UNIT 4

ECONOMIC-ADMINISTRATIVE FUNCTION IN A COMPANY

PART I: ACCOUNTING

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1. ACCOUNTING: BASIC NOTIONS

1.1. Information and fair value accounting

Once we start a business, we will have to make other decisions related to the day-to-day business.

The main function of accounting is to provide information to the company's manager so he/she can make timely decisions. Accounting is the main business information and control mechanism.

The relevant information for accounting is everythig that is related to the **valuation of business assets**: bank accounts, buildings, computers, merchandise, bank loans…

In order to register information related to the composition and valuation of corporate assets, accounting uses a series of **predetermined standards** which are established by law.

Accounting information must be carried out in the most **objective** way. It must be **reliable**, ie, free from manipulation of data and material errors. In this sense, accounting information should present the **fair value of the company's equity** (patrimonio), and the **results (losses or profits) derived from its activity**, according to legislation.

One of the principles used is named ***relative importance.*** According to this principle, it is only necessary to record those events that are relevant. Events that are insignificant (for example to lose a pencil) in relation to business size will not be counted.

In Spain, the **General Accounting Plan** (Plan General Contable, PGC in spanish) is the accounting reference text that regulates the information contained in the accounting books.

The General Accounting Plan in force in Spain is that of **2008**, a plan designed to make Spanish and European accounting more similar to other countries. This fact facilitates international comparison of accounting in an increasingly globalized world.

In Spain, there are **two accounting plans**, depending on the size of the company.

- **General PGC:** for companies that have Assets equal to or greater than € 2,850,000, their annual turnover is equal to or greater than € 5,700,000 and have more than 50 employees.
- **PGC for SMEs** (Summary Annual Accounts, Cuentas Anuales Abreviadas): whose Assets are less than € 2,850,000, turnover less than € 5,700,000 and have 50 or fewer workers.

To choose the second one is necessary to collect, at least two of the characteristics described above, throughtout a period of two years.

1.2. Annual Accounts (Cuentas Anuales)

One of the most important parts of the PGC, is that which refers to the Annual Accounts. As its name indicates, Annual Accounts **summarize the information** referred to a period of time (normally one year) and are **formed**, among others, by the **Balance Sheet** (Balance de Situación) and the **Income Statement** (Cuenta de Resultados o Cuenta de Pérdidas y Ganancias).

The Annual Accounts are documents or accounting statements that summarize the information regarding the business assets, the financial situation and the results of each year.

In addition to the Annual Accounts we have to consider the Inventory of the company, a kind of detailed balance sheet, where the assets are arranged in a single column.

Both of them form the Inventory and Annual Accounts book, that is mandatory according to Trade and Accounting Standards. It is composed, among others, by the following documents:

- **Balance sheet** (Balance de Situación)
- **Income Statement** (Cuenta de pérdidas y ganancias)
- Schedule (Memoria)
- Statement of changes in net assets
- Cash Flow Statement (Only in companies with general PGC)

We will analyze the most important ones: Balance sheet and Income statement.

Each of the periods of time, normally a calendar year (año natural), in which companies divide their activity is called a ***period*** (ejercicio económico) to determine whether the management has responded as expected.

In order to prepare the Annual Accounts, which usually happens every December 31, coinciding with the end of the calendar year, it is necessary an annotation mechanism that previously registers the information. This important function corresponds to the Daily book (Libro Diario), the other mandatory book according to the Code of Commerce. In the Daily book are registered all the business operations.

2. COMPANY EQUITY (Patrimonio empresarial)

Accounting records everything that has to do with business equity, which we represent as a set of elements of a different nature (goods or assets in general, rights and debts or liabilities) susceptible to valuation.

Business equity = Assets + Rights - Liabilities

An asset (or good) is any element necessary for the development of business activity (machines, transport, goods, money ...). For its part, rights are, in general, amounts of money pending collection (pendientes de cobro) (for example, an invoice, una factura). Instead, liabilities are amounts of money still to be paid (for example, taxes). The difference in value between the assets and the rights you own and the liabilities you have constitutes the reliable (real o fehaciente) equity of the company. In Accounting, this difference is called Net or Equity and is what the company is really worth (su valor real).

Net (Equity) = Assets (Goods) + Rights – Liabilities (Debts)

From the Net formula it is possible to establish new groups:

Assets (Goods) + Rights = Net + Liabilities

Since the transformation of goods and rights into money supposes wealth for the company, they are called as an active set or **Assets** (Activo). On the other hand, all debts, as they constitute a burden (una carga), are called Liabilities (Pasivo) if you have to return to others and Net (Neto), if you do not have to return to anybody.

Assets = Net + Liabilities

This equality is known as the **fundamental equity equation** and is overall used to represent the equity of companies. Each of these groups (assets, net or liabilities) receives the name of **equity mass** (masa patrimonial)

Example:

If the only asset you have is a house valued at € 300,000 but that was acquired with a bank loan (préstamo bancario) of € 200,000, the net or equity is worth € 100,000.

House (€ 300,000) = Net (€ 100,000) and Bank Loan (€ 200,000)

Assets (€ 300,000) = Net (€ 100,000) + Liabilities (€ 200,000)

2.1. The balance sheet

The fundamental equity equation allows us to relate the origins and applications of funds (el origen y la aplicación de los fondos) at a glance, through the Balance sheet.

The **Balance sheet** is a document that summarizes the overall situation of the company at a given moment of time by presenting its assets, rights and liabilities valued.

ASSETS **Investments**	**EQUITY (NET) AND LIABILITIES** **Sources of funding**
Assets (Goods) *Rights (to be collected)* (Applications of funds)	*Equity (Net)* *Liabilities (Debts)* (Sources of funds)

Example

If we wanted to represent by means of a balance sheet the personal assets that we used as a model in the previous section, this would be the result:

ASSETS **Investments**	**EQUITY AND LIABILITY** **Sources of funding**
House € 300.000	Equity € 100.000 Debts € 200.000

Comment: The net and liabilities break down (desglosan) the sources of own financing (€ 100,000) and bank financing (€ 200,000) that have made possible the investments (house) present in the assets.

Each of the elements that make up the company equity are called **accounts** (**cuentas**) and they are gathered in different **submasses**, that we are going to study later. The name of each account is determined in PGC.

We are going to study now the structure of the Balace sheet. The diffents groups of elements that we are going to describe can be considered as equity submasses:

A. ASSETS (ACTIVO)

Assets show the investments that the company needs to make in order to carry out its business activity, ordered according to the length of stay in the company. In this sense, assets are classified as non-current assets (with a permanence of more than one year) and current assets (with a permanence of one year or less).

- **Non-current assets (Activo No Corriente).** It is made up of those assets linked to the company for more than one year. The most important groups are:

  - **Intangible Assets (Inmobilizado Inmaterial).** They are those goods that the company needs to produce but that do not have physical materiality. Example: an industrial property (a patent or a trademark (marca)) or a computer application.
  - **Tangible Investments (Inmobilizado Material).** It is made up of those tangible and corporeal assets owned by the company, which the company uses for its productive activity during a series of periods. Example: Land, Buildings, Machinery, Information technology equipment, Furniture or Motor vehicles.
  - **Financial Investments (Activo Financiero).** It is made up of those investments, temporary or permanent, that finance the activities of other private or public companies. Example: Permanent investments in other companies (shares (acciones) acquired with

the intention of controlling another company) or Fixed Income Securities (valores de renta fija) that generate a fixed interest.

Amortization

Most non-current assets lose value over time due to **wear** (uso) and **tear** (desgaste) or obsolescence. This fact is reflected in the accounting through the concept of amortization.

Amortization reflects the irreversible value losses suffered by the various elements of the Non-Current Assets. They appear with a negative sign in the Balance Sheet.

For example, imagine the case of a van that the company purchased for € 120,000. In five years it does not have the same value due to its wear and tear.

Obsolescence is the loss of utility of machinery or other types of goods due to technological change. For example, the typewriter that was replaced by the computer.

