SESSION 1: ACCOUNTING FIRST STEPS

Accounting for Finance

The Accountant’s Role

- In my view (and many accountants will disagree), it is the role of accounting
  - To check transactions and operations, as they occur
  - To record them in a consistent manner
  - To report the results in standardized form
- Much as accounting wants to makes itself more relevant and central to businesses, it is not the role of accounting:
  - Forecast the future, no matter how tempted.
  - Value assets or operations.
- **Bluntly put, an accountant is a historian, chronicling events that have already occurred, not predicting the future.**

The Accounting Questions..

- *What do you own?* List out the assets that a business has invested in, and how much it spent on those investments and *perhaps what these assets are worth today*.
- *What do you owe?* Specify the contractual commitments that a business has to meet, to stay in business. Simply put, this should include all borrowings, but is not restricted to those.
- *How much money did you make?* Measure the profitability of the business, both with accounting judgments on expenses, and based upon cash in and cash out.

The Accounting Statements

- **The balance sheet**, which summarizes what a firm owns and owes at a point in time, as well as an estimate of what equity is worth (through accounting eyes).
- **The income statement**, which reports on how much a business earned in the period of analysis, while providing detail on revenues and expenses.
- **The statement of cash flows**, which reports on cash inflows and outflows to the firm during the period of analysis and allows for a measure of cash earnings (as opposed to accounting earnings) and cash flows.

1. Balance Sheet

Balance Sheet

Assets		Liabilities	
Long Lived Physical Assets	**Fixed Assets**	**Current Liabilties**	Short term obligations
Short Lived Assets	**Current Assets**	**Debt**	Long term debt
Investments in Securities & other business	**Financial Assets**	**Other Liabilities**	Other long term obligations
Assets which are not physical	**Intangible Assets**	**Equity**	Shareholders' Equity

2. Income Statement

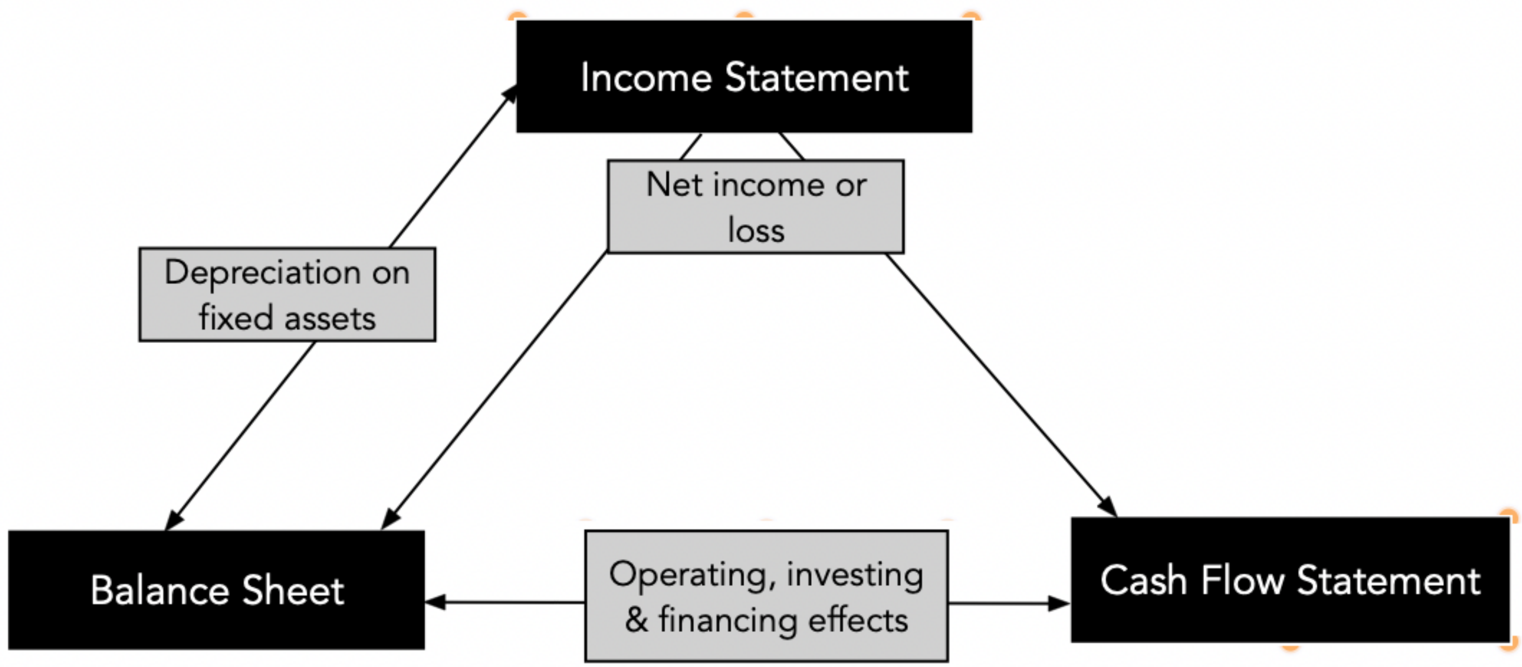
	Item	*Explanation*
Start with	Revenues	Accountant's estimate of the revenues/sales generated by any transactions made the business during the period.
Net out	Cost of Goods Sold	Expenses associated with producing products or services that represent top line sales
To get	Gross Profit	Production profitability
Net out	Other Operating Expenses	Includes selling, general and administrative and other expenses associated with operations, but not directly tied to producing goods and services
To get	Operating Profit	Profitability of business
Net out	Financial Expenses	Expenses associated with the use of non-equity capital, especially debt.
To get	Taxable Income	Income for equity investors, prior to taxes
Net out	**Taxes**	Taxes due on taxable income
To get	**Net Income**	Income for equity investors, after taxes

3. Statement of Cash Flows

Statement of Cash Flows

Net cash flow from operations, after taxes and interest expenses	Cash Flows From Operations
Includes divestiture and acquisition of real assets (capital expenditures), disposal and purchase of financial assets and cash spent on acquisition of other firms.	+ Cash Flows From Investing
Net cash flow from the issue and repurchase of equity, from the issue and repayment of debt and after dividend payments.	+ Cash Flows from Financing
Net cash flow, after investing and financing	= Net Change in Cash Balance

The Interconnections



The Accounting Standards

- **Accounting is a rule-driven process**, and over time, those rules have been formalized, especially for publicly traded companies. This formalization is driven by two considerations:
  - *Standardization*, to allow for comparisons across companies
  - *First principles*, to ensure that earnings, asset value and cash flows measure what they are supposed to measure.
- While accounting standards around the world remain different, they have converged (for the most part) around two standards:
  - **GAAP (Generally Accepted Accounting Principles),** representing rules developed by FASB (Financial Accounting Standards Board) to cover US financial reporting.
  - **IFRS (International Financial Reporting Standards)**, representing rules developed by IASB (International Accounting Standards Board) for companies listed globally, followed by about 90 countries as of 2020.

IFRS Standards are required for domestic public companies

IFRS Standards are permitted but not required for domestic public

IFRS Standards are required or permitted for listings by foreign

The IFRS for SMEs Standard is required or permitted

The IFRS for SMEs Standard is under consideration

The Bottom Line

- The raw material that we use to do financial analysis and valuation almost always takes the form of accounting statements.
- Consequently, it behooves us all to understand how accountants think (even if we disagree with them) in putting these statements together.
- The challenge is that accounting thinking keeps changing, as we move through time, and we have to understand those changes (both the what and the why), to keep up with them.