CHAPTER IV

(1) ACCOUNTING

Accounting, broadly conceived as the measurement and communication of economic information relevant to decision makers, has undergone dramatic changes during the past decade. Recent advances in quantitative methods, the behavioral sciences, and information technology are influencing current thinking in financial as well as managerial accounting. Leasing, pension plans, the use of convertible securities and warrants in mergers and adquisitions, inflation, and corporate diversification are but a few of the challenging problems facing the accountant.

Despite the mass of techinical procedures and detailed financial reports, accounting is fundamentally concerned with managerial action in human organizations. It is therefore encouraging that the accountant's task is increasingly being viewed in terms of the contribution which he can make to the overall management of the enterprise rather than in terms of the more procedures by which he tries to achieve his own more limited financial objectives. People are now interested in the means by which the accountant contributes to the long-term direction of the enterprise.

An important aspect of the changing view of accounting is that increasing attention is - being given to its human and social dimensions. Both accountants and managers are now explicitly recognizing that it is impossible to deal adequately with accounting problems without also considering the motivations, values and behaviors of the human members of the enterprise. The accountant contributes to the success of an enterprise primarily by the way in which he influences the behavior of other people and, at least in theory, his procedures should be designed to stimulate managers and employees to behave in a manner which is likely to contribute to the effectiveness of the enterprise as a whole.

Accounting information is designed to serve - as the basis for many important decisions -- both within and outside the enterprise. It - is designed to assist in planning, coordinating and controlling complex and interrelated activities and to motivate people at all levels in the enterprise to make and implement those decisions which will further organizational purposes. Not surprisingly, the accounting procedures which are used to satisfy these and many other important organizational functions have become highly technical in nature. Economics is increasingly being used to provide a sound basis for selecting information which is relevant for decision making, - mathematical skills now contribute to our potential for rigorously analyzing complex financial problems, and advances in computer -

technology means that information is quickly available.

Accounting helps Management:

Most businesses that fail lack adequate records. Every businessman must keep books in order to know at all times his investment, inventory, sales, receipts, expenses, profits, losses, and net worth.

Business decisions must be based on facts. Managers of some firms watch their own progress so closely that they have financial reports - prepared every hour; these reports tell them whether their decisions are justified by the facts. A manufacturer must know his production costs in order to set his prices; a retailer must watch his sales and inventory closely or the two will be out of balance. Every business must constantly watch expenses. The only way an adequate check can be maintained is through keeping accounting records.

Financial Statements:

When people speak of financial statements, -- they usually refer to both the Balance Sheet and the Income Statement.

The Balance Sheet:

A balance sheet shows the financial condition of a business at a given date. It reports how much a business has, how much it owes, and what its net worth is. What it has is shown on the asset side; what it owes is shown on the liability side; and its net worth is the difference between assets and liabilities. The assets are the physical properties of the company, such as cash, buildings, equipment, and other property. The liabilities are the debts of the company, such as amounts owed to firms from which it has bought merchandise.

On both sides of the balance sheet there are subdivisions. These are helpful in interpreting the statement. Some of the more important classifications follow.

Current Assets include cash and other items that will ordinarily be converted into cash in the normal operations of a business. The merchandise inventory is a current asset because it is converted into cash when it is sold. Accounts receivable-the amount owed by customers are current assets because they will usually be paid in 30 or 60 days.

Prepaid Expenses are payments a company has made for supplies or services that it will ordinarily use in its business. For example, the wrapping paper and cardboard boxes a department store has on hand constitute prepaid expenses. The company may have purchased a six-month supply, which is a prepaid expense until it is used. When a firm pays its insurance or taxes in advance, the amounts are classified as prepaid expenses until they are expended and are listed with the company's assets. Each of these items is generally classified on the balance sheet as a current asset since they will be consumed in the next fiscal year.

Fixed Assets are the permanent properties used for business purposes. Land, buildings, and equipment are of this type and are classified as fixed assets.

Through use and the passage of time, there is a decrease in the value of fixed assets. This decline is referred to as depreciation. Depreciation will continue as long as the asset is in use. In the preparation of a balance sheet, the accumulated amount of depreciation on a fixed asset should be deducted from the original cost. This procedure gives the present value of the asset.

