regulation
- Easy to change your legal structure later if circumstances change

Partnership

Disadvantages

- the liability of the partners for the debts of the business is unlimited
- each partner is ‘jointly and severally’ liable for the partnership’s debts; that is, each partner is liable for their share of the partnership debts as well as being liable for all the debts
- there is a risk of disagreements and friction among partners and management
- each partner is an agent of the partnership and is liable for actions by other partners
- if partners join or leave, you will probably have to value all the partnership assets and this can be costly

Limited Liability Company

- Formed by a group of persons
- Official registered as a separate legal entity
- Shareholders own shares in Company
- Limited liability of Shareholders
- Perpetual existence
- Flexible Management structure
- Easy transferability of financial interests
- Taxation considerations
- Dividends distribution

Public Company

- Same structure of a Limited Liability Company
- Greater complexity and regulatory requirements
- Cost of setting Up
- Financial Reporting more detailed
- Investor Appetite
- Generation of greater funds
- Attracting top talent
- Reducing risk
- Image and brand

Government & Parastatal

Wholly owned by government

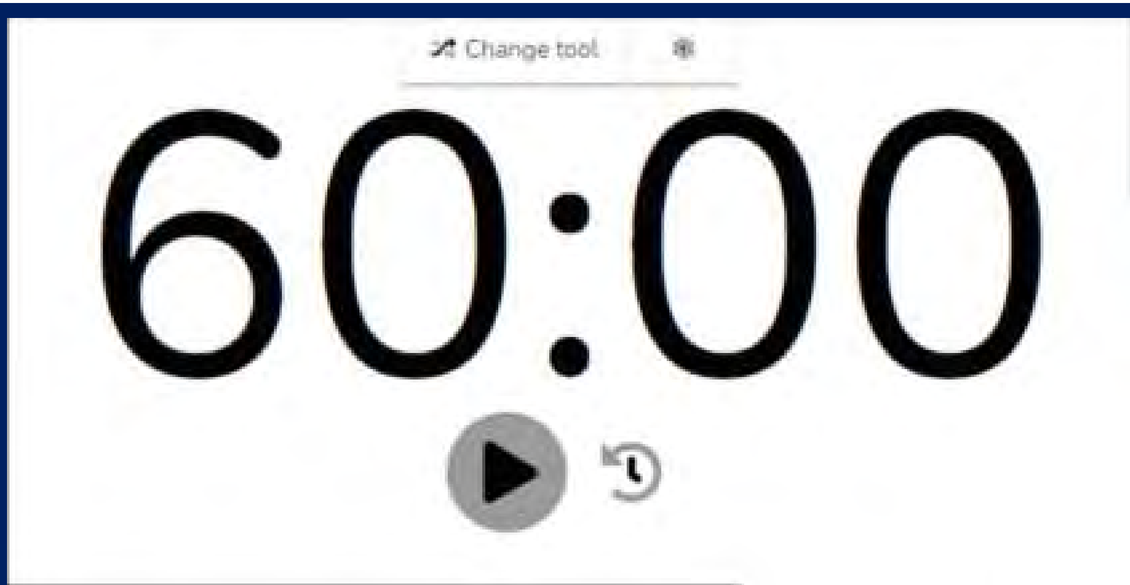
Advantages

- Control of strategic products
- Provides products at cheap prices
- Reduces duplication of resources
- Employs people
- Implement government policy
- Source of income to government, reducing tax burden
- Enjoys economies of large-scale operations

Government & Parastatal

Disadvantages

- Operates below full capacity
- Most times at a loss
- Provides poor quality products as they are mostly monopolies
- Political interference in operations
- Expensive to run and maintain
- Bureaucracy leads to inefficiencies
- No employee incentive to excel
- Loaded with cronies and government supporters
- Corruption



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Accounting Concepts

Accounting Concepts

- Concepts represent the rules that are applied in recording transactions and preparing the Financial Statements

- **Business Entity Concept**
- **Money Measurement Concept**
- **Historic Cost Concept**
- **Realisation Concept**
- **Dual Aspect Concept**
- **Consistency Concept**
- **Materiality Concept**
- **Accruals Concept**
- **Prudence Concept**
- **Going Concern Concept**
- **Substance over Form**

Business Entity Concept

- Only the transactions of the business should be recorded and **NOT** the owner's private transactions

E.g.

