

AI3



Web content

Francesco Manni
Alessio Faccia

Financial accounting

Text & Cases





Aracne editrice

www.aracneeditrice.it
info@aracneeditrice.it

Copyright © MMXIX
Giacchino Onorati editore S.r.l. – unipersonale

www.giacchinoonoratieditore.it
info@giacchinoonoratieditore.it

via Vittorio Veneto, 20
00020 Canterano (RM)
(06) 45551463

ISBN 978-88-255-1726-2

*No part of this book may be reproduced
by print, photoprint, microfilm, microfiche, or any other means,
without publisher's authorization.*

I edition: January 2019

Contents

9 *Preface*

Part I Setting up of a business

13 Chapter I
Business idea and management

15 Chapter II
Business startup

2.1. The choice of the most appropriate legal structure, 15 – 2.2. Self-employed [Sole trader (UK) — Sole proprietorship (USA)], 15 – 2.3. Limited company, 16 – 2.4. Limited partnership IT (Società in accomandita), 16 – 2.5. LLP — Limited Liability Partnership (UK) [LLC — Limited Liability Company (USA)] IT (Società a Responsabilità Limitata con opzione per il regime di trasparenza fiscale), 17 – 2.6. Corporation (C Corporation), 17 – 2.7. S Corporation IT (Società per Azioni trasparente), 17 – 2.8. Business partnership, 18 – 2.9. Cooperative, 18 – 2.10. Unincorporated association (sports club or a voluntary group with no plan to to make a profit), 19 – 2.11. Social enterprise (to help people or communities), 19.

21 Chapter III
Financial accounting & Management accounting

Part II The double-entry bookkeeping system

27 Chapter I
Recording accounts

1.1. T-Account method, 27 – 1.2. Double-entry bookkeeping system, 28 – 1.2.1. *Ledger accounting book*, 29 – 1.2.2. *Journal accounting book*, 29 – 1.3. Nature of accounts, 29 – 1.4. Combination of accounts with a different nature, 31 – 1.4.1. *A financial account and an economic account*, 31 – 1.4.2. *Two*

(or more than two) financial accounts, 32 – 1.4.3. Two (or more than two) economic accounts, 32 – 1.5. The accounting equation, 33 – 1.6. Financial statements, 38.

Part III

The accounting system

A full case study

43 Chapter I

The accounting system

1.1. T–Account method, 43 – 1.2. Start–up of a limited company, 43 – 1.3. Purchase of goods, 48 – 1.4. Incurring acquisition expenses, 52 – 1.5. Rent expenses, 56 – 1.6. Service expenses, 59 – 1.7. Sales revenues, 62 – 1.8. Overdraft facilities, 65 – 1.9. Purchase of a tangible asset, 66 – 1.10. Purchase of an intangible asset, 69 – 1.11. Bartering assets, 72 – 1.12. Bank loan, 75 – 1.13. Factoring (with recourse), 79 – 1.14. Factoring (without recourse), 83 – 1.15. Ordinary maintenance, 86 – 1.16. Extraordinary maintenance, 89 – 1.17. Paid in capital (capital increase), 92 – 1.18. Payroll, 95 – 1.19. Payment of employees, 99 – 1.20. Issuing bonds, 102 – 1.21. Financial investments, 106 – 1.22. Lending money, 109 – 1.23. Returns and allowances (purchase), 112 – 1.24. Advances to suppliers, 115 – 1.25. Advances from customers, 121 – 1.26. Rent revenues, 127 – 1.27. Credit collection, 130 – 1.28. Payment of loan installments, 133 – 1.29. Service revenues, 136 – 1.30. Write off (uncollectable receivables), 139 – 1.31. Payments with note payables, 142 – 1.32. Disposal of tangible assets, 145 – 1.33. Insurance expenses, 148.

153 Chapter II

Adjusting entries

2.1. Adjusting entries and the accrual basis, 153 – 2.2. Deferral and accrual, 154 – 2.3. Deferred operations: prepaid expense, 157 – 2.4. Deferred operations: unearned revenue, 163 – 2.5. Deferred operations: inventory, 169 – 2.6. Deferred operations: depreciation & amortization, 172 – 2.7. Impairment test, 178 – 2.8. Accrued operations: employees' retirement bonus, 184 – 2.9. Accrued operations: accrued revenues, 187 – 2.10. Accrued operations: accrued expenses, 190 – 2.11. Accrued operations: unbilled revenues, 199 – 2.12. Accrued operations: unbilled expenses, 202 – 2.13. Accrued operations: bad debt expense, 205 – 2.14. Accrued operations: income taxes, 208 – 2.15. Ending transaction: destination of the final result, 211.

Part IV
Cash flow (dynamic) analysis

- 217 Chapter I
The cash flow according to theory and practice
- 225 Chapter II
From accrued to cash logic
- 229 Chapter III
Dynamic (cash flow) and static (ratio) analysis

Part V
Cash flow statements

- 233 Chapter I
Formats
 - 1.1. Funds flow statement, 233 – 1.2. Working capital statement, 234 – 1.3. Cash flow statement (FCF), 237.
- 243 Chapter II
Cash flow from/for operating activities (CFO)
 - 2.1. Direct method, 243 – 2.2. Indirect method , 244.
- 247 Chapter III
Cash flow for/from investing/disinvesting activities (CFI)
- 249 Chapter IV
Cash flow for/from financing activities (CFF)
- 251 Chapter V
Cash flow International Statements

Part VI
**Cash flow statement
Case study**

- 259 Chapter I
Case study

Part VII
Ratios (static) analysis

267 Chapter I

Ratios, a static analysis system

1.1. From financial statement to ratios analysis, 267 – 1.2. Performance, 268 – 1.3. ROE, 269 – 1.4. ROD, 270 – 1.5. ROI, 270 – 1.6. ROA, 271 – 1.7. ROS, 272 – 1.8. Asset turnover, 272 – 1.9. Liquidity (short-term solvency), 274 – 1.10. Cash ratio, 274 – 1.11. Quick ratio – acid test liquidity ratio, 276 – 1.12. Current ratio – net working capital ratio, 276 – 1.13. Financial strength, 277 – 1.14. Financial leverage multiplier, 277 – 1.15. Debt to equity ratio, 278 – 1.16. Structure (medium/long-term solvency), 279 – 1.17. First ratio, 279 – 1.18. Second ratio, 279.

281 Chapter II

A comprehensive analysis of the case study

Preface

This book has been designed and written for the students and this is why some topics are repeated. Bibliographic references are not mentioned, but only some direct quotations. Actually, at first we had been preparing a bibliography, but then we have decided to give it up due to an excessive disproportion with the aims of the text.

The accounting standards considered for this text are the IAS/IFRS ones, sometimes compared to Italian GAAPS and US GAAPS.

Even if both parties of the book were revised and written by both authors, Prof. Francesco Manni has mainly focused on the parts I, IV, VII (from 1.1 at 1.8) whereas Dr. Alessio Faccia on the parts II, III, V, VI, VII (from 1.9 at 1.18).

We must thank especially two people who helped us to correct the text and who provided useful suggestions for its improvement: Pierfrancesco Marletta and Vera. In any case, any possible mistake is to be attributed solely to the authors.

PART I

SETTING UP OF A BUSINESS

Business idea and management

It all starts with the idea of the entrepreneur.

He clarifies in his mind that a human need for production of a good or service at that time has not yet been met.

The main purpose of a business is (indeed it must be) to satisfy human needs, otherwise it is set to go down quickly.

The idea can be put into practice independently (self-employed) or collectively (company) and the protagonists invest a personal capital, taking on a risk.

Business risk is not having the assurance of an annuity (as is the case with investing in other investments such as renting a property or collecting coupons of a bond, assuming that the counterparty does not fail). This happens because the entrepreneur anticipates costs for gaining production factors, but he is not sure that these costs can be covered and exceeded by subsequent revenues that can be obtained.

Starting a business is also an activity that requires constant engagement and includes knowledge in the most diverse areas (accounting, law, security, pay, industry-specific rules...). Where management fails to understand the specific rules, it is necessary to consult with independent consultants to decrease the risk of business and use diligence on what should be implemented.

Management choices determine the company's success or failure.

Several studies deal with management and what are the best ways to get the best results. The results, however, must be reliably measured by a detection system. This system is generally defined and known as "accounting". Such a system allows not only to measure ex post results (financial accounting), but also to provide support for decision making (management accounting).

It is therefore essential to have an efficient accounting system that respects national and international standards.

The support that accounting provides to businesses and their managers is crucial because it especially enables:

- a)* tracking all the transactions made;
- b)* analyzing them;
- c)* carrying out evaluations of the effectiveness and efficiency of the management;
- d)* to calculate the amount of income taxes to pay;
- e)* compare the performances of different companies.

Business startup

2.1. The choice of the most appropriate legal structure

The setup of a business requires, first of all, the choice of the most appropriate legal structure of the entity to run. The structure is important in order to define legal responsibilities, duties and taxes to manage.

The main types are as follows.

2.2. Self-employed [Sole trader (UK) — Sole proprietorship (USA)]

Individuals run a business, there is an identity between the business and the owner. The individual can keep business' profits after paying taxes on them. Running a business as an individual entrepreneur does not mean to work alone, despite the responsibility of the business is only of the entrepreneur, he can hire staff (subordinate employees).

The trader is responsible for:

- a) business debts, bills for anything he buys for his business (liabilities);
- b) keeping records of his business's sales and expenses;
- c) sending a self-assessment tax return every year;
- d) paying income tax on the profits his business makes and national insurance;
- e) registering for VAT.

Even if there is a perfect coincidence between the business and the owner, the holder may still give to the business a fictitious name to the business.

2.3. Limited company

Limited Companies must be registered (“incorporated”) with Companies House. For the registration are required some information like: a company name, an address for the company, at least one director, at least one shareholder, the agreement of all initial shareholders (“subscribers”) to create the company — known as a “memorandum of association”, details of the company’s shares and the rights attached to them — known as a “statement of capital”, written rules about how the company is run — known as “articles of association”.

Once the company is registered, shareholders receive a “Certificate of Incorporation”. This confirms that the company legally exists and shows the company number and date of formation¹.

The liability to members for debts in a limited company is limited.

- a) Limited by shares, private company limited by shares owned by its members (called “shareholders”). Each member is liable only for the original value of the shares they were issued but did not pay for it.
- b) Limited by guarantee, the members (who are not called shareholders) of the company financially back it up to an agreed amount.

2.4. Limited partnership IT (Società in accomandita)

This structure has at least one “general partner” and one “limited partner”.

All partners pay tax on their share of the profits, but general partners (unlike limited partners) have responsibilities and unlimited liability for any debts the business can’t pay.

The rules are different for setting up a limited liability partnership, an “ordinary” business partnership or a private limited company.

1. Website: www.gov.uk/limited-company-formation/overview.

2.5. LLP — Limited Liability Partnership (UK) [LLC — Limited Liability Company (USA)] IT (Società a Responsabilità Limitata con opzione per il regime di trasparenza fiscale)

A limited liability partnership (or company) is an “incorporated” partnership with two or more members (people or companies), known as “corporate members”.

Each member is a limited partner (not personally liable for debts the business can’t pay) but he pays taxes on their share of the profits.

It is a hybrid type of structure that provides members with the limited liability (like a limited company) and the tax efficiencies and operational flexibility of a partnership.

LLPs are not taxed as a separate business entity. Instead, all profits and losses are “passed through” the business to each member.

2.6. Corporation (C Corporation)

A corporation is an independent legal entity owned by shareholders. The corporation itself is held legally liable for the actions and debts the business incurs, not the shareholders that own it.

Corporations are more complex than other business structures because they tend to have expensive administrative fees and complex taxes and legal requirements. Because of these issues, corporations are generally suggested for establishing larger companies with multiple employees.

Corporations offer the ability to sell their ownership shares in the business through stock offerings².

2.7. S Corporation IT (Società per Azioni trasparente)

An “S corporation” is similar to a “C corporation” but individuals are taxed only on the personal level. What makes the “S corp” different from a traditional corporation (“C corp”) is that profits and losses can pass through to your personal tax return. Consequently, the business is not taxed itself. Only the shareholders are taxed. However, there is an

2. Website: /www.sba.gov/content/corporation.

important caveat; many shareholder who works for the company must pay him or herself “reasonable compensation”. Basically, the shareholder must be paid considering the fair market value, or the IRS might reclassify any additional corporate earnings as “wages”.

2.8. Business partnership

There are several different types of partnerships, which depend on the nature of the arrangement and partner responsibility for the business.

A partnership is a single business where two or more people share ownership.

Each partner contributes to all aspects of the business, including money, property, labor or skill. In return, each partner shares the profits and losses of the business.

There are generally three types of partnership arrangements:

- a) “general Partnerships” assume that profits, liability and management duties are divided equally among partners. If you opt for an unequal distribution, the percentages assigned to each partner must be documented in the partnership agreement;
- b) “limited Partnerships” (also known as a partnership with limited liability) are more complex than general partnerships. Limited partnerships allow partners to have limited liability as well as limited input with management decisions. These limits depend on the extent of each partner’s investment percentage. Limited partnerships are attractive to short term project investors;
- c) “joint Ventures” act as general partnership, but for only for a limited period of time or for a single project. Partners in a joint venture can be recognized as an ongoing partnership if they continue the venture, but they must file as such.

2.9. Cooperative

People form cooperatives to meet a collective need or to provide a service that benefits all member-owners.

A cooperative is a business or an organization owned and operated for the benefit of those using its services. Profits and earnings generated by the cooperative are distributed among the members, also known as user-owners.

Typically, an elected board of directors and officers run the cooperative while regular members are voting power to control the direction of the cooperative. Members can become part of the cooperative by purchasing shares, though the amount of shares they hold does not affect the weight of their vote.

Cooperatives are common in the healthcare, retail, agriculture, art and restaurant industries³.

2.10. Unincorporated association (sports club or a voluntary group with no plan to to make a profit)

An “unincorporated association” is an organization set up through an agreement between a group of people who come together for a reason other than making a profit. Individual members are personally responsible for any debts and contractual obligations.

If the association starts trading and makes a profit, you’ll need to pay Corporation Tax and file a Company Tax Return in the same way as a limited company⁴.

2.11. Social enterprise (to help people or communities)

You must choose a business structure if you’re starting a business that helps people or communities (a “social enterprise”).

If you want to set up a business that has social, charitable or community-based objectives, you can set up as a:

- a) limited company;
- b) charitable incorporated organisation;

3. Website: www.sba.gov/category/navigation-structure/starting-managing-business/starting-business/choose-your-business-stru.

4. Website: www.gov.uk/business-legal-structures/unincorporated-association.

- c) co-operative;
- d) industrial and provident society;
- e) community interest company (CIC);
- f) sole trader or business partnership.

If you're setting up a small organization like a sports club or a voluntary group and don't plan to make a profit, you can form an "unincorporated association" instead of starting a business⁵.

Accounting standards are a set of rules that are used for measuring the financial performance of a firm. The financial performance of a firm necessitates to be reviewed by the stakeholders. Financial statements are prepared to review the financial details of all the activities carried out by the organization. Different organizations, depending on the size or type of the organization, follow different accounting procedures. Therefore, there is a need for a common set of rules for accounting, to ensure comparability. The main objective of these rules is to avoid any variations in the way different accounting features are treated by different organizations. These set of rules help to measure and thus compare the performance of companies in a standardized way across the globe. Accounting standards ensure that there is consistency in the way financial statements are formed.

Generally, listed companies should comply with the admission, disclosure rules and standards. In such a way, companies succeed in demonstrating the quality of their business to investors. As a result, this helps to encourage investor confidence.

Accounting Standards and Companies Ordinance & Stock Exchange rules must be both followed by the issuers of financial report. Even if an expressed full compliance is obviously complicated, it is necessary to apply both because the aim of the accounting standards and Stock Exchange rules are different but complementary and it is necessary to respect them at the same time.

Stock exchange rules can't ensure (stand-alone) an appropriate information to stakeholders because those rules don't involve the correct recording of business transactions, but only the final reporting and representation.

It is instead desirable to harmonize the set of rules and standards to reduce the complexity of the preparation of the financial statements.

5. Website: <https://www.gov.uk/set-up-a-social-enterprise>.