Undergraduate Diploma in Business Administration
Module 03 Financial Analysis MQF Level 5 (8 ECTS)

Lecture 3
Phase 1: The Accounting Cycle & Building the Statements

Lecturer: Christabel Debono

Date: 18th April 2026

Undergraduate Diploma in Business Administration

Lecture Summary

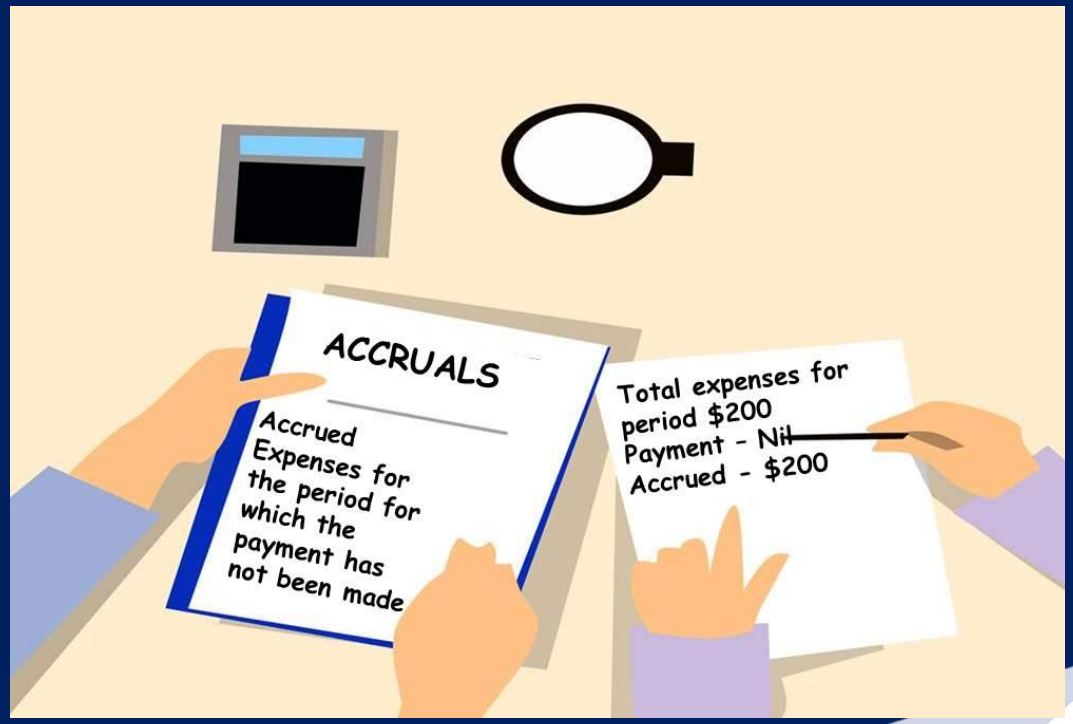
- **Period-End Adjustments:** Basic overview of adjusting entries (e.g., depreciation, accruals) before drafting statements.
- **Building the Income Statement:** Taking revenue and expense accounts from the Trial Balance to compute Profit/Loss.
- **Building the Balance Sheet:** Taking the remaining asset, liability, and equity accounts from the Trial Balance to draft the Statement of Financial Position.
- Demonstrating how Net Income from the Income Statement flows into the Equity section of the Balance Sheet.

€15,000

The Accrual Basis of Accounting

- To evaluate a business's true financial strength, external analysts, banks, and smart managers we use the accrual basis of accounting.

- **We record financial events when the economic action occurs, regardless of when the cash actually changes hands.**



Examples

ABC Ltd does a massive software installation for a client in December. It takes 50 hours of hard work.

The client says, 'Thanks, I'll pay you the €5,000 next February.'

Question

Did we earn revenue in December?

Examples

Our employees worked the last week of December, but payday isn't until 5th January.

Question

Did we incur an expense in December?

The Matching Principle

- Expenses must be matched to the exact period in which they helped generate revenue. If we used electricity in December to power our servers, that expense belongs in December, even if the bill is paid in January.

The Matching Principle

- This brings us to the most important rule in financial statement preparation which is **The Matching Principle**.

Think of this as the 'Effort vs. Reward' rule.

- To measure performance accurately, **we must match our expenses (the effort) to the exact same period as the revenues (the reward) they helped generate.**

The Matching Principle

If we spent €2,000 on electricity in December to keep our machine running so we could make €30,000 in sales, that electricity expense *must* be reported on December's Income Statement.

If we wait and put that expense in January when we finally pay the bill, we are lying about December's profits (making them look too high) and lying about January's profits (making them look too low).

Without the Matching Principle, our Financial Statements are useless for decision-making.

The Accrual Principle

- **Definition:** Recording an event where the economic action has finished, but the cash transaction has not yet happened.
  - *Accrued Expense:* We received the benefit, but haven't paid yet (e.g., the €300 in unpaid wages).
  - *Accrued Revenue:* We did the work, but haven't billed the client yet (e.g., the €1,500 unbilled server installation).
- **Why we use it:** To capture hidden liabilities and assets. For short-term decision-making, a financial manager needs to know exactly what obligations are coming due soon to manage liquidity, even if the formal invoice hasn't arrived on their desk yet.

Deferrals

- Paying cash for an expense in advance of actually using or consuming the benefit. It sits on the Balance Sheet as a Current Asset until it is used.
- **Why we use it:** It reflects resources the company owns and has available for future use. Expensing a 12-month policy all on day one would falsely lower current profits and hide a valuable short-term asset from the Balance Sheet.

Types of Adjustments

- *Accruals:* Action happened, cash has not yet moved (e.g., employees worked, but payday is next week).
  - ***Deferrals/Prepayments:*** Cash moved, action has not yet finished (e.g., paying for a full year of insurance upfront).
  - ***Depreciation:*** Allocating the cost of a large physical asset over its useful life.

Depreciation & Accumulated Depreciation

- ***Depreciation Expense:*** The systematic allocation of a physical, long-term asset's cost over its expected useful life.
  - *Accumulated Depreciation:* A "contra-asset" account that keeps a running total of all the depreciation recorded against an asset over time, without erasing the asset's original historical cost on the Balance Sheet.

Depreciation & Accumulated Depreciation

It spreads the heavy cost of major investments over time. It helps managers evaluate if the asset is generating enough value year-over-year to justify its initial cost, while the Accumulated Depreciation account allows analysts to see exactly how old or "used up" the company's equipment is.

This is the raw data extracted from the accounting system on 31st December

Account	Debit (€)	Credit (€)
Cash	15,000	
Accounts Receivable	8,000	
Prepaid Insurance	2,400	
Equipment	50,000	
Accumulated Depreciation		10,000
Accounts Payable		6,000
Share Capital		40,000
Retained Earnings (Jan 1)		12,000
Service Revenue		30,000
Wage Expense	18,000	
Rent Expense	4,600	
Totals	**98,000**	**98,000**

Scenario 1: Prepaid Expenses (Deferral)

- TechFlow purchased a 12-month insurance policy on December 1st for €2,400 (recorded as Prepaid Insurance). It is now December 31st.
- **Calculate the insurance expense for December and determine the new balance of Prepaid Insurance.**
  - €2,400 / 12 months = €200.
    - Debit: Insurance Expense €200
    - Credit: Prepaid Insurance €200

Scenario 2: Accrued Expenses

- The company's employees earn €100 per day in total. The last week of December had 3 working days that will not be paid until January 5th.
- **Calculate the accrued wages and draft the entry.**
- 3 days * €100 = €300.
  - Debit: Wage Expense €300
  - Credit: Wages Payable €300

Accrued Revenue

- TechFlow completed a server installation for a client on December 30th.

  The €1,500 invoice has not yet been sent or recorded.

- **Update the revenue and receivable accounts.**

- The work is done, so revenue is earned.
  - Debit: Accounts Receivable €1,500
  - Credit: Service Revenue €1,500

Depreciation

- The €50,000 Equipment has a 5 year useful life and no residual value.

  The €10,000 in Accumulated Depreciation represents last year's usage.

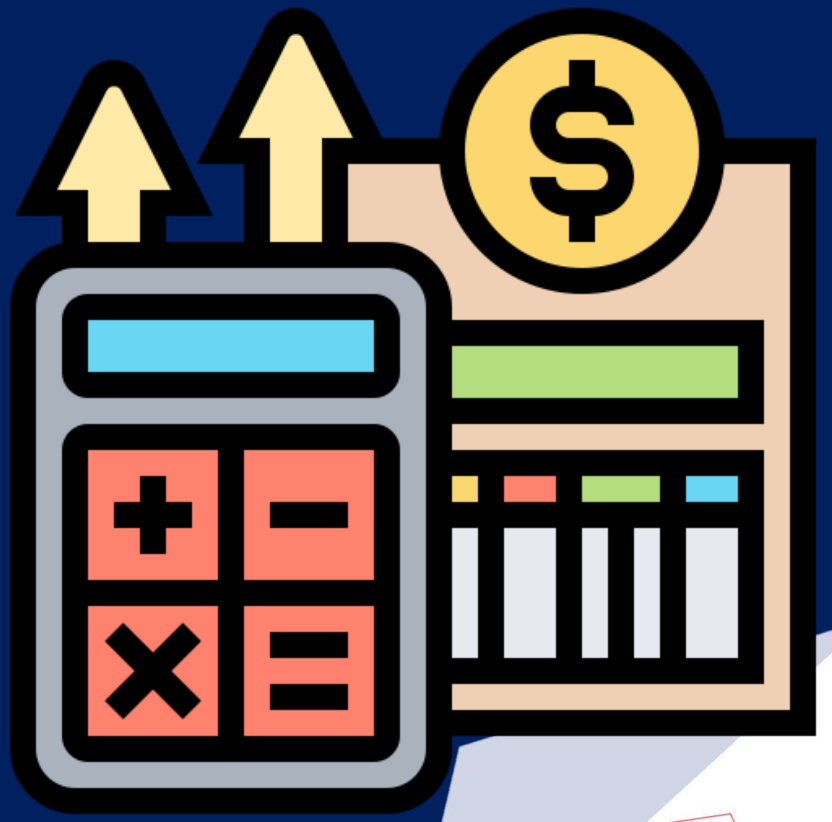
- Calculate the straight-line depreciation for this current year.

- €50,000 / 5 years = €10,000 per year.
  - Debit: Depreciation Expense €10,000
  - Credit: Accumulated Depreciation €10,000

Undergraduate Diploma in Business Administration

Income Statement

What is the main purpose of an income statement ?



To report a company's financial performance over a specific accounting period (such as a month, quarter, or year). It answers one fundamental question: **Did the business generate a profit from its operations?**

Income Statement – Core Functions

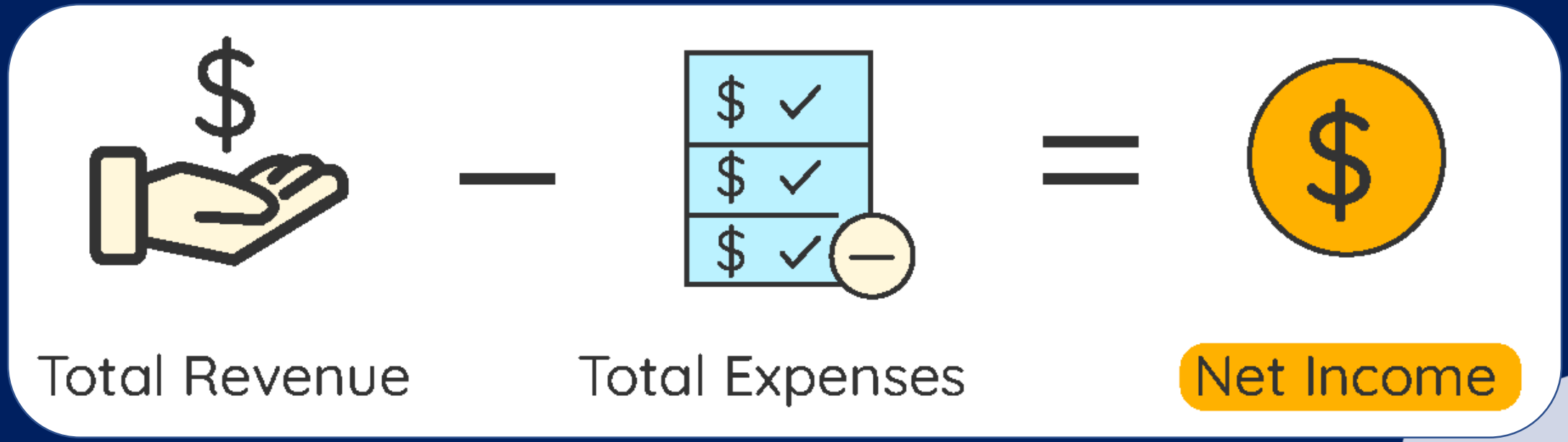
- **Tracking Profitability:** By detailing how revenues are transformed into net income (or net loss), it shows whether the company's core business model is currently viable.
- **Applying the Matching Principle:** It pairs the revenues earned during a period with the exact expenses incurred to generate that revenue. This provides a true economic picture of the company's operational efficiency, rather than just looking at cash moving in and out of the bank.

Income Statement – Core Functions

- **Categorising Income and Costs:** It breaks down exactly where money is coming from (sales, services) and where it is being spent (wages, rent, depreciation, administrative costs). This allows management to identify trends, control costs, and make informed short-term decisions.
- **Guiding External Decisions:** Investors, analysts, and creditors rely heavily on the income statement to evaluate the business's past performance, predict its future trajectory, and determine if it is a safe investment or credit risk.

Income Statement

Ultimately, the entire statement is driven by one simple, fundamental equation:



or Net Loss

Gross Profit

- **Definition:** Revenue minus the Direct Costs (also known as Cost of Goods Sold or Cost of Sales) required to produce that specific product or deliver that specific service.
- **What it Excludes:** It does *not* include overhead, rent, marketing, or admin salaries. It only includes the costs directly tied to the sale (e.g., the cost of the flour for the bakery, or the cost of the raw server hardware for an IT install).

Sales – Cost of goods sold = Gross profit

Gross Profit

- **Why Managers Use It:** It answers a critical question:

Are we pricing our core product correctly?

If a business has a negative Gross Profit, it means every time they sell an item, they lose money. No amount of cutting overhead or marketing will save the business; the core pricing model is fundamentally broken.

Net Profit

- **Definition:** Gross Profit minus all remaining Operating Expenses (rent, depreciation, insurance, admin wages), plus or minus any interest and taxes.

Net Profit

Why Managers Use It: It answers the ultimate question:

Is the entire business model sustainable?

A company can have a fantastic Gross Profit (making a 50% margin on every product sold), but if their rent is too high or they took out massive loans with high interest, their Net Profit will be negative, and the business will still fail.

Net Profit – Information

Before drawing up an income statement you should prepare the trial balance (we've done in the last lecture). This contains nearly all the information needed plus some adjustments that would be needed to it.

Income Statement Step by Step

Category / Line Item	Description	Amount
Revenues (Sales)	The total money earned from selling goods or providing services.	€ X,XXX
Less: Cost of Goods Sold (COGS)	The direct costs to produce those specific goods/services (e.g., raw materials, direct technician labor).	(€ X,XXX)
Gross Profit	(Revenue - COGS). The profit made strictly from the core product before overhead.	€ X,XXX

Operating Expenses	The indirect costs of running the business (Overhead).	
* Selling Expenses	Marketing, advertising, sales commissions.	(€ X,XXX)
* General & Administrative	Rent, insurance, depreciation, office salaries, utilities.	(€ X,XXX)
Total Operating Expenses	The sum of all overhead costs.	(€ X,XXX)

Operating Income	**(Gross Profit - Total Operating Expenses). The profit from normal, day-to-day business operations.**	**€ X,XXX**
Non-Operating Items	Revenues and expenses not tied to the core business.	
*** Interest Expense**	The cost of borrowing money (e.g., bank loan interest).	(€ X,XXX)
*** Income Tax Expense**	Taxes owed to the government.	(€ X,XXX)
Net Income (Net Profit/Loss)	(Operating Income - Non-Operating Items). The final "Bottom Line."	€ X,XXX

Class exercise:
Business Accounting – Frank Woods – Income Statement – 7.1

Class exercise:
Business Accounting – Frank Woods – Income Statement – 7.2

Undergraduate Diploma in Business Administration

BAKERY SCENARIO

A	B
€500,000	€100

You have half a million euros in assets. Are you in a strong financial position right now, or are you about to go bankrupt?

Balance Sheet

- You might be 'rich' on paper, but you are broke in reality.
  - Why? Because you cannot pay the flour supplier with a brick from your building. You need cash.
- This is why, on a Balance Sheet, we never just lump everything we own into one big list. We separate our accounts by the most ruthless factor in business: **Time**.

Balance Sheet – Current Assets

- **The 12-Month Rule (Current vs. Non-Current Assets)**
- To survive, a Financial Manager divides the world using the **12-Month Rule**.
- First, we have **Current Assets**. *Resources a company expects to convert to cash, sell, or consume within the next 12 months.* This is your financial ammunition. It's your Cash, your Inventory (the bread on the shelves), and your Accounts Receivable (money customers owe you right now). It is liquid. It moves fast.

Balance Sheet – Non-Current Liabilities

- Next, we have **Non-Current Assets**. *These are long-term investments and resources held for extended use, lasting longer than 12 months.* You do not buy these to sell them quickly; you buy them to build the infrastructure of your business. The €500,000 bakery building, the heavy commercial ovens, your delivery trucks.

Class Quiz

A massive, €10,000 commercial dough mixer machine.

Current or Non-Current Assets?

Class Quiz

A €500 sack of flour in the storage room.

Current or Non-Current Assets?

Class Quiz

A patent for a revolutionary new recipe

Current or Non-Current Assets?

Class Quiz

A €2,000 invoice sent to a hotel for yesterday's catering job

Current or Non-Current Assets?

We need to think in terms of liquidity—how fast things turn into cash.

Statement of Financial Position

Now, let's flip the equation. Assets are what we own. **Liabilities** are what we owe. And just like assets, debts are governed by the 12-Month Rule. Time dictates how much pressure you are under.

Statement of Financial Position– Current Liabilities

Current Liabilities are your immediate threats. *These are debts and obligations that absolutely must be paid within the next 12 months.*

These keep Financial Managers awake at night. This is your Accounts Payable (the €500 flour bill), the wages you owe your staff next Friday, and the electricity bill.

Statement of Financial Position– Current Liabilities

Non-Current Liabilities are your long-term strategies. *These are debts due after more than one year.* This is a 15-year mortgage on the bakery building or a 5-year bank loan used to buy the delivery trucks. You have time to generate the money to pay these off.

Class Quiz

A €50,000 bank loan, but it's not due for 5 years.

Current or Non-Current Liability?

Class Quiz

The €2,000 tax bill the government demands by the end of the month.

Current or Non-Current Liability?

Class Quiz

The interest payment on that 5-year bank loan that is due next Tuesday.

Current or Non-Current Liability?

BAKERY SCENARIO

Why did the bakery almost fail despite having a €500,000 building?

BAKERY SCENARIO

You must pay your Current Liabilities using your Current Assets.

The building is a Non-Current Asset. The flour bill is a Current Liability. They don't match.

If a company has €50,000 in Current Liabilities (bills due soon) but only €10,000 in Current Assets (cash and inventory), that company is suffocating, no matter how many buildings or machines they own.

Class exercise:
Business Accounting – Frank Woods – Statement of Financial Position – 7.1

Undergraduate Diploma in Business Administration

Class exercise:
Business Accounting – Frank Woods – Statement of Financial Position – 7.2

Class exercise:
Business Accounting – Frank Woods – Statement of Financial Position – 9.3 *(From an Income statement)*

21 ACADEMY

Undergraduate Diploma in Business Administration