- Groceries bought for the Owner
- Necklace bought for Director's spouse
- Holiday Hampers bought for Clients

Money Measurement Concept

- Only Transactions that can be expressed in **monetary terms** are to be booked

E.g.

- Purchase of Transport Loader
- Acquiring a Bank Loan
- Employee Skills
- Brand value of Company

Historic Cost Concept

- All transactions are recorded at their **cost** to the business

E.g.

- Stocks bought at cost
- Office furniture bought at 50% discount
- Work of Art bought for Eur15,000; yet art valuers estimate it is worth Eur 100,000

Realisation Concept

- Profits are realized when cash or a receivable replaces the goods or services
- A transaction is **NOT** realized when an order is received or when a debtor pays their debt

E.g.

- Client receives the TV set bought
- Salesperson brings in an email asking for prices of goods

Dual Aspect Concept

- Every transaction will affect two items in the business
- Represented by both a **DEBIT** and a **CREDIT** entry in the Ledgers

E.g.

- Purchase of stock by cash
- What are the effects ?

Consistency Concept

- Transactions of a **similar nature** should always be recorded in the same consistent way

E.g.

- Depreciation percentage every year – should this be the same ?
- Definition of Sales Accounts
- Comparability

Materiality Concept

- Requires that transactions are to be recorded if they have a **material value**
- What is trivial ?
- What is of value ?

E.g.

- Electricity bulbs
- Ducking Tape
- Depreciation of Water cooler
- Paper reams by photocopier

Accruals Concept

- The Financial Statements should only include the income earned and the expenses incurred for that **particular** period / year

E.g.

- No Water & Electricity bill received at end of Year
- Rent payable for next year already paid
- Sales commissions due at Christmastime

Prudence Concept

- Profits must **NOT** be overstated and the value of Assets must **NOT** be shown to be too high, or higher than actual
- It is the Accountant's duty to ensure that the readers of the financial statements get a true and proper view of the financial state of the business

E.g.

- Write-off of Bad Debts
- Revaluation of Buildings

Going Concern Concept

- A basic assumption is that a business will continue to exist for a long period of time
- Allows users to presume that the business activity will carry on, and any investments made will render a positive return

E.g.

- Knowledge of a rival and better product to hit the markets
- Government intervention against business brand

Substance over form

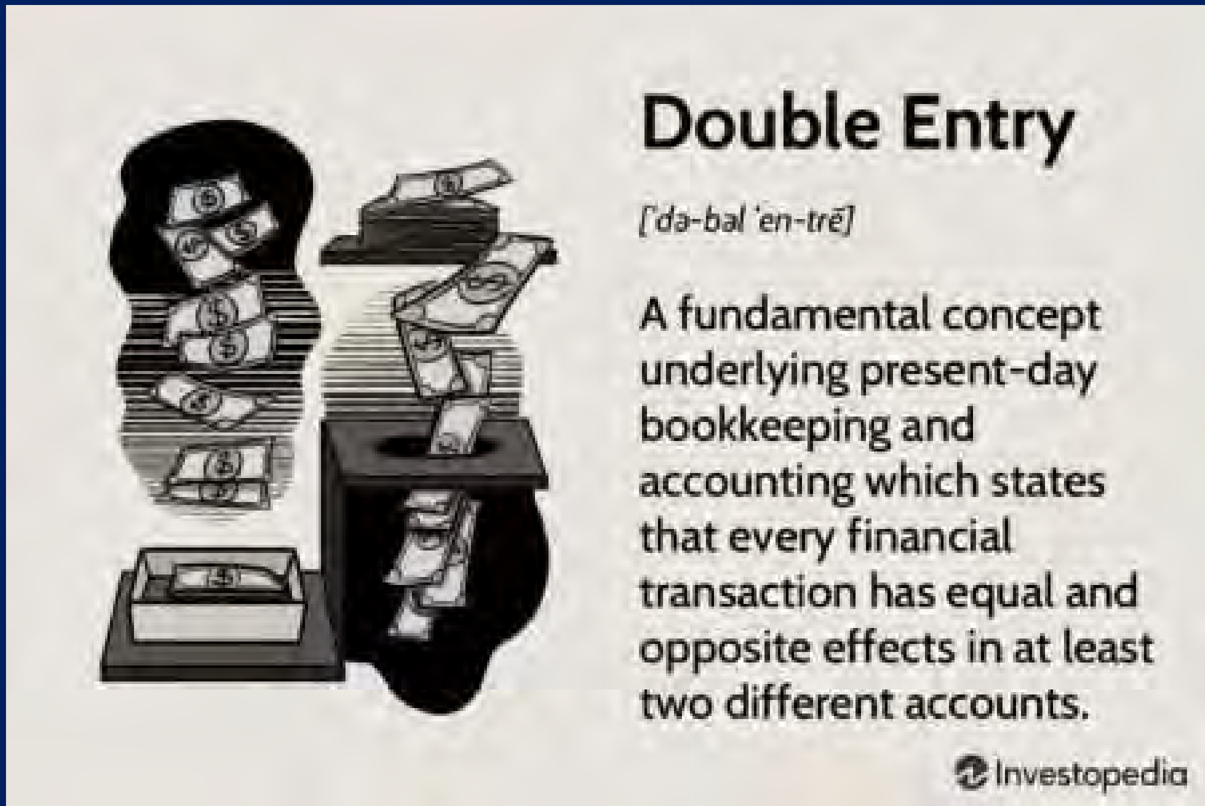
- The **PRACTICAL** view vs the **LEGAL VIEW** in Accounting
- Practical – the substance
- Legal – the form

E.g.

- Equipment bought on hire purchase terms
  - Practical – owned by business and gives a return
  - Legal – still remains the possession of the seller until last payment is settled

Double Entry & Bookkeeping

Double Entry



Double Entry Bookkeeping

- Every financial transaction has equal and opposite effects in two different accounts
- Transactions are recorded in terms of debits and credits
- The sum of all debits must be exactly equal to the sum of all credits

Dr. **Miscellaneous Expense** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Cash	24,000			
				Balance C/d	24,000
		24,000			**24,000**
	Balance b/d	24,000			

Dr. **Dividend** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Cash	2,500			
				Balance C/d	2,500
		2,500			**2,500**
	Balance b/d	2,500			

Dr. **Equipment** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance B/d	20,000			
	To Cash	15,000			
				Balance C/d	35,000
		35,000			**35,000**
	Balance b/d	35,000			

Dr. **Depreciation** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
	To Accumulared Derepciation	2,000			
				Balance C/d	2,000
		2,000			**2,000**
	Balance b/d	2,000			

Dr. **Accumulated Depreciation** Cr.

Date	Particulars	Amount	Date	Particulars	Amount
				By Balance B/d	6,000
				By Derepciation	2,000
	Balance C/d	8,000			
		8,000			**8,000**
				Balance b/d	8,000

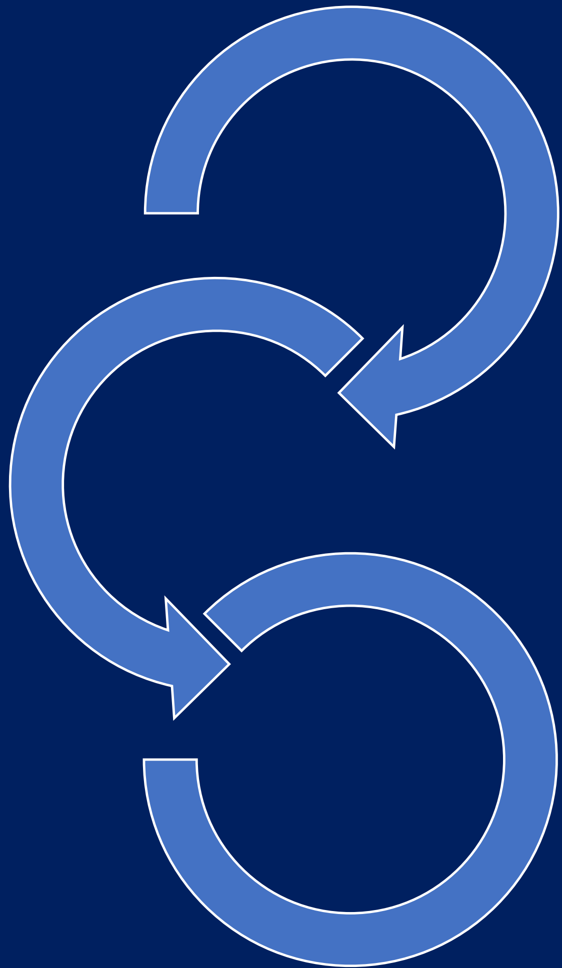
Daily Process

The transactions recorded in an entity must be initiated by:

- Documents
- Records
- Third party interaction
- Manual vs electronic

Process flow

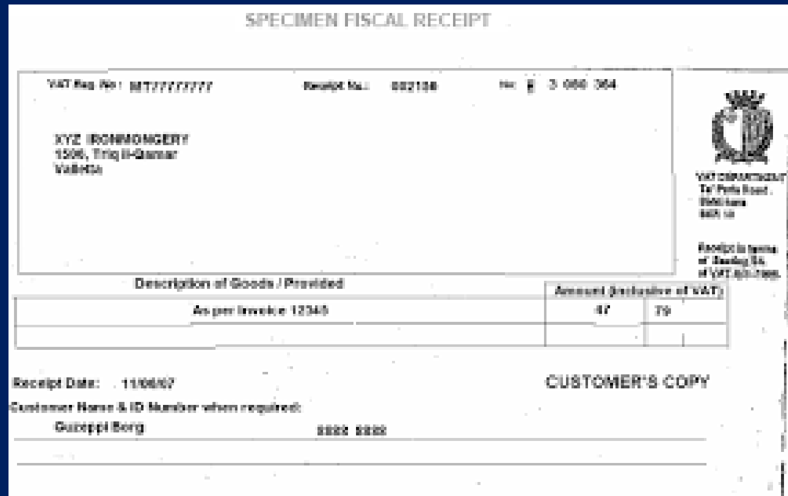
- Orders
- Approvals
- Receipt of goods
- Confirmation
- Recording in Day Books
- Authorisation for Payment
- Payment
- Reconciliation



Daily Books

- Revenue Cycle
  - Cash Sales
  - Sales Invoices
  - Fiscal Invoices / Cash Register Chits / Z Readings
  - Receivables (or Debtors)

Samples of Sales Invoices



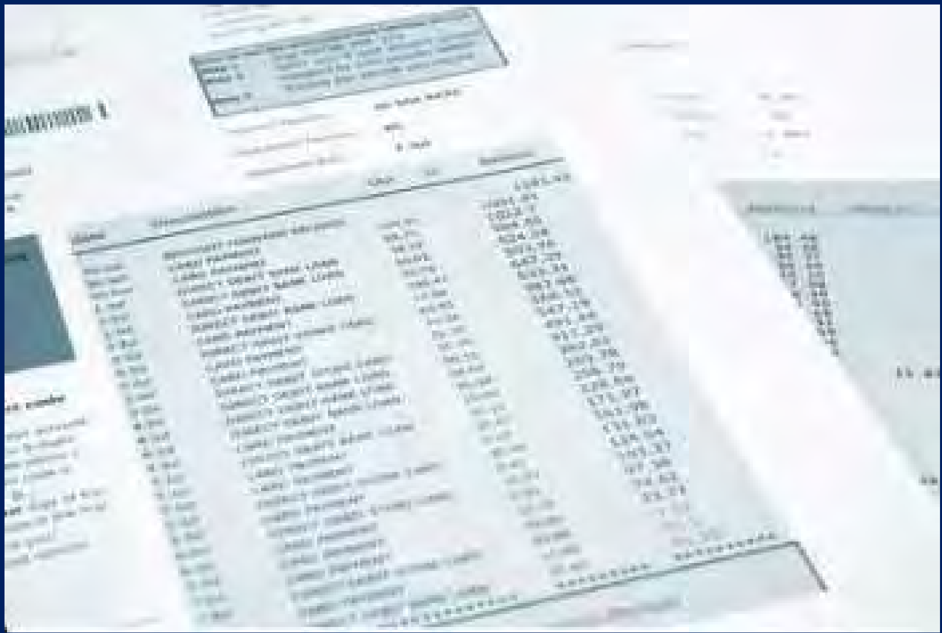
Daily Books

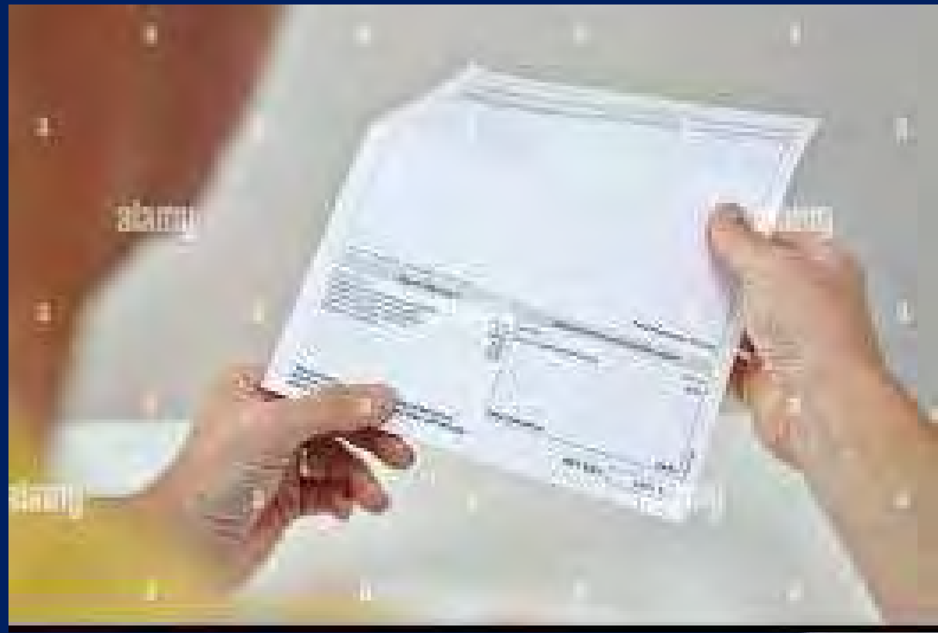
- Purchasing Cycle
  - Purchase Orders
  - Purchase Invoices
  - Cash Expense
  - Payables (or Creditors)

Daily Books

- Banking Cycle
  - Receipts
  - Payments
  - Bank Statements
  - Reconciliations
- Payroll
  - Time-keeping
  - Processing
  - Settlement
  - Documentation

Bank Statements





Cash vs. Accrual Accounting

Cash accounting	Accrual accounting
Recognizes revenue when cash has been received	Recognizes revenue when it's earned (eg. when the project is complete)
Recognizes expenses when cash has been spent	Recognizes expenses when they're billed (eg. when you've received an invoice)
Taxes are not paid on money that hasn't been received yet	Taxes paid on money that you're still owed
Mostly used by small businesses and sole proprietors with no inventory	Required for businesses with high revenues

The Basics of Double Entry

- In the double-entry system, transactions are recorded in terms of debits and credits
- Since a debit in one account offsets a credit in another, the sum of all debits must equal the sum of all credits
- The double-entry system of book-keeping standardizes the accounting process and improves the accuracy of prepared financial statements, allowing for improved detection of errors
- The list of all debits and all credits, as per each individual account in the Nominal Ledger is called a TRIAL BALANCE

Examples of Double Entry Transactions

Purchase of machine by cash

- Debit Machine Account Increase in Asset
- Credit Cash Account Decrease in Asset

Payment of utility bills

- Debit Utility Expense Increase in Expense
- Credit Cash Account Decrease in Asset

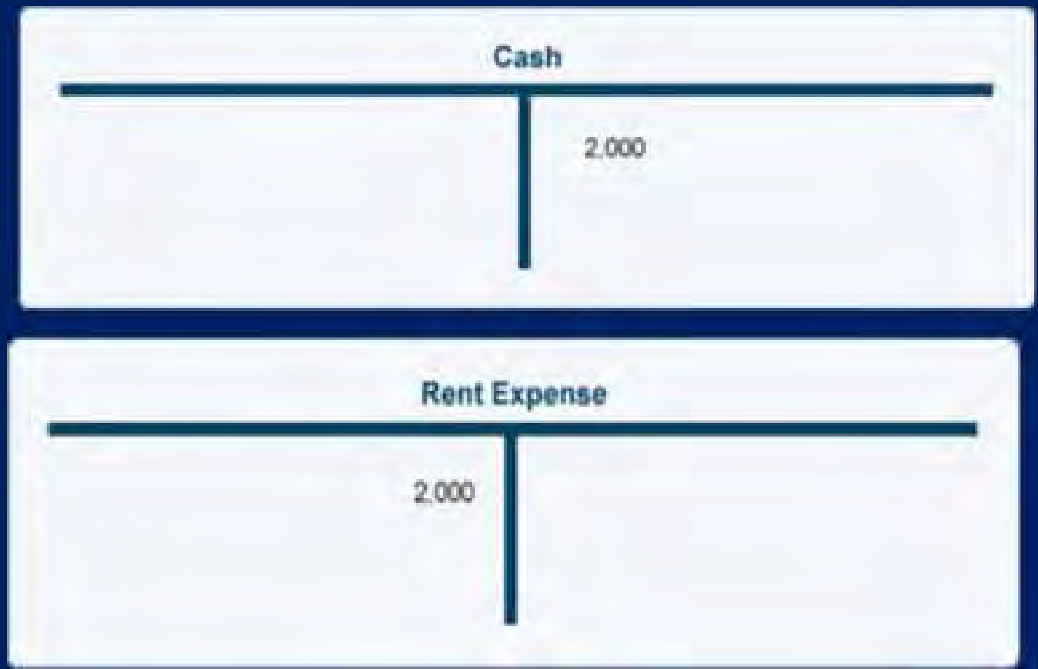
Double Entry Bookkeeping

T-accounts

- Every account has two "**sides**", a right side and a left side.
- A debit refers to an entry on the left side of an account, and a credit refers to an entry on the right side of an account

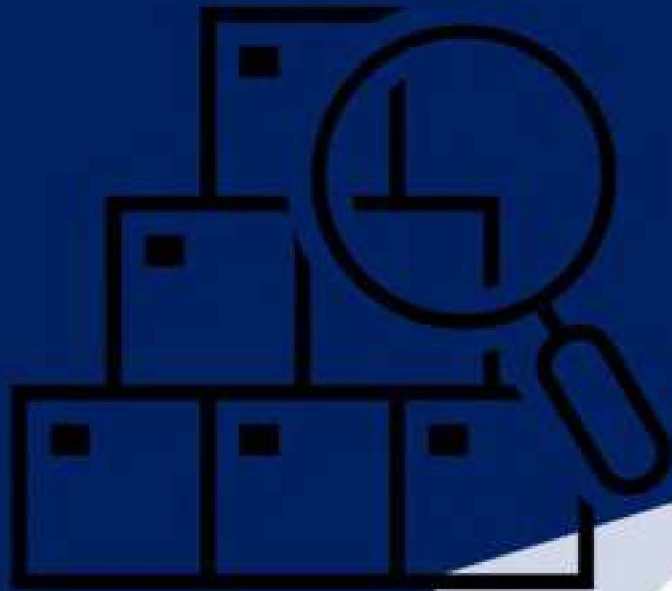
Double Entry Book keeping

If a company pays its rent of €2,000 for the current month, the transaction will be shown like this:



Double Entry Book Keeping

- Advantages
- Helps prepare more accurate financial statements directly from the books of account
- Provides a historical and chronological record of all transactions in a period
- Provides referencing to original documents
- Helps detect any possible errors



Double Entry Book Keeping

The Basics:

- Expenses are always debits
- Revenues are always credits
- Debit the Cash account when cash is received
- Credit the Cash account when cash is paid out

Double Entry Book Keeping

E.g.

- A new desk is purchased costing €10,600 for the business

- The transaction has two parts:

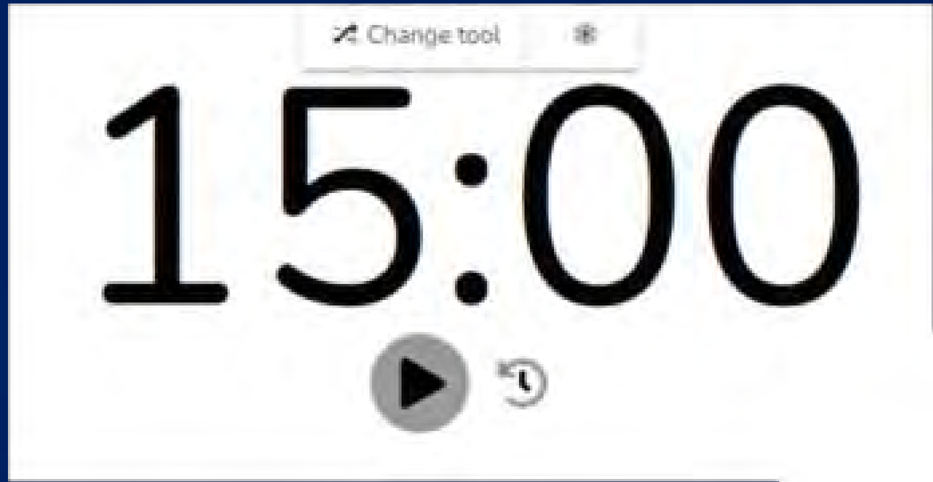
- Business spends an asset ("cash") to buy another asset ("furniture").

- The accounting entry should be
- done in two accounts:
- •the Cash account
- •the Furniture account

Double Entry Records

The Double-Entry System for Assets, Liabilities, Capital, Revenues and Expenses is the following:

- In the case of Assets and Expenses, an increase in the account is illustrated by debiting the account, whilst a decrease is accounted for by crediting the account
- In the case of Liabilities, Capital and Revenues, an increase in the account is illustrated by crediting the account, whilst a decrease is accounted for by debiting the account



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Group Work
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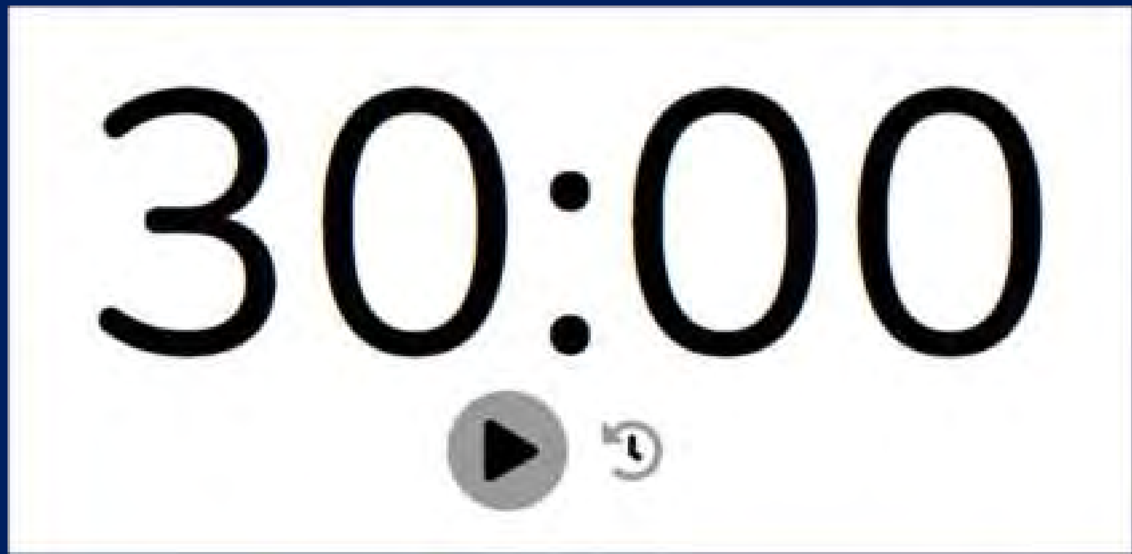
Group Work

- Get the 5 Groups together
- Assigned Business Structure
- Prepare an Organigram of the different Departments
- Identify a product or Service
- Explain which Accounts will be used
- Where would these feature ?
- Any issues

Group Work



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