Foundations of Accounting & Finance

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Week - 01

Lecture - 01

Introduction to Financial Accounting and Cost Accounting

Welcome to the course on Foundations of Accounting and Finance. In this course, we will delve into the fundamentals of both accounting and finance. Let us begin by addressing some common questions you may have about the course content and its relevance.

Course Level

The course aims at developing skills to understand, evaluate and use financial information in business decision making. The course will introduce participants to the vocabulary of financial accounting, management accounting, and corporate finance. The course is aimed to develop an understanding of the important tools and techniques used in analyzing financial information. It will also aid in developing the necessary skills to apply these tools and techniques in the context of business decisions. The purpose of this course is to begin building confidence in applying the concepts, while at the same time encouraging you to strive for a level of sophistication at which overconfidence in these concepts is unlikely. At any given time in the course, you will be working simultaneously at three mental levels:

- How can you use the concepts to help you "think like a manager"?
- Integrating the new concepts into your continually evolving picture of what it means to you and to "Think like a manager.”
- Building an awareness of the subtlety and ambiguity in the concepts which people who haven't thought about them as long cannot see.

The course essentially aims at building up the necessary and sound foundation of Accounting and Finance for two purposes – one, these foundations would be helpful to have a better understanding of other courses, and second, it would help the participants to master 'the language of business' and thereby to understand 'the business better.'

This course is designed at a very basic level, serving as an introductory or level one course in Accounting and Finance. It is intended for individuals who are new to these subjects or those seeking to build a sound foundation in accounting and finance.

Course Overview

Throughout this course, we will explore key concepts in both accounting and finance, focusing on the following areas:

1. **Financial Accounting**

In financial accounting, we discuss the basic three financial statements and how these financial statements interact. I am not going to delve deep into the formal preparation, the method of preparing a financial statement. Instead, I will focus on what these financial statements contain, how do you read them? and how to interpret them? When a transaction occurs, how the financial statements are impacted is crucial, and we will spend time trying to understand the concept.

At the end of this part of the course, you should feel comfortable holding or reading a financial statement or an annual report of a company, and the terms in the statement should not be unfamiliar. You should be familiar with the terminology and understand how the financial statement reflects various transactions affecting assets, liabilities, revenues, expenditures, and more. This overview provides basic knowledge of financial statements, their contents, interactions, and their utility. In addition, we cover some basic zero-level analysis of financial statements as part of this course.

2. **Cost & Management Accounting**

We move on to the cost and management accounting part, where we will be covering the basic statements or information that is used by the company's management to make decisions. We start with the definition of 'cost,' different types of 'cost,' and the use of this information for making decisions. We will also spend some time in attempting to understand the behavior of different kinds of costs in terms of distinguishing between direct, indirect, fixed, and variable costs and exploring how costs vary. We also delve into the concept of breakeven analysis and discuss how to make fundamental decisions such as product mix, pricing, and others using cost accounting information.

3. **Corporate Finance**

Transitioning from Accounting to Finance: The Balance Sheet presents Assets on one side and the Owners' Equity and Liabilities on the other. Assets represent the Investments made by a company. Owners' Equity and Liabilities represent the sources of Financing the Investments in Assets. Thus, the two sides of the Balance sheet represent the two key decision areas in Corporate Finance, viz. Investments and Financing. What might be a little puzzling to some readers about this observation is that the Assets side of a Balance sheet includes items such as Cash and Inventories, which may not fit with the idea of Investments. The decision of a business to hold cash or inventories is as much an investment decision as the decision to buy another company or a brand or to build a factory. Some of the investments involve decisions over a longer time horizon compared to others.

The Owners' Equity and Liabilities side of the Balance sheet represents the sources of financing. The Owners' Equity section represents both paid-in capital, which follows from a company's decision to issue stocks, and Retained Earnings, which follows from the decision of the Owners to put profits back into the business. The amount of Retained Earnings is also a consequence of the decision about how much a company chooses to pay as Dividends, another Corporate Finance decision termed as Dividend Policy. Corporate Finance decisions viz. Investment and Financing decisions are based on the use of cash flows rather than Profit or Loss. Profit or Loss can be used as starting points to derive these relevant cash flows, but by themselves, Profit or Loss cannot be a basis for Corporate Finance Decisions.

To the basic ideas presented, we must now add a time dimension. Corporate Finance decisions represent choices from among Investment and Financing alternatives. As a company makes Investment decisions, it plots the future operating and investment cash flows that are likely to result from the decision and then puts a value on these cash flows. Likewise, in making a Financing decision, the company would plot the likely future cash flows likely to result from the financing decision and again put a value on it. In contrast to this future orientation in Corporate Finance decisions, the analysis of Financial Statements is an examination of past performance. Computing Ratios or using other techniques to analyze financial statements will tell us how a company did in the past. While this can be useful for predicting future performance, the orientation in using financial accounting data is more towards the past than towards the future.

