Introduction to Financial Accounting

Learning Objectives

- Comfortably use **terms** like 'accounting', 'management accounting', 'financial accounting', 'financial reporting', 'financial statements', 'reporting periods', 'equity', 'asset', 'liability', 'income', 'expense', 'depreciation', 'impairment', 'current', and 'non-current', and 'IFRS'.
- Contrast the key accounting functions of **recording** and **reporting**.
- Explain the distinguishing **objective** of business and the basic **forms** of business.
- Recognise the advantages of **incorporating** a business with limited liability and describe the differences between types of companies, including between listed and unlisted companies.
- Discuss the financing, investing and operating activities of a business and the dividend decision, and describe how **financial accounting** achieves its objective of reporting the effects of these activities and decisions.
- Describe the principle of **double-entry**
- Analyse the fourteen main types of business events in terms of the accounting equation.
- Contrast the information reported using **accrual accounting** with the cash basis of accounting.

The accounting landscape

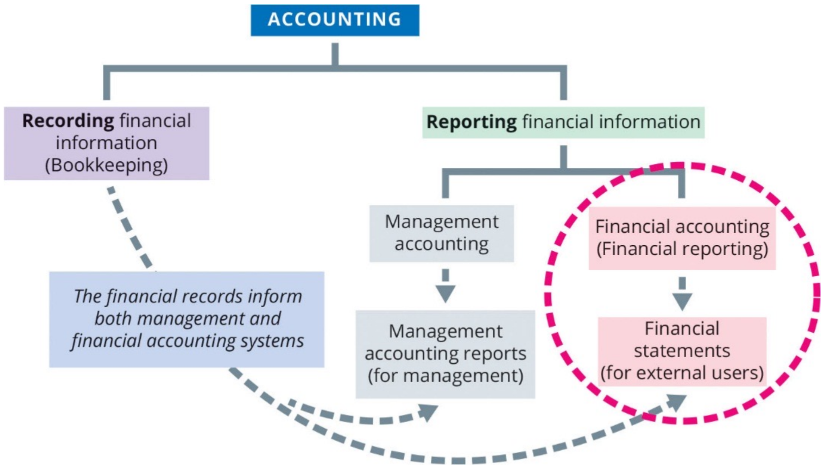
Read Chapter 1.1

- Accounting is the **recording and reporting** of financial information about an entity.
- The **entity** could be a business, a government institution, a club, a society, or even an individual or a family.
- The **principles and practices of accounting** are similar no matter what entity it is serving, although there are some small differences.
- **Recording** involves entering financial information into an accounting system, which is usually a software package.
- Two main **types of reporting**:
  - Management accounting
  - Financial accounting (also called financial reporting).

The accounting landscape

- The reports generated by financial accounting are called **the financial statements.**
- They **consist** of:
  - The statement of financial position.
  - The statement of comprehensive income.
  - The statement of cash flows.
  - The statement of changes in equity.
- In many respects, **accounting is the language of business**, and financial statements are the scorecard.

The accounting landscape



Characteristics of businesses

Read Chapter 1.2

- Businesses have **owners** who want the business to create **value** for them.
- The two commonest forms of **unincorporated businesses** are sole traders and partnerships (though some partnerships may be incorporated, depending on the jurisdiction).
- By establishing a business as a **separate legal person** entitled to own assets, owe debts, sue, and be sued, **incorporation** allows the business to transact in its own capacity.
- **Incorporation** makes it easier for business owners to sell portions of their ownership and makes it easier for accountants to record these transfers of ownership.
- Most incorporated businesses have **limited liability**.

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Characteristics of businesses

	Unincorporated businesses (eg sole traders and partnerships)	Incorporated businesses (eg companies)
Less 'red tape'	Yes	No
Owners can avoid management responsibility	No	Yes
Easy transfer of portions of ownership	No	Yes (though may be restricted)
Perpetual succession	No	Yes
Limited liability	No	Yes (though not for all types)
Tax savings	Usually better for incorporated businesses, though this depends on business size, tax rates, and other features of tax legislation	

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Characteristics of businesses

- Business law in each country usually establishes a few **different types of companies.**
- **Non-profit organisations** like charities are often able to register as companies, even though they are not businesses, as they do not aim to make their shareholders wealthier.
- With limited liability companies that are for-profit, there is generally a distinction between **private companies and public companies**.
- Shares of a **private company**, as the name suggests, may not be publicly traded, whereas a **public company's** shares are not subject to any trading restrictions.
- A public company may choose to list its shares on a **stock exchange**.

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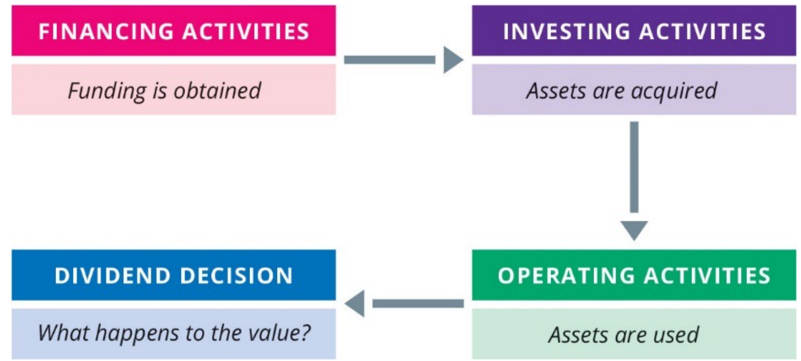
Characteristics of businesses

UNINCORPORATED BUSINESSES	INCORPORATED BUSINESSES
Sole traders	Listed public companies
	Unlisted public companies
Unincorporated partnerships	Private companies
	Other incorporated types of business

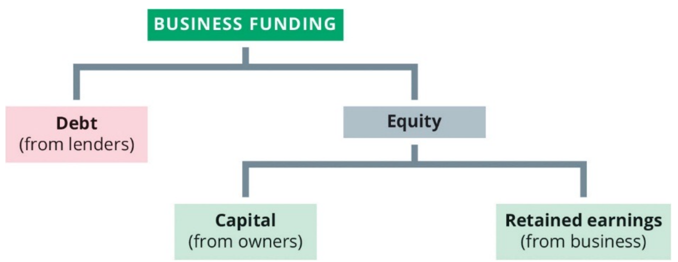
Creating business value

Read Chapter 1.3



Creating business value—financing activities

- A business is **financed through a mix of debt and equity**, called the **capital structure**.
- Debt can **leverage** up returns to owners but also increases the **risk** of a business making a loss.



Creating business value – financing activities

- Mr Cautious contributes R100 000 to the business, and his business does **not** borrow any money.
- Ms Risky also contributes R100 000 to her business, but this business **borrows** a further R100 000 from the bank at an interest rate of 8% p.a.
- Each of their businesses uses the funds raised to **invest** in assets which earn a 10% return (before interest) each year.

	Mr Cautious	Ms Risky
Return before interest (R100k * 10%, R200k * 10%)	R10 000	R20 000
Interest (R100k * 8%)	-	(R8 000)
Return after interest	R10 000	R12 000

- This wonderful effect is known as **leverage or gearing**.

Creating business value—financing activities

- What if interest rates were to **rise** to 25%?

	Mr Cautious	Ms Risky
Return before interest	R10 000	R20 000
Interest (R100k * 25%)	-	(R25 000)
Return after interest	R10 000	(R5 000)

We can see from this example one of the great **trade-offs** in business, if not in life: **you cannot get greater returns without taking on more risk**.

Creating business value—investing activities

- Once the business has **raised funding**, it must do something with this money.
- The resulting **investing activities** might include procuring an office building, constructing a factory, acquiring another business, investing in a brand, developing a new consultancy service, or purchasing a million other things.
- The items a business acquires for use in the value creation process are called **'assets'**.

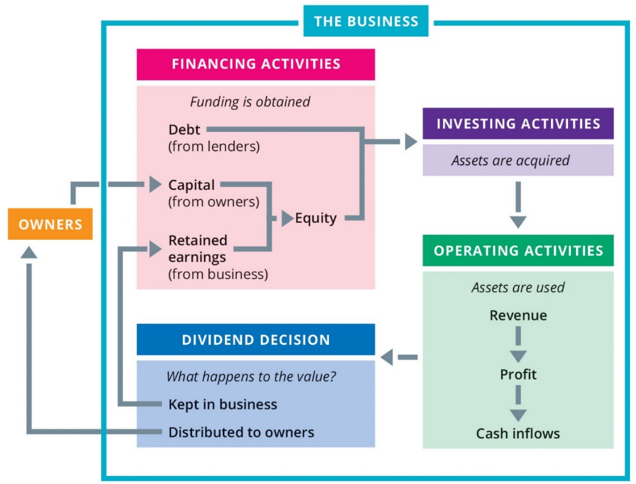
Creating business value—operating activities

- To create value, a business's operating activities must use its assets to **generate revenue and earn profit** and then convert the profit into **net operating cash inflows**.
- **Operating activities** include manufacturing, maintenance, software development, marketing, administration, and everything else that happens in a business each day to achieve the sale of its goods or services.
- Not only do these processes need to run **efficiently and effectively**, but key operating decisions need to be made well.
- These **decisions include** the price at which goods or services are sold, the way in which costs are controlled, the extent to which advertising is used to promote goods and services, whether key functions are outsourced, etc.

Creating business value—dividend decision

- Also called the **distribution decision**.
- Value can either be kept in the business as retained earnings or paid out as **dividends**.
- Earnings that are **retained** are used to fund further growth.
- In **theory,** rational investors should prefer for value to be retained by a business (especially if there are good growth prospects).
- In **practice,** psychological factors influence the dividend decision
- The dividend decision has a **signalling effect** in financial markets: a deviation from expectations is understood to be an important indicator of the business's prospects.

Creating business value—big picture



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The financial accounting system

Read Chapter 2.1

INPUTS	PROCESS	OUTPUTS
Transactions & other business events	Double-entry bookkeeping & year-end reporting procedures	Financial statements

ASSETS = EQUITY + LIABILITIES

ASSETS – LIABILITIES = EQUITY

- **Assets** are items that we control, such as inventory, motor vehicles, buildings, patents, accounts receivable, etc.
- **Liabilities** are amounts that we owe to others, such as bank loans and accounts payable.
- **Equity** is the accounting value of the owners' claim on the business.

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The financial accounting system

- Equity is often referred to as **'book value'** or **'net asset value'.**
- **Income** is defined as any increase in equity that is not caused by a contribution by owners.
- An **expense** is any decrease in equity not caused by a distribution to owners.
- The **five elements** of accounting are assets, liabilities, equity, income, and expenses.

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Underlying assumptions

- **Accrual accounting** reports the effects of transactions when the transactions themselves occur, not necessarily when cash changes hands.
- **Going concern** is the assumption that an entity will continue to operate in the foreseeable future.

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The financial accounting system

- In accounting, the information relating to each type of asset, liability, equity, income, and expense is stored in a single place, called an **account**.
- Every transaction has **two distinct effects** on the accounts.
- One effect is called a **debit** and the other is a **credit**.
- This is described as the **'double-entry'** accounting system.
- Unless an error has been made, the debits always **equal** the credits.

Assets	–	Liabilities	=	Equity
Increases are debits		Increases are credits		Increases are credits
Decreases are credits		Decreases are debits		Decreases are debits

Example: Dream Team

Dream Team is a business which buys and sells pillows. The following transactions took place during the financial year that ended 31 December 20x1:

1. The owner deposits R100 000 into the business' bank account.
2. Raised a loan from the bank of R50 000, which was deposited into the business' bank account on 1 January.
3. Purchased stock for R90 000 on credit.
4. Sold stock with a cost of R30 000 for R52 000 cash.
5. Paid R5 000 for electricity used.
6. On 31 December, paid interest on the loan for the 20x1 year at a rate of 15% p.a.
7. On 31 December, repaid R25 000 of the bank loan.
8. The owner withdrew R3 000 cash from the business for personal use.

How do the transactions affect the financial position of the business in terms of A = E + L?

Next module: Introduction to Recording and Reporting