WELCOME

- **Unit Title: Financial Awareness**
- **Level: EDEXCEL L5**

1.1 purpose of financial accounting

- The scope and objectives of financial accounting,
- useful figures for people about their resources, e.g. cost of assets, loans outstanding, income received, expenses consumed

1.2 The main users of accounting information and their needs

- Consider the scope, objectives and range of users of financial statements and how objectives and user needs will vary depending on the type of organisation.
- Organisations will include sole trader, partnership, private company, public company

Identify the main characteristics of useful information

- Understandable, relevant, reliable and comparable
- concept of maximisation of shareholder wealth and the conflicts which exist between various stakeholder groups

1.5 The distinction between capital and revenue

- Explain the difference between capital and revenue expenditure
- Distinguish between expenditure of a long-term and a short-term nature
- Give examples of how these two types of expenditure differ

1.6 The role and scope of auditing in business both external and internal

- Explain the role of auditing in securing reliability in reporting financial results
- The importance of good auditing has surfaced as an important issue in the wake of the collapse of large multinational corporations, for example Enron and WorldCom.

Objective of financial accounting

- *The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.*

The scope of financial accounting is:

- to make economic decisions- e.g. whether to invest in the company's securities
- recommend them to other investors,
- whether to extend trade or bank credit to the company.
- evaluate a company's past performance and current financial position

1.2 The main users of accounting information and their needs

- Internal stakeholders
- ● Managers of the company
- ● Employees
- ● Directors
- External stakeholders
- ● Shareholders
- ● Trade creditors (suppliers)
- ● Providers of finance
- ● Trade unions
- ● Financial analysts and advisers
- ● Government and their agencies, including The Inland Revenue
- ● The public
- ● Trade debtors (customers)

FUNDAMENTAL CONCEPTS OF ACCOUNTING

- Accounting is the language of business and it is used to communicate financial information.
- In order for that information to make sense, accounting is based on 12 fundamental concepts.
- These fundamental concepts then form the basis for all of the Generally Accepted Accounting Principles (GAAP).

Accounting concepts

- ENTITY
- MONEY MEASUREMENTS
- GOING CONCERN
- COST
- DUAL ASPECT
- OBJECTIVITY
- TIME PERIOD
- CONSERVATISM
- REALIZATION
- MATCHING
- CONSISTENCY
- MATERIALITY

Entity

- **Entity**
  Accounts are kept for entities and not the people who own or run the company. Even in proprietorships and partnerships, the accounts for the business must be kept separate from those of the owner(s).

Money-Measurement

- **Money-Measurement**
- For an accounting record to be made it must be able to be expressed in monetary terms. For this reason, financial statements show only a limited picture of the business. Consider a situation where there is a labor strike pending or the business owner's health is failing; these situations have a huge impact on the operations and financial security of the company but this information is not reflected in the financial statements.

Going Concern

- Accounting assumes that an entity will continue to operate indefinitely. This concept implies that financial statements do not represent a company's worth if its assets were to be liquidated, but rather that the assets will be used in future operations. This concept also allows businesses to spread (amortize) the cost of an asset over its expected useful life.

Cost

- An asset (something that is owned by the company) is entered into the accounting records at the price paid to acquire it. Because the "worth" of an asset changes over time it would be impossible to accurately record the market value for the assets of a company. The cost concept does recognize that assets generally depreciate in value and so accounting practice removes the depreciation amount from the original cost, shows the value as a net amount, and records the difference as a cost of operations (depreciation expense.)

Dual Aspect

- This concept is the basis of the fundamental accounting equation:
- **Assets = Liabilities + Equity**
- Assets are what the company owns.
- Liabilities are what the company owes to creditors against those assets
- Equity is the difference between the two and represents what the company owes to its investors/owners.

Objectivity

- The objectivity concept states that accounting will be recorded on the basis of objective evidence (invoices, receipts, bank statement, etc…). This means that accounting records will initiate from a source document and that the information recorded is based on fact and not personal opinion.

Time Period

- This concept defines a specific interval of time for which an entity's reports are prepared. This can be a fiscal year (Mar 1 – Feb 28), natural year (Jan 1 – Dec 31), or any other meaningful period such as a quarter or a month.

Conservatism

- This requires understating rather than overstating revenue (income) and expense amounts that have a degree of uncertainty. The rule is to recognize revenue when it is reasonably certain and recognize expenses as soon as they are reasonably possible. The reasons for accounting in this manner are so that financial statements do not overstate the company's financial position.

Realization

- Revenues are recognized when they are earned or realized. Realization is assumed to occur when the seller receives cash or a claim to cash (receivable) in exchange for goods or services. This concept is related to conservatism in that revenue (income) is only recorded when it actually occurs and not at the point in time when a contract is awarded

Matching

- To avoid overstatement of income in any one period, the matching principle requires that revenues and related expenses be recorded in the same accounting period. If you bill $20,000 of services in a month, in order to accurately represent the income for the month you must report the expenses you incurred while generating that income in the same month.

Consistency

- Once an entity decides on one method of reporting (i.e. method of accounting for inventory) it must use that same method for all subsequent events. This ensures that differences in financial position between reporting periods are a result of changed in the operations and not to changes in the way items are accounted for.

Materiality

- Accounting practice only records events that are significant enough to justify the usefulness of the information. Technically, each time a sheet of paper is used, the asset "Office supplies" is decreased by an infinitesimal amount but that transaction is not worth accounting for.

MD&A

- Management's Discussion and Analysis (MD&A) provides an assessment of the financial performance and condition of a company from the perspective of its management. For publicly held companies in the U.S., the MD&A is required to discuss results from operations, with a discussion of trends in sales and expenses, capital resources and liquidity, with a discussion of trends in cash flows, and a general business overview based on known trends.

AUDIT

- An **audit** is an independent review of an entity's financial statements. Public accountants conduct audits and examine the financial reports and supporting records. The objective of an audit is to enable the auditor to provide an opinion on the fairness and reliability of the financial statements.

key financial statements

- The **income statement** reports on the financial performance of the firm over a period of time. The elements of the income statement include revenues, expenses, and gains and losses.
- The **balance sheet** reports the firm's financial position at a point in time. The balance sheet consists of assets, liabilities, and owners' equity. Transactions are measured so that the fundamental accounting equation holds: assets = liabilities + owners' equity

key financial statements

- The **cash flow statement** reports the company's cash receipts and outflows. These cash flows are classified as either operating, investing, or financing.
- The **statement of changes in owners' equity** reports the amounts and sources of changes in equity investors' investment in the firm in a period of time.

Identify the groups of business activities for financial reporting

- **Operating activities** are transactions that involve the firm's everyday lines of production and trade. Sales and their related costs are typically a firm's primary operating activities. Other examples of operating activities include paying taxes and buying short-term assets and taking on short-term liabilities to support the firm's ordinary business.
- **Investing activities** are the firm's transactions to acquire or dispose of long-term assets. Purchases and sales of property, plant and equipment are investing activities, as are purchases and sales of securities issued by others.
- **Financing activities** are transactions through which the firm raises or repays capital. These include issuing or repaying debt, issuing or repurchasing stock, and paying dividends to shareholders.

classify accounts into the financial statement elements.

- **Assets** are the firm's economic resources.
- **Liabilities** are creditors' claims on the firm's resources.
- **Owners' equity** includes paid-in capital (common and preferred stock), retained earnings, and other comprehensive income.
- **Revenue** includes sales, investment income, and gains.
- **Expenses** include the cost of goods sold, selling and administrative expenses, depreciation, interest and tax expenses, and losses.

Explain the process of recording business transactions

- Keeping the accounting equation in balance requires **double-entry accounting**, in which a transaction has to be recorded in at least two accounts
- *Purchase equipment for $10,000 cash. Property, plant and equipment (an asset) increases by $10,000. Cash (an asset) decreases by $10,000.*
- *Borrow $10,000 to purchase equipment. PP&E increases by $10,000. Notes payable (a liability) increases by $10,000.*

Information flows through an accounting system in four steps

- **Journal entries** record every transaction, showing which accounts are changed by what amounts. A listing of all the journal entries in order by date is called the "general journal."
- The **general ledger** sorts the entries in the general journal by account.
- At the end of the accounting period, an **initial trial balance** is prepared that shows the balances in each account. If any adjusting entries are needed, they will be recorded and reflected in an **adjusted trial balance**.
- The account balances from the adjusted trial balance are presented in the **financial statements**.

Capital and Revenue Expenditure

- **CAPITAL EXPENDITURE**
- Outlay resulting in the increase or acquisition of an asset or INCREASE in the earning capacity of a business
- **REVENUE EXPENDITURE**
- Outlay as is necessary for the MAINTENANCE of earning capacity including the upkeep of the fixed assets in a fully efficient state.

- **Q1 (a) (i) What is accounting?**
- (ii) **What are the main reasons for keeping accounts?**
- **(b) (i) Why might the following stakeholders be interested in financial information about** a company?
- (1) Managers of the company
- (2) Shareholders of the company
- (3) Trade creditors
- (4) Employees
- (5) Government departments and government agencies