Recommended Text Books

To support your learning, we will be referring to three prescribed textbooks throughout the course. You may wonder why three textbooks are necessary. It is because we cover three distinct areas of accounting and finance, and each textbook complements a different part of the course. However, we will not be covering these textbooks chapter by chapter. Instead, we will focus on key concepts relevant to our discussions. You can refer to these textbooks for additional knowledge or to practice numerical problems.

For financial accounting, I will use "Accounting: Texts and Cases by Robert Anthony, David Hawkins, and Kenneth A. Merchant". For Cost and management accounting, we will refer to Managerial Accounting by Garrison, Noreen, and Brewer. Lastly, for Corporate Finance, we will use "Corporate Finance by Stephen A. Ross, Randolph W. Westerfield, Jeffrey Jaffe, Bradford D. Jordan, and Ram Kumar Kakani." I will incorporate problems and materials from these textbooks into our discussions. While purchasing these books is not mandatory, having access to them through a library would be beneficial for your learning.

Targeted Audience

Now, let's consider whom will this course benefit. Will it be helpful for someone preparing for a competitive exam or a specific finance or accounting exam? The answer is both yes and no. Yes, because this course will provide you with a sound understanding of the concepts in accounting and finance. For instance, you'll learn about the balance sheet, its contents, and how transactions affect it. You will intuitively grasp the logic behind these concepts. However, this course is not designed to train you to solve a multitude of problems or to prepare you for an exam with hundreds of questions. So, this course serves as a foundation in accounting and finance, providing a basic conceptual understanding on the fundamentals of finance and accounting.

Teaching Pedagogy

Financial accounting entails three financial statements and how they interact with each other. Similarly, the course covers the basics of cost accounting and corporate finance. In essence, this is a fundamental, level-one course. It is beneficial for individuals who want to gain an understanding of accounting and finance but may not have a thorough knowledge of these subjects. The course spans 30 hours, with approximately 50 percent of the time dedicated to financial accounting, followed by cost and management accounting, and finally, corporate finance. This emphasis on financial accounting is essential as it forms the basis for understanding corporate finance.

I. Financial Accounting

Now, let us delve into the specifics of why I term this course as "Accounting and Finance." What sets these two disciplines apart? To begin with, let us distinguish between them and explore their contents.

In accounting, we further classify into two parts: financial accounting and cost or management accounting. I often interchangeably use the terms cost and management accounting. Financial accounting deals primarily with recording transactions. Every transaction, whether it involves spending cash or purchasing goods on credit, is meticulously recorded. For instance, when you spend money at a shop, buy goods on credit, or pay in advance for a product, these transactions are recorded in financial accounting books. The recording takes place the moment a transaction which can be expressed in monetary terms takes place, and this is referred to as a transfer of ownership.

Understanding Transactions with Numerical Examples:

Transactions involve the exchange of goods or services, irrespective of payment being immediate or deferred. Recording these transactions accurately is the essence of financial accounting.

1. **Transaction 1: Pay and Buy:** This involves paying for goods or services and receiving cash compensation immediately. For instance, if you have 10,000 rupees in your wallet

and you spend 7,000 rupees on goods at shop X, the ownership of the 7,000 rupees transfers to the seller, and you take possession of goods worth 7,000 rupees.

2. **Transaction 2: Pay Advance:** Here, payment is made in advance, even though the goods or services are not received immediately. For example, if you pay 3,000 rupees in advance at shop B, the ownership of the 3,000 rupees transfers to the seller - therefore, a transaction is deemed to have taken place. The advance is held by shop B until the goods or services are provided.

3. **Transaction 3: Buy, Pay Later:** In this case, goods or services are received, but payment is deferred to a later date. For instance, if you purchase goods worth 10,000 rupees at shop C but pay later, the ownership of the goods transfers to you immediately, but you are liable to pay the seller at a later date, and hence a transaction has occurred.

In financial accounting, recording transactions is the primary activity. While we'll delve into recording methods later, at this stage, let us restrict it to the fact that every transaction is meticulously recorded as it occurs.

Users of Financial Accounting

Financial accounting serves both internal and external stakeholders of an organization. These stakeholders include employees, creditors, shareholders, government entities, and other interested parties. Whereas, cost or management accounting is predominantly for internal use of the organization and is treated as confidential.

Internal Stakeholders:

1. **Employees:** They need to understand the financial health of the company, including cash position, profitability, and performance, to assess job security and overall company stability.

2. **Management:** Internal stakeholders such as management utilize financial accounting to manage company resources effectively, monitor cash flow, and make informed decisions regarding investments and operations.

External Stakeholders:

1. **Creditors:** Entities providing loans or credit to the company use financial accounting information to evaluate the company's ability to repay debts, assess creditworthiness, and determine interest rates.

2. **Shareholders:** Shareholders rely on financial accounting to evaluate the company's financial performance, profitability, and overall health, which impacts dividend payouts and share prices.

3. **Government Entities:** Governments use financial accounting data to enforce taxation policies, assess tax liabilities based on company profits, and ensure compliance with financial regulations.

Assessment of Financial Position:

Recording transactions marks the initial stage in financial accounting. These recorded transactions empower stakeholders to evaluate the financial position of the company, encompassing aspects such as cash flow (representing the current cash holdings), receivables (indicating the amount owed to the company for goods sold), payables (representing the outstanding amounts the company owes), and borrowings (including the extent of borrowed funds and the associated interest payments).

Benefits for Stakeholders:

- **Internal Stakeholders:** Management and employees benefit from understanding the company's financial position to make informed decisions.
- **External Stakeholders:** Creditors, shareholders, and government entities rely on financial accounting to evaluate financial stability, assess risk, and make strategic decisions.

II. Cost or Management Accounting

Cost or management accounting is exclusively internal to the company and primarily used for decision-making purposes by the management.

Purpose:

- **Decision Making:** Management accounting provides crucial information, such as the cost of manufacturing one additional unit or a product or service, unavoidable costs, controllable costs etc., for decision-making. These decisions revolve around pricing decisions, make or buy decisions, cost control measures, product mix decisions and resource allocation.

Examples of Decisions:

1. **Pricing Decisions:** Determining the optimal selling price for products by considering manufacturing costs, overheads, and desired profit margins. For instance, in manufacturing automobile parts, management accounting aids in the calculation of the cost of manufacturing, setting selling prices, assessing profitability given a level of sales, and comparing performance with competitors.
2. **Make or Buy Decision:** Whether it is worthwhile to buy an input product or go in for backward integration and resort to manufacturing the raw material or input product.

3. **Cost Control Measures:** Analyzing and identifying areas where costs can be reduced or optimized to enhance profitability. For example, cost accounting information helps in prioritizing the production of different parts based on their profitability and demand, optimizing the product mix accordingly.

4. **Product Mix Optimization:** Evaluating the profitability of different products and prioritizing production based on demand and profitability. For example, I manufacture three different kinds of parts, part A, part B, and part C, but I do not have the plant capacity to manufacture all three parts given the kind of demand. I need to prioritize which part I should manufacture more and which part I should manufacture less. Cost accounting information assists in assessing the profitability of each product and understanding manufacturing costs, sales prices, and profit margins to inform internal decision-making processes.

5. **Resource Allocation:** Allocating resources such as labor, materials, and overheads efficiently to maximize profitability and operational efficiency. This involves forecasting cash flows, production volumes, and product demand to facilitate proactive planning and resource management.

Budgeting and Forecasting:

- Management accounting involves forecasting cash flows, production volumes, and product demand to facilitate proactive planning and resource management. For instance, organizations forecast cash flows for the next few months to plan their activities effectively.

Cost Allocation:

- Allocating common costs such as rent for shared facilities and salaries for shared personnel among different products or departments to accurately determine the full cost of each product. This involves dividing common costs like rent and salaries among products to determine the full cost of each product.

Confidentiality:

- Cost accounting information is considered confidential and internal to the organization to prevent competitors from exploiting cost structures and gaining a competitive advantage. For example, cost accounting information helps in maintaining confidentiality by not disclosing cost details to competitors.

Profit Analysis:

- Internal profit analysis involves evaluating the profitability of each product and understanding manufacturing costs, sales prices, and profit margins to inform internal decision-making processes. For instance, internal profit analysis helps in assessing the profitability of products and understanding their contribution to overall profitability.

Summary

Accounting encompasses two main verticals: financial accounting and cost accounting, each serving distinct purposes within an organization. Financial accounting caters to both internal and external stakeholders by recording transactions, which are then consolidated to assess the company's financial position. This information is utilized by stakeholders for various purposes, such as decision-making and financial analysis. On the contrary, cost accounting, also known as management accounting, is primarily focused on internal decision-making processes. It involves evaluating pricing strategies, cost control measures, product profitability, and budgeting for future operations. These two verticals constitute the foundation of accounting, and further details on each will be explored throughout the course.