Unit 1 The Fundamentals of Finance

Learning Outcomes

By the end of this unit the learner will be able to:

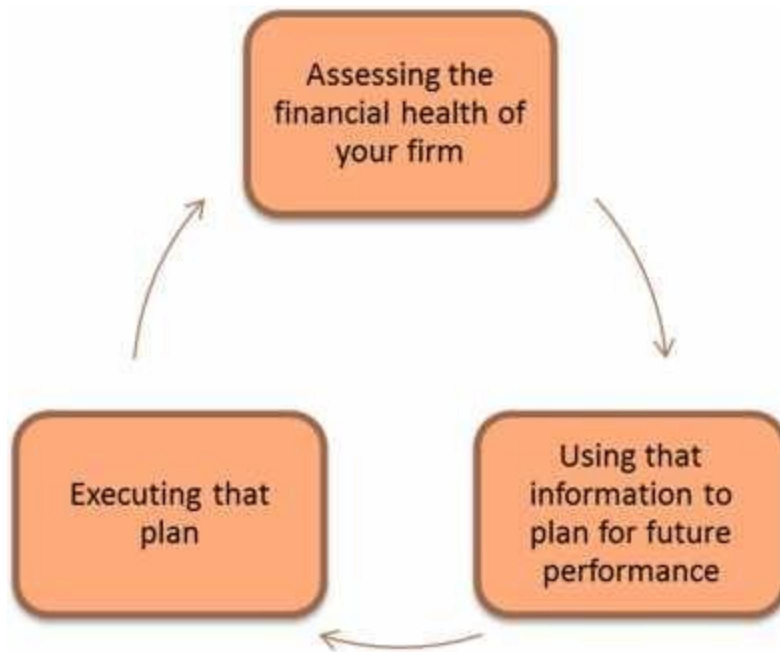
- ✓ Define basic financial terminology

The Fundamentals of Finance

Finance

The Encarta Dictionary defines finance as, “the business or art of managing the monetary resources of an organization, country, or person.” Bookkeeping, banking, and accounting, are all separate processes with their own definitions.

Seth Godin describes finance as a three-cycle process that continues endlessly:



Once a company finishes the third step – executing its plan – it goes back and reassesses its performance again, and this cycle of finance repeats itself in a continuous loop.

Basic Concepts

Recording Financial Transactions

A useful budget is prepared under the same umbrella of guidelines as the company’s actual financial statements. There must be consistency in the way the numbers are prepared. As such, it is necessary to understand some key terms.

Bookkeeping is the exercise of recording all the transactions that take place in a business. Transactions take place between the business and:

- Customers, who buy products and services sold by the business

- Employees, who are paid wages and provided benefits
- Vendors, who sell services, equipment, and supplies to the business
- Government agencies, who collect taxes from the business
- Sources of equity capital (investors or owners who put money in and take it out of the business)
- Sources of debt capital (banks and lending institutions)

Accounting, on the other hand, is the methodology used to accomplish this goal and to prepare related statements and reports. Accounting guidelines govern how businesses record transactions. They also dictate the design of the recordkeeping system that a business uses and how reports are prepared, based on the information gathered and put into the system.

This brings us to another question. Often, we hear the terms "financial statements" and "financial reports" used interchangeably. Is there a difference?

For the purpose of our courses, yes, there is a major difference. A **financial report** is a document prepared for internal company use. It can come in many forms and be used for many purposes. A **financial statement** is a formal document prepared in a specific format as outlined by your region's Generally Accepted Accounting Principles (which we will discuss in a moment) or another governing organization (such as your tax legislation).

Types of Costs

There are two parts to a budget: sources of cash and uses of cash. When we think about uses of cash we can break them down as follows.

Sunk Costs

A sunk cost has already been incurred; it just needs to be paid. It is the result of a past irrevocable decision and is sunk in the sense that it cannot be avoided. As a result, sunk costs may not impact future decisions.

Recurring Costs

Quite simply, recurring costs recur and require a periodic outlay of funds. Material costs, supplies, heat, and lights are prime examples.

Generally Accepted Accounting Principles

Accounting forces people to measure things in a relatively consistent manner. A good budget is prepared based on consistent rules as well. Accountants refer to the rules in their rule book as **generally accepted accounting principles** (GAAP). The objective of GAAP is to ensure comparability among different companies and overall reliability of information.

While there can be slight differences between regions, GAAP typically includes the following principles:

- The **matching principle**: Earnings and expenses must be booked in the relevant accounting or budget period when one benefits the other. This is necessary to properly evaluate results.
- The **cost principle**: Assets and service, and the resulting liability, are taken into the accounting records at cost.
- The **consistency principle**: A company's accounting procedures need to remain consistent over time. If they are changed, the reasons for the change and the financial impact of the change must be documented in detail.
- The **objectivity principle**: Whenever possible, the amounts used in recording transactions are based upon objective evidence rather than on subjective judgments.
- The **realization principle**: This principle defines revenue as an inflow of assets (not necessarily cash) in exchange for goods or services. It requires the revenue to be recognized at the time, but not before it is earned.

Budgeting Terms

A **budget** is an operating plan that outlines projected revenue and expenses for a particular period of time.

A **projection** is a prediction for the future, based on past data, *extrapolation,* and summarizing key factors.

Forecasting is the process of putting together several *projections* to create a *projection* for the future. (Think of a weather forecast.)

Extrapolation is the process of applying past data to the future to arrive at a reasonable *projection.*

Your Role in Company Finances

What's My Role?

Understanding the cycle of finance will help you figure out where you fit into your company's financial structure. No matter what your role is, you can help save your company money. Small savings add up!

What if…

- You work in the company's payroll department and you could save $2.50 per employee check, per payday? How much could you save your company over one pay period?
- You supervise a team that produces widgets and you find a way for them to produce two extra widgets a day without any extra cost? If they sell for $49.99 each, how much income would the extra two items bring in per year?
- You find a new advertising method that has the same reach but saves $30,000 a month. What else could you do with that money?

Test Your Knowledge

What can you do to improve your organization’s finances?

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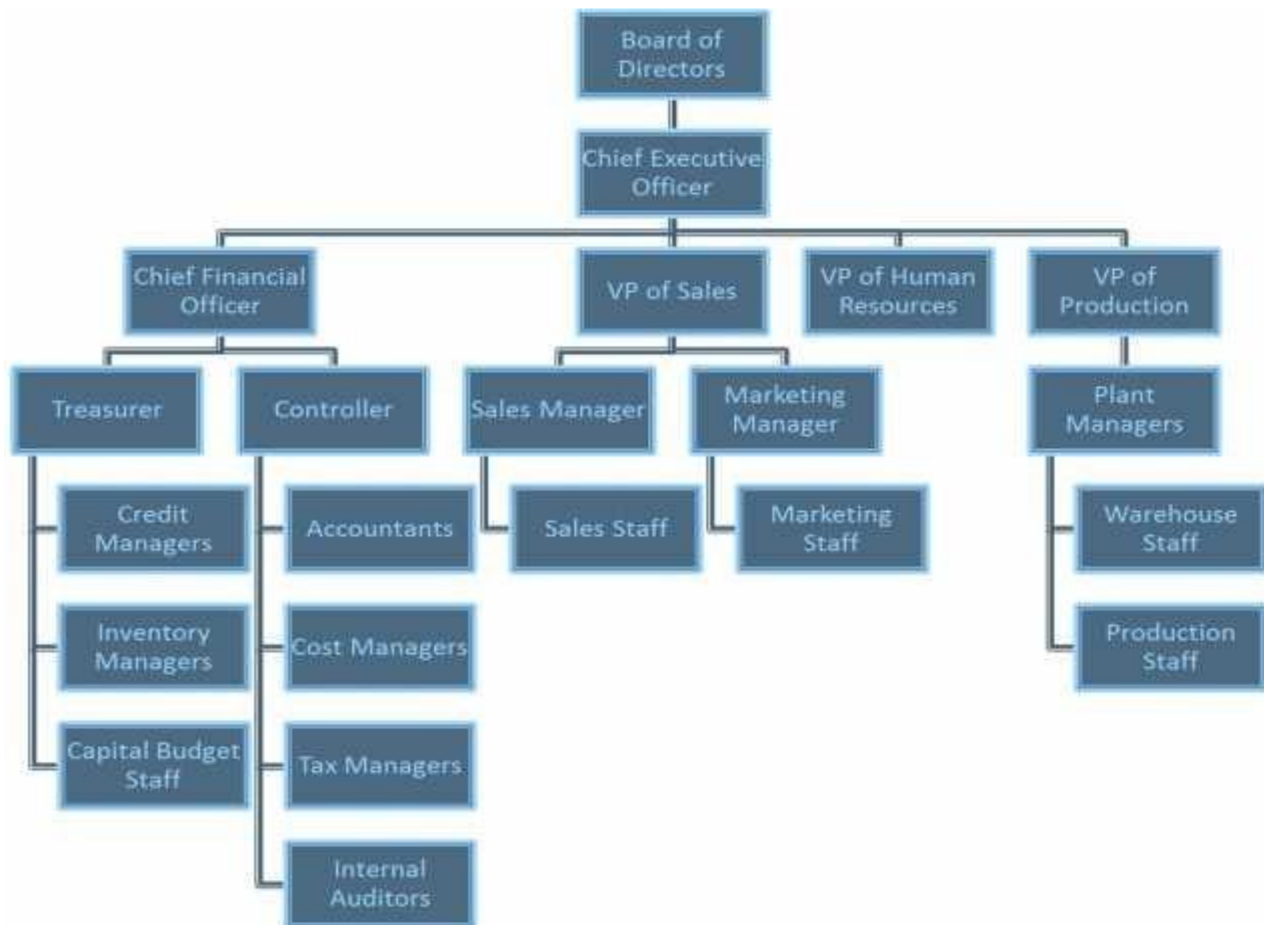
The Big Picture

Once you’ve thought about your role, think about your organization and look at what financial-based roles exist. Understanding their responsibilities will help you get a better picture of what your role is, and it will help you identify who to go to when you need help.

Here is how many mid-sized organizations are structured, although not all organizations will have all roles:



The board of directors usually leads the company's financial direction. Their vision is usually carried out by the Chief Executive Officer (CEO).The CFO, or Chief Financial Officer of a company, is just behind the CEO.

Governing Organizations

Financial rules and regulations are constantly changing. If you're going to be involved in your company's finances in any way, you should be aware of important regulations that apply to your organization.

Once again, the Internet will be your greatest ally. Just make sure that the site you are visiting is the actual, regulated site, and not an imposter. We've listed the biggest regulatory bodies below.

Area	Organization	website
Australia	Australian Securities & Investments Commission	http://www.asic.gov.au/asic/asic.nsf
Canada	Canadian Securities Administrators	http://www.securities-administrators.ca/

Area	Organization	website
China	China Securities Regulatory Commission	http://www.csrc.gov.cn/pub/csrc_en/
Hong Kong	Securities and Futures Commission	http://www.sfc.hk/sfc/
India	Securities and Exchange Board of India	http://www.sebi.gov.in/
International	Bank for International Settlements and Basel Committee	http://www.bis.org/
International	International Organization of Securities Commissions	http://www.iosco.org
International	International Association of Insurance Supervisors	http://www.iaisweb.org/
International	IFRS Foundation, including International Accounting Standards Board and IFRS Interpretations Committee	http://www.ifrs.org
Japan	Securities and Exchange Surveillance Commission	http://www.fsa.go.jp/sesc/english/index.htm
New Zealand	Financial Markets Authority	http://www.fma.govt.nz/
United Kingdom	European Securities Committee	http://ec.europa.eu/internal_market/securities/esc/index_en.htm
United Kingdom	European Securities and Markets Authority	http://www.esma.europa.eu/
United States	U.S. Securities and Exchange Commission	http://www.sec.gov/

Wikipedia also offers a list of financial regulatory authorities (organized by country) at http://en.wikipedia.org/wiki/List_of_financial_regulatory_authorities_by_country. (Again, We assume no liability or responsibility for the content or accuracy of websites external to the company.)

The Accounting Cycle

Underlying Principles

Methods of Recording Transactions

There are two basic methods for recording transactions: the cash method and the accrual method. The most commonly accepting accounting method is the accrual method.

The **cash accounting method** is a system which records income when it is received and records expenses when they are paid. For example, if you sold goods and gave the purchaser 30 days to pay you, you would not book the sale until you are paid, which could be as long as 30 days. Only certain types of businesses, primarily farmers and fishermen, are permitted to use this method of accounting. Cash accounting is not widely used because it does not give the most accurate picture of what is happening in the business, particularly in countries where it is common practice to extend credit to customers.

The **accrual method of accounting** counts income and expenses when they are due to or from the business, as distinct from when they are received or paid. Income is recorded when the business has the right to receive the income, and expenses are recorded and considered when they are due, even if they haven't yet been paid.

This accounting process measures a firm's income by matching a firm's revenues against its expenses within an accounting period. (Properly enough, this is called the **matching principle**.)

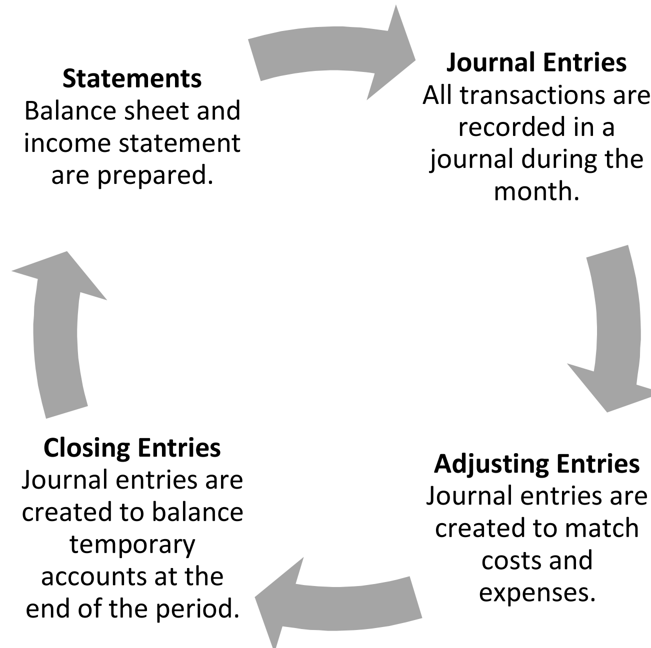
Under accrual accounting, the total sales on the income statement seldom match the firm's actual cash receipts during a particular operating period. Nor do the expenses duplicate its cash disbursements. One area where "incurred" expenses often deviate from "paid" expenses is employee expense reports: the company has incurred these expenses but they have not been paid because the employee has not submitted his expense claim.

Accounting Periods

At the beginning of its existence, a business establishes its fiscal year end. This is any 12 consecutive months. Many businesses use the calendar year end (December 31st) as their fiscal year end but they do not have to. Many businesses also break their fiscal year into smaller accounting periods, such as 12 monthly periods or four quarterly periods of three months. Management will use the accounting periods to compare results against prior periods or even against a budget.

Overview of the Accounting Cycle

Let's take a look at the life cycle of accounts in a business. This cycle takes place during each accounting period (typically a month or a quarter).



Now, let's define some of the terms that we see here.

The **journal** is the book that all transactions are originally recorded in (although these days, it's often an electronic document, not an actual book!). Generally they are recorded in chronological order and given an entry number. The **ledger** is the final book of entry, with transactions recorded by account and according to whether they are a debit or credit.

A **transaction** can be any kind of financial event, such as a bill being paid, a sale being received, a check being written, etc.

Balance sheets and **income statements** are two of the most important financial statements. They should be prepared at the end of each financial period. (We'll look at these statements later in the course.)

Permanent accounts are those that appear on a balance sheet (such as cash or accounts to be paid). These accounts always carry a balance (as long as your business is in business, of course!). **Temporary accounts** (such as expenses and revenue) are closed at the end of each period, so that they do not carry over a balance.

Further Reading: