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DI BERGAMO

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di Scienze Aziendali

Corso di Laurea Magistrale in
**ACCOUNTING, GOVERNANCE AND
SUSTAINABILITY**

Bookkeeping and Accounting

International and Advanced Accounting

RELATORI

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SEDE

Bergamo

SOME FUNDAMENTALS

In all activities and in all which require money and other economic resources, accounting is required to account for these resources.

Where we 'll go
on vacation this
summer?

mmm...what is
the **budget**?



SOME FUNDAMENTALS

«Just a second
Bob.....
the **accounts**
don't **balance**»



SOME FUNDAMENTALS



With 2014 now well and truly in full swing, many families will be looking at ways to get their finances in check through more efficient **budgeting**.



SOME FUNDAMENTALS

What does “Accounting” mean?

The systematic and comprehensive **recording of financial transactions** pertaining to a business.

Accounting also refers to the process of **summarizing, analyzing and reporting** these transactions.

The financial statements that summarize a large company's operations, financial position and cash flows over a particular period are a concise summary of hundreds of thousands of financial transactions it may have entered into over this period.

SOME FUNDAMENTALS

Objective of Accounting

Objective of accounting may differ from business to business, the general objectives of Accounting are:

- **To keep systematic record:** It is very difficult to remember all the business transactions that take place. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.

SOME FUNDAMENTALS

➤ **To ascertain the results of the operation:** Accounting helps in ascertaining result i.e., profit earned or loss suffered in business during a particular period.

For this purpose, a business entity prepares either a Trading and Profit and Loss account or an Income and Expenditure account which shows the profit or loss of the business by matching the items of revenue and expenditure of the some period.

SOME FUNDAMENTALS

- **To ascertain the financial position of the business:** In addition to profit, a businessman must know his financial position i.e., availability of cash, position of assets and liabilities etc. This helps the businessman to know his financial strength.
- **To portray the liquidity position:** Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners and about other factors that may affect an enterprise's liquidity and solvency.

SOME FUNDAMENTALS

- **To protect business properties:** Accounting provides up to date information about the various assets that the firm possesses and the liabilities the firm owes, so that nobody can claim a payment which is not due to him.
- **To facilitate rational decision – making:** Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.
- **To satisfy the requirements of law**

SOME FUNDAMENTALS

Accounting is an Art of:

Recording

classifying

Summarizing

Interpreting

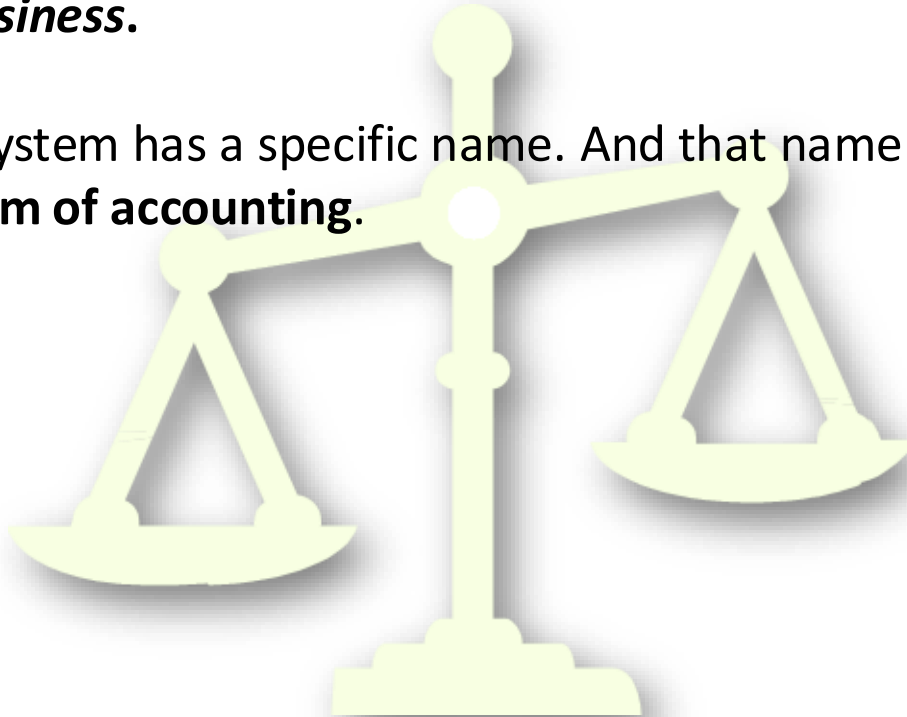
Reporting

SOME FUNDAMENTALS

What does “Accounting” mean?

You learnt that accounting is *a system of recording information about a business.*

Well, this system has a specific name. And that name is **the double entry system of accounting.**



DOUBLE ENTRY ACCOUNTING

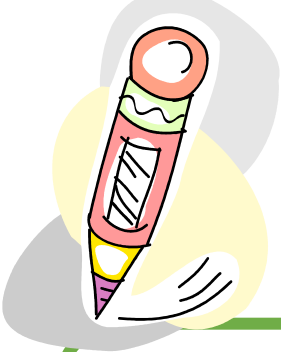


The system of double entry may be well compared to a scale which must have equal weight on both sides in order that the scale is balanced.

Thus if the weight of one side of the scale is increased or decreased the same weight must be correspondingly added to or removed from, the other side.

A more common expression of double entry book keeping system is the **accounting equation**.

A simple example



Introducing accounting with a very simple example

Using a very simple example, we **draft a company constitution** and then its **management** for the realization of its objectives,

The business idea



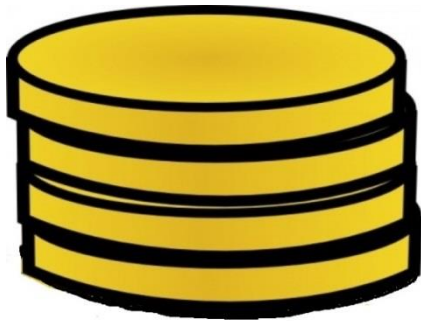
Peter decides to undertake the business of **selling sandwiches** at the stadium in his city and convince a friend to join this initiative by pouring their savings into a bank.

Peter and his friend **invest € 2,00 each one** in this initiative.

A company with **2 partners** with **50% each one** and an **initial capital of € 4.00**.

Company Establishment

At this stage, the company **assets** are made up of **money** (€ 4.00) which comes from the savings of the two friends (€ 4.00)



Shareholders' equity

Using accounting language, we can say that the **bank** is bound by two friends as a source of financing of the business purposes, and **cash** constitutes the use (available to the two friends to carry out the activity)



The management starts!

At this point, Peter goes to the bakery and buys some sandwiches paying € 2,00.

With the purchase, he realizes that the initial financial resources are not sufficient to carry on the business.

Peter turns to his father and gets a loan of € 11,00.

The management starts!

After the **investment** transaction

(= sandwiches purchase)

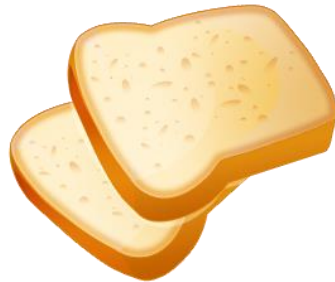
and the **loan** transaction

(= obtain new resources),

the company's **equity** has been **enriched** by a new source but also new uses:

Balance Sheet

Uses



Sources



Other transactions

With the money obtained Peter goes to the grocery store and buy **ham** for a value of € 8,00.

On the same day prepare some **ham sandwiches**; he encountered many difficulties due to the lack of a **knife** to cut the sandwiches in half.

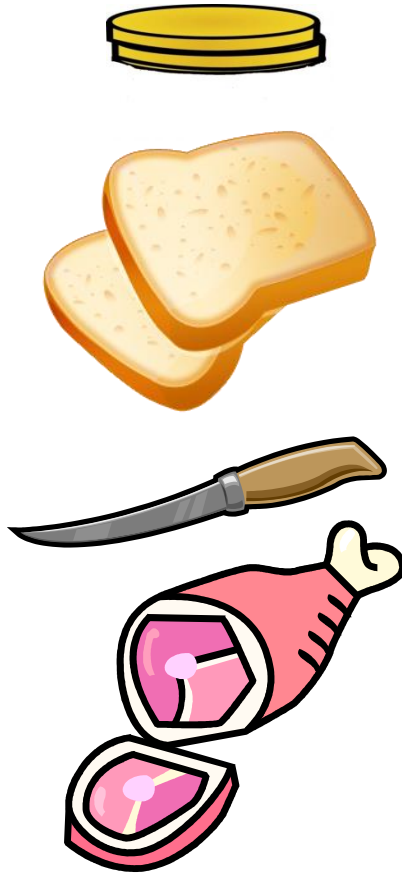
Peter and his partner decided to buy a knife to the value of € 4.00 each one to improve the quality of their products.



The company's equity undergoes a major change, but only from the point of view of uses.
The sources of funding have not changed.

Balance Sheet

Uses



Sources



The production process

The bread and the ham are used (=consumed) for the production of sandwiches, while the knife assumes the function of **"instrumental good"** lasting several years.

The knife can be used in most production processes, while the bread and ham once used (consumed =) must be repurchased.

the bread and ham do not enter into equity but are to be considered "**purchase costs of raw materials**" that will be used for the production process "sandwiches production".

After the production, Peter sells sandwiches to two customers, receiving in cash € 11,00.

We can distinguish the elements (uses / sources) that form the **assets of the company** (all that is available for the future management) from the elements that will be consumed in the process for obtaining two sandwiches, then sold.

Statement



Here, is introduced the **Income**

Balance Sheet

Uses



Sources



Income statement

Uses



Sources



Balance Sheet

Uses

12,00



4,00



Sources

4,00



11,00



Income statement

Loss

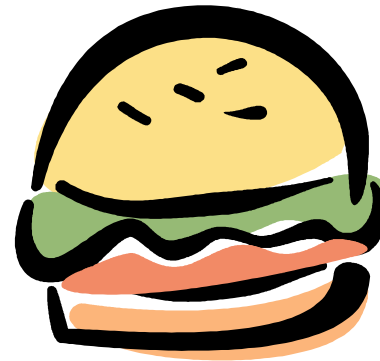
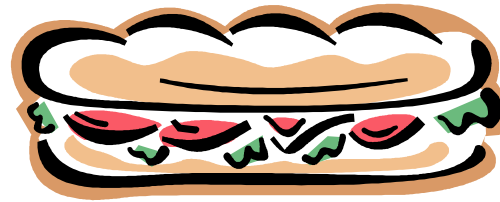
2,00



8,00



Profit



11,00

The accounting language

Accounting as all registers has its own rules.

Every company organizes its own chart of accounts, that is, a list of accounts entitled to the class of values recognized in the accounts.

Let's see how to summarize our element:

Balance sheet

Uses		Sources	
Cash	12,00	Equity	4,00
Equipment	4,00	Financial debts	11,00

Income statement

COSTI	RICAVI
Raw material 10,00	Revenues 11,00

The economic result

The income statement shows that the two friends have made a profit of € 1.00
(Revenues - Costs)

This profit of € 1.00 increased the initial capital (€ 4,00 + 1,00) **bringing sources and uses in balance**

The Balance Sheet

Uses		Sources	
Cash	12,00	Equity	4,00
Equipment	4,00	Profit	1,00
	-----	Financial debts	11,00
	16,00		-----
			16,00

Learn to identify transaction elements

What we learn from this simple example



Learn to identify transaction elements

The main objective of Double Entry Accounting is to create a balanced financial picture, that is, we should not only know how money was used, we should also know where it came from. We achieve this balance in information through the way we record and organize financial transactions – so it is very important to understand **the elements of a financial transaction**.

Financial transactions are exchanges of things of value. In order to record a financial transaction, we need to be able to answer these four questions.

1. How was the money used? What was either acquired or paid for by this exchange?
2. Where did the money come from? What is the source of the money in this exchange?
3. What is the value of the exchange?
4. When? What is the date of the transaction?



Learn to identify transaction elements

1. How was the money used? What was either acquired or paid for by this exchange?



Acquisition/Uses are:

- Expenses
- Increases in what you own
- Decreases in what you owe

Expenses:

Consumable item such as Rent, Phone Service, Food or Fuel. Those are short term acquisitions, what you've paid for is used up and may even be used up by the time they are paid for but while they lasted, they belonged to you.

Increases in what you Own:

Increasing what you own is an acquisition: It is easy to identify the acquisition in things you own such as Cash and Assets like Vehicles, Buildings and Equipment.

Decreases in what you Owe:

As I pay off something I owe, like a car loan, that is an acquisition because I have increased my own claim on that car, I own more of it and the bank owns less of it.

Learn to identify transaction elements

2. Where did the money come from? What is the source of the money in this exchange?



Sources Are:

- Increases in Income
- Increases in what you Owe
- Decreases in what you Own

Income:

Income is the amount you charge in exchange for your products or services. When you receive a paycheck, the Paycheck is the Acquisition/Use and the *Source* is *Income*.

Increases in What you Owe:

Loans are temporary sources, meaning that eventually you will pay them back. Loans increase when they are Sources, and they decrease when they are Acquisitions/Uses.

Investments into a business by its Owners are Sources. The business essentially *owes* its owners the amount they've invested. In the case of a cash investment, Cash is the Acquisition/Use and the Owner's Investment (Equity) is the Source. Equity increases when it is a Source.

Decreases in What you Own:

The easiest Source to identify is Cash, we often use cash to pay for the things we buy. Using cash as the Source actually causes a decrease in the things you own – in this case, a decrease in cash. Other things you own can also be used as a Source. If you trade one car for another, at least part of the Source in this case is your original Car.

Learn to identify transaction elements

Transaction Example: November 1, 20xx Paid \$500 **to landlord for Rent with Check #100**

- **1: Acquisition/Use** = Rent
- **2: Source** = Checking Account (Check/Cash)

In this case, we took money from the Checking Account and used it to pay Rent.

What if I didn't trade cash for rent, what if **I traded accounting services with my landlord in exchange for rent?**

- **1: Acquisition/Use** = Rent
- **2: Source** = Accounting Services (Sales = Income)

In this case, the Acquisition/Use would still be Rent, I still had use of the space for the month, but this time, instead of the Source being the Checking Account, the Source is Accounting Services (Income).

Now lets say another tenant noticed the accounting services and **asked me to do some accounting work for her.**

Let's say the agreement for this work is that she'll pay me in exchange for the work.

- **1: Acquisition/Use** = Checking Account (Check/Cash)
- **2: Source** = Accounting Services (Sales/Income)

In this case, we earned Money from the Accounting Services Provided

Learn to identify transaction elements

Let's say that I used \$1500 of **my own money to open a new checking account** for my business.

- 1: Acquisition/Use = Checking Account
- 2: Source = Owner's Investment (Owner's Equity)

In this case we're recording the Business's transactions, the Business acquired money in the checking account and increased how much investment the owner has in the business.

Learn to identify transaction elements

Identify the Use and the Source for each of these financial transactions.

Transactions 1 – 7 occur in November 20XX

Description	Acquisition/Use (Debit)	Source (Credit)
1. Owner invested in the business and deposited \$1500 into the Business Checking Account		
2. Paid Rent of \$500 with Check #100		
3. Bought Office Phone/Fax for \$75 with Check #101		
4. Used check #102 to buy new Printer for \$150		
5. Bought \$75 of Office Supplies with Check #103		
6. Bought \$500 in parts for Server with Check #104		
7. Bank Charges of \$10 deducted from Checking Account		

Learn to identify transaction elements

All of the transactions to this point have been **cash transactions** but a common event is to receive **goods or services “on account” or “on credit”**. In that case, we record the receipt of goods and services when we are billed for them.

1. Receive the goods or services on account – no entry recorded
2. Receive a bill for the goods or services – record receipt of Goods or Services and the Obligation to Pay (**Accounts Payable**).
 - **Acquisition/Use** = Goods or Services
 - **Source** = Accounts Payable
3. Pay the bill – record Payment of Accounts Payable
 - **Acquisition/Use** = Accounts Payable (Decrease what I owe)
 - **Source** = Checking Account

Learn to identify transaction elements

Sometimes, we are **providing** the goods or services on “account” or “credit”.

1. Provide the goods or services on account – no entry recorded
2. Send a bill for the goods or services – record the Sale of Goods or Services and record our customer's Obligation to Pay us (**Accounts Receivable**).

- **Acquisition/Use** = Accounts Receivable
- **Source** = Sale/Income

3. Receive payment for the bill – record Cash Receipt for Payment of Accounts Receivable

- **Acquisition/Use** = Checking Account (Check/Cash)
- **Source** = Accounts Receivable (decrease what I own)

Learn to identify transaction elements

Transactions 8 – 16 of Table 2 occur in December 20XX Description

Description	Acquisition/Use	Source
8. Owner invested another \$1100 and deposited it into Checking Account		
9. Bought \$700 Office Chair with Check #105		
10. Had car's Oil Changed for \$25 – used Check #106		
11. Deposited \$500 check for providing Advertising Space on site into Checking Account		
12. Received \$150 Phone Bill		
13. Received \$100 Electric Bill		
14. Received Credit Card Statement \$930 – additional entries below (prior to #15): Credit Card Interest and Fees \$ 30		
• Office Desk \$245		
• Fuel \$25		
• Business Magazines \$65		
• Business Lunch \$45		
• Website Hosting \$120		
• Server Parts \$400		
15. Paid \$500 on Credit Card with Check #107	Accounts Payable	
16. Bank Charges of \$15 deducted from Checking Account		

Journal Entries



We've been using substituting “**Acquisition/Use**” for the Accounting term “**Debit**” and “**Source**” for the Accounting term “**Credit**”.
Moving forward, we'll use the accounting terminology.

Just remember that Debit always means
“Acquisition/Use” and Credit always means “Source”.
No exceptions.

Journal Entries

Let's review the four questions that must be answered for each transaction. They are:

1. How was the money used? What was either acquired or paid for by this exchange?
2. Where did the money come from? What is the source of the money in this exchange?
3. What is the dollar value of the exchange?
4. When? What is the date of the transaction?

The answers for each of these questions are recorded in a journal, hence the term “**journal entry**”.

Journal Entries

Let's review the four questions that must be answered for each transaction. They are:

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4. When? What is the date of the transaction?

The answers for each of these questions are recorded in a journal, hence the term “**journal entry**”.

Journal Entries

Date	Account Name	Debit	Credit
January 1	Accounts Receivable	1,000.00	
	Cost of Goods Sold	750.00	
	-Revenues (Sales)		1,000.00
	-Inventory		750.00
To record the sale of inventory on credit.			

Accounting Journals are grids of rows and columns.

For the purpose of this exercise, we'll use five columns, the columns from left to right are **Date**, **Description**, a numeric column for **Debit Amounts** and a numeric column for **Credit Amounts**.

The left numeric column is always the Debit Column and the right numeric column is always the Credit Column.



Journal Entries

Example 4: Transaction # 1

Answer 1: The money was deposited into the Checking Account.

Answer 2: The money came from the Owner.

Answer 3: \$1,500

Answer 4: November, 2010

Date	Description	Ref	Debit	Credit
Nov/2010	Checking Account	1	\$1,500.00	
	Owner Investment			\$1,500.00
	<i>*Deposited \$1500 from owner into checking account</i>			

As you can see, the amount from Question 3 has been entered twice (**double entry**), once in the Debit Column and once in the Credit Column.

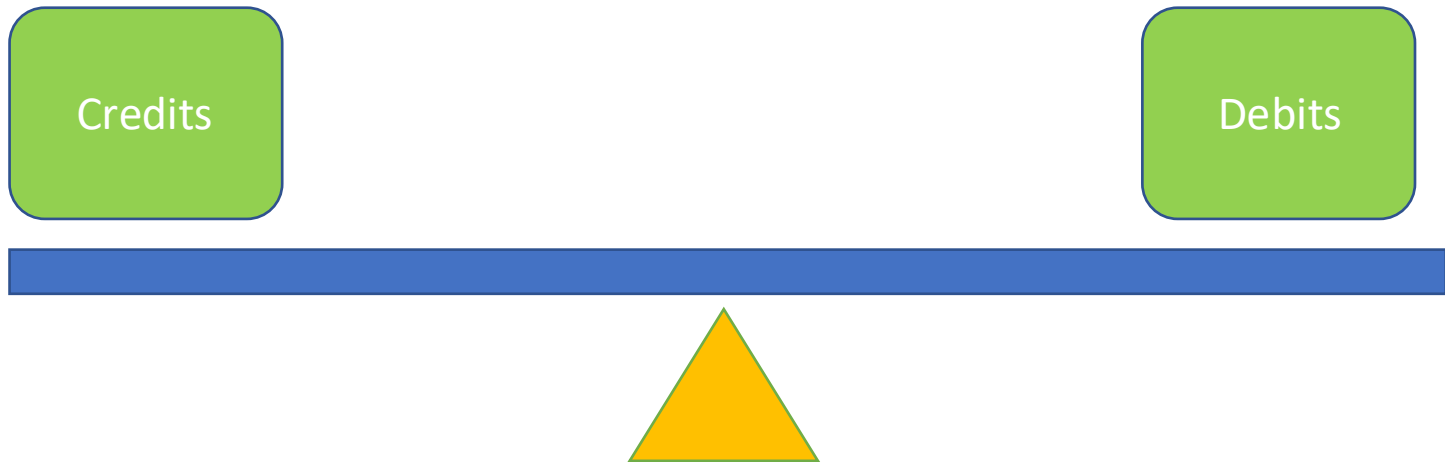
This is the double entry method and it creates a balanced picture of a business - associating values to the answers to both questions 1 and 2. If you have answered all four questions for each transaction and the **Debit and Credit columns always add up to the same number, your books are in balance.**

This brings us to the most basic rule of accounting.

