Accounting I

Degrees in Management and Economics

Accounting

Middle term exam: 11/04 at 10:00 (30%)
Exercise in class: 18/05 (20%)

Final Exams
EN: 08/06 at 9:00 (50%)
ER: 04/07 at 9:00

Accounting I

GOALS AND MAIN CONCEPTS ON FINANCIAL ACCOUNTING

Accounting

Accounting: system of ***collecting***, ***processing*** and ***reporting*** financial information for decision makers

1. **Balance sheet :** a statement of financial position at the end of the period
2. **Net Income statement:** statement of comprehensive income for the period
3. **Changes in equity statement**: a statement of changes in equity for the period
4. **Cash flow statement**: a statement of cash flows for the period
5. **Notes**: comprising a summary of accounting policies and other explanatory notes

Accounting

Accounting

Financial Accounting

External users

Investors and Creditors
Customers and Suppliers
Workers…

Management Accounting

Internal Users

CEOs
Board of Directors…

Accounting

Financial Accounting	Management Accounting
Mandatory	
It is imposed by law and supports the accountability process	Not mandatory by law; it is the management process and managers that justifies its existence
Periodicity	
The financial statements are published annually. In some situations, e.g., for listed firms, the report can be trimestral or other.	Internal reports. The frequency and periodicity is defined by the managements.
Standards	
It is subject to national standards (SNC) and international standards (IAS/IFRS)	It is not subject to any national or international standards.
Nature of data	
The data shown is usually objective and verifiable	The data shown is usually subjective

Goal

Goal of the Financial statements

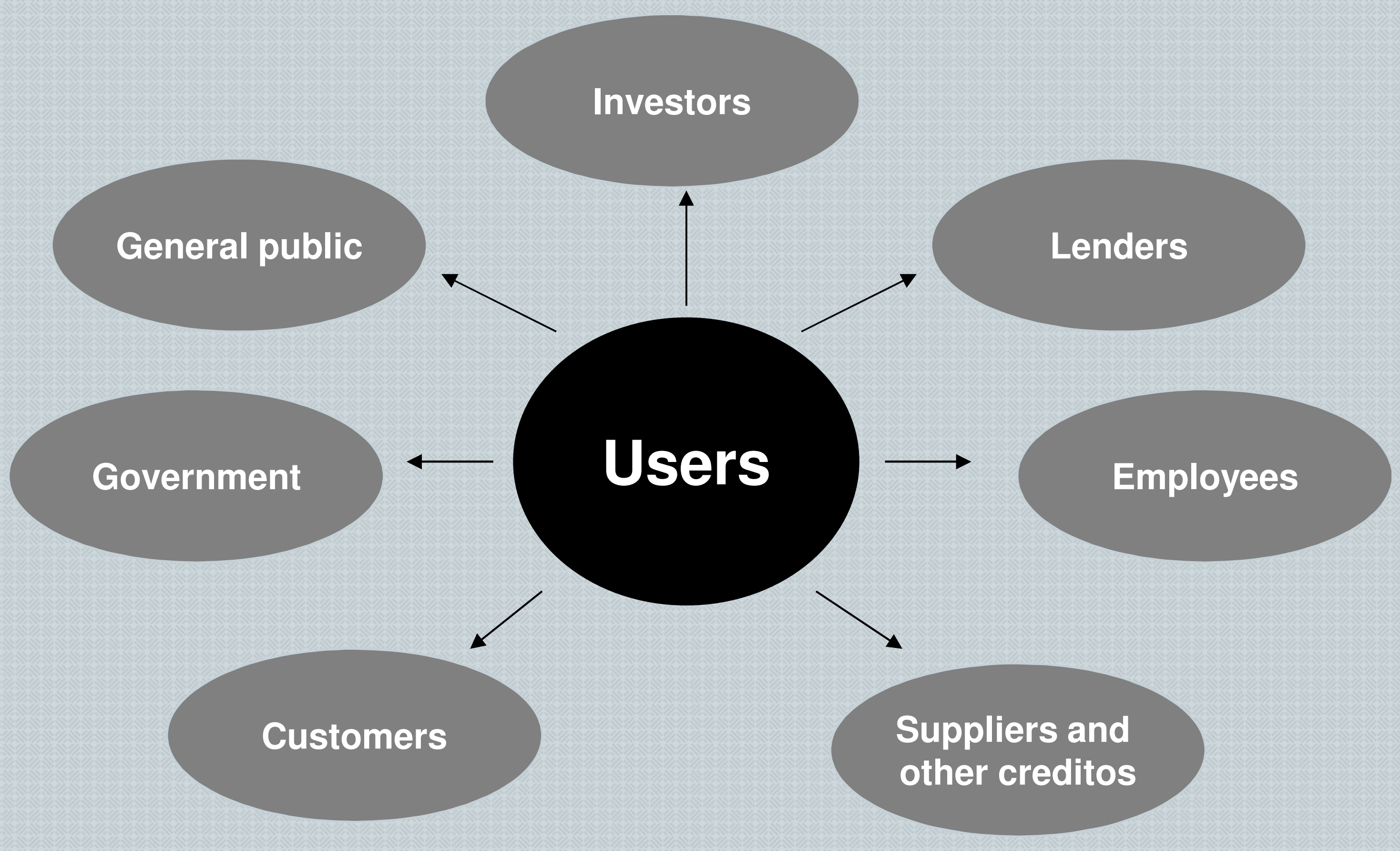
- Provide information about the financial position, financial performance and changes in financial position to assist the decision process

Balance sheet

Income statement

Cash Flow statement

Users of financial information



Qualitative characteristics

- **Qualitative characteristics of financial information:**
  - **Understandability**
  - **Relevance**
  - **Reliability**
  - **Comparability**

Qualitative characteristics

Understandability

The information must be readily understandable to the users of financial statements

.

Qualitative characteristics

Relevance → Materiality

The information must be relevant to the needs of the users, which is the case when it may influence the economic decision of its users

- ***Reporting, omission or misstatement***

Qualitative characteristics

Reliability →
- Faithful representation
- Substance over legal form
- Neutrality
- Prudence
- Completeness

The information must be free of material errors and bias, and not misleading. It must faithfully represent the transactions and events that affect the firm.

Qualitative characteristics

Comparability

- Consistency in time (Longitudinal comparison)
- Consistency in space (Cross sectional comparison)

The information must be comparable to the financial information presented for <u>other accounting periods</u>, so that the users can identify trends in the performance and financial position of the firm.
Users must also be able to <u>compare</u> the financial reports of <u>different entities</u> in order to evaluate their relative financial position, financial performance and cash flows.

Qualitative characteristics

- **Constraints on Relevant and Reliable Information**
  - **Timeliness** - If there is undue delay in the reporting of information it may lose its relevance.
  - **Balance between Benefit and Cost** - The benefits derived from information should exceed the cost of providing it.
  - **Balance between Qualitative Characteristics -** the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial reports
  - **True and Fair View/Fair Presentation -** the application (…) of appropriate accounting standards normally results in financial reports that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

Accounting Assumptions

Accrual assumption

- Transactions are recorded using the accrual basis of accounting, where the recognition of revenues and expenses arises when earned or used, respectively. If this assumption is not true, a business should instead use the cash basis of accounting to develop financial statements that are based on cash flows.

Going concern

- A business will continue to operate for the foreseeable future. If this assumption is not true (such as when bankruptcy appears probable), deferred expenses should be recognized at once.

Accounting I

GOALS AND MAIN CONCEPTS OF FINANCIAL ACCOUNTING

FINANCIAL STATEMENTS

Enterprise value

Set of elements (assets and liabilities) subject to management and assigned to a particular purpose.

Composition: nature of the elements: Assets, Liabilities and Shareholder's Equity	**Value**: Value of the Assets minus value od the Liabilities

Patrimony

When looking at the patrimony we should consider:

(a) Composition = nature of elements
Constitutive (Assets and Liabilities)

(b) Value (Assets – Liabilities)

Transactions

All the events that changes the value and/or composition of the enterprise value.

Permutations (Qualitative) ⇒ It changes the composition of the elements of the firm, but not the value of the enterprise	Alterations (Quantitative) ⇒ It changes the composition of the elements of the firm, and also the value of the enterprise

Transactions

Alterations

Positives
(it increases the value
of the enterprise)

Negatives
(it decreases the value
of the enterprise)

Patrimony – fact sheet

- It is a fact sheet any occurrence involving changes in the firm composition and/or value
- <u>Qualitative or permutation fact sheets</u> ⇒ variation in the composition of the patrimony, but not in its value.
- <u>Quantitative or modifying fact sheets</u> ⇒ variation in the composition and value of the patrimony.

Financial Statements

The objective of financial reports is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions

Financial Statements

1. Statement of financial position (***balance sheet***) at the end of the period
2. ***Statement*** of comprehensive ***income*** for the period (or an income statement and a statement of comprehensive income)
3. ***Statement*** of ***changes*** in ***equity*** for the period
4. ***Statement*** of ***cash flows*** for the period
5. **Notes**

Balance Sheet

- The balance sheet (also called the statement of financial position) shows the financial status of a company at a particular instant in time (usually December 31st) and compares with the previous period.

- The left side lists the resources of the firm (investment)

- The right side lists the claims against those resources (funding)

Balance Sheet

Vertical display

Assets

Owners' Equity

Liabilities

Financial Statements

- **Recognition of the elements of the financial statements:**

  - **Asset** is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

  - **Liability** is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

See Conceptual Framework

Balance Sheet

Accounting Equation:

Assets = Liabilities + Owners' Equity

Assets> Liabilities⇨ Owners' equity> 0

Assets< Liabilities⇨ Owners' equity < 0

Assets= Liabilities⇨ Owners' equity = 0

Expanded Balance Sheet Equation

(1) Assets = Liabilities + Stockholders' Equity

(2) Assets = Liabilities + Paid-in Capital + Retained Earnings

(3) Assets = Liabilities + Paid-in Capital + Revenues - Expenses

Classified Balance Sheet

- A **classified balance sheet** further groups asset, liability, and owners' equity accounts into subcategories

- Assets are classified into two groups:
  - **Non-current** (or long-term) assets
  - **Current assets**

- Liabilities are classified into
  - **Non-current** (or long-term) liabilities
  - **Current** liabilities

Classified Balance Sheet

- **Current assets** are cash and other assets that a company expects to convert to cash, sell, or consume during the next 12 months (or within the normal operating cycle if longer)

- Current assets are listed in the order in which they are likely to be converted to cash during the coming year

- In Portugal, with SNC: Assets presented in order of liquidity (less liquid to more liquid).

- **Non-current** are assets owned over 12 months

Classification of assets

- Fixed tangible assets
- Intangible assets
- Investment Properties
- Financial investments
- Inventories
- Biological Assets
- Accounts receivable
- Bank deposits

Liabilities

- **Current liabilities** are those that come due within the next year (or within the operating cycle if longer)

- **Non-current liabilities** are those that come due not earlier than 12 months after the balance sheet reporting.

Classification of Liabilities

- Provisions
- Loans obtained
- Deferred taxes
- Accounts payable
- State and other public entities

In Portugal, with SNC: Liabilities are presented in order of decreasing maturity (from the largest maturity to the smallest).

Owners' Equity

- Represents the position of the owners of the firm
- The values are ordered according to the historical formation
  - Paid in capital
  - Legal Reserves
  - Other reserves
  - Retained earnings
  - Net income of the period

  - *Difference between book value and market value.*

Accounting I

INCOME STATEMENT

Financial Flow

1 – Related with the Financial position (Balance Sheet)

- **Obligation to pay**: acquisition of goods and services regardless of their payment or use (recognition in the Balance Sheet as a liability);

- **Right to receive**: sales of goods and services regardless of their receipt or production (recognition in the Balance Sheet as an Asset).

