Università
della
Svizzera
italiana

Facoltà
di
scienze
economiche

Principles of Accounting

01 – Introduction

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Chapter 1 - Objectives

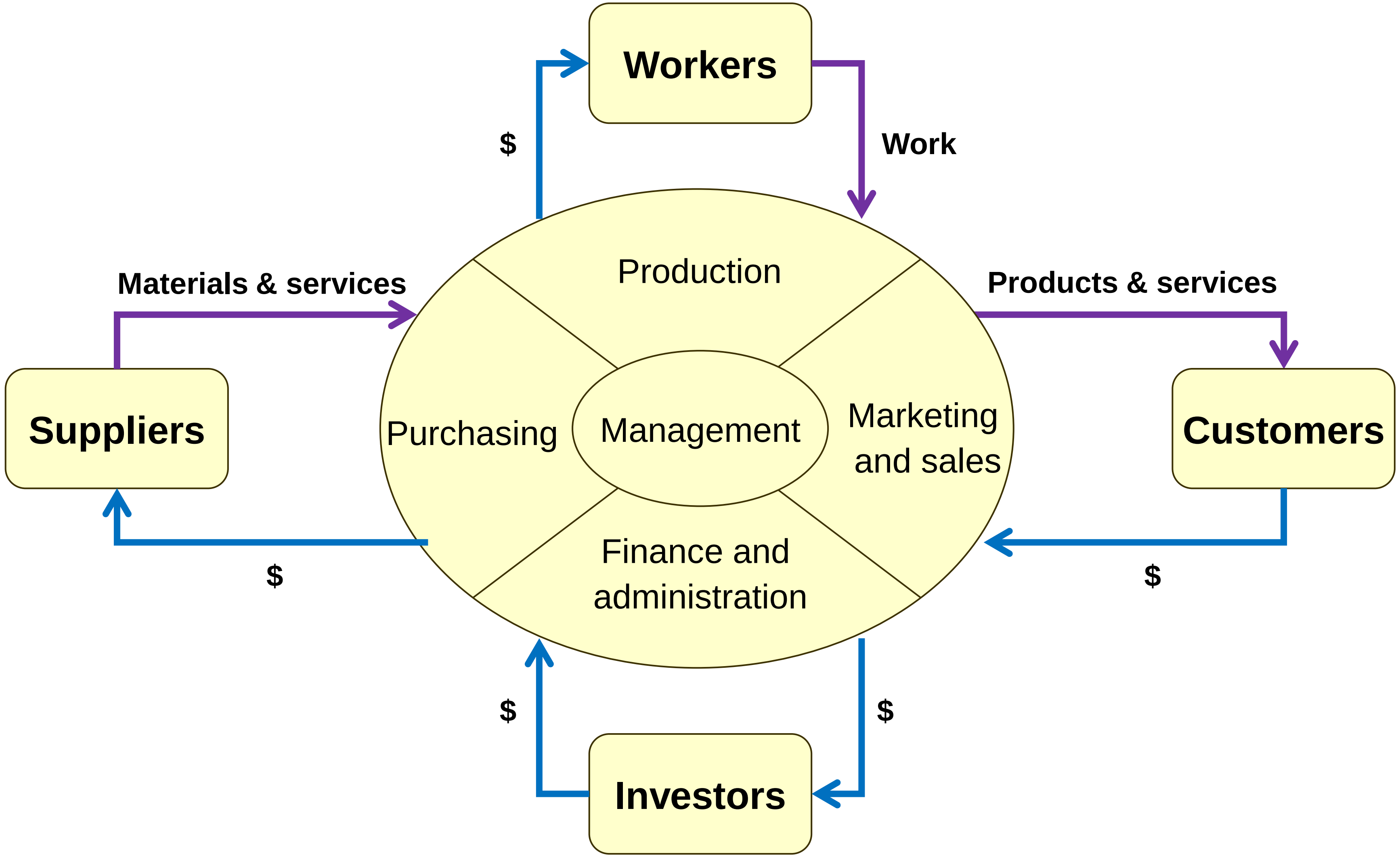
Goals

- Understand the importance and purposes of accounting for the management of a firm
- Understand the business management cycle (financing, investing, production and sale)
- Understand the importance of profitability, liquidity and solvency
- Understand the role of accounting as an internal and external information system
- Know the structure of a company's accounting system

Teaching materials

- Nosetti O. (1992), Introduzione alla contabilità finanziaria, Chapters 1-3

The company as an open system



Businesses are **open autonomous systems**.

They maintain **exchanges with various external entities**.

They acquire resources from investors, suppliers, workers etc. and transform them into products and services for their customers.

Adapted from: Nosetti O. (1992), *Introduzione alla contabilità finanziaria*, p. 7

The company as an open system – Monetary exchanges

The acquisition of productive resources and the sale of products & services take place as **monetary exchanges**

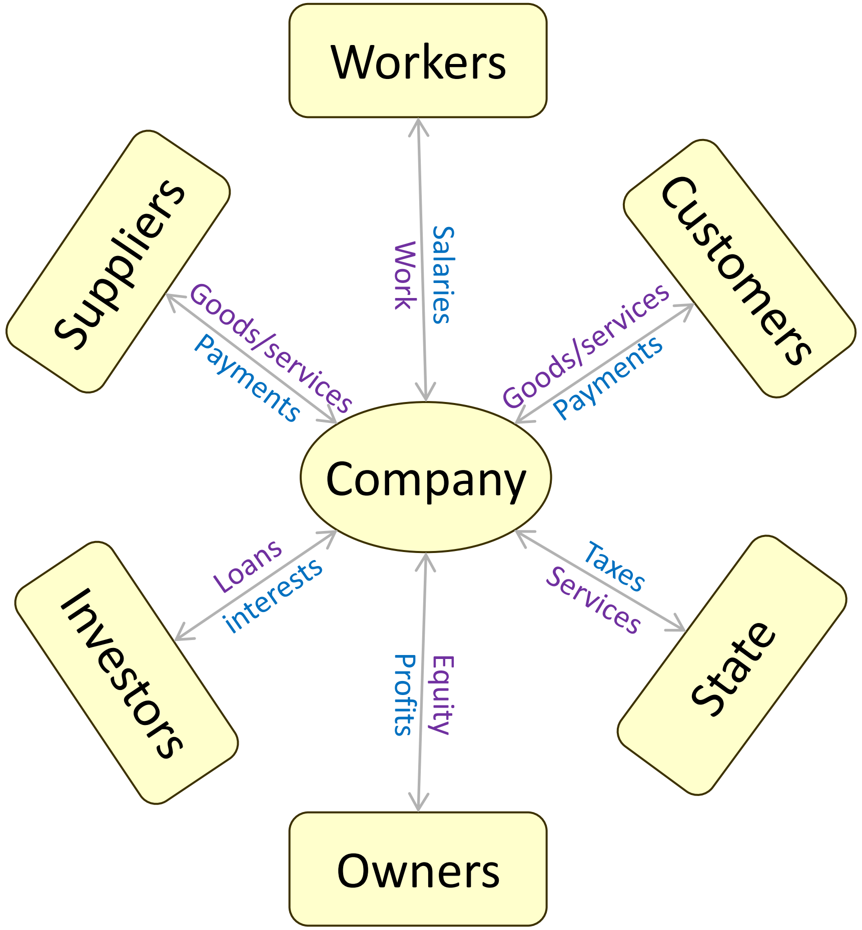
- An exchange typically involves the transfer of **goods & services** in exchange for a given amount of **money** (which equals their value)
- The company may be in a position to
  → **purchase** (e.g. materials, trade goods, services, workforce etc.)
  → **sales** (e.g. products and services to customers)
- The money can be paid:
  → **immediately** (on cash → a cash inflow or outflow is generated)
  → **in the future** (on credit → a credit or debt is generated)

Two aspects are therefore important which we can define as "**monetary**" and "**economic**"

The company as an open system – Objectives

The purpose of a company generally encompasses three objectives that should be achieved jointly:

- satisfy **customer needs** by designing, producing, distributing and marketing goods or services that satisfy their needs
- satisfy **social expectations** by offering a fair reward to all the stakeholders who contribute to the functioning of the company by providing the necessary resources (including a fair **profit** to the owners)
- be able to **operate economically** in a way that is sustainable over time and in conditions of financial autonomy