Journal Entries

This brings us to the most basic rule of accounting.

Total Debits must always equal Total Credits



Journal Entries

Sometimes there is more than one answer to one or both of those questions.

In those cases, **multiple lines may be used** and the amounts must be split up for each answer.

For example, in the case of a credit card statement there can be many different types of charges on one statement. You have already seen an example of this in the first exercise, now we'll see how the journal entry looks for multiple line answers.

In this case, since there are multiple answers for Question 1, the descriptions and the amounts related to each separate part of the answer are listed on separate lines but the total of the amounts associated with Question 1 and with Question 2 will always be equal, fulfilling the requirement that Total Debits = Total Credits.

Journal Entries

- Example 5: Transaction 299, Credit Card Statement for December 2010, Total Due = \$150.00 (individual charges are listed separately and include 75.00 for Office Supplies etc... as seen below)

Date	Description	Ref	Debit	Credit
Dec/2010	Office Supplies	299	\$75.00	
	Fuel		\$25.00	
	Magazine Subscription		\$50.00	
	Accounts Payable			\$150.00
	*Credit Card Statement Dec/2010			
Totals:			\$150.00	\$150.00

Journal Entries

Create the Journal Entries

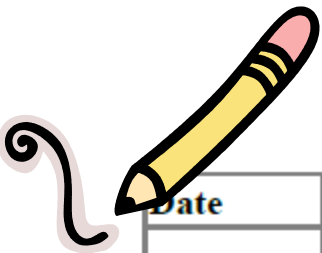


Create Journal Entries for the transactions 1-16 in Tables 1 and 2 from our first exercise in the grid below. Add the transaction reference number in the “Ref” column. This will be important later when we transfer our entries to the General Ledger.

Date	Description	Ref	Debit	Credit
Nov/2010	Checking Account	1	\$1,500.00	
	Owner's Investment			\$1,500.00
	<i>*Deposited \$1500 from owner into checking account</i>			
Nov/2010	Rent	2		

Journal Entries

Now, it's your turn!

[illegible]

Journal Entries

Journal entries gather great information but they don't really tell you anything by themselves.

Account Ledger

Donald Lynch
1102 East Shore Rd.

Beulah MI 49231

Unit # - 1 - C
Date - 02/15/2008
Rent - \$45.00
Balance - \$55.00

Our next step is to organize our transactions and post them into a ledger to make our journal entries meaningful. The rest is all about arranging our journal entries by description (account) and date.

Date	Description	Reference	Debit	Credit	Balance
02/24/2006	February Rent	INITIAL	\$7.32		\$7.32
02/24/2006	Initial Deposit	INITIAL	\$41.00		\$48.32
02/19/2006	Misc. Sale	lock	\$8.00		\$56.32
02/19/2006	Cash on Account	#213		\$56.32	\$0.00
03/01/2006	March Rent		\$41.00		\$41.00
03/15/2006	Late Charge		\$10.00		\$51.00
04/01/2006	April Rent		\$41.00		\$92.00
04/06/2006	Cash on Account	cash		\$41.00	\$51.00
04/15/2006	Late Charge		\$10.00		\$61.00
05/01/2006	May Rent		\$41.00		\$102.00
05/09/2006	Cash on Account	# 54667		\$61.00	\$41.00
05/15/2006	Late Charge		\$10.00		\$51.00
06/01/2006	June Rent		\$41.00		\$92.00
06/07/2006	Cash on Account	# 5545		\$92.00	\$0.00
07/01/2006	July Rent		\$41.00		\$41.00
07/07/2006	Cash on Account	cash		\$41.00	\$0.00
08/01/2006	August Rent		\$41.00		\$41.00
09/01/2006	September Rent		\$41.00		\$82.00
09/15/2006	Late Charge		\$10.00		\$92.00
09/19/2006	Cash on Account	# 1231		\$41.00	\$51.00

Make Sense of the Journal Entries

The first step to take in organizing journal entries is to make a list of the descriptions we used in answering Questions 1 and 2.

That list will be called our **Chart of Accounts**.

Don't let the terminology get in the way, the Chart of Accounts *really is* **just a list of transaction descriptions**.

Let's start with the list of descriptions we've already generated.

Remember that we did not create this list first, we just added descriptions as new things happened. It is most common for an accountant to set up the Chart of Accounts ahead of time and then add to it as needed but that is not required, you can just create the list as you are recording journal entries.

Once the Chart of Accounts has been started though, make sure to check for existing descriptions that might fit when recording journal entries so you don't create duplicates.

Make Sense of the Journal Entries

List of Descriptions from transaction Questions 1 and 2

- Checking Account
- Owner's Investment
- Rent
- Office Phone/Fax
- Printer
- Office Supplies
- Server Parts
- Bank Charges
- Office Chair
- Oil Change
- Advertising Sales
- Phone Service
- Accounts Payable
- Electric Service
- Credit Card Interest and Fees
- Office Desk
- Fuel
- Magazine Subscription
- Business Lunch
- Website Hosting

Make Sense of the Journal Entries

Let's edit our list a little bit.

Group accounts together with more general descriptions where it makes sense to do so.

For example, you wouldn't add individual accounts for paper, pens and staples, you would just use one account called Office Supplies.



Another example might be to use Office Furniture as an account rather than separating the chair and desk.

Make Sense of the Journal Entries

From the transactions in the Tables 1 and 2, we have started a Chart of Accounts. Column 1 is the list of accounts generated from the transactions. In Column 2, we combine some accounts and make the descriptions more general and in Column 3, we eliminate duplicates.

<u>Original Descriptions</u>	<u>Revised</u>	<u>Chart of Accounts</u>
Checking Account	Checking Account	Checking Account
Owner's Investment	Owners' Equity	Owners' Equity
Rent	Rent	Rent
Office Phone/Fax	Office Equipment	Office Equipment
Printer	Office Equipment	
Office Supplies	Office Supplies	Office Supplies
Server Parts	Computer Hardware	Computer Hardware
Bank Charges	Bank Charges	Bank Charges
Office Chair	Office Furniture	Office Furniture
Oil Change	Repairs and Maintenance	Repairs and Maintenance
Advertising Sales	Advertising Sales	Advertising Sales
Phone Service	Phone Service	Phone Service
Accounts Payable	Accounts Payable	Accounts Payable
Electric Service	Electric Service	Electric Service
Credit Card Interest and Fees	Credit Card Interest and Fees	Credit Card Interest and Fees
Office Desk	Office Furniture	
Fuel	Fuel	Fuel
Magazine Subscription	Subscriptions	Subscriptions
Business Lunch	Meals	Meals
Website Hosting	Website Hosting	Website Hosting

Make Sense of the Journal Entries

Now, that we have created the **Chart of Accounts** we can use it to make sense of our **journal entries**.

To do this we will transfer our **journal entries** into our **General Ledger**.

The General Ledger reorganizes journal entries and sorts them by Account rather than by Journal Entry transaction number.

Example 6:

General Journal				
Date	Description	Ref	Debit	Credit
Nov/2010	Checking Account	1	\$1,500.00	
	Owner Investment			\$1,500.00
Nov/2010	Rent	2	\$500.00	
	Checking Account			\$500.00

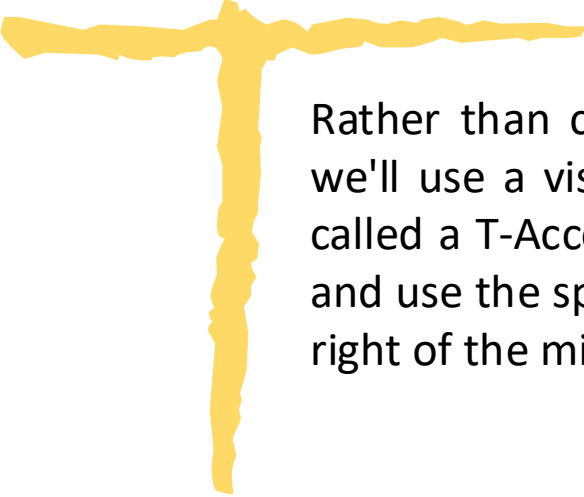
General Ledger					
Account:	Checking Account				
Date	Description	Ref	Debit	Credit	Balance
Nov/2010	Owner Investment	1	\$1,500.00		\$1,500.00
Nov/2010	Rent, Check#100	2		\$500.00	\$1,000.00

Make Sense of the Journal Entries

In a hand written General Ledger each account has its own page(s) where all entries for that account are listed and a running balance is kept.

Notice that the debits and credits do not balance for the General Ledger Account “Checking Account”. This is because we're only looking at part of each journal entry when we're looking at a specific general ledger account.

Notice how the Ref fields for both the journal and the ledger correspond to each other, if I look for Ref 1 in the journal, I can see the entire entry rather than **just the part that relates to the Checking Account.**



Rather than create a page here for each account in our general ledger, we'll use a visual tool used by many accountants called a **T-Account**. It's called a T-Account because you just draw a T, put the account title on top and use the space left of the mid line to record **debits** and the space to the right of the mid line to record **credits**.

Make Sense of the Journal Entries

T-ACCOUNT

Checking Account

General Ledger

Account:	<i>Checking Account</i>			
Date	Description	Ref	Debit	Credit
Nov/2010	Owner Investment	1	\$1,500.00	
Nov/2010	Rent, Check#100	2		\$500.00
Nov/2010	Office Phone/Fax, Check #101	3		\$75.00

T-Accounts are a compact and easy way to view the effects of transactions on multiple accounts.

Make Sense of the Journal Entries

T-Accounts for November Transactions (1-7 from Table 1)

Checking Account	Owner's Equity	Rent	Office Equipment	Office Supplies	Computer Hardware
1 1500	1 1500	2 500	3 75	5 75	6 500
2 500	cr 1500	dr 500	4 150	dr 75	dr 500
3 75			dr 225		
4 150					
5 75					
6 500					
7 10					
dr 1500		Bank Charges			
cr 1310		7 10			
-1310		dr 10			
dr 190					

Make Sense of the Journal Entries

Create entries in the T-Accounts for the December transactions from Tables 1 and 2.

Checking Account	Owner's Equity	Computer Hardware	Bank Charges
Office Furniture	Repairs & Maintenance	Sales	Accounts Payable
Phone Service	Electric Service	Credit Card Fees	Fuel
Subscriptions	Meals	Website Hosting	

Now, it's your turn!

Organizing the Chart of Accounts

Accounts for the Financial Statements are organized in very specific order so before we can produce and analyze the statements, we need to understand how to organize our Chart of Accounts.

The Chart of Accounts is organized using three different methods.

- First: Accounting Types
- Second: Order of Liquidity - the ease of converting to cash without loss of value
- Third: Account Numbers

Accounting Types:

The 7 Basic Accounting Types (In order) Are:

- **Assets** - *Things you own
- **Liabilities** - Things you owe
- **Equity** - Owners Stake in Company
- **Revenue** - Income through Sales of the Services or Products of the Business
- **Costs of Goods Sold** - Costs to provide the service or to manufacture or acquire the product the business sells
- **Expenses** – *Operating costs, these have no lasting value but are part of the cost of running a business
- **Other Revenue and Expenses** - Revenue and Expenses that are unusual cases and are not directly related to the business product and are not usual costs of running a business

* The cost of an item will sometimes cause it to be classified as an expense rather than as an asset. For concept purposes, we will discuss the cost exception at a later point with the discussion on depreciation.

Organizing the Chart of Accounts

Costs and Expenses are very similar and at this point **if you aren't sure whether something is a Cost or an Expense, classify it as an Expense.**

The difference between Costs and Expenses can only be determined if you know what the **business “does for a living” what does it sell?** If you know what the business sells, you will be able to determine what the costs of that product or service are.



In the case of our example business, **the business is selling advertising space on its website**. The owner creates the web pages and is not collecting a salary at this time.

The **software** to create the web pages is provided for free so the only direct costs for the product are Website Hosting costs.

Organizing the Chart of Accounts

Let's take a look at our Chart of Accounts in its original order. Try to Identify the accounting Type for each Account.

Account	Accounting Type
Checking Account	
Owners' Equity	
Office Equipment	
Office Supplies	
Computer Hardware	
Bank Charges	
Office Furniture	
Repairs and Maintenance	
Advertising Sales	
Phone Service	
Accounts Payable	
Electric Service	
Credit Card Interest and Fees	
Fuel	
Subscriptions	
Meals	
Website Hosting	

Sorting by Order of Liquidity

The Chart of Accounts' second method of organization is Order of Liquidity.

Order of Liquidity sorting applies to Assets and Liabilities.

Cash is the most liquid of all assets and other assets are listed in the order that they can be expected to convert to cash (turnover) at close to their current value.

Accounts are listed in **descending order of liquidity within their accounting types**, **with cash at the top of the list for Assets**.

Assets and Liabilities are divided into the Subtypes of **Current** and **Fixed/Long Term** to group items of similar liquidity together.



Sorting by Order of Liquidity

Order of Liquidity Guidelines

Assets

Current Assets

Cash

Receivables

Inventory

Fixed Assets

Property

Plant

Equipment

Liabilities

Current Liabilities

Long Term Liabilities

The “Current” subtype applies to assets and liabilities expected to turnover within **ONE year**.

The “Current” subtype for Assets and Liabilities is important for two reasons. First, it groups together items with a high turnover rate and second, it provides a quick warning sign for cash management.

Current Liabilities are usually paid by Current Assets so having a higher balance in Current Liabilities than in Current Assets is a warning sign – it is not foolproof so use caution when using it as a management tool.

Sorting by Order of Liquidity

Accounts Sorted by Accounting Type and Order of Liquidity

Account	Accounting Type
Checking Account	Current Asset
Office Equipment	Fixed Asset
Computer Hardware	Fixed Asset
Office Furniture	Fixed Asset
Accounts Payable	Current Liability
Owners' Equity	Equity
Sales	Revenue
Website Hosting	Cost of Goods Sold
Repairs & Maintenance	Expense
Fuel	Expense
Office Supplies	Expense
Subscriptions	Expense
Meals	Expense
Phone Service	Expense
Electric Service	Expense
Bank Charges	Expense
Credit Card Fees & Interest	Expense

Quiz

Answer the following true/false questions:

- 1. The balance side of a revenue account is the debit side.**
- 2. The balance side of an expense account is the debit side.**
- 3. If withdrawals exceed net income, the owner's equity is increased.**



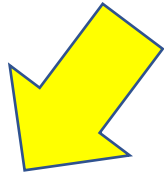
SOME FUNDAMENTALS

**Accounting
information are
presented in the
financial
statement**

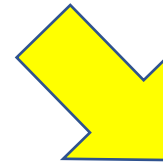


WHAT IS A FINANCIAL STATEMENT?

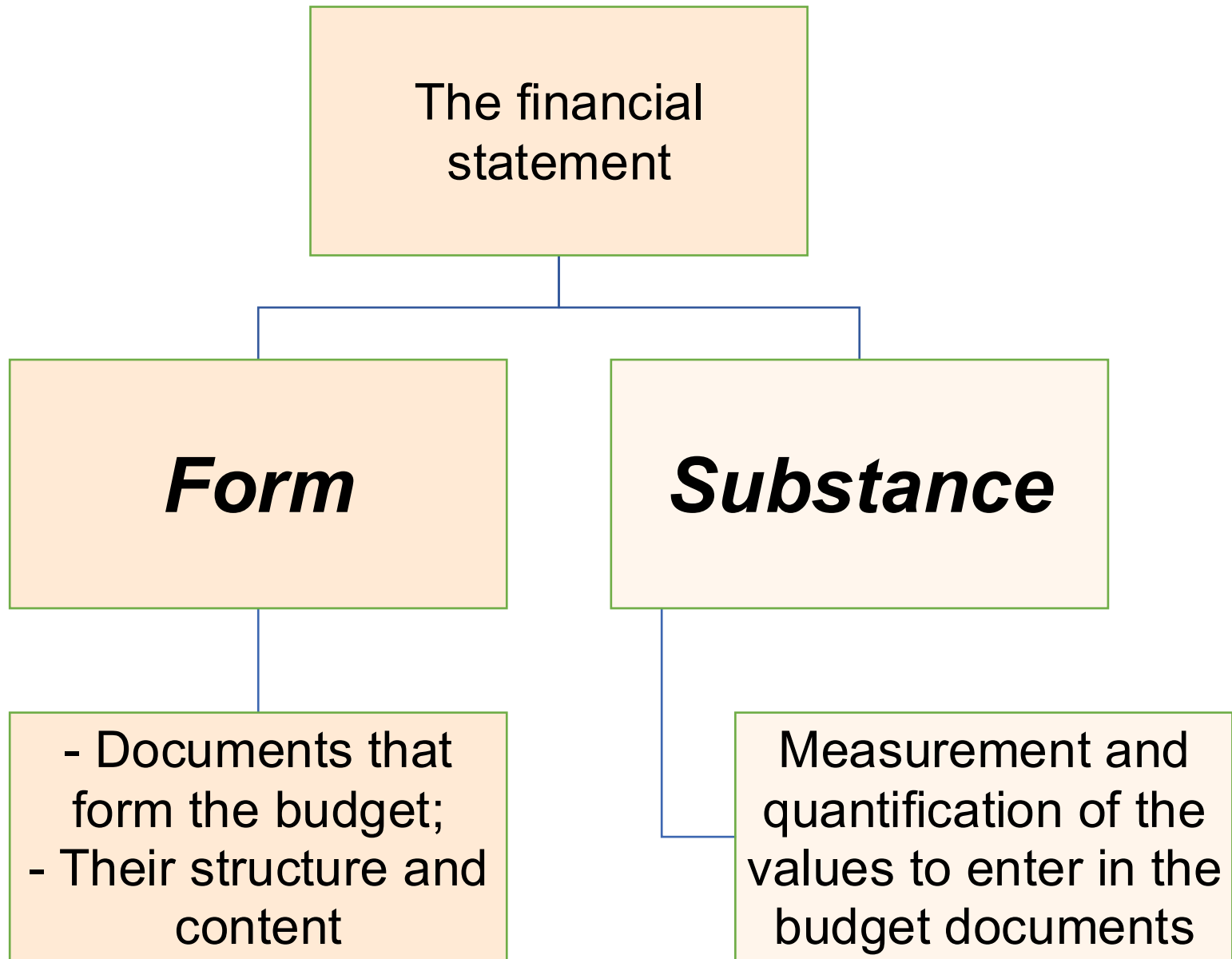
- ✓ ... is a reporting process;
- ✓ ... is a document reporting business financial performance and resources.



**What does it
reports?**



Who is it for?



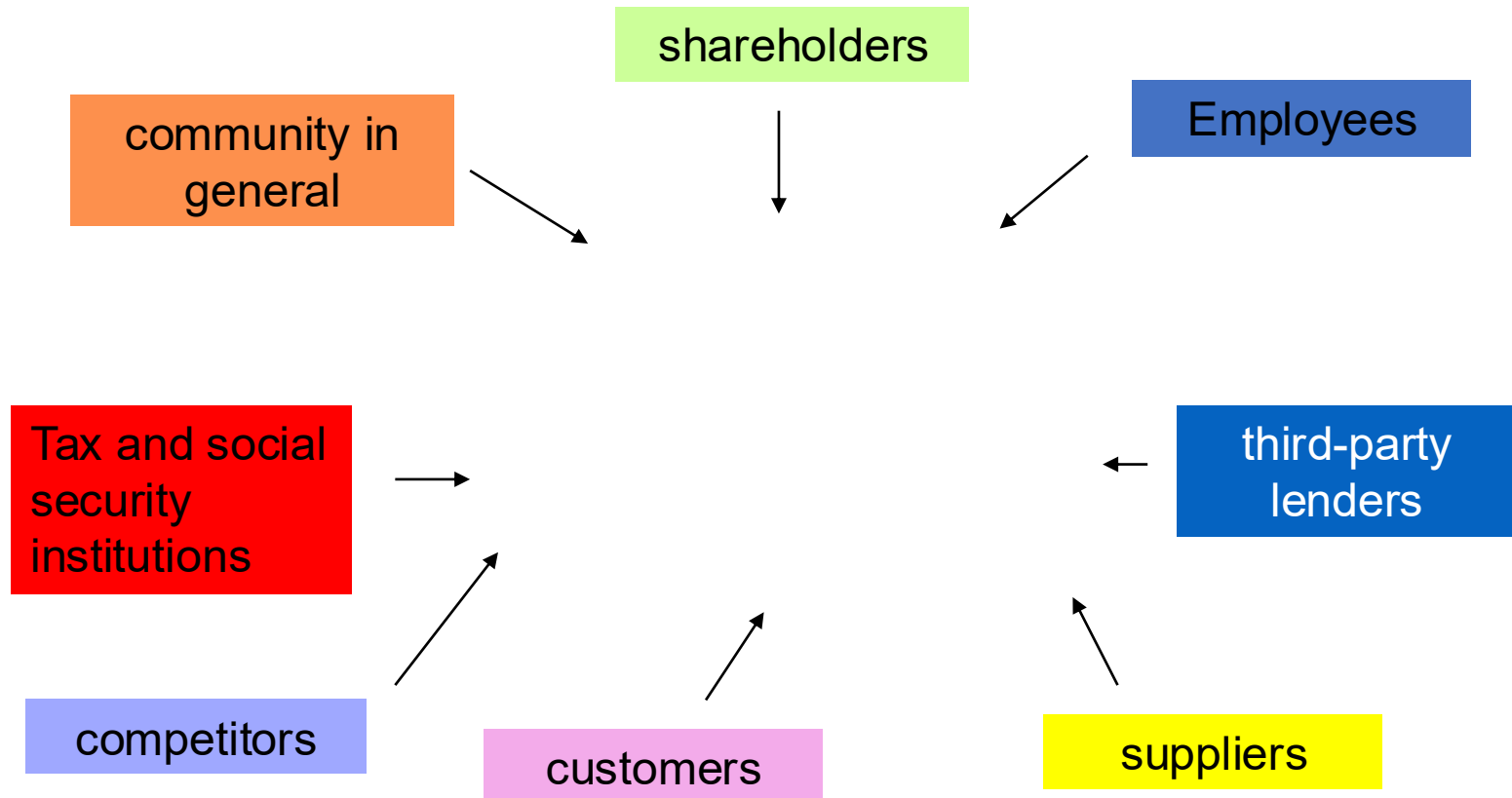
Who are users of financial reports?

What are their needs/objectives?



The stakeholders

A person, group or organization that has interest or concern in an organization.



SOME FUNDAMENTALS

- ***Investors/owners:*** Is the money invested in the business making a suitable return for them or could it earn more if invested elsewhere?
Is the business a safe investment; that is, is it likely to become insolvent/bankrupt?
Should the investors invest more money in the business?

SOME FUNDAMENTALS

Investors are concerned about the risk and return provided by their investments. They need information to help make decision about: buying ore selling shares; the company's ability to pay dividends; whether the management has been running the company efficiently; the liquidity position of the company; the company's future prospects; and how the company's shares compare with those of its competitors.

This group also includes analysts and advisers (for example, financial analysts, financial journalists, economists, statisticians, researchers and stockbrokers) who require information to pass on to clients and other interested parties;

SOME FUNDAMENTALS

➤ ***Suppliers:*** Is the business able to pay for the goods bought on credit?

Will the business continue to be a recipient of the goods which the supplier produces?

They need to know whether the company will be good customer and pay its debts when they fall due;

SOME FUNDAMENTALS

- *Customers:* Is the business able to supply the goods that customers require and when they require them? Will the business continue in operation so that warranties on goods purchased will be met? They are interested in whether the company will be able to continue producing and supplying goods;

SOME FUNDAMENTALS

- **Lenders:** Is there adequate security for any loan made? Does the business make a sufficient profit and have enough cash available to make the necessary payments of interest and capital to the lender?
- They wish to assess whether their loans and interest can be repaid at the appropriate time. They also need to verify that the value of any security remains adequate and that any financial restrictions (such as maximum debt/equity ratios) have not been breached.

SOME FUNDAMENTALS

➤ *Employees:* Does the business make sufficient profit and have enough cash available to make the necessary payments to the employees? Will the business continue in operation at its current level so that an employee has secure employment?

They are interested in the stability and profitability of their employer.

They require information to help assess: their employment security and future job prospects; the company's ability to pay salaries and wages, pension and other benefits; and their position in collective pay bargaining;

SOME FUNDAMENTALS

➤ **Public:** The majority of the public's needs in respect of employment, pollution, and health and safety are not as yet particularly well provided for in financial statements: can improvements in presentation be made?

SOME FUNDAMENTALS

➤ **Government:** What is the starting point for the calculation of taxable income? Is the business properly complying with legislation designed to protect shareholders, creditors and the environment?

It includes the tax authorities, regulatory departments and local authorities, are concerned with tax and company law compliance, the ability to pay tax and the general contribution of the company to the economy.

SOME FUNDAMENTALS

Financial reporting → Communication of financial information

Objective of financial reporting



Communicate economic measurements of, and information about, the resources and performance of the reporting entity **useful** to those having reasonable rights to such information.

Assumptions that underlie the preparation of financial statements:

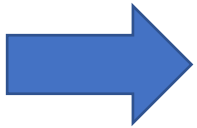
- ✓ **Going concern**: an entity will continue in operation for the foreseeable future, which is usually regarded as being at least one year.
- ✓ **Accruals accounting**: the effects of transactions are recognised when they occur and are recorded and reported in the accounting periods to which they relate, irrespective of cash flows arising from transactions.

The balance sheet

Generally financial reports consist of:

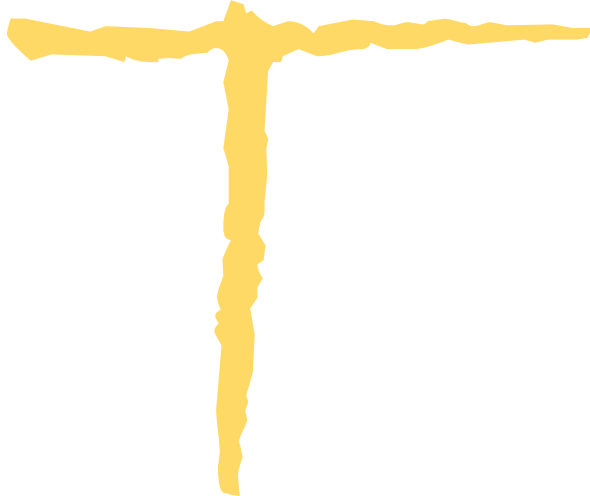
- The financial statements:
 - A statement of financial position (Balance sheet)
 - A statement of comprehensive income
 - A statement of changes in equity
 - A statement of cash flows
- Notes to the financial statements
- Narrative information (such as directors' report)

SOME FUNDAMENTALS



From the General Ledger to the Financial Statement

T-ACCOUNT

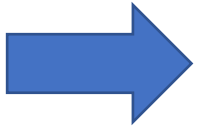


Balance Sheet

As of December 31, 2011 (000s)

<u>Assets</u>		<u>Liabilities</u>	
Cash	481	Accounts Payable	625
Marketable Securities	1,346	Current Portion L-T Debt	1,021
Accounts Receivable	1,677	Taxes Payable	36
Inventory	2,936	Accrued Expenses	<u>157</u>
Prepaid Expenses	172	Total Current Liabilities	1,839
Other Current Assets	<u>58</u>		
Total Current Assets	6,670	Long-term Debt	<u>2,332</u>
		Total Liabilities	4,171
Gross Value of Property, Plant & Equipment	2,019	<u>Stockholders Equity</u>	
Accumulated Depreciation	<u>(664)</u>	Common Stock and Paid-in Cap	194
Net Property, Plant, Equipment	1,355	Retained Earnings	<u>4,009</u>
		Total Shareholders' Equity	4,203
Note Receivable	<u>349</u>		
Total Assets	<u>8,374</u>	Total Liabilities and Equity	<u>8,374</u>

SOME FUNDAMENTALS



The Trial balance

Once we've completed the entries in the T-Accounts and calculated the balances for each account, we **can create a summary of the accounts and their balances**.

This summary is called the **Trial Balance**. The Trial Balance is formatted in a grid similar to the Journal Entry grid.

The columns of the Trial Balance shown below should look familiar to you.

Now though, instead of listing each transaction separately into the grid, we list the Accounts and their balances as of the Trial Balance date.

Trial Balance at Nov. 30, 2010		
Account	Debit	Credit
Checking Account	190.00	
Office Equipment	225.00	
Computer Hardware	500.00	
Owners' Equity		1500.00
Rent	500.00	
Office Supplies	75.00	
Bank Charges	10.00	
Totals	\$1,500.00	\$1,500.00

The trial balance

Notice, that total debits still equal total credits.

Notice that the Owners Equity Account has a credit balance.

If I were calculating the balance in a ledger, I would have *subtracted* the \$1500 entry from zero and ended up with a negative balance.

This doesn't mean that the owners have negative equity in their company, it is only a way to indicate that the **balance is a credit balance**.

Types of accounts that should have credit balances are accounts that ***increase*** when they are used as the ***Source*** side of the transaction's journal entry. Types of accounts that increase when they are used as Source Accounts are **Purchases on Account or Credit, Loans, Investments into the company by its owners and Income**. For example, Accounts Payable is a source account type, so I would expect it to have a credit balance.

If it has a debit balance, that means that I have over-paid an account.

The trial balance

Types of accounts that should have debit balances are accounts that **increase** when they are used as the **Acquisition/Use** side of the transaction's journal entry. Types of accounts that increase when they are used as Acquisition/Use Accounts are **Assets** (what you own), **Costs** and **Expenses** (both are consumable items).

For example, the checking account is an Asset - something I own – type of account so I would expect for it to have a debit balance, if it has a credit balance, that means I am overdrawn.

It is important to identify accounts by **their Acquisition/Use or Source classifications** and watch their balances to make sure they have the correct debit or credit balances. In the Trial Balance above, all of the account balances are either debit or credit as would be expected by their classifications.

The trial balance

Debit/Credit Classifications for the Accounts used in the November transactions

Account	Debit	Credit	Increases as	Classification / Expected Balance	More Description
Checking Account	190.00		Acquisition/Use	Debit	Something the business owns
Office Equipment	225.00		Acquisition/Use	Debit	Something the business owns
Computer Hardware	500.00		Acquisition/Use	Debit	Something the business owns
Owners' Equity		1500.00	Source	Credit	Owners Investment into Company
Rent	500.00		Acquisition/Use	Debit	Consumable (Acquisition/Use)
Office Supplies	75.00		Acquisition/Use	Debit	Consumable (Acquisition/Use)
Bank Charges	10.00		Acquisition/Use	Debit	Consumable (Acquisition/Use)

The trial balance

Create your Own Trial Balance for December from the T-Account Balances

T-Accounts for December Transactions:

Checking Account	
1 1100	
	2 700
	3 25
4 500	
	8 500
	9 1240
dr 1600	
-1240	
dr \$360	

Owner's Equity	
1 1100	
	cr \$1,100

Computer Hardware	
7 400	
dr \$400	

Bank Charges	
9 15	
dr \$15	

Now, it's your turn!

Office Furniture	
2 700	
7 245	
dr \$945	

Repairs & Maintenance	
3 25	
dr \$25	

Sales	
	4 500
	cr \$500

Accounts Payable	
	5 150
	6 100
	7 930
8 500	
dr 500	
	cr 1180
	-500
	cr \$680

Phone Service	
5 150	
dr \$150	

Electric Service	
6 100	
dr \$100	

Credit Card Fees	
7 30	
dr \$30	

Fuel	
7 25	
dr \$25	

Subscriptions	
7 65	
dr \$65	

Meals	
7 45	
dr \$45	

Website Hosting	
7 120	
dr \$120	

|--|--|

The trial balance

Trial Balance for November Transactions only

Account	Debit	Credit
Checking Account	190.00	
Office Equipment	225.00	
Computer Hardware	500.00	
Owners' Equity		1500.00
Rent	500.00	
Office Supplies	75.00	
Bank Charges	10.00	
Totals	\$1,500.00	\$1,500.00

Trial Balance for December Transactions only

Account	Debit	Credit
Checking Account		
Office Equipment		
Computer Hardware		
Office Furniture		
Accounts Payable		
Owners' Equity		
Sales		
Website Hosting		
Repairs & Maintenance		
Fuel		
Subscriptions		
Meals		
Phone Service		
Electric Service		
Office Supplies		
Bank Charges		
Credit Card Fees & Int		
Totals		

Combine the Account Balances for November and December and Create a Trial Balance for Dec. 31.

The trial balance

Cumulative Trial Balance at Dec. 31, 2010

Account	Debits	Credits
Checking Account		
Office Equipment		
Computer Hardware		
Office Furniture		
Accounts Payable		
Owners' Equity		
Sales		
Website Hosting		
Rent		
Repairs & Maintenance		
Fuel		
Subscriptions		
Meals		
Phone Service		
Electric Service		
Office Supplies		
Bank Charges		
Credit Card Fees & Int		
Totals		

Comparative Trial Balance at Dec. 31, 2010

Account	November	December	Total
Checking Account	190.00		
Office Equipment	225.00		
Computer Hardware	500.00		
Office Furniture	0.00		
Accounts Payable	0.00		
Owners' Equity	-1500.00		
Sales	0.00		
Website Hosting	0.00		
Rent	500.00		
Repairs & Maintenance	0.00		
Fuel	0.00		
Subscriptions	0.00		
Meals	0.00		
Phone Service	0.00		
Electric Service	0.00		
Office Supplies	75.00		
Bank Charges	10.00		
Credit Card Fees & Int	0.00		
Totals	\$0.00	\$0.00	0.00

The trial balance

Trial Balance for November Transactions only

Account	Debit	Credit
Checking Account	190.00	
Office Equipment	225.00	
Computer Hardware	500.00	
Owners' Equity		1500.00
Rent	500.00	
Office Supplies	75.00	
Bank Charges	10.00	
Totals	\$1,500.00	\$1,500.00

Trial Balance for December Transactions only

Account	Debit	Credit
Checking Account	360.00	
Office Equipment	0.00	
Computer Hardware	400.00	
Office Furniture	945.00	
Accounts Payable		680.00
Owners' Equity		1100.00
Sales		500.00
Website Hosting	120.00	
Repairs & Maintenance	25.00	
Fuel	25.00	
Subscriptions	65.00	
Meals	45.00	
Phone Service	150.00	
Electric Service	100.00	
Office Supplies		
Bank Charges	15.00	
Credit Card Fees & Int	30.00	
Totals	\$2,280.00	\$2,280.00

The trial balance

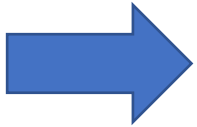
Cumulative Trial Balance at December 31

Account	Debits	Credits
Checking Account	550.00	
Office Equipment	225.00	
Computer Hardware	900.00	
Office Furniture	945.00	
Accounts Payable		680.00
Owners' Equity		2600.00
Sales		500.00
Website Hosting	120.00	
Rent	500.00	
Repairs & Maintenance	25.00	
Fuel	25.00	
Subscriptions	65.00	
Meals	45.00	
Phone Service	150.00	
Electric Service	100.00	
Office Supplies	75.00	
Bank Charges	25.00	
Credit Card Fees & Int	30.00	
Totals	\$3,780.00	\$3,780.00

Comparative Trial Balance at December 31

Account	November	December	Total
Checking Account	190.00	360.00	550.00
Office Equipment	225.00	0.00	225.00
Computer Hardware	500.00	400.00	900.00
Office Furniture	0.00	945.00	945.00
Accounts Payable	0.00	-680.00	-680.00
Owners' Equity	-1500.00	-1100.00	-2600.00
Sales	0.00	-500.00	-500.00
Website Hosting	0.00	120.00	120.00
Rent	500.00	0.00	500.00
Repairs & Maintenance	0.00	25.00	25.00
Fuel	0.00	25.00	25.00
Subscriptions	0.00	65.00	65.00
Meals	0.00	45.00	45.00
Phone Service	0.00	150.00	150.00
Electric Service	0.00	100.00	100.00
Office Supplies	75.00	0.00	75.00
Bank Charges	10.00	15.00	25.00
Credit Card Fees & Int	0.00	30.00	30.00
Totals	\$0.00	\$0.00	0.00

SOME FUNDAMENTALS



From the Trial balance to the Financial Statement

Balance Sheet

As of December 31, 2011 (000s)

Assets

Cash	481
Marketable Securities	1,346
Accounts Receivable	1,677
Inventory	2,936
Prepaid Expenses	172
Other Current Assets	<u>58</u>
Total Current Assets	6,670
Gross Value of Property, Plant & Equipment	2,019
Accumulated Depreciation	<u>(664)</u>
Net Property, Plant, Equipment	1,355
Note Receivable	<u>349</u>
Total Assets	<u>8,374</u>

Liabilities

Accounts Payable	625
Current Portion L-T Debt	1,021
Taxes Payable	36
Accrued Expenses	<u>157</u>
Total Current Liabilities	1,839
Long-term Debt	<u>2,332</u>
Total Liabilities	<u>4,171</u>

Stockholders Equity

Common Stock and Paid-in Cap	194
Retained Earnings	<u>4,009</u>
Total Shareholders' Equity	4,203
Total Liabilities and Equity	<u>8,374</u>

The balance sheet

It features a photograph of the qualitative and quantitative consistency of the various active and passive elements that make up the firm's capital.

Form: divided into two separate sections

Assets

Liabilities

The balance sheet



The Balance Sheet is like the “X” on a map that says “**You are Here**”. It tells you what your business owns, what it owes and what it is worth (book value).

Items listed on the **Balance Sheet** have **lasting value** and they remain on the balance sheet until they are disposed of.

Items that do not have lasting value are listed on the Income Statement.

The balance sheet

The first section of the balance sheet reports the company's *assets* and includes such things as cash, accounts receivable, inventory, prepaid insurance, buildings, and equipment.

The next section reports the company's *liabilities*; these are obligations that are due at the date of the balance sheet and often include the word "payable" in their title (Notes Payable, Accounts Payable, Wages Payable, and Interest Payable).

The final section is *stockholders' equity*, defined as the difference between the amount of assets and the amount of liabilities.

The balance sheet

Assets – definitions:

- ✓ resources of the company that **have been acquired through transactions, and have future economic value**. Assets also include costs paid in advance that have not yet expired, such as prepaid advertising, prepaid insurance, prepaid legal fees, and prepaid rent.
- ✓ **resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity**. Future economic benefits represent the potential to contribute to the cash flow of the entity. Future economic benefits embodied in an asset may flow to the entity in a variety of ways.

The balance sheet

The **asset classifications** and their order of appearance on the balance sheet are:

- Current Assets
- Investments
- Property, Plant, and Equipment
- Intangible Assets
- Other Assets

The balance sheet

Liabilities are obligations of the company; they are amounts owed to creditors for a past transaction. They also include amounts received in advance for future services.

Examples of liability accounts reported on a company's balance sheet include:

- ✓ Notes Payable
- ✓ Accounts Payable
- ✓ Salaries Payable
- ✓ Wages Payable
- ✓ Interest Payable
- ✓ Other Accrued Expenses Payable
- ✓ Income Taxes Payable
- ✓ Customer Deposits
- ✓ Warranty Liability
- ✓ Lawsuits Payable
- ✓ Unearned Revenues
- ✓ Bonds Payable
- ✓ Etc.

The balance sheet

Liability: this is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow of resources from the entity.

A liability can be legally enforceable (for example, a binding contract) but can also arise from normal business practice or custom (for example, company policy to rectify faults even after warranty has expired)

The balance sheet

Equity: this represents the residual interest in the assets of an entity after deducting all its liabilities. It may be sub-classified into different components which reflect differing rights or show restrictions on the ability of the entity to distribute certain reserves. The creation of reserves is sometimes required by statute or law to protect creditors from losses, and the existence and size of these reserves, together with transfers during the accounting period, is important information for users. It is important to note that the equity figure in the financial statements is unlikely to correspond with the market value of the entity or the sum that could be raised by disposing of the assets either on a piecemeal or going concern basis.

The balance sheet

Owner's Equity—along with liabilities—can be thought of as a source of the company's assets. Owner's equity is sometimes referred to as the book value of the company, because owner's equity is equal to the reported asset amounts *minus* the reported liability amounts.

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

$$\text{Owner's Equity} = \text{Assets} - \text{Liabilities}$$

The balance sheet

Examples of stockholders' equity accounts include:

- ✓ Common Stock
- ✓ Preferred Stock
- ✓ Paid-in Capital in Excess of Par Value
- ✓ Paid-in Capital from Treasury Stock
- ✓ Retained Earnings
- ✓ Etc.

The balance sheet

Balance sheet - structure

ASSETS

Current assets
Investments
Property, plant, and equipment
Intangible assets
Other assets
Total assets

LIABILITIES & OWNER'S EQUITY

Current Liabilities
Long-term liabilities
Total liabilities

Owner's equity
Total liabilities & owner's equity

The balance sheet

Balance sheet - example

<u>ASSETS</u>		<u>LIABILITIES</u>	
Current assets		Current liabilities	
Cash	\$ 2,100	Notes payable	\$ 5,000
Petty cash	100	Accounts payable	35,900
Temporary investments	10,000	Wages payable	8,500
Accounts receivable - net	40,500	Interest payable	2,900
Inventory	31,000	Taxes payable	6,100
Supplies	3,800	Warranty liability	1,100
Prepaid insurance	1,500	Unearned revenues	1,500
Total current assets	<u>89,000</u>	Total current liabilities	<u>61,000</u>
Investments	<u>36,000</u>	Long-term liabilities	
Property, plant & equipment		Notes payable	20,000
Land	5,500	Bonds payable	400,000
Land improvements	6,500	Total long-term liabilities	<u>420,000</u>
Buildings	180,000		
Equipment	201,000	Total liabilities	<u>481,000</u>
Less: accum depreciation	(56,000)		
Prop, plant & equip - net	<u>337,000</u>		
Intangible assets		<u>STOCKHOLDERS' EQUITY</u>	
Goodwill	105,000	Common stock	110,000
Trade names	200,000	Retained earnings	229,000
Total intangible assets	<u>305,000</u>	Less: Treasury stock	(50,000)
Other assets	<u>3,000</u>	Total stockholders' equity	<u>289,000</u>
Total assets	<u>\$ 770,000</u>	Total liabilities & stockholders' equity	<u>\$ 770,000</u>

Balance sheet under italian civil code

STATEMENT OF THE FINANCIAL POSITION (art. 2424 c.c.)	
Attivo	Passivo
<i>A) Receivables from shareholders</i>	<i>A) Owners' Equity</i>
<i>B) Fixed assets</i>	I – Shareholders Capital
I – Intangible Fixed Assets	II – Share Premium Reserve
II – Tangible Fixed Assets	III – Revaluation Reserve
III – Financial Fixed Assets	IV – Legal Reserve
<i>C) Current Assets</i>	V – Statutory Reserve
I – Inventories	VI – Treasury Reserve
II – Trade Receivables	VII – Other Reserves
III – Financial Current Assets	VIII – Retained Earnings
IV – Cash and Equivalents	IX – Net income of the year
<i>D) Accruals and Prepayments</i>	<i>B) Provisions for risks and charges</i>
	<i>C) Employees Benefits</i>
	<i>D) Payables</i>
	<i>E) Accruals and Deferred Income</i>

Balance sheet under italian civil code

Balance Sheet Format

What we have	Assets	What the Business Owns
=	=	
	Liabilities	What the Business Owes and must repay
	+	
Where it came from	Equity	What the Business is Worth (What the Business Owners have invested plus Business Net Income)

Total Assets must equal Total Liabilities plus Equity

Income Statement

The Income Statement gives a detailed explanation of how much money you earned and what your costs were.

Items listed on the Income Statement **do not have lasting value**, they are used up within the current business year. Income Statement balances do not carry forward the way Balance Sheet balances do, they are reset and **started at zero again at the beginning of each business year**.

Income Statement

The income statement reports a **company's profitability during a specified period of time.**

The period of time could be one year, one month, three months, 13 weeks, or any other time interval chosen by the company.

The main components of the income statement are revenues, expenses, gains, and losses.

Revenues include such things as sales, service revenues, and interest revenue. Expenses include the cost of goods sold, operating expenses (such as salaries, rent, utilities, advertising), and non-operating expenses (such as interest expense).

Income Statement

The format of the income statement or the profit and loss statement will vary according to the complexity of the business activities.

However, most companies will have the following elements in their income statements:

A. Revenues and Gains

1. Revenues from primary activities (and in case from secondary activities)
2. Gains (e.g., gain on the sale of long-term assets, gain on lawsuits)

Income Statement

B. Expenses and Losses

1. Expenses involved in primary activities (and in case from secondary activities)
2. Losses (e.g., loss on the sale of long-term assets, loss on lawsuits)

If the net amount of revenues and gains minus expenses and losses is positive, the bottom line of the profit and loss statement is labeled as **net income**. If the net amount (or bottom line) is negative, there is a **net loss**.

Income Statement

Income: this is defined as 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. Income includes both revenues and gains.

The former arises in the ordinary course of business (for example, sales, royalties, rents, fees and interest) while the latter represent other items of income which may not normally arise in the ordinary course of business (for example, a gain arising on the disposal of non-current assets).

Income Statement

Both types of income, however, are treated the same for accounting purposes. In addition, income may also include unrealized gains (for example, the revaluation of marketable securities or non-current assets). Gains are often reported net of related expenses.

Income Statement

Expenses: these are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets that result in decreases in equity, other than those relating to distributions to equity participants.

This includes losses (for example, those arising on the disposal of non-current assets) as well as expenses incurred in the ordinary course of business (for example, wages, depreciation and heat and light).

Expenses also include unrealized losses (for example, those arising on foreign currency transaction), and they are often reported net of any related income.

Income Statement

Income and expenses are presented in the statement of comprehensive income in different ways and under different headings so as to provide relevant information for making economic decisions.

Distinguishing between items of income and expense and combining them in different ways also permits several measures of performance to be displayed (for example, gross margin, profit before taxation and profit after taxation).

Income Statement

Income Statement (costs classified by nature)

Sales Revenues

Other income

Changes in inventories of finished goods and work in progress

Work performed by entity and capitalised

Raw material and consumables used

Employee benefit expense

Depreciation and amortisation expense

Impairment of property, plant and equipment

Other expenses

Finance costs

Share of profit/loss of associates and joint ventures accounted by equity method

Profit/loss before tax

Income tax expense

Profit/loss for the period

- attributable to minority interests

- attributable to equity holders of the parent

Income Statement

Income Statement (costs classified by destination)

Sales Revenue

Cost of sales

Gross Profit

Distribution costs

General and administrative expenses

Other operating income

Other operating expenses

Finance costs

Share of profit of associates

Profit before income tax

Income tax expense

Profit/loss for the period

- attributable to minority interests
- attributable to equity holders of the parent

Income Statement

STATEMENT OF COMPREHENSIVE INCOME (art. 2425 c.c.)
A) Value of production
B) Production Costs
A-B) Operating Gross Margin
C) Financial Revenues and Expenses
D) Impairment of Financial Assets
E) Extraordinary Revenues and Expenses
EBT – Earnings before taxes (A-B+/-C+/-D+/-E)
Income Taxes (current, deferred, prepaid)
Net income of the year

Income Statement

Income Statement Format

+ Revenue	Total Sales Amount
- Cost of Goods Sold	What it cost to purchase and/or manufacture products and/or provide services sold
= Gross Margin	Amount of Revenue left after direct costs to cover operating expenses
- Expenses	Operating Costs Consumed (No lasting Value)
= Net Income(Loss)	Profit(Loss) from sales after all consumable costs. Represents the increase or decrease, for the current year, in what the Business is worth

EXERCISE

THE IMPACT OF SELECTED TRANSACTIONS ON INCOME AND EQUITY AND THE PREPARATION OF INCOME STATEMENT AND BALANCE SHEET

Required:

- *Read the following transactions and recognize the “nature” of the specific accounts (A=Assets; L=Liabilities; OE=Owners' Equity; R=Revenues; E=Expenses);*
- *Prepare the income statement and the balance sheet on December 31, 2011, of “The Library”.*

EXERCISE

Transactions:

1. On January 1, 2011 “The Library” is established to merchandise books (total share capital: 20.000 Euros). The shareholders contribute cash for 16.000 Euros and a building for the rest.
2. On March 15, 2011 “The Library” buys a piece of land whose price is 6.000 Euros. “The Library” pays cash 2.000 Euros and 4.000 Euros within September 15, 2011.
3. On June 3, 2011 “The Library” buys some books for a total amount of 2.000 Euros. The payment of the purchase is due on June 30.

EXERCISE

4. On June 8, 2011 “The Library” sells half of the books previously bought for a total amount of 1.200 Euros. The payment is postponed to June 15 (perpetual inventory system).
5. On June 30 “The Library” pays the amount due for the purchase of the books (see transaction nr. 3).
6. On June 30, 2011 “The Library” pays cash salaries to its employees for the amount of 100 euros.
7. On July 31, 2011 “The Library” issues bonds to collect money. The total value of the bonds issued is 2.000 Euros.

EXERCISE

8. On Sept. 15 “The Library” pays its debt related to the purchase of land.
9. On Oct. 30, 2011 “The Library” sells the piece of land previously purchased earning a total amount of 7.000 Euros, collecting cash.
10. At the end of the accounting period the building is depreciated for 5% of its value.

EXERCISE

Solution

Jan. 1	Cash	16.000		
	Building	4.000		
			Common stock	20.000
March 15	Land	6.000	Cash	2.000
			Accounts payable	4.000
June 3	Inventory	2.000	Accounts payable	2.000
June 8	Accounts receivables	1.200	Sales revenues	1.200
June 8	Cost of Goods sold	1.000	Inventory	1.000
June 15	Cash	1.200	Accounts receivable	1.200
June 30	Accounts payables	2.000	Cash	2.000
June 30	Wages and salaries	100	Cash	100
July 31	Cash	2.000	Bonds payable	2.000
Sept. 15	Accounts payable	4.000	Cash	4.000
Oct. 30	Cash	7.000	Land	6.000
			Gain on sale of land	1.000
Dec. 31	Depreciation exp.	200	Accum. depr. on build.	200

EXERCISE

Balance sheet/Statement of financial position – 31 Dec 2011			
<i>Assets</i>		<i>Liabilities + Owners' Equity</i>	
<i>Non - current assets</i>		<i>Current liabilities</i>	
Building - net	3.800	Bonds payables	2.000
<i>Current assets</i>		<i>Equity</i>	
Inventory	1.000	Common stock	20.000
Cash	18.100	Net profit	900
TOTAL	22.900	TOTAL	22.900

EXERCISE

Income statement/Statement of the comprehensive income 31 Dec 2011	
Sales revenues	1.200
Cost of goods sold	1.000
<i>Gross profit</i>	200
Gain on the sale of land	1.000
Wages and salaries	100
Depreciation exp.	200
NET PROFIT	900

SOME FUNDAMENTALS

When a new business entity is created, the starting position is that there is no balance sheet because there is no entity.

The new business will have to be owned by someone.

This outside person or other body will put some cash into the entity as equity capital.

Equity is the source of the cash that the entity now owns.

Resources/Applications	Claims/Sources
Cash	Capital (or equity)

SOME FUNDAMENTALS

The separation of the entity from the owner is implied by showing the owner's contribution as a claim/source.

The cash is an asset, i.e. a resource, whereas the equity capital is a claim on the business by the owner.

Suppose that capital of € 100,000 had been put in to begin the operation. This gives the balance sheet as follows:

Resources		Claims/Sources	
Cash	100,000	Capital	100,000

SOME FUNDAMENTALS

Suppose the entity runs a retail shop that undertakes the following transactions after initial input of capital of € 100,000:

- 1) Borrows € 50,000 from the bank;
- 2) Buy property for € 50,000;
- 3) Buys inventory (goods to be sold again) costing € 45,000, paying cash;
- 4) Sells one-third of the quantity of this inventory for € 35,000, on credit (the customer agree to pay later);
- 5) Pays wages for the period, in cash, of € 4,000;
- 6) € 16,000 of the money due from the customer is received;
- 7) Buys inventory costing € 25,000 on credit

SOME FUNDAMENTALS

	Resources			Claims	
Transaction	Cash	Receivables	Other assets	Outsiders: liabilities	Owner: capital and profit
<i>0 Original capital</i>	+100				+100
<i>1. Borrowing</i>	+50			+50	
<i>2. Buy property</i>	-50		+50		
<i>3. Buy inventory for cash</i>	-45		+45		
<i>4. Sell some inventory</i>		+35	-15		+20
<i>5. Pay wages</i>	-4				-4
<i>6. Customer pays</i>	+16	-16			
<i>7. Buy inventory on credit</i>			+25	+25	
Totals	+67	+19	+105	+75	+116

What happen in companies reality ?

