



## **Core Module 6: Basic Accounting Learner Resource Guide**

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## Chapter One

### Personal Finance

#### Introduction

Personal finance is the process of planning and managing personal financial activities such as income generation, spending, saving, investing, and protection. The process of managing one's personal finances can be summarized in a budget or financial plan. In this chapter we will analyze the most common and important aspects of individual financial management.

The key to successful money management is developing and following a personal financial plan. Research has shown that people with a financial plan tend to save more money, feel better about their progress, and make more appropriate decisions – no matter what their income. Moreover, a written financial plan is far more effective than a mental one. Seeing your plan in writing helps to remind you about what actions are necessary to reach your goals and it helps you to check your progress more easily than relying on memory alone.

## **1.1 Financial Planning**

A successful financial plan can be developed in six steps:

What Are the 6 Steps of Financial Planning?

You can recall the six steps by memorizing the acronym, EGADIM:

1. **E**stablish the goal/relationship
2. **G**ather data
3. **A**nalyze data
4. **D**evelop a plan
5. **I**mplement the plan
6. **M**onitor the plan

### **1.1.1 Financial Planning Process Step 1: Establish the Goal / Relationship**

Establishing the goal or relationship is where the adviser introduces himself or herself a client or prospective client and explains the financial planning process. The adviser may ask open-ended questions to uncover necessary information to start the plan. This information may include a range of topics, from financial goals, to feelings about market risk, to dreams about retiring in the Caribbean.

The purpose of establishing the goal or relationship is to form the foundation or purpose of planning itself. Financial planners do this by asking open-ended questions, which are questions that cannot be answered by a simple yes or no. Here some examples of open-ended questions you can use in your own planning:

Do-it-yourselfers can fulfill this step by simply getting to know themselves a bit better with open-ended questions, like these:

- What are your feelings about investing in the stock market? Why do you think you feel that way?
- What are some of your earliest memories and resulting experiences of financial planning (i.e., first savings account, first cheque account, and first credit card)
- What are your financial strengths? What are your financial weaknesses?
- How do you plan to save enough for retirement?



The step of establishing the goal forms a guiding philosophy to direct investment objectives, cash management, insurance needs, and other financial instruments to help achieve your specific financial goals.

First, take time to set goals and decide as an individual or family what you hope to accomplish financially.

Knowing what is important to you and your family is a critical first step in a successful personal financial plan. Use the **Setting Goals** worksheet to decide which financial goals are most important to the family and how much will be needed each month to accomplish these goals.

The following is an example of a well defined financial goal:

**“I want to buy a house that costs around R550,000 in 2022.”**

This goal is specific, measurable, and tied to a time frame. It is reasonable when you are willing and able to include the goal in your everyday spending priorities.

Prioritize goals in terms of their importance to you and your family. Goals will differ in the length of time needed to achieve them. It may not be possible to start working on all goals in the same year. However, long-term goals need a place in the financial plan over time. Both short- and long-term financial goals will require regular savings.

The first short-term goal for every family should be an **emergency cash reserve**. In addition to the regular savings that are needed to achieve your specific goals, most families also need a “rainy day” fund for the unexpected financial emergencies that happen without warning. The emergency cash reserve should equal 3-6 months of your monthly expenses, if your job is secure. If your job is not secure, a 12-month cash reserve may be a safer cushion. No matter how much you choose to set aside for emergencies, your cash reserve should be easily available, safe, and only used for emergencies. One way to build your cash reserve is to have a regular amount of savings automatically deducted from your paycheck and deposited into a savings account.

### 1.1.2 Financial Planning Process Step 2: Gather the Relevant Data

The relevant data you gather is required to make recommendations for the appropriate strategies and financial products to reach your goals. For example, what is your time horizon? Do you want to accomplish this goal in five years, 10 years, 20 years, or 30 years? What is your risk tolerance? Are you willing to accept a high relative market risk to achieve your investment goals, or will a conservative portfolio be a better option for you?

Also, how far along are you in your goals? Do you have any money saved yet? Do you have life insurance? Do you have a will? Do you have children? If so, what are their ages?

For example, if you are gathering data for retirement planning, some of the key information needed is your annual income, savings rate, years until proposed retirement, age when you are eligible to receive Social Security or a pension, how much you've saved to date, how much you will save in the future, expected rate of return and more.

### 1.1.3 Financial Planning Process Step 3: Analyze the Data

You've gathered the relevant data, now can analyze it! Continuing the retirement planning example in Step 2, the data you've gathered can help you arrive at some basic assumptions.

Let's assume you have 30 years until retirement, you've already saved R50,000, you expect an 8.00% return on your investments, and you can save R250 per month going forward.

You can analyze the data with a financial calculator or you can go to one of many online calculators, such as Kiplinger's Retirement Savings Calculator, plug in the numbers and see if your retirement nest egg will be just right for you.

Using a financial calculator, these assumptions will arrive at approximately R920,000 at the proposed retirement date of 30 years from now. Is this enough? Is your retirement goal achievable? Often, the initial assumptions are not quite enough to obtain the goal. This where you begin devising alternative solutions that are in the next step.

#### **1.1.4 Financial Planning Process Step 4: Develop the Plan**

Let's say you need R1 million to reach your goal. The previous assumptions (in Step 3: Analyze the Data) made you about R100,000 short of your goal. If you can handle taking more market risk, you could increase your exposure to stocks in an aggressive portfolio of mutual funds and assume a 9.00% rate of return.

If all other assumptions remain the same, and by increasing your expected return by 1.00%, your 30-year time horizon, and savings rates would bring you to a nest egg worth nearly R1.2 million! But what if you want to keep the rate of return at 8.00%? You could increase your savings rate to R300 per month and still come close to your goal with R990,000.

The key word in Step 4 is "develop." Financial planning requires devising alternative solutions that are achievable for each individual. With so many different variables to consider, your plan needs to develop, which means to evolve with your needs but remain within your capabilities and risk tolerance.

#### **1.1.5 Financial Planning Process Step 5: Implement the Plan**

Implementing the plan means you are putting your plan to work! But as simple as this sounds, many people find that implementation is the most difficult step in financial planning. Although you have the plan developed, it takes discipline and desire to put it into action. You may begin to wonder what may happen if you fail. This is where inaction can grow into procrastination.

Successful investors will tell you that just getting started is the most important aspect of success. You don't need to start out at a high level of savings or at an advanced level of investment strategy. You could learn how to invest with just one fund or you could start saving a few dollars per week to build up to your first investment. Just do it!

#### **1.1.6 Financial Planning Process Step 6: Monitor the Plan**

It's called "financial planning" for a reason: Plans evolve and change just like life. Once the plan is created, it's essentially a piece of history. This is why the plan needs to be monitored and tweaked from time to time. Think of what can change in your life, such as marriage, the birth of children, career changes and more.

These life events may require new perspectives or changes to your financial plans. Now think events or changes beyond your control, such as tax laws, interest rates, inflation, stock market fluctuations, and economic recessions.

## Bottom Line

Now that you know the 6 steps of financial planning, you can apply them to any area of personal finance, including insurance planning, tax planning, cash flow (budgeting), estate planning, investing, and retirement. Why not plan for yourself like the professionals do it?

Whether you do it yourself or hire an advisor, remember to keep referring back to the steps as significant life or financial changes occur. You may also want to do as the professional financial planners do and sit down and reevaluate your plan on a periodic basis, such as once per year.

## 1.2 Net Worth

Your net worth is essentially the total value of everything you own minus the amount that you owe in debts. What you own is referred to as your assets, while what you owe others is called your liabilities. Your assets include your cash, your bank accounts, your house, your car and everything else valuable. Your liabilities include your mortgage, your car payment and your student loans. If you were to sell all your assets and pay off all of your debts, the amount you would have left over is called your net worth.

### 1.2.1 How to calculate net worth

Calculating your net worth is a useful way to determine your financial health. There are many online calculators and tools that you can use, but running the calculations yourself can help you thoroughly understand your financial status. Follow these steps to calculate your net worth:

- a) Estimate the value of your assets

The first step is to make a thorough list of all your assets. It is easy to forget some important items, so make sure to include:

- Retirement savings
- Bonds
- Stocks
- Real estate
- Vehicles
- All checking and savings accounts

Once you have created this list, you need to estimate the value of each. You can use websites like Zillow to find general estimations of the value of your house. You can also visit sites like Kelley Blue Book or Edmunds to find out what your car may be worth. Ebay, Amazon and other

online retail sites can provide information to determine the value of other significant possessions like computers, gaming systems or recreational equipment.

b) Make a list of your debts

Next, you will need to make a complete list of your liabilities. These include:

- Credit card debt
- Student loans
- Bank loans
- Car loans
- Home mortgage

The specific numbers associated with these items are sometimes available online, but you may also have to call your bank or a loan office to find out the exact amount you owe. Listing your liabilities is certainly less enjoyable than listing your assets, but collecting this information is a necessary part of the final calculation.

c) Calculate the totals and subtract

The next step in calculating your net worth is adding up the totals associated with your assets and liabilities. To make this easier, be sure to list the individual figures so that the decimal points line up on your paper. If you are using a spreadsheet, it should be fairly easy to complete the necessary calculation within the application. Once you have the two totals, it is time to subtract your liabilities from your assets. Once you have done this, the resulting figure is your total net worth.

### 1.2.2 Examples of calculating net worth

An individual's net worth depends on many factors, including salary, the current economy and geographic location. Here are some examples of how to calculate net worth in a variety of situations:

Example 1:

Eddie is a 25-year-old graduate student who just completed a master's degree in psychology. He bought an apartment for R250,000 and he owes R175,000 on the mortgage. His parents gifted him a 10-year-old Jeep that is worth R8,000. He has R800 in credit card debt, R5,000 in a savings account and R40,000 of student loans. Eddie is looking for a new job and needs to calculate his net worth in order to negotiate for a competitive salary.

First, Eddie needs to list his assets and add up their worth:

- Apartment: R250,000
- Car: R8,000
- Savings: R5,000

Total assets: R263,000

Next, Eddie must determine his total debt:

- Mortgage: R175,000
- Credit card debt: R800
- Student loans: R40,000

Total liabilities: R215,800

If Eddie subtracts the R215,800 of liabilities from his R263,000 in assets, he will get a total of R47,200. This is Eddie's current net worth.

Example 2:

Elizabeth is a 35-year-old administrative assistant living in Salt Lake City. She recently got a new job, so she has accumulated R1,500 in her 401(k) but only has R2,000 in savings. She owns a R125,000 house and is paying off the R100,000 mortgage. She has a new car worth R18,000, but she still owes R12,000 in regular car payments. She does not have any student loans but has R10,000 in credit card debt.

Elizabeth's assets list includes:

- 401(k): R1,500
- Savings account: R2,000
- House: R125,000
- Car: R18,000

The total value of her assets is R146,500.

Meanwhile, her list of liabilities looks like this:

- Mortgage: R100,000
- Car payments: R12,000
- Credit card debt: R10,000

The total value of Elizabeth's liabilities is R122,000.

To calculate her net worth, Elizabeth subtracts R122,000 from R146,500 and is left with R24,500 as her final net worth total.

### 1.2.3 How to improve your net worth

Maintaining a healthy net worth can increase your career opportunities, improve your lifestyle and help you to develop professionally. If your net worth is currently low or even negative, there are several important steps you can take to improve your net worth, such as:

1. **Focus on paying off debts:** One of the fastest ways to increase your net worth is to work on decreasing the amounts owed in liabilities. To accomplish this, you can adjust

your budget to be able to pay more than the minimum payment toward your student loans or car balance. You can also change the payment schedule to become bi-monthly or weekly, which can help you focus on getting your debts paid off as soon as possible.

2. **Lower your spending:** Limiting your spending can be challenging, but it is one of the most effective ways to increase your net worth. Using your credit cards less, adapting a slimmer budget and canceling subscriptions are all great ways to lower your spending and build up your bank account.
3. **Make some extra money:** Selling unnecessary valuables, picking up freelance work and putting in overtime hours are all effective options for making some additional income that can help raise your net worth. If you are making some supplementary income on the side, you will also be able to dedicate more of your primary income to paying off your liabilities.

**Article:**

4 Step Plan for Getting Out of Debt

Admit the Problem and Pick a Debt-Payment Tactic

**BY**

**PAULA PANT**

Updated March 09, 2019

There are plenty of articles that describe the tactics people use to get out of debt. They cut up their credit cards, or stick their plastic cards into a jar of peanut butter. They stop buying coffees at Starbucks and apply the extra money to paying down their Visa. They trade their car in for an older or more fuel-efficient model, or bring a renter into their spare bedroom.

But there are a few mental and emotional issues that people should address, as well, if they want to conquer their debt.

**#1: Admit You Have a Problem**

Admit that you have a spending problem. Admit that you went over your head. Don't make excuses. Yes, times were tough. Yes, money was tight. But there were things you could have done differently.

As long as you make excuses, you give yourself silent permission to continue repeating the same bad financial habits. You risk falling into the same spending traps that led you into debt in the first place. The first step to repaying your debt is to come clean with yourself, stop making excuses, stop pointing your finger at external factors beyond your control, and focus on how you can change your life.

**#2: Know the Difference Between a Want and a Need**

Too few people understand the line between necessities and luxuries. Bread and milk are necessities. Oreo cookies and ice cream – although technically a “grocery,” in the sense that you buy it at a grocery store – are luxuries. Keeping the air conditioner at 78



or 80 degrees during the summer is a necessity; cranking the air-conditioner down to 68 or 70 degrees is a luxury.

The 50/30/20 budgeting rule of thumb, popularized by Harvard economist Elizabeth Warren, says people should budget 50 percent of their income toward needs, 30 percent toward wants and 20 percent on savings and debt reduction.

If you're serious about stomping out your debt, you may want to take this one step further: devote 40 percent of your income towards savings and debt reduction, and only 10 percent toward wants. Accept that this will require serious sacrifices: cable television, trips to the zoo, restaurant meals and new clothes may all need to get cut from the family budget.

### **#3: Pick a Tactic and Stick With It**

There are two popular tactics that people use to crush their debt. One is called the "**debt snowball.**" Under this strategy, a person should save R1,000 in an emergency fund, and then apply every spare dime to the debt with the smallest balance, regardless of its interest rate. They should pay that debt until it's closed (while making minimum payments on the other debts, of course).

Once that debt is crossed off the list, they should apply all the money they were using to the next-smallest debt on their list, and so forth. Each vanquished debt creates a "snowball" effect of increasing the momentum on the next one. Plus, each conquered debt creates a psychological victory that motivates the person to attack the next one.

The other tactic is called "**debt stacking.**" This strategy says a person should throw every spare cent at the debt with the highest interest rate, regardless of the total balance. Once it's crossed off the list, the person should apply that money towards the next-highest rate, and so forth. This strategy saves the most money in interest payments over the life of all the loans, although – depending on the size of the balance -- it may take longer for a psychological victory of crossing off a debt.

There's great debate over which strategy is better. My opinion is that personal finance is personal; the best tactic is the one that suits your personality the best.

That said, here's my advice: pick one tactic -- debt snowball or debt stacking -- and stick with it. Don't switch back-and-forth between different debt-repayment tactics. Adhere to the method that you've chosen for several weeks or months. Switch only as a last resort, if you truly believe that this tactic just doesn't suit you.

### **#4: Celebrate**

Anytime you reach a psychological win – whether that's one debt crossed off your list, or two weeks of adherence to your repayment plan, or whatever other symbolic victory you experience – celebrate it. Rejoice in it.

But here's the kicker: don't celebrate it by spending money. That's like celebrating a 5-pound weight loss with a double-cheeseburger.



Instead, learn free ways to celebrate. Throw a Frisbee in the park. Take a long bubble bath. Re-read your favorite childhood book. Go on a long walk in the forest with your dog. Celebrate without opening your wallet.

## 1.3 Budgeting

### 1.3.1 What is Budgeting? What is a Budget?

**Budgeting** is the process of creating a **plan to spend your money**. This spending plan is called a **budget**. Creating this spending plan allows you to determine in advance whether you will have enough money to do the things you need to do or would like to do.



*Budgeting is simply balancing your expenses with your income. If they don't balance and you spend more than you make, you will have a problem. Many people don't realize that they spend more than they earn and slowly sink deeper into debt every year.*

If you don't have enough money to do everything you would like to do, then you can use this planning process to prioritize your spending and focus your money on the things that are most important to you.

### 1.3.2 Why is Budgeting so Important?

Since budgeting allows you to create a spending plan for your money, **it ensures that you will always have enough money for the things you need** and the things that are important to you. Following a budget or spending plan will also keep you out of debt or help you work your way out of debt if you are currently in debt.

### 1.3.3 What about Budget Forecasting and Planning?

Once you create your first budget, begin to use it and get a good feel for how it can **keep your finances on track**, you may want to map out your spending plan or budget for 6 months to a year down the road. By doing this you can easily forecast which months your finances may be tight and which ones you'll have extra money. You can then look for ways to even out the highs and lows in your finances so that things can be more manageable and pleasant.

