MODULE 03: FINANCIAL ANALYSIS

Lecture Title 02: FINANCIAL STATEMENTS

Lecturer: Antoine P. Portelli

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ACADEMY

Undergraduate Diploma in Business Administration

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

What we covered in Lecture 01

- History & Accounting Environment
- Who are the Users of Financial information
- Accounting Principles
- Accounting Theory
- Business Set-Ups
- Accounting Concepts
- Double Entry & Book-keeping
- Group Work

Accounting Principles

- All users will see the same financial statements

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

Business Organisations

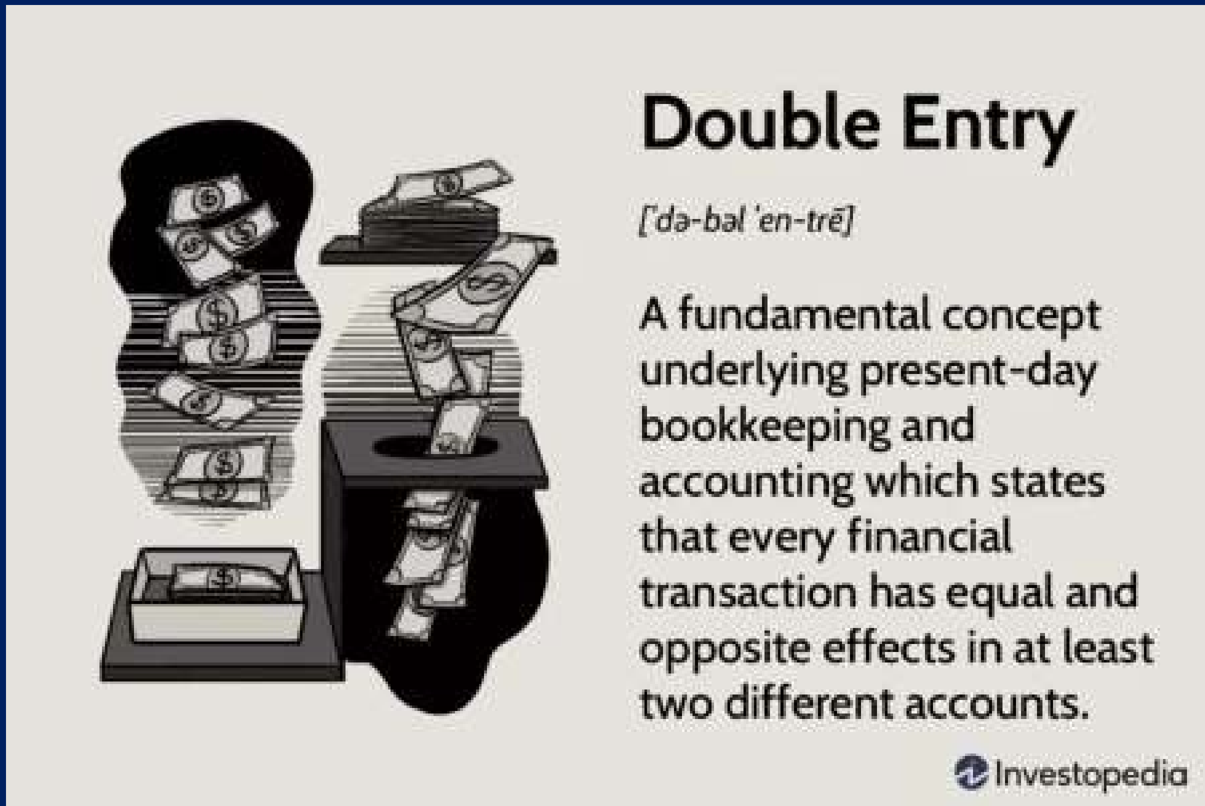
- Self-Employed – Sole Trader
- Self-Employed – With employees
- Partnership
- Limited Liability Company
- Public Company
- Government & Parastatal
- Group Structure
- VOs and Associations
- Trusts

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

Double Entry



Today’s Agenda

Basics of Double Entry

Accounting Terms & Equation

Trial Balance

Financial Statements

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

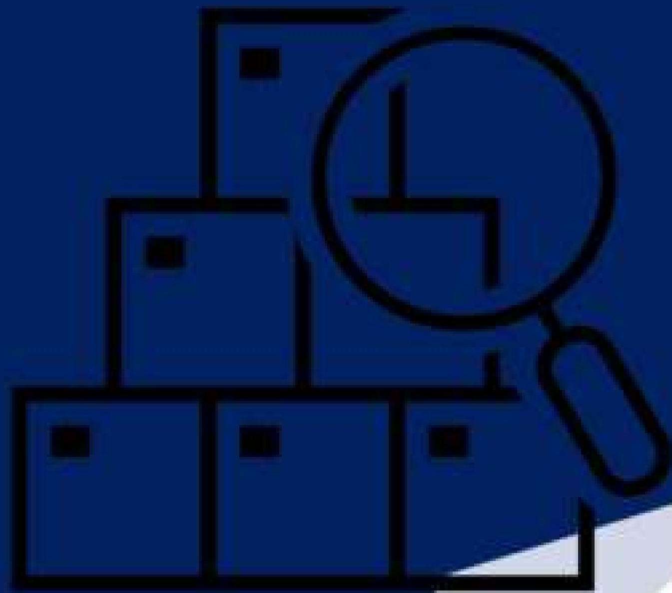
- Every account has two "**sides**", a right side and a left side.
- A debit refers to an entry on the left side of an account, and a credit refers to an entry on the right side of an account

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

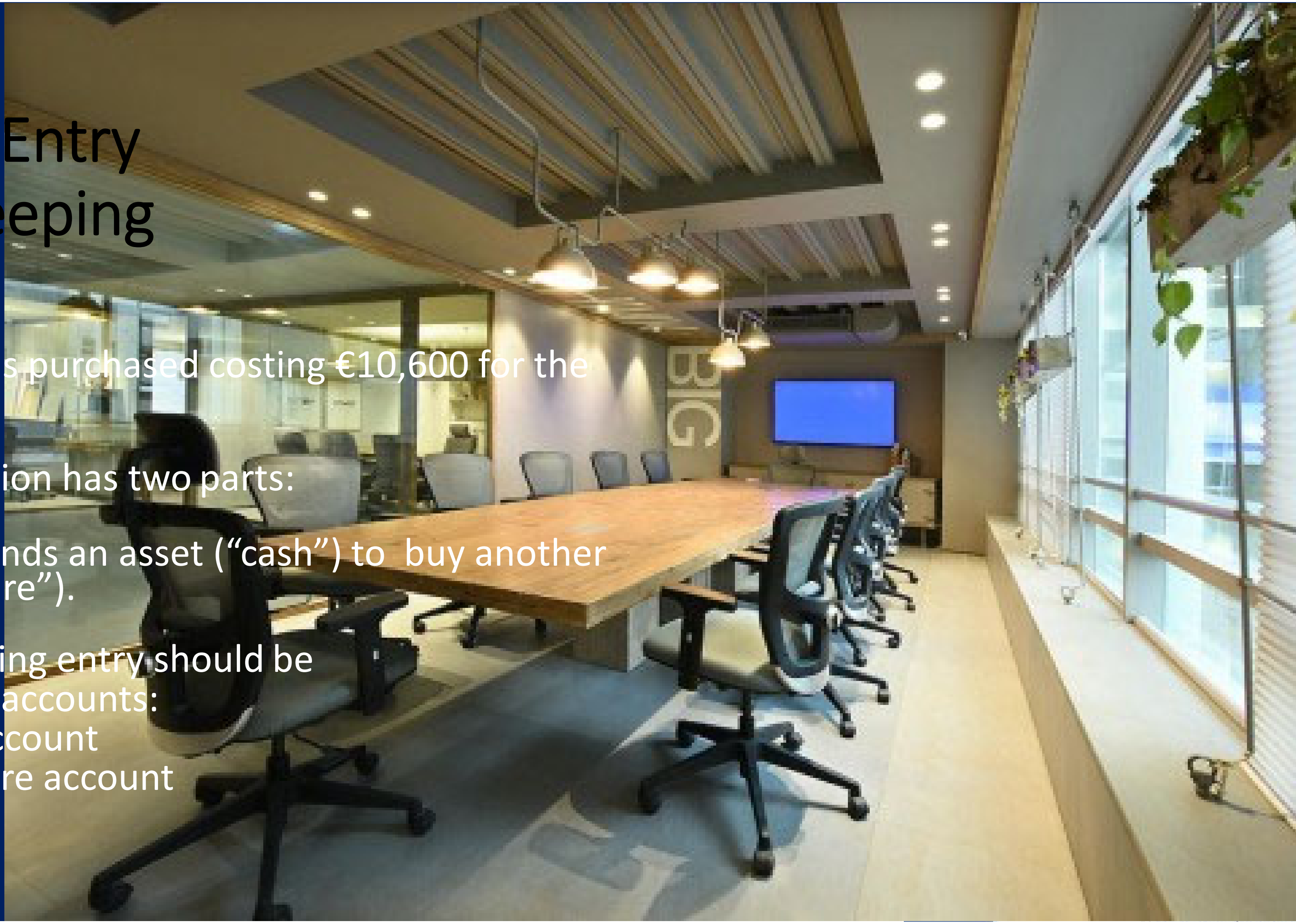


Double Entry Book Keeping

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

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

Accounting Terms

Accounting Terms

- Accounting is composed of the following different groups or items:
- **Fixed Assets**, which refer to those assets which are purchased by the business or introduced into the business by the owner(s), which will be retained within the business for a considerably long period of time, normally more than one year.
- Examples are Land and Buildings, Machinery, Motor Vehicles and Furniture.

Accounting Terms

Depreciation

- Fixed Assets are always quoted net of depreciation, this being a method of allocating the cost of a tangible asset over its useful life. Businesses depreciate long- term assets for both tax and accounting purposes

Accounting Terms

Intangible Assets

- Examples of intangible assets
  - Goodwill
  - Patents, copyrights and trademarks
  - Exploration rights
  - Formulas, processes, and designs (e.g. Software)
  - Licenses, franchises, memberships, and customer lists
  - Leases and leaseholds
- Careful as these are more “risky” (can be difficult to determine value)
- What is their amount relative to total amount of assets?
- Do similar business hold same amounts of intangibles ?

Accounting Terms

- **Goodwill** is when one company acquires another companies, goodwill can arise as a result of such transactions
- Goodwill = Purchase price – book value of assets acquired
- Example: Company A purchases Company B for a price of €1 million

Accounting Terms

- As a result, the balance sheet of companies A and B are amalgamated (consolidated) into a new single balance sheet
- That is done by adding together all the items and the difference if there is will be goodwill.
- There is usually goodwill as Company A has to pay a premium to the owners of Company B
- If the total assets of company B amounts to €800K the difference between purchase price and €800K is the goodwill €200K

What to look for? Did the purchase of the new company result in increased earnings ?

Accounting Terms

Other Investments

- These are not expected to be sold for cash and are not property, plant or equipment. Normally they are not used in the normal operations of the business.
- These could be:
    - investments in securities or other financial instruments
    - they could also represent investments in other companies
- In the latter case, it is different than acquiring a company as here we could just have 10% of another company
- What to look for:
- How are the investments being valued ?
- Do we need to re-value ?
- What would be a fair value ?
- In extreme cases, should we impair (write-down) investment ?

Accounting Terms

- **Current Assets**, which refer to those assets which are purchased by the business or introduced into the business by the owner(s), which will be resold or disposed of within a short period of time, which is normally less than one year.
- Examples are Stock, Debtors, Prepaid Expenses, Cash at Bank and Cash in Hand.
- Trading Assets are a collection of securities held by a firm that are held for the purpose of reselling for a profit. Trading assets are recorded as a separate account from the investment portfolio.

Accounting Terms

- **Prepayments**, are the adjustment for debts or installment payment accounted before their official due date. A prepayment can be for the entire balance or for any upcoming payment that is paid in advance of the date for which the borrower is contractually obligated to pay it.
- Examples of a prepayment are water and electricity bills deposits paid upfront.

Accounting Terms

- **Long-Term Liabilities**, which refer to those liabilities which will be repaid after a considerably long period of time, which is normally more than one year.
- Examples are Bank Loans, Loans from individual businesses and any long-term creditors.
- Mortgages are types of loans that are secured with real estate or personal property.

Accounting Terms

- **Current Liabilities**, which refer to those liabilities which will be repaid within a short period of time, normally within one year. Examples are Expenses Owing, Accruals, Creditors, Dividends Payable and Revenues Prepaid (deposits received).
- **Accruals** are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due telephone company for the call charges for which a bill hasn't been received yet.

Accounting Terms

- **Capital**, which is defined as being all those items, and not only money, which are introduced into an organization by the owner(s) of the business.
- Nominal amount per share. It is important to make a distinction between authorised share capital (maximum amount that can be issued) and issued or outstanding share (actual amount issued)
- Another distinction to be made is between ordinary (or common) and preferred shares
- Sometimes a company can have more than 1 class of ordinary shares, such as voting and non-voting shares

Accounting Terms

- **Share Premium**, sometimes shares are not issued at their nominal amount but at a higher amount. In that case, we say that shares were issued at a premium.
- E.g. nominal value per share is €1 but investors paid €2/share. In that case the additional €1 paid will be recorded in the Balance Sheet under share premium account.
- Need to record this because the company has received an additional €1 per share
- Sometimes this is also referred to as capital in excess or surplus capital

Accounting Terms

Retained Earnings

- Reserves, these are defined as the amount of profits that the shareholders decide to leave in the company so that the company can have more money to operate with.
- This item refers to past profits which the company has earned throughout its life. If retained earnings is positive then company has made profits. If retained earnings is negative then company has made losses

Accounting Terms

Retained Earnings

- The net income which is not distributed in the form of dividends each year is added to retained earnings or deducted from retained earnings if it is a loss
- This amount of money will give us an idea about how much money is available to reinvest in business, to purchase fixed asset, ensure adequate working capital to run business, etc.
- For example, if retained earnings are negative, maybe it is a wise decision to delay purchase of shares as business has not figured out how to make profits

Accounting Terms

- Accounting is composed of the following different groups or items:
- **Revenues**, which refer to all those earnings that the business earns during a financial year.
- Revenues are accounted for when they are earned, and not when the actual money is received.
- Examples are Sales, Rent Receivable and Interest Receivable.

Accounting Terms

- **Cost of Sales**, COGS is the cost of creating the products that a company sells; therefore, the only costs included in the measure are those that are directly tied to the production of the products.
- In normal trading companies this is calculated as Opening Stock and Purchases less closing stock.
- Expenses, which refer to all those payments made by the business in its' daily operations.
- Similar to revenues, expenses are accounted for when they are incurred, and not when the actual money is paid.
- Examples are Wages & Salaries, Rent, Water & Electricity, Stationery, Motor Vehicles Expenses and Depreciation.

The Accounting Equation

The Accounting Equation

The Accounting Equation is the following:

ASSETS = CAPITAL + LIABILITIES

&

Net Current Assets = Current Assets – Current Liabilities

- Net Current assets or Working Capital is the amount that indicates how much capital is being generated or used up by day-to-day activities. If net current assets are negative, the company may have difficulty financing its day-to-day operations.

Trial Balance

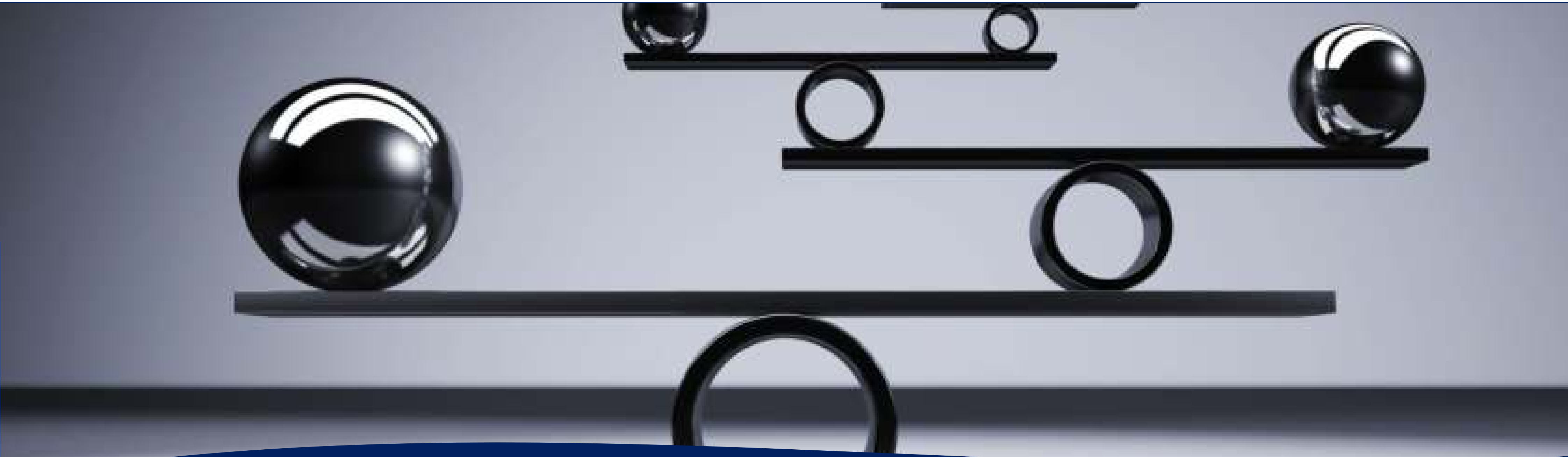
The Trial Balance

- Is a **report** that is run at the end of an accounting period, listing the ending balance in each account
- It represents all **general ledger accounts** of a business
- The name comes from the need of a trial to prove that the debit balance is equal to the credit balance
- The Trial Balance is made up of two columns - one for the debit account balances and the other for the credit account balances the totals of which must agree.
- If these totals do not agree, then there are some errors in the accounts

Trial Balance

Trial balance for George's Catering
on the 31st of May 2010

	FOLIO	DEBIT $	CREDIT $
Baking equipment	100	12,000	
Debtors	101	0	
Bank	102	14,800	
Capital	300		15,000
Drawings	301	500	
Loan	200		1,000
Creditors	201		0
Services rendered	400		15,500
Salaries	500	4,000	
Telephone expense	501	200	
		31,500	31,500



The Trial Balance

Post-closing trial balance:

- It is done after the period is closed
- Groups all the Nominal Ledger Accounts
- It is usually asked for by the auditors when they begin an audit

The Trial Balance

Common errors that might occur:

- Entries made twice
- Entries not made at all
- Entries to the wrong account
- Reversed entries
- Transposed numbers
- Unbalanced entries