Accounting definition Balance sheet and Income statement

Principles and Practices of Business Finance

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Agenda

1. What is Accounting.
2. Main users of financial information
3. Accounting answers three basic questions
4. Accounting Standards and main assumption
5. Financial Statements
6. Accounting Items
7. Balance sheet statement
8. Income statement

What is Accounting?

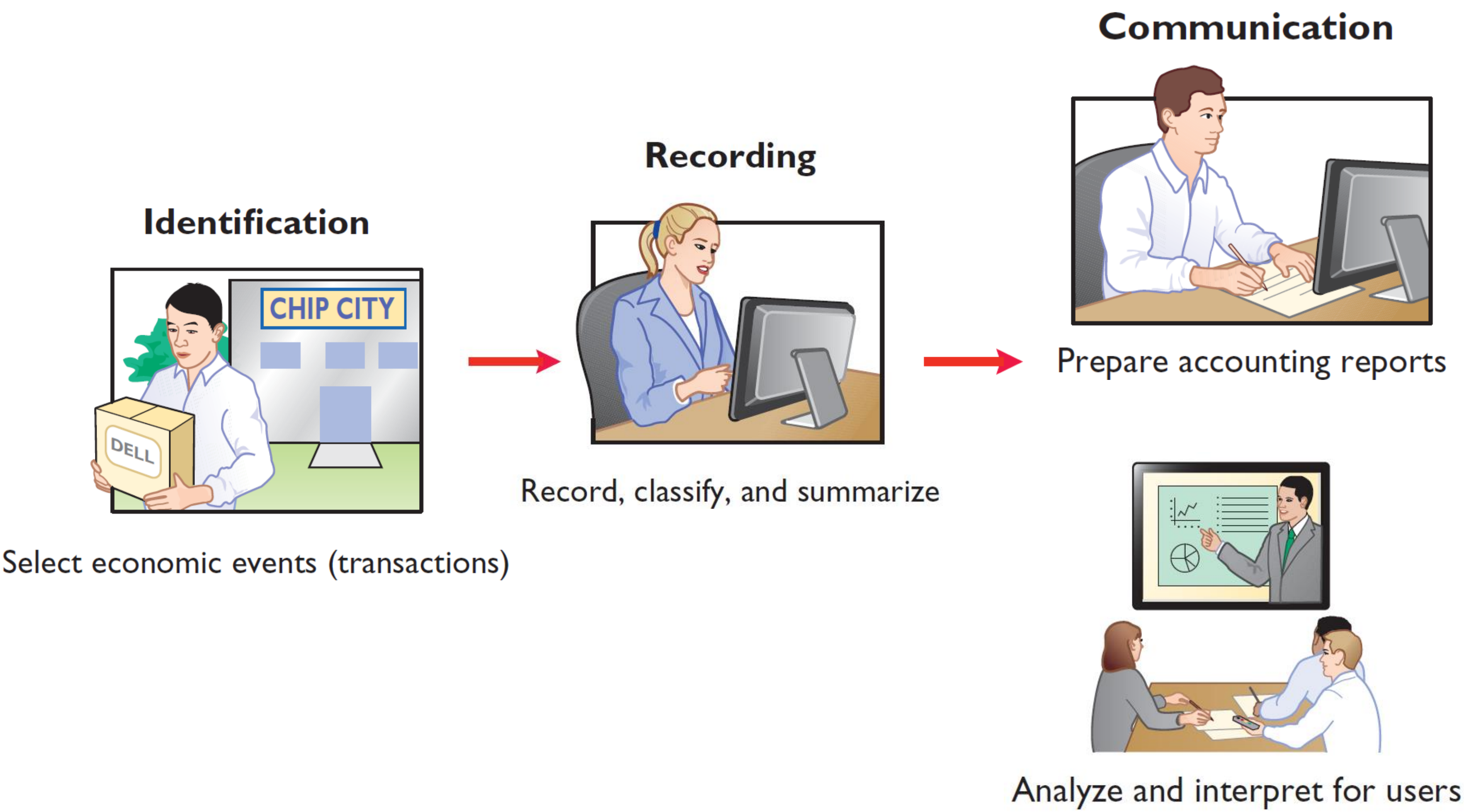
The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.

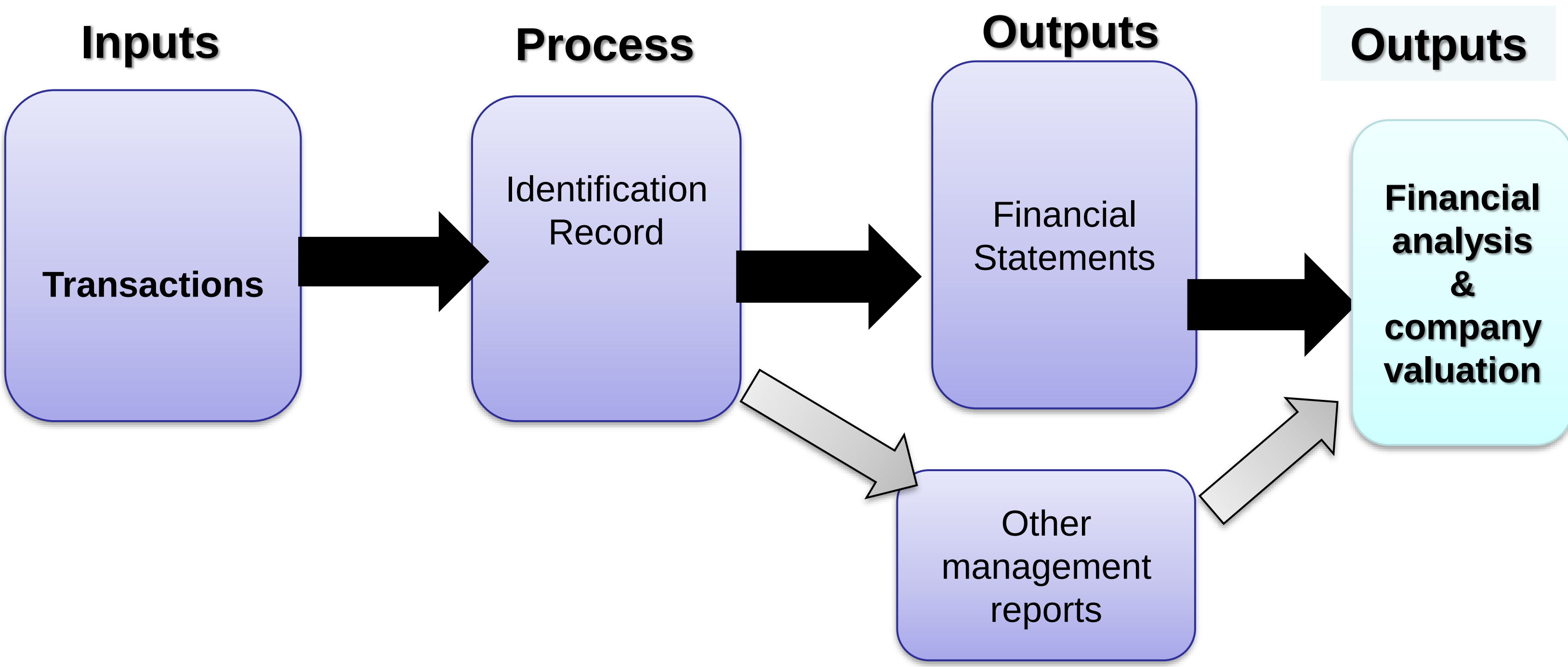
consists of three basic activities—it

- **identifies**,
- **records**, and
- **communicates**

the economic events (transactions) of an organization to interested users.

Accounting Three Activities




Inputs
Transactions
Process
Identification
Record
Outputs
Financial
Statements
Other
management
reports
Outputs
Financial
analysis
&
company
valuation

Main users of financial information

Who Uses Accounting Data?

Internal parties within the organization
Owners
Managers
Employees

What kind of information do they need and why?

External parties outside the organization
Customers
Lenders
Suppliers
Competitors
Government
Investment analysts

Users of financial information are interested in…

Owners	Evaluate management + profitability
Managers	Information about the financial situation → for making proper decisions
Employees	Information about the financial situation → future career + wages and salaries
Customers	The company is a secure source of supply and there is no danger of having to close down
Lenders	To ensure that the company is able to pay interest payments
Suppliers	The company’s ability to pay its debts
Competitors	Information about the financial situation
Government	Activities of the company, statistical information
Investment analysts	Information for their clients or audience

Accounting answers three basic questions

1. What profit has the business made?
2. How much does the business own?
3. How much does the business owe to others?

Accounting Standards and main assumption

International Accounting Standards Board (IASB) http://www.iasb.org/

International Financial Reporting Standards

Financial Accounting Standards Board (FASB) http://www.fasb.org/

Generally Accepted Accounting Principles (GAAP)

Accounting main assumption is the Accruals basis which means that we recognize and record any revenue and income and expenses whenever they are earned or incurred without waiting until cash is paid or received.

Financial Statements

- Financial statements are formal records of a company's financial activities that provide information about its financial performance and position.

✓ The balance sheet,

✓ Income statement,

✓ Cash flow statement,

✓ Statement of change in equity.

✓ Notes to financial statement

Accounting Items

The elements of financial statements

- Assets
- Liabilities
- Equity
- Revenues
- Expenses

Balance sheet statement

Basic Accounting Equation

- Provides the **underlying framework** for recording and summarizing economic events.
- Assets **must** equal the sum of liabilities and equity.

Assets = **Liabilities** + **Equity**

The classification of assets

Assets are resources which the business owns

Non-current/Fixed assets

- The business wants to keep and use for more than one year
- Tangible fixed assets
- Intangible fixed assets
- Investment assets

Current assets

- Converted into cash or consumed within one year
- Inventory
- Trade debtors/Accounts Receivable
- Cash at bank and cash in hand

The classification of liabilities

Liabilities: Claims owed by the business to someone else.

Current liabilities

- Amounts for payment due within one year
- Trade creditors / Accounts payable
- Bank overdraft
- Short-term credit

Non-current liabilities

- Amounts due for payment over more than one year
- Long-term loans
- Bonds issued by the company

Owners' Equity

Equity: the claim of the owner(s) against the business

- Parts of the Owners' Equity section of the Balance Sheet for a sole trader:
  - ➢ Opening capital (+)
  - ➢ Capital injections (+)
  - ➢ Profit/loss for the year (+/-)
  - ➢ Drawings (-)

The Accounting equation

Non-current assets + Current assets = Equity + Non-current liabilities + Current liabilities

Example

Apple Inc.

CONSOLIDATED BALANCE SHEETS
(In millions, except number of shares, which are reflected in thousands, and par value)

	September 28, 2024	September 30, 2023
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 29,943	$ 29,965
Marketable securities	35,228	31,590
Accounts receivable, net	33,410	29,508
Vendor non-trade receivables	32,833	31,477
Inventories	7,286	6,331
Other current assets	14,287	14,695
Total current assets	152,987	143,566
Non-current assets:		
Marketable securities	91,479	100,544
Property, plant and equipment, net	45,680	43,715
Other non-current assets	74,834	64,758
Total non-current assets	211,993	209,017
Total assets	$ 364,980	$ 352,583
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	$ 68,960	$ 62,611
Other current liabilities	78,304	58,829
Deferred revenue	8,249	8,061
Commercial paper	9,967	5,985
Term debt	10,912	9,822
Total current liabilities	176,392	145,308
Non-current liabilities:		
Term debt	85,750	95,281
Other non-current liabilities	45,888	49,848
Total non-current liabilities	131,638	145,129
Total liabilities	308,030	290,437
Commitments and contingencies		
Shareholders' equity:		
Common stock and additional paid-in capital, $0.00001 par value: 50,400,000 shares authorized; 15,116,786 and 15,550,061 shares issued and outstanding, respectively	83,276	73,812
Accumulated deficit	(19,154)	(214)
Accumulated other comprehensive loss	(7,172)	(11,452)
Total shareholders' equity	56,950	62,146
Total liabilities and shareholders' equity	$ 364,980	$ 352,583

Impact of business transactions on the balance sheet

Balance Sheet of the *Business* as at *Date*

	£'000	£'000		£'000	£'000
Current assets			**Current liabilities**		
Inventories	25		Trade creditors		25
Trade debtors	20				
Bank	40				
		85			
			Non-current Liabilities		
Non-current (=Fixed) assets			LT Loan		20
Premises	25				
Vehicle	5		**Equity**		80
Machine	10				
		40			
		125			125

1, Increase in an asset = increase in a source of finance

Illustration:

Purchased inventories on credit, £ 15,000

Balance Sheet of the *Business* as at *Date*

	£'000	£'000		£'000	£'000
Current assets			**Current liabilities**		
Inventories	**40**		**Trade creditors**		**40**
Trade debtors	20				
Bank	40		**Non-current Liabilities**		
		100	LT Loan		20
Non-current assets					
Premises	25		**Equity**		80
Vehicle	5				
Machine	10				
		40			
		140			**140**

2, Increase in a source of finance = decrease in an other source of finance

Illustration:

Bank provides £ 25,000 short term loan to pay out trade creditor

Balance Sheet of the *Business* as at *Date*

	£'000	£'000		£'000	£'000
Current assets			**Current liabilities**		
Inventories	40		**Trade creditors**	**15**	
Trade debtors	20		**ST Loan**	**25**	
Bank	40				**40**
		100			
Non-current assets			**Non-current Liabilities**		
Premises	25		LT Loan		20
Vehicle	5				
Machine	10		**Equity**		80
		40			
		140			140

3, Decrease in an asset = decrease in a source of finance

Illustration:

Trade creditor is paid out from bank account

Balance Sheet of the *Business* as at *Date*

	£'000	£'000		£'000	£'000
			Current liabilities		
Current assets			**Trade creditors**	**0**	
Inventories	40		ST Loan	25	
Trade debtors	20				**25**
Bank	**25**				
		85	**Non-current Liabilities**		
Non-current assets			LT Loan		20
Premises	25				
Vehicle	5		**Equity**		80
Machine	10				
		40			**125**
		125			

4, Increase in an asset = decrease in an other asset

Illustration:

Trade debtor pays £ 10,000 to bank account

Balance Sheet of the *Business* as at *Date*

	£'000	£'000		£'000	£'000
			Equity		80
Current assets			**Non-current Liabilities**		
inventory	40		LT Loan		20
Trade debtors	**10**		**Current liabilities**		
Bank	**35**		Trade creditors	0	
		85	ST Loan	25	
Non-current assets					25
Premises	25				
Vehicle	5				
Machine	10				125
		40			
		125			

Income statement

Profit (or loss) for the period **=** **Total revenue for the period *less* Total expenses incurred in generating that revenue**

Relevant concepts

- ***Realization concept***

  Sales are recognized when goods are transferred to the customers, irrespective of when payment is made for them. Profit arises when sales takes place.

- ***Matching concept (Accrual basis)***

Expenses are recorded in the same accounting period as the revenues they help generate.

The layout of the income statement

Sales revenue

less

Cost of sales

equals

Gross profit

less

Operating expenses

equals

Operating profit

less

Financial expenses

equals

Profit for the period

Accounting terms

- Gross profit: revenue from sales – cost of sales
- Operating profit: gross profit – operating expenses (salaries, rent etc.)
- Profit for the period (= net profit): operating profit – financial expenses (interest paid on borrowings)

Income statement for the year ended 31 December 2013

	£
sales revenue	112,000
Cost of Sales	42,000
Gross profit	**70000**
Salaries and wages	(20,000)
Rent and rates	(12,000)
Electricity	(2,500)
Telephone and postage	(2,500)
Insurance	(2,500)
Motor vehicle running expenses	(2,500)
Depreciation	(3,000)
Operating profit	**35,000**
Interest on borrowings	3,000
Profit for the period	**32,000**

Income statement & Balance sheet

Income Statement 31-12-2024	
	£
sales revenue	112,000
Cost of Sales	42,000
Gross profit	**70000**
Salaries and wages	(20,000)
Rent and rates	(12,000)
Gheat and light	(2,500)
Telephone and postage	(2,500)
Insurance	(2,500)
Motor vehicle running expenses	(2,500)
Depreciation	(3,000)
Operating profit	**35,000**
Interest on borrowings	3,000
Profit for the period	**32,000**

Balance sheet 31-12-2024	
	£
Assets	
Current assets	
Inventories	23,000
Trade receivables	18,000
Cash at banks	12,000
	53,000
Non-Current assets	
Property	45,000
plant and equipment	30,000
Motor vans	19,000
	94,000
Total Assets	**147,000**
Equity and Libilities	
Current Liabilities	
Trade Payables	37,000
Non Current labilities	
Long term borrowing	50,000
Equity	
Capital	28,000
Retained earnings	32,000
	60,000
Total equity and liabilities	**147,000**

Relationship between I/S and B/S

Profit belongs to the owners.

The accounting equation can be extended to: