



# Unit 1

# Introduction to Accounting and Finance

Staff Training Solutions

## Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Describe the art of finance and financial management
- ✓ Explain key financial terms
- ✓ Determine your role in company finances
- ✓ Find the rules and regulations for your area and industry

## Unit 1

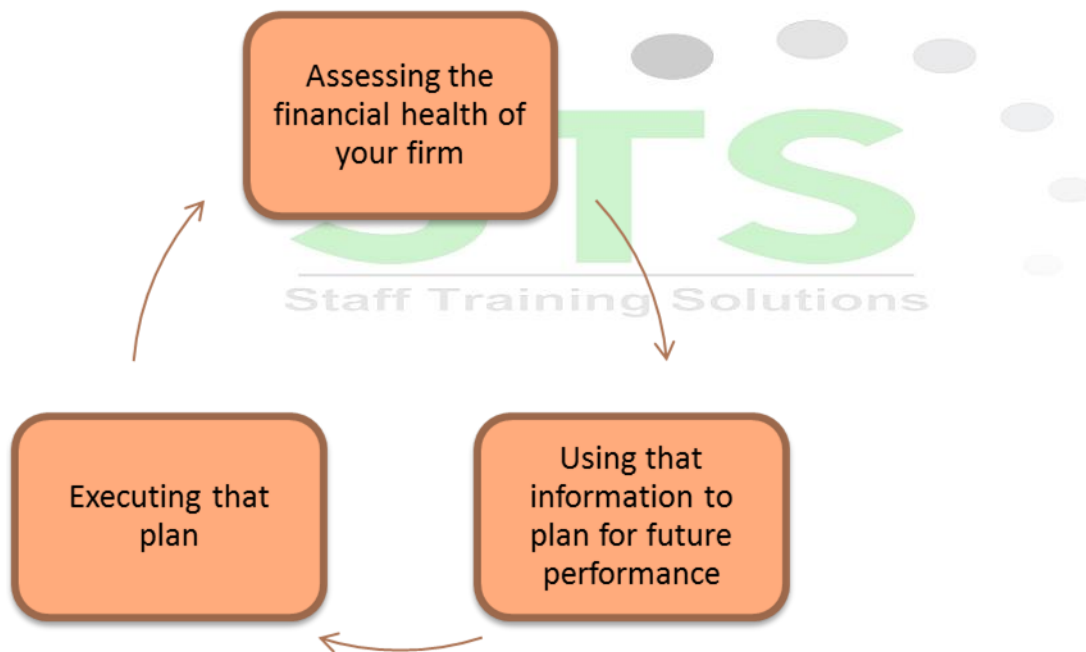
### Introduction to Accounting and Finance

#### Starting with the Basics

##### Finance

The Encarta Dictionary defines finance as, “the business or art of managing the monetary resources of an organization, country, or person.” Bookkeeping, banking, and accounting, are all separate processes with their own definitions.

Seth Godin describes finance as a three-cycle process that continues endlessly:



Once a company finishes the third step – executing its plan – it goes back and reassesses its performance again, and this cycle of finance repeats itself in a continuous loop.

## Recording Financial Transactions

**Bookkeeping** is the exercise of identifying, categorizing, and recording all the transactions that take place in a business. In general, everything a company does results in a bookkeeping transaction, including things that take place between the business and:

- Customers, who buy products and services sold by the business
- Employees, who are paid wages and provided benefits
- Vendors, who sell services, equipment, and supplies to the business
- Government agencies, who collect taxes from the business
- Sources of equity capital (investors or owners who put money in and take it out of the business)
- Sources of debt capital (banks and lending institutions)

**Accounting**, on the other hand, is the methodology used to record the transactions and prepare financial statements and reports. Accounting guidelines govern how businesses record transactions. They also dictate the design of the recordkeeping system that a business uses and how reports are prepared, based on the information gathered and put into the system.

This brings us to another question. Often, we hear the terms “financial statements” and “financial reports” used interchangeably. Is there a difference?

For the purpose of our courses, yes, there is a major difference. A **financial report** is a document prepared for internal use. It can come in many forms and be used for many purposes as it is usually company specific. A **financial statement** is a more widely requested formal document that is prepared in a specific format as outlined by your region’s Generally Accepted Accounting Principles (which we will discuss in a moment) or another governing organization (such as your tax legislation).

## General Accepted Accounting Principles (GAAP)

Accounting forces people to measure things in a relatively consistent manner. A good budget is prepared based on consistent rules as well. Accountants refer to the rules in their rule book as **generally accepted accounting principles** (GAAP). The objective of GAAP is to ensure comparability among different companies and overall reliability of information.

There can be slight differences between regions, but GAAP typically includes the following principles:

- **Comparability** among different companies.
- **Reliability** of information.
- The **business entity concept**: A business is a separate distinct entity from its owner/owners.

- The **matching principle**: Earnings and expenses must be recorded in the same accounting period that they relate to each other.
- The **cost principle**: Assets and service, and the resulting liability, are taken into the accounting records at cost.
- The **consistency principle**: A company's accounting procedures need to remain consistent over time. If they are changed, the reasons for the change and the financial impact of the change must be documented in detail.
- The **time period principle**: The operating period of the business is divided into equal periods of time, such as a month or a quarter.
- The **going-concern principle**: The business will continue to operate, using its assets to carry on its operations and, with the exception of merchandise, not offering the assets for sale that are necessary to run the business.
- The **objectivity principle**: Whenever possible, the amounts used in recording transactions are based upon objective evidence rather than on subjective judgments.
- The **stable currency assumption**: The idea that the purchasing power of the unit of measure used in accounting (such as the dollar or the euro) does not change. (In other words, a dollar bill will not become worthless overnight.)
- The **realization principle**: This principle defines revenue as an inflow of assets (not necessarily cash) in exchange for goods or services. It requires the revenue to be recognized at the time, but not before it is earned.

## Getting to Know the Players

### What's My Role?

Understanding the cycle of finance will help you figure out where you fit into your company's financial structure. No matter what your role is, you can help save your company money. Small savings add up!

What if...

- You work in the company's payroll department and you could save \$2.50 per employee check, per payday? How much could you save your company over one pay period?
- You supervise a team that produces widgets and you find a way for them to produce two extra widgets a day without any extra cost? If they sell for \$49.99 each, how much income would the extra two items bring in per year?
- You find a new advertising method that has the same reach but saves \$30,000 a month. What else could you do with that money?

### What can you do to improve your organization's finances?

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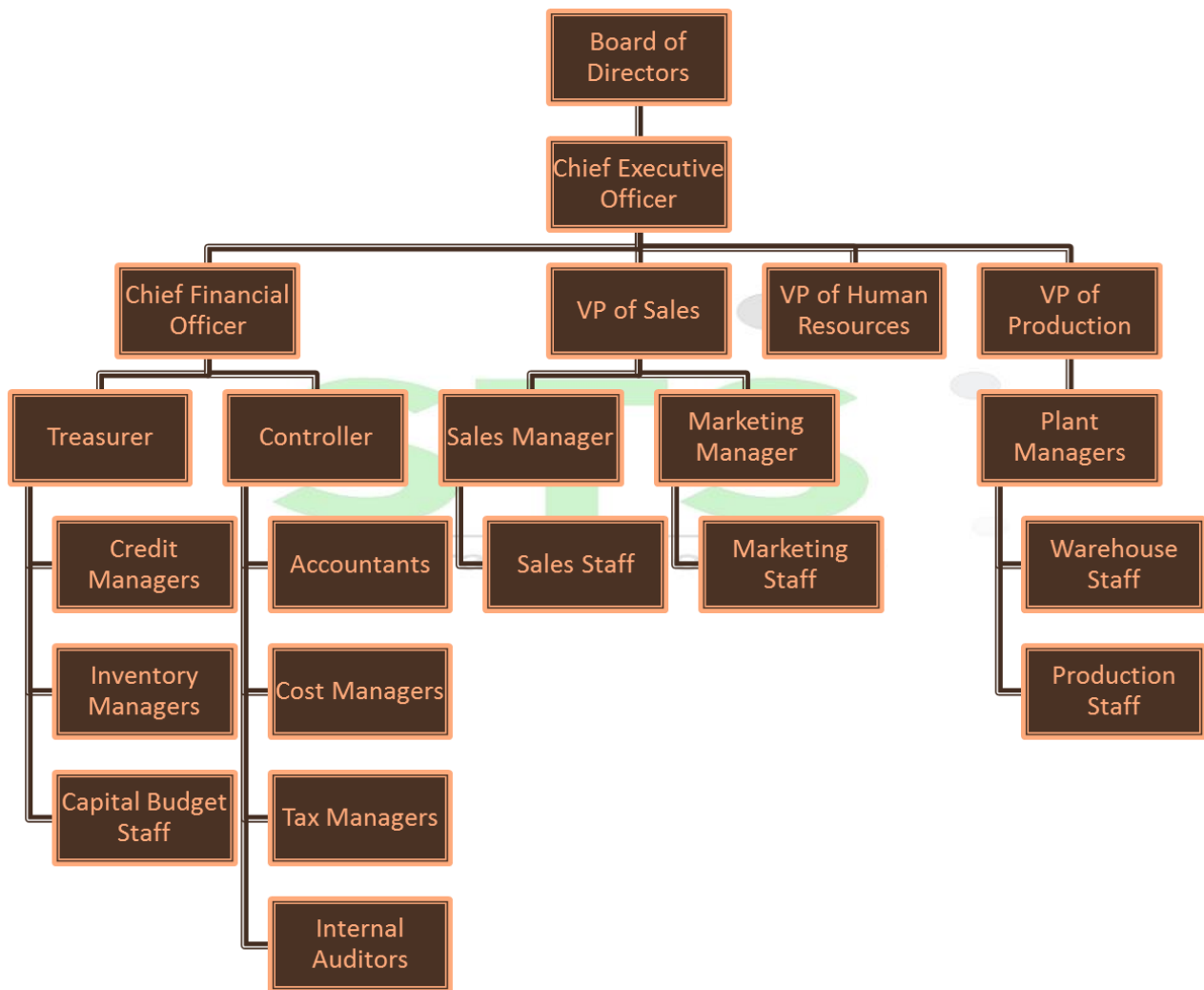
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## The Big Picture

Once you’ve thought about your role, think about your organization and look at what financial-based roles exist. Understanding their responsibilities will help you get a better picture of what your role is, and it will help you identify who to go to when you need help.

Here is how many mid-sized organizations are structured, although not all organizations will have all roles:



The board of directors usually leads the company’s financial direction. Their vision is usually carried out by the Chief Executive Officer (CEO).The CFO, or Chief Financial Officer of a company, is just behind the CEO.



### Governing Organizations

Financial rules and regulations are constantly changing. If you're going to be involved in your company's finances in any way, you should be aware of important regulations that apply to your organization.

Once again, the Internet will be your greatest ally. Just make sure that the site you are visiting is the actual, regulated site, and not an imposter. We've listed the biggest regulatory bodies below.

Area	Organization	website
Australia	Australian Securities & Investments Commission	<a href="http://www.asic.gov.au/asic/asic.nsf">http://www.asic.gov.au/asic/asic.nsf</a>
Canada	Canadian Securities Administrators	<a href="http://www.securities-administrators.ca/">http://www.securities-administrators.ca/</a>
China	China Securities Regulatory Commission	<a href="http://www.csrc.gov.cn/pub/csrc_en/">http://www.csrc.gov.cn/pub/csrc_en/</a>
Hong Kong	Securities and Futures Commission	<a href="http://www.sfc.hk/sfc/">http://www.sfc.hk/sfc/</a>
India	Securities and Exchange Board of India	<a href="http://www.sebi.gov.in/">http://www.sebi.gov.in/</a>
International	Bank for International Settlements and Basel Committee	<a href="http://www.bis.org/">http://www.bis.org/</a>
International	International Organization of Securities Commissions	<a href="http://www.iosco.org">http://www.iosco.org</a>
International	International Association of Insurance Supervisors	<a href="http://www.iaisweb.org/">http://www.iaisweb.org/</a>
International	IFRS Foundation, including International Accounting Standards Board and IFRS Interpretations Committee	<a href="http://www.ifrs.org">http://www.ifrs.org</a>
Japan	Securities and Exchange Surveillance Commission	<a href="http://www.fsa.go.jp/sesc/english/index.htm">http://www.fsa.go.jp/sesc/english/index.htm</a>
New Zealand	Financial Markets Authority	<a href="http://www.fma.govt.nz/">http://www.fma.govt.nz/</a>

Area	Organization	website
United Kingdom	European Securities Committee	<a href="http://ec.europa.eu/internal_market/securities/esc/index_en.htm">http://ec.europa.eu/internal_market/securities/esc/index_en.htm</a>
United Kingdom	European Securities and Markets Authority	<a href="http://www.esma.europa.eu/">http://www.esma.europa.eu/</a>
United States	U.S. Securities and Exchange Commission	<a href="http://www.sec.gov/">http://www.sec.gov/</a>

Wikipedia also offers a list of financial regulatory authorities (organized by country) at [http://en.wikipedia.org/wiki/List\\_of\\_financial\\_regulatory\\_authorities\\_by\\_country](http://en.wikipedia.org/wiki/List_of_financial_regulatory_authorities_by_country). (Again, BOLC assumes no liability or responsibility for the content or accuracy of websites external to the company.)

## The Accounting Cycle

### Underlying Principles

#### Methods of Recording Transactions

There are two basic methods for recording transactions: the cash method and the accrual method. The most commonly accepted accounting method is the accrual method.

The **cash accounting method** is a system which records income when it is received and records expenses when they are paid. For example, if you sold goods and gave the purchaser 30 days to pay you, you would not book the sale until you are paid, which could be as long as 30 days. Only certain types of businesses, primarily farmers and fishermen, are permitted to use this method of accounting. Cash accounting is not widely used because it does not give the most accurate picture of what is happening in the business, particularly in countries where it is common practice to extend credit to customers.

The **accrual method of accounting** counts income and expenses when they are due to or from the business, as distinct from when they are received or paid. Income is recorded when the business has the right to receive the income, and expenses are recorded and considered when they are due, even if they haven't yet been paid.

This accounting process measures a firm's income by matching a firm's revenues against its expenses within an accounting period. (Properly enough, this is called the **matching principle**.)

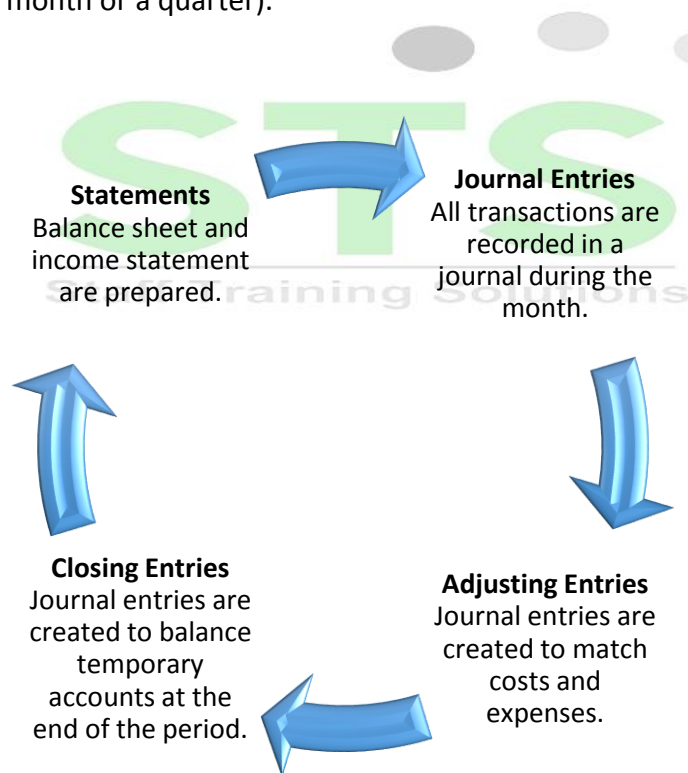
Under accrual accounting, the total sales on the income statement seldom match the firm's actual cash receipts during a particular operating period. Nor do the expenses duplicate its cash disbursements. One area where "incurred" expenses often deviate from "paid" expenses is employee expense reports: the company has incurred these expenses but they have not been paid because the employee has not submitted his expense claim.

### Accounting Periods

At the beginning of its existence, a business establishes its fiscal year end. This is any 12 consecutive months. Many businesses use the calendar year end (December 31<sup>st</sup>) as their fiscal year end but they do not have to. Many businesses also break their fiscal year into smaller accounting periods, such as 12 monthly periods or four quarterly periods of three months. Management will use the accounting periods to compare results against prior periods or even against a budget.

### Overview of the Accounting Cycle

Let's take a look at the life cycle of accounts in a business. This cycle takes place during each accounting period (typically a month or a quarter).



Now, let's define some of the terms that we see here.

The **journal** is the book that all transactions are originally recorded in (although these days, it's often an electronic document, not an actual book!). Generally they are recorded in chronological order and given an entry number. The **ledger** is the final book of entry, with transactions recorded by account and

according to whether they are a debit or credit. (We'll take a brief look at these classifications in our next session.)

A **transaction** can be any kind of financial event, such as a bill being paid, a sale being received, a check being written, etc.

**Balance sheets** and **income statements** are two of the most important financial statements. They should be prepared at the end of each financial period. (We'll look at these statements later on in the workshop.)

**Permanent accounts** are those that appear on a balance sheet (such as cash or accounts to be paid). These accounts always carry a balance (as long as your business is in business, of course!). **Temporary accounts** (such as expenses and revenue) are closed at the end of each period, so that they do not carry over a balance.

**Case Study: Happy Haircuts**

**Background**

Harry Henderson, the owner of Happy Haircuts, has come to you for help in understanding his current financial position. He provides you with the following financial information about last month.

- Harry's company earned \$4,000 by cutting hair. \$3,500 of this was paid in cash. \$500 has not been received.
- Harry paid the rent, which was \$1,000.
- Harry paid his employees \$1,000 in wages.
- Harry had \$500 in power and water bills (utilities), which were not paid.
- Harry also bought a new computer for \$1,000 and has not yet paid for it.
- Harry spent \$800 on hair supplies and paid for them in cash.

**Task**

Calculate Harry's net profit or loss for the month using accrual and cash accounting.

	Accrual	Cash
Revenue		
Expenses		
Rent		

Wages		
Utilities		
Equipment		
Supplies		
<b>Total Expenses</b>		
<b>Net Profit or (Loss)</b>		

## The Key Reports

### The Income Statement

The first key financial statement we will review is the **income statement**, also known as a profit and loss statement or operating statement. This is a summary of the income and expenses of a business during a certain period: monthly, quarterly, or annually. If the company has more income than expenses for a certain period it has net income (a profit). If the expenses exceed income, the company has a net loss.

Income can be broken into two broad categories: **service income** and **sales income**. The difference between the two lies in the need to consider inventory costs. Service income is derived from performing a service while sales income is derived from selling a product of some type. In general, service companies have staff that perform a service for a customer, while sales companies have product that they sell.

With service income, the profit can be determined simply by deducting expenses associated with performing the service. With sales income, however, you must consider the cost of creating the product (raw materials, labor, overhead, etc.). This inventory cost is referred to as the **cost of goods sold**.

The income statement equation typically looks like this:

$$\text{Revenue} - \text{Expenses} = \text{Net Income or Loss}$$

- **Revenue** is what the business earned from the sale of goods and services during this period.
- **Expenses** are bills (phone and Internet bill, insurance, payroll, advertising, etc.) incurred during this period.
- **Net income or loss** is the net financial result of the business efforts during that period. It must be added to the Equity portion of the balance sheet, which we will discuss in a moment.

Some examples of the types of accounts that influence net income and are reported on the income statement usually include:

- Revenue
- Advertising expenses
- Repair expenses
- Utilities expenses
- Wage expenses

### Sample Income Statement

<b>Acme Widgets Inc. Income Statement For the Month Ended February 28, 2020</b>	
<b>REVENUE</b>	
Widget Sales	\$20,000
Widget Installation	\$1,500
Interest Income	\$500
<b>Total Revenue</b>	<b>\$22,000</b>
<b>EXPENSES</b>	
Rent	\$4,500
Utilities	\$1,200
Advertising	\$8,000
Wages	\$5,000
<b>Total Expenses</b>	<b>18,700</b>
<b>NET INCOME (LOSS)</b>	<b>\$3,300</b>

## The Balance Sheet

The purpose of a balance sheet is to show what a company owns and owes as of a specific date. Income statements are prepared “for the period ending” and balance sheets are prepared “as at” a certain date.

The balance sheet summarizes what the business owns and compares it to what the business owes. It does so in a standard format to make it easy to see what kind of financial shape the business is in. If a business has more assets than liabilities, that’s a good sign. On the other hand, if a company has more liabilities than assets, it might be a sign of trouble.

### Balance Sheet Equation

The balance sheet reflects the most basic financial equation:

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

- **Assets** are anything that the business owns. Some examples: cash, office equipment, vehicles, tools, real estate, buildings, and land. **Bills that are prepaid** (such as monthly insurance premiums) are also considered an asset, as are **accounts receivable** (money that others owe to you).
- **Liabilities** are anything the business owes to others, including banks and suppliers. Money which a company owes as a result of its ongoing trading are generally called **accounts payable**.
- **Equity** is often a measure of what the business is worth. It is the combination of profits and money invested in or withdrawn from the company by its owners.

This is what people refer to as balancing the books: ensuring that this equation is always in balance. Accounts typically reported on the balance sheet include:

- Accounts receivable (money owed to the company but not collected)
- Cash
- Equipment
- Accounts, and notes payable
- Prepaid items
- Unearned revenue
- Vehicles, land, and buildings, and their accumulated, individual depreciation (decrease in value)

The term **consolidated balance sheet** refers to the “consolidation,” or adding together, of individual balance sheets of various related companies into one balance sheet, which shows the financial position of the entire group of companies.

### Current vs. Fixed Assets

On a balance sheet, the assets of a business are generally broken down into two groups: current assets and fixed assets.

**Current assets** are generally considered to be anything that will be converted into cash within one year, such as cash, accounts receivable, and inventory. Current assets continually turn over through the company.

**Fixed assets** are more permanent in nature. This includes vehicles, equipment, machinery, land, and buildings. They represent an investment in items that are necessary to carry on its normal operations. Fixed assets can also revolve (to purchase new equipment or update technology, for example) but usually they revolve very slowly.

**Liquidity** measures how quickly a company can convert its assets into cash. An ample cash balance provides security that the company can meet its obligations. The easier the conversion is, the more liquid the asset. Here is a list of current assets in order from most to least liquid:

- Accounts receivable
- Inventory
- Fixed assets

### Sample Balance Sheet

<b>Acme Widgets Inc. Balance Sheet As at February 28, 2020</b>			
<b>Assets</b>		<b>Equity</b>	
Cash	\$2,500	Owner's Capital	\$5,000
Accounts Receivable	7,500	Retained Earnings (Cumulative Net Income)	3,300
Computer Equipment	1,000	Less Withdrawals and Dividends	(300)
Supplies (Inventory)	1,500		
<b>Total Assets</b>	<b>\$12,500</b>	<b>Total Equity</b>	<b>\$8,000</b>
<b>Liabilities</b>			
Accounts Payable	\$500		
Notes Payable	4,000		
<b>Total Liabilities</b>	<b>\$4,500</b>		

**Remember:**

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

$$12500 - 4,500 = 8,000$$

**The Cash Flow Statement****What is the Cash Flow Statement?**

The cash flow statement shows the flow of cash for an accounting period. This statement links the cash accounting method and the accrual accounting method: it analyzes what transactions impacted cash and what transactions were accruals.

The cash flow statement is usually divided into three sections.

**Operating**

- Cash flow for day-to-day operations
- Examples: Customer revenue, tax payments, interest, supplies purchased

**Investing**

- Cash flow generated from or consumed by assets
- Examples: Sale of a vehicle or purchase of a building

**Financing**

- Cash flow in from selling stocks or bonds, or borrowing
- Cash flow out from purchasing stock back, paying out dividends, and repaying borrowed money

**Sample Cash Flow Statement**

<b>Acme Widgets Inc. Statement of Cash Flows For the Month Ended February 28, 2020</b>	
<b>Cash Flows from Operating Activities</b>	
Net Income	\$3,300
Add back non-cash amortization	NA
<b>Subtotal</b>	<b>\$3,300</b>
<b>Net Changes in Non-Cash Working Capital</b>	

Accounts Receivable	(\$7,500)
Supplies (Inventory)	(1,500)
Accounts Payable	500
<b>Total cash provided by (used by) operating activities</b>	<b>(\$5,200)</b>
<b>Cash Flows from Investing Activities</b>	
Cash used to purchase computer equipment	(\$1,000)
<b>Total cash provided by (used by) investing activities</b>	<b>(\$1,000)</b>
<b>Cash Flows from Financing Activities</b>	
Cash received from the issuance of shares	\$5,000
Cash received from the issuance of notes payable	4,000
Cash paid via dividends	(300)
<b>Total cash provided by (used by) financing activities</b>	<b>\$8,700</b>
<b>INCREASE (DECREASE) IN CASH DURING THE PERIOD</b>	<b>\$2,500</b>
<b>CASH BALANCE BEGINNING OF PERIOD</b>	<b>0</b>
<b>CASH BALANCE END OF PERIOD</b>	<b>\$2,500</b>

## Statement of Retained Earnings

### What is the Statement of Retained Earnings?

This statement shows how much of the company's profits were kept inside the company, and not paid out in dividends.

### Sample Statement of Retained Earnings

<b>Statement of Retained Earnings for Acme Widgets Inc. As At February 28, 2020</b>	
Opening retained earnings	0
Add net income for the period	\$3,300

<b>Total Retained Earnings</b>	<b>\$3,300</b>
Minus dividends paid	(300)
<b>Retained earnings</b>	<b>\$3,000</b>

## Keeping Score

### Understanding the Chart of Accounts

Unless you are starting a business from scratch, you won't need to worry about setting up a chart of accounts. However, you may need a new account, in which case you should understand where it fits in. It is also vital that you understand the hierarchy of accounts in order to understand how transactions flow through the business.

First, let's review the two key equations that we looked at before lunch.

The **income statement equation** is:

$$\text{Revenue} - \text{Expenses} = \text{Net Income or Loss}$$

The **balance sheet equation** is:

$$\text{Assets} - \text{Liabilities} = \text{Equity}$$

Every accounting transaction involves parts of these equations. Below is a list of some common accounts in the chart of accounts and where they would fit into the equations.

#### Assets

- Cash
- Vehicles
- Accounts receivable (money that others owe to you)
- Equipment and tools
- Buildings and land

#### Liabilities

- Accounts payable (debts that you owe, due within one year from today)
- Notes payable (debts that you owe, due beyond one year from today, except for mortgages)
- Mortgages payable

**Equity**

- Capital (money the owner has put into the business)
- Withdrawals (money the owner takes out of the business)
- Dividends (money paid to shareholders and owners)

**Revenue**

- Money the business has earned for goods or services

**Expenses**

- Advertising
- Insurance
- Interest
- Payroll
- Rent
- Supplies
- Utilities
- Anything that is spent to keep the business running

**Single vs. Double Entry Accounting**

There are two main methods of accounting: single and double entry.