Each year the amortizations must appear as an expense (gasto) in the Income Statement. You must bear in mind that **it is an expense that does not imply outflow of money** in the company. However, the reported profit decrease because the difference between expenses and income is smaller.

- **Current Assets (Activo Corriente):** It is made up of those elements that are in constant rotation, i.e., that are renewed several times in the same financial period. The fundamental submasses of this type of asset are inventories, realizable and available (cash):
  - **Inventories (Existencias).** They are composed of those materials that are used in the production of the product or the goods already manufactured that constitute the company's own activity. All these assets have to undergo (sufrir, experimentar) a transformation or sale to become liquid after a period of time. They are the raw materials, the containers or the goods.
  - **Trade Receivable (Realizable).** These are invoices pending to be paid by Clients (due to sales of merchandise) or by debtors (deudores) (due to the provision of services). People who owe money to the company are called in general Debtors or Receivables (Deudores). If we have a bill of Exchange (letra de cambio) against a client, that we will charge in a periodo of time we say that we have *Trade receivables, trade bills receivable (clientes, efectos a cobrar)*
  - **Cash (Disponible).** It is composed by those elements that, due to being liquid, have immediate availability. There are mainly two: Cash, and Banks and financial institutions (money in bank accounts).

EQUITY MASS	EQUITY SUBMASS 1	EQUITY SUBMASS 1.1.	ACCOUNT PGC
ASSETS	NON-CURRENT ASSETS	INTANGIBLE ASSETS	Industrial property
		MATERIAL INVESTMENTS	Land, Buildings…
		FINANCIAL INVESTMENTS	Fixed Income Securities…
	CURRENT-ASSETS	Inventories	Merchandise…
		Trade receivable	Clients…
		Cash	Cash, Bank accounts…

B. NET (EQUITY) (NETO) AND LIABILITIES (PASIVO)

We are going to study both given their similarity. Net is referred to the own resources of the company. However, liabilities are resources that belong to third parties. Net and non-current liabilities are classified as long-term (permanence greater than 1 year), while in the short term (permanence equal to or less than 1 year) only current liabilities are included.

- **Net (Equity) (Neto o Patrimonio Neto)** It is made up of resources that do not have to be returned throughout the life of the company. They are the most stable funds of the company, since they are not required by third parties. Examples of Equity are Capital (contributions from individual entrepreneurs), Share Capital (Capital social) (contributions from partners in corporate companies), Reserves (undistributed profits that are used to increase the own resourcess) and Profit/Loss pending distribution or application (Beneficios o pérdidas pendientes de distribución).
- **Non-current liabilities (Pasivo No Corriente):** It is made up of those debts with a repayment term greater than one year. A very common example is long-term debt with financial institutions (bank loans).
- **Current liabilities (Pasivo Corriente).** Also called short-term enforceable (exigible a corto plazo), it is made up of those debts whose repayment period is equal to or less than one year. These are debts pending payment with Suppliers (proveedores) (of merchandise), Creditors (Acreedores) (for supplies, called other payables) or public entities such as Social Security or Taxation authorities (Administración Tributaria).

Observe: If we owe a bill of exchange (letra de cambio) to a supplier that we will return within a period of time, it is called Suppliers trade bills payable (proveedores, efectos a pagar).

Submass	Equity element	PGC (Accounts)
NON-CURRENT ASSETS	Computer programs	Computer software
	Land, mines, quarries (canteras)	Land and natural resources
	Flats, commercial premises, warehouses	Buildings
	Machines for production	Machinery
	Furniture and non-electronic office furniture	Furniture
	Computers and electronic devices	Information Technology Equipment
	Vehicles with which the company develops its activity	Motor vehicles
CURRENT ASSETS	Goods acquired by the company for sale without transformation	Merchandise
	Rights on sales of the product that constitutes the main activity of the company	Trade receivables (Clients)
	Bills of exchange pending to be collected (Letras de cambio pendientes de cobro)	Trade receivables, trade bills receivable (Clientes, efectos a cobrar)
	Money in bank accounts	Banks and financial institutions
	Cash availiability	Cash
NET (EQUITY)	Own resources of individual entrepreneurs	Capital
	Own resources in corporate companies	Share Capital
	Undistributed profits	Reserves
NON CURRENT LIABILITIES	Long-term bank loans	Non-current debt with financial institutions
CURRENT-LIABILITIES	Debts with habitual suppliers	Suppliers
	Debts with service providers	Payables for the rendering of services (Deudas por prestación de servicios)
	Bills of exchange pending to be paid	Suppliers, trade bills payable (Proveedores, efectos a pagar)
	Contributions pending to be paid to Social Security	Social Securty, payables
	Debts pending payment with the Tax Agency (Hacienda)	Output VAT (Value Added Tax) IVA a ingresar

Exercise

The assets of the company Scaece, S.A. are composed by the following elements:

- Business premises (Locales de negocio) valued at € 500,000.
- A truck that was purchased for € 58.000.
- Several computers valued at € 4.700.
- Business management software valued at € 800.
- Goods ready for sale for an amount of € 7.500.
- € 12700 in a bank current account.
- € 3.490 in cash.
- Several clients owe the company € 4.700.
- Scaece, S.A. owes € 208.000 to the Logroño Bank that must pay in 10 years
- Scaece, S.A. owes € 15.700 to Caja de la Rioja that must be paid in 10 months and € 8.900 euros to suppliers of merchandise.
- The loss of value of tangible assets, due to obsolescence and wear and tear, was € 14.700.
- The owners contributed € 344.590.

Describe the **Balance Sheet.**

ASSETS (Assets or goods, and rights pending to be paid)
Non-Current Assets 548.800
Computer software € 800
Business premises € 500.000
Motor Vehicles € 58.000
Information Technology Equipment € 4.700
Amortization € -14.700
Current Assets 28.390
Merchandise € 7.500
Clients € 4.700
Banks and financial institutions € 12700
Cash € 3.490
TOTAL ASSETS 577.190

NET AND LIABILITIES
Equity or Net 344.590
Capital € 344.590
Non-current Liabilities € 208.000
Long-term bank loan € 208.000
Current Liabilities € 24.600
Short-term bank loan € 15.700
Suppliers € 8.900
TOTAL NET AND LIABILITIES 577.190

3. INCOME STATEMENT (CUENTA DE PÉRDIDAS Y GANANCIAS O CUENTA DE RESULTADOS)

Accounting also discloses the results obtained by the company during a certain period of activity, which depend on good or bad business management.

From an accounting point of view, **business management** is expressed through the difference between **income and expenses**. If incomes are greater than expenses, the **results** of the exercise will be positive. Otherwise they will be negative.

The division of business management into periods of activity is more than logical: in addition to assess if the management obeyed what was expected in order to adopt the appropriate measures, it is necessary to pay taxes on profits, and to present Annual Accounts. Remember that the Income Statement is a document of the Annual Accounts.

3.1. Most common expenses and income

Expenses:

- Purchase of merchandise. Provision of goods that constitute the usual actitivity of the company.
- Leases (arrendamientos). Rental expenses.
- Services of independent professionals. Amount paid to professionals for the services provided. Example: Lawyers, consultants (asesores) or notaries.
- Banking services. Expenses for bank commissions.
- Utilities (Suministros). Non-storable (no almacenable) consumption expenses. Example: Light, water or gas.
- Other tributes. Amounts paid for taxes different to Corporation Tax (Impuesto de Sociedades). For example, the Real Estate Tax (el Impuesto sobre Bienes Inmuebles)
- Corporation Tax. Main tax on the profits of corporate companies which, in general, 25%.
- Wages and salaries. Personnel salaries.
- Social Security payable by the company. Contributions paid for company's workers.
- Other financial expenses. Interest on payables (intereses de deudas). They are interest on debts with financial institutions (like a bank accounts against the company).
- Allowances (Dotaciones) for amortization. Quantification of the depreciation experienced by intangible and tangible assets during the year. Remember that the expense is recognized but it does not imply an outflow of money from the company.

Income:

- Sales of merchandise: Income derived from the sale of the goods that constitute the normal activity of the company.

