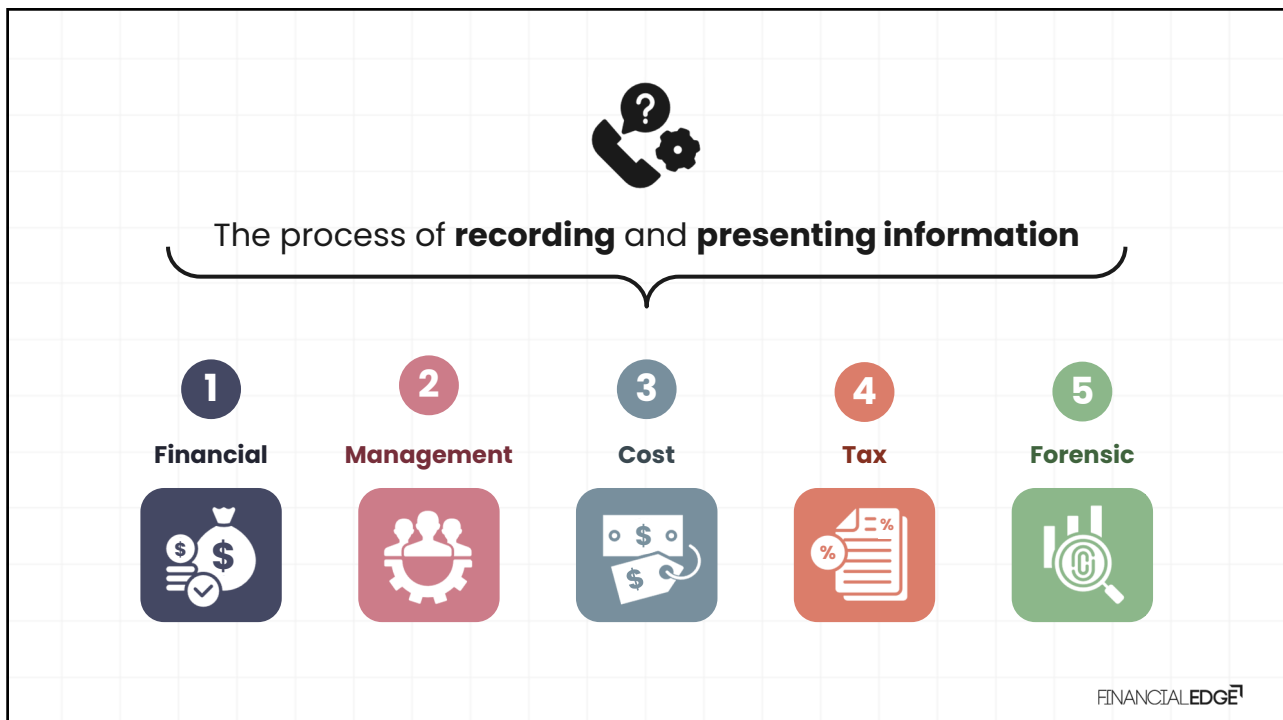
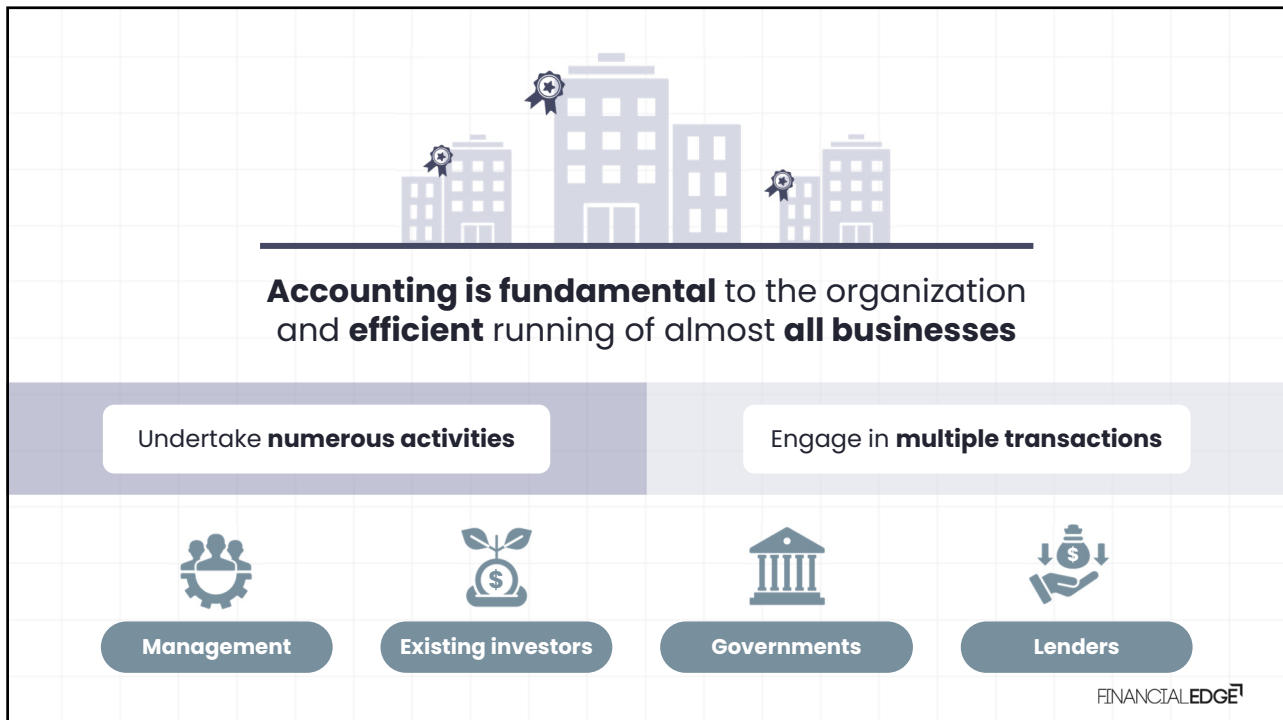




Accounting Foundations

What is Accounting?







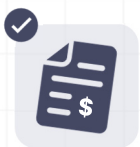
Financial



Management

FINANCIALEDGE⁷

Financial



**Financial
statements**



**Accounting
rules**

Type of business

Jurisdiction



**Summary of
financial position,
performance
and cash flows**



**Primarily for
external parties**

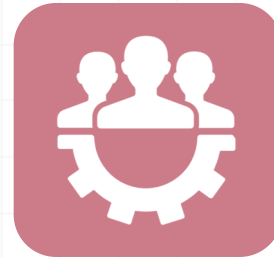


Standardized

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Financial



Management



Management



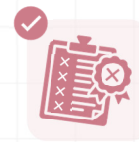
**Management
team**



More **detailed**
information



Intended for
internal use



**Not
standardized**



Who Uses Financial Statements? - Part 1










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Financial Statements

Primarily prepared by the company to **explain to the company's owners, or shareholders**, how the **company** that they own has **performed**










External users

**Investors****Lenders****Suppliers****Customers****Competitors****Government****Employees****Management****Others**FINANCIALEDGE⁷

InvestorsLendersSuppliersCustomersCompetitorsGovernmentEmployeesManagementOthers


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InvestorsLendersSuppliersCustomersCompetitorsGovernmentEmployeesManagementOthers