The company as an open system – Management balances

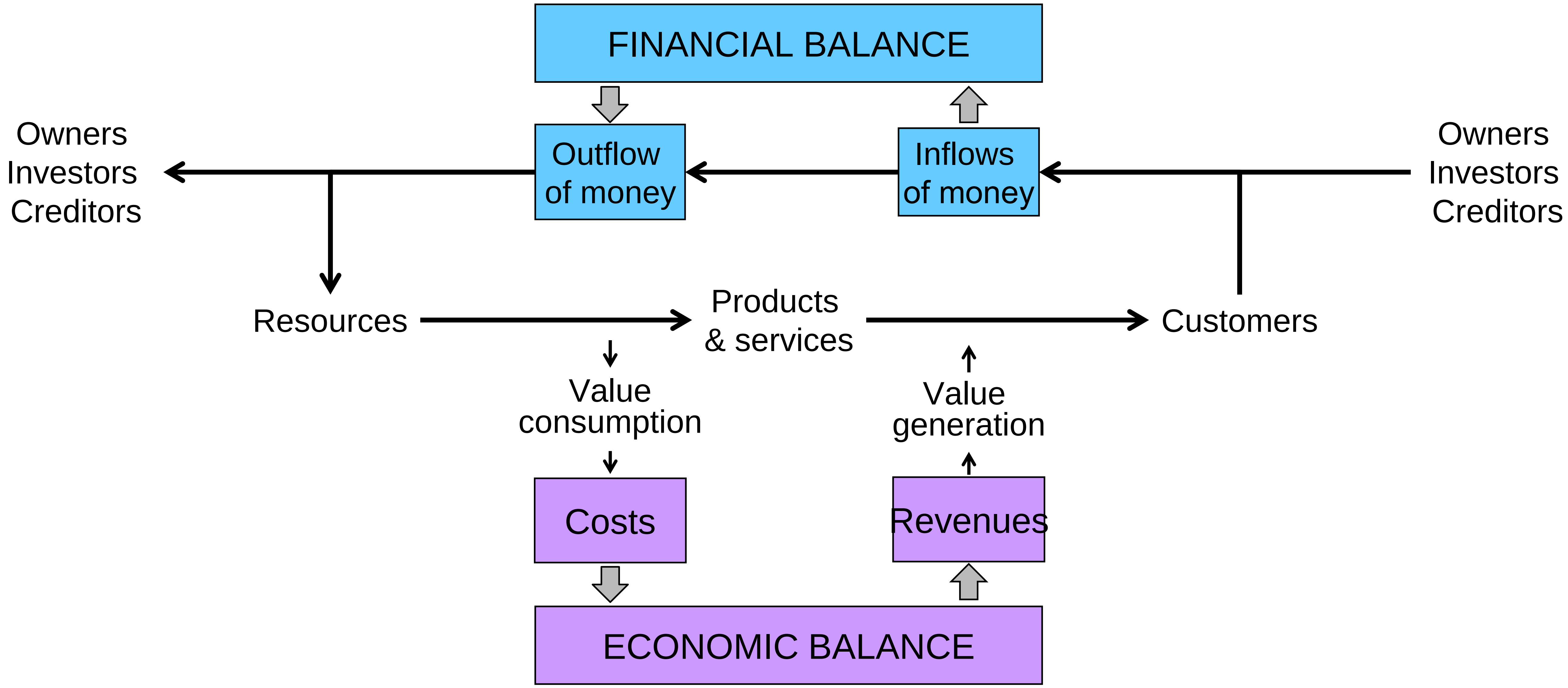
To operate economically, sustainably and in financial autonomy, the company:

- must be able to meet its short term commitments
→ **LIQUIDITY**
- must be able to meet its long term commitments even against adverse situations
→ **SOLVENCY**
- must be able to generate enough profits to adequately compensate its investors
→ **PROFITABILITY**

This requires managing and balancing 3 fundamental aspects:

- **financial balance**: the ability to manage **inflows** and **outflows of money** to be able to honor your obligations in time
- **patrimony balance:** the ability to maintain enough **equity** (**assets** - **liabilities**) to cope with adversity and pay long term obligations
- **economic balance**: the ability to create sufficient **revenues** to cover the **costs** and generate enough profits

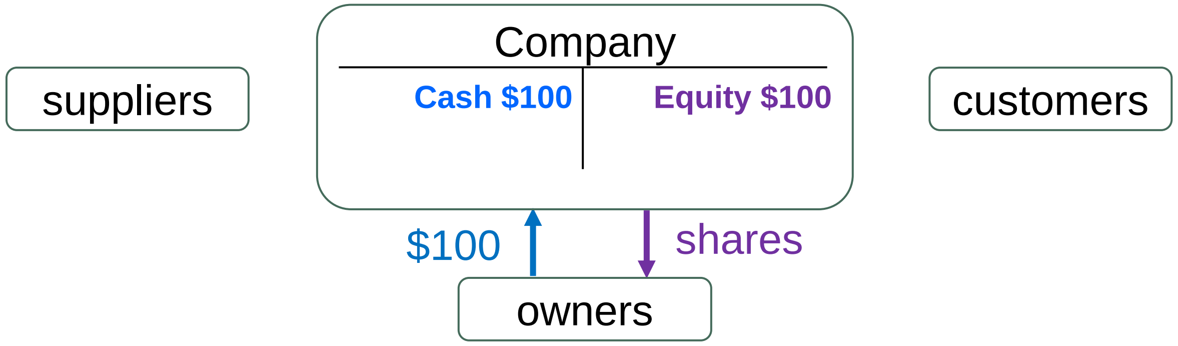
Economic and financial balance



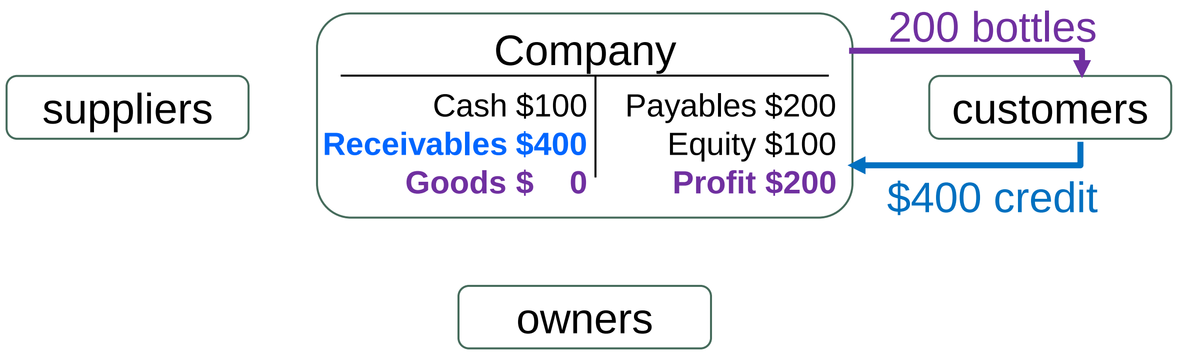
Adapted from: Ferrari D. (2012), course "The basics of financial accounting", SUPSI

Example of financial imbalance

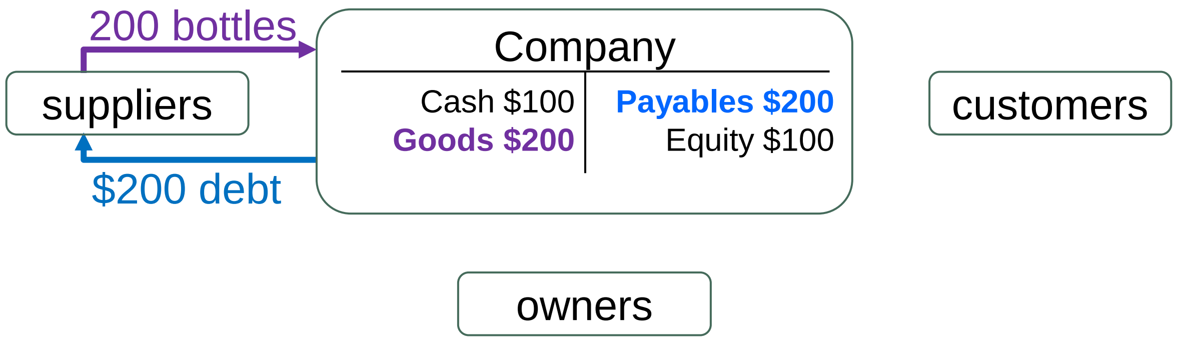
1) The owners invest $100 in the company



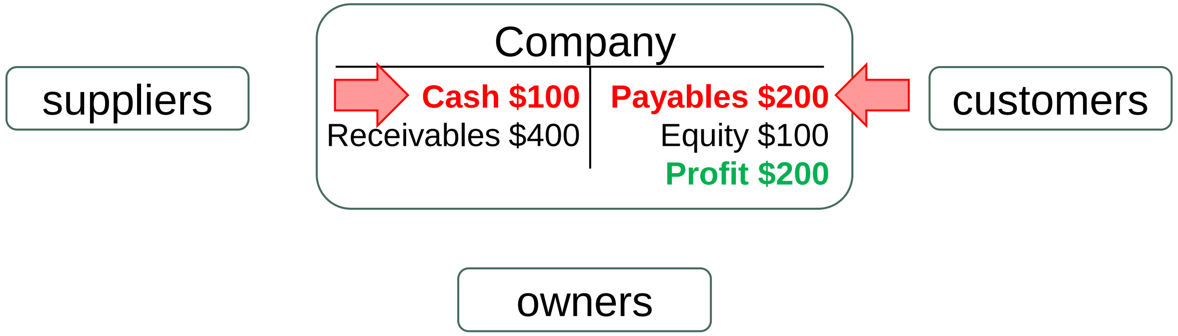
3) The company sells all merchandise for $400 on credit (200 bottles at $2 each, thus realizing a profit of $200)



2) The company buys merchandise on credit (200 bottles for $1 each)

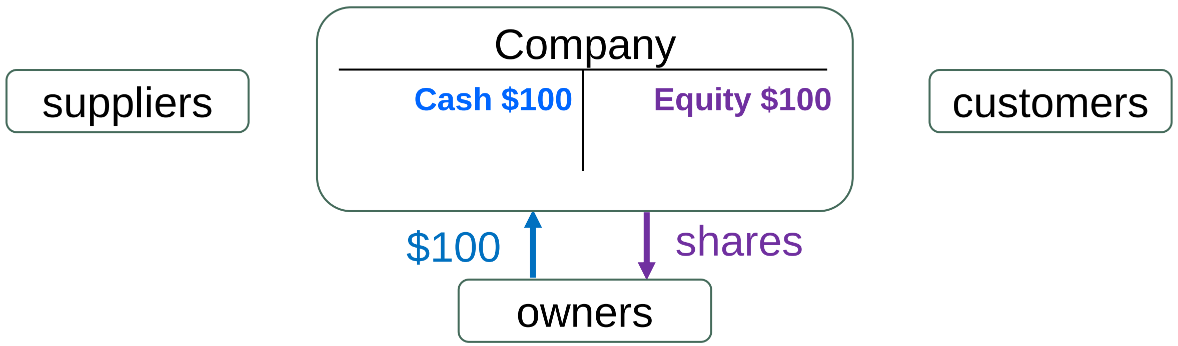


4) What happens if customers don't pay before debts to suppliers expire ?

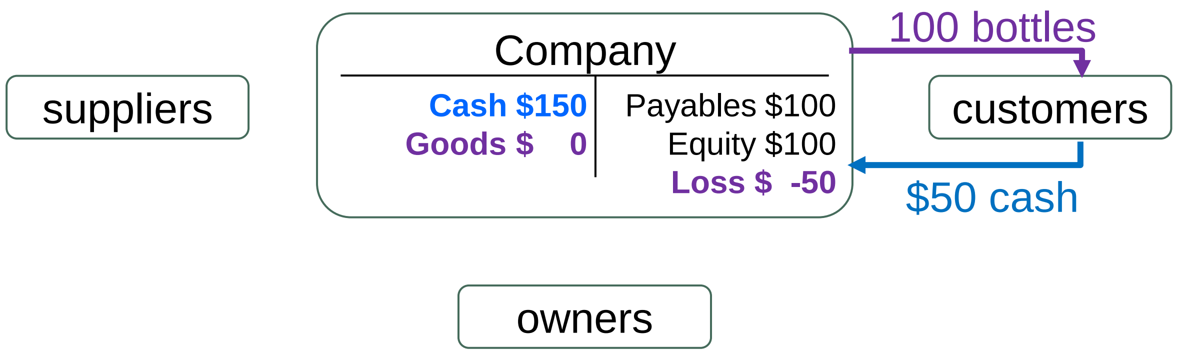


Example of economic imbalance

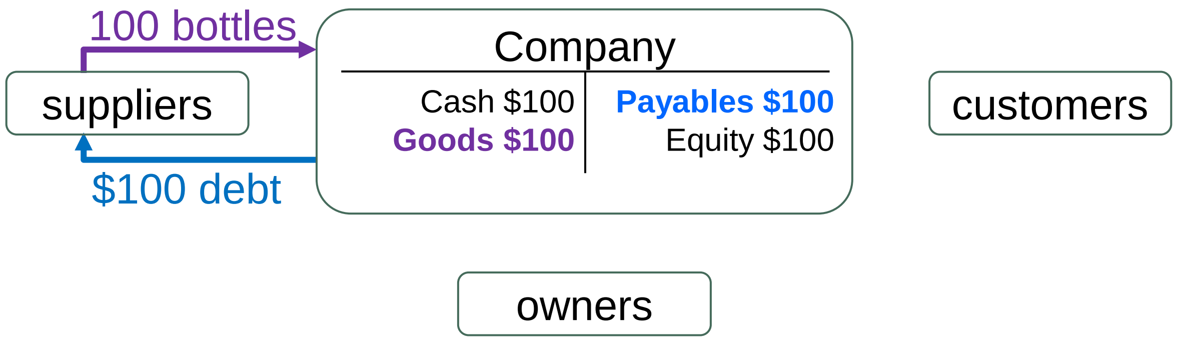
1) The owners invest $100 in the company



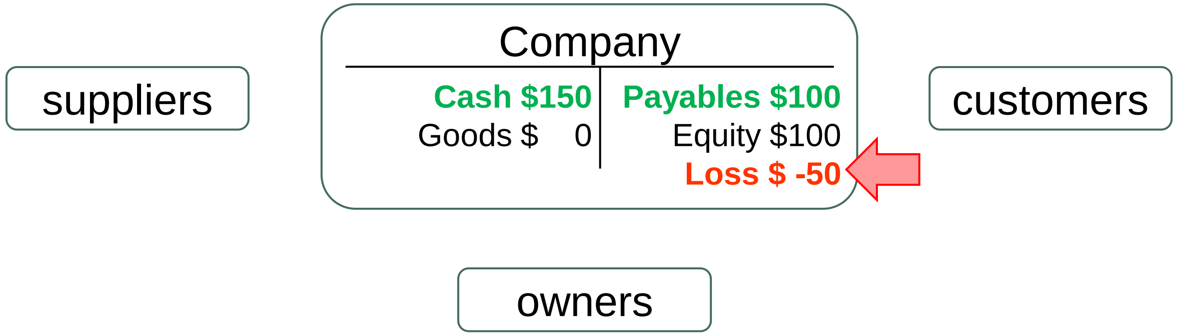
3) The company sells all merchandise for $50 on cash
(100 bottles at $0.50 each, thus realizing a loss of $50)



2) The company buys merchandise on credit
(100 bottles for $1 each)



4) What happens if the company continues to sell
at one price lower than the costs ?



Importance of economic and financial balance

- Economic balance +

SHORT-TERM RISK The company is healthy but lack of liquidity can kill it in the short term	**ALL IS GOOD** The company is healthy, it will be able to last and generate value for its owners
GREAT RISK The company is at risk of failing in the short term unless there is a rapid turnaround	**LONG-TERM RISK** The company can survive for a while but will fail if the business model does not change

- Financial balance +

Both are:

- **necessary**
  → to survive (oxygen)
  → to thrive (food)

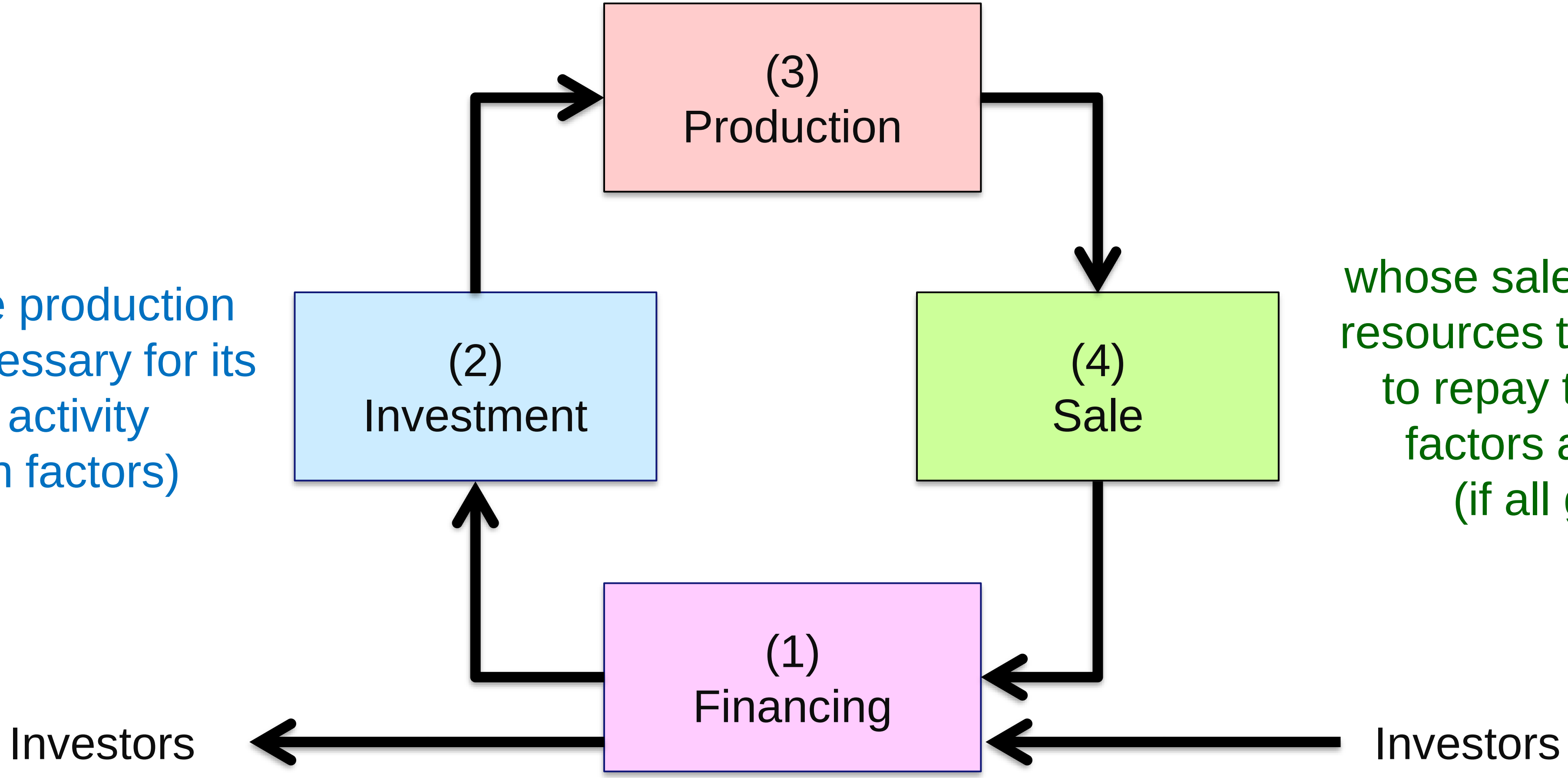
- **interrelated**
  → resorting to loans will generate interest costs ;
  → generating losses, will leat to a lack of money sooner or late

Adapted from: Davlila A., Oyon D. (2012), *Malea Fashion District* , 2ed

The business management cycle

that will be consumed to produce,
market and sell products or services

to acquire the production resources necessary for its business activity (production factors)



whose sale generates new resources that can be used to repay the production factors and investors (if all goes well).

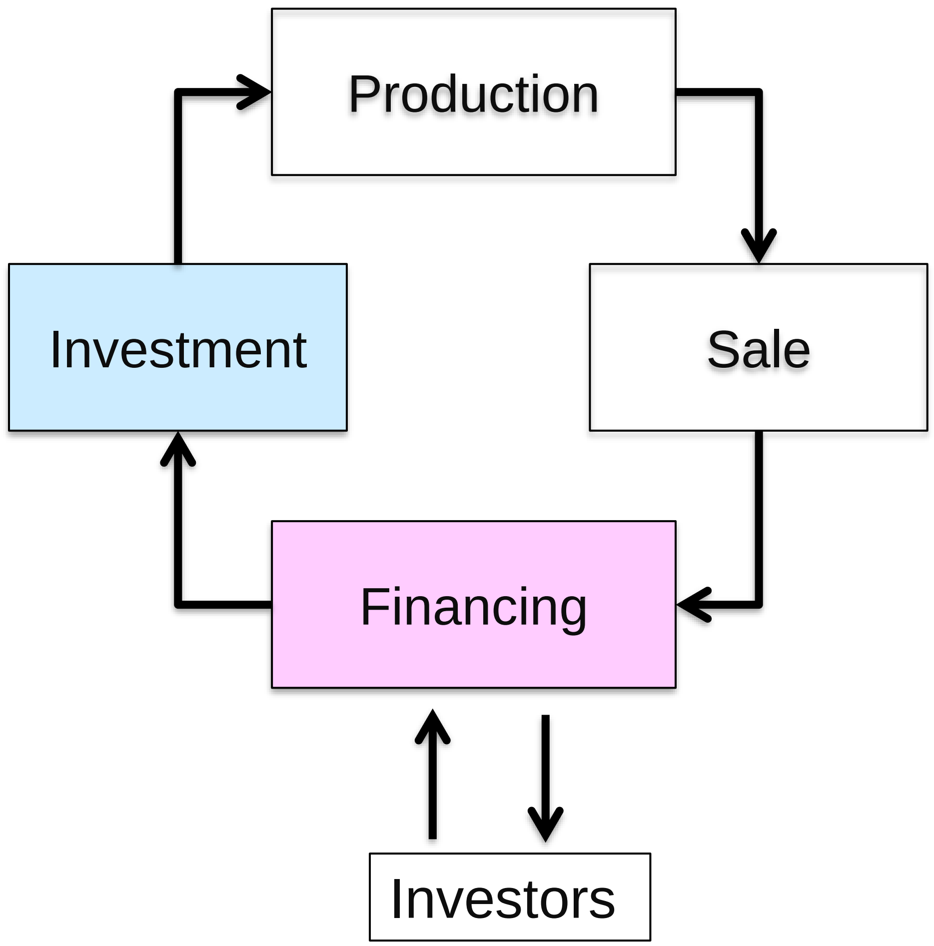
a company must get
sufficient financial capital

The business management cycle → Balance sheet

To run a business you need to find enough financial capital to acquire the resources necessary for the business.

- The capital might come from owners or other investors. For the company they are **financing**; in accounting they are called **equity** (given by owners) **liabilities** (given by third parties).
- The capital is used to acquire the production means required by the company's activity. For the company they are **investments**; in accounting they are called **assets.**

These are two faces of the same entity, the **patrimony**, seen as what the company owns (assets) and what it owes to others (liabilities + equity). They are summarized in the **balance sheet**. Being faces of the same entity → **assets = liabilities + equity**



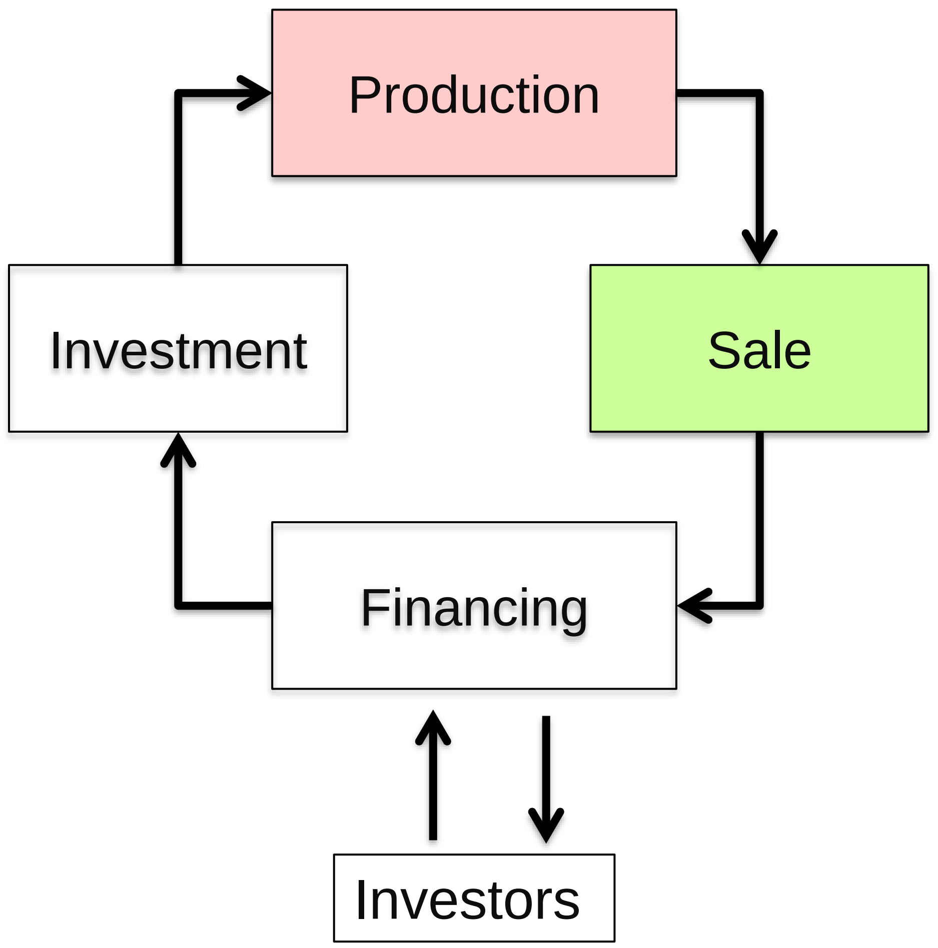
The business management cycle → Income statement

The assets are used to carry out the company's activities, which typically consist of transforming productive factors into goods and services that are sold to customers.

- This is done through various **”production” activities** (design, manufacture and sell products and services, managing the company…) that use resources (materials, workforce, energy, etc.) whose consumption generates **costs**.

- The products and services are finally provided, through **sales**, to customers, who in exchange pay a monetary value to the company. In accounting, this value is called **revenue**.

These two aspects generate the **net income**. If revenues exceed costs, the result is a **profit**; if costs exceed revenues it is a **loss**. In accounting they are summarized in the **income statement** .



The business management cycle – Examples of operations

financial transactions	Accounting analysis	Financial statements

1. Mr. Trucker wants to create a freight transport company. To do this he decides to draw on his savings and pays 50’000 in cash to the company’s bank account.

Where do the resources come from?
Since the financing comes from the owner, 50’000 are recorded as **equity**.

How are the resources used?
At the moment the cash is left in the company’s bank account: the **assets** therefore include 50’000 as **bank**.

	Assets	BALANCE SHEET		Liabilities	
(+50)	Bank	50'000	Equity	50'000	(+50)

Costs	INCOME STATEMENT	Revenues

2. The company buys a truck by paying 40’000 in cash.

How are the resources used?
The total assets don’t change, but their composition does as **bank decreases** by 40’000 (from 50’000 to 10’000) and the vlaue of **vehicles increases** by 40’000 (from 0 to 40’000).

	Assets	BALANCE SHEET		Liabilities
(–40)	Bank	10'000	Equity	50'000
(+40)	Vehicles	40'000		

Costs	INCOME STATEMENT	Revenues

The business management cycle – Examples of operations

financial transactions	Accounting analysis
3. To carry out its activity, the company spends 2’000 on fuel, 5’000 on staff and 1’000 on rent for the premises (all payments are made in cash from the bank account). The depreciation of the truck amounts to 4’000.	**What resources are consumed?** Resources like fuel, staff and rent are entirely consumed in the period and are directly recorded as **costs**. Trucks are used for several years so they only consume part of their value in the period (also a **cost**). This **reduces the value of assets** (bank and vehcles) **and the net income** (for now a loss of 12’000, which will be part of the equity).
4. The company sells transportation services to customers for 20’000. This amount was entirely collected in cash during the period.	**What revenues are generated?** The value of the services sold to customers constitutes **revenues**. This **increases** the value of the **assets** (bank) as well as the **net income** (for now a profit of 12’000, which will be part of the equity).

Financial statements

	Assets	BALANCE SHEET	Liabilities		
(–8)	Bank	2'000	Equity	50'000	
(–4)	Vehicles	36'000	Net loss	- 12'000	(-12)
	Costs	**INCOME STATEMENT**	**Revenues**		
(+2)	Fuel	2'000			
(+5)	Personnel	5'000			
(+1)	Rent	1'000			
(+4)	Depreciation	4'000			
(-12)	Net loss	- 12'000			

	Assets	BALANCE SHEET	Liabilities		
(+20)	Bank	22'000	Equity	50'000	
	Vehicles	36'000	Net income	8'000	(+20)
	Costs	**INCOME STATEMENT**	**Revenues**		
	Fuel	2'000	Revenues	20'000	(+20)
	Personnel	5'000			
	Rent	1'000			
	Depreciation	4'000			
(+20)	Net income	8'000			

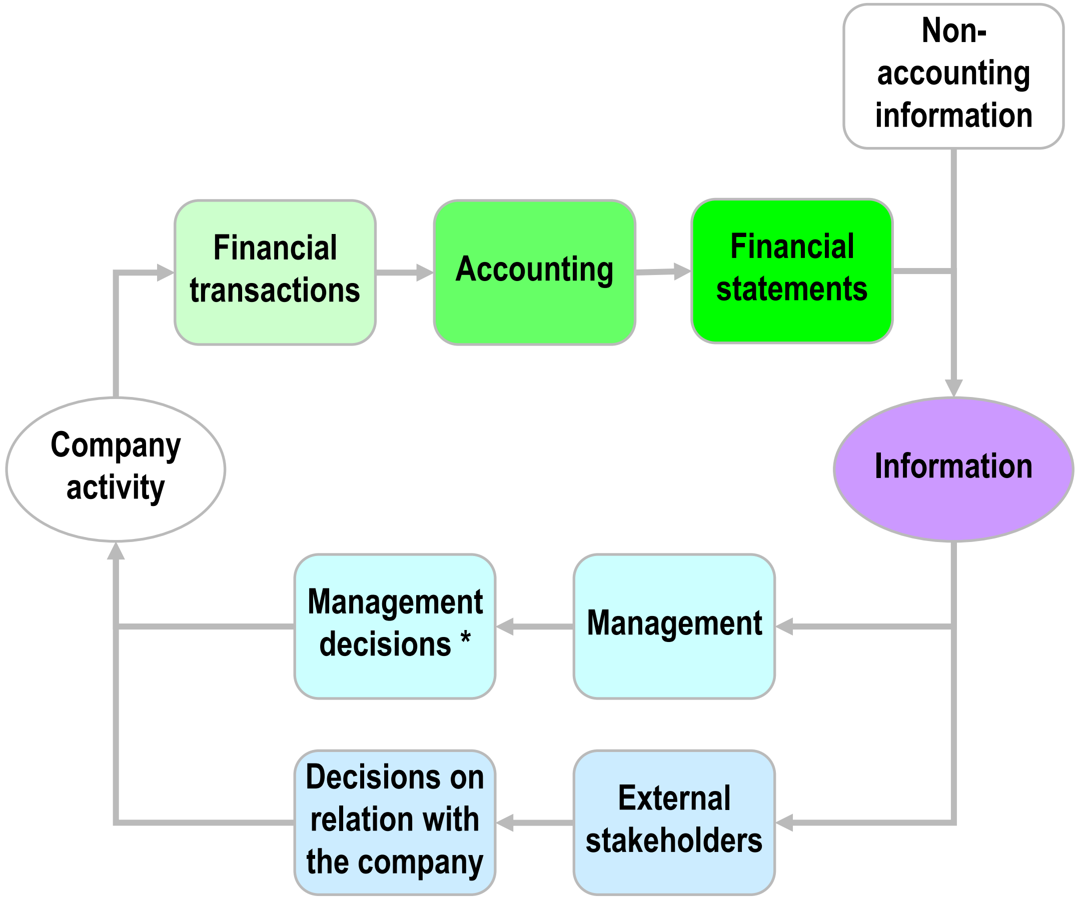
The purpose of accounting

So far we have seen that:

- the company entails monetary exchanges with other entities
- these exchanges generate economic and/or financial impacts
- economic and financial balances are important

From this we can deduce the purpose of accounting:

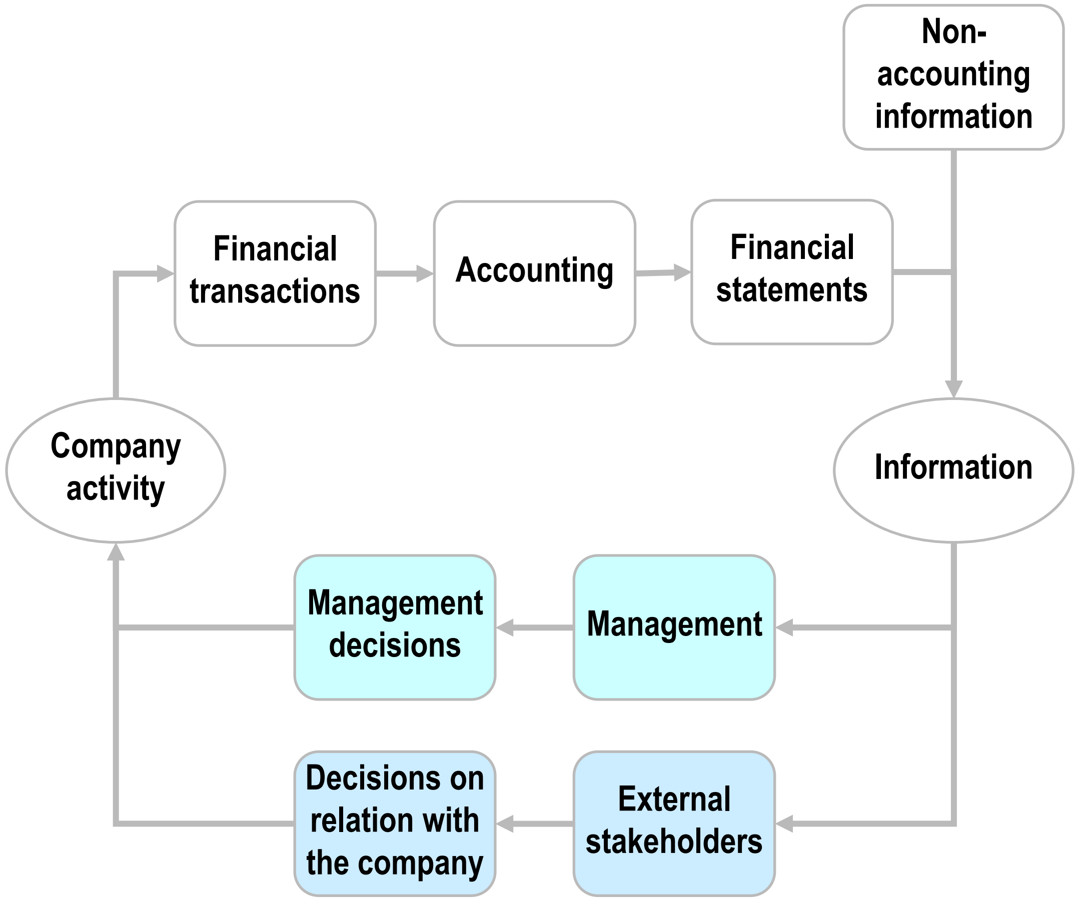
- **keep track of financial transactions** (monetary exchanges)
- in order to detect, analyze and **record the monetary and economic impacts** of each business transaction
- to produce **information** summarized in financial statements showing **the financial and economical situation** of the firm
- so that different stakeholders can **make decisions**



The purpose of accounting – The users

The information that can be obtained from the financial statements is useful for many **internal and external users** aving different objectives in studying the data:

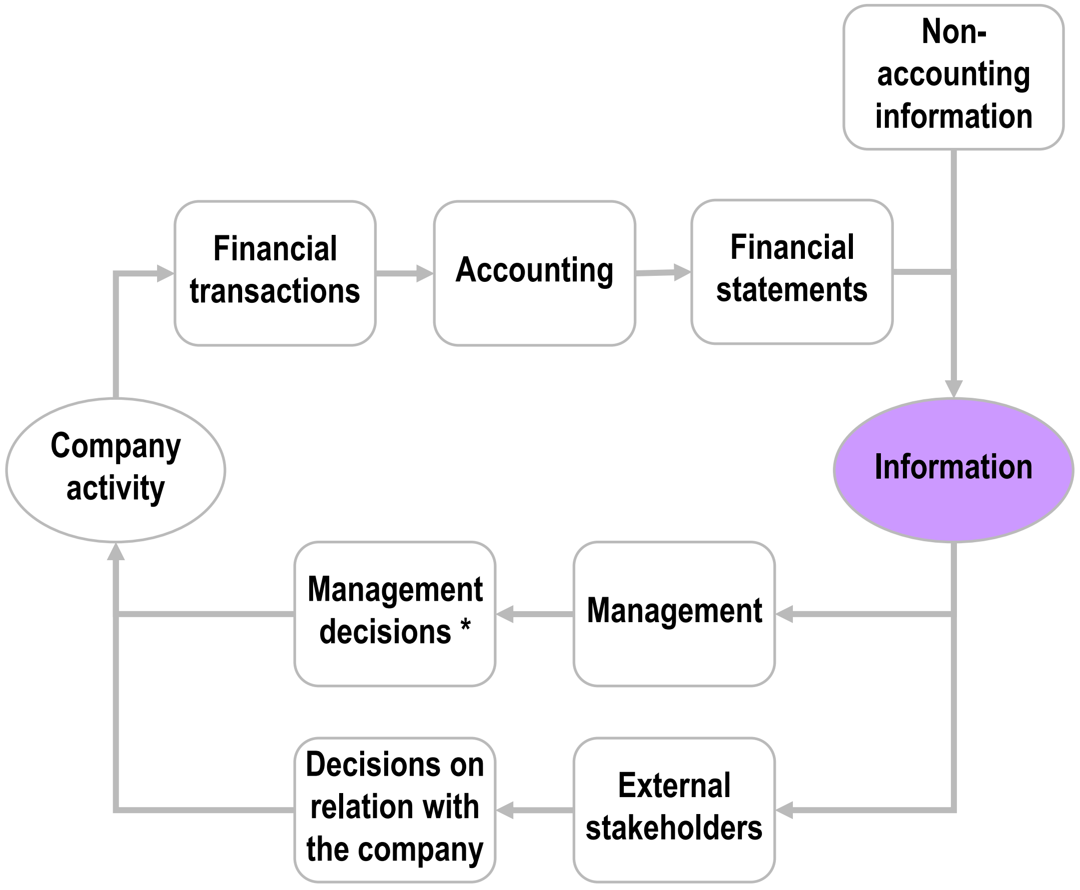
- **Management** (make management & control decisions…)
- **Owners** (evaluate risks and returns, dividends…)
- **Lenders** (evaluate whether to grant loans...)
- **Providers** (decide to provide goods/services on credit…)
- **Public entities** (set taxes, check law compliance...)
- **Customers** / **Workers** / …



The purpose of accounting – Information

The users are typically interested in verifying whether the company is able to operate economically and be financially autonomous. This requires 3 conditions:

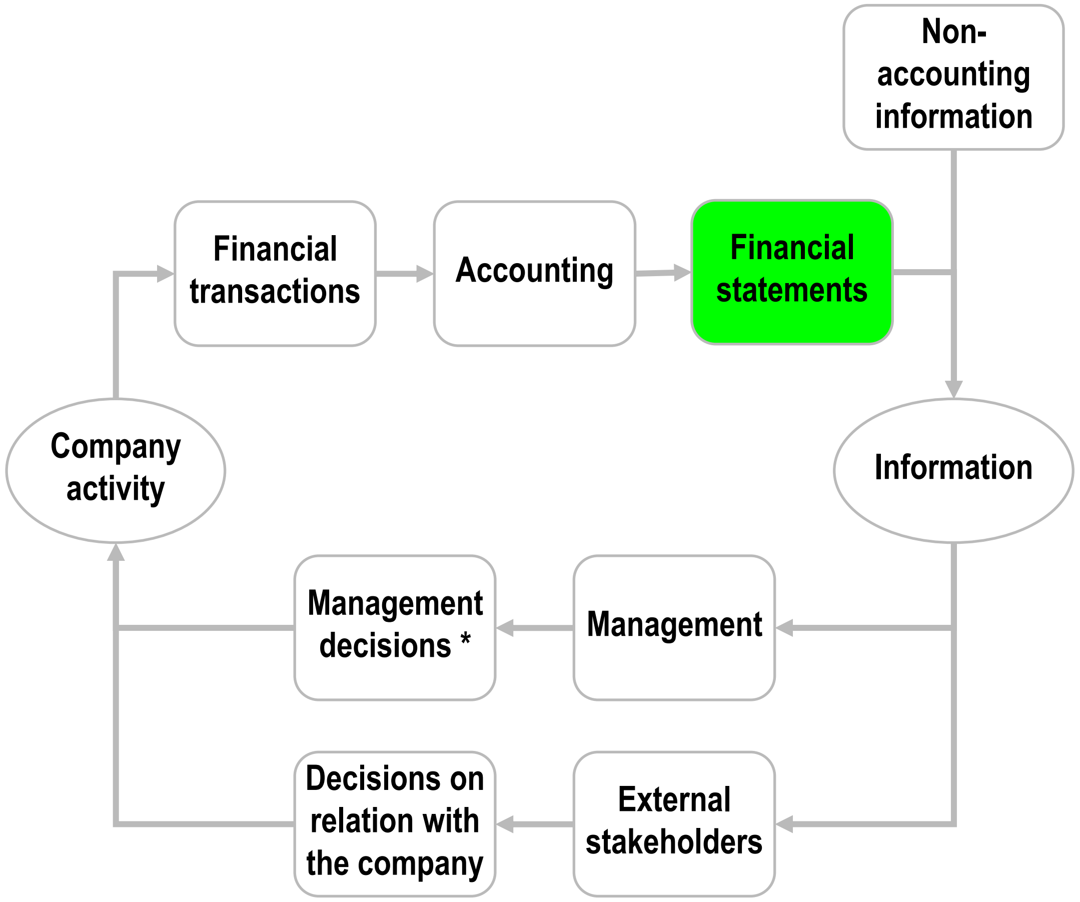
- financial balance (**LIQUIDITY**): the ability to manage inflows and outflows of money to be able to **honor short-term commitments on time**
- patrimony balance (**SOLVENCY)**: the ability to **honor long-term commitments** and survive even in the event of adversities
- economic balance (**PROFITABILITY**): the ability to generate enough profits with **revenues to cover the costs** and provide an adeguate return to the owners



The purpose of accounting – Financial statements

To inform on its asset, financing and earning position, the firm periodically prepares an annual account with:

- **Balance sheet**: shows the **assets** and financing position (**liabilities** and **equity**) of the company at a given date, typically at the beginning and ending of the period
- **Profit and loss account (income statement)**: shows the earnings of the company over the period, etailing the **revenues**, **costs** and **net income**
- **Cash flow statement** (required only for large companies): shows the amount of cash generated (cash inflows) and consumed (cash outflows) in the period.
- **Notes to the accounts**: shows additional information that supplement and explain the other financial statements

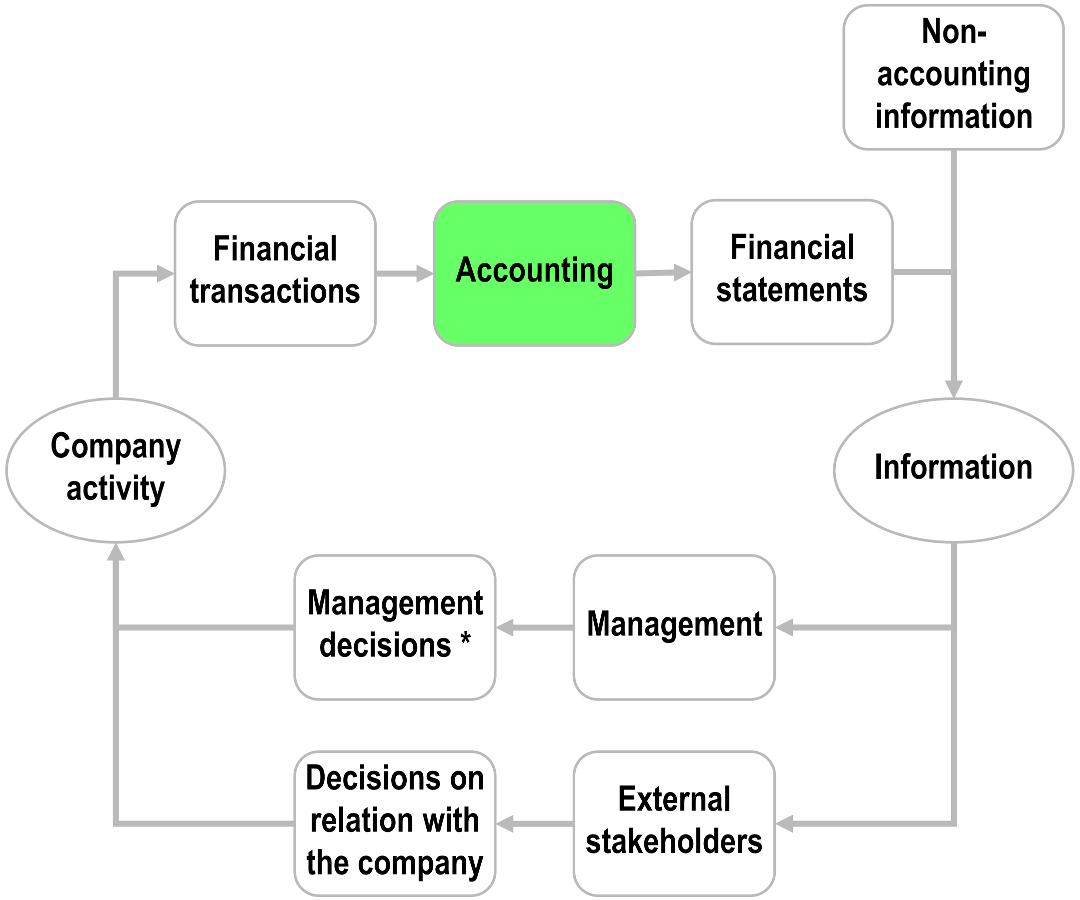


The purpose of accounting – Accounting

Accounting is the art of **recording, classifying and summarizing** in a significant manner and in terms of money, **transactions** and event which are, in part at least, of a financial character (AICPA)

Accounting is a cyclical activity that involves identifying transactions, recording them in a **journal** using a **chart of accounts**, posting them to a **ledger,** calculating ending balances for each account and feed them in the financial statement.

