Accounting, Finance & Capital Budgeting

(Relevant to AAT Examination Paper 2: Business Communication and Organization and Management)

Sebastian A. Bombaci, CPA

Accounting and finance play key roles in every organization. Without the proper financial controls an organization cannot run effectively and, in the worst case, an organization may fall into bankruptcy. The financial industry can be separated into three broad areas:

1. Accounting
2. Finance
3. Capital budgeting

1. Accounting

The main focus of accounting is to provide financial information about an entity's operations and financial status to its shareholders and stakeholders. This information is communicated through the external financial reports (the most common of which is the annual report) that show, in monetary terms, the assets and liabilities under the control of management.

Accounting is defined by the American Institute of Certified Public Accountants (AICPA) as "…the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof..." [1]

Accounting information has a number of characteristics which include reliability, objectivity, understandability, consistency and comparability. These characteristics allow users of financial statements to compare how an entity's business performance varies across different years as well as comparing its performance against similar entities in the same industry group.

Accounting is further sub-divided into a number of branches, with the three most notable being financial reporting, management accounting and auditing.

Financial reporting focuses on the preparation of financial statements for shareholders and stakeholders, and these statements are published in the public domain. Whilst the legal obligation for the preparation of financial statements is owed directly to the shareholders, business entities now acknowledge that there are many decision makers who rely on the external financial statements. These stakeholders include creditors, suppliers, bankers, employees, government agencies, and even customers.

The preparation of external financial reports is a highly regulated process and is governed by both local business laws and accounting standards. The last 20 years has seen a harmonization of local accounting standards with international financial reporting standards (IFRS).

The IFRS Foundation[2] is an independent, not-for-profit private sector organization working in the public interest. Its principal objectives are:

- To develop a single set of high quality, understandable, enforceable and globally accepted IFRSs through its standard-setting body, the International Accounting Standards Board (IASB);

---

[1] Singh Wahla, Ramnik. AICPA committee on Terminology. Accounting Terminology Bulletin No. 1 Review and Résumé.

[2] http://www.ifrs.org/The+organisation/IASCF+and+IASB.htm

- To promote the use and rigorous application of those standards;
- To take account of the financial reporting needs of emerging economies and small and medium-sized entities (SMEs); and
- To bring about convergence of national accounting standards and IFRSs to high quality solutions.

The financial statements record the financial activities of an entity. A business enterprise produces four basic financial statements:

1. The balance sheet, which is also referred to as statement of financial position or condition, and which provides details of a company's assets (what it owns), liabilities (what it owes), and owners' equity (what is owed to shareholders) at a given point in time.
2. The income statement, which is also referred to as the profit and loss statement (P&L), and which details the earned income, incurred expenses, and the profits generated over a period of time (usually one year). The P&L statement details the operation of the entity including sales and expenses incurred during the stated time period.
3. The statement of cash flows highlights how and when an entity receives cash and how it pays out cash. The cash flow statement details how cash flows occur for operating, investing and financing activities.
4. The statement of retained earnings provides information to shareholders on how the earnings generated by an entity in a given period are preserved on behalf of the shareholders.

In addition, the financial statements incorporate an extensive set of notes, management discussion and an analysis of the entity's performance. The notes to financial statements are considered an integral part of the financial statements.

Management accounting focuses on providing accounting and other information to help internal managers make business decisions and to manage the day-to-day operations of an entity. Unlike financial accounting, there are no legal requirements covering the preparation of management accounting reports and statements. These reports are for internal use within the entity and typically none of these reports are made available to either shareholders or stakeholders.

With this accounting information an entity's managers can make more informed business decisions, decide where to allocate an entity's scare resources, and enable them to develop better control functions.

In contrast to financial reporting, management accounting information is:

- Designed and intended solely for use by managers within the entity
- Developed and designed to meet the individual needs of managers
- Confidential information and not made available to the public
- Focused on managing the future performance of the entity, (forward-looking) compared with financial reports which are used to detail past performance (backward-looking)
- Not under any legal obligation to comply with local laws or accounting standards
- Used by the entity in its decision-making processes

Auditing is the third sub-branch of accounting. ISA 200 states "…The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all

material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with ISAs and relevant ethical requirements enables the auditor to form that opinion[3]…'

Simply put, audits are carried out to assess the reliability of information provided by an entity's management in the financial statements they have prepared for distribution to their shareholders and stakeholders. For a financial audit, a set of financial statements are said to be true and fair when they are free of material misstatements.

As it is impossible to test every financial transaction carried out by an entity, an auditor uses statistical sampling to reduce the number of audit tests required to provide reasonable assurance that the statements are free from material error. Auditors also test the strength of an entity's internal control systems to manage their business processes and financial transactions.

Audits were originally aimed at determining the effectiveness of an entity's financial systems. However today audits are also conducted on many non-financial business processes such as environmental performance[4] and adherence to ethical codes of conduct.

2. Finance

Finance focuses on managing the usage, procurement and disbursement of funds within an entity. This usually encompasses two main areas: the raising of money by issuing debt or equity, or the investment of an entity's monies by the purchasing of debt or equity. Put simply, finance deals with the saving and lending of money on the capital and debt markets.

The capital and debt markets include money, bond and share markets. For instance money market allows entities to manage their short-term financial requirements to ensure they have enough liquidity (cash) to meet their day-to-day financial obligations. Capital markets, such as the share and bond markets, enable entities to raise long-term capital which they can use for business expansion. There are many financial institutions which are involved in the finance industry, including commercial and investment banks, thrifts, insurance companies and credit unions.

As each type of financial investment has its own particular risks, finance also involves an understanding of risk and risk mitigation. Hence, finance has to deal with the impacts of both time and uncertainty on the possible future returns available from each investment.

3. Capital budgeting

Before an entity raises finance on the capital markets, it needs to determine how much capital (money) it needs to meet its tactical and strategic plans. This planning process is called capital budgeting. It enables the entity to estimate the long-term investments it needs to make in new assets such as new

---

[3] International Standard On Auditing 200, International Auditing and Assurance Standards Board

[4] ISO14,000

plant and equipment to ensure its future business operations and growth. To put it simply, the capital budget is the budget for major expenditures that the entity will undertake over the next two to five years.

To develop the cost estimates which are included in the capital budget, accountants and finance professionals use a variety of financial analysis techniques to help them decide which projects and major expenditures should be undertaken by the entity. These techniques take into account the time value of money and the expected cash outflows (expenses) and inflows (returns) from the project. Some of these techniques include the discounted cash flow method, the accounting rate of return method and the net present value method.