**Single Entry Accounting**

In general, each accounting entry has two parts: a debit and a credit. With single entry accounting it is possible to create a transaction that has only a debit or a credit (only one side). This method is usually used for very small businesses that use cash-based accounting and entries are recorded when money moves in or out. Single entry accounting is not popular.

A checkbook is a good example of a single entry accounting system. You make entries in your checkbook as you make deposits and write checks.

Check #	Date	Description	Payment		Deposit		Balance	
							5000	00
101	01/01/20	Rent	1000	00			4000	00
N/A	01/05/20	Deposit from Smith Plumbing			675	21	3324	79

In single entry accounting, items are not simply noted in the checkbook but are actually entered into the accounting records. The risk with single entry accounting is that the second side of the entry is not ultimately made and the balance sheet does not balance.

**Double Entry Accounting**

This is the method used by most businesses and preferred by accountants. With this method, every valid entry or transaction must involve two (or more) accounts. (In fact, most accounting software packages will not allow you to post a single entry transaction!) Both sides – the debit and the credit – of the transaction must balance and this ensures that all financial statements balance.

For example, let’s say that the business buys a \$2,000 computer on credit. The company’s assets go up by \$2,000 (the debit) but the liabilities also go up by \$2,000 (the credit). As this is paid, assets (cash) decrease as payments are made and the liability goes down by the same amount.

Some notes about recordkeeping:

- Dollar signs are typically not used in journals or ledgers, but should be placed in financial reports and statements (even if it is on the first line only).
- Commas (to show thousands of dollars) are not required in journals or ledgers but should be placed in financial reports and statements for clarity.
- Dashes or blank spaces can be used to indicate zeroes.

**Self-Test**

**Classify each of the accounts listed below.**

	Assets	Liabilities	Equity	Revenue	Expenses
Wages paid during the month					
Maintenance garage					
Long-term investments					
Fees for servicing widgets					
Short term loan					
Owner’s salary					
Accounts receivable					
Office supplies					

Money from widget sales					
Accounts payable					

## A Review of Financial Terms

Term	Definition
	Total of the money owed by the company to suppliers or vendors.
	Money due to the company from customers that have not been paid.
	Expenses that have been incurred but are not due to be paid.
	Revenue that has been earned but is not yet due to be paid. (Typically this is because it has not been invoiced.)  Example: You are working on a six-month project and the bill will not be sent until the project is complete. In the accrual accounting system, you will need to create an adjusting entry for each of the first five months to show earnings.
	A journal entry that moves the difference between revenue and expenses from the income statement to the owner's equity.
	Total price paid for the products being sold by the business, including shipping costs.
	The decrease in value of a fixed asset over its life. This expense is spread out over its future life. It is considered a source of cash because it can reduce your tax bill.
	What the shareholders or company owner has left after all liabilities have been paid.
	Profit before expenses, interest, taxes, and other charges have been deducted.
	The sum of finished products, work in progress, and raw materials on hand.

Term	Definition
	The company's debts.
	Profit after expenses, interest, taxes, and other charges have been deducted.
	An asset that you have paid for but not used. For example, businesses often pay insurance up-front at the beginning of the year. The expense is incurred all at once and then the asset is redeemed over the course of the year.
	The profits of a business that are not paid to shareholders or the owner. They are retained by the business, reinvested in the company, and therefore accumulate.

### Further Reading:

- ✓ *Brookson, Stephen. Essential Managers: Managing Budgets. DK Publishing, 2000.*
- ✓ *Kemp, Sid. Budgeting for Managers. McGraw-Hill, 2003.*
- ✓ *—. Perfect Solutions for Difficult Employee Situations. McGraw-Hill, 2004.*