

Accounting fundamentals

Business – Chapter 30

Overview

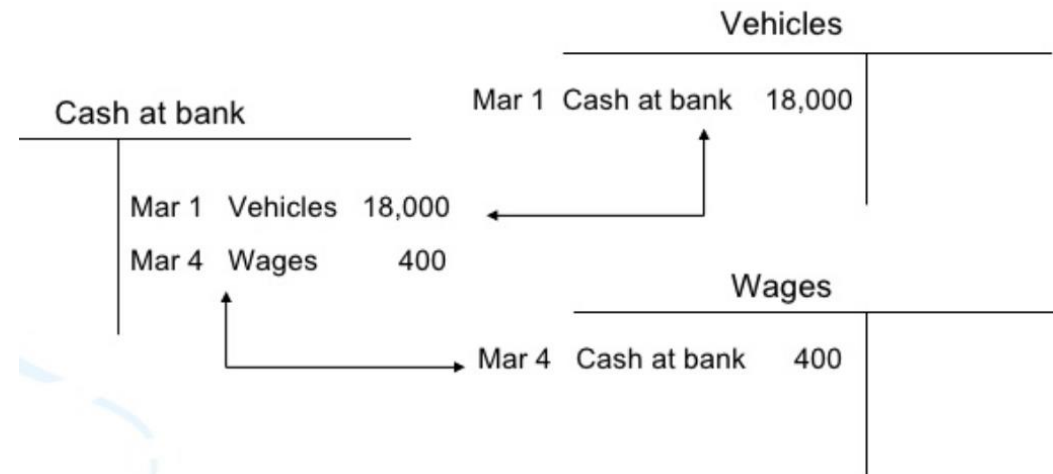
- Keeping **business accounts**
- Who are the **users** of business-accounting records
- Components of an **income statement**
- Components of a **Statement of financial position**
- Using **ratio analysis**, **liquidity ratios**, and **profit-margin ratios** to analyse business accounts
- Evaluate **limitations** of *ratio analysis* and *published business accounts*

Introduction

- Monetary records of transactions
- Businesses are required to keep records by law: users include
 - Government
 - Investors
 - Other stakeholders
- Accountants:
 - *Financial accountants*: prepare **published accounts** (following legal requirements)
 - *Management accountants*: prepare accounting details for **internal use** (by managers)

Accounting convention

- Use **same basic principles** world-wide
 - Compare accounts of companies in different countries (e.g., multinational companies)
- **Double-entry principle**: each transaction (buying or selling of goods) are recorded on two sides in order to balance the accounts



Accruals

- When a service is supplied to a business but it has not been paid yet



Money-measurement principle

- All accounting data are **converted into money**
- Only items/transactions that can be expressed in monetary terms are recorded



Prudence concept or conservatism

- Accountants must provide or record losses as soon as they are anticipated (not necessarily realised)
- Profits should not be recorded until they have been realised

Realisation concept

- All revenues and profits should be recorded in the accounts **when the legal title to the goods is transferred**
- Example: Sales are not recorded when an order is taken or when payment is actually made. But **when the goods or services have been provided.**

Main business accounts

1. Income statement (or *profit and loss account*)
2. Statement of financial position (or *balance sheet*)
3. Cash-flow statement

Income statement (or *profit and loss account*)

- It gives:
 - Gross and operating **profit** of the company
 - Details on how the **operating profit is split up** between
 - **Dividends** to shareholders
 - **Retained earnings** (profit)

Statement of financial position

- It gives the:
Net worth or **equity** of the company

Equity = what company owns - what company owes

or

Equity = assets - liabilities

Cash-flow statement

- It gives:
 - Where cash was **received** from, and
 - What it was **spent on**

Income statement

$$\text{Revenue} = \text{selling price} \times \text{quantity sold}$$

≠ cash received by business

	Revenue	3,060	
(minus)	Cost of sales	(1,840)	Trading account
(equals)	Gross profit	1,220	
(minus)	Overheads/expenses	(580)	Profit and loss section
(equals)	Operating profit (formerly net profit)	640	
(minus)	Interest	(80)	
(equals)	Profit before tax	560	
(minus)	Tax @ 20%	(112)	Appropriation account
(equals)	Profit for the year	448	
(minus)	Dividends to shareholders	200	
(equals)	Retained earnings	248	

Table 30.4 Income statement for Energen plc for the year ended 29 March 2013

Income statement

$$\text{Revenue} = \text{selling price} \times \text{quantity sold}$$

≠ cash received by business

$$\text{Cost of Sales} = \text{opening stocks} + \text{purchases} - \text{closing stocks}$$

only goods used & sold during the year are recorded as cost of sales

	Revenue	3,060	
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$$\text{gross profit} = \text{Revenue} - \text{cost of sales}$$

Table 30.4 Income statement for Energen plc for the year ended 29 March 2013

Cost of sales

This can be laid out as:

Opening stocks (at the start of the year)	\$500
Purchases during the year	\$2,500
Total stock (available for sale)	<u>\$3,000</u>
Closing stocks (at the end of the year)	(\$750)
Cost of goods sold	\$2,250

Activity 30.1: Calculating gross profit

- 16 minutes

Income statement

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overheads : expenses that are not directly related to the number of items made or sold.

(e.g., management salaries, lighting costs, ...)

operating profit : profit made **before tax and interest** are subtracted

profit before tax

profit after tax

Income statement

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Table 30.4 Income statement for Energen plc for the year ended 29 March 2013

shows how profit is distributed between the owners

dividends : shareholders

retained earnings

Activity 30.2

- 25 minutes