Extending your budget out into the future also allows you to forecast how much money you will be able to save for important things like your vacation, a new vehicle, your first home or home renovations, an emergency savings account or your retirement. Using a realistic budget to forecast your spending for the year can really help you with your long term financial planning. You can then make realistic assumptions about your annual income and expense and plan for long term financial goals like starting your own business, buying an investment or recreation property or retiring.

### 1.3.4 How to Make a Budget in Six Simple Steps

Before you embark on making a budget, find a good template you can use to fill in the numbers for your expenses and income.

While you can use old-fashioned pen and paper to budget your money, it's easier and more efficient to use a monthly budget spreadsheet or a budgeting app. These will contain designated fields for income and expenses in various categories, as well as built-in formulas to help you figure your budget surplus or shortfall with minimal effort.

#### 1. Gather Your Financial Paperwork

Before you begin, gather up all your financial statements, including:

- Bank statements
- Investment accounts
- Recent utility(water and electricity etc.) accounts
- Credit card bills
- Retail accounts
- Receipts from the last three months
- Mortgage or auto loan statements

You want to have access to any information about your income and expenses. One of the keys to the budget-making process is to create a monthly average. The more information you can dig up, the better.

#### 2. Calculate Your Income

How much income can you expect each month? If your income is in the form of a regular paycheck where taxes are automatically deducted, then using the net income (or take-home pay) amount is fine. If you are self-employed or have outside sources of income, such as child support or Social Security, include these as well. Record this total income as a monthly amount.

If you have a variable income (for example, from a seasonal or freelance job), consider using the income from your lowest-earning month in the past year as your baseline income when you set up your budget.

#### 3. Create a List of Monthly Expenses

Write down a list of all the expenses you expect to have during a month. This list could include:

- Mortgage payments or rent
- Car payments
- Insurance
- Groceries
- Utilities
- Entertainment
- Personal care
- Eating out
- Childcare
- Transportation costs
- Travel
- Student loans
- Savings

Use your bank statements, receipts, and credit card statements from the last three months to identify all your spending.

#### 4. Determine Fixed and Variable Expenses

Fixed expenses are those mandatory expenses that you pay the same amount for each time.<sup>2</sup> Include items like mortgage or rent payments, car payments, set-fee internet service, trash pickup, and regular childcare. If you pay a standard credit card payment, include that amount and any other essential spending that tends to stay the same from month to month.

If you plan to save a fixed amount or pay off a certain amount of debt each month, also include savings and debt repayment as fixed expenses.

Variable expenses are the type that will change from month to month, such as:

- Groceries
- Gasoline
- Entertainment
- Eating out
- Gifts<sup>3</sup>

If you don't have an emergency fund, include a category for "surprise expenses" that might pop up over the month and derail your budget.

Start assigning a spending value to each category, beginning with your fixed expenses. Then, estimate how much you'll need to spend per month on variable expenses.

If you're not sure how much you spend in each category, review your last two or three months of credit card or bank transactions to make a rough estimate.

#### 5. Total Your Monthly Income and Expenses

If your income is higher than your expenses, you are off to a good start. This extra money means you can put funds towards areas of your budget, such as retirement savings or paying off debt.

If you have more income than expenses, consider adopting the “50-30-20” budgeting philosophy. In a 50-30-20 budget, "needs," or essential expenses, should represent half of your budget, wants should make up another 30%, and savings and debt repayment should make up the final 20% of your budget.

If your expenses are more than your income, that means you are overspending and need to make some changes.

## 6. Make Adjustments to Expenses

If you're in a situation where expenses are higher than income, find areas in your variable expenses you can cut. Look for places you can reduce your spending—like eating out less—or eliminate a category—like canceling your gym membership.

If your expenses are far above your income, or you have significant debt, reducing your variable expenses may not be enough. You may need to trim your fixed expenses and increase your income to balance your budget.

Aim to have your income and expense columns to be equal. This equal balance means all of your income is accounted for and budgeted toward a specific expense or savings goal.

### 1.3.5 How to Use Your Budget

After you have set up your budget, you must monitor and continue to track your expenses in each category, ideally every day of the month. The same budgeting spreadsheet or app used to make your budget can also be used to record your expense and income totals.

Recording what you spend throughout the month will keep you from overspending and help you identify unnecessary expenses or problematic spending patterns. Take a few minutes each day to record your expenses, rather than putting it off until the end of the month.

If you're not confident that you can budget your money, adopt the envelope system where you divide cash for spending into separate envelopes for different spending categories. When an envelope becomes empty, you'll have to stop spending in that particular category.

As you use your budget, keep an eye on how much you have spent. Once you have reached your spending limit in a category, you will either need to stop that type of spending for the month or move money from another category to cover additional expenses.

Your goal in using your budget should be to keep your expenses equal to or lower than your income for the month.

### 1.3.6 Budgeting Tips

Once you have set up a basic budget, customize it according to your financial situation and goals.

1. If you work on commission, be aggressive in saving to help cover periods when the market is slow.

2. If you have cash flow issues because you are paid only once a month, divide that payment by weeks, and keep the cash you planned to spend in remaining weeks in a separate account until you need it.
3. Pay with a credit card only if you will have the money to pay it off at the end of the month. Otherwise, you will owe interest on top of the price of whatever you bought.
4. Adjust your budget monthly if you find you overestimated or underestimated your expenses. Keep an eye on large expenses that only occur every few months, such as insurance payments.
5. If you tend to overspend in certain categories, use budgeting hacks such as switching to a cash-only budget.
6. Once your expenses are lower than your income, budget towards savings goals before you increase your spending.
7. Take time to learn other financial skills to improve your financial literacy and make your money work harder for you.

### 1.3.7 Using Budget Sheets to Manage Income and Necessities

Budget sheets, or spreadsheets, are a great visual tool for tracking income and costs. With a single glance, you can see what you spend and how your costs compare to your income. To get started, you'll need to collect all your pay stubs and other income information as well as your receipts for a whole month. If you use a debit or credit card to pay for necessities, that information will be on your monthly statement. If not, you'll need to collect the receipts yourself.

#### a) Track Your Income

This sheet is where you'll track the money you bring in each month. If you're not sure (because, for example, you earn tips that vary each month) you'll need to keep a careful record for at least a couple of months. For now, though, you can estimate your tips.

Income Source	Monthly Income
Source 1:	
Source 2:	
Source 3:	
TOTAL:	

#### b) Track Your Necessary Expenses

This worksheet consists of all the bills you have to pay, although not all categories (like property taxes) will apply to all people. Many of these costs can also be reduced by shopping around. The miscellaneous categories are for you to fill in personal nondiscretionary costs, like elderly care.

<b>Necessary Expense</b>	<b>Monthly Estimate</b>	<b>Actual Expense</b>
Rent or Mortgage		
Groceries		
Water and Electricity		
Health Insurance/Co-Pays		
Auto Insurance		
Auto Repairs/Maintenance/Fuel		
Public Transport		
Phone (Landline and Cell Phone)		
Loan Repayment		
Homeowners/Renters Insurance		
Homeowners Association Fee		
Property Tax		
Life Insurance		
Hair Cuts		
Basic Toiletries		
Child Care		
Clothing		
Retirement		
Misc #1		
Misc #2		
<b>TOTAL:</b>		

**c) Next Steps for Money Management**

Working out the relationship between your income and your necessary expenses means you're well on the way to managing your budget. If you found that your necessary expenses are the same as or greater than your income, you'll need to find more ways to save.

Before starting to cut your costs, though, it's important to get a full picture of what you really spend. Very few people spend only on necessities. Discretionary, or optional, expenses are part of everyone's life. They include the money you spend on dinner with a friend, birthday gifts, and vacation.

If you're like most people, you'll want to save some money to give yourself more flexibility. The good news is saving money comes easily once you know the areas you need to target.

## 1.4 Credit

**Credit** is an agreement whereby a financial institution agrees to lend a borrower a maximum amount of money over a given time period. Interest is typically charged on the outstanding balance.

In the accounting world, a credit is also a journal entry reflecting an increase in assets.

### 1.4.1 How Does Credit Work?

Credit cards and home equity lines are examples of credit. Your bar tab is another form of credit.

Not all lines of credit are alike. The borrower's creditworthiness and relationship with the lender affect the terms of the lending agreement, as does bank competition, prevailing market conditions and the size of the line in question. Some lenders apply fixed amortization rates to outstanding balances on a line of credit, while some permit interest-only payments for a time, followed by a lump-sum payment of the principal. If the lender has the right to demand repayment at any time, this is called demand credit.

As with any debt, a wide array of specific terms and requirements may apply to a line of credit. It is common in a revolving line of credit, for example, for the lender to charge a company a commitment fee to keep the unborrowed portion of the line available to the borrower. Lenders also may require a compensating balance, liens on the borrower's assets or collateral on a percentage of the line. This is called securing the line. Some lines of credit are unsecured and are thus not backed by specific assets (this often the case with credit cards). Interest rates on unsecured lines are generally higher than secured lines to compensate the lender for the added risk in the event of a default.

### 1.4.2 Why Does Credit Matter?

Credit gives borrowers the ability to purchase goods and services (or for companies, credit gives borrowers the ability to invest in projects) that they normally might not be able to afford. By lending the money, creditors make money by charging interest while helping borrowers pursue their projects. **However, as many people have learned the hard way, taking on too much debt can cause a lifetime of damage.**

Article: **18 Sep 2019** By Athenkosi Sawutana

Choosing the correct product according to your needs is critical in making smart financial decisions. Credit options can be separated into two main categories – loans and credit facilities. But for some people, the lines can be quite blurred between the two.

Justmoney finds out from Cowyk Fox, managing executive of Everyday Banking at Absa, about the differences between the two.

**Tip: A good credit score can help you achieve your goals. What is a loan?**

Loans are generally fixed amounts that are required for a specific purchase, says Fox.

They can be associated with an asset, but do not necessarily have to be. Buying a vehicle or a house would mean that the asset is still in the possession of the bank until the loan is repaid, but for a personal loan this is not the case – you have full discretion to use the money as you see fit.

All fixed-term loans are set up with a fixed-term, and constant repayment amount, unless the interest rate changes. This helps to simplify financial planning and budgeting.

**ALSO READ: Should you choose a fixed or floating interest rate?**

The terms can range from 3 months to 30 years, depending on the type of loan it is. Home loans usually have longer terms after vehicle finance.

With a loan, your interest will depend on the total amount you have borrowed. Whether you use the money or not, you will still pay the interest.

With unsecured loans, such as personal loans, the interest may be higher. This is because creditors have no way of recovering their funds if you default on your payments for any reasons.

Another significant thing to note about loans is that once you pay back the owed amount, you'll have to apply again to get a new amount. You will go through the same application process – you will have to submit the relevant documents, your affordability will be accessed, and your creditworthiness checked.

You would generally qualify for a bigger loan than a credit facility.

**What is a credit facility?**

The consumer report issued by the National Credit Regulator shows that credit facilities are very popular with South African consumers.

Credit facilities entail credit limits that are available for you to utilise at any point in time, says Fox. Credit cards, garage cards, store cards, and overdrafts are types of credit facilities.

When it comes to credit facilities, everything you repay is available to use again and interest is only calculated on the balance that you have used.

Credit facilities are usually combined with a payment mechanism, such as a card, which offers a compelling alternative for cash.

The benefits of using a credit facility are the availability of credit at all times. It can come in handy in cases of emergency.

According to Fox, interest-free periods which are typically 55 days, as well as reward programmes are some of the benefits that most banks offer on credit cards. Airport lounge access and travel insurance are some of the perks of owning a credit card.

However, credit facilities typically have higher interest rates after those interest-free periods.

### **Which is the best credit option?**

Deciding which credit option to take would depend on how you plan to use the credit. A loan is appropriate for a specific requirement such as a home or vehicle. It allows you to budget and pay-off within a predetermined period of time.

Credit facilities, on the other hand, are there for day-to-day use, with flexibility and back-up credit at any time. Additional benefits are also available when using the interest-free periods and rewards benefits optimally.

***Ensure that your debt is protected in case of disability, terminal illness, retrenchment, and debt. Apply for credit life cover .***

<https://www.justmoney.co.za/news/2019/09/18/know-the-difference-between-a-loan-and-a-credit-facility/>

## **1.5 Bank Statements**

### **1.5.1 What is a bank statement?**

A bank statement is a document that shows all the transactions that have happened in your bank account. This includes deposits, withdrawals, interest earned, bank fees paid and the total balance on the day the statement was sent.

Bank statements are usually sent every month, and show the transactions of that month. Some banks post bank statements to the account holder. But online bank statements are becoming much more popular. You can often view these on your bank's website or mobile app.

### **1.5.2 Bank Reconciliation**

There can be times when your financial records might not be the same as your bank's. Bank reconciliation involves comparing these records and identifying any differences between the two. This is important for keeping track of your business' money.

There are a few reasons the balance on your records may not be the same as the bank's:

- **When someone hasn't yet cashed a cheque you've sent:** The money owed from that cheque is still in your bank account – but it's no longer yours to spend.
- **Changes to bank accounts at the end of a month:** This can happen when you withdraw or deposit money just before the bank sends a statement. Those changes to the account might not show until the following month's statement.
- **Deposits in transit:** Deposits you've made and recorded in your books that haven't yet processed through the bank.
- **The bank deducts loan payments:** The bank can deduct money for loans before you enter that information into your systems.

For example, if you've sent someone a cheque but they haven't cashed it yet. That money is still in your bank account – but it's no longer yours to spend.

If you withdraw or deposit money just before the bank sends a statement, those changes to your balance might not show up. This normally happens at the end of the month. If you make a deposit to the bank on October 31, for example, it might not show on the bank's records until the November bank statement.

Another example is when the bank deducts money for loans before you've entered that information into your system.

Bank reconciliation helps you identify these cases so you know exactly how much money is available to your business. It's also needed to identify any cases of human error, bank charges and possible fraud.

### 1.5.3 What is a cash flow statement?

A cash flow statement is a financial report that shows where your money is coming from and where it's going. It's also known as a 'statement of cash flows' or a 'CFS'.

At first glance, a cash flow statement looks similar to an income statement. But cash is different to income – cash only includes spendable money. Income includes fixed term assets, long term assets and sales made on credit.

Cash flow statements show whether you're able to cover short term expenses like accounts and personal loans. It is also useful for investors, as it shows how well a business can bring in money.

### 1.5.4 What is personal cash flow management?

Personal Cash flow management is the process of tracking how much money is coming into and going out of your account. This helps you predict how much money will be available to you in

the future. It also helps you identify how much money you need to cover debts, like paying accounts.

Cash flow is the term used to describe changes in how much money a person has from one point to another. Cash flow management is keeping track of this flow and analysing any changes to it. This helps you spot trends, prepare for the future, and tackle any problems with your cash flow.

It pays to practice cash flow management often to make sure you have enough money to keep going.

## Chapter 2

### Basic Accounting

#### Introduction

Accounting is known as the "language of business". Accounting is a means through which information about a business entity is communicated. Through the *financial statements*, the end-product reports in accounting, it delivers information to different users.

Let's take a moment to illustrate that.

Meet Mr. Strauss.

Mr. Strauss started a printing business. He invested R100,000 personal money to start the company's operations. After a month, he wants to know how much the business made. He also wants to know if the money he invested is still there.

Without a way of recording the activities of the business, we will not be able to answer his questions. Surely we can tell him, "Mr. Strauss, we made a lot this month!", but we need proof! And he needs the figures!

We can easily answer Mr. Strauss' questions if we kept track of the company's transactions. If we used R30,000 of the R100,000 we had at the beginning to buy printers and pay the bills, then we'd have R70,000 cash left. If we collected R50,000 from our customers, then we would have R120,000. *Easy, right?*

Okay, that's just a *tiny bit* of what accounting can do. What if we have thousands of transactions? Also, there's a lot more to accounting than just recording. How much income did we make? How much do we owe our creditors? Is this a good investment? And so on. *Cool!*

## 2.1 Accounting Definition

Technical definitions of accounting have been published by different accounting bodies. The American Institute of Certified Public Accountants (AICPA) defines accounting as:

*"the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least of financial character, and interpreting the results thereof."*

Studying the statement above will give us a better understanding of accounting.

### 2.1.1. Accounting is considered an art

Accounting is considered an art because it requires the use of skills and creative judgment. One has to be trained in this discipline to be able to perform accounting functions well.

Accounting is also considered a *science* because it is a body of knowledge. However, accounting is *not an exact science* since the rules and principles are constantly changing (improved).

### 2.1.2. Accounting involves interconnected "phases"

*Recording* pertains to writing down or keeping records of business transactions. *Classifying* involves grouping similar items that have been recorded. Once they are classified, information is *summarized* into reports which we call financial statements.

### 2.1.3. Concerned with *transactions and events having financial character*

For example, hiring an additional employee is qualitative information with no financial character. Hence, it is not recorded. However, the payment of salaries, acquisition of an office building, sale of goods, etc. are recorded because they involve *financial* value.

### 2.1.4. Business transactions are expressed *in terms of money*

They are assigned amounts when processed in an accounting system. Using one of the examples above, it is not enough to record that the company paid salaries for April. It must include monetary figures – say for example, R20,000 salaries expense.

### 2.1.5. Interpreting the results

Interpreting results is part of the *phases of accounting*. Information is useless if they cannot be interpreted and understood. The amounts, figures, and other data in the financial reports have meanings that are useful to the users.

By studying the definition alone, we learned some important concepts in accounting. It also gave us an idea of what accountants do.

The simple things you do and encounter everyday can actually be related to *some level* of accounting. You make budgets, count change and check the receipts from the supermarket. You may also have listed things you spent your money with at one point in your life.

We are surrounded by business – from managing our own money to seeing profit statements of big corporations. And where there is business, there sure is accounting.

## 2.2 Purpose of Accounting

In this session you will learn the purpose of accounting and the different types of financial information.

We learned that accounting is the language of business; a means of communicating information about an economic entity to different users for decision-making.

An **economic entity** is a separately identifiable organization which makes use of resources to achieve its goals and objectives.

An economic entity may be a *business entity* operating primarily to generate profit, or a *non-profit entity* carrying out charitable and not-for-profit operations.

This means that a "business entity or business organization" refers to the for-profit type of economic entity. Some authors use "business entity" to refer to both for-profit and not-for-profit organizations. Nonetheless, all economic entities – *whether business or non-profit* – rely on accounting in processing and providing financial information.

From the illustration presented, and for a straightforward answer, it is clear that the ultimate purpose of accounting is to provide information to different users. The users utilize the information in making economic decisions.

It can actually be depicted from some definitions made by accounting bodies. According to the American Institute of Certified Public Accountants (AICPA):

*Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action.*

And then, we have another definition – one which has been in use for a long time already – by the American Accounting Association (AAA).

*Accounting is the process of identifying, measuring and communicating economic information to permit informed judgment and decision by users of the information.*

Both of the above definitions and the very nature of accounting suggest its basic purpose – to provide information needed by users in making economic decisions.

## 2.3 Accounting Information

Here's a list of the different types of information provided by accounting reports. These things will be clearer when you get to the sessions on *Financial Statements*. For now, it is sufficient (and good) to know what information we are talking about.

1. **Results of operations.** This pertains to the profit generated by the company for a certain span of time (for a year, for a quarter, for a month, etc.). This is measured by deducting all expenses from all income. The resulting amount is called *net income*.
2. **Financial position.** How much resources does the entity currently have? How much does the entity owe third parties? How much is left for the owners after we pay all obligations using our resources? The first question refers to the entity's total *assets*; the second to *liabilities*, and the third to *capital*.
3. **Solvency and liquidity.** *Solvency* refers to the entity's ability to pay obligations when they become due. *Liquidity* pertains to its ability to meet *short-term* obligations.
4. **Cash flows.** The financial statements also show the inflows and outflows of cash in the different activities of the business (operating, investing, and financing activities).
5. **Other information.** The financial statements provide *qualitative*, *quantitative*, and *financial* information. One of the characteristics of the financial statements is *relevance*. Any information that could affect the decisions of users should be included in the financial reports.

## 2.4 Users of Financial Statements

The objective of accounting is to provide information to users for decision-making. But, who exactly are these "users of financial statements"? What information do they need?

The users of accounting information include: the owners and investors, management, suppliers, lenders, employees, customers, the government, and the general public.

### 1. Owners and investors

Stockholders of corporations need financial information to help them make decisions on what to do with their investments (shares of stock), i.e. hold, sell, or buy more.

Prospective investors need information to assess the company's potential for success and profitability. In the same way, small business owners need financial information to determine if the business is profitable and whether to continue, improve or drop it.

### 2. Management

In small businesses, management may include the owners. In huge organizations, however, management is usually made up of hired professionals who are entrusted with the responsibility of operating the business or a part of the business. They act as agents of the owners.

The *managers*, whether owners or hired, regularly face economic decisions – How much supplies will we purchase? Do we have enough cash? How much did we make last year? Did

we meet our targets? All those, and many other questions and business decisions, require analysis of accounting information.

### **3. Lenders**

Lenders of funds such as banks and other financial institutions are interested in the company's ability to pay liabilities upon maturity (*solvency*).

### **4. Trade creditors or suppliers**

Like lenders, trade creditors or suppliers are interested in the company's ability to pay obligations when they become due. They are nonetheless especially interested in the company's *liquidity* – its ability to pay *short-term* obligations.

### **5. Government**

Governing bodies of the state, especially the tax authorities, are interested in an entity's financial information for taxation and regulatory purposes. Taxes are computed based on the results of operations and other tax bases. In general, the state would like to know how much the taxpayer makes to determine the tax due thereon.

### **6. Employees and Unions**

Employees are interested in the company's profitability and stability. They are after the ability of the company to pay salaries and provide employee benefits. They may also be interested in its financial position and performance to assess company expansion possibilities and career development opportunities.

### **7. Customers**

When there is a long-term involvement or contract between the company and its customers, the customers become interested in the company's ability to continue its existence and maintain stability of operations. This need is also heightened in cases where the customers depend upon the entity.

For example, a distributor (reseller), the customer in this case, is dependent upon the manufacturing company from which it purchases the items it resells.

### **8. General Public**

Anyone outside the company such as researchers, students, analysts and others are interested in the financial statements of a company for some valid reason.

#### Internal and External Users

The users may be classified into **internal** and **external** users.

Internal users refer to managers who use accounting information in making decisions related to the company's operations.

External users, on the other hand, are not involved in the operations of the company but hold some financial interest. The external users may be classified further into users with *direct* financial interest – owners, investors, creditors; and users with *indirect* financial interest – government, employees, customers and the others.

## 2.5 Types of Accounting / Branches of Accounting

As a result of economic, industrial, and technological developments, different specialized fields in accounting have emerged.

The famous branches or types of accounting include: financial accounting, managerial accounting, cost accounting, auditing, taxation, AIS, fiduciary, and forensic accounting.

### 1. Financial Accounting

Financial accounting involves recording and classifying business transactions, and preparing and presenting financial statements to be used by *internal and external users*.

In the preparation of financial statements, strict compliance with *generally accepted accounting principles* or GAAP is observed. Financial accounting is primarily concerned in processing *historical* data.

### 2. Managerial Accounting

Managerial or management accounting focuses on providing information for use by *internal users*, the management. This branch deals with the needs of the management rather than strict compliance with generally accepted accounting principles.

Managerial accounting involves financial analysis, budgeting and forecasting, cost analysis, evaluation of business decisions, and similar areas.

### 3. Cost Accounting

Often times considered as a subset of management accounting, cost accounting refers to the recording, presentation, and analysis of *manufacturing costs*. Cost accounting is very useful in manufacturing businesses since they have the most complicated costing process.

Cost accountants also analyze actual costs versus budgets or standards to help determine future courses of action regarding the company's cost management.

### 4. Auditing

*External auditing* refers to the examination of financial statements by an independent party with the purpose of expressing an opinion as to fairness of presentation and compliance with GAAP. *Internal auditing* focuses on evaluating the adequacy of a company's internal control structure by testing segregation of duties, policies and procedures, degrees of authorization, and other controls implemented by management.

## 5. Tax Accounting

Tax accounting helps clients follow rules set by tax authorities. It includes tax planning and preparation of tax returns. It also involves determination of income tax and other taxes, tax advisory services such as ways to minimize taxes legally, evaluation of the consequences of tax decisions, and other tax-related matters.

## 6. Accounting Information Systems

Accounting information systems (AIS) involves the development, installation, implementation, and monitoring of accounting procedures and systems used in the accounting process. It includes the employment of business forms, accounting personnel direction, and software management.

## 7. Fiduciary Accounting

Fiduciary accounting involves handling of accounts managed by a person entrusted with the custody and management of property of or for the benefit of another person. Examples of fiduciary accounting include trust accounting, receivership, and estate accounting.

## 8. Forensic Accounting

Forensic accounting involves court and litigation cases, fraud investigation, claims and dispute resolution, and other areas that involve legal matters. This is one of the popular trends in accounting today.

### Focusing on a Specialization

If you want to focus on a specialization, you may want to consider obtaining an accounting certification in your chosen field. It will give you an edge over those who are uncertified. Due to the increasing population and demand for competitive professionals, you need to step it up a little to get recognized.

Some of the most famous certifications include the Certified Public Accountant (CPA), Certified Management Accountant (CMA), Certified Internal Auditor (CIA), Certified Financial Planner (CFP), and Certified Information Systems Auditor (CISA).

## 2.6 Basic Accounting Principles

Accounting principles serve as bases in preparing, presenting and interpreting financial statements.

They provide a foundation to prevent misunderstandings between and among the preparers and users of financial statements.

The Conceptual Framework of Accounting mentions the underlying assumption of *going concern*.

In addition, the concepts of *accrual*, *accounting entity*, *monetary unit*, and *time period* are also important in preparing and interpreting financial statements.

### 2.6.1 Going Concern Assumption

The going concern principle, also known as *continuing concern concept* or *continuity assumption*, means that a business entity will continue to operate indefinitely, or at least for another twelve months.

Financial statements are prepared with the assumption that the entity will continue to exist in the future, unless otherwise stated.

The going concern assumption is the reason assets are generally presented in the balance sheet at cost rather than at fair market value. Long-term assets are included in the books until they are fully utilized and retired.

### 2.6.2 Accrual Basis of Accounting

The accrual method of accounting means that "revenue or income is recognized when earned regardless of when received and expenses are recognized when incurred regardless of when paid".

Hence, income is not the same as *cash collections* and expense is different from *cash payments*. Under accrual basis, revenues and expenses are recognized when they occur regardless of when the amounts are received or paid.

For example, ABC Company rendered repair services to a client on December 9, 2019. The client paid after 30 days – January 8, 2020.

When should the income be recognized? – On the date it is considered earned (when the service has already been rendered). Hence, the income should be recognized in December 2019 even if it has not yet been collected as of that date.

Another example, suppose ABC Company received its electricity bill for the month of March on April 5 and paid it on April 10. When should the electricity expense be recorded?

*Correct!* – March. Why? Because, the electricity expense was for the month of March even if the bill has been received and paid in April. In other words, the "electricity" was used/consumed in March.

### 2.6.3 Accounting Entity Concept

The accounting entity concept recognizes a specific business enterprise as one accounting entity, *separate and distinct* from the owners, managers, and employees of that business.

In other words, it means that a company has its own identity set apart from its owners or anyone else. Personal transactions of the owners, managers, and employees must not be mixed with transactions of the company.

For example, if ABC Company buys a vehicle to be used as delivery equipment, then it is considered a transaction of the business entity.

However, if Mr. A, owner of ABC Company, buys a car for personal use using his own money, that transaction is not recorded in the company's accounting system because it clearly is not a transaction of the company.

#### **2.6.4 Time Period (Periodicity)**

The time period assumption, also known as periodicity assumption, means that the indefinite life of an enterprise is subdivided into time periods (*accounting periods*) which are usually of equal length for the purpose of preparing financial reports on financial position, performance and cash flows.

An accounting period is usually a 12-month period – either *calendar* or *fiscal*.

A calendar year refers to a 12-month period ending December 31. A fiscal year is a 12-month period ending in any day throughout the year, for example, April 1 to March 31 of the following year.

The need for timely reports has led to the preparation of more frequent reports, such as *monthly* or *quarterly* statements.

#### **2.6.5 Monetary Unit Assumption**

The monetary unit assumption has two characteristics – quantifiability and stability of the currency.

*Quantifiability* means that records should be stated in terms of money, usually in the currency of the country where the financial statements are prepared.

*Stability of the rand (or euro, pound, peso, etc.)*, a.k.a. *stable rand concept* means that the purchasing power of the said currency is stable or constant and that any insignificant effect of inflation is ignored.

It is to be noted however that financial statements of a company reporting in the currency of a hyperinflationary economy (*an economy with very high inflation rate*) must be restated, in accordance with applicable accounting standards.

#### **2.6.6 Other Principles Derived from the Above Concepts**

Some of the other principles in accounting include:

- Matching Principle – The matching concept means that expenses are recognized in the period the related income is earned, and income is recognized in the period the related expenses are incurred. In essence, income is matched with expenses and vice versa. Through the accrual basis of accounting, better matching of income and expenses is achieved.

- Revenue Recognition Principle – In accrual basis accounting, revenue or income is recognized when earned regardless of when received. It means that income is recorded when the service is fully performed or when sale occurs, even if the amount is not yet collected.
- Expense Recognition Principle – Also under accrual basis accounting, expenses are recognized when incurred regardless of when they are paid. In other words, expenses are recorded when used (incurred), even if they are not yet paid.
- Historical Cost Principle – Items in the balance sheet are generally presented at historical cost. Nonetheless, some accounts are measured using other bases such as fair market value, current cost, and discounted amount. You will learn more about them in intermediate accounting studies.

## 2.7 The Accounting Cycle: 9-Step Accounting Process

The accounting cycle, also commonly referred to as *accounting process*, is a series of procedures in the collection, processing, and communication of financial information.

As defined in earlier lessons, accounting involves recording, classifying, summarizing, and interpreting financial information.

Financial information is presented in reports called *financial statements*. But before they can be prepared, accountants need to gather information about business transactions, then record and collate them to come up with the values to be presented in the reports.

The cycle does not end with the presentation of financial statements. Subsequent steps are needed to be done to prepare the accounting system for the next cycle.

### 2.7.1 Accounting Cycle Steps

#### 1. Identifying and Analyzing Business Transactions

The accounting process starts with identifying and analyzing business transactions and events. Not all transactions and events are entered into the accounting system. Only those that pertain to the business entity are included in the process.

For example, a personal loan made by the owner that does not have anything to do with the business entity is not accounted for.

The transactions identified are then analyzed to determine the accounts affected and the amounts to be recorded.

The first step includes the preparation of business documents, or *source documents*. A business document serves as basis for recording a transaction.

## 2. Recording in the Journals

A journal is a book – paper or electronic – in which transactions are recorded. Business transactions are recorded using the double-entry bookkeeping system. They are recorded in journal entries containing *at least* two accounts (one debited and one credited).

To simplify the recording process, special journals are often used for transactions that recur frequently such as sales, purchases, cash receipts, and cash disbursements. A general journal is used to record those that cannot be entered in the special books.

Transactions are recorded in chronological order and as they occur.

Journals are also known as *Books of Original Entry*.

## 3. Posting to the Ledger

Also known as *Books of Final Entry*, the ledger is a collection of accounts that shows the changes made to each account as a result of past transactions, and their current balances.

After the posting all transactions to the ledger, the balances of each account can now be determined.

For example, all journal entry debits and credits made to Cash would be transferred into the Cash account in the ledger. We will be able to calculate the increases and decreases in cash; thus, the ending balance of Cash can be determined.

## 4. Unadjusted Trial Balance

A trial balance is prepared to test the equality of the debits and credits. All account balances are extracted from the ledger and arranged in one report. Afterwards, all debit balances are added. All credit balances are also added. Total debits should be equal to total credits.

When errors are discovered, *correcting entries* are made to rectify them or reverse their effect. Take note however that the purpose of a trial balance is only test the equality of total debits and total credits and not to determine the correctness of accounting records.

Some errors could exist even if debits are equal to credits, such as double posting or failure to record a transaction.

## 5. Adjusting Entries

Adjusting entries are prepared as an application of the *accrual basis of accounting*. At the end of the accounting period, some expenses may have been incurred but not yet recorded in the journals. Some income may have been earned but not entered in the books.

Adjusting entries are prepared to update the accounts before they are summarized in the financial statements.

Adjusting entries are made for accrual of income, accrual of expenses, deferrals (*income method or liability method*), prepayments (*asset method or expense method*), depreciation, and allowances.

## 6. Adjusted Trial Balance

An *adjusted trial balance* may be prepared after adjusting entries are made and before the financial statements are prepared. This is to test if the debits are equal to credits after adjusting entries are made.

## 7. Financial Statements

When the accounts are already up-to-date and equality between the debits and credits have been tested, the financial statements can now be prepared. The financial statements are the end-products of an accounting system.

A complete set of financial statements is made up of: (1) Statement of Comprehensive Income (*Income Statement and Other Comprehensive Income*), (2) Statement of Changes in Equity, (3) Statement of Financial Position or *Balance Sheet*, (4) Statement of Cash Flows, and (5) Notes to Financial Statements.

## 8. Closing Entries

Temporary or nominal accounts, i.e. income statement accounts, are closed to prepare the system for the next accounting period. Temporary accounts include *income, expense, and withdrawal* accounts. These items are measured periodically.

The accounts are closed to a summary account (usually, Income Summary) and then closed further to the appropriate capital account. Take note that closing entries are made only for temporary accounts. Real or permanent accounts, i.e. balance sheet accounts, are not closed.

## 9. Post-Closing Trial Balance

In the accounting cycle, the last step is to prepare a post-closing trial balance. It is prepared to test the equality of debits and credits after closing entries are made. Since temporary accounts are already closed at this point, the post-closing trial balance contains real accounts *only*.

## \*10. Reversing Entries: Optional step at the *beginning* of the new accounting period

Reversing entries are optional. They are prepared at the beginning of the new accounting period to facilitate a smoother and more consistent recording process.

In this step, the *adjusting entries* made for accrual of income, accrual of expenses, deferrals under the income method, and prepayments under the expense method are reversed.

## 2.8 Elements of Accounting: Assets, Liabilities, and Capital

The three major elements of accounting are: Assets, Liabilities, and Capital.

These terms are used widely in accounting so it is necessary that we take a close look at each element. But before we go into them, we need to understand what an "*account*" is first.

What is an Account?

The term "account" is used often in this session. Thus, we need to understand what it is before we proceed. In accounting, an *account* is a descriptive storage unit used to collect and store information of similar nature.

For example, "Cash".

Cash is an *account* that stores all transactions that involve cash receipts and cash payments. All cash receipts are recorded as increases in "Cash" and all payments are recorded as deductions in the same account.

Another example, "Building". Suppose a company acquires a building and pays in cash. That transaction would be recorded in the "Building" account for the acquisition of the building and a reduction in the "Cash" account for the payment made.

Now, let's take a look at the **accounting elements**.

### 2.8.1 Assets

Assets refer to resources owned and controlled by the entity as a result of past transactions and events, from which future economic benefits are expected to flow to the entity. In simple terms, assets are *properties or rights owned by the business*. They may be classified as current or non-current.

**A. Current assets** – Assets are considered current if they are held for the purpose of being traded, expected to be realized or consumed within twelve months after the end of the period or its normal operating cycle (whichever is longer), or if it is cash. Examples of current asset accounts are:

1. Cash and Cash Equivalents – bills, coins, funds for current purposes, checks, cash in bank, etc.
2. Receivables – Accounts Receivable (receivable from customers), Notes Receivable (receivables supported by promissory notes), Rent Receivable, Interest Receivable, Due from Employees (or Advances to Employees), and other claims
  - *Allowance for Doubtful Accounts* – This is a valuation account which shows the estimated uncollectible amount of accounts receivable. It is a *contra-asset* account and is presented as a deduction to the related asset – accounts receivable.
3. Inventories – assets held *for sale* in the ordinary course of business
4. Prepaid expenses – expenses paid in advance, such as, Prepaid Rent, Prepaid Insurance, Prepaid Advertising, and Office Supplies

**B. Non-current assets** – Assets that do not meet the criteria to be classified as current. Hence, they are long-term in nature – useful for a period longer than 12 months or the company's normal operating cycle. Examples of non-current asset accounts include:

1. Long-term investments – investments for long-term purposes such as investment in stocks, bonds, and properties; and funds set up for long-term purposes

2. Land – land area owned for business operations (*not for sale*)
3. Building – such as office building, factory, warehouse, or store
4. Equipment – Machinery, Furniture and Fixtures (shelves, tables, chairs, etc.), Office Equipment, Computer Equipment, Delivery Equipment, and others
  - *Accumulated Depreciation* – This is a valuation account which represents the decrease in value of a fixed asset due to continued use, wear & tear, passage of time, and obsolescence. It is a *contra-asset* account and is presented as a deduction to the related fixed asset.
5. Intangibles – long-term assets with no physical substance, such as goodwill, patent, copyright, trademark, etc.
6. Other long-term assets

### 2.8.2 Liabilities

Liabilities are *economic obligations* or *payables* of the business.

Company assets come from 2 major sources – borrowings from lenders or creditors, and contributions by the owners. The first refers to liabilities; the second to capital.

Liabilities represent claims by other parties aside from the owners against the assets of a company.

Like assets, liabilities may be classified as either current or non-current.

**A. Current liabilities** – A liability is considered current if it is due within 12 months after the end of the balance sheet date. In other words, they are expected to be paid in the next year.

If the company's normal operating cycle is longer than 12 months, a liability is considered current if it is due within the operating cycle.

Current liabilities include:

1. Trade and other payables – such as Accounts Payable, Notes Payable, Interest Payable, Rent Payable, Accrued Expenses, etc.
2. Current provisions – estimated short-term liabilities that are probable and can be measured reliably
3. Short-term borrowings – financing arrangements, credit arrangements or loans that are short-term in nature
4. Current-portion of a long-term liability – the portion of a long-term borrowing that is currently due.
 

*Example:* For long-term loans that are to be paid in annual installments, the *portion* to be paid next year is considered current liability; the rest, non-current.
5. Current tax liabilities – taxes for the period and are currently payable

**B. Non-current liabilities** – Liabilities are considered non-current if they are not currently payable, i.e. they are not due within the next 12 months after the end of the accounting period or the company's normal operating cycle, whichever is shorter.

In other words, non-current liabilities are those that do not meet the criteria to be considered current. *Hah! Make sense?* Non-current liabilities include:

1. Long-term notes, bonds, and mortgage payables;
2. Deferred tax liabilities; and
3. Other long-term obligations

### 2.8.3 Capital

Also known as *net assets* or *equity*, *capital* refers to what is left to the owners after all liabilities are settled. Simply stated, capital is equal to *total assets minus total liabilities*. Capital is affected by the following:

1. Initial and additional contributions of owner/s (investments),
2. Withdrawals made by owner/s (dividends for corporations),
3. Income, and
4. Expenses.

Owner contributions and income *increase* capital. Withdrawals and expenses *decrease* it.

The terms used to refer to a company's capital portion varies according to the form of ownership. In a sole proprietorship business, the capital is called *Owner's Equity* or *Owner's Capital*; in partnerships, it is called *Partners' Equity* or *Partners' Capital*; and in corporations, *Stockholders' Equity*.

In addition to the three elements mentioned above, there are two items that are also considered as key elements in accounting. They are *income* and *expense*. Nonetheless, these items are ultimately included as part of capital.

### 2.8.4 Income

Income refers to an increase in economic benefit during the accounting period in the form of an increase in asset or a decrease in liability that results in increase in equity, other than contribution from owners.

Income encompasses *revenues* and *gains*.

*Revenues* refer to the amounts earned from the company's ordinary course of business such as *professional fees* or *service revenue* for service companies and *sales* for merchandising and manufacturing concerns.

*Gains* come from other activities, such as gain on sale of equipment, gain on sale of short-term investments, and other gains.

Income is measured every period and is ultimately included in the capital account. Examples of income accounts are: Service Revenue, Professional Fees, Rent Income, Commission Income, Interest Income, Royalty Income, and Sales.

## 2.8.5 Expense

Expenses are decreases in economic benefit during the accounting period in the form of a decrease in asset or an increase in liability that result in decrease in equity, other than distribution to owners.

Expenses include *ordinary expenses* such as Cost of Sales, Advertising Expense, Rent Expense, Salaries Expense, Income Tax, Repairs Expense, etc.; and *losses* such as Loss from Fire, Typhoon Loss, and Loss from Theft. Like income, expenses are also measured every period and then closed as part of capital.

*Net income* refers to all income minus all expenses.

## Conclusion

And we've come to the end of this lesson. We have covered all the elements of accounting. For a recap: *assets* are properties owned by a business; *liabilities* are obligations to other parties; and, *capital* refers to the portion of the assets available to the owners of the business after all liabilities are settled.

# Chapter 3

## The Accounting Equation and How It Stays in Balance

### Introduction

The accounting equation is the unifying concept in accounting that shows the relationships between and among the accounting elements: assets, liabilities, and capital.

Total assets is equal to total liabilities and capital.

In this lesson (and the next ones), you will learn about the basic accounting equation and how it stays in balance.

### 3.1 Basic Accounting Equation

The basic accounting equation is:

#### **Assets = Liabilities + Capital**

When a business is put up, its resources (assets) come from two sources: contributions by owners (capital) and those acquired from creditors or lenders (liabilities).

In other words, all assets initially come from liabilities and owners' contributions.

As business transactions take place, the values of the accounting elements change. The accounting equation nonetheless always stays in balance.

Every transaction has a two-fold effect. Meaning, at least two accounts are affected. Let's illustrate all of that through these examples.

Assume the following transactions:

1. Mr. Alex invested R20,000 to start a printing business,
2. The company obtained a loan from a bank, R30,000,
3. The company purchased printers and paid a total of R1,000.

How will the transactions affect the accounting equation?

#### **Let us take a look at transaction #1:**

Transaction	Assets	=	Liabilities	+	Capital
1. Owner's investment	20,000.00	=		+	20,000.00

Again, every transaction has a two-fold effect. In the above transaction, *Assets* increased as a result of the increase in *Cash*. At the same time, *Capital* increased due to the owner's contribution. Remember that capital is *increased* by contribution of owners and income, and is *decreased* by withdrawals and expenses. No liability is affected hence, stays at zero.

### Let's continue with transaction #2:

Transaction	Assets	=	Liabilities	+	Capital
1. Owner's investment	20,000.00	=		+	20,000.00
2. Loan from bank	30,000.00	=	30,000.00	+	

In transaction #2, the company received cash. Thus, the value of total assets is increased. At the same time, it incurred in an obligation to pay the bank. Therefore, liabilities are increased. The liability in this case is recorded as *Loans Payable*.

Notice that the accounting equation is still equal (balanced).

### Let's add transaction #3:

Transaction	Assets	=	Liabilities	+	Capital
1. Owner's investment	20,000.00	=		+	20,000.00
2. Loan from bank	30,000.00	=	30,000.00	+	
3. Purchased printers	1,000.00 (1,000.00)	=		+	

The company acquired printers, hence, an increase in assets. However, the company used cash to pay for the printers. Thus, it also results in a decrease in assets. Transaction #3 results in an increase in one asset (*Service Equipment*) and a decrease in another asset (*Cash*).

*For those who are new to accounting format:* The parentheses "(")" around the 1,000 amount above means "minus" or "less".

Liabilities and capital were not affected in transaction #3. Still, the equation in this transaction is equal. It resulted to a zero effect in both sides.

At this point, the balance of total assets is R50,000. The combined balance of liabilities and capital is also at R50,000.

As illustrated above, the accounting equation is (and should always be) in balance.

### The Accounting Equation: More Examples

The accounting equation is a mathematical expression that shows the relationship among the different elements of accounting, i.e. assets, liabilities, and capital (or "equity").

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

Because of the two-fold effect of transactions, the equation always stays in balance.

To help you better understand how the accounting equation works and stays in balance, here are more sample transactions and their effects to the accounting equation.

In addition to transactions 1, 2 and 3 in the previous lesson, assume the following data:

4. Rendered services and received the full amount in cash, R500
5. Rendered services on account (*receivable from customer*), R750
6. Purchased office supplies on account (*payable to supplier*), R200
7. Had some equipment repaired for R400, to be paid after 15 days
8. Mr. Alex, the owner, withdrew R5,000 cash for personal use
9. Paid one-third of the loan obtained in transaction #2
10. Received customer payment from services in transaction #5

The transactions will result to the following effects:

Transaction	Assets	=	Liabilities	+	Capital
1. Owner's investment	20,000.00	=		+	20,000.00
2. Loan from bank	30,000.00	=	30,000.00	+	
3. Purchased printers	1,000.00 (1,000.00)	=		+	
4. Service revenue for cash	500.00	=		+	500.00
5. Service revenue on account	750.00	=		+	750.00
6. Supplies on account	200.00	=	200.00	+	
7. Repair of equipment		=	400.00	+	(400.00)
8. Owner's withdrawal	(5,000.00)	=		+	(5,000.00)
9. Payment of loan	(10,000.00)	=	(10,000.00)	+	
10. Collection of accounts	750.00 (750.00)	=		+	
Balance	36,450.00	=	20,600.00	+	15,850.00

### Examples Explained

4. The company received cash for services rendered. *Cash* increased thereby increasing assets. At the same time, capital is increased as a result of the income (*Service Revenue*). As we've mentioned in the *Accounting Elements* lesson, income increases capital.
5. The company rendered services on account. The services have been rendered, hence, already earned. Thus, the R750 worth of services rendered is considered income even if the amount has not yet been collected. Since the amount is still to be collected, it is recorded as *Accounts Receivable*, an asset account.

6. Office supplies worth R200 were acquired. This increases the company's *Office Supplies*, part of the company's assets. The purchase results in an obligation to pay the supplier; thus a R200 increase in liability (*Accounts Payable*).
7. The company incurred in R400 *Repairs Expense*. Expenses decrease capital. The amount has not yet been paid. Thus, it results in an increase in total liabilities.
8. The owner withdrew R5,000 cash. *Cash* is decreased thereby decreasing total assets. *Withdrawals* or *drawings* decrease capital.
9. One-third of the R30,000 loan was paid. Therefore, *Cash* is decreased by R10,000 as a result of the payment. And, liabilities are decreased because part of the obligation has been settled.
10. The R750 account in a previous transaction has been collected. Therefore, the *Accounts Receivable* account is decreased and *Cash* is increased.

Notice that every transaction results in an equal effect to assets and liabilities plus capital. The beginning balances are equal. The changes arising from the transactions are equal. Therefore, the ending balances would still be equal.

The balance of the total assets after considering all of the above transactions amounts to R36,450. It is equal to the combined balance of total liabilities of R20,600 and capital of R15,850 (*a total of R36,450*).

$Assets = Liabilities + Capital$  is a mathematical equation. Using algebra, the formula can be rewritten to get other versions of the equation.

- $Liabilities = Assets - Capital$
- $Capital = Assets - Liabilities$

### 3.2 Expanded Accounting Equation

Like the basic accounting equation, the *expanded accounting equation* shows the relationships among the accounting elements.

What's the difference? In the expanded accounting equation, the "capital" portion is broken down into several components: *contributions, withdrawals, income, and expenses*.

We know that capital is affected by *contributions, withdrawals, income, and expenses*.

Contributions and income increase capital. Withdrawals and expenses decrease it.

Hence, the accounting equation for a sole proprietorship can be rewritten as:

**$Assets = Liabilities + Capital - Withdrawals + Income - Expenses$**

Owners' contributions are often recorded directly into Capital. Thus, *additional contributions* are already included in "Capital".

Nevertheless, if you want to show all of the components, then you can rewrite the equation as:

**$Assets = Liabilities + (Capital\ at\ beginning + Additional\ Contributions - Withdrawals + Income - Expenses)$**

## Example

Assume the following transactions:

1. Mr. Alex invested R20,000 to start a printing business
2. The company obtained a loan from a bank, R30,000
3. The company purchased printers and paid a total of R1,000
4. Rendered services and received cash, R500
5. Rendered services on account, R750
6. Purchased office supplies on account, R200
7. Had its equipment repaired for R400, to be paid after 15 days
8. Mr. Alex, the owner, withdrew R5,000 cash for personal use
9. Paid one-third of the loan obtained in transaction #2
10. Received customer payment from services in transaction #5.

The effects to the expanded accounting equation of the transactions are as follows:

	A	=	L	+	C	-	With.	+	Inc.	-	Exp.
1	20,000	=		+	20,000	-		+		-	
2	30,000	=	30,000	+		-		+		-	
3	1,000 (1,000)	=		+		-		+		-	
4	500	=		+		-		+	500	-	
5	750	=		+		-		+	750	-	
6	200	=	200	+		-		+		-	
7		=	400	+		-		+		-	400
8	(5,000)	=		+		-	5,000	+		-	
9	(10,000)	=	(10,000)	+		-		+		-	
10	750 (750)	=		+		-		+		-	
Bal	36,450	=	20,600	+	20,000	-	5,000	+	1,250	-	400

Notice that the equation stays in balance. If you take the total of the right side of the equation (i.e. liabilities, capital, income, expense, and withdrawals) you will get R36,450, which is equal to the total assets in the left side.

*Study the examples above and try to determine what specific items were affected under each element and why they increased or decreased. Do it one transaction at a time. If you find it difficult, refer to the detailed explanations in the previous lesson.*

## Conclusion

The accounting equation, whether in its basic form or its expanded version, shows the relationship between the left side (assets) and the right side (liabilities plus capital). It also shows that resources held by the company are coupled with claims against them.

There is a two-fold effect in every transaction. This results in the movement of at least two accounts in the accounting equation. The amount of change in the left side is always equal to the amount of change in the right side, thus, keeping the accounting equation in balance.

The accounting equation is very important. It will guide you in understanding related accounting principles and provides a foundation that will help you solve many accounting problems.

## 3.3 Understanding and Analyzing Business Transactions

An accounting system must record all business transactions to ensure complete and reliable information when the financial statements are prepared.

What is a business transaction? A *business transaction* is an activity or event that can be measured in terms of money and which affects the financial position or operations of the business entity.

A business transaction has an effect on any of the accounting elements – assets, liabilities, capital, income, and expense.

Transactions may be classified as exchange and non-exchange. *Exchange transactions* involve physical exchange such as purchasing, selling, collection of receivables, and payment of accounts.

*Non-exchange transactions* are events that do not involve physical exchanges but where changes in monetary values are determinable, e.g. wear and tear of equipment, fire loss, typhoon loss, etc.

To qualify as an accountable/recordable business transaction, the activity or event must:

### 1. Be a transaction involving the business entity

The separate entity concept or accounting entity assumption clearly establishes a distinction between transactions of the business and those of its owner/s.

If Mr. Bright, owner of Bright Productions, buys a car for personal use using his own money, it will not be reflected in the books of the company. Why? Because it does not have anything to do with the business. Now if the company purchases a delivery truck, then that would be a business transaction of the company.

If Mr. Grim invests R20,000 into the company, would that be recorded in the books of the business? Ask this: Does it have anything to do with the company? Yes. Then, that would be a recordable business transaction.

In any case, always remember that a business is treated as an individual entity, separate and distinct from its owners.

## **2. Be of a financial character (in a certain amount of money)**

Transactions must involve monetary values, meaning a certain amount of money must be assigned to the elements or accounts affected.

For example, Bright Productions renders video coverage services and expects to collect R10,000 after 10 days. In this case, it's explicit. The income and receivable can be measured reliably at the R10,000.

Fire, typhoon and other losses may be estimated and assigned with monetary values.

The mere request (order) of a customer is *not* a recordable business transaction. There should be an actual sale or performance of service first to give the company a right over the income or revenue.

## **3. Have a dual or "two-fold" effect on the accounting elements**

Every transaction has a dual or two-fold effect. For every value received, there is a value given; or for every debit, there is a credit. This is the concept of double-entry accounting.

For example, Bright Productions purchased tables and chairs for R6,000. The company received tables and chairs thereby increasing its assets (increase in Office Equipment). In return, the company paid cash; thus, there is an equal decrease in assets (decrease in Cash). For more illustration and examples, check out the lesson about the Accounting Equation [here](#).

## **4. Be supported by a source document**

As part of good accounting and internal control practice, business transactions must be supported by source documents. The source documents serve as bases in recording transactions in the journal.

Examples of source documents are: Official Receipt issued whenever cash is received, Sales Invoice for sales transactions, Cash Voucher for payment in cash, Statement of Account from suppliers, Vendor's Invoice, Promissory Notes, and other business documents.

The first step in the accounting process is actually to prepare the source document and determine the effects of the business transaction to the accounts of the company. After which, the accountant records the transaction through a journal entry.

Examples of business transactions will be given and explained in detail as you go through the lessons in this chapter. To see how business transactions are actually analyzed, you may jump to [Accounting Equation](#), [Journal Entries](#), and [More Journal Entry Examples](#). The next lessons will discuss the rules of debit and credit, and chart of accounts first.

### **3.3.1 Rules of Debit and Credit: Left versus Right**

In this session, you will learn the rules of debit and credit; when and how to use them.

First, let us recall the definition of an *"account"*. An account is a storage unit that stores similar items or transactions.

Examples of accounts are: Cash, Accounts Receivable, Office Equipment, Accounts Payable, Service Income, Rent Expense, and so on.

Let's take Cash, for instance. The Cash account stores all transactions that involve cash, i.e. cash receipts and cash disbursements.

### **3.3.2 Debit and Credit**

Second, let us define *"debit"* and *"credit"*. Debit means left and credit means right. Do not associate any of them with plus or minus yet. Debit simply means left and credit means right – that's just it! "Debit" is abbreviated as "Dr." and "credit", "Cr."

The terms originated from the Latin terms "debere" or "debitum" which means "what is due", and "credere" or "creditum" which means "something entrusted or loaned".

### **3.3.3 Normal Balance**

And third, we define what we call *"normal balance"*. Each account has a debit and a credit side. You could picture that as a big letter T, hence the term *"T-account"*. Again, debit is on the left side and credit on the right. Normal balance is the side where the balance of the account is *normally* found.

Asset accounts normally have debit balances, while liabilities and capital normally have credit balances. Income has a normal credit balance since it increases capital. On the other hand, expenses and withdrawals decrease capital, hence they normally have debit balances.

Now what is the significance of the "normal balance"?

When you place an amount on the normal balance side, you are increasing the account. If you put an amount on the opposite side, you are decreasing that account. Therefore, to increase an asset, you debit it. To decrease an asset, you credit it. To increase liability and capital accounts, credit. To decrease them, debit.

### **Example**

Let us take Cash. Cash is an asset account. Again, asset accounts normally have debit balances. Therefore, to increase Cash you debit it. To decrease Cash, you credit it.

Another example – let's take Accounts Payable. It is a liability account. Liability accounts normally have credit balances. Thus, if you want to increase Accounts Payable, you credit it. If you want to decrease Accounts Payable, you debit it.

The same rules apply to all asset, liability, and capital accounts.

### To Sum It Up

Here's a table summarizing the normal balances of the accounting elements, and the actions to increase or decrease them. Notice that the normal balance is the same as the action to increase the account.

Accounting Element	Normal Balance	To Increase	To Decrease
1. Assets	Debit	Debit	Credit
2. Liabilities	Credit	Credit	Debit
3. Capital	Credit	Credit	Debit
4. Withdrawal	Debit	Debit	Credit
5. Income	Credit	Credit	Debit
6. Expense	Debit	Debit	Credit

**Tip:** You don't need to memorize the whole table. Just be familiar with the normal balance portion and you'll be okay. The normal balance is the same as the action to increase the account. The action to decrease the account is simply the opposite of that.

Done? Now try these:

1. To increase Office Equipment, *debit or credit?*
2. To increase Rent Payable
3. To record/increase Rent Expense
4. To decrease Accounts Payable
5. To record/increase Service Revenue
6. To decrease Cash
7. To record/increase Loss from Fire
8. To decrease Delivery Equipment
9. To increase Accumulated Depreciation

Answers:

1. Debit; 2. Credit; 3. Debit; 4. Debit; 5. Credit; 6. Credit; 7. Debit; 8. Credit.

What about item #9? How do you increase Accumulated Depreciation?

Accumulated Depreciation is a contra-asset account (deducted from an asset account). For contra-asset accounts, the rule is simply the opposite of the rule for assets. Therefore, to increase Accumulated Depreciation, you credit it.

We will apply these rules and practice some more when we get to the actual recording process.

### 3.3.4 Chart of Accounts

Before recording transactions into the journal, we should first know what accounts to use. This is where a *chart of accounts* comes in handy.

A chart of accounts is a list of all accounts used by a company in its accounting system. It makes the bookkeeper's work easier.

The accounts included in the chart of accounts must be used consistently to prevent clerical or technical errors in the accounting system.

Take note, however, that the chart of accounts vary from company to company. The contents depend upon the needs and preferences of the company using it.

Accounts are classified into assets, liabilities, capital, income, and expenses; and each is given a unique account number. A coding system is used to organize the accounts.

Provided below is a sample chart of accounts for a small sole proprietorship business:

#### Chart of Accounts Example

##### Gray Electronic Repair Services

#### Chart of Accounts

#### ASSETS (1000-1999)

1000	Cash
1010	Accounts Receivable
1011	Allowance for Doubtful Accounts
1020	Notes Receivable
1030	Interest Receivable
1040	Service Supplies

- 1510 Leasehold Improvements
- 1520 Furniture and Fixtures
- 1521 Accumulated Depreciation – Furniture and Fixtures
- 1530 Service Equipment
- 1531 Accumulated Depreciation – Service Equipment

**LIABILITIES (2000-2999)**

- 2000 Accounts Payable
- 2010 Notes Payable
- 2020 Salaries Payable
- 2030 Rent Payable
- 2040 Interest Payable
- 2050 Unearned Revenue
- 2060 Loans Payable

**OWNER'S EQUITY (3000-3999)**

- 3000 Mr. Gray, Capital
- 3010 Mr. Gray, Drawing

**REVENUES (4000-4999)**

- 4000 Service Revenue
- 4010 Interest Income
- 4020 Gain on Sale of Equipment
- 4999 Income Summary

## **EXPENSES (5000-5999)**

5000	Rent Expense
5010	Salaries Expense
5020	Supplies Expense
5030	Utilities Expense
5040	Interest Expense
5050	Taxes and Licenses
5060	Depreciation Expense
5070	Doubtful Accounts Expense

Additional accounts can be added as the need arises. For bigger companies, the accounts may be divided into several sub-accounts.

For example, employee salaries may have various accounts for different departments and be included in the chart of accounts as:

- 5011 Salaries Expense – Administrative,
- 5012 Salaries Expense – Servicing,
- 5013 Salaries Expense – Marketing, etc.

Again, take note that the chart of accounts of one company may not be suitable for another company. It all depends upon the company's needs. In any case, the chart of accounts is a useful tool for bookkeepers in recording business transactions.

### **3.4 The Double Entry Accounting System**

In this lesson, we are going to learn the double entry accounting system or double entry bookkeeping.

It is one of the basic foundations upon which the steps in the accounting cycle and other accounting principles are based.

The double entry accounting system emerged as a result of the industrial revolution. Merchants in the olden times recorded transactions in simple lists, similar to what we call today as *single entry method*.

Through the ages, business became more and more complex, hence, the development of more effective ways to keep track of business transactions.

The first accounts of the double entry bookkeeping system was documented by *Luca Pacioli*, a Franciscan monk and hailed as the *Father of Modern Accounting*.

Under the double entry bookkeeping system, business transactions are recorded with the premise that each transaction has a two-fold effect – a value received and a value given.

To better understand the double entry method, let us first take a look at the single entry system.

### 3.4.1 Single Entry Bookkeeping

The single entry bookkeeping system does not explicitly record the two-fold effect of transactions. Under this method, separate books are maintained for the company's *basic accounts* such as cash, receivables, and payables. Therefore, the accounting records are incomplete.

For example, consider the following transactions:

- On October 1, 2019, Mr. Briggs invested R30,000 to start a marketing consultancy business.
- On October 5, the company purchased a computer for the office, R1,000.
- On October 8, the company rendered services and received R500.

Under the single entry, the company may use a *cashbook* to record its cash receipts and disbursements. After recording the above transactions, the cashbook will look this:

Date	Particulars	Amount	Balance
10-01-2019	Beginning balance		R 0.00
10-01-2019	Investment of owner	R 30,000.00	30,000.00
10-05-2019	Purchase of computer	(1,000.00)	29,000.00
10-08-2019	Cash from customer	500.00	29,500.00

We can readily determine the cash balance using this recording method. However, it will be difficult to determine the balances of other accounts such as revenues and expenses unless the company maintains separate books for them as well.

An important note to consider here is that a valid set of financial statements can still be prepared even if the accounting system is incomplete. But, it will require additional work to reconstruct the accounts to conform to the double-entry method.

### 3.4.2 Double Entry Bookkeeping

Under the double entry method, every transaction is recorded in at least two accounts. Once all transactions are processed into the accounting system, the balances of all accounts will be readily available.

All accounts have a *debit* and a *credit* side. Debit means *left* and credit means *right*.

Because of the two-fold or duality effect of transactions, the total effect on the left will always be equal to total the effect on the right. Hence, the famous line "debit equals credit".

**Now, here is the rule:** To *increase an asset*, you debit it; to *decrease an asset*, you credit it. The opposite applies to liabilities and capital. To *increase a liability or a capital* account, you credit it; to *decrease a liability or capital* account, you debit it. *Expenses* are debited when incurred and *income* is credited when earned.

Here's a table to summarize that:

Accounting Element	To Increase	To Decrease
1. Asset	Debit	Credit
2. Liability	Credit	Debit
3. Capital investment	Credit	Debit
4. Capital withdrawal	Debit	Credit
5. Income	Credit	Debit
6. Expense	Debit	Credit

*Tip: If you are having a hard time remembering the table above, you actually only need to familiarize yourself with the "To Increase" part. The action to decrease the accounts is simply the opposite.*

Transactions are recorded using *journal entries* in the journal. A *journal entry* is a record showing the date of the transaction, the account/s debited, the account/s credited, their respective amounts, and an explanation to describe the transaction.

Using the transactions presented earlier, the journal would look like this:

Date 2019	Particulars	Debit	Credit
Oct 1	Cash	30,000.00	
	Mr. Briggs, Capital		30,000.00
	To record initial investment.		

Date 2019	Particulars	Debit	Credit
5	Computer Equipment	1,000.00	
	Cash		1,000.00
	To record purchase of computer.		
8	Cash	500.00	
	Service Revenue		500.00
	To record services rendered for cash.		

As mentioned earlier, every transaction has a two-fold effect. Thus, each transaction is recorded in at least two accounts. Notice the two-fold effects in the above examples.

You will learn how to prepare journal entries in another lesson. For a head start, let us take a look at how we came up with the journal entry for the first transaction. In that transaction, Mr. Briggs invested R30,000 to start a marketing consultation business on October 1, 2019.

1. Place the date of the transaction on the leftmost side of the journal.
2. Determine the account to be debited and the amount. In this case, there is an increase in cash because of the contribution. To increase cash, an asset account, we debit it. So, we would then record Cash and place the amount, 30,000 on the debit column.
3. Next, we determine the account credited. We are recording the owner's initial contribution. It increases the company's capital; therefore we would credit the capital account – Mr. Briggs, Capital, and place the amount in the credit column. Credits are recorded below the debits. Also, notice the indentions used.
4. Finally, provide a brief explanation at the end of the entry.

See if you can figure out the logic behind the other two journal entries.

After recoding the transactions, we now have a running record of *all* accounts, and hence a complete accounting system.

In addition to the journals, some companies maintain separate books for some of their important accounts for better control.

The preparation of journal entries through the double entry bookkeeping method, along with the other steps in the accounting cycle, results in a more systematic accounting system. You will learn more about journal entries in detail, including how to prepare them, and the rest of the steps of the process in later lessons.

## Chapter 4

### Financial Statements

#### Introduction to Financial Statements: An Overview

Financial statements refer to a specific set of reports produced in an entity's accounting system. The objective of these reports is to provide information about the entity.

A complete set of financial statements includes 5 components.

#### Statement of Comprehensive Income

The Income Statement, also known as Profit and Loss Statement (*P&L Statement*), shows the *results of operations* of an entity over a particular period of time. The income statement presents the period's income and expenses and the resulting net income or loss.

Many large companies today prepare a *Statement of Comprehensive Income*. The Statement of Comprehensive Income presents a company's results of operations (net income or loss) and its other comprehensive income (OCI). If the company has no other comprehensive income, then the contents of the Income Statement and Statement of Comprehensive Income would be the same.

*Other comprehensive income* include gains and losses that cannot be reported in the Income Statement such as revaluation surplus, translation adjustments, and unrealized gains, for a given period. Other comprehensive income is covered in higher financial accounting studies.

#### Statement of Changes in Capital

The Statement of Changes in Capital (*or Statement of Changes in Equity*) shows the balance of the capital account at the beginning of the period, the changes that occurred during the period, and the ending balance as a result of such changes. Capital is affected by contributions and withdrawals of owners, income, and expenses.

The title used for this report varies depending upon the form of business ownership. It is called *Statement of Owner's Equity* in sole proprietorships, *Statement of Partners' Equity* in

partnerships and *Statement of Stockholders' Equity* in corporations.

### **Statement of Financial Position**

A *Balance Sheet* presents an entity's assets, liabilities, and capital as of a given point in time. This report shows the entity's financial position and condition, hence, also called *Statement of Financial Position*.

All asset amounts are added. All liability and capital accounts are also added. The total amount of assets should be equal to the total amount of liabilities plus capital.

### **Statement of Cash Flows**

The Statement of Cash Flows, or *Cash Flow Statement*, presents the beginning balance of cash, the changes that occurred during the period, and the cash balance at the end of the period as a result of the changes.

The cash flow statement shows the cash inflows and outflows from three activities: operating, investing, and financing.

*Operating* activities pertain to transactions that are directly related to the company's main course of business. *Investing* activities refer to "where the company puts its money". These activities include long-term investments, acquisition of property, plant and equipment; and other transactions related to non-current assets. *Financing* activities include transactions in which a company acquires its funds. These include loans from banks (long-term liabilities) and contributions from owners.

### **Notes to Financial Statements**

The Notes to Financial Statements, or *Supplementary Notes*, provide information in addition to those presented in the Balance Sheet, Income Statement, Statement of Changes in Equity, and Cash Flow Statement. The notes contain disclosures required by accounting standards, supporting computations, breakdown of line items in the face of the financial statements, and other information that users may be interested in.

### **Relationship among the Financial Statements**

The financial statements contain interrelated information. This is the reason the financial statements are prepared in the sequence presented above. In fact, some of the figures in one financial statement component are actually taken from another component.

1. The *net income* from the Income Statement is used in the Statement of Changes in Equity. Remember that income and expenses affect capital.
2. The *ending balance of capital* in the Statement of Owner's/Partners'/SH's Equity is forwarded to the Balance Sheet (under Capital).

3. The *cash balance* presented in the Balance Sheet is supported by the Statement of Cash Flows. The ending balance of cash in the Statement of Cash Flows is the same amount presented in the Balance Sheet.
4. The notes to financial statements show *supporting computations* of the amounts and *additional information* about the items presented in the above reports.

Let us now look in more detail on how these Financial Statements are compiled.

#### 4.1 Income Statement – a.k.a. Profit and Loss Statement

The Income Statement, also referred to as Profit and Loss (P&L) Statement, shows an entity's results of operations for a particular period.

It presents an entity's revenues and expenses, and the resulting net income or net loss.

This lesson presents an Income Statement example and provides important points you need to know in preparing and understanding the said report.

##### 4.1.1 Income Statement Example

Here is a sample income statement of a *service type sole proprietorship* business. Let us name the company *Strauss Printing Services*. All amounts are assumed and simplified for illustration purposes.

#### Strauss Printing Services

##### Income Statement

For the Year Ended December 31, 2019

Service Revenue		R 160,000
Less: Expenses		
Salaries Expense	R 40,000	
Supplies Expense	26,100	
Rent Expense	20,500	
Utilities Expense	11,300	
Depreciation Expense	5,000	102,900
Net Income	R 57,100	

## Explanation and Pointers

1. An income statement shows the net income or net loss of a business. This is achieved by deducting all expenses from all income.
2. A typical income statement starts with a heading which consists of three lines. The first line presents the name of the company; the second describes the title of the report; and the third states the period covered in the report.
3. Notice that the third line is worded "*For the Year Ended...*" This means that the income statement presents information for a specific **span of time**. In the above example, the period covers 1 year that ends on December 31, 2019. Hence, the amounts presented in the report are income and expenses from January 1, 2019 to December 31, 2019.
4. Income accounts are presented before expenses. In the above statement, the income account is Service Revenue. Other income accounts for service type businesses include Professional Fees, Rent Income, Tuition Fees, etc.
5. Expenses are presented after the income accounts. It is a good practice to arrange expenses according to amount (largest to smallest). Some users who are interested in the company's expenses are concerned about the size of each expense. Arranging the expenses from largest to smallest results in a more useful and organized report. Nonetheless, *Miscellaneous Expense* or *Sundry Expense* is presented last.
6. If income exceeds expenses, there is a **net income**. If expenses exceed income, there is a **net loss**. Notice how computations are presented. A single line is drawn every time an amount is computed. The resulting amount is *double-ruled* when it is no longer followed by any operation. For example, R57,100 (*net income*).
7. The income statement complies with the **accrual basis of accounting**. Income is recognized when earned regardless of when collected. Expenses are recognized when incurred regardless of when paid.  
This means that income and expenses presented in the income statement have been earned and incurred, respectively. Nonetheless, it does not mean that they have all been collected or paid.
8. International accounting standards suggest that companies should present other comprehensive income in their financial statements. A **Statement of Comprehensive Income** shows the contents of an income statement followed by a list of "other comprehensive income".
9. **Other comprehensive income** includes gains and losses that cannot be reported as profit and loss, such as unrealized gains and losses, and revaluation surplus. This is taken up in higher financial accounting studies.
10. When the company does not have other comprehensive income, the contents of the income statement and the statement of comprehensive income are the same. In any case, international accounting standards favor the use of the title "Statement of Comprehensive Income".



## **More Income Statement Examples**

The results of operations of a company is summarized in the *income statement*.

The income statement presents all revenues and all expenses. Revenues minus expenses is equal to *net income*.

The net income is the primary measure of a company's financial performance for a particular period.

Here are examples of the income statement.

The amounts are assumed and contents are simplified for illustration purposes.

### **Example 1: Service Business**

XYL Graphic Designs, Inc.

#### Income Statement

For the Year Ended December 31, 2019

Service Revenue		R 270,000
Less: Expenses		
Salaries Expense	80,000	
Rent Expense	30,000	
Advertising Expense	16,000	
Utilities Expense	10,000	
Depreciation Expense	8,000	
Supplies Expense	2,000	146,000
Income before Tax		<u>R 124,000</u>
Less: Income Tax Expense		48,360
Net Income		<u><u>R 75,640</u></u>

The income statement starts with a heading made up of three lines. The heading contains: (1) the name of the company, (2) the title of the financial statement, and (3) the period covered by the report.

The income statement of a service type business is quite simple. Revenue accounts are presented first followed by all of the company's expenses. The resulting amount is then

subjected to income tax. *Note: Income tax treatment depends upon the tax laws of the state/country.*

Some income statements of service businesses present "Cost of Service" in a separate line after revenues. It shows the expenses that are directly associated with the services rendered.

**Example 2: Merchandising Business, and for Manufacturing too..**

GHI Market Associates Corporation

Income Statement

For the Year Ended December 31, 2019

Sales	R 960,000
Less: Cost of Sales	680,000
Gross Profit	<u>R 280,000</u>

Less: Operating Expenses

Selling Expenses

Sales Salaries Expense	R 40,000	
Advertising Expense	15,000	
Utilities Expense - Store	6,000	
Depreciation Expense - Store	5,000	
Store Supplies Expense	4,000	R 70,000

Administrative Expenses

Office Salaries Expense	R 22,500
Utilities Expense - Office	6,500
Depreciation Expense - Office	5,000
Permits and Licences	4,000
Office Supplies Expense	2,500

Bad Debts Expense	1,500	42,000
Total Operating Expenses		<u>R 112,000</u>
Operating Income		R 168,000
Other Revenues and Expenses		
Gain on Sale of Equipment	R 20,000	
Interest Expense	(12,000)	8,000
Income before Tax		<u>R 176,000</u>
Less: Income Tax Expense		68,640
Net Income		<u><u>R 107,360</u></u>

Example 2 shows how an income statement of merchandising and manufacturing businesses would look like. In the above example, a separate line for "Cost of Sales" is presented. It shows the cost of items sold, hence also known as "Cost of Goods Sold".

Selling expenses were shown separately from administrative expenses. Selling expenses pertain to expenses directly related to the selling and marketing functions. Administrative expense pertain to those associated with the activities of the administration such as billing and collection, hiring, board meetings, etc.

The difference between all revenues and all expenses is then subjected to income tax to arrive at the company's net income.

### Conclusion

Though they may be presented differently, all income statements have the same goal and purpose. An income statement presents a company's revenues and expenses over a particular period of time, to give the users information about the operating performance of the company. When studying company figures, it is good to compare income statements over different periods or with income statements of other companies.

#### 4.1.2 Statement of Comprehensive Income

Here's a sample Statement of Comprehensive Income, which includes *other comprehensive income*. This topic is taken up in higher accounting so you need not worry about it yet.

#### **Strauss Printing and Publishing, Inc.**

#### **Statement of Comprehensive Income**

## For the Year Ended December 31, 2019

Service Revenue		R 160,000
Less: Expenses		
Salaries Expense	R 40,000	
Supplies Expense	26,100	
Rent Expense	20,500	
Utilities Expense	11,300	
Depreciation Expense	5,000	102,900
Net Income		<u>57,100</u>
Other Comprehensive Income		
Revaluation Surplus	20,000	
Unrealized Translation Gain	10,200	30,200
Total Comprehensive Income		<u><u>87,300</u></u>

### 4.2 Statement of Owner's Equity

This lesson presents the Statement of Owner's Equity (or Statement of Changes in Owner's Equity) along with important points you need to know in preparing and understanding this report.

A Statement of Owner's Equity shows the changes in the capital account due to contributions, withdrawals, and net income or net loss.

Capital is increased by *owner contributions* and *income*, and decreased by *withdrawals* and *expenses*.

The Statement of Owner's Equity, which is prepared for the sole proprietorship type of business, shows the movement in capital as a result of those four elements.

#### 4.2.1 Statement of Owner's Equity Example

Here is a sample Statement of Owner's Equity of a *service type sole proprietorship* business, *Strauss Printing Services*. All amounts are assumed and simplified for illustration purposes.

Assume that the company started the year 2019 with R100,000 capital. During the year, the owner made R10,000 additional contributions and R20,000 total withdrawals. The Statement of Owner's Equity would look like this:

**Strauss Printing Services**

**Statement of Owner's Equity**

**For the Year Ended December 31, 2019**

Strauss, Capital – beginning	R 100,000
Add: Additional Contributions	10,000
Net Income	57,100
Total	R 167,100
Less: Strauss, Drawings	20,000
Strauss, Capital – ending	R 147,100

**Explanation and Pointers**

1. A Statement of Owner's Equity (SOE) shows the owner's capital at the start of the period, the changes that affect capital, and the resulting capital at the end of the period. It is also known as "Statement of Changes in Owner's Equity".
2. A typical SOE starts with a heading which consists of three lines. The first line shows the name of the company; second the title of the report; and third the period covered.
3. The title of the report is Statement of Owner's Equity. This is used for sole proprietorships. For partnerships, the title used is "Statement of Partners' Equity" and for corporations, "Statement of Stockholders' Equity".
4. Notice that the third line is worded "*For the Year Ended...*" This means that the SOE presents information for a specific **span of time**. In the above example, the period covers 1 year that ends on December 31, 2019. Hence, the amounts presented pertain to changes to owner's equity from January 1, 2019 to December 31, 2019.
5. The capital account used in the illustration is **Strauss, Capital**. The capital account used would vary from company to company.
6. Income increases capital. Expenses decrease it. Net income is equal to income minus expenses. Hence, net income would increase the capital account. If expenses exceed income, there is a net loss. In such case, net loss will decrease the capital account.
7. Notice that the **net income** above, R 57,100, is the bottom-line amount in the company's Income Statement.

8. **Strauss, Drawings** represents the total withdrawals made by the owner during the period. The owner made R 20,000 total drawings. This amount is deducted to get the capital balance.
9. The Statement of Owner's Equity example above shows that the company has **R147,100** in capital as a result of the following: R100,000 balance at the beginning of the year, plus R10,000 owner's contributions during the year, plus R57,100 net income, and minus R20,000 withdrawals.
10. Good accounting form suggests that a single line is drawn every time an amount is computed (it signifies that a mathematical operation has been completed). The bottom-line amount is *double-ruled*, i.e. R 147,100.

### 4.3 Balance Sheet – a.k.a. Statement of Financial Position

A balance sheet shows the financial position or condition of a company as of a certain date. It is also called *Statement of Financial Position*.

Ad

*Financial position* pertains to the resources owned and controlled by the company (*assets*), and the claims against them (*liabilities and capital*).

Hence, if you have a report that presents a company's assets, liabilities and capital, then you are probably looking at a company's balance sheet.

This lesson shows what a Balance Sheet looks like and provides some points you need to know about this financial report.

#### 4.3.1 Balance Sheet Example

Moving on from our previous illustrations, here is a sample balance sheet for *Strauss Printing Services*, a *service type sole proprietorship* business.

All amounts are assumed and simplified for illustration purposes.

### **Strauss Printing Services**

### **Statement of Financial Position**

**As of December 31, 2019**

#### **ASSETS**

Current Assets:

Cash	R 21,000	
Accounts Receivable	16,000	
Prepaid Expenses	4,500	R 41,500
<hr/>		
Non-current Assets:		
Property, Plant and Equipment	145,000	
Total Assets		R 186,500
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### LIABILITIES AND OWNER'S EQUITY

#### Current Liabilities:

Accounts Payable	R 8,400	
Rent Payable	8,000	R 16,400
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#### Non-current Liability:

Loans Payable	23,000	
Strauss, Capital	147,100	
Total Liabilities and Owner's Equity		R 186,500
<hr/> <hr/>		

#### Explanation and Pointers

1. A Balance Sheet shows the financial position or condition of the company; thus, it is also called "Statement of Financial Position".
2. A typical balance sheet starts with a heading which consists of three lines. The first line presents the name of the company; the second describes the title of the report; and the third states the date of the report.
3. Notice that the third line is worded "As of..." Unlike the other components of the financial statements which cover a span of time ("*For the period ended..*"), the balance sheet presents information **as of a certain date** (at a specific point in time). In the above example, the contents of the balance sheet pertain to the financial condition of the company on December 31, 2019.
4. A balance sheet summarizes the assets, liabilities, and capital of a company. Assets refer to properties owned and controlled by the company. Liabilities are obligations to creditors, lenders, etc. And capital represents the portion left for the owners of the business after all liabilities are paid. For detailed lessons about assets, liabilities and capital, check out the Elements of Accounting.

5. Assets and liabilities are classified as either **current or non-current**. *Current assets* are properties that will be converted into cash within 12 months or within the operating cycle of the business. *Current liabilities* are due within 12 months or within the operating cycle. Non-current assets and non-current liabilities are those that do not meet the above qualifications.
6. "Total assets" and "total liabilities and capital" should always be **equal**.
7. The capital amount, *R147,100 for Strauss, Capital*, was actually taken from the Statement of Owner's Equity.
8. The balance sheet may be presented in two forms: account form and report form. In **account form**, assets are presented on the left side while liabilities and capital are presented on the right. In **report form**, assets are presented first and then followed by liabilities and capital. The example above is presented using the *report form*.
9. Good accounting form suggests that a single line is drawn every time an amount is computed. It signifies that a mathematical operation has been completed. The "total assets" and "total liabilities and capital" amounts are *double-ruled*.

#### 4.4 Cash Flow Statement

A Statement of Cash Flows (or Cash Flow Statement) shows the movement in the *Cash* account of a company.

It presents cash inflows (receipts) and outflows (payments) in the three activities of business: *operating, investing, and financing*.

Accountants follow the accrual basis in measuring income and expenses.

However, some users are particularly interested in the cash transactions of the company; hence the need to present a Statement of Cash Flows.

This lesson takes a look at the Statement of Cash Flows and provides some important points in understanding it.

##### 4.4.1 Statement of Cash Flows Example

Here is a sample cash flow statement for *Strauss Printing Services*, a *service type sole proprietorship* business.

All amounts are assumed and simplified for illustration purposes.

#### Strauss Printing Services

#### Statement of Cash Flows

**For the Year Ended December 31, 2019**

### Cash Flow from Operating Activities:

Cash received from customers	R 146,000	
Cash paid for expenses	(81,000)	
Cash paid to suppliers	(47,500)	R 17,500

### Cash Flow from Investing Activities:

Cash paid to acquire additional equipment	(20,300)	
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### Cash Flow from Financing Activities:

Cash received from investment of owner	R 10,000	
Cash received from bank loan	50,000	
Cash paid for bank loan – partial payment	(27,000)	
Cash paid to owner – withdrawal	(20,000)	13,000
Net Increase (Decrease) in Cash for the Year	R 10,200	
Add: Cash – January 1, 2019	10,800	
Cash – December 31, 2019	R 21,000	

### Explanation and Pointers

1. Statement of Cash Flows presents the inflows and outflows of cash in the different activities of the business, the net increase or decrease in cash, and the resulting cash balance at the end of the period. **Cash inflows** refer to receipts of cash while **cash outflows** to payments or disbursements.
2. A typical cash flow statement starts with a heading which consists of three lines. The first line presents the name of the company; the second describes the title of the report; and the third states the period covered in the report.
3. Notice that the third line is worded "*For the Year Ended...*" This means that the information included in the report covers a span of time. In the illustration above, the report presents inflows and outflows of cash for 1 year, i.e. from January 1 to December 31, 2019.
4. Cash inflows and outflows are classified in three activities: operating, investing, and financing.
5. **Operating activities** refer to the main operations of the company such as rendering of professional services, acquisition of inventories and supplies, selling of inventories for merchandising and manufacturing concerns, collection of accounts, payment of accounts to

suppliers, and others. Generally, operating activities refer to those that involve **current assets and current liabilities**.

6. Investing activities may be summed up as: "where the company puts its money for long-term purposes", such as acquisition of property, plant and equipment; and investment in long-term securities. Selling these properties are also considered investing activities. In general, investing activities include transactions that involve **non-current assets**.
7. Financing activities refer to: "where the company gets its funds", such as investment of the owner/s, and cash proceeds from bank loan and other long-term payables. The payment of such items (i.e. withdrawal of owner/s and payment of loans) are also financing activities. Generally, financing activities include those that affect **non-current liabilities and capital**.
8. All inflows are presented in positive figures while all outflows in negative (in parentheses).
9. After inflows and outflows are presented, the net increase or decrease in cash is computed. Then it is added to the beginning balance of cash to get the balance at the end. Easy, *right*? In simple sense, this report presents the cash balance **at the beginning of the period**, the changes **during the period**, and the resulting balance **at the end of the period**.
10. Notice that the cash balance at the end, R 21,000, is the same as the cash balance presented in the company's Balance Sheet.
11. Good accounting form suggests that a single line is drawn every time an amount is computed. It signifies that a mathematical operation has been completed. The computed balance at the end of the report is *double-ruled*.

## 4.6 Statement Preparations

### 4.6.1 How to Prepare an Income Statement

An income statement contains information about a company's revenues and expenses and the resulting net income.

Net income is computed by deducting all expenses from all revenues. It is the primary measure of the company's ability to make money.

In this session, we will prepare an income statement of a sole proprietorship service-type business using information from previous lessons. We will be using the adjusted trial balance from this lesson: Adjusted Trial Balance.

When you're ready, let's begin.

#### **Step 1: Gather the necessary information**

In an accounting system, the best tool to take information from would be the "adjusted trial balance". This is the most updated trial balance (i.e. prepared after considering adjustments to several accounts). In any case, any report that shows a complete listing of company accounts can be used.

Let's take the adjusted trial balance of *Gray Electronic Repair Services*.

**Gray Electronic Repair Services**

**Adjusted Trial Balance**

**December 31, 2019**

Account Title	Debit	Credit
Cash	R 7,480.00	
Accounts Receivable	3,700.00	
Service Supplies	600.00	
Furniture and Fixtures	3,000.00	
Service Equipment	16,000.00	
Accumulated Depreciation		R 720.00
Accounts Payable		9,000.00
Utilities Payable		1,800.00
Loans Payable		12,000.00
Mr. Gray, Capital		13,200.00
Mr. Gray, Drawing	7,000.00	
Service Revenue		9,850.00
Rent Expense	1,500.00	
Salaries Expense	3,500.00	
Taxes and Licenses	370.00	
Utilities Expense	1,800.00	
Service Supplies Expense	900.00	

Depreciation Expense	720.00	
Totals	R 46,570.00	R 46,570.00
	R 46,570.00	R 46,570.00

### Step 2: Start by making the heading

The heading of a financial statement is made up of three lines. The first line contains the name of the company (Gray Electronic Repair Services). The second line shows the title of the report (Income Statement). And the third line indicates the period reported.

For income statements, we use *For the Year Ended...*, *For the Quarter Ended...*, *For the Month Ended...*, etc., depending on the period covered in the report. Nonetheless, some annual income statements omit the "For the Year Ended" phrase.

**Gray Electronic Repair Services**

**Income Statement**

**For the Year Ended December 31, 2019**

### Step 3: Report all revenue accounts

From the trial balance, we will look for and report all income or revenue accounts. You will need to be familiar with different income accounts such as Service Revenue, Sales, Professional Fees, Interest Income, etc. In the adjusted trial balance above, there is only one revenue account - *Service Revenue*.

**Gray Electronic Repair Services**

**Income Statement**

**For the Year Ended December 31, 2019**

Service Revenue	R 9,850
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*Note: If there are multiple revenue accounts, you need to list them down and take the sum total of all revenues.*

### Step 4: Report all expense accounts

From the adjusted trial balance again, we will take all expenses and include them in the report. Once they are all listed, we will get the sum of all the expenses.

**Gray Electronic Repair Services**

**Income Statement**

**For the Year Ended December 31, 2019**

Service Revenue		R 9,850
Less: Operating Expenses		
Salaries Expense	R 3,500	
Utilities Expense	1,800	
Rent Expense	1,500	
Service Supplies Expense	900	
Depreciation Expense	720	
Taxes and Licences	370	8,790

It is a good practice to list the expenses from highest to lowest *whenever possible*. This allows better analysis of company expenses.

Drawing a horizontal line means that a mathematical operation has been performed. The line after 370 indicates that we took the sum of all expenses which amounts to 8,790. The total amount of expenses is aligned with the total amount of revenues.

**Step 5: Compute for the net income**

Net income is equal to total revenues minus total expenses.

**Gray Electronic Repair Services**

**Income Statement**

**For the Year Ended December 31, 2019**

Service Revenue		R 9,850
Less: Operating Expenses		
Salaries Expense	R 3,500	
Utilities Expense	1,800	
Rent Expense	1,500	
Service Supplies Expense	900	

Depreciation Expense	720	
Taxes and Licences	370	8,790
Net Income		R 1,060

Again, we drew a single line under 8,790 to indicate that a mathematical operation was made. Two horizontal lines are drawn under the final amount (1,060 net income). This is known as "double-rule" and is similar to enclosing the final answers in a box or circle in your math test.

So there you go. The preparation is somewhat easy – you just need to be familiar with the different revenue and expense accounts.

### Some Important Notes

This is a simplified illustration of preparing an income statement. Income tax expense was not considered in the above example. The treatment of income taxes depends upon the applicable laws of the state or country. Nonetheless, if the company is subject to income tax, the income tax expense should be deducted to get the net income. Since income tax expense is based on income, we need to get the income before tax first.

Total Revenues - Total Operating Expenses = Income Before Tax

Income Before Tax - Income Tax Expense = Net Income

Also, the income statements of merchandising and manufacturing businesses will look a little different from the above example. *Gross Profit* is computed before deducting the operating expenses. Gross profit is equal to *Sales* minus *Cost of Sales*.

### 4.6.2 How to Prepare a Balance Sheet

The "Balance Sheet", also known as "Statement of Financial Position", shows a company's financial condition as of a certain date.

Financial condition is presented by reporting how much assets the company owns, how much liabilities it owes to others, and its equity or capital (assets minus liabilities).

In this session, we will continue the illustration from previous lessons and prepare a balance sheet.

Like the other financial statements we have prepared, we will use this adjusted trial balance: Adjusted Trial Balance.

If everything's good, let's begin.

#### Step 1: Gather the needed information

Like in any other financial statement, we need to gather information to be used in preparing a balance sheet. Any source that shows updated account balances can be used. The most appropriate tool for this, however, would be the adjusted trial balance.

## Gray Electronic Repair Services

### Adjusted Trial Balance

December 31, 2019

Account Title	Debit	Credit
Cash	R 7,480.00	
Accounts Receivable	3,700.00	
Service Supplies	600.00	
Furniture and Fixtures	3,000.00	
Service Equipment	16,000.00	
Accumulated Depreciation		R 720.00
Accounts Payable		9,000.00
Utilities Payable		1,800.00
Loans Payable		12,000.00
Mr. Gray, Capital		13,200.00
Mr. Gray, Drawing	7,000.00	
Service Revenue		9,850.00
Rent Expense	1,500.00	
Salaries Expense	3,500.00	
Taxes and Licenses	370.00	
Utilities Expense	1,800.00	
Service Supplies Expense	900.00	
Depreciation Expense	720.00	
Totals	R 46,570.00	R 46,570.00

### Step 2: Prepare the heading

The first line contains the name of the company. The second line shows the title of the report. We can use either "Balance Sheet" or "Statement of Financial Position". The third line indicates the date of the report.

The income statement, statement of changes in equity, and statement of cash flows use *For the Year Ended, For the Month Ended, For the Quarter Ended*, etc. However, we cannot use any of those phrases in a balance sheet since we are not reporting information for a period of time, but rather, information as of a certain date.

Therefore, we shall use "As of...". Though, some balance sheets omit the phrase.

<b>Gray Electronic Repair Services</b>			
<b>Balance Sheet</b>			
<b>As of December 31, 2019</b>			

**Step 3: Report all company assets**

From the trial balance, we take all assets and report them in the balance sheet. Current assets are reported separately from non-current assets. After which, we will compute for the total current assets, the total non-current assets, and the total assets. A single line is drawn every time a mathematical operation is made. The amount of total assets is double-ruled.

<b>Gray Electronic Repair Services</b>			
<b>Balance Sheet</b>			
<b>As of December 31, 2019</b>			
ASSETS			
Current Assets:			
Cash		R 7,480	
Accounts Receivable		3,700	
Service Supplies		600	
Total Current Assets			11,780
Non-Current Assets:			

Furniture and Fixtures	R 3,000	
Service Equipment	16,000	
Less: Accumulated Depreciation	720	
Total Non-Current Assets		18,280
<b>TOTAL ASSETS</b>		<b>R 30,060</b>

*Note: The above step requires you to be familiar with assets accounts. The next steps will require knowledge of liability and capital accounts.*

#### **Step 4: Report all liabilities**

After the "assets" portion, we will now present "liabilities and capital". We will start by presenting current liabilities, followed by non-current liabilities. After that, we will take the totals of each as well as the amount of total liabilities – just like what we did for assets.

<b>Gray Electronic Repair Services</b>		
<b>Balance Sheet</b>		
<b>As of December 31, 2019</b>		
ASSETS		
Current Assets:		
Cash	R 7,480	
Accounts Receivable	3,700	
Service Supplies	600	
Total Current Assets		11,780
Non-Current Assets:		
Furniture and Fixtures	R 3,000	
Service Equipment	16,000	
Less: Accumulated Depreciation	720	

Total Non-Current Assets		18,280
TOTAL ASSETS		R 30,060
<b>LIABILITIES AND CAPITAL</b>		
Current Liabilities:		
Accounts Payable	9,000	
Utilities Payable	1,800	
Total Current Liabilities		10,800
Non-Current Liabilities:		
Loans Payable	12,000	
Total Non-Current Liabilities		12,000
Total Liabilities		20,800

**Step 5: Report the ending balance of capital**

The trial balance above does not show the ending balance of capital. The ending balance of capital can be taken from the Statement of Changes in Equity. If you have been following our sessions, we prepared it before preparing this balance sheet. In any case, any source may be used as long as it gives you the *ending balance* of capital.

After including capital, we will take the total amount of "*liabilities and capital*". That amount is double-ruled.

<b>Gray Electronic Repair Services</b>
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<b>Balance Sheet</b>		
<b>As of December 31, 2019</b>		
<b>ASSETS</b>		
Current Assets:		
Cash	R 7,480	
Accounts Receivable	3,700	
Service Supplies	600	
Total Current Assets		11,780
Non-Current Assets:		
Furniture and Fixtures	R 3,000	
Service Equipment	16,000	
Less: Accumulated Depreciation	720	
Total Non-Current Assets		18,280
<b>TOTAL ASSETS</b>		<b>R 30,060</b>
<b>LIABILITIES AND CAPITAL</b>		
Current Liabilities:		
Accounts Payable	9,000	
Utilities Payable	1,800	
Total Current Liabilities		10,800
Non-Current Liabilities:		
Loans Payable	12,000	
Total Non-Current Liabilities		12,000
<b>Total Liabilities</b>		<b>22,800</b>

Gray Capital, ending		7,260
TOTAL LIABILITIES AND CAPITAL		R 30,060

Total assets should be equal to total liabilities and capital. If they are not, then something must have gone wrong during the process.

There you have it. The balance sheet we have just prepared is for a sole proprietorship business. In a partnership, several capital accounts will have to be presented – one for each partner. In a corporation, the capital portion is known as stockholders' equity and is made up of capital stock, reserves, and retained earnings.

# Chapter 5

## Analysing Financial Reports

### Introduction

The process of reviewing and analyzing a company's financial statements to make better economic decisions is called analysis of financial statements. In other words, the process of determining financial strengths and weaknesses of the entity by establishing the strategic relationship between the items of the balance sheet, profit and loss account, and other financial statements.

The term 'analysis' means the simplification of financial data by methodical classification of the data given in the financial statements, 'interpretation' means, 'explaining the meaning and significance of the data so simplified.' However, both 'analysis and interpretation' are interlinked and complementary to each other.

### 5.1 Significance of Financial Analysis

#### a) Finance Manager

Analysis of financial statements helps the finance manager in:

- Assessing the operational efficiency and managerial effectiveness of the company.
- Analyzing the financial strengths and weaknesses and creditworthiness of the company.
- Analyzing the current position of financial analysis,
- Assessing the types of assets owned by a business enterprise and the liabilities which are due to the enterprise.
- Providing information about the cash position company is holding and how much debt the company has in relation to equity.
- Studying the reasonability of stock and debtors held by the company.

#### b) Top Management

Financial analysis helps the top management

- To assess whether the resources of the firm are used in the most efficient manner
- Whether the financial condition of the firm is sound
- To determine the success of the company's operations
- Appraising the individual's performance
- evaluating the system of internal control
- To investigate the future prospects of the enterprise.

### **c) Trade Payables (Suppliers)**

Trade payables analyze of financial statements for:

- Appraising the ability of the company to meet its short-term obligations
- Judging the probability of firm's continued ability to meet all its financial obligations in the future.
- Firm's ability to meet claims of creditors over a very short period of time.
- Evaluating the financial position and ability to pay off the concerns.

### **d) Lenders**

Suppliers of long-term debt are concerned with the firm's long-term solvency and survival. They analyze the firm's financial statements

- To ascertain the profitability of the company over a period of time,
- For determining a company's ability to generate cash, to pay interest and repay the principal amount
- To assess the relationship between various sources of funds (i.e. capital structure relationships)
- To assess financial statements which contain information on past performances and interpret it as a basis for forecasting future rates of return and for assessing risk.
- For determining credit risk, deciding the terms and conditions of a loan if sanctioned, interest rate, and maturity date etc.

### **e) Investors**

Investors, who have invested their money in the firm's shares, are interested in the firm's earnings and future profitability. Financial statement analysis helps them in predicting the bankruptcy and failure probability of business enterprises. After being aware of the probable failure, investors can take preventive measures to avoid/minimize losses.

### **f) Labour Unions**

Labour unions analyze the financial statements:

- To assess whether an enterprise can increase their pay.
- To check whether an enterprise can increase productivity or raise the prices of products/ services to absorb a wage increase.

## 5.2 Objectives of Financial Analysis

Let us look at some of the main objectives of financial analysis,

1. **Reviewing the performance of a company over the past periods:** To predict the future prospects of the company, past performance is analyzed. Past performance is analyzed by reviewing the trend of past sales, profitability, cash flows, return on investment, debt-equity structure and operating expenses, etc.
2. **Assessing the current position & operational efficiency:** Examining the current profitability & operational efficiency of the enterprise so that the financial health of the company can be determined. For long-term decision making, assets & liabilities of the company are reviewed. Analysis helps in finding out the earning capacity & operating performance of the company.
3. **Predicting growth & profitability prospects:** The top management is concerned with future prospects of the company. Financial analysis helps them in reviewing the investment alternatives for judging the earning potential of the enterprise. With the help of financial statement analysis, assessment and prediction of the bankruptcy and probability of business failure can be done.
4. **Loan Decision by Financial Institutions and Banks:** Financial analysis helps the financial institutions, loan agencies & banks to decide whether a loan can be given to the company or not. It helps them in determining the credit risk, deciding the terms and conditions of a loan if sanctioned, interest rate, maturity date etc.

## 5.3 Tools of Financial Analysis

Financial statements are prepared to have complete information regarding assets, liabilities, equity, reserves, expenses and profit and loss of an enterprise. To analyze & interpret the financial statements, commonly used tools are comparative statements, common size statements etc. Let us take a look.

### 5.3.1 Comparative Statements

Also known as 'horizontal analysis', are financial statements showing financial position & profitability at different periods of time. These statements give an idea of the enterprise financial position of two or more periods. Comparison of financial statements is possible only when same accounting principles are used in preparing these statements.

#### Comparative Balance Sheet

The progress of the company can be seen by observing the different assets and liabilities of the firm on different dates to make the comparison of balances from one date to another. To

understand the comparative balance sheet, it must have two columns for the data of original balance sheets. A third column is used to show increases/decrease in figures. The fourth column gives percentages of increases or decreases.

By comparing the balance sheets of different dates, one can observe the following aspects

- Current financial position and Liquidity position
- Long-term financial position
- Profitability of the concern

#### Comparative Income Statement

Traditionally known as trading and profit and loss A/c. Net sales, cost of goods sold, selling expenses, office expenses etc are important components of an income statement. To compare the profitability, particulars of profit & loss are compared with the corresponding figures of previous years individually. To analyze the profitability of the business, the changes in money value and percentage is determined.

By comparing the profits of different dates, one can observe the following aspects:

- The increase/decrease in gross profit.
- The study of operational profits.
- The increase or decrease in net profit
- Study of the overall profitability of the business.

#### 5.3.2 Common Size Statements

Common size statements are also known as 'Vertical analysis'. Financial statements, when read with absolute figures, can be misleading. Therefore, a vertical analysis of financial information is done by considering the percentage form. The balance sheet items are compared:

- to the total assets in terms of percentage by taking the total assets as 100.
- to the total liabilities in terms of percentage by taking the total liabilities as 100.

Therefore the whole Balance Sheet is converted into percentage form. And such converted Balance Sheet is known as Common-Size Balance Sheet. Similarly profit & loss items are compared:

- to the total incomes in terms of percentage by taking the total incomes as 100.
- to the total expenses in terms of percentage by taking the total expenses as 100.

Therefore the whole Profit & loss account is converted into percentage form. And such converted profit & loss account is known as Common-Size Profit & Loss account. As the numbers are brought to a common base, the percentage can be easily compared with the results of corresponding percentages of the previous year or of some other firms.

### 5.3.3 Trend Analysis

Also known as the Pyramid Method. Studying the operational results and financial position over a series of years is trend analysis. Calculations of ratios of different items for various periods is done & then compared under this analysis. Whether the enterprise is trending upward or backward, the analysis of the ratios over a period of years is done. By observing this analysis, the sign of good or poor management is detected.

### 5.3.4 Ratio Analysis

Quantitative analysis of information contained in a company's financial statements is ratio analysis. It describes the significant relationship which exists between various items of a balance sheet and a statement of profit and loss of a firm.

## 5.4 What are Financial Ratios?

Financial ratios are created with the use of numerical values taken from financial statements to gain meaningful information about a company. The numbers found on a company's financial statements – balance sheet, income statement, and cash flow statement – are used to perform quantitative analysis and assess a company's liquidity, leverage, growth, margins, profitability, rates of return, valuation, and more.

Financial ratios are grouped into the following categories:

- Liquidity ratios
- Leverage ratios
- Efficiency ratios
- Profitability ratios
- Market value ratios

### 5.4.1 Uses and Users of Financial Ratio Analysis

Analysis of financial ratios serves two main purposes:

#### 1. Track company performance

Determining individual financial ratios per period and tracking the change in their values over time is done to spot trends that may be developing in a company. For example, an increasing debt-to-asset ratio may indicate that a company is overburdened with debt and may eventually be facing default risk.

#### 2. Make comparative judgments regarding company performance

Comparing financial ratios with that of major competitors is done to identify whether a company is performing better or worse than the industry average. For example, comparing the return on assets between companies helps an analyst or investor to determine which company is making the most efficient use of its assets.

Users of financial ratios include parties external and internal to the company:

- **External users:** Financial analysts, retail investors, creditors, competitors, tax authorities, regulatory authorities, and industry observers
- **Internal users:** Management team, employees, and owners

## 5.4.2 Liquidity Ratios

Liquidity ratios are financial ratios that measure a company's ability to repay both short- and long-term obligations. Common liquidity ratios include the following:

The current ratio measures a company's ability to pay off short-term liabilities with current assets:

$$\text{Current ratio} = \text{Current assets} / \text{Current liabilities}$$

The acid-test ratio measures a company's ability to pay off short-term liabilities with quick assets:

$$\text{Acid-test ratio} = \text{Current assets} - \text{Inventories} / \text{Current liabilities}$$

The cash ratio measures a company's ability to pay off short-term liabilities with cash and cash equivalents:

$$\text{Cash ratio} = \text{Cash and Cash equivalents} / \text{Current Liabilities}$$

The operating cash flow ratio is a measure of the number of times a company can pay off current liabilities with the cash generated in a given period:

$$\text{Operating cash flow ratio} = \text{Operating cash flow} / \text{Current liabilities}$$

## 5.4.3 Leverage Financial Ratios

Leverage ratios measure the amount of capital that comes from debt. In other words, leverage financial ratios are used to evaluate a company's debt levels. Common leverage ratios include the following:

The debt ratio measures the relative amount of a company's assets that are provided from debt:

$$\text{Debt ratio} = \text{Total liabilities} / \text{Total assets}$$

The debt to equity ratio calculates the weight of total debt and financial liabilities against shareholders' equity:

$$\text{Debt to equity ratio} = \text{Total liabilities} / \text{Shareholder's equity}$$

The interest coverage ratio shows how easily a company can pay its interest expenses:

$$\text{Interest coverage ratio} = \text{Operating income} / \text{Interest expenses}$$

The debt service coverage ratio reveals how easily a company can pay its debt obligations:

$$\text{Debt service coverage ratio} = \text{Operating income} / \text{Total debt service}$$

#### 5.4.4 Efficiency Ratios

Efficiency ratios, also known as activity financial ratios, are used to measure how well a company is utilizing its assets and resources. Common efficiency ratios include:

The asset turnover ratio measures a company's ability to generate sales from assets:

$$\text{Asset turnover ratio} = \text{Net sales} / \text{Total assets}$$

The inventory turnover ratio measures how many times a company's inventory is sold and replaced over a given period:

$$\text{Inventory turnover ratio} = \text{Cost of goods sold} / \text{Average inventory}$$

The accounts receivable turnover ratio measures how many times a company can turn receivables into cash over a given period:

$$\text{Receivables turnover ratio} = \text{Net credit sales} / \text{Average accounts receivable}$$

The days sales in inventory ratio measures the average number of days that a company holds on to inventory before selling it to customers:

$$\text{Days sales in inventory ratio} = 365 \text{ days} / \text{Inventory turnover ratio}$$

#### 5.4.5 Profitability Ratios

Profitability ratios measure a company's ability to generate income relative to revenue, balance sheet assets, operating costs, and equity. Common profitability financial ratios include the following:

The gross margin ratio compares the gross profit of a company to its net sales to show how much profit a company makes after paying its cost of goods sold:

$$\text{Gross margin ratio} = \text{Gross profit} / \text{Net sales}$$

The operating margin ratio compares the operating income of a company to its net sales to determine operating efficiency:

$$\text{Operating margin ratio} = \text{Operating income} / \text{Net sales}$$

The return on assets ratio measures how efficiently a company is using its assets to generate profit:

$$\text{Return on assets ratio} = \text{Net income} / \text{Total assets}$$

The return on equity ratio measures how efficiently a company is using its equity to generate profit:

$$\text{Return on equity ratio} = \text{Net income} / \text{Shareholder's equity}$$

#### 5.4.6 Market Value Ratios

Market value ratios are used to evaluate the share price of a company's stock. Common market value ratios include the following:

The book value per share ratio calculates the per-share value of a company based on equity available to shareholders:

$$\text{Book value per share ratio} = \text{Shareholder's equity} / \text{Total shares outstanding}$$

The dividend yield ratio measures the amount of dividends attributed to shareholders relative to the market value per share:

$$\text{Dividend yield ratio} = \text{Dividend per share} / \text{Share price}$$

The earnings per share ratio measures the amount of net income earned for each share outstanding:

$$\text{Earnings per share ratio} = \text{Net earnings} / \text{Total shares outstanding}$$

The price-earnings ratio compares a company's share price to its earnings per share:

$$\text{Price-earnings ratio} = \text{Share price} / \text{Earnings per share}$$

### 5.5 Guide to financial statement analysis

The main task of an analyst is to perform an extensive analysis of financial statements. In this session, we will break down the most important methods, types, and approaches to financial analysis.

This guide is designed to be useful for both beginners, with the main topics covering: (1) income statement, (2) balance sheet, (3) cash flow, and (4) rates of return.

#### #1 Income statement analysis

Most analysts start their analysis of financial statements with the income statement. Intuitively, this is usually the first thing we think about with a business...we often ask questions such as, "how much revenue does it have, is it profitable, what are the margins like?"

In order to answer these questions, and much more, we will dive into the income statement to get started.

There are two main types of analysis we will perform: vertical analysis and horizontal analysis.

## Vertical analysis

With this method of analysis of financial statements, we will look up and down the income statement (hence, “vertical” analysis) to see how every line item compares to revenue, as a percentage.

For example, in the income statement shown below, we have the total dollar amounts and the percentages, which make up the vertical analysis.

As you see in the above example, we do a thorough analysis of the income statement by seeing each line item as a proportion of revenue.

The key metrics we look at are:

- Cost of Goods Sold (COGS) as a percent of revenue
- Gross profit as a percent of revenue
- Depreciation as a percent of revenue
- Selling General & Administrative (SG&A) as a percent of revenue
- Interest as a percent of revenue
- Earnings Before Tax (EBT) as a percent of revenue
- Tax as a percent of revenue
- Net earnings as a percent of revenue

## Horizontal Analysis

Now it’s time to look at a different way to evaluate the income statement. With horizontal analysis, we look across the income statement at the year-over-year (YoY) change in each line item.

In order to perform this exercise, you need to take the value in Period N and divide it by the value in Period N-1 and then subtract 1 from that number to get the percent change.

For example, revenue in 2017 was R4,000 and in 2016 it was R3,000. The YoY change in revenue is equal to  $R4,000 / R3,000$  minus one, which equals 33%.

## #2 Balance sheet and leverage ratios

Let’s move on to the balance sheet. In this section of financial statement analysis, we will evaluate the operational efficiency of the business. We will take several items on the income statement, and compare them to the company’s capital assets on the balance sheet.

The balance sheet metrics can be divided into several categories, including liquidity, leverage, and operational efficiency.

### The main liquidity ratios for a business are:

- Quick ratio
- Current ratio
- Net working capital

### The main leverage ratios are:

- Debt to equity
- Debt to capital
- Debt to EBITDA
- Interest coverage
- Fixed charge coverage ratio

### The main operating efficiency ratios are:

- Inventory turnover
- Accounts receivable days
- Accounts payable days
- Total asset turnover
- Net asset turnover

Using these ratios, we can determine how efficiently a company is generating revenue and how quickly it's selling inventory.

Using the above financial ratios derived from the balance sheet will help you assess the solvency and leverage of a business.

### #3 Cash flow statement analysis

With the income statement and balance sheet under our belt, let's look at the cash flow statement and all the insights it tells us about the business.

The cash flow statement will help us understand the inflows and outflows of cash over the time period we're looking at.

#### Cash flow statement overview

The cash flow statement, or statement of cash flow, consist of three components:

- Cash from operations
- Cash used in investing
- Cash from financing

Each of these three sections tells us a unique and important part of the company's sources and uses of cash during the time period being evaluated.

Many investors consider the cash flow statement the most important indicator of a company's performance and it's hard to imagine that until only recently companies didn't even have to file a cash flow statement.

Today, investors quickly flip to this section to see if the company is actually making money or not, and what its funding requirements are.

It's important to understand how different ratios can be used to properly assess the operation of an organization from a cash management standpoint.

## 5.6 Limitations of Financial Analysis

Although there are many advantages of the financial statements, there are certain disadvantages of the same. As the analysis is done on the basis of data provided in the financial statements which can be incorrect.

Hence, it is necessary for the firms to consider in mind various limitations as well.

1. While doing the financial analysis, firms often fail to consider the price changes. When firms compare data from various time periods, they do it without providing the index to the figures. Hence, the firm does not show the inflation impact.
2. Intangible assets not recorded. Firms do not record many intangible assets. Instead, any expenditure made to create an intangible asset are immediately charged to expense.
3. Firms consider only the monetary aspects of the financial statements. They do not consider the non-monetary aspect.
4. Firms prepare the financial statements on the basis of on-going concept, as such, it does not reflect the current position.
5. The statements do not necessarily provide any value in predicting what will happen in the future.

## Accounting Glossary

The world of accounting is full of technical jargon that is often hard to follow. We've tried to strip this jargon away and create a plain-speaking glossary that covers the most common accounting terms you'll find.

### A

#### **Accounts Payable**

An amount owing to a supplier for the provision of goods or services. Also known as a Trade Creditor.

#### **Accounts Receivable**

An amount due from a customer for the provision of goods or services. Also known as a Trade Debtor.

#### **Accounts**

A collection of documents that present accounting information over a set period, normally quarterly or annually. The main documents within a set of accounts are the profit and loss statement, balance sheet, cash flow statement, and statement of changes in equity, as well as accompanying explanatory notes. Also known as Financial Statements.

#### **Accruals Basis**

An accounting method. Revenue is reported as it is earned, and expenses are reported as they are incurred. This means that income and expenses are reported as they occur, not when the associated cash is received or paid.

#### **Amortisation**

An expense allocated systematically against an intangible asset over a period of time.

#### **Asset**

A resource controlled by an entity from which future economic benefits are expected to flow. Examples of assets include accounts receivable, cars, cash, investments, land and buildings, and plant and machinery.

#### **Audit**

An independent review of an entity's financial statements that provides an opinion on whether the financial statements comply with generally accepted accounting practice.

### B

#### **Balance Sheet**

One of the main financial statements. It provides an overview of an entity's assets, liabilities and owner's equity at a particular point in time. Also known as a Statement of Financial Position.

## C

### **Cash**

Refers to money that is readily available. Examples include cash on hand, bank deposits, and cheques.

### **Cash Basis**

An accounting method. Revenue is reported as cash is earned and expenses are recognised when cash is paid. This method tends to be used by individuals and small companies.

### **Cash Flow Statement**

Appears in financial statements. It provides details regarding the sources and use of cash over a given period. Information is usually presented in three sections, covering operating activities, investing activities and financing activities. Also known as a Statement of Cash Flows.

### **Company**

An entity, legally separate from its owners, that is formed to carry on a business or investment activity. A company is one possible business structure and differs to a business structure as a sole trader or partnership. Your accountant or lawyer can advise on the best possible business structure for you.

### **Corporation Tax**

A tax levied on companies each financial year. Companies are usually subject to corporation tax on their trading profits, investments, and any chargeable gains.

### **Cost of Goods Sold**

The costs attributable to making and producing finished goods for sale, including raw materials. Also known as Cost of Sales.

### **Creditor**

A person or organisation to whom the entity owes money. For example, if a bank lent money to a business, then the bank would be a creditor on the business' balance sheet.

### **Current Asset**

An asset that is reasonably expected to convert into cash within one year of the balance sheet date. Examples of current assets include cash, accounts receivable, and inventory.

### **Current Liability**

A liability that is expected to be settled, usually within one year of the balance sheet date. Examples of current liabilities include accounts payable.

## D

### **Debtor**

Someone, be it a person or organisation, that owes the entity money.

### **Depreciation**

An expense allocated systematically against an asset over its estimated useful life.

**Dividend**

An amount paid out of post-tax profits to a company's shareholders. The amount of dividend a shareholder receives is often based on the number of shares they hold.

**Drawings**

Refers to cash taken from a business for personal use. The term is commonly used in the context of a sole trader business or partnership.

**E****Equity**

When referring to a business, equity is the difference between the entity's assets and liabilities.

**F****Financial Statements**

A collection of documents that present accounting information over a set period, normally quarterly or annually. The main documents within a set of financial statements are the profit and loss statement, balance sheet, cash flow statement, and statement of changes in equity, as well as accompanying explanatory notes. Also known as Accounts.

**Fixed Asset**

Another term for property, plant and equipment held by a business. Items of property, plant and equipment are recognised as assets when their cost can be reliably measured and it is probable that future economic benefits will flow to the business as a result of holding the asset.

**G****Going Concern**

An accounting term that features within financial statements. A going concern is a business that can remain in business and meet all of its commitments. If a business is not described as a going concern then it is likely the business will go bankrupt.

**Gross**

The amount before any deduction is taken.

**Gross Profit**

Sales minus cost of sales.

**I****Income Statement**

One of the main financial statements that summarises the revenues, costs, and expenses that a business has incurred over a period of time. Also known as the Profit and Loss Statement.

**Income Tax**

A tax that individuals pay on their income. Income covers items such as employment income,

profits from a sole trade, pension income, and investment income. However, not all income is subject to income tax. Some exceptions include any premium bond or national lottery winnings.

### **Intangible Asset**

An asset that has no physical presence. Examples of intangible assets include goodwill, patents, and trademarks.

### **Inventory**

Refers to the cost of raw materials, work-in-progress, and finished goods that can be sold to customers. Also known as Stock.

## **L**

### **Liability**

A present obligation that has arisen as a result of past events. The settlement of the obligation is normally achieved by the business paying an amount to lenders or suppliers. Examples of liabilities include bank loans and trade creditors.

### **Limited Liability Company**

Usually refers to a company where shareholders have their liability limited to the amount of capital they have contributed.

### **Liquidity**

The measure of whether a person or organisation can generate enough cash to meet their immediate or short-term obligations. In accounting terms, a company is considered liquid if its current assets can meet its current liabilities.

## **N**

### **Net**

The amount remaining after deductions have been taken.

### **Net Assets**

Total assets minus total liabilities. In a sole trader business, net assets are known as owner's equity. In a company, net assets are known as shareholders' equity.

### **Net Profit**

The amount remaining once all expenses have been deducted from total revenue. These expenses include all operating expenses, interest, and tax.

## **O**

### **Ordinary Share**

Represents equity ownership in a company. Holders of ordinary shares are usually entitled to vote at the company's meetings and may be entitled to share in the profits of the company.

## **P**

## **Partnership**

In a partnership, two or more entities such as individuals or companies enter into an agreement to carry on a trade or business for profit and to share in those resulting profits. A partnership is one possible business structure and is different to a sole trader or company business structure. Your accountant or lawyer can advise on the best possible business structure for you.

## **Preference Share**

A share that usually entitles its owner to a fixed dividend, the payment of which takes priority over any dividend that an ordinary shareholder is entitled to.

## **Profit**

The remaining amount once costs have been deducted from sales. Often used as a measure of a business' success. See Gross Profit and Net Profit for further information.

## **Profit and Loss Statement**

One of the main financial statements that summarises the revenues, costs, and expenses that a business has incurred over a period of time. Also known as the Income Statement.

## **R**

### **Retained Earnings**

Cumulative earnings of a company that have been retained for future re-investment or for future distribution to the company's owners.

## **S**

### **Shareholder**

An owner of one or multiple shares in a company. See Ordinary Share and Preference Share for further information.

### **Sole Trader**

A sole trader is a self-employed individual who runs their own business. A sole trader is personally responsible for any profits or losses their business makes. A sole trader is one possible business structure and differs to a business structure as a company or partnership. Your accountant or lawyer can advise on the best possible business structure for you.

### **Statement of Cash Flow**

Appears in financial statements. It provides details regarding the sources and use of cash over a given period. Information is usually presented in three sections, covering operating activities, investing activities and financing activities. Also known as a Cash Flow Statement.

### **Statement of Changes in Equity**

One of the main financial statements. It shows the changes to each shareholder's equity account over an accounting period. Also known as a Statement of Shareholders' Equity.

**Statement of Financial Position**

One of the main financial statements. It provides an overview of an entity's assets, liabilities and owner's equity at a particular point in time. Also known as a Balance Sheet.

**Stock**

Refers to the cost of raw materials, work-in-progress, and finished goods that can be sold to customers. Also known as Inventory.

**T****Turnover**

The sales of a business.

**Trade Creditor**

An amount owing to a supplier for the provision of goods or services. Also known as Accounts Payable.

**Trade Debtor**

An amount due from a customer for the provision of goods or services. Also known as Accounts Receivable.

**W****Working Capital**

Calculated by subtracting current liabilities from current assets. Refers to the amount of money or assets a business can use in its day-to-day operations.

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