Introduction to Accounting and Finance A Simple Guide

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Abstract:
This book provides a brief description of the basis of business financial management. The contents are developed in accordance with the needs of university students who are not majoring in accounting or finance as well as for anyone who needs fundamental information related to accounting and finance. In summary, this book covers the basic concepts and principles of financial accounting, double-entry system, adjusting and closing entries, financial statements preparation and assessment, introduction to finance and financial management, time value of money, capital budgeting technique and working capital management. This book aims to help anyone who wants to read and interpret the financial information of an organisation for improving the quality of financial-related decision making.

Keywords: Accumulated Depreciation, Monetary unit, Statement of Financial Performance, Unsecured loans, WACC

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A Simple Guide

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Penerbit UTHM

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CONTENT

PREFACE

This book aims to provide a simple and easy explanation of the fundamentals of financial accounting and financial management. The content is designed to meet the requirements of university students who are not majoring in accounting or finance, as well as anyone seeking a fundamental understanding of accounting and finance principles. Additionally, this book functions as a concise guide for private- or public-sector employees who wish to acquire a foundational understanding of accounting and finance. For this purpose, most of the technical terms and information have been simplified to help the reader quickly understand the basic concepts of financial statements and financial management. Specifically, this book provides the reader with a basic understanding of financial statement preparation, financial analysis, and the roles of financial management in facilitating effective decision-making. Importantly, this book will enhance the quality of financial decision-making for anyone who wishes to read and interpret the financial information of an organisation. We hope that you will find this book useful.

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CHAPTER 1

INTRODUCTION TO ACCOUNTING

Introduction

Accounting is a system designed to convey financial information to stakeholders, which is essential for assisting them in making crucial decisions. In this regard, accounting knowledge is an essential skill for understanding a company's performance, which are presented in its financial statements. This chapter introduces the functions of accounting in business organisations, the types of accounting branches, and the accounting principles and assumptions underlying financial statement preparation. In addition, this chapter discusses the various business entities that exist in today's business environment.

Learning Outcomes

On completion of the chapter, you should be able to:

1. Describe the nature and role of accounting.
2. Understand the main users of financial information.
3. Distinguish between financial and management accounting.
4. Recognise different types of businesses.

1.1 Accounting: Nature and roles

Accounting

Accounting is defined as the process of identifying, recording, and communicating financial information. This information is useful for those who need to make financial decisions, plan their business, and measure and control their business activities. Diagram 1.1 depicts the general accounting process within a business organisation.

CHAPTER 2

ACCOUNTING EQUATION

Introduction

This chapter explains the accounting equation, which is the foundation of the double-entry bookkeeping system. To provide a fundamental grasp of the key components of accounting recording, the main components that comprise the accounting equation (assets, liabilities, and owner's equity) are first discussed.

Learning Outcomes

On completion of the chapter, you should be able to:

1. Define assets, liabilities, owner's equity, revenue, and expenses, and classify items into these categories.
2. Explain what the accounting equation means.
3. Analyse the effect of transactions on the accounting equation.

2.1 Classification of assets, liabilities, and owner's equity

A business can be assessed in terms of what it owns and what it owes. Relevant accounts related to assets, liabilities, and owner's equity are presented systematically in financial statements. Financial statements are a formal, written report of the financial activities of an organisation for a specific accounting period. The reports detail the financial outcomes of business activities within an organisation. Four main financial statements that represent the financial effects of a business are statements of financial performance, owner's equity or shareholder equity (for a company), financial position, and cash flow.

i. Income statement/ Statement of financial performance

The income statement summarises the net income or loss for a given accounting period. This statement normally covers a year; however, it can also be prepared for monthly, quarterly, or semi-annual periods.

CHAPTER 3

BOOKKEEPING SYSTEM: DOUBLE ENTRY

Introduction

This chapter describes in detail how accounting information is recorded using the double-entry bookkeeping method. The double-entry system is a highly structured data entry system that allows businesses to monitor their financial condition over time. In this chapter, you will learn how to use T Accounts, the conventional method for entering data in a double-entry system. This chapter also discusses the typical forms of financial statements prepared by organisations. The format and objectives of the provision of the financial statements will also be explained.

Learning Outcomes

On completion of the chapter, you should be able to:

1. Understand the double-entry bookkeeping system.
2. Explain what is meant by the terms' 'debit' and 'credit' and their rules.
3. Create some simple ledger accounts.
4. Recognise the flow of the accounting process, starting with journalising, postings, and trial balance.
5. Distinguish the types of financial statements.

3.1 Double entry bookkeeping system

Business transactions have dual-effects records, which means one transaction affects at least two separate accounts. The accounts may consist of asset accounts, liability accounts, or a combination of assets, liabilities, and equity. This led to the creation of a special account under the category of assets and liabilities of equity. Examples of transactions include:

CHAPTER 4

THE ADJUSTING PROCESS

Introduction

Several adjustments are normally made before the financial accounts are finalised. The adjustments are due to some outstanding matters at the end of the accounting period (month or year), which must be included in the accounts. This chapter describes three common categories of adjustments that occur during a last-minute adjustment.

Learning Outcomes

On completion of the chapter, you should be able to:

1. Understanding the factors that led to the adjustment.
2. Make adjustments for inventories, accruals, depreciations, and prepayments.
3. Prepare a set of financial reports incorporating adjustments.

4.1 The adjusting process

Adjustment is needed to present more accurate financial statements by ensuring the correct balances of all related income, asset, and liability accounts. Primarily, adjustment is caused by non-cash transactions, which generally result from three factors.

a. Accrual basis
b. Periodic concept
c. Revenue and matching principles

CHAPTER 5

CASH FLOW STATEMENT

Introduction

Every business needs sufficient cash flow to support its daily operations. From a financial accounting perspective, income is not the same as cash since revenue from credit is also included in the income statement. Thus, the income statement does not accurately reflect the quantity of cash available. The actual cash balance is a key indicator of a company's liquidity, which is crucial information for the business. The statement of cash flows provides information regarding changes in cash. It details the cash receipts, cash payments, and net change in cash as a result of operating, investing, and financing activities during a period. This chapter discusses the importance of cash flow statements and their preparation format.

Learning Outcomes

On completion of the chapter, you should be able to:

1. Identify the importance of cash flow statements.
2. Distinguish the components of cash flow statements.
3. Prepare a statement of cash flows using both the direct method and the indirect method.

5.1 Importance of cash flow statement

A cash flow statement is important for planning the short-term and long-term financial needs of a business. Unlike profit, it does not necessarily guarantee a firm's growth or survival. Many businesses fail for lack of cash even though they have high profits. Hence, the level of cash held by a company is a crucial factor in ensuring the success of its operations. Other important aspects of a cash flow statement are:

CHAPTER 6

FINANCIAL STATEMENT ANALYSIS

Introduction

This chapter describes the analysis of the financial statements for a detailed examination and interpretation of the financial statements. The analysis is important to the users of financial information to evaluate the financial health of a business and predict its future performance. Several methods, including ratio analysis, horizontal analysis, and vertical analysis, are utilised to facilitate the analysis.

Learning Outcomes

On completion of the chapter, you should be able to:

1. Understand the use of the horizontal and vertical analysis techniques for analysing the financial statements.
2. Explore the relationship between financial data using ratio analysis.

6.1 Analysis of financial statement

Financial statement analysis involves the examination of the financial statements to assess the fundamental aspects of financial performance and to gain insights into the operations of the business. This analysis is useful for the interpretations of the firm's activities; hence, it helps the users in making better decisions. Financial statement analysis also reviews a firm's past and present financial performance, understanding risks and returns, and the projection of the company's future prospects.

CHAPTER 7
INTRODUCTION TO FINANCE

Introduction

This chapter introduces the field of finance, its functions, main areas, financial institutions, and markets. Moreover, it describes agency theory, the cost of money, risk and return principles. Understanding finance and financial management is crucial for individuals and enterprises to make well-informed financial decisions.

Learning outcomes

On completion of the chapter, you should be able to:

1. Explain the concept of finance and its main areas.
2. Discuss the goals of corporation and agency theory.
3. Understand the concepts of cost of money, risk, and return.

7.1 Definition of finance

Finance is a discipline that focuses on the creation and management of money, particularly the acquisition, expenditure, and investment of funds. It encompasses all parties, including individuals, businesses, institutions, and governments, and activities such as investing, financing, saving, and planning. Financial management usually concerns making and maintaining the overall wealth of the owners. This relates to the classic goal of the firm, which is to maximise shareholder wealth by maximising the firm's value and stock price. Therefore, financial management knowledge is essential for making informed economic decisions for business and personal reasons.

Financial management is the process of raising and investing a company's funds to maximise the wealth of its owners. Typically, the financial manager is involved in the following tasks:

CHAPTER 8

TIME VALUE OF MONEY

Introduction

The chapter introduces the concept of the time value of money and its significance in the process of decision-making. It focuses on the calculation of the equivalence value of money considering various cash flow streams, its application, and the formulas for simple interest and compound interest.

Learning outcomes

On completion of the chapter, you should be able to:

1. Discuss the concept of the time value of money and its role.
2. Determine the future and present value of money using a different stream of cash flows.
3. Compare different categories of interest.

8.1 Time value of money

The timing of cash flows has important financial consequences due to the effect of interest that can be received over a given amount of time. The present value of money is more valuable compared to the future value of the same amount. This concept is based on the time value of money, which states that the present value of money obtained now is worth more than the same amount of money earned in the future. The rationale lies in the potential to use and invest money now to generate more returns or benefits sooner. Over the course of time, the value of money decreases due to factors such as inflation, opportunity costs, and uncertainty. Consequently, many individuals and businesses prioritise receiving funds sooner to mitigate the risk of value depreciation and to enable immediate utilisation or investment for potential financial growth.

CHAPTER 9

CAPITAL BUDGETING

Introduction

Capital budgeting is the process of making decisions regarding long-term investments in order to maximise the wealth of the business and its owners. It involves measuring the incremental cash flows associated with investment proposals and evaluating the attractiveness of these cash flows relative to the project's costs. This chapter focuses on the various decision criteria for capital investment based on payback period, net present value, internal rate of return, and profitability index.

Learning Outcomes:

On completion of the chapter, you should be able to:

1. Understand the concepts and importance of capital budgeting.
2. Evaluate capital investment decisions using capital budgeting methods.

9.1 Definition of capital budgeting

Capital budgeting refers to the evaluation and analysis of capital investments, typically involve long-term projects, substantial amounts of funding. It involves the process of determining which investment projects should be accepted given a limited allocation of funds. The chosen project will normally have a significant impact on the firm's growth and strategic performance. Any capital investment decision should be consistent with the maximisation of shareholder wealth.

CHAPTER 10

WORKING CAPITAL MANAGEMENT

Introduction

This chapter explains the management of current assets and current liabilities to support daily business operations. It also addresses the evaluation of the effectiveness of working capital management through the cash conversion cycle and operating cycle.

Learning Outcomes

On completion of the chapter, you should be able to:

1. Understand the concept of working capital and its related components.
2. Calculate the operating cycle and cash conversion cycle for measuring working capital efficiency.
3. Explain the sources of short-term credit and its associated costs.

10.1 Working capital management

Working capital (WC) is a measure of business liquidity through its current assets (CA) and current liabilities (CL). WC represents a company's ability to satisfy its short-term financial obligations with the help of CA. Inventory, receivables, and payables are the three primary components of WC as inventories and receivables are the keys to generating sales, and accounts payable are typically used to fund inventories. WCM is important because CA is one of the business's primary asstes and a source of liquidity for owners' wealth creation. If liquidity is mismanaged, a business may fail. Table 10.1 shows the WC concept.

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