Investors

Prospective investors want to know if the **company is good to invest in**

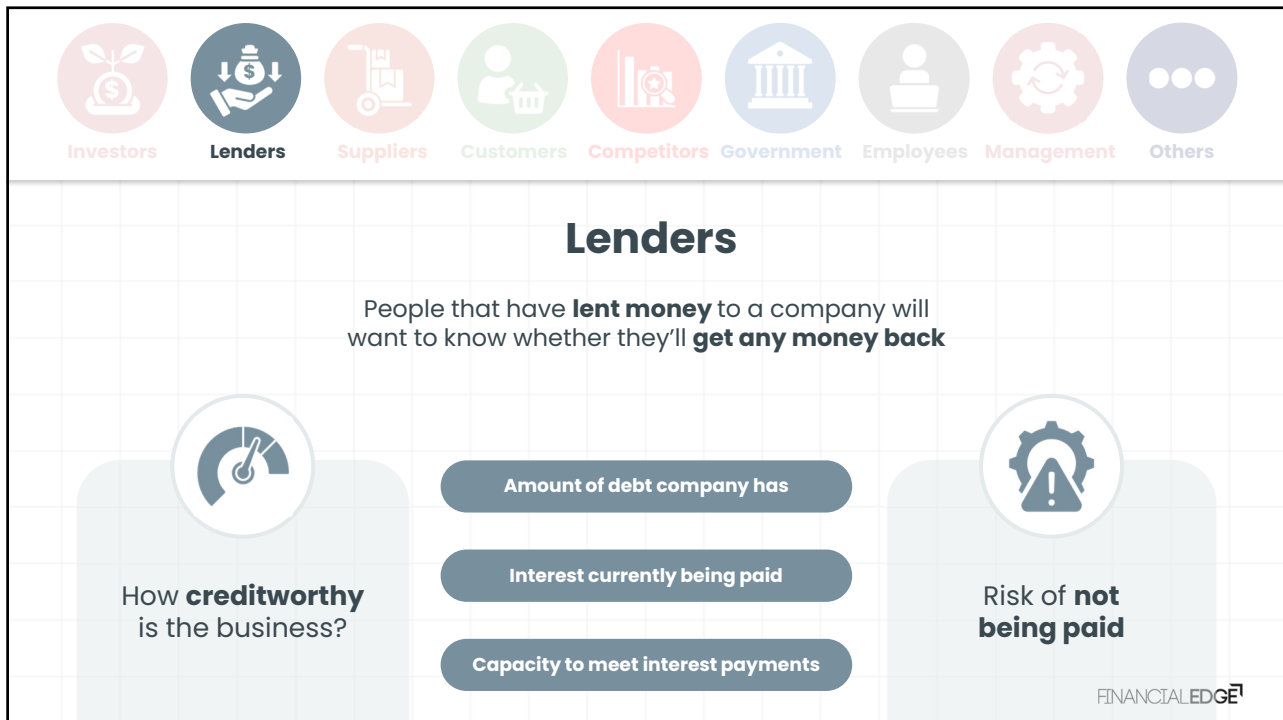


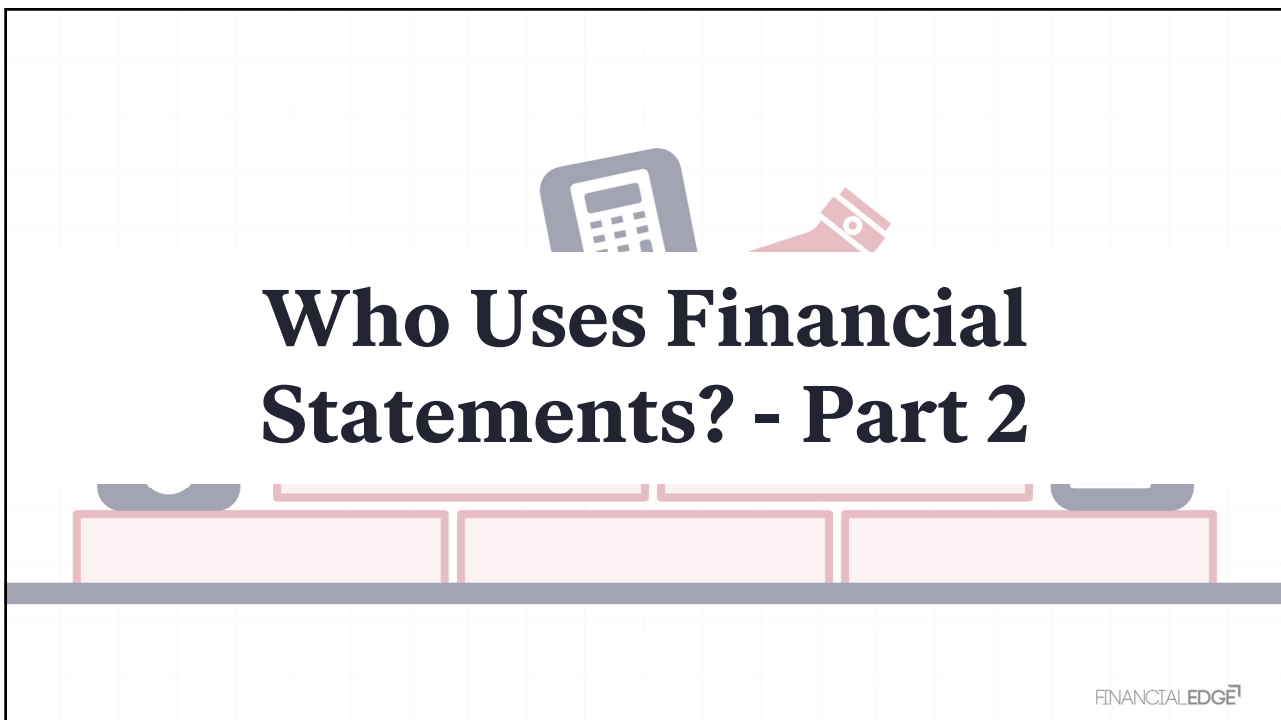
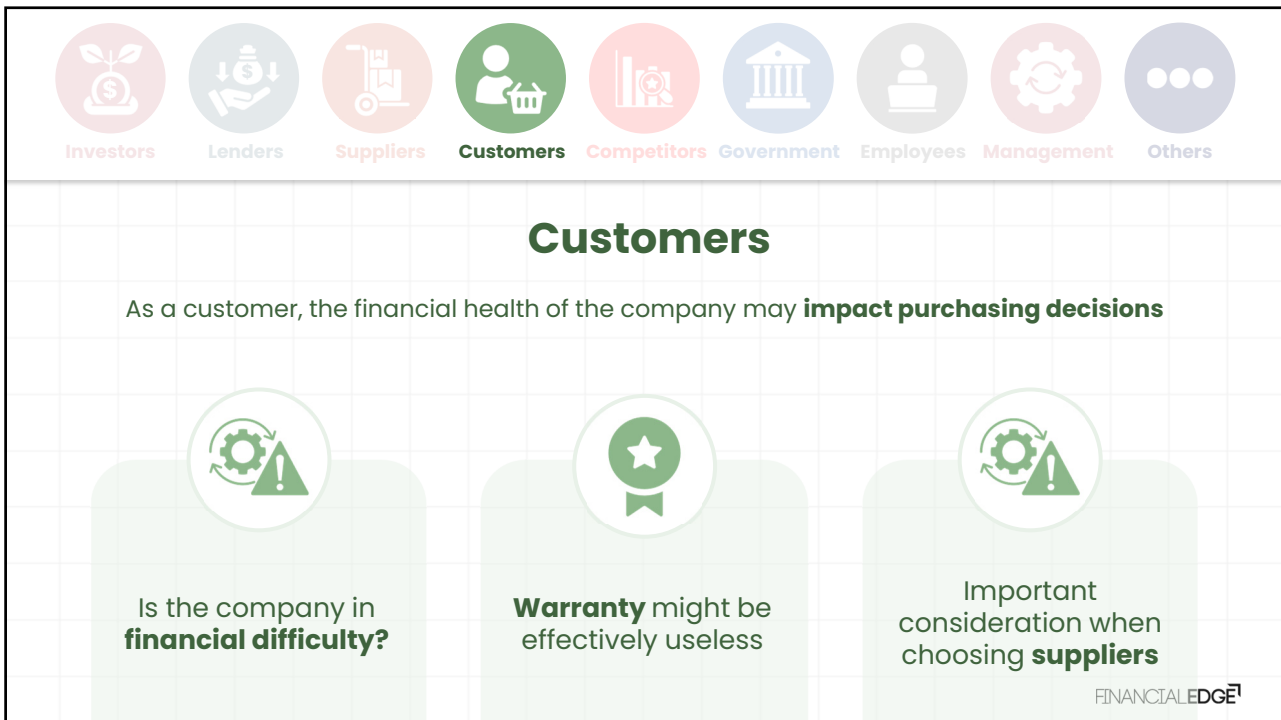
Has **money** been **employed wisely** to generate **returns**?