Economic Flow

2 – Related with Performance (Income Statement)

- **Expenses**: consumption and use of goods and services regardless of their acquisition and payment (recognition in the Income Statement as expenses)
- **Revenues**: production of goods and services regardless of their sale and receipt (recognition in the Income Statement as revenues)

Economic Flow

- **Definition of the elements of financial statements:**
  - **Related with performance**
    - **Income** is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants

      => *Revenue and gains*
    - **Expenses** are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

      => *Expenses and losses*

See Conceptual Framework

Monetary Flow

3 – Related with cash flows (Cash Flow Statement)

- **Cash out flow:** corresponds to exits of cash in the company regardless of the period of acquisition and use of goods and services

- **Cash in flow:** corresponds to entries of cash in the company regardless of the period of the sale and production

The Income Statement

Vertical display

Revenues

Expenses

Net Income

The Income Statement

- An **income statement** is a report of all revenues and expenses pertaining to a specific time period
- It shows the economic performance of the company
- **Net income** = revenues minus all expenses
- A **net loss** occurs if expenses exceed revenues

The Income Statement

- Income Statement by Nature:
  - Expenses are grouped according to its nature, independently of the department or function that supported them

Compulsory

- Income Statement by functions:
  - The results are grouped having into account the department or function that had them

Optional

Net Income statement – by nature

- Expenses are grouped according to its nature, independently of the department or function that supported them
  - Cost of good sold (cost of sales);
  - External Services;
  - Wages
  - Impairments;
  - Amortizations and Depreciations;
  - etc

Goal: Net income (= Balance sheet)

Net Income statement – by functions

The results are grouped having into account the department or function that had them

- Cost of sales and services;
- Distribution costs
- Administrative costs
- R&D costs
- Financing costs;

Net income (= Balance sheet)

Net Income statement – by nature

Sales and service revenues

Cost of sales and services

External Supplies and Services Expenses

Staff expenses

Impairments

Provisions

Other revenues

Other expenses

EBITDA – ***E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation & **A**mortization*

Net Income statement – by nature

Depreciation and amortization expenses

Earnings before Interests and Taxes (EBIT)

Interest revenues

Interest expenses

Earnings before Taxes (EBT)

Income Tax

Net Income (of the period)

Accounting I

FINANCIAL STATEMENTS
CASH FLOW STATEMENT
CHANGE IN EQUITY STATEMENT

Cash Flow statement

- Shows where the cash comes from and where it was used
- Shows payments and receipts
- It is presented in vertical format, showing the values for years N and N-1.

Cash Flow Statement

Vertical display

Cash flow from Operating activities

Cash flow from Investing activities

Cash flow from Financing activities

Variation in cash and equivalents
Effects to consider from differences in exchange rates and variation in fair value

Balance sheet

Variation in cash and equivalents in end of period

Statement of Cash Flows

1 **Cash Flows from Operations**

Collections, Payments, Wages

2 **Cash Flows from Investing**

Purchase & Sales of PP&E, Long Term Securities, Making Loans

3 **Cash Flows from Financing**

Borrowing, Repaying

Issuing and Redeeming Debt & Equity

Dividends

Cash Flow statement

- Firms can have revenues but, because there is the possibility to pay/receive in another way that is not in cash (payment/receipts on account), these may happen in several different moments of time=> hence, a revenue does not mean a receipt of money
- It helps to determine the capacity to receive and pay in cash.
  - Liquidity
    - May be a sign of the continuity of the firm!

Variation in OE statement

- Aims to show the facts that changed owners' equity, during a period of time.

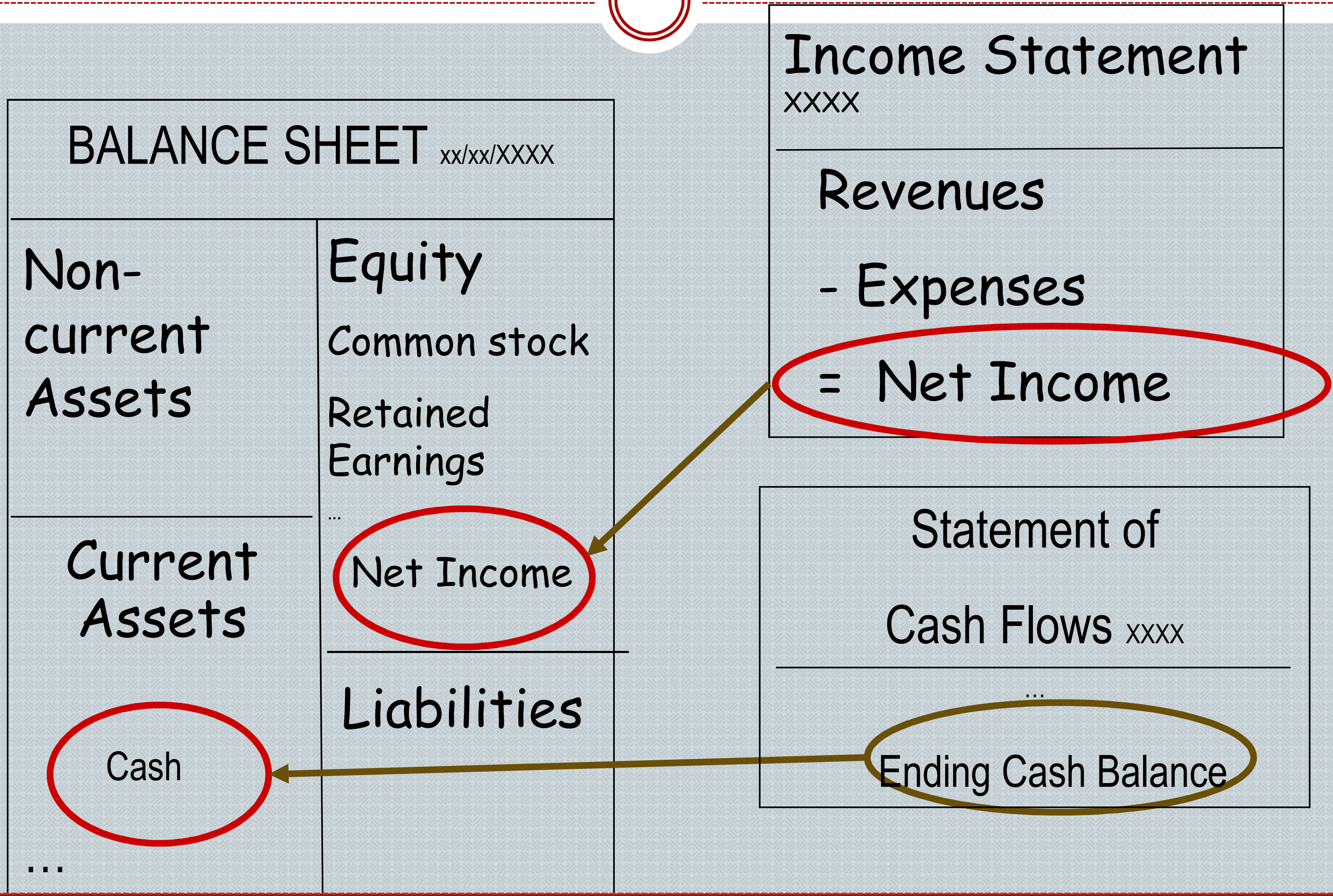
- It is presented in vertical format, showing the values for years N and N-1.

Matrix display

Notes

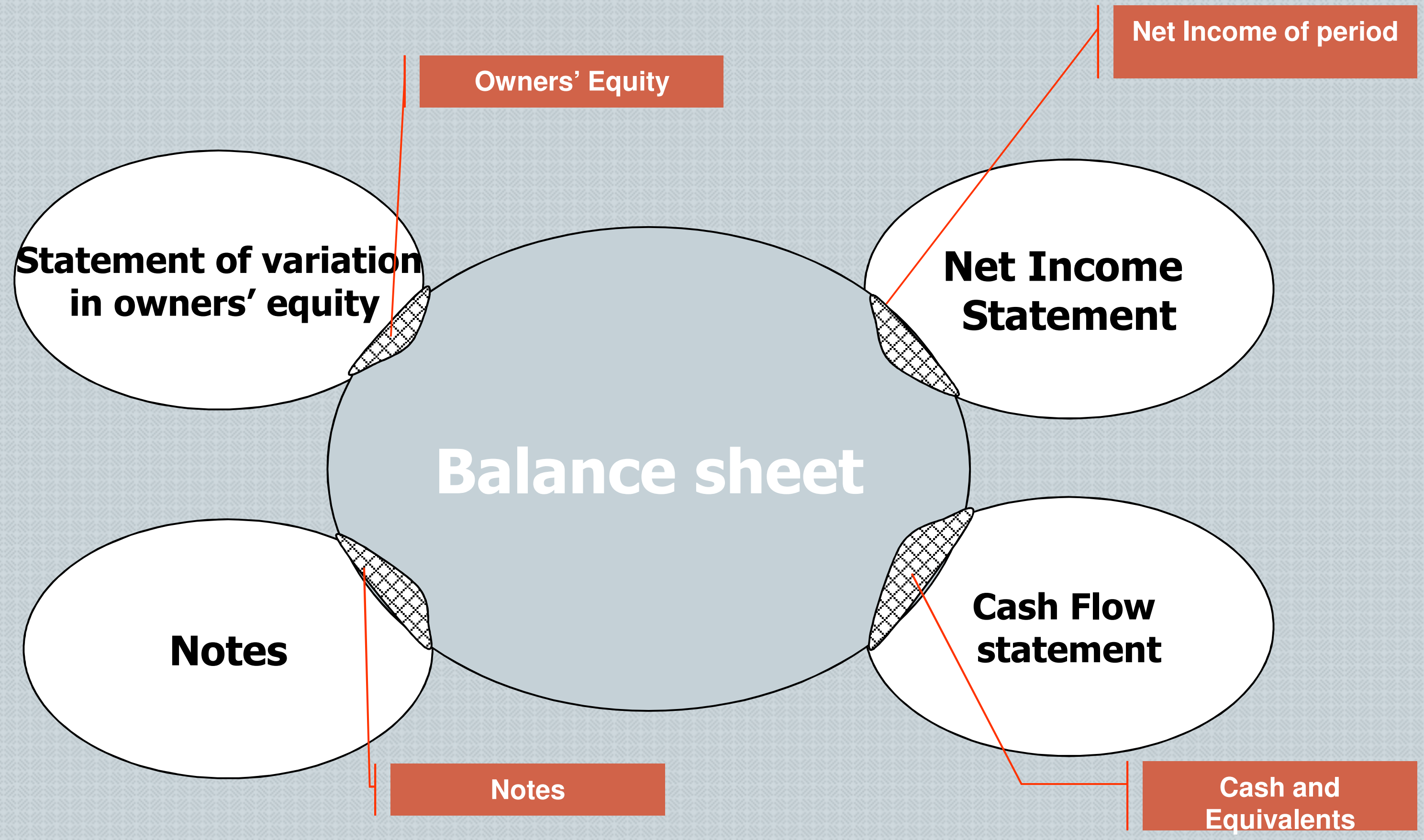
- The other financial statements are quantitative statements
- In the Notes the predominant information is qualitative (or narrative) and it is connected with all other financial statements

Financial Statements



Financial Statements

- **Articulation between financial statements**



Accounting I

ACCOUNTING METHOD

Accounts

- An account is a summary record of the changes in a particular asset, liability, or owners' equity item

- The double-entry accounting system records each transaction in at least two accounts

- A compound entry affects more than two accounts

Accounts

- The elements of transactions are organized into **accounts** that group similar items together

- In a double-entry system, a **ledger** contains the records for a group of related accounts

- A **general ledger** is the collection of accounts that accumulate the amounts reported in the financial statements

Accounts

Account

Debit | Credit

Debit (abbreviated Dr.) denotes an entry to the left side of any account

000,00 €

Debit an Account

Credit (abbreviated Cr.) denotes na entry to the right side of any account

000,00 €

Credit na Account

Some accountants use the word “charge” instead of debit

Accounts

Account

Debit	Credit
000,00 €	**000,00 €**

Balance of an account: difference between the total of debits (D) and the total of credits (C).

Debit Balance	**D>C**
Credit Balance	**D<C**
Null Balance (settled)	**D=C**

Accounts

Account

Debit	Credit
1 920,00 €	3 220,00 €
700,00 €	675,55 €
1 020,00 €	
Credit Balance 255,55 €	
3 895,55 €	3 895,55 €

To settle an account: is to calculate the balance of the account and write that difference where it is the gap in order to obtain the same value in both sides of the account.

Debits = Credits

Accounts

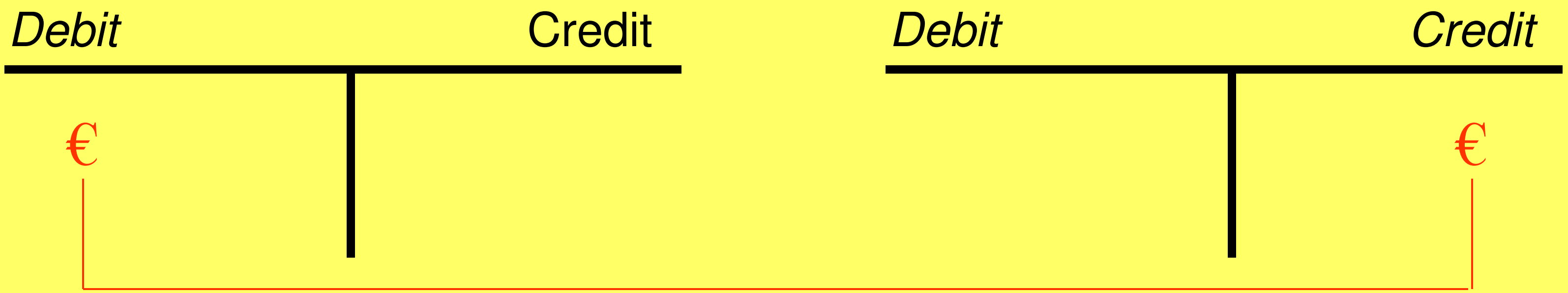
Chart of Accounts
SNC

Class 1: Money and Equivalents
Classe 2: Accounts Receivable and Payable
Classe 3: Inventories
Classe 4: Investments
Classe 5: Owners' Equity
Classe 6: Expenses
Classe 7: Revenues
Classe 8: Results

Double Entry booking

- Each transaction affects at least two accounts
- For each transaction debit(s) are equal to credit(s)
- The process of creating a new T-account in preparation for recording a transaction is called opening the account
- An account balance is the difference between the total left-side and right-side amounts, or vice versa, according to the type of account, at any particular time

Double Entry booking



Debit(s)= Credit(s)

Double entry booking

- Asset accounts have left-side balances
  - Entries on the left side (debit) increase asset account balances
  - Entries on the right side (credit) decrease them
- Liabilities and owners' equity accounts have right-side balances
  - Entries on the right side (credit) increase their balances
  - Entries on the left side (debit) decrease them
- Revenue is written on the right side (credit) since they represent increases in net income
- Expenses are written on the left side (debit) since they represent decreases in net income

Double entry booking

Balance Sheet

Assets

D C

\+ −

Equity

D C

− +

Liabilities

D C

− +

Assets = Equity + Liabilities

Debits = Credits

Sum of Debit Account Balances = Sum of Credit Account Balances

Recording Process

- The **general journal** is a formal chronological listing of each transaction and how it affects the balances in the accounts
- **Transactions** are entered into the ledger
- Each record has
  - Date
  - Title of the account;
  - Description
  - Value

Journalizing Transactions

- **Journalizing** is the process of entering transactions into the general journal
- A **journal entry** is an analysis of all the effects of a single transaction on the various accounts, usually accompanied by an explanation
- A compound entry means that a single transaction affects more than two accounts

Journalizing Transactions

- Classification of journal entries
  - Simple
  - Complex.

Documents

- Sales order
- Purchase order
- Shipping list
- Invoice
- Receipt
- Debit Note
- Credit Note
- Cheque