In the reality this is not so simply: the determination of profit or loss must be done in accordance with the **accrual basis** and other important principles (**framework**).

Appropriate **adjusting entry records** are necessary in order to obtain the values of revenue that express goods / services sold during the period and cost values that express the inputs consumed in the production of goods / services sold .

- ✓ inventories
- ✓ amortization
- ✓ Provisions for future expenses

SOME FUNDAMENTALS

Qualitative Characteristics of Useful Financial Information

- **Relevance** : To be useful, information must be relevant to the decision-making needs of the users; such needs will vary between user groups (for example, see information needs of users above) and over time (for example, as employees get older, information on the performance of their company pension may be of greater interest).

SOME FUNDAMENTALS

Information is relevant when it influences the economic decisions of users by helping them to evaluate past, present or future economic events or confirming or correcting their past evaluations.

Financial statements do not normally contain information about future activities.

However, historical information can be used as the basis for predicting future financial position and performance; users then have to use their predictions as the basis for their decision-making.

SOME FUNDAMENTALS

Information that helps users assess the future performance and financial position of an entity is likely to be relevant.

An item is likely to be relevant by virtue of its nature (for example, high-profile litigation) and materiality.

Information is material if its omission or misstatement could influence the decision-making of users.

SOME FUNDAMENTALS

Information can be relevant because of its nature irrespective of materiality.

For example, if an entity has commenced operating activities in a country with an unstable economy, this could change the users' assessment of the overall risk that the entity is exposed to and as a result change the users' assessment of the entity's future results.

Consequently, irrespective of the materiality of that segment's results, the information may be disclosed.

Information should be released on a timely basis to be relevant to users.

SOME FUNDAMENTALS

- *Faithful representation:* To be useful, financial information must not only be relevant, it must faithfully represent the transactions it is intended to represent.

SOME FUNDAMENTALS

This fundamental characteristic seeks to maximise the underlying characteristics of:

- **Completeness** – reports should present a rounded picture of the economic activities of the reporting entity and, to be reliable, the information must be complete. An omission can cause information to be false or misleading and therefore unreliable;
- **Neutrality** - to be reliable, the information must be neutral, that is, free from bias. This will be enhanced by the application of accounting standards, which are neutral as between competing interest, and
- Freedom from error.

SOME FUNDAMENTALS

- *Comparability*: This involves consistency in the application of accounting concepts and policies, and is vital to users in their decision-making.

The ability to identify trends in performance and financial position and compare those both from year to year and against other entities assists users in their assessments and decision-making. It is important that users are able to understand the application of accounting policies in order to compare financial information. To achieve comparability users must be able to identify where an entity has changed its policy from one year to the next and where other entities have used different accounting policies for similar transactions.

SOME FUNDAMENTALS

➤ *Verifiability*: This helps to assure users that the information is a faithful representation of the underlying transactions and events.

This will be enhanced in the case of financial reports which are independently verified and implies:

- Substance over form – transactions must be accounted for and presented on the basis of their commercial or economic reality rather than their legal form. Only by applying substance over form will users see the effects of the commercial or economic reality of the transactions

SOME FUNDAMENTALS

- **Prudence** – many estimates are made in the preparation of financial statements (for example, inventory valuation, estimated useful lives of assets, recoverability of debts). Being cautious when exercising judgement in arriving at these estimates is known as prudence. While this is a generally accepted concept in the preparation of financial statements, the concept does not extend to including excess provisions, overstanding liabilities or understating income or assets.

SOME FUNDAMENTALS

- *Timeliness*: The usefulness of information is diminished the later it is produced after the time to which it relates, and also if the intervals at which it produce are unreasonably long;

SOME FUNDAMENTALS

- *Understandability* An essential quality of financial information is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business, economic activities and accounting, together with a willingness to study the information with reasonable diligence. Information on complex issues should be included if relevant and should not be excluded on the grounds that it is too difficult for the average user to understand. However, in certain circumstances, too much detail is as much a defect as too little.

INTRODUCTION

Statement of Cash Flows

The statement of cash flows explains the change in a company's cash (and cash equivalents) during the time interval indicated in the heading of the statement.

The change is divided into:

- *Operating activities*: this section explains how a company's cash (and cash equivalents) have changed due to operations
- *Investing activities* that refer to amounts spent or received in transactions involving long-term assets
- *Financing activities*: this section reports such things as cash received through the issuance of long-term debt, the issuance of stock, or money spent to retire long-term liabilities.

INTRODUCTION

Statement of Stockholders' Equity

The statement of stockholders' (or shareholders') equity lists the changes in stockholders' equity for the same period as the income statement and the cash flow statement. The changes will include items such as net income, other comprehensive income, dividends, the repurchase of common stock, and the exercise of stock options

The accounting practice

Generally accepted accounting principles (GAAP) refer to the standard framework of guidelines for financial accounting used in any given jurisdiction; generally known as accounting standards or standard accounting practice. These include the standards, conventions, and rules that accountants follow in recording and summarizing and in the preparation of financial statements.

In particular, the principles set out :

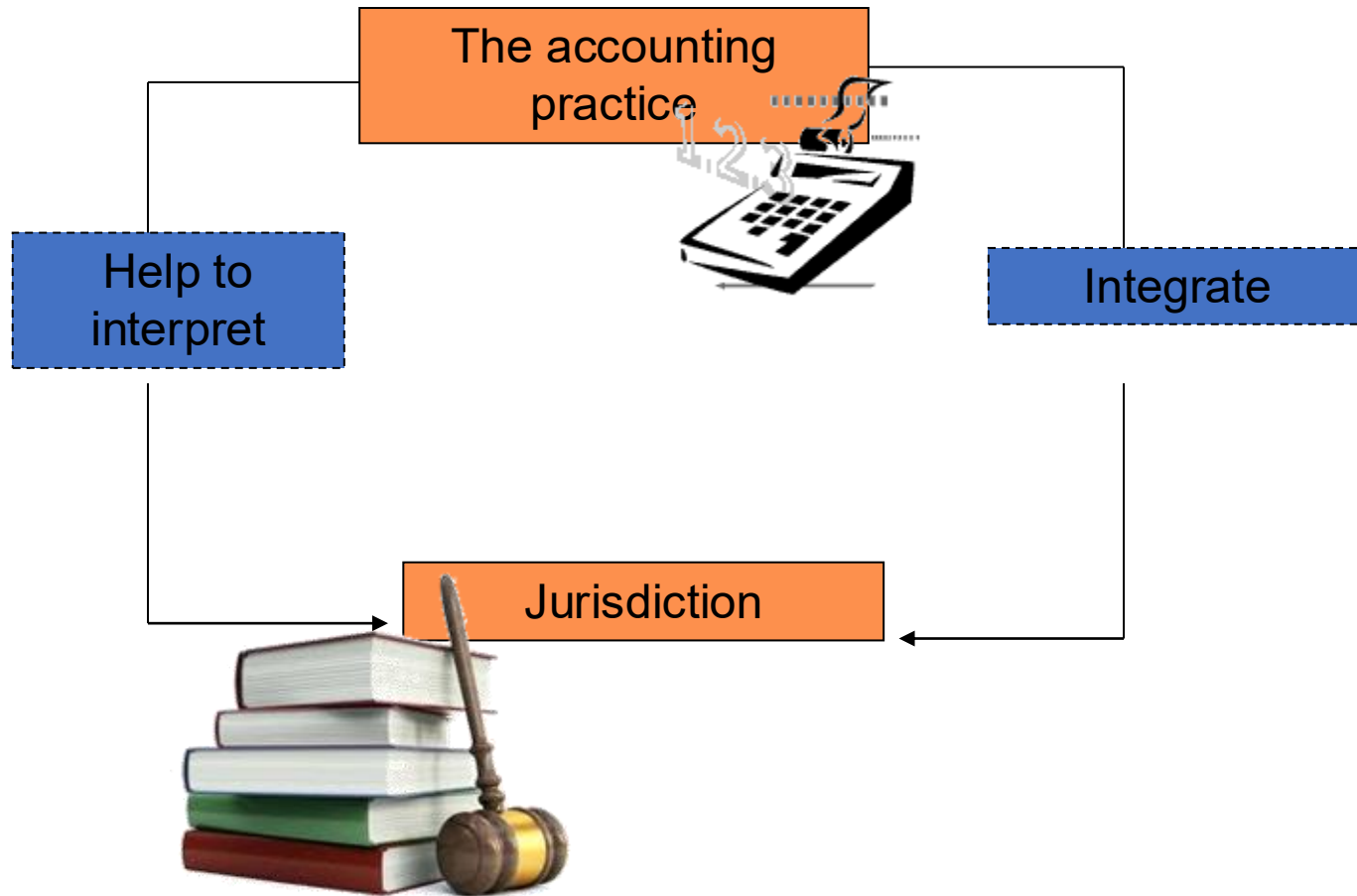
- The identification of the facts to be recorded;
- Modalities for the accounting of the events;
- The criteria for valuation of assets and liabilities;
- Criteria for the presentation of the figures in the financial statements;
- The contents of the notes.

INTRODUCTION to accounting Standards

An accounting standard is a rule or set of rules that prescribes the method by which financial statements should be prepared and presented.

They are issued by a national or international body of the accountancy profession, and they are intended to apply to all financial statements which are intended to give a true and fair view of the financial position and profit/loss. Accounting standards are detailed working regulations within the framework of government legislation and they cover areas in which the law is silent.

The accounting practice





economic integration



Globalization



Internationalization

Economic exchanges and
availability of information
for the decisions taking
push towards accounting harmonization

Non Financial Reporting - ESG

Corporate Sustainability Reporting Directive (CSRD) EU Directive no. 2022/2464

Which companies does it apply to?

All companies with at least two of the following characteristics:

- > 250 employees;
 - > € 40 m turnover;
 - > € 20 m total asset value
- And listed SMEs

How many companies is involved?

Around 50,000 companies

What standards is reporting based on?

EFRS

How is the collected data published?

Sustainability information will be published together with the Year-End Management Report.

Is the certification of a third and independent party mandatory?

Yes, the requirements are being defined