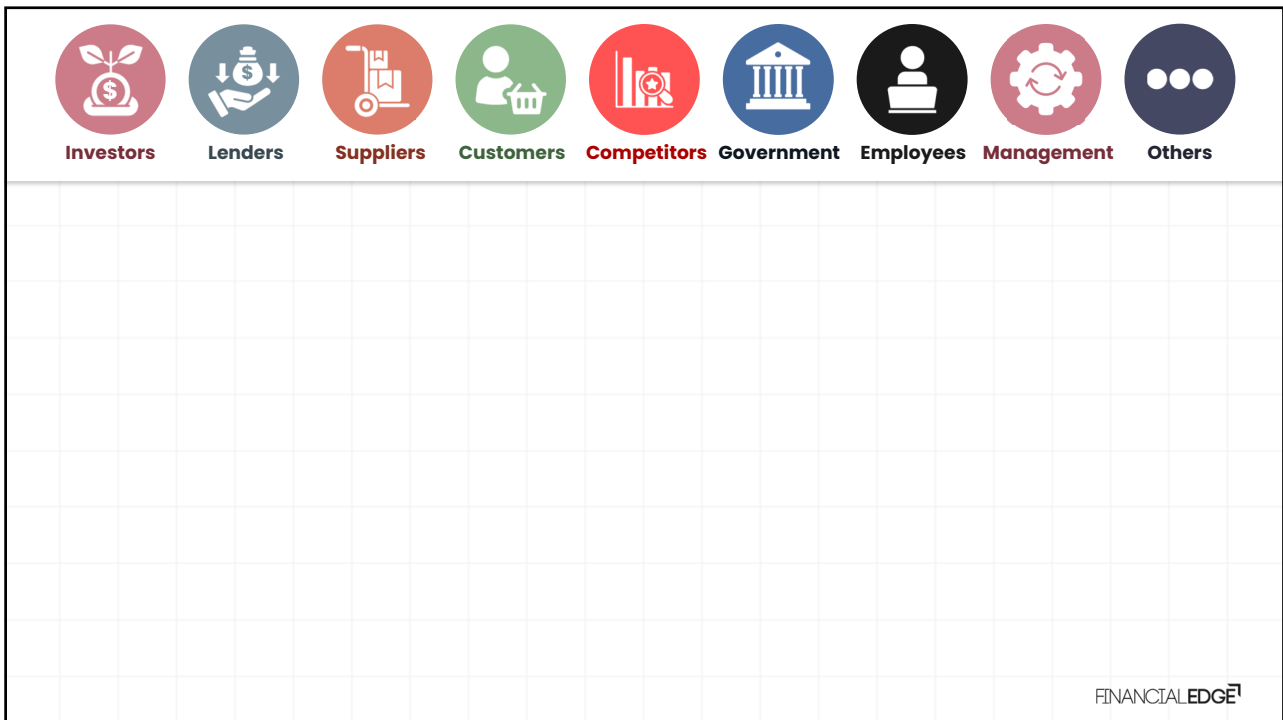


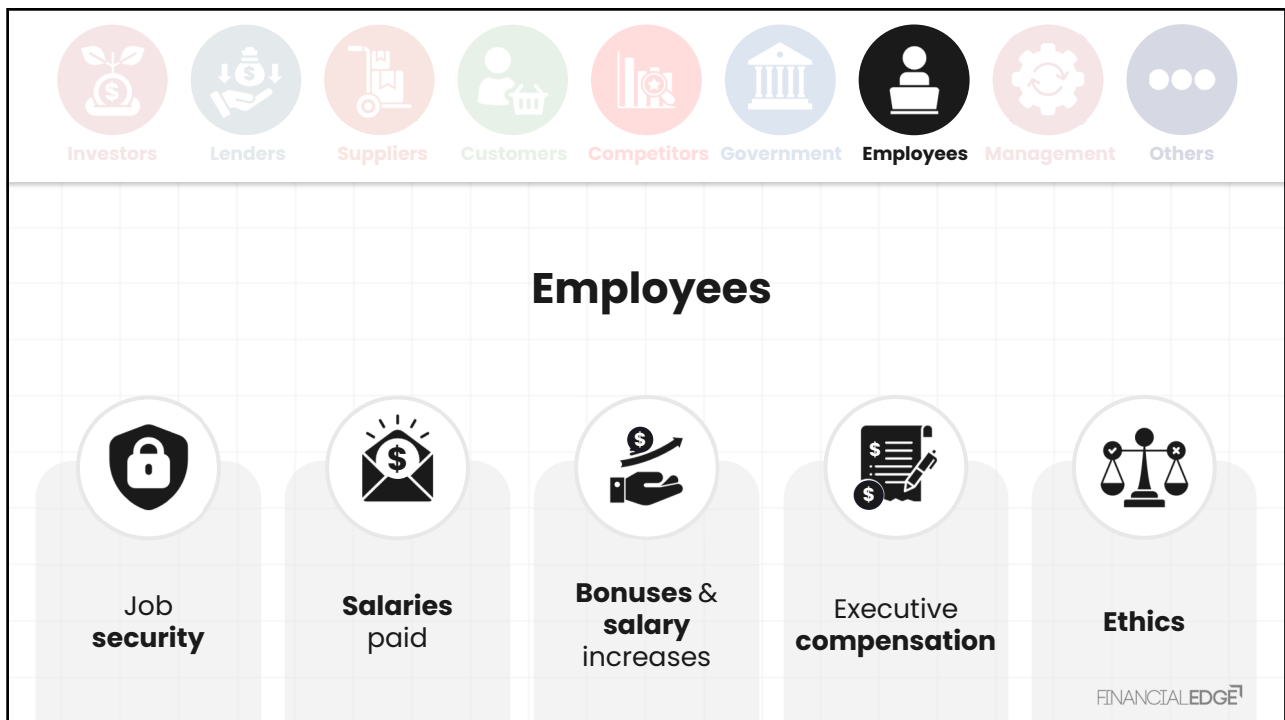
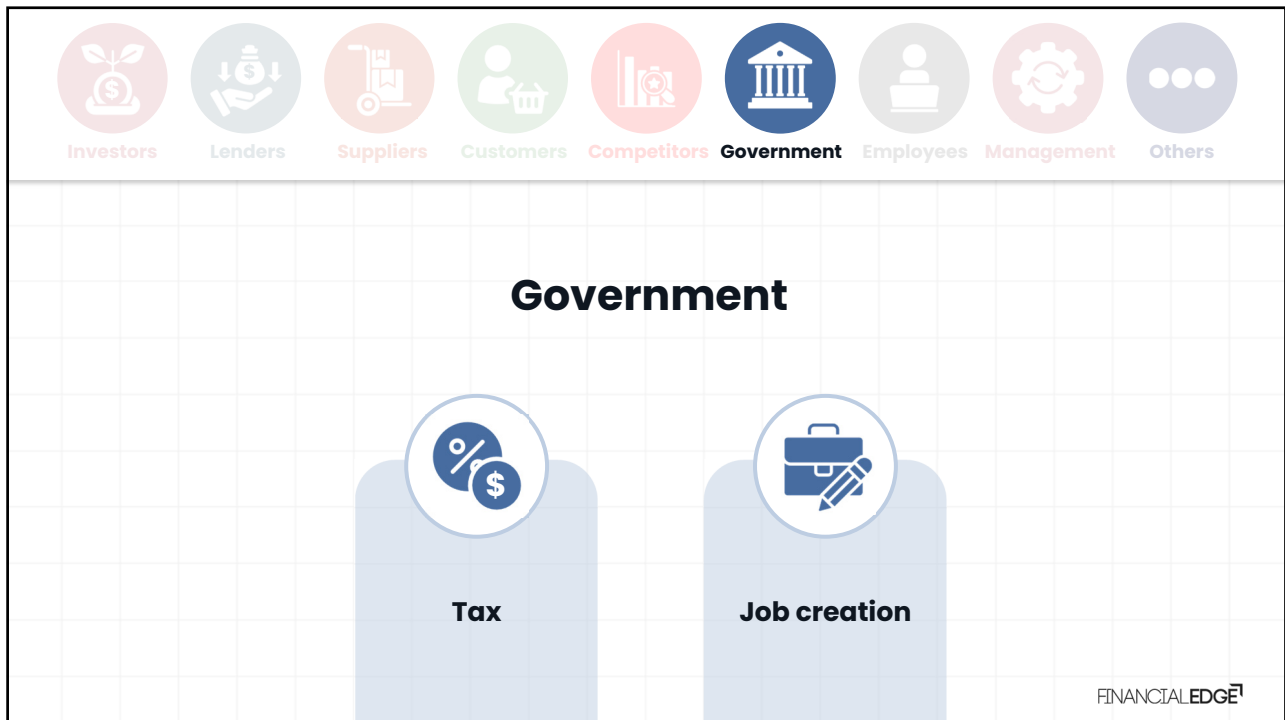
Possible **future performance**?

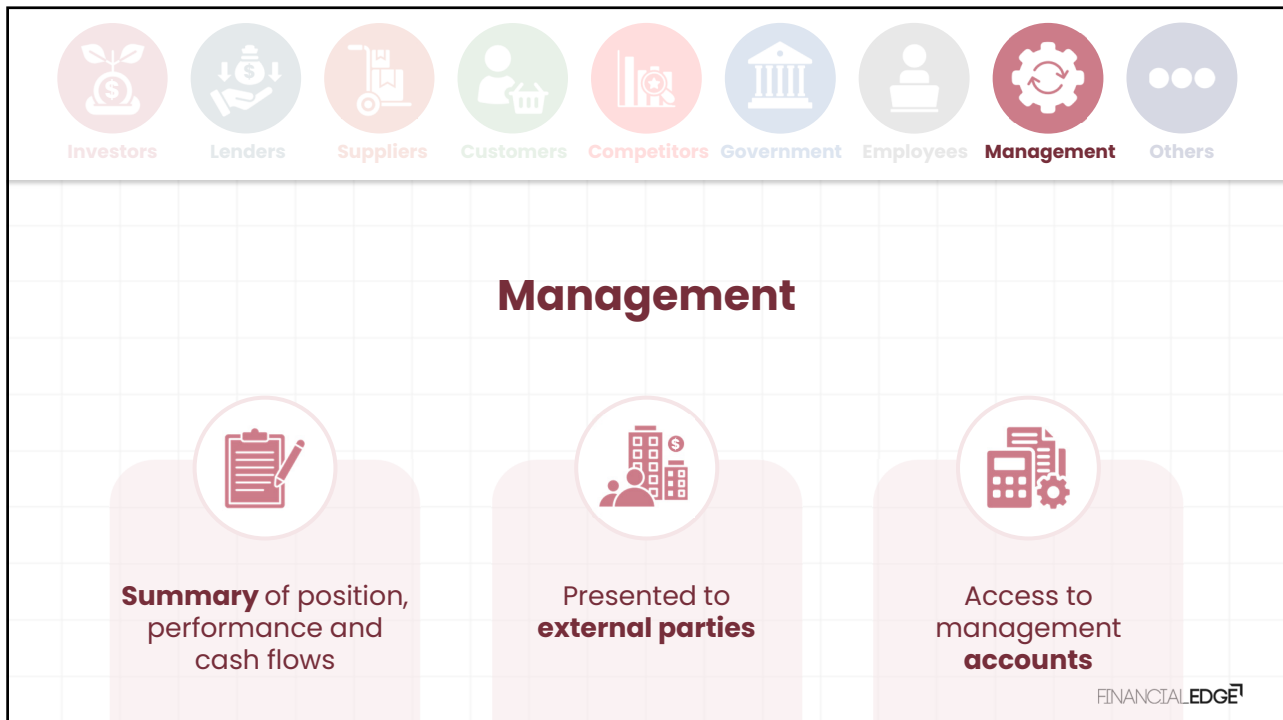
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What are the Three Main Financial Statements?

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**Income
Statement**

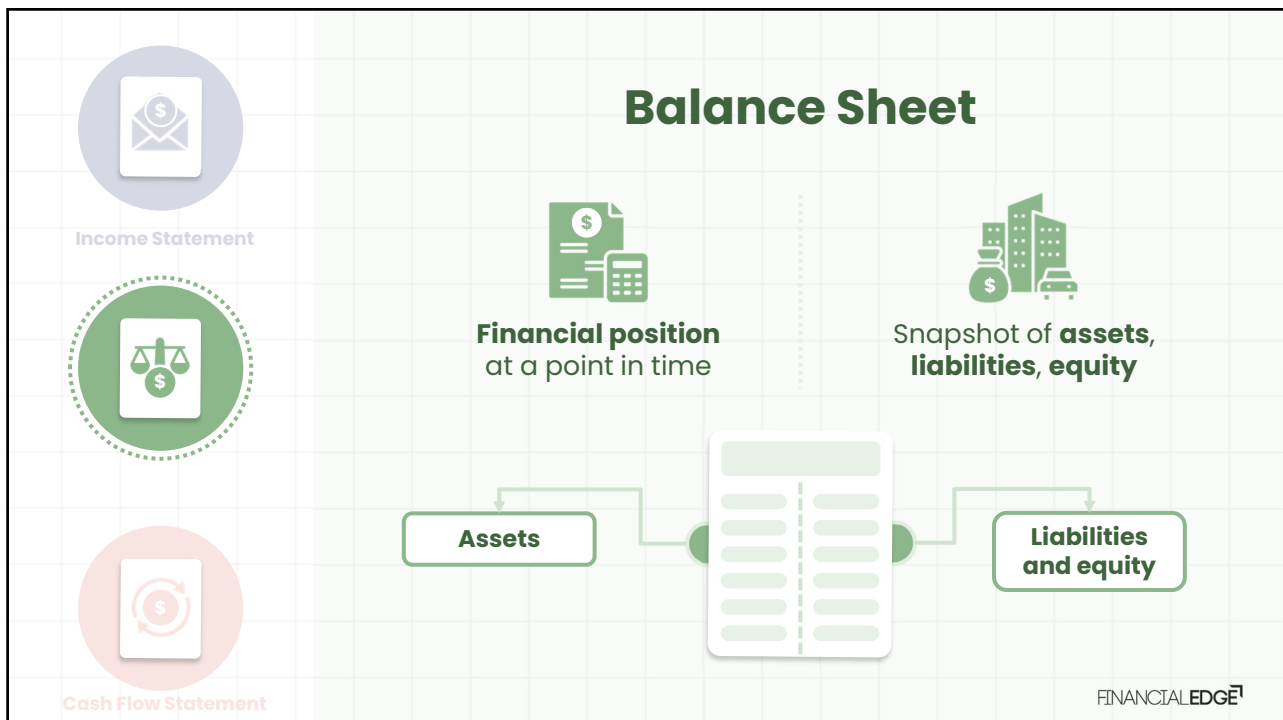
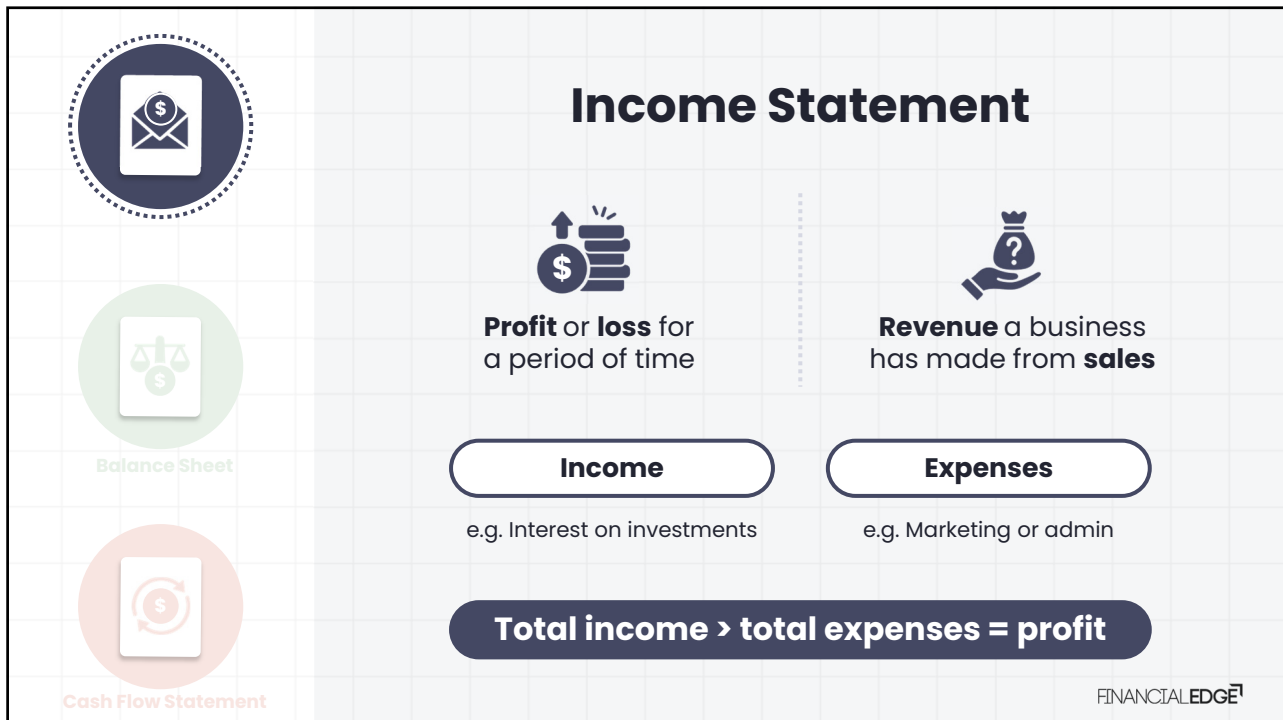