Current Liabilities are debts that must be - paid within a year. The suppliers of merchandise usually require payment in 30 to 60 days after making shipment. Amounts owed to them on open account are referred to as accounts - payable; amounts owed on signed notes are -- called notes payable.

Fixed Liabilities are the debts of a company that will be outstanding for a long period of time. A 20-year mortgage for the purchase of a building and bonds sold to finance a company are good illustrations of fixed liabilities.

The profit and loss statement

Not all important financial information is revealed by the balance sheet. It tells nothing about the income or expense of a business. The report that presents this information is - the profit and loss statement. (Sometimes it is called the income and expense statement, or the income statement.)

All profit and loss statements cover a period of time. The five important items that appear on almost every profit and loss statement are sales, cost of goods sold, gross profit, operating expenses, and net profit.

The sales are the major source of income for - most businesses. Because of their importance,

they are placed at the top of the statement. The cost of goods sold is subtracted from the sales in order to secure the gross profit. The gross profit is the margin of profit that a merchant receives on his sales.

After the gross profit (sometimes called gross margin) is determined, the operating expenses are deducted in order to find the net profit or net income. Usually the operating expenses will be itemized in some manner in order to give greater information on the operations of the company.

Depreciation, or the annual reduction in value of fixed assets, is one of the important items of operating expenses. The cost of fixed assets should never be included under opera-- ting expenses; only their depreciation should be listed.

The net profit on a profit and loss statement is found by subtracting operating expenses - from the gross margin. It will always appear near the bottom and is the most important figure on the entire report, because it is a - measure of the success or failure of the business.

Journals and Ledgers

Accounting must provide a complete record so that no important financial detail in the -- history of a business is omitted. In order -

to provide this information, the first record of a transaction is made in a journal-sometimes called a book of original entry. This Journal provides a permanent explanation of the day-to-day activities of the business. In a well-kept journal, one should be able to refer to any period of time, even a time long past, and find what financial transactions took place.

Usually, large businesses will have several kinds of journals in which to record various transactions. The important kinds are cash-receipts journal, cash-payments journal, sales journal, purchases journal, and general journal.

After the day-to-day entries have been made in the journals, the amounts are transferred to accounts in the ledger. This process is called posting. In this book are accounts for such classifications as cash, accounts receivable, sales, purchases, and dozens of other categories that appear on the financial statements. The ledger is a book of final entry, and it is a permanent record. By looking at the sales account in the ledger, for example, a merchant can tell how his sales have changed from day to day or from year to year. Whenever financial statements are prepared, the final amounts are taken from the ledger.

The three important ledgers that most businesses keep are general ledger, accounts-receivable ledger, and accounts-payable ledger.

The general ledger is a book that includes all the accounts of the business-assets, liabilities, incomes, and expenses. Additions and reductions are entered in these accounts.

The cash account in the general ledger, is a two-sided form:

C A S H

Received		Paid Out	
Jan 1	$ 150	Jan 10	$ 10
12	200	15	40

The amounts received are entered on the left and those paid out on the right. The difference between the two sides is the cash on hand.

Details of accounts receivable (amounts people owe us) and accounts payable (amounts owed to them) are usually kept in special ledgers that are separated from the general ledger. The accounts-receivable ledger contains a record of the amount each customer owes.

The accounts-payable ledger is a record of the amounts owed to others. Although smaller than the accounts-receivable ledger, it is usually large enough to require the work of several -- full-time clerks.

CHAPTER V

FINANCE

Theory of Financial Management

Finance is not unique from other aspects of - business operations in that it has a role, as do other management functions, in the optimization efforts of the firm. Goals are set, - decisions are made, and models are used to -- help reach optimal decisions in terms of attaining these goals. In the language of the behavioral theory of the firm, financial management involves goals, choices, and models. A positive statement of the goals of the firm in modern financial literature has been expressed in terms of either the maximization of - value (or wealth) or the maximization of expected utility. Consider the following three elements:

1. Alternative policies or decisions are related to alternative streams of earnings over some projected period.

2. An appropriate procedure for handling differences in timing of cash flows must be determined.

3. Investor attitudes toward risk must be determined, and ways of measuring risk and bringing it into the analysis must be developed.