MODULE 03: FINANCIAL ANALYSIS

Lecture 01: Accounting Concepts

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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

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

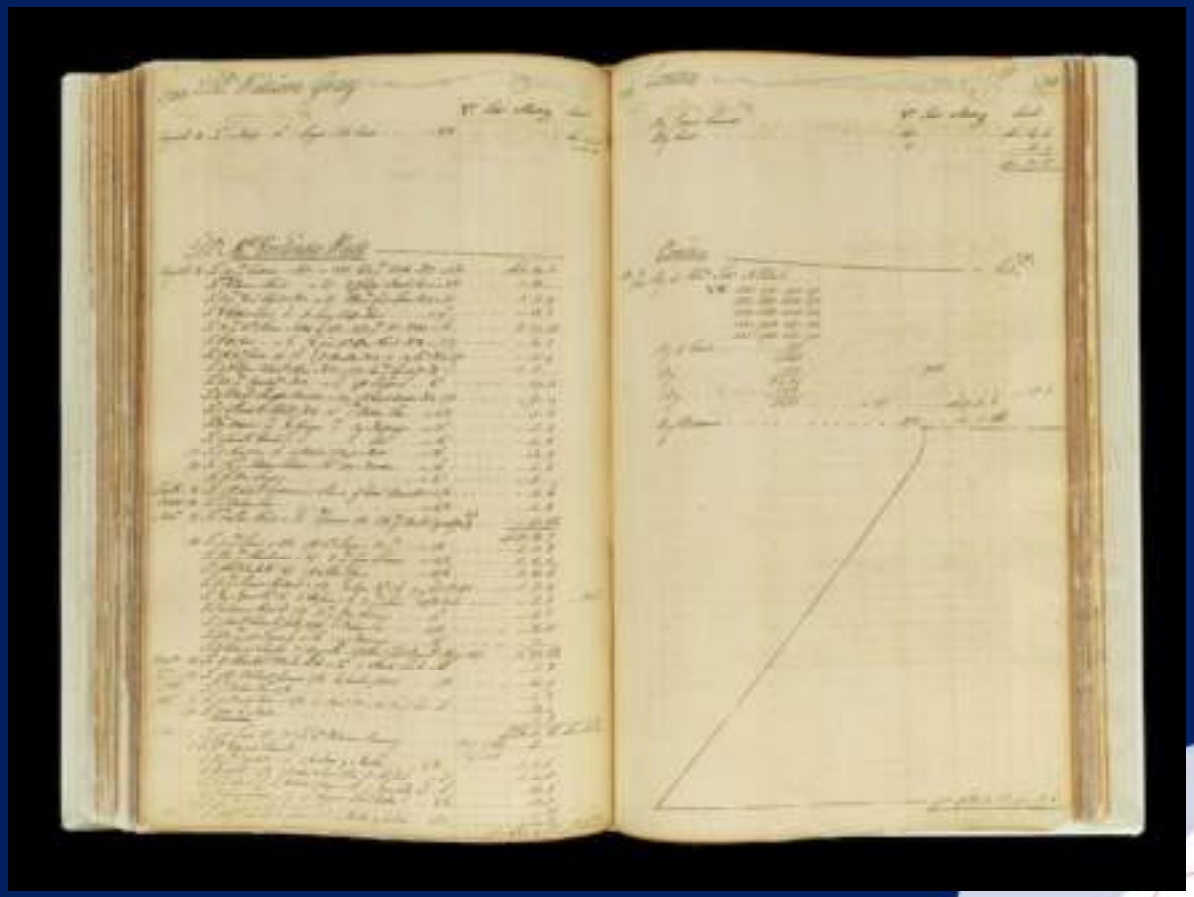
- Double-entry bookkeeping was developed in the mercantile period of Europe
- To help rationalize commercial transactions and make trade more efficient
- It also helped merchants and bankers understand their costs and profits
- Some thinkers have argued that double-entry accounting was a key calculative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

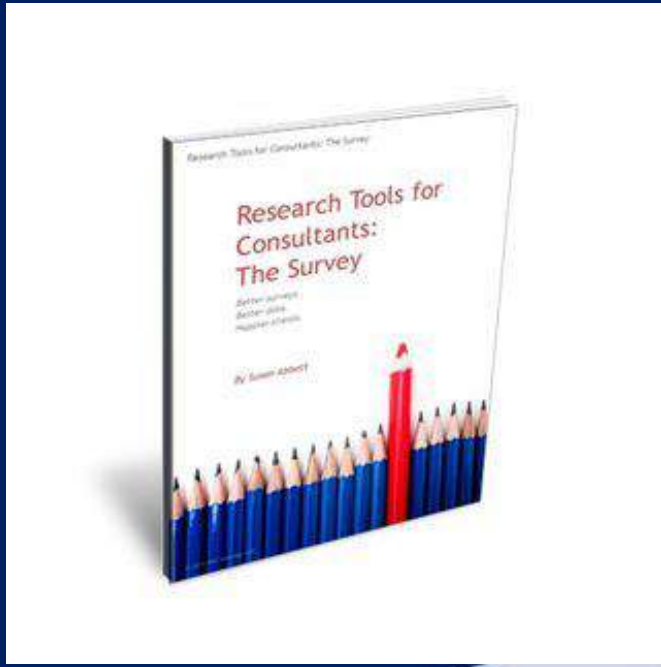
- Owners / Shareholders / Partners
  - (Current Profitability, Capital Growth, Dividend Returns)
- Investors
  - (Future Profitability, Risks of Investment)
- Government
  - (Profitability, Taxation payments)

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



Accounting Principles

Accounting Principles

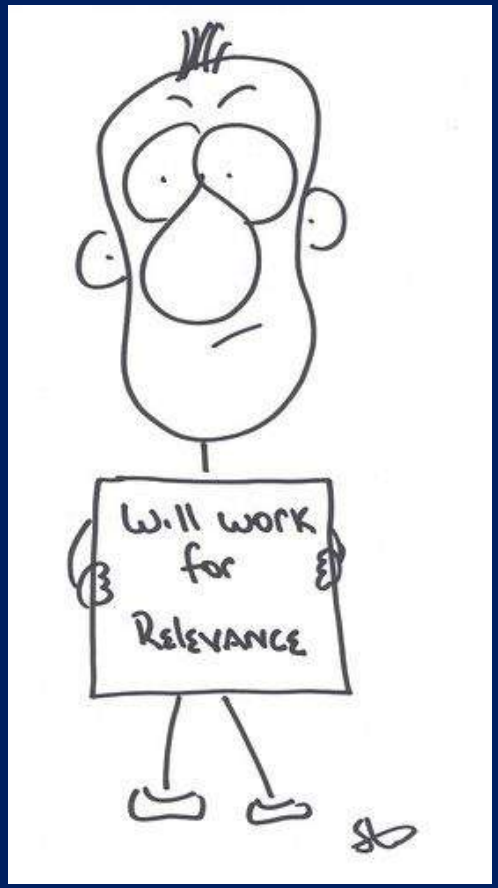
- All users will see the same financial statements

- 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

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

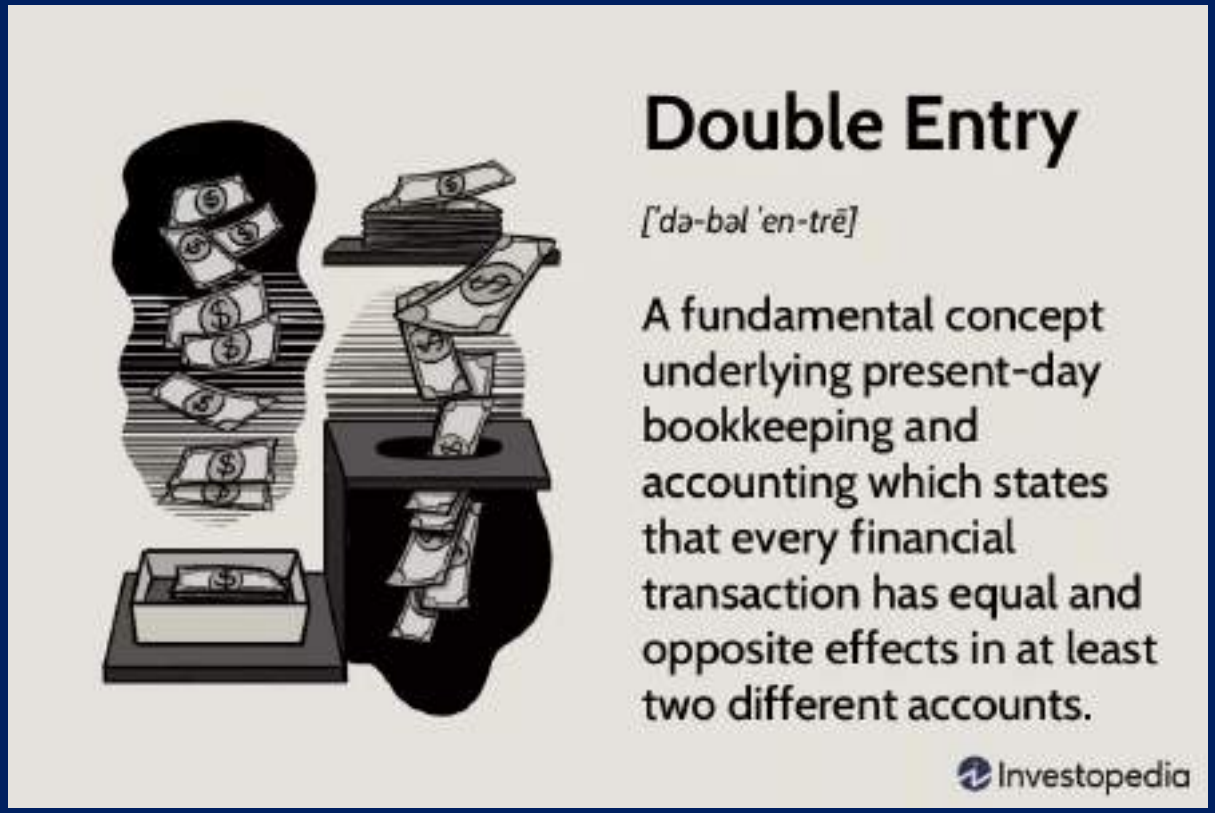
- The **PRACTICAL** view vs the **LEGAL VIEW** in Accounting
- Practical – the substance
- Legal – the form

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

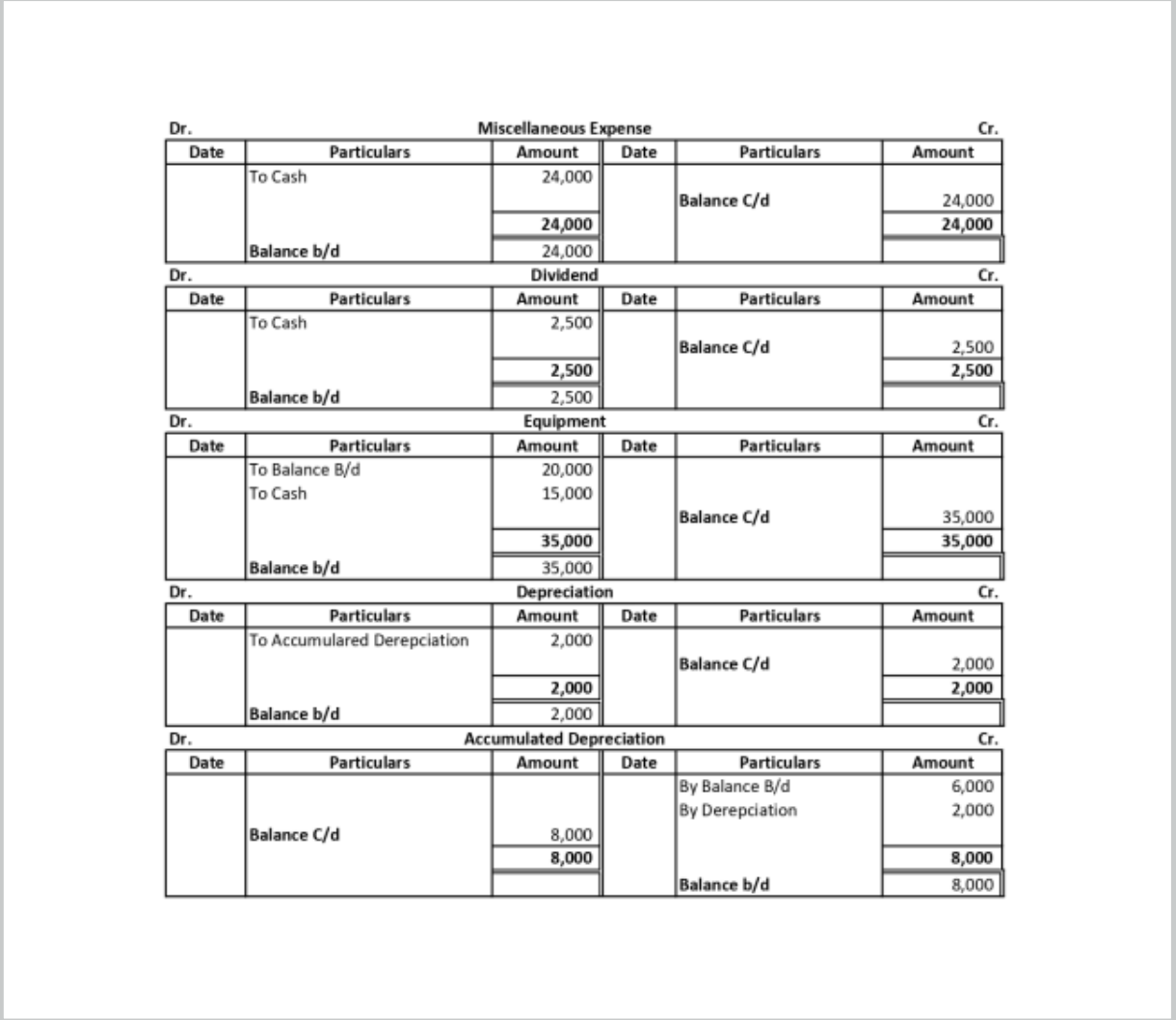
Double Entry &
Bookkeeping

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

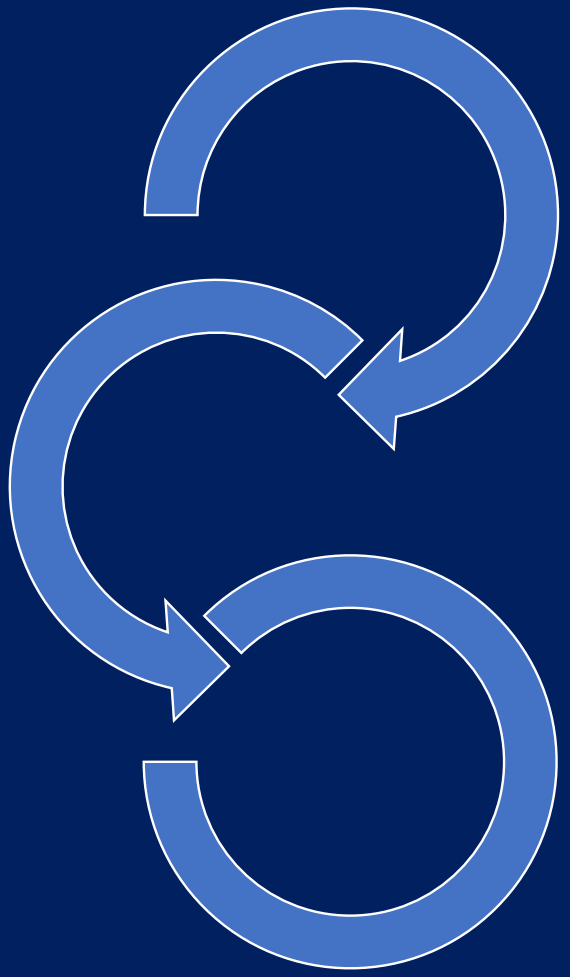
Daily Process

The transactions recorded in an entity must be initiated by:

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

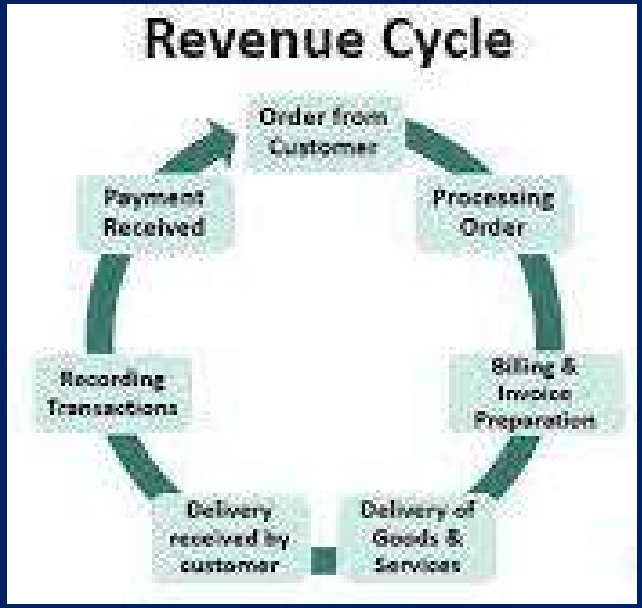
Process flow

- 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

WP LIGHTHOUSE

INVOICE

1 Accounting Street,
St Venera

Phone +356 21 35 22 32
Email info@wplighthouse.com
Website Malta

Date 28/06/2015
Invoice No. 527

Issued To
ABC
address

Delivered To
ABC
address

Customer's Reference	Sales Person	Your Tax Id	Delivery Note No.	Due Date
	Gabor Mann		auto	28/06/2015

Payment Terms: Cash Only

Item Code	Item Description	Quantity Unit	Price	Discount %	Total
Service	Service01	5.00 hr	22.00		110.00
Service	Service01 (discount)	5.00 hr	-22.00		-110.00
Serv02	Service02	1.00 ea	10.00		10.00

Sub-total 10.00
VAT (if 18%) (18%) 1.80
TOTAL INVOICE 11.80

SPECIMEN FISCAL RECEIPT

VAT Reg No: MT7777777T Receipt No.: 002138 No: 3 000 364

XYZ IRONMONGERY
1506, Triq il-Qannar
VaBMSt

Description of Goods / Provided	Amount (inclusive of VAT)	
As per invoice 12345	47	79

Receipt Date: 11/06/07

CUSTOMER'S COPY

Customer Name & ID Number when required:
Guiseppi Berg 0000 0000

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

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Group Work
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Groups

GROUP 1	Muhammad Ahmed Chorahi	SOLE TRADER
GROUP 1	Anmol Dharwal	SOLE TRADER
GROUP 1	Vishal Singh Charak	SOLE TRADER
GROUP 1	Ayush K C	SOLE TRADER
GROUP 1	Abdullah Al Tajowar	SOLE TRADER
GROUP 1	Aniket Choudhary	SOLE TRADER
GROUP 2	Saiteja Palubai	PARTNERSHIP
GROUP 2	MD Showrav	PARTNERSHIP
GROUP 2	MD Kamrul Islam	PARTNERSHIP
GROUP 2	Yogesh Bhattarai	PARTNERSHIP
GROUP 2	Abdul Raheem Khan	PARTNERSHIP
GROUP 2	Ganga Kumari Khatri	PARTNERSHIP
GROUP 3	Nitisha Kandel	LIMITED LIABILITY COMPANY
GROUP 3	Jayan Dhanaha Magar	LIMITED LIABILITY COMPANY
GROUP 3	Ibrahim Tariq	LIMITED LIABILITY COMPANY
GROUP 3	Binod Kumar Chaudhary	LIMITED LIABILITY COMPANY
GROUP 3	Sameer Gurung	LIMITED LIABILITY COMPANY
GROUP 3	Abhinas Dawadi	LIMITED LIABILITY COMPANY

Groups

GROUP 4	Bishal Gopal Dhaubhadel	PUBLIC COMPANY
GROUP 4	Muhammad Umar	PUBLIC COMPANY
GROUP 4	Amar Shaheer Ali	PUBLIC COMPANY
GROUP 4	Dipendra Neupane	PUBLIC COMPANY
GROUP 4	Anas Mehmood	PUBLIC COMPANY
GROUP 4	Trishna Shahi	PUBLIC COMPANY
GROUP 5	Jasmeen Kaur	SOLE TRADER
GROUP 5	Binisha Thapa	SOLE TRADER
GROUP 5	Sujatam Prajapati	SOLE TRADER
GROUP 5	Suman Kumar Basnet	SOLE TRADER
GROUP 5	Deepak Kumar	SOLE TRADER
GROUP 5	Hiralal Sunar	SOLE TRADER
GROUP 6	Jharana Rana Magar	PARTNERSHIP
GROUP 6	Lebogang Kando Boiditswe	PARTNERSHIP
GROUP 6	Gurdeep Kaur Mann	PARTNERSHIP
GROUP 6	Umair Hassan	PARTNERSHIP
GROUP 6	Rabina Nepali	PARTNERSHIP

Groups

GROUP 7	Kame Bahadur Roka	LIMITED LIABILITY COMPANY
GROUP 7	Nirmal Rayamajhi	LIMITED LIABILITY COMPANY
GROUP 7	Amrita Pahadi	LIMITED LIABILITY COMPANY
GROUP 7	Dhawa Lajum Gurung	LIMITED LIABILITY COMPANY
GROUP 7	Aayush Dhami	LIMITED LIABILITY COMPANY
GROUP 8	Arya Sharma	PUBLIC COMPANY
GROUP 8	Chandan Mehra	PUBLIC COMPANY
GROUP 8	Abishek Thapa	PUBLIC COMPANY
GROUP 8	Anish Gurung	PUBLIC COMPANY
GROUP 8	Biki Ganesh	PUBLIC COMPANY
GROUP 9	Joyal Kohar	LIMITED LIABILITY COMPANY
GROUP 9	Shiwani Sundas	LIMITED LIABILITY COMPANY
GROUP 9	Shital Kumari Das Kathbaniya	LIMITED LIABILITY COMPANY
GROUP 9	Bivash Timalsina	LIMITED LIABILITY COMPANY
GROUP 9	Sarensh Chaudhary	LIMITED LIABILITY COMPANY

Group Work

- Get the 9 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