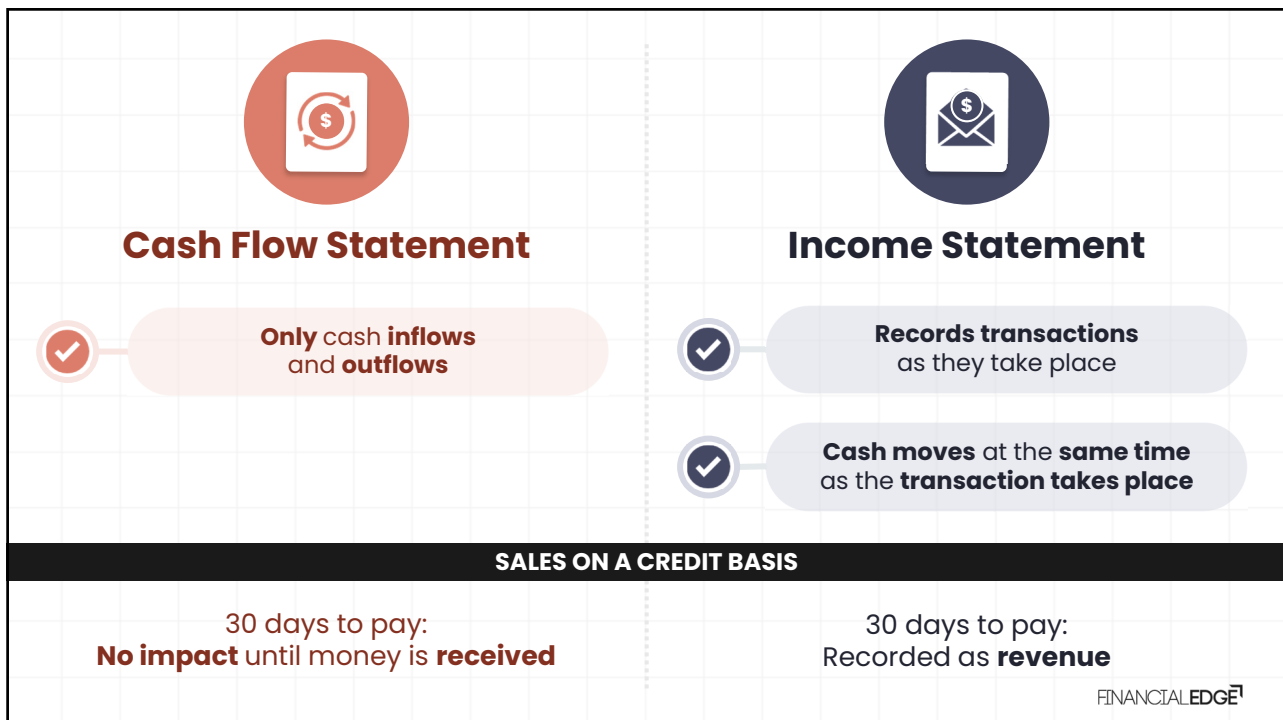
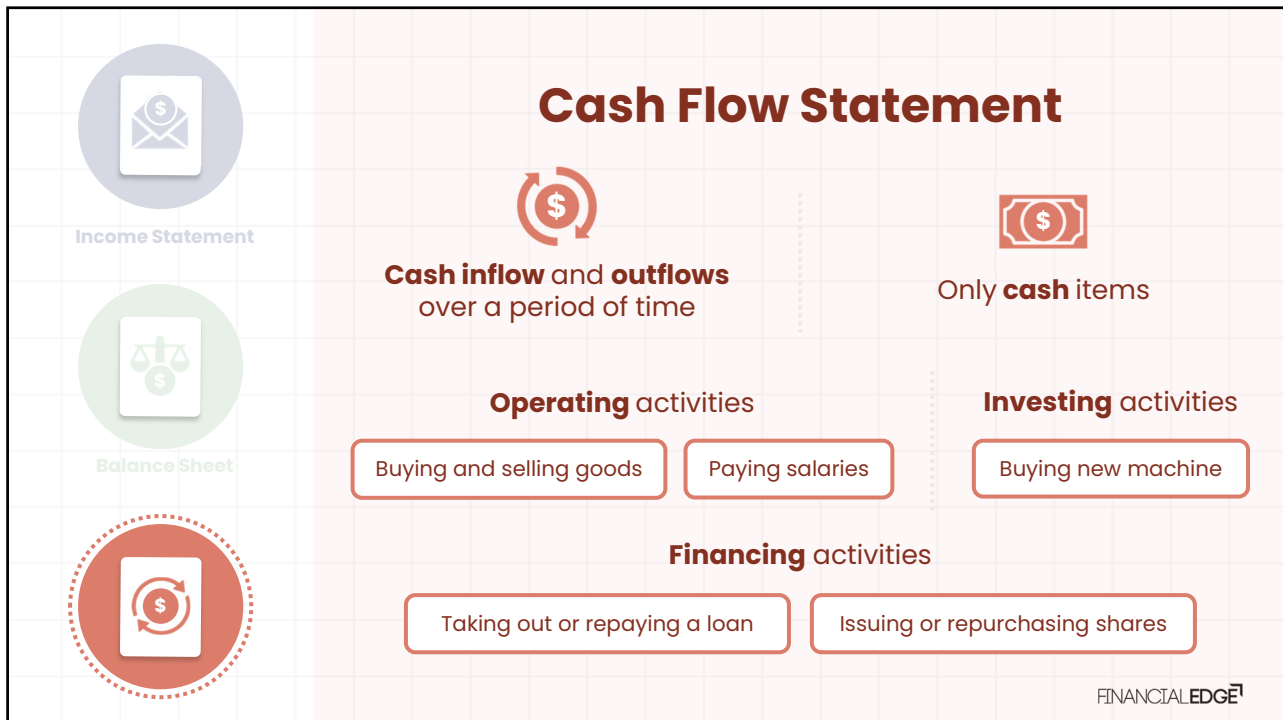
**Balance
Sheet**



**Cash Flow
Statement**

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What Else is in Financial Reports? – Annual Report