- Provision of services: Income whose origin are services rendered by the company.
- Another financial income: Interest on bank accounts in favor of the company.

The Income Statement is the document that summarizes the results of the company's financial year by presenting expenses and income.

3.2. Presentation template

Expenses and income are arranged, depending on their nature, into 4 groups:

- **Result from operating activities (Resultado de Explotación).** Results related to the typical activity of the company.
- **Net Finance Income/(Expense) (Resultado financiero).** Results related to the financing of the company.
- **Profit/(Loss) before Income Tax. (Resultado antes de Impuestos).** Sum of operating and financial results.
- **Profit/(Loss) for the period (after tax). (Resultado del Ejercicio).** In the case of companies, the final result is what remains after deducting the Corporation Tax.

A) Result from operating activities	+ Income (sales or services rendered) - Expenses (purchases, supplies (utilities), salaries ...)
B) Net Finance Income/ (Expenses)	+ Financial Income - Financial expenses
C) Profit/(Loss) before Income Tax (A + B)	
- Income Tax	
D) Profit/(Loss) for the period	

Example:

Design S.A., is a company dedicated to the production and sale of furniture. In 2020, the company presents the following data:

- Total sales: € 453.000.
- Salaries: € 170.000.
- Merchandise purchases: € 290.000.
- Interest on debts: € 2.200.
- Financial income: € 130.
- Profits from the sale of a company building: € 57.900.
- Amortizations: € 2.200.

Sales of merchandise	453.000
Merchandise purchased	-290.000
Personnel Expenses (Salaries)	-170.000
Amortizations	-2.200
Profits from the sale of a company building	57.900
A) Result from operating activities	**48.700**

Financial Income	130
Financial Expenses	-2200
B) Net Finance Income/ (Expense)	**-2070**
C) Profit/(Loss) before Income Tax (A + B)	**46.630**
Income Tax (25%)	11.657,50
D) Profit/(Loss) for the period	**34.972,50**

4. ACCOUNTING ANALYSIS

We have learned to classify accounting information. Now, we are going to analyze and interpret it.

1. Balance Sheet Analysis: Financial balance (equilibrio financiero) and working capital (fondo de maniobra)

Any company has debts that it must face. To do this you must have financial resources that allow you to pay your debts.

The company is in a **financial balance** (equilibrio financiero) if it can pay its short-term debts when they must be paid.

There are various **situations** of the company regarding its financial balance:

- **Maximum stability**

The company has no Liabilities. Therefore, Assets is financed with Equity (Net). The *company is not at financial risk*.

- **Ordinary (Normal) financial situation**

Total Assets of the company are greater than Liabilities. Furthermore, Current Assets are greater than current liabilities.

It is said that in this case the company has a **Working Capital (Fondo de Maniobra)**. The Working Capital is the difference between Current Assets and Current Liabilities.

In this case, the company has *sufficient short-term resources to deal with its short-term debts.*

- **Financial instability (provisional insolvency)**

Total Assets are greater than Liabilities. But the Current assets are less than the Current liabilities. In this case the Working Capital is negative.

The company may have *difficulty paying* back its *short-term debts,* because it lacks sufficient liquidity. This can lead to legal problems.

- **Financial instability (final insolvency)**

Total Assets are less than Liabilities. The company is unable to pay all its debts, even if all its Assets are sold. It is said that the company is in a *bankruptcy situation* and will have to sell all its Assets.

- **Maximum financial instability (final insolvency)**

Assets are 0. Liability is greater than zero. *The company does not keep any Assets and no creditor will be able to collect its debts.*

Example

The Balace Sheet of a company is the following:

ASSETS		**EQUITY AND LIABILITIES**	
Non-current Assets	**870**	Equity	328
Current-Assets	**490**	Non-current Liabilities	630
Merchandise	240	Current-Liabilities	402
Debtors	160		
Cash	90		
Total	**1360**	**Total**	**1360**

We are going to calculate Working Capital

Working Capital = Current Assets – Current Liabilities = 490 – 402 = 88

We observe that it is positive, so that we can affirm that this company is in a **normal financial situation a**nd is stable from a financial point of view.

2. Ratios of financial balance

Other way to analyze and interpret accountig is through ratios.

A **ratio** is a quotient (cociente) between two related quantities

The characteristics of the calculation of ratios as an analysis technique are:

- A **numerical indicator** that summarizes information on the business situation.
- As the company is not an isolated entity but rather operates in a specific sector where it competes with other companies, the ratios **must be accompanied by other data and indicators** that allow an objective interpretation. In this sense, it is common to compare its own ratios with those of other benchmark companies in the sector to examine possible differences.
- The company is a dynamic being, so ratios can also be used to **compare them with those of another period** and thus observe the **evolution of the business** performance.
- As the ratios **analyze partial aspects of the company**, it is necessary to **complement the results** in order to gain perspective.

2.1. Financial ratios

The financial ratios analyze the ability of the company to pay off its debts within the previously established deadlines. Being a good payer is a fundamental rule of start-up businesses.

Ratio	Calculation	Meaning	Optimal guideline value
Treasury	T = Cash / Current Liabilities	Immediate Liquidity	(0,8 – 1,2)
Solvency	S = Current Assets / Current Liabilities	Working capital	(1 – 2)
Liquidity	L = (Current Assets – Merchandise)/ Current Liabilities	Short-term solvency	(1,5 – 1,8)
Guarantee	Assets / Total Liabilities	Long-term solvency	(1,7 – 2)

- **Treasury (Disponibilidad):** this ratio only considers the most liquid asset. If it is very close to zero, it means that the company may have difficulies paying its debts in the short term.
- **Solvency:** This ratio includes the concept of Working Capital. Its value is considered to be between 1 and 2. With these values, the company foresees that part of the Current Assets cannot be used to meet short-term debts (for example, due to customer defaults). If the value is less than 1, the Working Capital is negative and the company may have problems paying its debts in the short term. If it is higher than 1, the Working Capital is positive.
- **Liquidity:** It verifies what is the capacity of the company to pay back its debts in the event that it cannot sell its stocks (merchandise). It is called the *acid test*. If its value is less than 1 it is a worrying situation.
- **Guarantee:** It aims to verify the guarantee that the company offers to creditors. If its value is less than 1, the company is permanently insolvent.

Example:

We are going to study how to apply ratio technique to the other company that we have described before:

Treasury: Cash (90)/ Current Liabilities (402) = 0,224

Being much less than 1 indicates that the company may have short-term financial problems.

Solvency: Current Assets (490)/ Current Liabilities (402) = 1,219

It is greater than 1, that is, the company is in financial balance.

Liquidity:

Current-Assets (490) – Merchandise (240) / Current Liabilities (402) = 0,622

It is less than 1 and this is concerning. This is so because the company could run into liquidity problems if it cannot sell and collect its stocks on time.

Guarantee: Assets (1360) / Total Liabilities (630 +402) = 1,318

It is higher than 1, that is, the company offers sufficient guarantee to creditors.

3. Return on Assets (Rentabilidad Económica) and Return on Equity (Rentabilidad financiera)

From the figures included in the Balance Sheet and in the Income Statement, the financial and economic profitability of the company can be determined.

- ***Return on/over Assets (ROA, Rentabilidad Económica)***

It expresses the yield (rendimiento) that could be obtained from the means used (Assets) and the operations of the company, regardless (con independencia de) of who finances this investment. It can be calculated through this formula:

ROA = Profit before interest and taxes / Total Assets

- ***Return on Equity (ROE, Rentabilidad Financiera):***

The financial profitability or profitability of the owners of the company measures the return that the owners receive for their investment. It can be calculated through this formula:

ROE= After-Tax Profits / Net (Equity)

Example:

The Total Assets of Caroma S.A. are € 985,400 and its Net are € 346,290 euros. We also know the profit before tax, which is € 91,840. Profit after tax is € 26,260.

ROA = Profit before interest and taxes (91,840) / Total Assets (985,400) = 0.0932 = 9.32%

ROE = Profits after taxes (26,260) / Equity (346,290) = 0.0758 = 7.58%