

Simplified

ACCOUNTING HANDBOOK

for

Small Business



ROVING ACADEMY

Gabay-negosyo sa pag-asenso

About the author

For many years now, among the author's personal advocacies has been to teach basic finance for non-accountants. This started by chance during the early stages of his professional career when he was first sent to a graduate school to attend a live-in advance executive management development program. Being the only CPA assigned to a sub-group within his class during the course, he was asked by his classmates who were then engineers, lawyers and marketing guys to help them understand basic finance.

Later, while working with a large multi-national company covering the Asian Region, he was also asked to conduct accounting courses for top non-finance executives working in a number of other Asian countries. Gradually, as this unique corporate involvement expanded to become one of his favourite pastime and personal advocacies, he was getting numerous requests from friends to conduct basic accounting and finance for Rotary Clubs, local Chambers of Commerce, and various NGOs.

Meanwhile, the author has also maintained his active membership with the Financial Executives Institute of the Philippines (FINEX) where he was Chairman of its SME Committee for a number of years. He was also an active member in other FINEX committees (Finance, Publication, National Affairs, Budget) while also writing business articles for various newspapers mostly covering SME-related topics.

On the side, he'd been one of DTI's Business Counsellors for SMEs. From time to time, he also conducts accounting seminars organized by DTI-BSMED for small business owners and would-be entrepreneurs who don't have basic knowledge in Accounting.

The author had also been associated mostly with multi-national corporations occupying various key Finance and top executive level positions both here and abroad.

He retired three years ago but has continued his personal advocacy works although on a limited scale now – to spend more time with his grandchildren and also to travel locally and overseas with his wife, to visit relatives and friends.

Preface

Just recently, I gave a seminar entitled *The Importance of Financial Statement* at the invitation of DTI-BSMED. While conducting this basic accounting course, it occurred to me that maybe I should have compiled all the seminar modules I've accumulated through the years and put them together as a handy basic accounting handbook for non-accountants.

After the seminar, I mentioned this idea to Mr. Jerry T. Clavesillas, Director of DTI-BSMED who graciously agreed to my suggestion.

With his invaluable support, I've finally completed this project that successfully led to the maiden publication of ***Simplified Accounting Handbook for Small Business***.

As initially discussed with Mr. Clavesillas, this handbook would be made available at all DTI's NCR and regional offices nationwide for distribution among others, to various small business owners or would-be entrepreneurs especially to those who have limited or no knowledge at all in accounting and finance.

We always hear this popular saying: laughter is the best (and free) medicine. By nature, we automatically laugh when we hear hilarious stories or see anything that looks amusing.

It's said that humour facilitates easy learning because laughter tends to give us a positive feeling effect. And when we're feeling positive, our brains become more motivated, energetic, creative, and productive.

Thus, to facilitate a 'stress-free' comprehension and learning, I thought of making this handbook not only concise but also easy to read – by showing funny analogies and caricatures in some sections that in my opinion might need supplementary illustration.

In teaching accounting to non-accountants, I've sensed that it's quite a challenge to conduct in just a few hours and for the attendees to quickly absorb – a course that has taken you 4 of 5 years to learn in college.

I've also noticed that some people have this preconception that Accounting is pure mathematics of some sort and therefore difficult to learn. In Chapter 2, I've enumerated many more accounting myths and unfounded biases that might help you change your thinking about this unfairly "feared" course.

Most of the caricatures used in this handbook were taken from royalty-free sources from Global Software Publishing and Wiz Technology, Inc. A number of comic strips were also taken from office.microsoft.com and other open sources available in the web. One particular relevant comic drawing was culled from a recent issue of the Philippine Daily Inquirer.

I'm truly grateful to DTI for giving me this rare opportunity to participate though small it may be – in its noble aspiration to help many small businesses and the would-be business owners in trying to spearhead their own business initiatives and ideas.

I wish further that SMEs will eventually succeed in their entrepreneurial endeavors which hopefully would redound to the socio-economic development of our society as a whole.

To the staff of DTI-BSMED, my special thanks to them for their excellent technical support and untiring efforts greatly needed in the making of this handbook.

Lastly, I'm truly appreciative and deeply thankful to Mr. Clavesillas for providing the resources of DTI and for his over-all guidance and enormous encouragement – without which the publication of this handbook could not have become a welcome reality.

Napoleon T. Cabello
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For my grandchildren, for reminding me that life is not a matter of
milestones but of moments.....

“Not everything that can be counted, counts and not everything that counts can be counted.” (William Bruce Cameron)

“It’s what you learn after you knew it all that counts.”
(John Wooden, American College Basketball coach)

“Never doubt that a small group of committed individuals can change the world. Indeed, it is the only thing that ever has.” (Margaret Mead, anthropologist)

“Small opportunities are often the beginning of a great enterprise.” (Demosthenes)

“To open a business is easy; to keep it open is very difficult.” (Chinese proverb)

“There will no progress if you keep on doing things exactly the same way all the time.” (Masaaki, author of Kaizen)

“If a man goes into business with only the idea of making money, the chances he won’t.” (Joyce Clyde Hall, founder, Hallmark Cards, Inc.)

The Golden Rules of Accounting (condensed)

- *The “going-concern” concept – when we keep the books, we assume that an enterprise will remain in business for a foreseeable future.*
- *Historical monetary terms – all transactions are expressed in monetary terms based on historical cost.*
- *Conservatism – it requires that losses be recognized as soon as they can be quantifiable, while gains must be recorded only when earned.*
- *Consistency – once an organization selects a particular accounting method, it must continue to use that method unless a change is made and then announced.*
- *Full disclosure – any change in accounting method that has a material impact must be fully disclosed together with the corresponding significant amount involved.*
- *Time period principle – it requires that an enterprise should prepare financial statements on a periodic basis.*
- *Entity rule – only business-related transactions which must be fully documented are to be recorded in the books of the company.*
- *Matching rule – revenues or sales must be matched to expenses or costs incurred to produce the products or services within the accounting cycle (usually one year).*
- *Most enterprises now if not all, are using a “Debit and Credit Journal Entry” system or otherwise called “Double-Entry” Bookkeeping.*
- *There are two ways in keeping the books of accounts of a company: (1) Cash basis; and (2) Accrual method.*

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1. Introduction

Before you proceed to the main sections of this handbook, let me trigger the following leading questions together with my own leading answers as your guiding compass in your short journey to this wonderful but challenging world of finance:

1. As a small business owner, how much Accounting knowledge you need to have?



My answer: While a thorough knowledge may not be absolutely necessary, it's important that the basics be understood. Financial awareness in the fundamentals of accounting is one of the very powerful tools that business owners or managers cannot afford to ignore.

2. That said, how much or how fast one could learn Accounting within a shortest time possible?

My answer: it depends on your personality and/or your business situation.

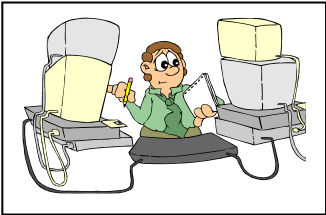
If you're naturally open to new things or ideas outside your comfort zone or enjoy reading for self-improvement, then your type of person may greatly improve your chances in learning accounting with less difficulty.



If you're already running a company or planning to manage one, a minimum hands-on or basic knowledge in accounting and finance is among the essential ingredients for success in business.

3. Alternatively, if I don't want to learn accounting hands-on, can I opt to hire my own Accounting staff but what if I cannot afford it?

Answer: You can easily hire a part-time accounting help or get an accountant on retainer basis. You can also buy reliable and affordable accounting software which is now readily available in the market; but you still need someone who has adequate accounting skill to operate the computerized system.



When you opt for any of these options, be sure you have a systematic filing system for your financial records and original supporting documents.

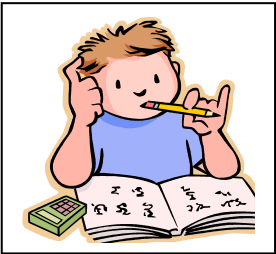


4. Is keeping financial records mandatory?

Answer: If your company's gross revenue does not exceed P50,000/quarter, you may keep a simplified set of books; however, if it exceeds P150,000/quarter, you must use BIR-prescribed journals and ledgers and your financial records must also be certified by an accredited Certified Public Accountant (CPA).



If they say that flower is the language of love, then conversely, we can claim that accounting is the language of business.



Business, large or small cannot live without numbers. Even our typical sari-sari store located in a small barangay has a little notebook or pad paper that keeps track of the owner's purchases and sales of his goods, a rough equivalent to a bookkeeper's journal or ledger.

Every commercial entity these days must have a system for recording revenues and expenses, and other financial transactions like asset acquisitions and borrowings. It's essential that at least a basic bookkeeping system is in place at the very start so that when the company grows, it would not be difficult to know how and where to start in trying to expand your basic financial recording system.

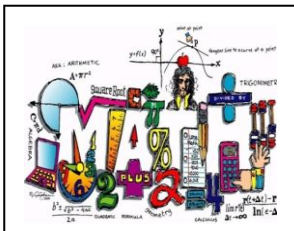


There is also a saying that there are only two things that are certain to happen in this life: one is death and the other, taxes! Just like sunrise or sunset, taxes are inevitable unless of course, it's already the end of the world.



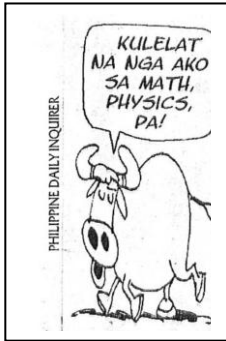
Generally unless specifically exempted by law, individuals and corporate entities alike must maintain the required books of accounts and pay the appropriate income tax and other internal revenue taxes.

If the above applies to you, then this is not an option. It's mandatory like the Ten Commandments in the bible!



Just like any profession, Accounting is not without misperceptions or unfair biases to contend with. For instance, I noticed that some people have this misguided idea that accounting is purely mathematics and therefore, difficult to learn.

You may also be surprised to know that some of us already do some automatic accounting routine right after waking up in the morning to go to work or when we go grocery shopping. It's already part of our second nature. You'll appreciate more what I mean when you read Chapter 2.



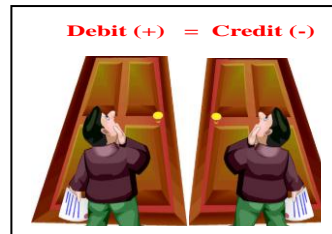
You might also find it consoling to hear that algebra or physics in high school are certainly much more difficult than accounting (had been there I tell you). Also, Accounting is not pure science. It's considered art as well, which is the relatively easier part to tackle with the use of pre-established recording and reporting system.

I hope you'll find some feeling of relief after reading Chapter 2 on the subject ***Misperceptions about Accounting (and Accountants)***.



In Chapter 3, history tells us that accounting may be considered man's oldest profession when our early ancestors had to account and tally all their limited resources from food to shelter in order to survive. This chapter also shows the difference between accounting and bookkeeping.

Chapter 4 gives you a quick glimpse of what I call ***The Golden Rules of Accounting***. Understanding these basic rules may lead you to appreciate more the surrounding concepts of debit and credit bookkeeping and accrual method of accounting.



The overriding concepts around the accrual method and double-entry bookkeeping are also further explained in Chapters 5 and 6.



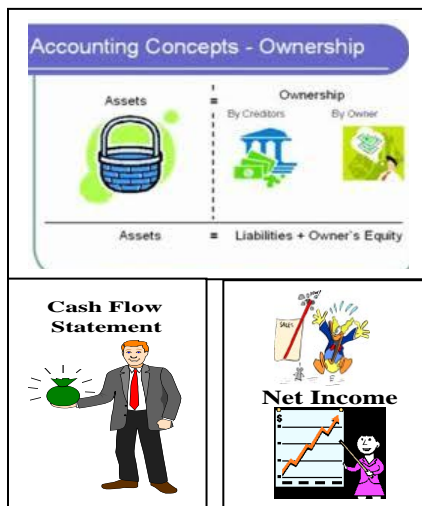
Interestingly, these 'Golden Rules' of Accounting have essentially remained unchanged for the last 500 years since Fr. Luca Pacioli, a Franciscan monk codified the first accounting profession as early as the Renaissance period in the 15th century!

The opening key to understand accounting is to appreciate how accounting transactions are recorded in the books of accounts as explained in Chapter 7. Every business regardless of size must keep track of all its financial transactions and activities for its own good.

This is extremely important for business owners and managers to do in order to determine the sound financial condition and profitability of the company. Not only that, management must also religiously keep records to compute all required taxes due to local and national government agencies.

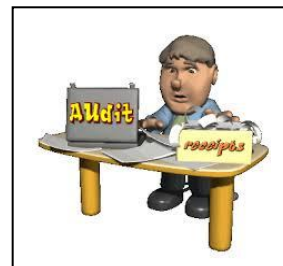


In this chapter, you might also find it particularly useful to read the sub-section on the *Accountant's Techniques in making Journal Entries*.



Each of the three basic financial statements (Balance Sheet, Income Statement, and Cash Flow Statement) is lengthily discussed and explained in Chapters 8, 9, 10 and 11. In these sections, you should be able to distinguish a balance sheet from an income statement and how the cash flow statement is calculated by simply comparing the account balances of two balance sheet periods (i.e. current year vs. prior year

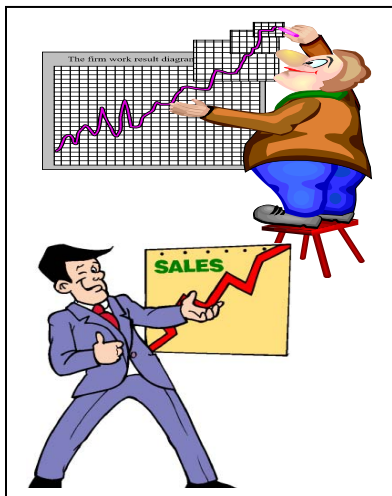
Chapter 12 basically answers the question why do we need to prepare financial statements. Foremost, this is a basic requirement especially if you're not specifically exempted from paying internal revenue taxes. Just like any type of sports, a company must also keep score of its business activities by preparing financial reports.



Unless you're already rich, most business owners need external financing that could either come from investors, lenders or suppliers. Understandably, these financiers would like to be reasonably assured of your financial capacity to pay off your debts by looking first at your financial reports.



Chapter 13 equally covers a very important subject: ***Financial Performance Analyses & Ratios***. Financial statements are not just prepared, submitted to whoever needs them, kept in office files, and forgotten. Simply reading the regular financial reports will tell you something but not that much.



So to really understand the financial condition of your company and to know whether or not it's efficiently run, you must perform various financial analysis showing ratios and percentage relationships of your financials.

Ratios which show effective performance indicators about a company are computed by comparing the ledger balances mostly from your financial statements covering at least two accounting periods.

Some chapters of this handbook contain ***Key Chapter Highlights*** at the bottom of the chapter concerned. This is to supplement your basic understanding and also to re-emphasize certain key concepts that you need to know to get by.

The last Chapter 14 consists of five ANNEXES as discussed in the following pages:

Annex “A” shows a condensed simulated flow of sample journal entries that goes into the Income Statement and Balance Sheet. Note that this is just a shortened version of a typical accounting cycle.

Given this limitation and still if you’re able to retrace the simulated recording and posting process, then congratulation! This means, so far you have already understood the basics of debits and credits and double-entry accounting.



Annex “B” through “D” show the pro-forma Income Statement, Balance Sheet, and Cash Flow Statement used in computing the financial ratios discussed in Chapter 13. Again if you are able to follow through the specific ratios and percentage calculations shown in this chapter, again I’m happy for you!

Annex “E” shows a sample of a typical Chart of Accounts taken from the World Bank’s website (www.smetoolkit.org) which I’ve modified somewhat to suit to our local conditions.

Some cautions though after you have read this handbook. It is not an all-inclusive Accounting book. Its main objectives are limited to the following:

- a) To provide the reader with the basic working knowledge and know-how regarding the fundamentals of bookkeeping, accounting, and finance;
- b) To be able to understand the basic important implications of and the critical needs for the financial statements of an enterprise;

- c) To appreciate the use of various analytical tools and financial ratios especially in managing a business from a practical point of view.

This means that to know a little a bit more than the basics, you still need at least an accounting-major graduate or preferably a CPA or tax consultant to ensure you're in full compliance with various business registration requirements, labor laws, BIR tax regulations, and the like.



Good examples of some these that were not extensively covered in this handbook are as follows:

- (i) Registration of appropriate ledgers and journals applicable to your business.
- (ii) Specific registration permits from SEC, barangay, DTI, BIR, DOLE, SSS, Philhealth, and other local and national government agencies.
- (iii) Computation and payment for VAT or sales tax, real estate tax, and other business taxes, where applicable.
- (iv) CPA accreditation requirements to have your financial statements audited and certified, where applicable.
- (v) Filing of income tax returns and audited financial statements with the BIR, SEC, etc.
- (vi) Other appropriate government agencies for tax and non-tax incentives like DTI's programs for SMEs and other agencies like TESDA, DOTC, DSWD, Cooperatives Development Authority, etc.

Lastly, after reading this handbook and you're able to understand the fundamentals of financial statements and relate their basic financial implications to your business situation, then I'm confident that you would be on your way to real "basic accounting literacy"!



2. Misperceptions about Accounting (and Accountants)

Just like any other profession, Accounting and the accountants are not without their own twists, misperceptions, or biases.

Accounting's Myths & Surprises

Let's start off with a question: What's the oldest profession?

You may be surprised to hear that what I'll tell you may not be the usual reply that most people expect.

You see, some historical findings have shown that Accounting instead should take the honor as man's "oldest profession". Why? Since prehistoric times, it was discovered that our early ancestors had already developed the instinct to count and tally forced by necessity to keep track almost anything from food to shelter, for sheer survival.



Archaeologists have shared similar findings when they unearthed numerous tax accounting records dating back from as early 2000 to 3300 BC. As new civilizations started to form governments, it was apparent that accounting gradually became a necessity in raising enough taxes to support the newly found bureaucracy (sounds familiar?).

Fast forward to the modern world and we may have inherited that instinct as already part of our second nature. Observe for instance our usual activities after waking up in the morning to go to work. What do we do? After you dress up, your other routine most likely would be to see if

you have enough cash for the day to pay for your bus fares, parking fees, meals, etc.

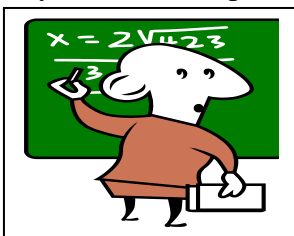
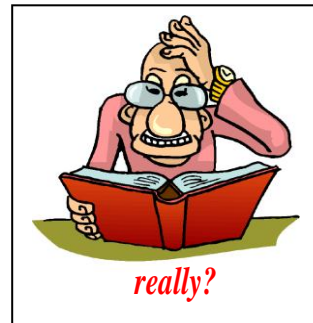
Unconsciously, you also do quick “balanced accounting” when you do grocery-shopping. Some would prepare first a list of items they needed to ensure they are within their buying limit. I was once behind a shopper who was quickly discarding some grocery stuffs at the checkout counter upon seeing the running totals shown in the cash register.

Notwithstanding, still I’m not sure why some people are not comfortable whenever we talk about Accounting. Worse, they find it confusing or even frustrating!

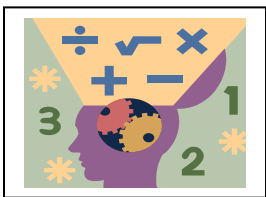


Why? My best guess is it can’t be arithmetic, because if you can manage to add, subtract, multiple, and divide – then dealing with the number should not be that annoying (remember most of us have cell phones that can also count!).

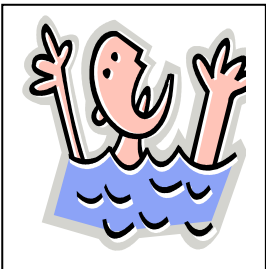
However, if it’s not arithmetic, then it could be because of some terminology used. For example, if you find strange terms like debit and credit or double-entry bookkeeping, depreciation, current ratio, or stockholders’ equity, mysterious – don’t you worry. They are just words with straightforward meanings, once they have been explained.



In reality, mathematics in Accounting is not that difficult contrary to what most people think. I still remember how I desperately struggled with my poor grades in Algebra during my care-free high school days! But when I was “forced” to take up

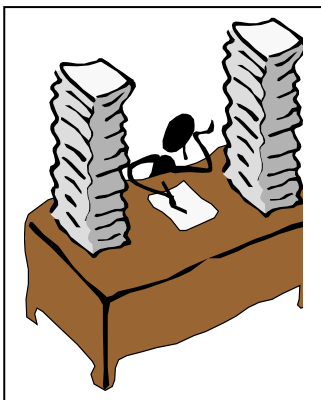
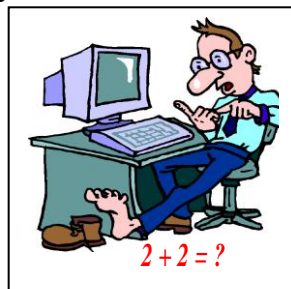


Accounting in college (so I could easily find work while studying), I was greatly relieved to discover for myself that Finance formulas were much simpler than my high school physics after all.



Another consolation is this: you don't have to remember many mathematical rules (like how to add/subtract positive or negative whole numbers or worse, fractions) to study Accounting. A simple "T-account" ledger system already in place can very well handle that as you'll see later in this handbook.

Also, there are no more than three simple mathematical equations to learn by heart to understand basic Accounting. Again, you'll realize what I mean here after reading Chapter 5 that touches on double-entry bookkeeping.



Moreover, Accounting is also not all "science". Technically speaking, Accounting is also considered an *art* in the way business transactions are recorded and finally presented in a standardized financial statement format. This "art of recording" part has been made easy to accomplish using simple bookkeeping system that includes journals, ledgers, and chart of accounts as explained in Chapter 7.

There is another possible reason why people generally shy away from reading Accounting books in the manner these books are being sold in most bookstores.

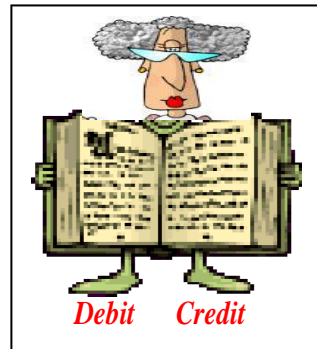
One time I was browsing for some condensed handbooks or primers about basic accounting so I could mention these as possible good reference materials during my seminars for non-accountants. I was

dismayed to discover I could not find any although I found one in one branch outlet but it was 2-inch thick and very pricey!

I've also observed that accounting books are usually displayed side-by-side with already intimidating thick books on Mathematics. No wonder, not too many would attempt to touch these poor Accounting books with a 10-foot pole!

Another hindrance is the way some people use certain accounting terms like “debit” and “credit” in their day-to-day interactions. As what is often heard from bankers for instance, most non-accountants think of debits as subtractions from their bank accounts and credits as additions to their bank deposits.

Debits and credits are totally different animals in the world of finance. Keeping the books of a company requires a unique system called double-entry bookkeeping which in itself already sounds ‘mysterious’ if not properly explained. Double-entry system is where you have to make at least two journal entries – a debit and a credit for every transaction.



Anyway, it would not be the end of the world if you cannot fully grasp how debits and credits technically work in accounting – just as you don't have to fully understand how unbelievably fast your PC is able to compute complicated and tedious mathematical functions in a matter of seconds!

You'll appreciate further this seeming ‘dilemma’ after you're finished reading Chapter 5.

Some Twists & Misperceptions about Accountants

After knowing some myths about the Accounting profession, now let's look at the poor and misunderstood accountants and hear some jokes about them (remember how laughter can do wonders!). Here goes:

- *“Accountant is someone who solves the problem you did not know you had in a way you don’t understand.”*
- *“There are three types of accountant: those who can count and those who can’t.”*
- *“Accountant is someone who knows the cost of everything and the value of nothing. Does this make him worth nothing?”*
- An accountant was overheard boasting to his colleagues: *“We’re in good hands. Nobody understands our financial statements.”*

But don’t get me wrong. I still like my fellow accountants for the following “amusing” reasons:

- *They are a very optimistic breed when they say that “for every exit there must be some entry somewhere” (that’s debit and credit bookkeeping).*
- *They are ‘nosy’ because they always like “to see the other side of the coin” (that’s double-entry accounting).*
- *They are always very exacting in following this basic bookkeeping principle: “For every item of value received there’s always a corresponding item of equivalent value that must be given away” (This sounds like the 3rd law of motion: “for every action there’s equal and opposite reaction”?).*
- *Accountants don’t make mistakes. They just call them “adjustments” (they are allowed to use an “adjusting journal entry” system to hide their blunders?).*
- *Accountants would like everything balanced. (This is like the stabilizing principle of nature we call equilibrium or harmony.)*



- *Accountants cannot afford to sleep on the job otherwise they would not be able to have every debit and credit transaction balanced against each other. (I have the suspicion this was the real intent of the father of accounting when he instituted the double-entry bookkeeping!).*



- *Accountants take half-day off when they leave at 5pm.*
- *They still believe that money is not what really counts though it must be counted to the last centavo.*

As you can see this time, accountants are not really boring professionals. They are just seriously passionate in everything they do during their waking moments.

3. What is Accounting?

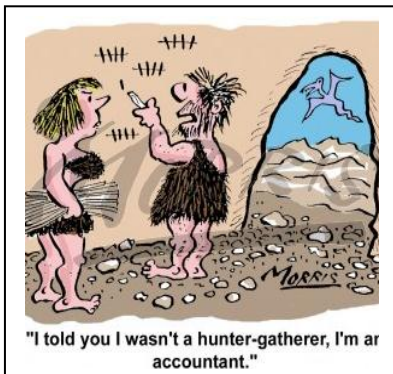
They say that to understand and appreciate more about the peculiarity of one's culture or tradition is to retrace its early roots. We can say the same thing for Accounting as a profession.



Let's therefore go back a bit to history and see how a simple way of monitoring critical survival items badly needed by early cave dwellers – had evolve into what is now called accounting or bookkeeping.

Brief History of Accounting

Some early historians claimed that Accounting should be called man's "oldest profession". This is because since prehistoric times, our early ancestors had already developed the instinct to count and tally forced by necessity to keep track almost anything for sheer survival.

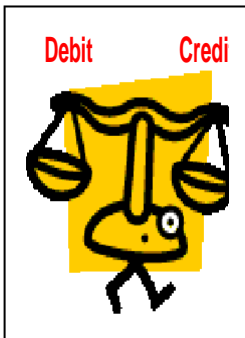
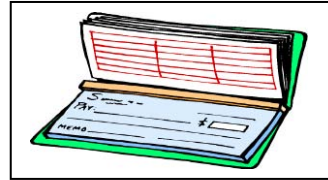


For instance, families had to account for food and clothing to face the harsh winter, even using a cumbersome numbering system. Later, as we coped with hard struggle beyond mere survival – and also simplified the numbering using Arabic numerals – we began to trade and able to establish the concept of value and eventually developed a monetary system.

As settlers progressed from mere subsistence to surplus status, the idea of exchange of goods and services evolved that later on, expanded into a new concept of transferring business ownership. These newly discovered business sophistications thus created the need for accurate and fair basis of valuation that both an interested buyer and seller could use.

There were also interesting discoveries by archaeologists when they unearthed numerous records of all things – various tax accounting activities! From as early 2000 to 3300 BC, as new civilizations started to form governments, accounting became a necessity to be able to raise taxes (sounds familiar).

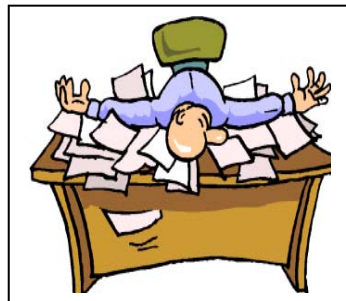
Prior to the 15th century, only one type of simplified, single entry bookkeeping was used (think of simple running balance entries in your check book for amounts deposited or check payments made).



From a simple single entry record keeping, Accounting had finally become a sophisticated profession during the Italian Renaissance era. In 1494, an Italian Franciscan Friar Luca Pacioli formally codified a double entry bookkeeping in his book “The Collected Knowledge of Arithmetic, Geometry, Proportion and Proportionality”. (In Chapter 5, we will discuss more about double entry accounting).

Differentiating Accounting from Bookkeeping

In its simplest definition, bookkeeping is the systematic recording of business transactions in financial and monetary terms. In contrast, accounting is the process of analyzing, classifying, summarizing and interpreting business and financial transactions.



Thus, bookkeeping is just a part confined to the recording aspect of accounting. The term accounting is much broader that goes further into the realm of designing the bookkeeping

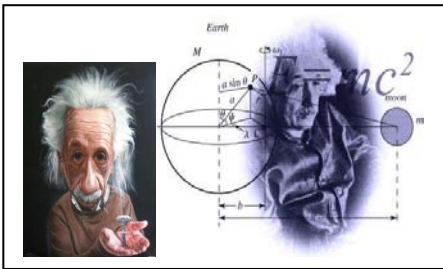


system, setting up controls, and analysing and verifying the recorded information. Usually, a bookkeeper reports to an accountant.

Accounting: an Art or Science?

It is both. Let me explain.

Accounting is considered an art in the way transactions are recorded, classified, summarized, and presented in standard financial statement formats.



On the other hand, accounting is also a science that requires analyses and interpretation using certain mathematical rules and unbending accounting equations. I'll explain this further in the later sections of this handbook.

Despite the great stride of globalization and information technology, Accounting has not significantly changed during the last 500 years. Its principles and concepts are essentially the same now as they have always been since the 14th century!

Key Chapter Highlights

- Just like culture, we should be able to understand or appreciate accounting if we retrace its historical origin. Historians have discovered that our early ancestors knew already how to count and tally in monitoring their limited supply of food and clothing in preparation for the coming harsh winter season.
- With accounting being considered part of our second nature, it stands to reason that it should not be difficult to learn this noble

and necessary profession to be able to survive the rigors of our modern day living.

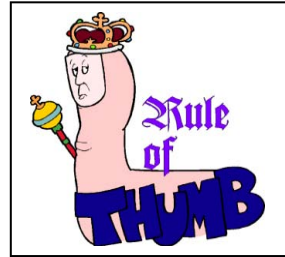
- The commercial use of double-entry bookkeeping did not come about until a Franciscan monk Luca Pacioli codified it in 1494, some 40 years after the printing press was invented.
- The main task of a bookkeeper is to journalize and record or post accounting entries to the books of accounts. Essentially, a bookkeeper is mainly responsible for the recording aspect.

On the other hand, an accountant has broader scope of responsibilities ranging from designing accounting and control systems to analysing and verifying recorded accounting entries.

- Accounting is both an art and science. The former is confined to recording and reporting aspects while the latter is focused on the analysis and interpretation of the numbers through the use of a few mathematical formulas and simple accounting equations.

4. The Golden Rules of Accounting

For being both an art and a science profession, Accounting has certain rules or principles to follow under the Generally Accepted Accounting Principles (GAAP) mandate.



External auditors appointed to certify to the correctness of the financial statements must disclose any non-compliance plus the significant financial impact of such non-compliance, if any. A summary of these rules are shown below.

- a) The “going-concern” concept – when we keep the books, we assume that an enterprise will remain in business for a foreseeable future (a dead horse is of no use in a racetrack).

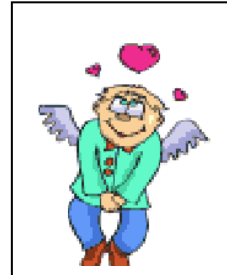


- b) Historical monetary terms – all transactions are expressed in monetary terms based on historical cost or fixed or determined actual value at the time the transaction has transpired.



Thus, assets already acquired cannot be subsequently re-valued using current market value. (This is why employees cannot be included as among the assets of the company because they don't have fixed and determinable monetary value. But they could still be considered “priceless”?).

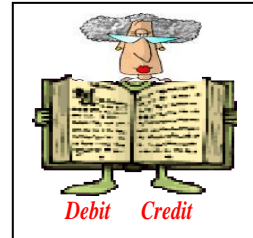
- c) Conservatism – it requires that losses be recognized as soon as they can be quantifiable, while gains must be recorded only when earned.



- d) Consistency – an enterprise has certain choices which of the Accounting methods or assumptions it prefers. But once an organization selects a particular method, it must continue to use that method unless a change is announced.
- e) Full disclosure – if the Accounting method or practice is changed and such change has a material impact, it must be disclosed along with the corresponding financial impact.
- f) Materiality – material events are those that would affect the judgment of an informed investor or any interested party or stakeholder. Material or significant transactions must be appropriately disclosed in the financial reports.
- g) Time period principle – it requires that an enterprise should prepare financial statements on a periodic basis. Thus, accounting cycle is followed once during each cycle which normally covers 12 months for tax purposes. For internal reporting purposes, the cycle could be monthly or quarterly or semi-annually depending on the preference of management. For publicly listed companies, the reporting period is every quarter.
- h) Entity rule – record only those transactions that strictly pertain to the business which must be duly documented. Items that are purely personal in nature must not be included or co-mingled with business transactions.
- i) Matching rule – revenues or sales must be matched to expenses incurred to produce the products or services within the 12-month

cycle of the company. Thus, expenses incurred to cover revenue generation activities beyond one year should not be recognized as such for the current year.

- j) Most enterprises if not all, are now using a “Debit and Credit Journal Entry” system or what is commonly called as “Double-Entry” Bookkeeping. This will be further explained in Chapter 5.



- k) There are two ways in keeping the books of accounts: (i) Cash basis; and (ii) Accrual method. This will be lengthily discussed in Chapter 6.
- l) Accounting has three basic financial outputs: (i) Income Statement; (ii) Balance Sheet; and (iii) Cash Flow Statement. These basic financial reports will be discussed more thoroughly in Chapters 8, 9, 10, and 11.
- m) Accounting has five main elements or values: (i) assets, (ii) liabilities, (iii) capital, (iv) revenues (sales), and (v) expenses. The first three are normally shown under Balance Sheet and the last two recorded under Income Statement.

Key Chapter Insights

- For being both an art and a science profession, Accounting has certain rules or principles to follow under the Generally Accepted Accounting Principles (GAAP) mandate.
- Your external auditor or accountant will play a vital role in seeing to it that the foregoing accounting principles where applicable, are strictly followed in the course of the preparation of your financial statements.

- The double-entry bookkeeping and other accounting principles enumerated above are necessary to produce accurate and reliable financial reports for the use of business owners, managers, and outside stakeholders (investors, lenders, government).
- Personal-related transactions must not be mixed with the official business activities of a company. All business transactions must be duly supported with original documents.

5 Double Entry Bookkeeping



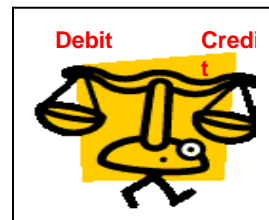
Prior to the 15th century, only one type of recording was used called Single-Entry bookkeeping (the format used was like entries in your check book). However in 1494, a Franciscan friar Luca Pacioli codified a Double-Entry Accounting concept in his book “Everything About Arithmetic, Geometry and Proportion”. The key concepts of this system are highlighted below.

- a) Every accounting transaction requires 2 portals of entry called a Debit (Dr.) and a Credit (Cr.).

(The word debit comes from the Latin verb *debere*, meaning ‘to owe’. Credit on the other hand, comes from the Latin verb *credere*, meaning ‘to trust’ or ‘to believe’. This is most likely the reason why a Debit is abbreviated as Dr. and a Credit, as Cr.)

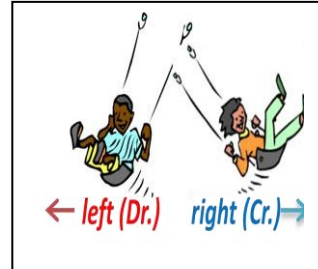


- b) A Debit is always a positive number (+) with the corresponding Credit a negative number (-).



- c) The sums of all Debit entries and the sums of all Credit entries must equal in value. This formula serves as an error detection tool to maintain mathematical accuracy.

- d) Double entry accounting is based the principle that every financial transaction has equal and opposite effects in at least two different accounts. This is to satisfy the following equation: **Asset = Liabilities + Capital + Income – Expenses**



(It's interesting to note that the above principle is somewhat identical to Newton's 3rd Law of Motion that "For every action, there is equal and opposite reaction; also, the rule of balanced equation in Accounting is akin to the stabilizing principle of Nature called equilibrium or harmony).

- e) It also treats each transactions as pairs of journal entries with broad characteristics as follows:

Pairing that is related to each other

For instance when you sell your product on credit, almost always the automatic pairing would be: (i) Accounts Receivable as debit entry and Sales Income as a credit entry; and (ii) when you borrow from a bank, the automatic pairing would be Cash as debit and Loans Payable as credit.



Pairing of a situation and its consequence

When a customer lost his business, a bad debt situation will not go away unless you do something. You may be faced with two options: sue the customer and debit Legal Claims Receivable or simply write the account off and debit Bad Debt Expense; in both instances, you credit Accounts Receivable to reduce your asset.



- f) Below are general rules in journalizing Debit and Credit transactions resulting in upward and downward effects in the financial statements:



Debit Journal Entries

- When you bought an asset like a car (Debit Fixed Asset).
- When you pay salary to your employees (Debit Salary Expense)

Credit Journal Entries

- When you gave up your cash to buy a car (Credit Cash and Debit Fixed Asset).
- When you received something but you have to pay it back later like a bank loan (Credit Loans Payable).
- When you sold your company products that contributes revenue to the company (Credit Sales Revenue)
- When a stockholder pays his capital contribution to the company (Credit Capital Stock).

- g) When recording a transaction, the debit entry is always posted to the left side of a “T-account” ledger, and the credit entry to the ledger’s right side as shown in Table 1.

Key Chapter Highlights

- Table 2 shows the graphic comparison between a Debit and a Credit in a tabular format for easy reading.
- The debit/credit intrinsic characteristics of the five major accounts are shown in Table 3.

- Tables 4 and 5 show a simulation of typical journal entries showing how they are posted to the General Ledger and finally summarized into balance sheet and income statement formats.
- To most non-accountants it would appear that an accounting transaction is recorded twice under the double-entry bookkeeping rule. On the contrary, there's only one business activity being recognized but recorded under two opposing perspectives.

It's like the two sides of a coin or a person and his shadow or with one's reflection in the mirror – there's only one coin or one person.



A good example is when you sell your trade products: you recognize an income (credit or negative number) in the Income Statement but at the same time you record an Accounts Receivable asset (debit or positive number) in your Balance Sheet for the same amount.

- Another hindrance also is when some people thought they already knew “debits” and “credits”. As what they often hear from their bankers for example, most non-accountants think of debits as subtractions from their bank accounts and credits as additions to their bank deposits.

(Actually what your bank is telling you is correct from its point of view as the lender; in your case, you're in the opposite end as the borrower).

Debits and credits are totally different animals in the world of finance. Keeping the books of a company requires a unique system called double-entry bookkeeping which in itself already sounds ‘mysterious’ if not properly explained.

Anyway, it would not be the end of the world if you cannot fully grasp at this time how debits and credits technically work in accounting – just as you don't have to fully understand how your PC is able to compute complicated and tedious mathematical functions or how your engine actually works when you drive your car to work.

Table 1

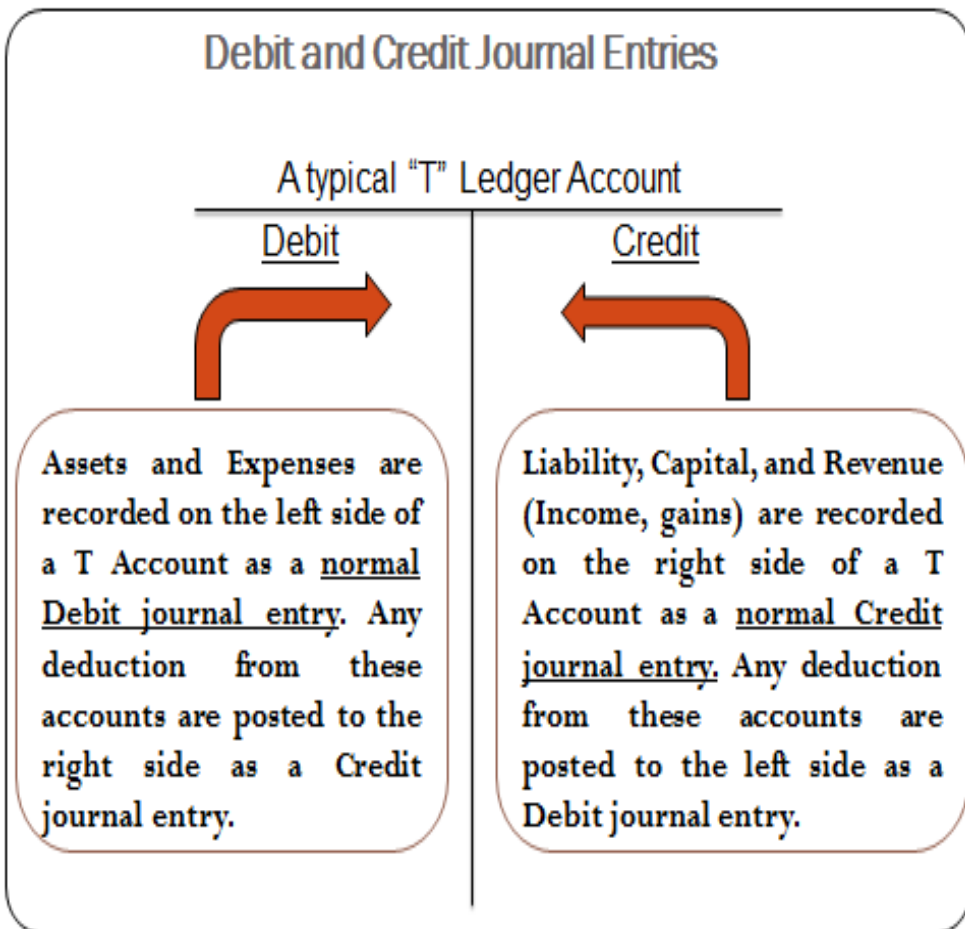


Table 2

Comparison between a Debit and a Credit	
A Debit is:	A Credit is:
<ul style="list-style-type: none"> • When you received something of value (you debit an asset account) . • When you incurred an expense like your employees' services (you debit "Salary Expense" and credit "Cash"). • Always a positive number and posted to the left side of a T-Account Ledger. • Total Debit accounts must always equal to total Credit accounts. 	<ul style="list-style-type: none"> • When you gave up something of value like your hard-earned money (you credit an asset account "Cash"). • When you sold your products (you credit "Sales Income"). • When a stockholder put in his capital (credit "Capital Stock"). • When your bank lent you money (credit "Loans Payable"). • Always a negative number and posted to the right side of a T-Account Ledger. • Total Credits must also equal to total Debits.

Table 3

The Five Major Account Categories below are shown with their respective "Debit" and "Credit" intrinsic characteristics:

	Debit (Left Side)	Credit (Right Side)
1. Asset (+)	Increase	Decrease
2. Liability (-)	Decrease	Increase
3. Capital (-)	Decrease	Increase
4. Revenue (-)	Decrease	Increase
5. Expense (+)	Increase	Decrease

Table 4

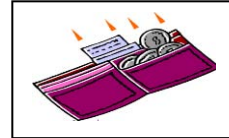
Sample Journal Entries:			
		<u>Debit</u>	<u>Credit</u>
(a) A stockholder puts in P3,000 as initial capital			
	Dr. Cash	3,000	
	Cr. Capital Stock		3,000
(b) Bought Raw Mat'ls 3/4 of which is in warehouse			
	Dr. Inventories	3,000	
	Dr. Cost of Goods Sold	1,000	
	Cr. Cash		4,000
(c) Sold on credit P3,000			
	Dr. Acct. Recible	3,000	
	Cr. Sales Income		3,000
(d) Sold in cash P1,000			
	Dr. Cash	1,000	
	Cr. Sales Income		1,000
(e) Borrowed from a bank P2,000			
	Dr. Cash	2,000	
	Cr. Loans Payable		2,000
(f) Paid salary to staffs P1,000			
	Dr. Salary Expense	1,000	
	Cr. Cash		1,000

Table 5

T-Account Ledgers							
Cash		Acct. Rec'ble		Inventories		Capital Stock	
Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
(a) 3,000	(b) 4,000	(c) 3,000		(b) 3,000			(a) 3,000
(d) 1,000	(f) 1,000						
(e) 2,000							
Tot 6,000	Tot 5,000						
Bal 1,000		Bal 3,000		Bal 3,000			Bal 3,000
Loans Payable		Sales Income		COGS		Salary Expense	
Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
	(e) 2,000		(c) 3,000	(b) 1,000		(f) 1,000	
			(d) 1,000				
	Bal 2,000		Bal 4,000	Bal 1,000		Bal 1,000	
Balance Sheet				Income Statement			
Assets				Sales Income	4,000		
Cash	1,000			Cost of Goods Sold	<u>1,000</u>		
Accts. Rec'ble	3,000			Gross Profit	3,000		
Inventories	<u>3,000</u>						
Total Assets	<u>7,000</u>			Salary Expense	<u>1,000</u>		
Loans Payable	2,000			Net Income	<u>2,000</u>		
Capital Stock	3,000						
Retained Earnings	<u>2,000</u>						
Total Liab. & Equity	<u>7,000</u>						

6. Cash Basis vs. Accrual Accounting Methods

Individuals (like you and me) and small businesses are normally on a cash basis of accounting. For instance, we recognize an income only upon receipt of cash (like when you got your pay check). Similarly, we record an expense when you pay it by cash, credit card, or checks.



A good example of cash basis system is when you record all your cash receipts and disbursements in your check book. For instance you:

- (a) Record a receipt of cash after your bank has validated your deposit.
- (b) Deduct an amount from your running balance after issuing your check to somebody.



In contrast, corporations mostly prefer the accrual system. Under this method:

- (a) Revenues are recognized when the products are delivered and received by your customers even if they have not yet paid the shipment.

In this case, you debit Accounts Receivable and credit Sales Revenue covering the products sold on credit.

- (b) Assets (like inventories) or expenses (like office supplies) are already booked as such after receiving the items even if you have not yet paid your suppliers.

In this case, you debit Inventories account in the balance sheet or an expense account in your income statement and credit a liability

account (Accrued Expenses Payable) to record your company's obligation to pay your supplier later under agreed payment terms.

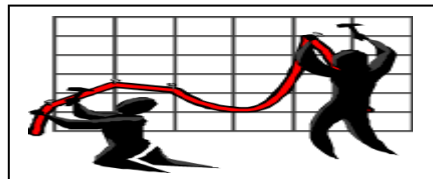
In either method, the BIR normally allows this provided you do it on a consistent basis. But should you really need to change this method, you have to mention this change in the financial statements together with the financial impact of such change.

The advantages of an accrual system are summarized below.

- (a) It automatically triggers critical warning signals in your balance sheet. Examples: high build-up in your accounts receivable for non-collection or high inventory levels due to over-stocking. This is shown below.

Part of Balance Sheet:			
	<u>2012</u>	<u>2011</u>	<u>2010</u>
Cash	200	150	100
Accts. Rec.	2,500	1,000	500
Inventories	3,000	1,500	1,000

- (b) The financial trends in your operations don't show wide swings or peaks-and-valley picture of your financial performance because as stated earlier, you consistently record your revenue for instance every time there's shipment even if not yet paid by your customer.



- (c) Your lenders and investors would be happy seeing more accurate and reliable information in your financial reports.



7. The Books of Accounts

Every business, no matter how small, must have a record keeping system for its assets, liabilities, revenues, expenses, and many other types of financial transactions.

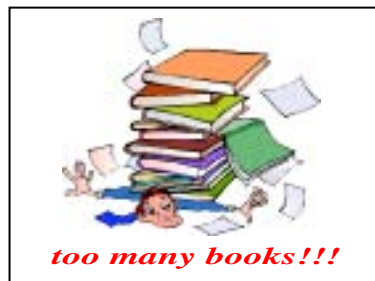
It is imperative to have this in place from the very start not only because you need to have a complete and reliable financial data about your company, but also to comply with reportorial and tax requirements imposed by local government units and national government agencies.



Journals & Ledgers

The following are the books of accounts required by the Bureau of Internal Revenue (BIR):

- Journal
- General Ledger
- Cash Receipts Book
- Cash Disbursements Book



Some business establishments also maintain the following additional books and subsidiary ledgers:

- Sales Book
- Purchases Book
- Subsidiary ledgers for Accounts Receivable and Payable

The BIR allows three types of Books of Accounts as follows:

1. Manual Books of Accounts – you may use the pre-formatted columnar journal and ledger books available at any bookstore.
2. Computerized Books of Accounts – normally this refers to accounting software being sold commercially which should need BIR's approval prior to its use.
3. Loose-leaf Books of Accounts – these are loose-leaf sheets of computer-printed books of accounts, which mean, these are simply computer print-outs instead of being hand-written.

As a general rule, the above books of accounts must be presented to the BIR for stamping and registration purposes prior to their use.

Chart of Accounts

The Chart of Accounts is the roadmap that an enterprise creates to organize its financial transactions. It is simply a listing of account names with their respective account codes assigned to keep track of major business transactions of an enterprise.

Usually, this account listing is sub-divided into two main sections: one set of accounts is specifically grouped under Balance Sheet, and the other under Income Statement.

For instance, account names such as Sales Revenue (income), Direct Materials Expense, Direct Labor, Depreciation, Salary Expense, Office Supplies Expense, etc. are typical accounts applicable to Income Statement.

On the other hand, examples of accounts for balance sheet are: Cash, Accounts Receivable, Inventories, Land, Vehicles, Accounts Payable, Loans Payable, etc.

Each business creates its own Chart of Accounts based on the nature of its operation, so you'll unlikely find two companies with exact listing of accounts. However, it's not uncommon to see similar or exact names of certain accounts that share similar major characteristics such as what I cited above.

A Chart of Accounts is a must in order to have a uniform and more accurate classification of journal entries. Any newly hired bookkeeper or accountant usually asks for this before he could accurately journalize his first accounting journal entry.

The books of the accounts of any business cannot be complete without a Chart of Accounts.

A sample of a Chart of Accounts is shown in ANNEX E.

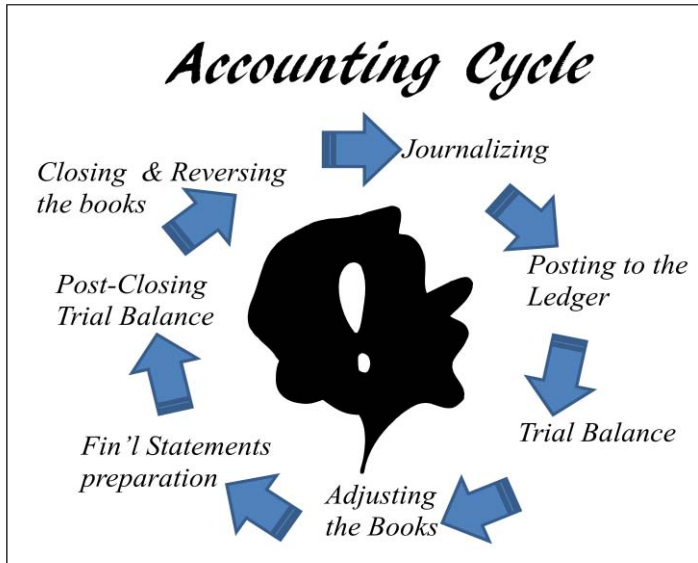
Accounting Cycle

Accounting cycle is a step-by-step process of recording, classification and summarization of economic transactions of a business. It generates useful financial information in the forms of Income Statement, Balance Sheet, and Cash Flow Statement.

The time-period principle of Accounting requires that a business should prepare its financial statements on periodic basis – at least yearly, for tax purposes, and quarterly (and also yearly) for publicly listed companies. For internal purposes however, financial reports may be prepared monthly or quarterly depending upon the reporting practice of a company.

Typical main functions of a bookkeeper include the tasks of accomplishing the whole accounting cycle. It's called a cycle because the accounting workflow is circular: entering transactions, manipulating the transactions through the accounting cycle, closing the books at the end of the accounting period, and then starting the entire cycle again for the next accounting period.

Shown below are the seven major steps involved in the accounting cycle described above.



To have some fairly basic knowledge in Accounting, you don't have to understand each of these steps. However, in this chapter I'll focus on the first step which is journalizing or the making of journal entries in preparation for the next level which is the posting to the appropriate ledgers.

Journalizing Techniques for the first step

You may wonder how an accountant or bookkeeper can quickly prepare so many multiple debit and credit journal entries involving numerous accounting transactions in such a short time. What's their secret?

For one, they would already have memorized almost all account names listed respectively under balance sheet and also income statement categories. This listing is called Chart of Accounts as mentioned above.

They must also have understood by heart most if not all the accounting principles already enumerated in the early chapters of this handbook.

In summary, let me enumerate below some of these principles in double-entry bookkeeping that guide accountants in making journal entries faster than any ordinary human being.

- a) All Debits (Dr.) are positive (+) numbers to record asset and expense entries only. Any decrease is recorded as a Credit.
- b) All Credits (Cr.) are negative (-) numbers to record liability, capital, and revenue entries only. Any decrease is recorded as a Debit.
- c) Each accounting transaction either goes to any of the two financial statements only (balance sheet or income statement) or both. The Cash Flow Statement is not part of this process flow.
- d) An asset which is mostly tangible (exception: Goodwill), is an item of value that can be used for more than a year. It will only be shown in the balance sheet.
- e) An expense is an item of relatively lesser value than an asset (like office supplies) which can only be used within a year. An expense may also have an intangible characteristic like legal fees or bank charges. Also, an expense may not necessarily involve cash like depreciation or amortization.

Expenses are shown in the income statement only and deducted from revenue or income to arrive at net income. This could also result in net loss if expenses exceed revenues.

- f) An item that has a characteristic of an expense but covers more than one year (like advance office rent say for three years) is shown as Deferred Charges in the balance sheet; conversely, any income that covers beyond one year is shown only in the liability section of the balance sheet as Deferred Credits.

- g) There are almost always automatic pairing of certain journal entries, examples of which are as follows:

	Debit	Credit
▪ Sales of products on credit...	Accts. Rec'ble	Sales
▪ Sales on cash basis.....	Cash	Sales
▪ Loan received from a bank...	Cash	Loans Payable
▪ Capital contribution.....	Cash	Cap. Stock
▪ Accrual of salary expense....	Salary Exp.	Accr. Exp. Pay.

To lighten you up, let me pose the following trivia to tickle your mind:

- *How do you differentiate a current asset from a fixed asset?*

Answer: a fixed asset is when it outlasts the final instalment payment.

- *How do you distinguish Accounts Receivable from Bad Debt Expense?*

Answer: the former is an asset account in your Balance Sheet when you sell your product to your regular customer;

The latter is an asset turned upside down and transferred to your Income Statement as 'loss forever' after lending your hard-earned money to your relatives.

Key Chapter Insights

- Businesses regardless of size that are required by law to pay taxes must maintain certain books of accounts consisting of journals and ledgers which must be duly registered with the BIR prior to their use.

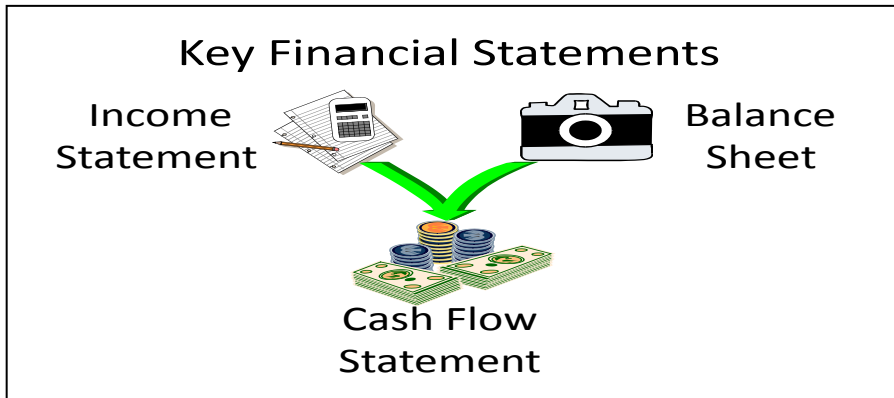


- An Accounting system even how simple cannot be complete without a Chart of Accounts. A bookkeeper or accountant uses this as an important reference before he can make accurate journal entries. Please refer to Chapter 14 marked Annex “E” for a good example of a typical Chart of Accounts.



- An Accounting Cycle is a complete step-by-step process starting from journalizing and recording of all business transactions up to the time these are posted to the subsidiary and general ledgers. The financial statements are then prepared based on the balances shown in these ledgers. To learn the basics of accounting, you don't have to know all these seven steps.

8. Financial Statements in General



Money and other financial activities are constant occurrences in a company and someone has to keep track of them. And that's the main job of accountants. That's why God created them in the first place.

Accountants and finance guys have special training (they go to school remember?) in analysing the financial health and growth of an enterprise. They mainly use numbers shown in the ledgers and summarize them as their basis in preparing the financial statements.



There are three basic financial statements that are normally prepared for an enterprise but only two are directly recorded in its books of accounts, namely: (i) Income Statement and (ii) Balance Sheet.

There are no separate books or ledgers kept for the 3rd financial report which is called Cash Flow Statement. This is merely a reconstruction of increases and decreases of ledger balances between two periods (usually current year vs. prior year). I'll explain this further in Chapter 11.

The Income Statement is as important to your understanding of a company's financial operation as the Balance Sheet. The Cash Flow Statement is somewhat secondary in a sense that it merely monitors the sources and uses of cash that flowed through an entity during a period (usually a year) – after these transactions would have already been reflected in the other two financial statements.

Very briefly, the Income Statement shows the “moving” results of the financial operation of a company consisting of sales revenues (income) less expenses for a given period (usually a year).

On the other hand, Balance Sheet shows a snapshot or a still picture of all existing assets, outstanding liabilities including equity or net worth (capital stock plus retained earnings) of a company as of a given period. This is why it can be said that an Income Statement is a movie while a Balance Sheet is just a photo.

Where do these Journal Entries go?

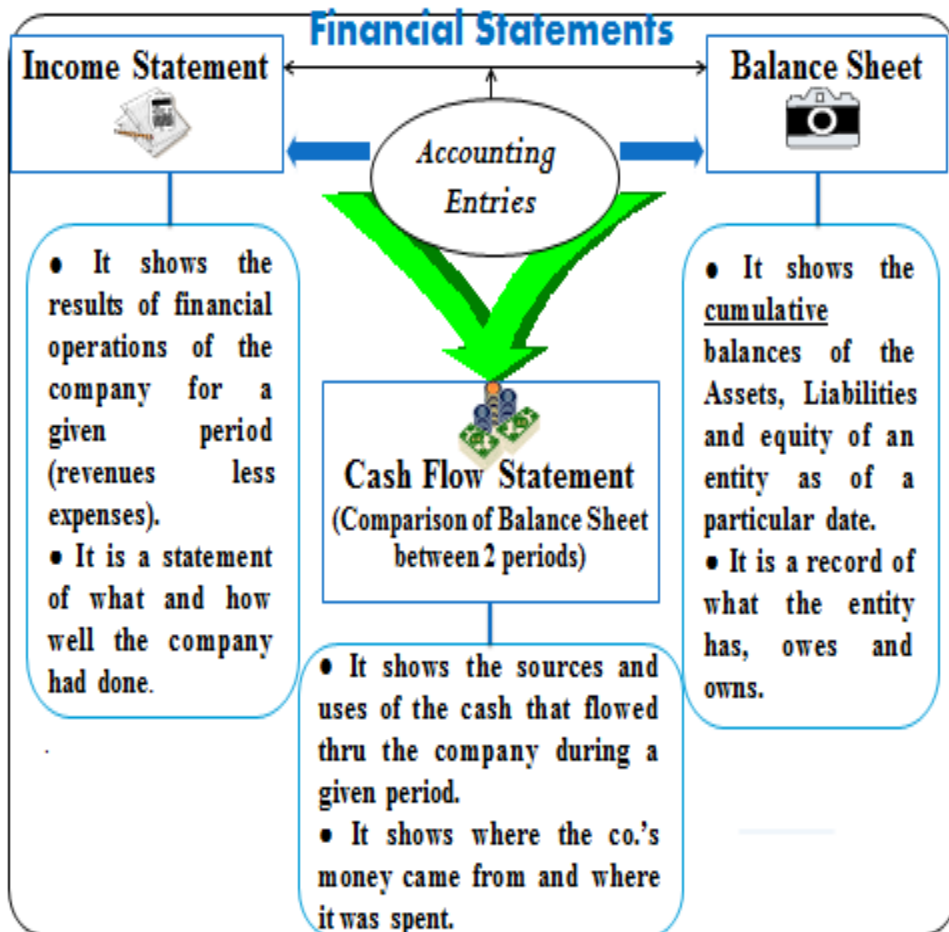
Each Accounting entry will either go only to Income Statement or only to Balance Sheet; but it could also go to both depending on the nature of the transactions involved.

For instance, when you sell your products, the resulting asset debit account (“Accounts Receivable”) will go to the Balance Sheet. On the other hand, the corresponding credit account as “Sales Revenue” will be recorded in the Income Statement.

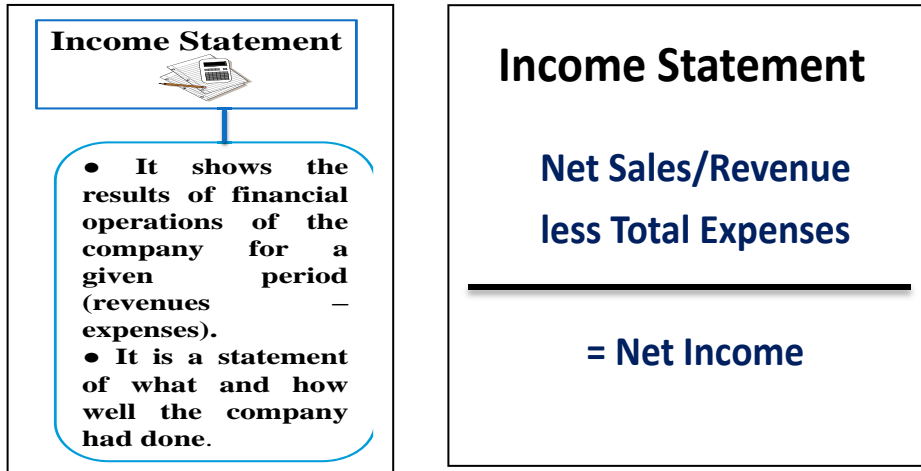
However, when your customer pays you later, this transaction will only be recorded in the Balance Sheet as debit to “Cash” and credit to “Accounts Receivable”.

In the following page is Table 6 which shows the flow of these journal entries into balance sheet and income statement.

Table 6



9. Income Statement



The Income Statement represents the result of a company's financial operation for a given period, usually a year. It shows all the revenues, incomes, and other forms of miscellaneous gains minus expenses and other operating costs resulting in Net Income or Net Loss (if expenses exceed revenues).

As stated earlier, the Balance Sheet is a snapshot of the company financial condition as of a certain date showing accumulated numbers from the very start while the Income Statement covers financial operation specifically for a given period only.

Thus, the Income Statement begins from zero at the start of the accounting period like starting January 1st). This is because the Net Income (Loss) residue of the previous year has already been previously closed out and transferred to Owners' Equity in the Balance sheet.

The key sections of an Income Statement are shown in Table 7 and its typical format can be seen in Table 8.

Table 7

**Key Sections of a Income Statement (I/S)
For the Year ended Dec. 31, 2012**

1. Sales
2. Less Cost of Sales
3. Gross Income (1 less 2)
4. Ordinary Business Expenses
5. Operating Income (3 less 4)
6. Other Income (Expenses)
7. Pre-Tax Income (5 less 6)
8. Income Tax
9. Net Income (7 less 8)

This shows the revenues, income, and expenses of the company for a particular period usually a year for tax purposes. However, interim I/S is also prepared covering a month, a quarter, or semi-annual depending on the company's accounting cycle.

Table 8

**Income Statement
For the Year ended 12-31-12**

Sales Revenue	22,000
Cost of Products Sold	<u>16,400</u>
Gross Income	5,600
Operating Expenses	<u>3,400</u>
Operating Income	2,200
Interest Income	<u>(170)</u>
Income before Tax	2,030
Income Tax	<u>960</u>
Net Income	1,070

A full-blown pro-forma Income Statement is shown in Chapter 14 marked ANNEX “B”.

Major Account Categories of an Income Statement

Let’s briefly define each of these major account categories:

- **Net Sales** – Total sales of finished goods or products purchased for resale less discounts, returns, and any similar reductions from invoice price. Note that the 12% VAT is recorded as Output Tax Payable and therefore not included as part of sales revenue.

Note that a sale of non-trade assets like old equipment or vehicles should not be included in the Sales Revenue account. However, any gain or loss in the disposal of this type of assets is to be recorded as Other Expense/Income shown below.

- **Cost of Products Sold or Cost of Sales** – direct materials, direct labour, and manufacturing overhead identified with the manufacture of finished products (except depreciation), or the acquisition cost of purchased items for resale (not applicable to service industry).

Just like in sales, the cost of materials and other expenses should not include the Input Tax (VAT) portion.

- **Depreciation** – an allowance for a loss in value of fixed assets due to use and obsolescence. This is spread over the estimated useful life of the fixed asset.
- **Other Operating Expense** – which cannot be directly associated with revenue generation. Ex: gains or loss on fixed asset disposal, inventory adjustments, obsolete reserves, claims, etc.

- **Marketing & Selling** – Expenses related to the sales and supply chain functions and other costs associated with marketing and field sales departments.
- **General and Administrative -- expenses such as salaries** related to administrative offices: Executive, HR, legal, Finance, Accounting, etc.
- **Other Expense/Income** – Interest expense, interest income, foreign exchange gain or loss and other non-operating expenses and revenues.

Key Points to remember related to Financial Statements in General

- There are only two buckets that each accounting entry will fall into: (1) Balance Sheet; and (2) Income Statement. The 3rd Cash Flow Statement is not included in the picture (do you know why?).
- However, there are instances when a journal entry will only go to either one of the two financial reports (can you cite some instances?).
- In the Income Statement, recall that there are only two main groupings of transactions:
 - (i) Sales, revenue, other income such as interest or miscellaneous income, etc., are all classified as negative (-) numbers; and
 - (ii) Cost of Sales, Expenses, depreciation, and other operating costs are all classified as positive (+) numbers. If you know this rule by heart, it would be easy (you only add and deduct) to compute the net income or loss of your company.
- In the Balance Sheet, there are also two main groupings: (i) Assets are all positive (+) numbers; (ii) Liabilities and Net Worth (Capital and Retained Earnings) are all negative (-) numbers.

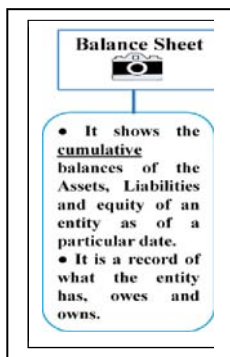
- Corollary to the above, all Debits are positive (+) numbers while all Credits are negative (-) numbers. No exception!

10. What is a Balance Sheet?

Balance Sheet As of Dec. 31, 2012			
<u>Assets</u>		<u>Liab. & Equity</u>	
Current Assets	12,000	Current Liab.	5,400
Fixed Assets	7,000	Long-Term Liab.	5,000
Non-Curr. Assets	<u>400</u>	Equity	<u>9,000</u>
Total Assets	19,400	Total Liab. & Equity	19,400

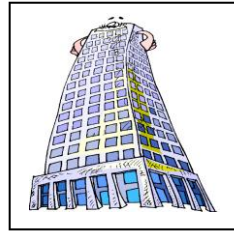
To understand the balance sheet, you must first understand how money moves in out of the company. Every transaction that an enterprise conducts represents either an inflow (from sales, loans or contribution of capital stock) or outflow (purchases of materials, expenses) of cash.

In addition, there are other transactions that are non-cash in nature that should also be taken into consideration. These are: depreciation of fixed assets or amortization of certain deferred charges like Research & Development.



Balance Sheet shows all existing assets acquired and outstanding liabilities incurred, including owners' equity as of a certain period (at year-end, at quarter-end, etc.). Thus, all asset acquisitions and obligations recorded from the very start of the company's operation are shown here. In other word, it's a snapshot of what the company owns and owes showing accumulated financial data from inception up to a certain cut-off date

In general, anything the company owns can be classified as an asset (inventories, vehicles, buildings, etc.). Assets have one thing in common – they are to generate cash (even cash still generates cash by placing it as an investment).



The word asset comes from the French word *assez* meaning ‘enough’. Originally, it was used because the property of a proprietor was judged in terms of whether it was sufficient for him to pay off his debt later.



Liabilities are amounts owed by the company to outside parties (lenders, suppliers, contractors, etc.). Liabilities must be paid on or before some specific date and for specific business purposes.

Owners’ equity is the amount left for the company’s owners (stockholders). This consists of Capital Stock + retained earnings of previous years - dividends +/- net income or loss for the current year.

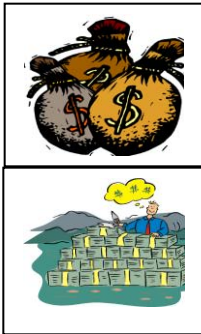


A Balance Sheet is usually prepared with comparable numbers of the prior year. The formula for the balance sheet is as follows:

$$\text{Assets} = \text{Liabilities} + \text{Capital} + \text{Equity}^*$$

$$^*\text{Equity} = \text{Capital} - \text{Dividends} + \text{Income} - \text{Expenses}$$

The assets of a company which are normally shown in the left side of the balance sheet are classified under the following account categories:



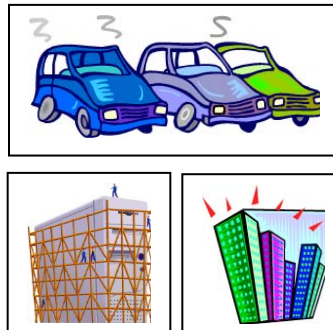
Current Assets

These include cash and other resources that are expected to turn into cash or to be used up within one year of the balance sheet date. Normally these consist of cash on hand and/or in banks, marketable securities or short-term investments, accounts receivable (owed by customers who buy from the company on credit), inventories (finished products or raw materials).

Also considered as part of current assets are: employee advances and other non-trade receivables, and prepaid expenses (i.e. office supplies bought in bulk covering more than one year of normal consumption).

Fixed Assets

This category named Fixed Assets is also captioned as Property, Plant & Equipment. This includes land, buildings, machinery, furniture, equipment, and other fixed assets which normally have a shelf life of more than one year. In zest, it's said that any durable item that would outlast the final instalment payment could be considered a fixed asset.



Other Non-Current Assets

Normally, Prepaid Expenses or Deferred Charges are shown here. An example of the former is insurance premiums paid in advance covering several years. For the latter, a good example is Research & Development Costs – money already spent that will yield a benefit in the coming years.

Intangibles like trademark, patent, or goodwill are also considered other non-current assets.

The following are normally shown in the rights side of the balance sheet:

Current Liabilities

Usually the first on the list here is Accounts Payable which represents amounts due within one year the company owes to its suppliers or contractors.

Next in the list is Accrued Expenses Payable. This represents amounts the company owes to various third parties like electric and telephone companies, and other service providers who have not been paid for services rendered as of the date of the balance sheet.



A portion of long-term debt (like bank borrowings) due within a year is classified as under current liabilities.

Other amounts due to the government like income tax and value-added tax are also shown under Current Liabilities.



Long-term Debt

What automatically comes to mind here is the long-term portion of your loans that is due after one year from the balance sheet date.

Stockholders' Equity

This is also called in its abbreviated name 'equity'. This refers to the financial stake the owners have in the company.

Normally, the company has assets, and after you deduct what it owes to anyone, then what is left is the equity. Note that this number can be zero or even negative if an enterprise owes more than its assets.

This situation is not impossible especially if a business has continued losses eventually eating up its retained earnings or even the owner's original capital.

Equity includes the stockholders' original capital, additional paid-in capital if any, and retained earnings (accumulated net profits net of dividends paid to stockholders through the years).

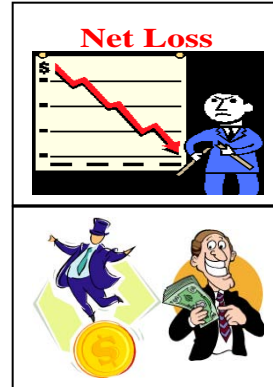


Table 9 shows a typical format of a Balance Sheet.

Table 9

Balance Sheet					
As of Dec. 31, 2012 and 2011					
			<u>2012</u>	<u>2011</u>	
<u>ASSETS</u>					
(what we own)					
Current Assets	Cash				
	Accts Rec'ble				
	Inventory Stocks				
Non-current Assets	Fixed Assets				
	Def. Charges/				
	Other Assets				
	Goodwill				
Total			=	Total	
			<u>2012</u>	<u>2011</u>	
<u>LIAB. & EQUITY</u>					
(who we owe)					
Current Liab.	Accts. Payable				
	Loans Payable				
	Accrued Expenses				
	Long-term Debt				Non-Curr. Liab.
EQUITY					
(what belongs to stockholders)					
Capital + Ret. Earnings - dividends					

This shows what the company owns, owes, and what belongs to the stockholders as of a certain period end such as :year-end, month-end, quarter-end, etc.

Note that all assets and liabilities are explicitly sub-divided into current and non-current portions as you can see in the above. This sub-

classification is important in determining current ratios, liquid ratios, and other financial ratios mentioned in Chapter 13.

A full-blown pro-forma Balance Sheet is shown in Chapter 14 marked ANNEX “C”

By the way, why is Balance Sheet named as such? It's not as you might think, called a balance sheet merely because the totals of the left and right sides are balanced. The reason rather is because a balance sheet is a listing of all ledger balances remaining after compiling all revenues and deducting expenses which results in a net balance (either a net income or net loss). This residue is then transferred to another sheet now called **Balance Sheet** (sounds tricky?).

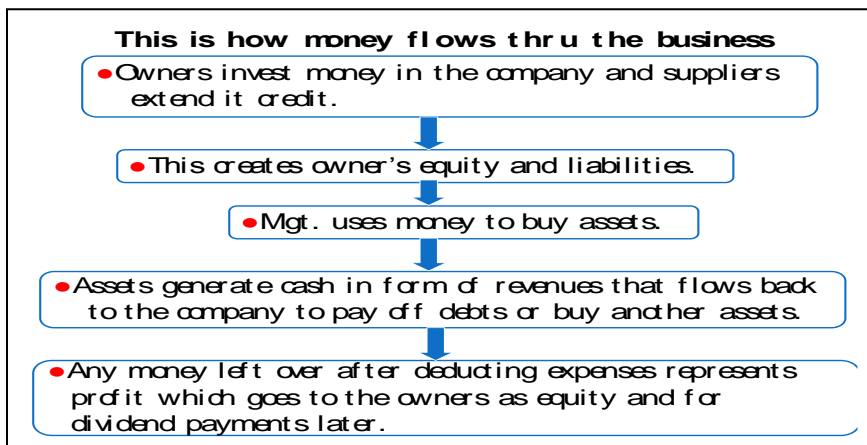
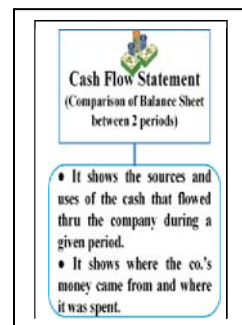
Key Chapter Highlights

- The sub-classification of all assets and liabilities into current and non-current portions is extremely important for purposes of computing various financial ratios comprehensively discussed in Chapter 13.
- Asset by its nature is always a Debit (+). Thus, when you buy an asset, you debit that account; if you dispose an asset, you credit that same asset account.
- Liability and Stockholders' Equity by their very nature are treated as Credit accounts (-); thus when you borrow money or receive a capital contribution, you credit these accounts; when your loan is paid off, you then debit a loans payable account.

11. The Cash Flow Statement



The Cash Flow Statement mainly keeps track of money coming in and money coming out through the business. Its process flow starting from the business owner, investors, lenders, or suppliers up to time these funds are used for working capital, asset acquisition, expansion, to pay off loans, or pay dividends is shown below.

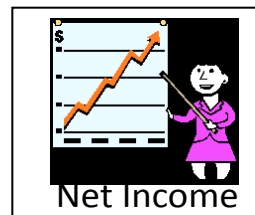


The basic concepts of a Cash Flow Statement are summarized below.

- a) Every transaction that a company conducts eventually represents either a cash inflow or outflow. For instance, cash inflows could come from sales, loans, or sale of capital stock while cash outflow occurs when the company buys materials, pays salaries, interest on loans, and other operating or miscellaneous expenses of an enterprise.



- b) It shows three sources of cash: (1) Operating Activities (net profit + working capital); (2) Investing activities, and (3) financing/lending activities and where the cash was spent during a period.



- c) The above are computed by simply comparing the increases/decreases between two periods of all Balance Sheet accounts except Cash.

- d) Just as not all cash inflows are revenues (loans from a bank, collection of employee advances), not all cash outflows are considered an expense (repaying a loan or paying your suppliers for materials purchased on credit).



- e) Thus, an increase in asset (except cash of course) is a use of cash, while a decrease in an asset is a source of cash. For instance, when your accounts receivable or finished goods inventory is higher than the prior year, this means your cash balance has become lower because more money is tied up in these particular accounts.

- f) The cash impact is the opposite when your receivables and inventories are lower resulting from either faster collection or you have more frequent inventory turnover, which means you're generating cash.
- g) Conversely, an increase in a liability or owners' equity accounts is a source of cash. This is because you received cash when your bank lends you or when stockholders decided to put in more capital to the company.
- h) "Non-cash" charge (i.e. depreciation) is a source of cash because no cash was spent on that account.

The cash flow concepts described in item (a) through (h) above are also illustrated in a tabular worksheet as shown in Table 10 below.

Table 10

Cash Flow Statement				
			Source of	Use of
	2012	2011	Funds	Funds
Net Income for 2012	(1,070)		1,070	
Accumulated Depreciation	(3,600)	(3,000)	600	
Accounts Receivable	4,000	3,800		200
Inventories	5,400	6,000	600	
Accounts Payable	(2,700)	(2,680)	20	
Accrued Expenses Payable	(1,660)	(1,600)	60	
Income Tax Payable	(640)	(380)	260	
From Operating Activities			2,610	200
Marketable Securities	1,700	920		780
Fixed Assets	10,600	9,990		610
Deferred Charges	400	380		20
From Investing Activities			0	1,410
Long-term Debt	(5,000)	(5,400)		400
Capital Stock	(5,600)	(5,600)	0	0
Dividends Paid	300			300
From Financing Activities			0	700
Total Sources and Uses of Funds			2,610	2,310

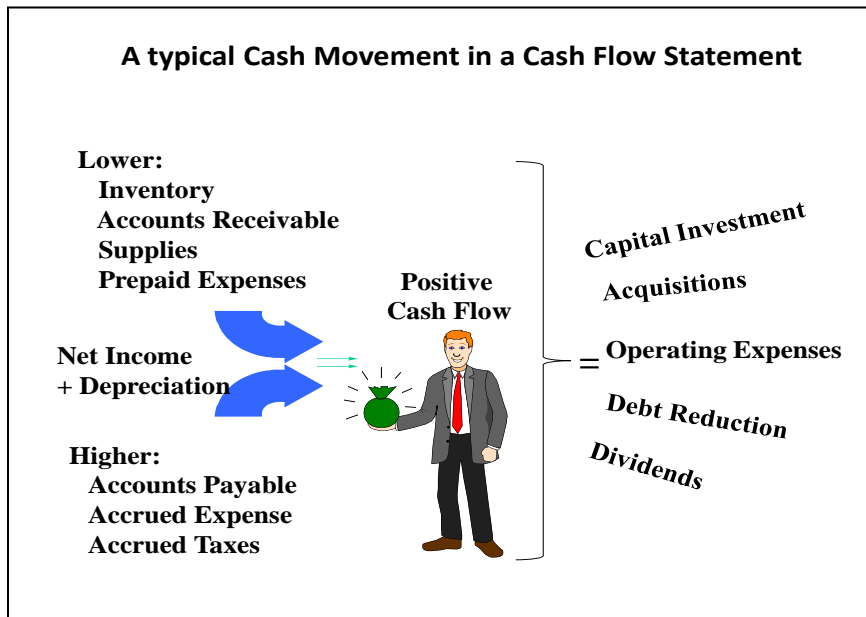
Using the worksheet data in Table 10, a typical output format of the Cash Flow Statement is then prepared as shown in Table 11 below.

Table 11

Sample A Company, Inc.	
Cash Flow Statement	
For the Year ended December 31, 2012	
Cash Flows from Operating Activities:	
Net Income	1,070,000
Depreciation	600,000
Decr (Incr) in Accts. Rec'ble	(200,000)
Decr (Incr) in Inventories	600,000
Incr (Decr) in Accts. Payable	20,000
Incr (Decr) in Accr. Exp. Payable	60,000
Incr (Decr) in Tax Payable	260,000
Net Cash flow from Operations	2,410,000
Cash Flows from Investing Activities:	
Decr (Incr) in Marketable Securities	(780,000)
Decr (Incr) in Fixed Assets	(610,000)
Decr (Incr) in Deferred Charges	(20,000)
Net cash Flow from Invest. Activities	(1,410,000)
Cash Flows from Financing Activities:	
Incr (Decr) in Long-term Debt	(400,000)
Incr (Decr) in Capital Stock	-
Dividends Paid	(300,000)
Net Cash flows from Fin. Activities	(700,000)
Net Change in Cash	300,000

I summarize in Table 12 below a graphic movement of cash starting from the time you generated cash from operation up to time you used the funds to pay your suppliers or pay off your maturing loans. Any cash residue would then be allocated to pay dividends or set aside some money to maintain your plant or replace your old equipment, or to expand your business.

Table 12



As stated earlier, the Cash Flow Statement is not formally recorded in the normal books of accounts of an enterprise. How is then done? Well, as mentioned above, the numbers are generated by simply comparing the balances of all Balance Sheet accounts between the current period and the prior year.

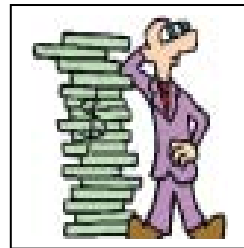
12. Importance of Financial Statements

Accounting's main function is to prepare financial reports and other financial performance analysis for submission to those who need such information about your company.

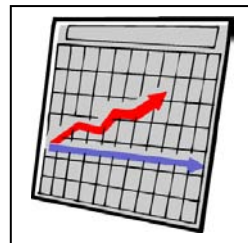


Business owners, company executives, investors, lenders, suppliers including government agencies and many other outside parties depend on financial reports regarding the financial condition and performance of the company.

Money transactions occur very frequently and someone has to record and monitor them. That's why God created accountants whose main job is to prepare regular and accurate financial reports to management so it can make the right financial decisions on a timely basis.



Just like any kind of sports, a company must keep score of its business activities. Thus, the internal use of financial reports alone is highly vital to chart the trends of project revenues and expenses, monitor cash flows, and keep tabs of costs and plan for the future. Various accounting reports generate important data you need in managing certain critical aspects of the business.



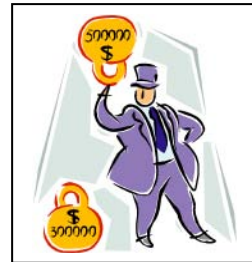
For example, up-to-date subsidiary ledgers would show which customers are past due on their accounts or even have exceeded their credit limits. This information is important to quickly avert potential bad debt situation. Financial data also help you assess whether or not your gross margins and operating expenses are within your budgets and projected net profits.

Financial inputs are also equally needed in deciding either to sustain or expand a business. Without this information, you run the risk of running out of cash, unnecessary wastage of your valuable resources, or missing out on opportunities to increase your current market base.



Employees also would like to see their employer's financial standing so they can assess the stability of their employment as steady source of their livelihood and wellbeing.

Stockholders, investors and major suppliers are also much interested to see how the company is doing financially as compared to other companies in the industry to guide them in making right investment choices.



Bankers are also interested to see a company's recent financial statements before making their lending decisions. If you mainly rely on outside financing, this is the most important reason to invest time and money in setting up or strengthening your Accounting Department.



Last but not least, the regular preparation of financial reports make it easier for your accounting staff to prepare the income tax returns and other reportorial documents required by local and national government agencies.



Key Chapter Highlights

- Table 13 shown in the following page explains why it's extremely important to prepare timely and accurate financial reports of a company.

- Under certain circumstances, the preparation of financial statements is not an option. It's mandatory especially on the part of government authorities as can be seen in Table 14.
- Don't forget that your bankers, major suppliers and contractors are also your important business partners, associates, and concerned stakeholders too. You should maintain their trust in you by providing them the needed information about your business as enumerated in Tables 15.A and 15.B.

Table 13

Why are Financial Statements (F/S) important?

- 1. With globalization and stiff competition, corporations now cannot live without numbers. Accounting is often regarded as the language of business.** 
- 2. F/S are important scorecard tools for managers and owners of the business. No F/S is just like playing basketball without keeping score...** 
- 3. Investors and banks not only will require your F/S., they may demand certain financial ratios to ensure their money is safe.** 
- 4. Employees and Union would like to see your financial statements as per mutual agreement.** 

Table 14

Why do we prepare financial statements?



1. Required by law (BIR/SEC/LGUs): - (1) If quarterly sales do not exceed P50,000, you may use simplified set of books of accounts authorized by the BIR; (2) If quarterly sales exceed P150,000, your books of accounts should be examined by a CPA duly accredited by BIR.

2. Provides valuable tools for management: (a) to measure cost and operation efficiencies; (b) to establish comparison vs. industry standards and competition; (c) a good starting point for forecasting, budgeting and long-term planning; and (d) basis to determine company's profitability, financial soundness, and long-term viability.



3. Required by your bank-lenders and major suppliers.

Table 15.A

Knowing your Lenders/Suppliers/Contractors
(1 of 2)

1. **Lenders are not content with shrinking equity which means you're not making money.**

2. **Banks would like to see at least 3 years of profitable operation with healthy liquidity ratios and safe debt/equity ratios.**

3. **Usually banks require collaterals (fixed assets, receivables, inventories, real estate).**



Table 15.B

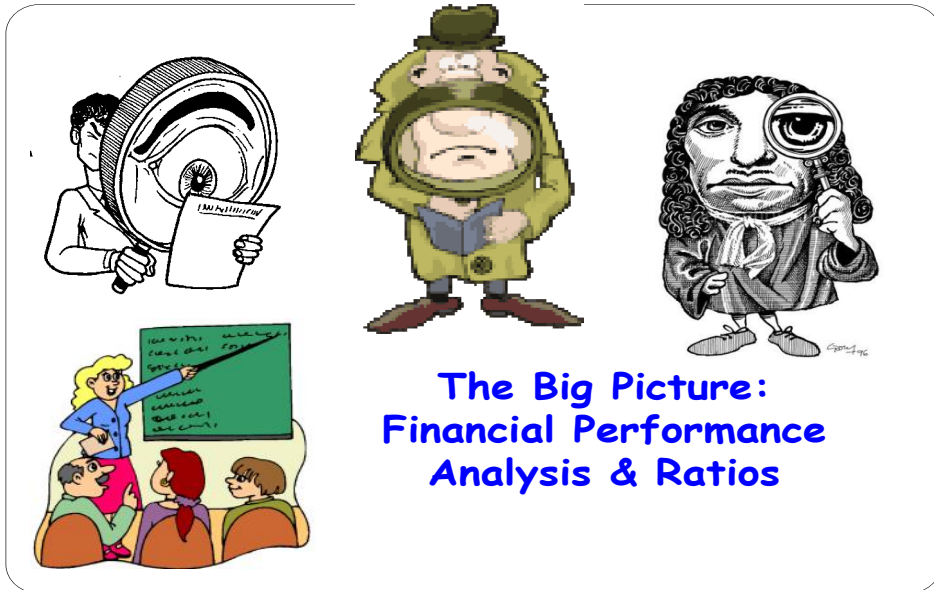
Knowing your Lenders/Suppliers/Contractors
(2 of 2)

4. **Impress your lenders with your management skills, knowledge about your industry, and reliability of your financial data.**

5. **Establish credibility with your vendors and contractors. Coordinate with your suppliers your raw material requirements.**



13. Financial Analyses & Ratios



In our personal endeavors and more so in business, we must set up certain standards or yardstick to measure what we are trying to manage and accomplish. These yardsticks are important tools which we can use as our guiding compass so we can appreciate how well we are achieving our financial goals.

One way to effectively manage the financial affairs of an organization is to use ratios. A ratio is a calculation that shows the relationship between two values. It is nothing more than a division exercise with a number on the top (numerator) divided by a number on the bottom (denominator).

$$\frac{\text{Numerator}}{\text{Denominator}} \equiv \text{Ratio or \%}$$

Simply put, ratios are percentage relationships between two account balances appearing in the balance sheet and income statement which usually cover a current year with comparison to the same trends for the prior year(s).

Ratio analysis enables you to measure a company's financial and operational performance and credit-worthiness (capability to pay its liabilities and take on additional debt for instance). Some of these important ratios and analyses are:

- Liquidity Ratios
- Solvency Ratios
- Profitability Ratios

The following are not part of the conventional financial ratios but just the same I have included them here as they are also equally considered important analytical tools to me in determining how cost-effective and efficient your company is being run:

- Break-even Analysis
- Suppliers' Discount Rate

Liquidity Ratios

These ratios evaluate your cash flow in measuring your company's capability in the short run to meet its short-term obligations when they become due. You can prepare for this eventuality for instance by converting faster your receivables and inventories into cash.

Liquidity ratios cover:

- Working Capital & Current Ratio
- Quick Ratio
- Days Sales Outstanding (DSO)
- Days Sales Inventory (DSI)
- Days Sales Payable (DSP)

Cash Conversion Cycle

This represents total number of days your accounts receivable and inventories remain in your books before these are converted into cash less the effective number of days your suppliers give you for your credit purchases.

This is an interesting analysis showing a scientific calculation of the total cash cycle of the company as shown in Table 16 below. The numbers will tell you if you have really managed your cash flow efficiently or not.

Table 16

Cash Conversion Cycle	
	<u>Days</u>
Days Sales Outstanding (DSO)	64.7
Days Sales Inventory (DSI)	126.9
Days Sales Payable (DSP)	<u>(59.9)</u>
Net Cash Conversion Cycle	131.7
This means it took you 131.7 days (4.39 mos.) to convert your receivables and inventories into cash.	

Solvency Ratios

These ratios measure how stable or leveraged a business is on the long-run. In other words, these ratios measure a company's capability to meet its long-term obligations. This type of analysis examines two key elements:

- The proportion of debt the company uses to run its operation.
- The company's capability to pay the interest on that debt.

Profitability Ratios

These ratios measure the company's earning power and management's efficiency in running the business.

Explained below are formulas used in computing the above-described financial ratios. The financial data used here are taken from various exhibits in Chapter 14 marked ANNEXES "B", "C", and "D".

Formulas for Liquidity Ratios

So you're able to follow through the ratio computation, let me illustrate how this is done for Working Capital and Current Ratios as examples. Refer to Tables 17.A and 17.B as shown in the next page.

For item # 1: if you deduct the amount of current liabilities (P5.4 million) from the current assets (P12 million), then the working capital should be P6.6 million.

For item # 2: Using the same numbers shown in the above, then 12 million divide by 5.4 million equals 2.2.

There's another tricky terminology you may encounter when you calculate financial ratios. I'm referring to the word "turnover" which unfortunately refers to so many things in the world of accounting.

Turnover could mean revenue or the amount of business transactions over a given period of time. In computing financial ratios, it could also mean the number of times certain assets (like accounts receivable) can turn into cash within a period, say a year. See item # 4 of Table 17.A in the next page.

For the calculations of all liquidity ratios described above, please refer to Tables 17.A and 17.B.

Table 17.A

Liquidity Ratios (1 of 2)

- 1) **“Working Capital”** measures a company’s capability to pay its current obligations. Formula:

$$\text{Current Assets} - \text{Current Liabilities} = 6,600,000$$

- 2) **“Current Ratio”** represents an effort to compare your short-term financial resources with your short-term obligations. Formula:

$$\text{Current Assets/Current Liabilities} = 2.2$$

This means that the company has twice the amount of current assets as compared to current liabilities. Bankers like to see a current ratio greater than 2.

- 3) **“Quick Ratio”** (or Quick Asset Ratio or Acid Test Ratio) which is a more stringent measure of liquidity. Formula:

$$\frac{\text{Curr. Assets less Inventories \& Prep. Exp.})}{\text{Curr. Liabilities less Overdrafts \& accruals}} = 1.76$$

This means the company has a good portion of its current assets in liquid assets rather than in inventories. Lenders like to see a quick ratio greater than 1.5

Table 17.B

Liquidity Ratios (2 of 2)

- 4) To compute “Days Sales Outstanding” (DSO), first you have to compute the Receivable Turnover:

$$\text{Credit Sales/Average Acct. Receivable Balance} = 5.64$$

$$\text{DSO Formula: } 365/\text{Receivable turnover (5.64)} = 64.7$$

64.7 is the average collection period or days sales outstanding. This means the ave. credit terms for your customers is over 2 months. The lower the DSO the better.

- 5) “Days Sales Inventory” (DSI):

- Inventory Turnover: $\text{Cost of goods sold/average inventories} = 2.88$

- DSI formula: $365/\text{Inventory Turnover} = 126.7$

This is the average number of days of your stocks in the warehouse before these are sold. The lower the DSI the better.

- 6) “Days Sales Payable (DSP)”:

- Accts. Payable Turnover: $\text{Cost of Goods Sold/Ave. Acct. Payable} = 6.1$

- DSP Formula: $365/\text{Accts. Payable Turnover} = 59.8$

This is the average Credit Term extended by your suppliers. The higher the DSP the better.

Note: If the numbers covered are less than one year, the 365 numerator should be adjusted proportionately.

Formulas for Solvency Ratios

These ratios measure how a business is stable or leveraged on the long-run and examine two key elements:

- The proportion of debt the company uses to run its operation.
- Its capability to pay the interest on that debt.

In analyzing these ratios, banks would be able to know the extent business owners are using external borrowings vis-à-vis stockholders capital in running the company.

Refer to Table 18.A and 18.B below for the computation of solvency ratios described above.

Table 18.A

Solvency Ratios (1 of 2)

These ratios measure how stable or leveraged a business is on the long-run and examine two key elements:

- **The proportion of debt the co. uses to run its operation.**
- **Its capability to pay the interest on that debt.**

1) Debt Equity Ratio: $\text{Total Liabilities} / \text{Owners' Equity} = 1.2$

This measures the extent to which the owners are using debt rather than their own funds to finance the company. D/E ratio of 2.5 or higher is not a good indication.

2) Equity Ratio Formula: $\text{Total Equity} / \text{Total Assets} = 46.4\%$

This means 46.4% of your assets is financed by equity (internal sources).

Table 18.B

Solvency Ratios (2 of 2)

3) Asset to Equity Ratio: Total Assets/Average Equity = 2.3

A high ratio here may indicate the company has taken on substantial debt merely to remain in business; this could result in higher interest cost putting its financial position in jeopardy.

4) Debt Ratio Formula: Total Debts/Total Assets = 53.6%

This means 53.6% of your assets is financed by borrowings (external sources).

5) Times Interest Earned formula:

$$\text{Net Income} + \text{Interest Exp.} / \text{Interest Exp.} = 4.96 \text{ times}$$

This measures how many times you would be able to pay interest based on operating profits less income tax.

Formulas for Profitability Ratios

Profitability Ratios measure the company's earning power and management's efficiency in running its operations. The formula computation is shown in Tables 19.A and 19.B.

Table 19.A

**“Profitability Ratios” measure the co.’s earning power
& management’s efficiency in running its operations
(1 of 2)**

1) Gross Margin: Gross Income/Sales = 25.5%

2) Operating Margin: Operating Income/Sales = 10.0%

3) Net Margin: Net Income/Sales = 4.9%

**4) “Asset Turnover” measures management’s
effectiveness at using assets to generate cash.**

Formula: Sales/Total Assets = 1.1 times

Table 19.B

**“Profitability Ratios” measure the co.’s earning power
& management’s efficiency in running its operations
(2 of 2)**

- 5) “Return on Assets” measures management’s
capability to use assets to generate a profit.**

Formula:

$$\text{Net Income/Average Total Assets} = 5.6\%$$

- 6) “Return on Investment”(ROI) or “Return on Equity”
(ROE) measures the return on the money the
shareholders have invested in the company.**

Formulas:

$$\text{ROI: Net Income/Equity} = 11.9\%$$

$$\text{ROE: Net Income/Ave. Equity} = 12.4\%$$

Break-even Analysis

A “break-even” point is that minimum level of operation where your sales revenue is just enough to barely cover your fixed operating costs and administrative expenses.

There are at least two variance factors commonly used in determining your “break-even” point: (a) Variance due to sales revenue; and (b)

Variance due to sales volume. (There's a 3rd variance which is a combination of the two factors but I'll not discuss it here so we can stick to basics).

For the 1st approach, you determine first your present gross margin which is in this case, 25.5% as shown in Table 19.A above.

For the 2nd factor, you compute first your existing unit margin (selling price per unit less production cost per unit) which in this case, is P127.27 (P500.00-372.73).

The formulas used here are illustrated in Tables 20 and 21.

Table 20

1. Break-even Analysis

To compute "Break-even" Sales where:

> Amount of Fixed Cost is P3,570,000

> Variable Cost is 74.55% of Sales

> Formula:

$$\frac{\text{Amount of fixed Cost}}{100\% - \text{Variable Cost \%}}$$

$$\frac{\text{P3,570,000}}{100\% - 74.55\%}$$

> Amount of "Break-even" Sales: P14,027,505

Proof: Sales	-----	P14,027,505
Less Var. Cost (74.55% of Sales)	-----	<u>(10,457,505)</u>
Gross Profit	-----	3,570,000
Less Fixed Cost	-----	<u>(3,570,000)</u>
Income (Loss)	-----	-0-

Table 21

2. Break-even Analysis

To compute “Break-even” Number of units sold where:

> Amount of Fixed Cost is P3,570.000

> Ave. Unit Price is P500 and ave. Unit Cost is P372.73

> Formula:

$$\frac{\text{Amount of fixed Cost}}{\text{Unit Price} - \text{Unit Cost}}$$
$$\frac{\text{P3,570,000}}{\text{P500} - \text{P372.73}}$$

> No. of units to be sold to break-even : 28,050.6 units

Proof: Sales (28,050.6 units x P500 unit price)-----	P14,025,300
Less Var. Cost (28,050.7 x P372.73)-----	<u>(10,455,300)</u>
Gross Profit -----	3,570,000
Less Fixed Cost -----	<u>(3,570,000)</u>
Income (Loss)-----	-0-

Effective Cost of Supplier’s Credit

This shows how to compute the effective discount rate of your suppliers using a sample credit term of 2/10, net 30 (2% discount if paid within 10 days, otherwise, no discount if paid on the 30th day).

The formulas used here are contained in Table 22 as shown in the following page.

Table 22

Effective Cost of Supplier's Credit

Formula:

$$\frac{\text{Discount \%}}{1 - \text{Disc.\%}} \times \frac{360}{(\text{Days Credit}) - (\text{Discount Period})}$$

Where the terms are: 2/10, net 30, the cost if discount is not taken is computed below:

$$\frac{2}{(100 - 2)} \times \frac{360}{(30 - 10)} = 36.7\%$$

14: ANNEXES

- A.1 Cash Receipts & Sales/Others Journals
- A.2 Cash Disbursements & Accruals Journals
- A.3 General Ledger Entries
- A.4 Simulated Balance Sheet & Income Statement
- B Pro-forma Income Statement
- C Pro-forma Balance Sheet
- D Pro-forma Cash Flow Statement
- D Sample of Chart of Accounts

ANNEX A.1

<u>Cash Receipts & Sales Journals 2012</u>											
<u>Date</u>	<u>OR #</u>	<u>Transactions</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Cr.</u>	<u>Other Accounts</u>			
			<u>Cash</u>	<u>Sales</u>	<u>Sales Ret.</u>	<u>Int. Income</u>	<u>Other Income</u>	<u>Account</u>	<u>Dr.</u>	<u>Cr.</u>	<u>Control</u>
									<u>Amount</u>	<u>Amount</u>	
3-Jan-12	0001	Deposited initial capital of the company	5,000					Capital Stock		(5,000)	0
4-Mar-12	0002	Interest income on savings acct. # 1	50			(50)					0
7-Jun-12	0003	Proceeds of scraps sold	100				(100)				0
9-Aug-12	0004	Recived Insurance claims	1,000				(1,000)				0
11-Aug-12	0005	Borrowed money from the bank	10,000					Loan Payable		(10,000)	0
12-Aug-12	0006	Cash Sales per Inv. 20001-20050	4,800	(5,000)	200						0
13-Sep-12	0007	Proceeds of scraps sold	20				(20)				0
14-Sep-12	0008	Interest income on savings acct. # 2	60			(60)					0
17-Oct-12	0009	Cash Sales per Inv. 20051-20080	3,000	(3,000)							0
20-Oct-12	0010	Proceeds of scraps sold	80				(80)				0
21-Oct-12	0011	Cash Sales per Inv. 20081-20100	7,500	(8,000)	500						0
24-Nov-12	0012	Proceeds of scraps sold	30				(30)				0
24-Dec-12	0013	Interest income on savings acct. # 3	75			(75)					0
24-Dec-12	0014	Sales on credit per Inv. 20101-20150		(2,000)				Acct. Rec'ble	2,000		0
24-Dec-12	0014	Cash Sales per Inv. 20101-20150	4,000	(4,000)							0
		Total for January	35,715	(22,000)	700	(185)	(1,230)			(15,000)	0
			<u>Dr.</u>	<u>Cr.</u>							
		<u>Summary of Journal Entries</u>									
		Dr. Cash	35,715								
		Dr. Sales Returns	700								
		Dr. Accounts Receivable	2,000								
		Cr. Sales		(22,000)							
		Cr. Interest Income		(185)							
		Cr. Other Income		(1,230)							
		Cr. Capital Stock		(5,000)							
		Cr. Loan Payable		(10,000)							
		Control Totals	38,415	(38,415)	0	Note: Figures in parenthesis are Credits					

ANNEX A.2

Check Disbursements & Accrual Journal for 2012										Other Accounts			
Date	Check #	Transactions	Dr. Salaries	Dr. Purchases	Dr. Supplies	Dr. Utilities	Dr. Transp/Meals	Dr. