

MODULE 03: FINANCIAL ANALYSIS

Lecture Title 02: FINANCIAL STATEMENTS

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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



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
- VO's 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



Double Entry

['da-bəl 'en-trē]

A fundamental concept underlying present-day bookkeeping and accounting which states that every financial transaction has equal and opposite effects in at least two different accounts.

 Investopedia

Analysis of Group Work from Lecture 1



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

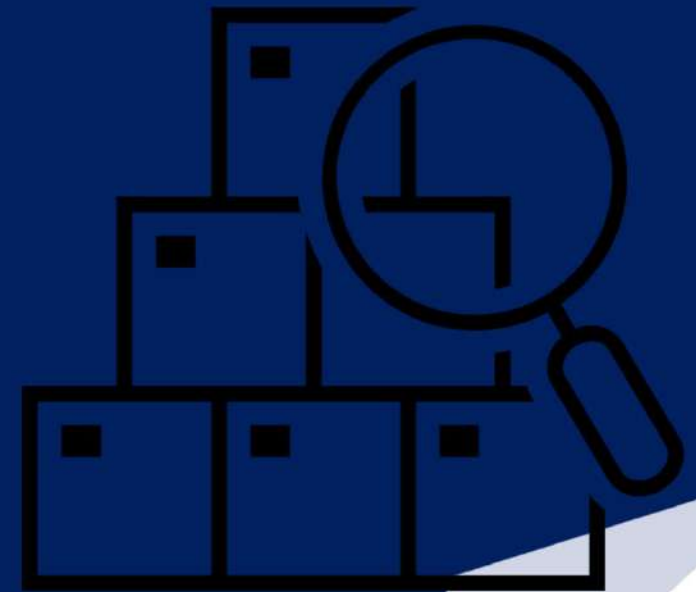
If a company pays its rent of €2,000 for the current month, the transaction will be shown like this:

Cash	
	2,000

Rent Expense	
2,000	

Double Entry Book Keeping

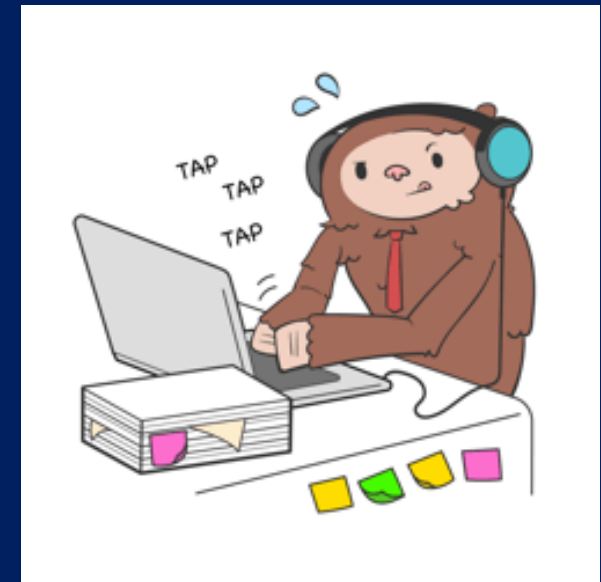
- Advantages
- Helps prepare more accurate financial statements directly from the books of account
- Provides a historical and chronological record of all transactions in a period
- Provides referencing to original documents
- Helps detect any possible errors



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
- $\text{Goodwill} = \text{Purchase price} - \text{book value of assets acquired}$
- 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.