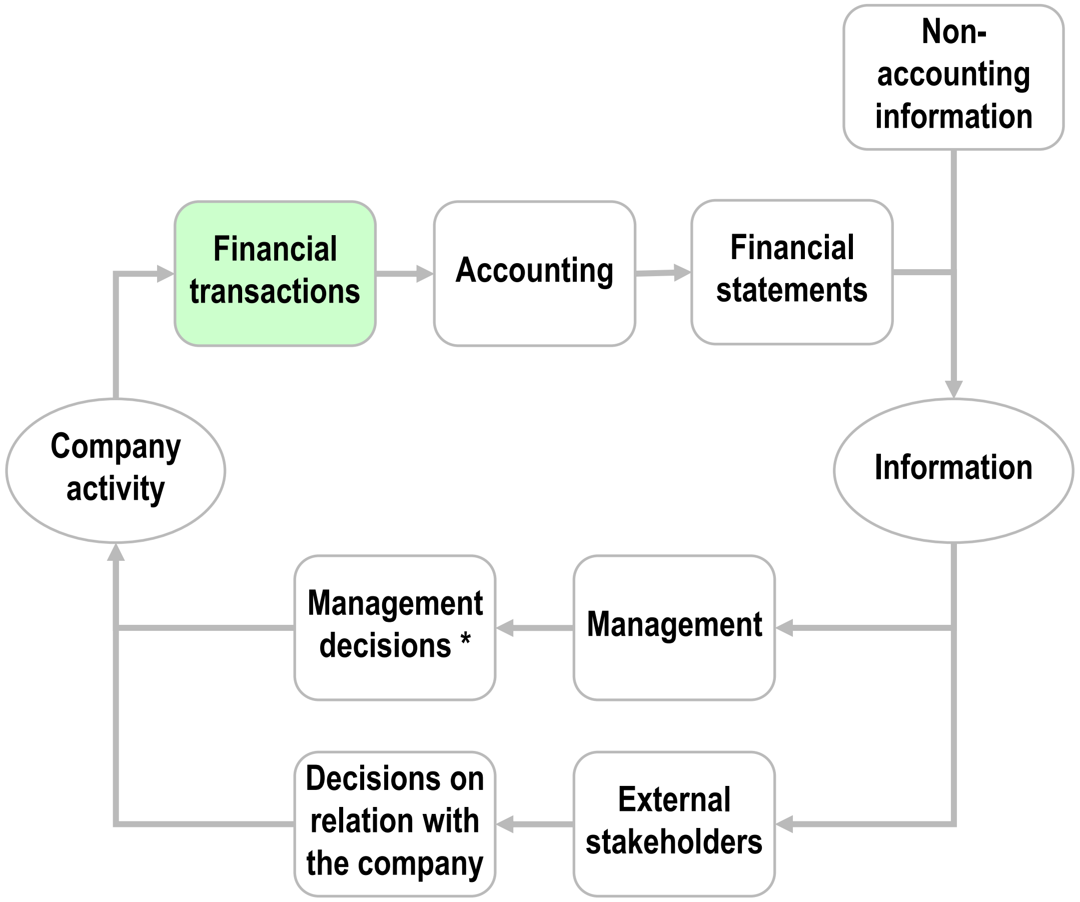
Transactions are recorded with a double-entry method that considers both the **financial/asset** and **economic** aspects of the transaction.



The purpose of accounting – Financial transactions

Accounting starts by identifying **financial transactions** and events that modify the company's economic, financial or asset situation. They can be external with third parties (like financing, purchases, sales, etc.) or internal (transformation activities). From an accounting perspective, the only relevant transaction are those that:

- **produce effects that are quantifiable in monetary terms** reliably: all elements of assets and income are measured with their value in money, creating a homogeneous unit of measurement (**homogeneity** principle)
- Have an impact on **the assets or income of the company**, considered as a distinct entity with respect to its owners, therefore distinguishing corporate and private assets/income (**entity** principle)



The purpose of accounting - According to law

The Swiss Code of Obligations highlights the information purpose of accounting is:

Art. 957*a*

[1] Accounting forms the basis for financial reporting. It records the transactions and circumstances that are required to present the asset, financing and earnings position of the undertaking (the economic position).

In other words, accounting:

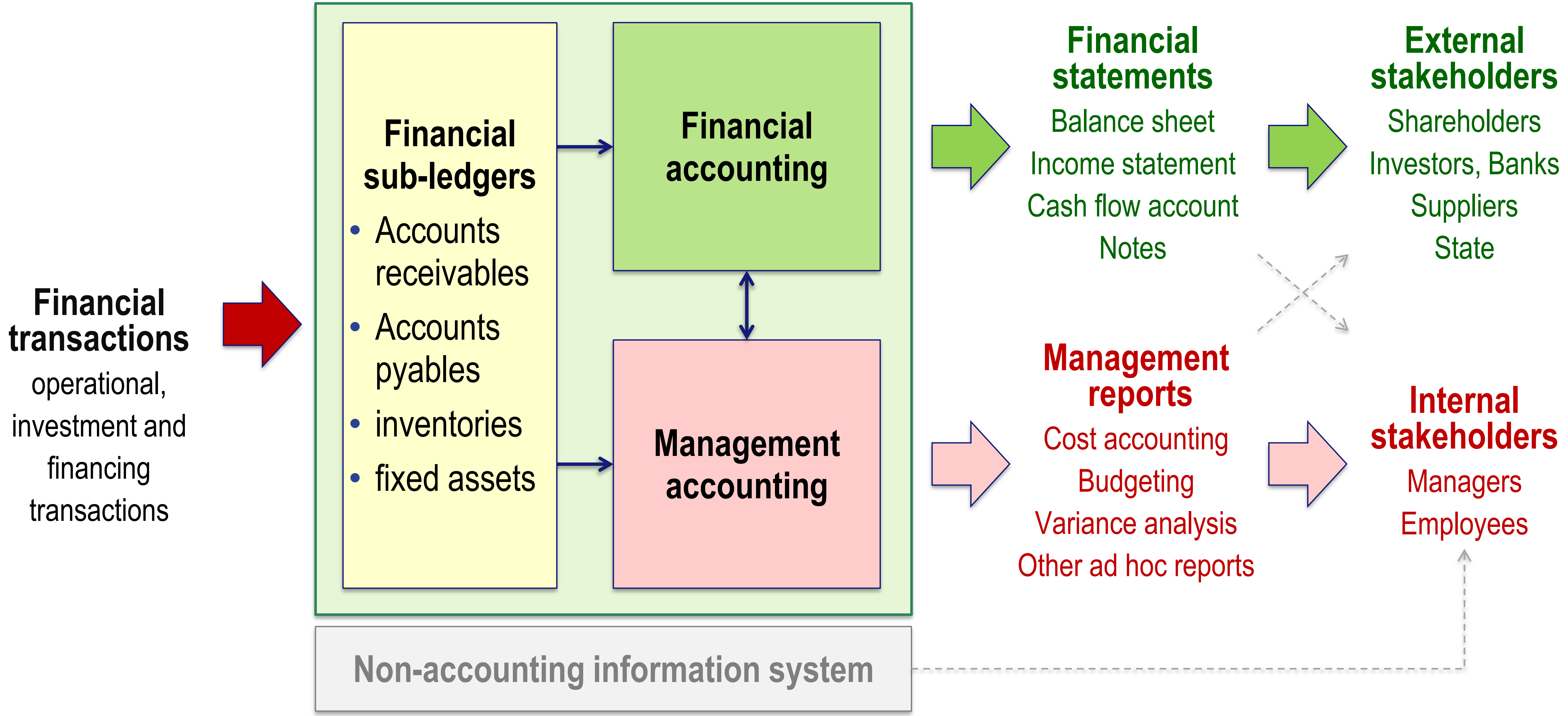
starts from the recording of **financial transactions**

which are systematically recorded by the **accounting system**

to produce **information** on the asset, financing and earnings

so that various **recipients** can make decisions

The structure of the accounting system



Financial accounting vs. managerial accounting

Financial accounting

- **Records transactions** & summarizes them in **financial statements** (balance sheet, income statement, cash flow statement)
- Has an **historical perspective**
- Emphasis on **precision and verificability**
- Mainly aimed at **external users** (owners, investors, suppliers, state,…)
- **Mandatory** and must conform to a set of **standards and rules**

Management accounting:

- **Supports decision-making processes** providing **internal eports** that are useful for planing, deciding and controlling.
- Has a **future perspective**
- Emphasis on **timeliness and relevance**
- Mainly aimed at **internal users** (managers and employees)
- **Not mandatory** and can be **adapted to the specific needs** of each company