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Annual Report

**Management
Discussion and
Analysis ('MD&A')**



**Financial
Statements**



**Notes or
Footnotes**

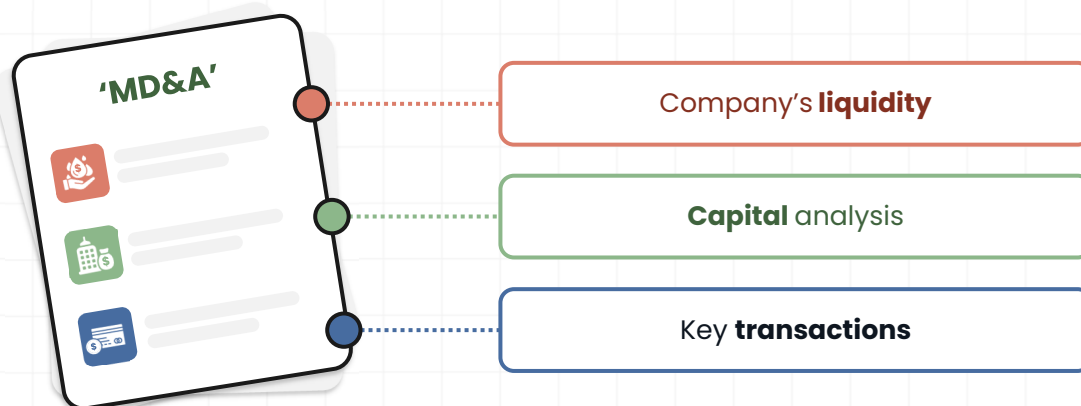
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Management Discussion and Analysis

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Management Discussion and Analysis

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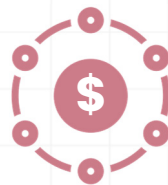
Before the financial statements



**Strategic
Direction
and Goals**



**Remuneration
of Directors**



**Key
Stakeholders**



**Environmental, Social
and Governance
(ESG) Information**

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Notes and Footnotes

Provide **more information** on **accounts** and **transactions**

Example



Analyzing the **debt level** of a company

Note of their **long-term debt** will include
a breakdown on **how much debt is due
for repayment** in the **next 5 years**

Important if...



Forecasting **future cash flows**



Potential **liquidity issues**

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What Else is in Financial Reports? – Press Release

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Press Release



Listed companies



Useful for **analysts**



Summary of **results**

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Press Release



Key performance metrics



Key points of MD&A



Reconciliation between
reported and **adjusted**
(management's)
profit numbers

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What Else is in Financial Reports? – Other Statements



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Statement of Comprehensive Income



Statement of Changes in Equity

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Statement of Comprehensive Income



Net income (bottom of income statement)



Adds or deducts adjustments directly to **equity**



Doesn't go through the income statement now



Could **hit** the income statement in **future**

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Statement of Comprehensive Income



Statement of Changes in Equity

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Reconciles **beginning equity** balances to **ending** balances



Example:
Dividends deducted from
retained earnings



Statement of Changes in Equity

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Statement of Comprehensive Income



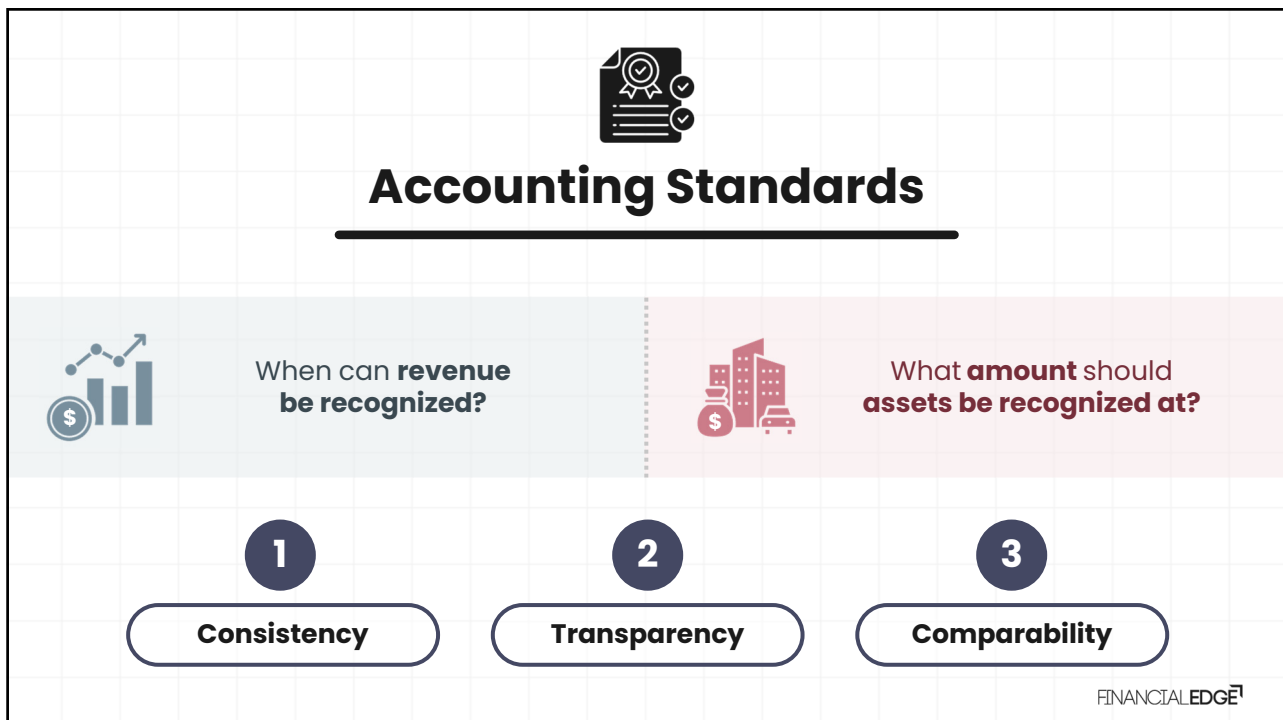
Statement of Changes in Equity

Provide **additional insight** into operations of the company



What are Accounting Standards?







Auditors

Individuals or **firms** authorized to **review** and **evaluate** a company's **financial records**



Provide **independent assurance** to stakeholders

Investors

Creditors



Auditors give **opinion** on **fair presentation**

Financial position

Operating results

Cash flows

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Accounting Standards



Set by **standard-setting** boards



Depends on the **jurisdiction**

International Financial Reporting Standards ('IFRS')

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Accounting Standards

International Financial Reporting Standards ('IFRS')

International Accounting Standards Board ('IASB')

Globally recognized

More than 140 jurisdictions

General **guiding principles** and **specific standards**

US Generally Accepted Accounting Principles ('US GAAP')

Closely aligned to IFRS

Some differences e.g. leases

Disclose **accounting standards** and **key accounting policies**

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How Often are Financial Statements Prepared?



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Frequency of Reporting

Prepare financial statements at least **annually**



Publicly traded companies – more frequently



US – quarterly reports called **10Qs**



UK and Europe – interim reports, semi-annual



Year-end date of a company is called **fiscal year**

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Microsoft



Fiscal year ends
JUNE 30th



File annual report
In the US, called 10K

Why do **companies** choose a **fiscal year**?

1

Better **align** their **reporting** with their **operating cycle**

2

Avoid having to **produce financial statements** during **busiest operating period**

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The Accounting Equation


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The balance sheet **must always balance**

Each transaction has **at least two impacts** on the balance sheet



If a company **takes out a bank loan**



Asset of **cash** will **increase**



Liabilities will increase by the amount it owes to the bank

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Debits and Credits

Accountants use a '**double-entry**' bookkeeping system.
For **every debit** there must be a **corresponding credit**



Debits



Credits



Assets



Debit to an asset: balance **increases**



Liabilities and equity: decrease balance

Liabilities and equity



Credit to an asset: balance **decreases**



Liabilities and equity: increase balance

**Understand how transactions impact assets, liabilities and equity
– what will increase and what will decrease?**

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Income Statement Items

Income items



Credits

Expenses



Debits

Bottom line of income statement (net profit)

+

Retained earnings – equity in the balance sheet



Reduction in profit is **decrease** in **equity**



Increase in profit is **increase** in **equity**

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Income Statement Items

EXAMPLE

Pay salaries of \$1 million cash

Reduce cash
balance by **\$1 million**



Salaries are **expense**
in income statement

Reduce **profit**

Reduce **equity**



Cash (asset)
down \$1 million



Equity down
\$1 million

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The Balance Sheet



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Assets

An asset is something **controlled by the business**, that is expected to generate some sort of **future economic benefit**



PHYSICAL

Buildings

Equipment

Inventory



INTANGIBLE

Patent

Trademark



FINANCIAL

Cash

Receivables

Debtors

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Assets

An asset is something **controlled by the business**, that is expected to generate some sort of **future economic benefit**

Current assets

< 12 months

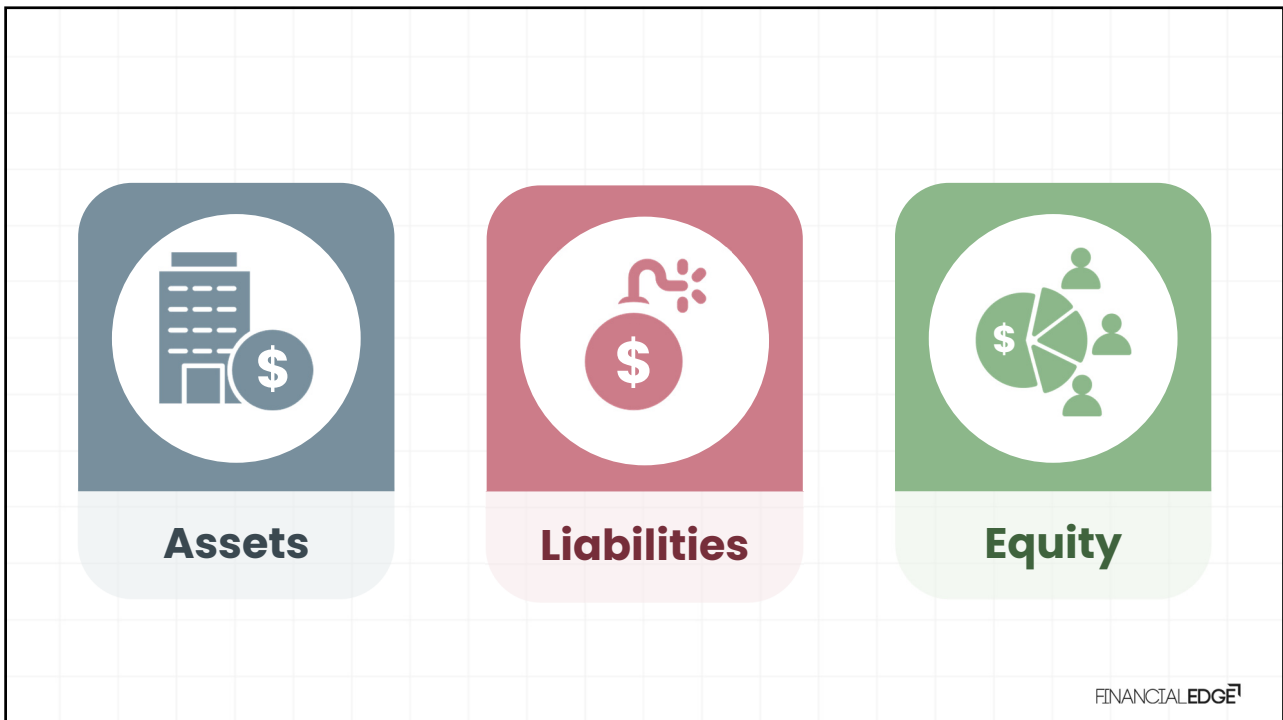
Inventory (or stock)

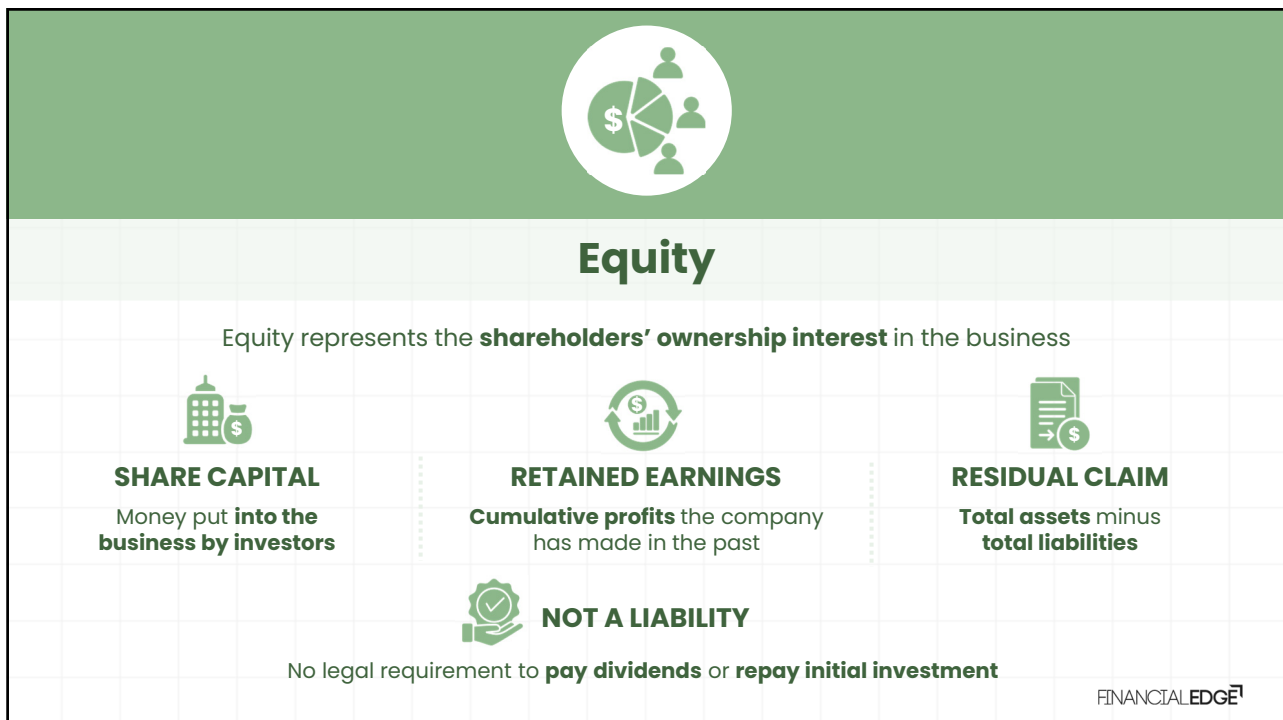
Non-current assets

> 12 months

Warehouses

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The Income Statement


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Income Statement

| | |
|---|-----|
| Revenue | X |
| Cost of Sales (also called cost of goods sold) | (X) |
| Gross Profit / (loss) | X |
| Selling, General and Admin. (SG&A) expenses | (X) |
| Operating Profit (also called operating income) | X |
| Interest Expense | (X) |
| Profit Before Tax | X |
| Tax Expense | (X) |
| Net Income (also called profit after tax) | X |

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Sales or Revenue

'Top line'

Income generated from core operations

Selling products

Providing services

Cost of Sales

Cost of making products that were sold in this period

Cost of providing services delivered in his period

Includes cost of materials, labour and overheads

Gross Profit

Sales minus cost of sales

Key measure of profitability

| | |
|---|-----|
| Revenue | X |
| Cost of Sales (also called cost of goods sold) | (X) |
| Gross Profit / (loss) | X |
| Selling, General and Admin. (SG&A) expenses | (X) |
| Operating Profit (also called operating income) | X |
| Interest Expense | (X) |
| Profit Before Tax | X |
| Tax Expense | (X) |
| Net Income (also called profit after tax) | X |

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| Selling, General & Admin Expenses | Operating Profit | | | | | | | | | | | | | | | | | | |
|---|--|---------|---|--|-----|-----------------------|---|---|-----|---|---|------------------|-----|-------------------|---|-------------|-----|---|---|
| <p>Other costs in making the sales and running the business</p> <p>Not directly incurred in making product or providing service</p> <p>Not financing costs Interest</p> | <p>Gross profit minus SG&A</p> <p>Crucial measure of profitability</p> <p>How good is the company at 'doing what it does'</p> <p>Independent of how company is financed</p> | | | | | | | | | | | | | | | | | | |
| <table> <tr> <td>Revenue</td><td>X</td></tr> <tr> <td>Cost of Sales (also called cost of goods sold)</td><td>(X)</td></tr> <tr> <td>Gross Profit / (loss)</td><td>X</td></tr> <tr> <td>Selling, General and Admin. (SG&A) expenses</td><td>(X)</td></tr> <tr> <td>Operating Profit (also called operating income)</td><td>X</td></tr> <tr> <td>Interest Expense</td><td>(X)</td></tr> <tr> <td>Profit Before Tax</td><td>X</td></tr> <tr> <td>Tax Expense</td><td>(X)</td></tr> <tr> <td>Net Income (also called profit after tax)</td><td>X</td></tr> </table> | | Revenue | X | Cost of Sales (also called cost of goods sold) | (X) | Gross Profit / (loss) | X | Selling, General and Admin. (SG&A) expenses | (X) | Operating Profit (also called operating income) | X | Interest Expense | (X) | Profit Before Tax | X | Tax Expense | (X) | Net Income (also called profit after tax) | X |
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| Tax Expense | (X) | | | | | | | | | | | | | | | | | | |
| Net Income (also called profit after tax) | X | | | | | | | | | | | | | | | | | | |
| FINANCIALEDGE ⁷ | | | | | | | | | | | | | | | | | | | |

| Interest | Profit Before Tax | Profit After Tax | | | | | | | | | | | | | | | | | | |
|--|--|---|---------|---|--|-----|-----------------------|---|---|-----|---|---|------------------|-----|-------------------|---|-------------|-----|---|---|
| <p>Impact of financing decisions</p> <p>Interest expense and potentially income</p> <p>More debt on the balance sheet means more interest expense</p> | <p>Operating profit minus interest expense (plus interest income)</p> | <p>'Bottom line'</p> <p>Belongs to the shareholders</p> <p>Added on to equity at the end of the period (retained earnings)</p> | | | | | | | | | | | | | | | | | | |
| <table><tr><td>Revenue</td><td>X</td></tr><tr><td>Cost of Sales (also called cost of goods sold)</td><td>(X)</td></tr><tr><td>Gross Profit / (loss)</td><td>X</td></tr><tr><td>Selling, General and Admin. (SG&A) expenses</td><td>(X)</td></tr><tr><td>Operating Profit (also called operating income)</td><td>X</td></tr><tr><td>Interest Expense</td><td>(X)</td></tr><tr><td>Profit Before Tax</td><td>X</td></tr><tr><td>Tax Expense</td><td>(X)</td></tr><tr><td>Net Income (also called profit after tax)</td><td>X</td></tr></table> | | | Revenue | X | Cost of Sales (also called cost of goods sold) | (X) | Gross Profit / (loss) | X | Selling, General and Admin. (SG&A) expenses | (X) | Operating Profit (also called operating income) | X | Interest Expense | (X) | Profit Before Tax | X | Tax Expense | (X) | Net Income (also called profit after tax) | X |
| Revenue | X | | | | | | | | | | | | | | | | | | | |
| Cost of Sales (also called cost of goods sold) | (X) | | | | | | | | | | | | | | | | | | | |
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| Interest Expense | (X) | | | | | | | | | | | | | | | | | | | |
| Profit Before Tax | X | | | | | | | | | | | | | | | | | | | |
| Tax Expense | (X) | | | | | | | | | | | | | | | | | | | |
| Net Income (also called profit after tax) | X | | | | | | | | | | | | | | | | | | | |

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The Cash Flow Statement

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Cash Flow Statement

Cash inflows and **outflows** over a period of time

Accrual  Accounting

Transactions will appear in the cash flow statement



Cash paid



Cash received

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Cash Flow Statement

Cash inflows and **outflows** over a period of time

Accrual  Accounting

Sale made to a customer on **credit**



INCOME
STATEMENT

Only when the customer pays the company



CASH FLOW
STATEMENT

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Cash Flow Statement

Cash inflows and outflows over a period of time



Operating activities



Investing activities



Financing activities

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Operating activities

Day-to-day activities



Sales



Purchases



Salaries



Taxes

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Investing activities

Purchases and sales of assets



Machinery



Buildings



Investments in
other companies

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Financing activities

Cash received from or paid to lenders and shareholders



Share issue

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Cash Flow Statement

Net cash flow for the period

Explains **change in cash balance** on balance sheet

| Balance Sheet | FY0 | FY1 |
|---------------|---|-----|
| Cash | 100  | 300 |

| Cash Flow Statement | FY1 |
|-----------------------|-------|
| Operating activities | 450 |
| Investing activities | (200) |
| Financing activities | (50) |
| Net cash flow for FY1 | 200 |

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Accrual Accounting

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Income Statement



Cash Flow Statement

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Income Statement

Income and **expenses** ONLY

Accrual accounting

Recognize when **something happens**,
not when **cash is received or paid**



Cash Flow Statement

ALL **cash inflows** and **outflows**

Cash paid for a machine will
be shown as **cash outflow**

Cash accounting

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EXAMPLE 1

Pay two year's rent in advance \$240,000

EXAMPLE 2

Electricity

FINANCIALEDGE⁷**EXAMPLE 1**

Pay two year's rent in advance \$240,000

Pay **two year's head office rent** in advance



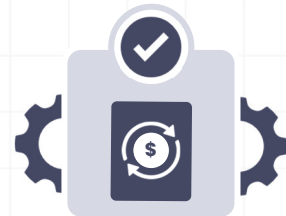
\$240,000

Accrual basis



Recognize expense in income statement as it is **incurred**

Cash flow statement



Full amount of **\$240,000** will be incorporated **when paid**

First six months of the year = **\$60,000** rent expense = **$\$240,000 / 24 \text{ months} * 6 \text{ months}$**

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EXAMPLE 2

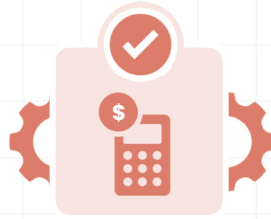
Electricity

Get bill at end of period



Need to **recognize electricity as an expense** as it is used

Accrual basis



Estimate the amount
Income statement = **Expense**
Balance sheet = **Liability**

Cash flow statement



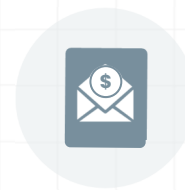
Expense **ONLY** appears when the **bill is actually paid**

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Company makes **sales**



To **customers** on **credit**



Sale will **appear** in **income statement** as soon as the sale is made

The company has **fulfilled its obligations to the customer** and the **sale has been made**

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The Matching Principle

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Matching Principle



Closely related to the **accrual principle**



Applies to the **income statement**



Expenses must be recognized in the **same period** as **revenue**

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Matching Principle

Example

Costs of goods sold

Unsold inventory is **asset on balance sheet** until it is **sold**

When it is sold, inventory is **taken out of balance sheet** and appears as **expense** in **income statement**

The **cost** has **been matched** to the **sale**

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Capitalization

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What Does it Mean to Capitalize a Company?

Recognize as an **asset** on the **balance sheet** instead of an **expense** in the **income statement**



Treated as an **expense**
in the **income statement**



The transaction is **recorded** as
a **purchase of an asset** on the
balance sheet (capitalization)

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Accounting Rules

Must meet the **definition** and **recognition** criteria of asset



Rental of head office building

Monthly costs is an **expense**

Cannot be capitalized



Purchase of machine

Can be capitalized

Asset on the balance sheet

Reduction in value as it is used is
shown as an expense in the income
statement (called **depreciation**)

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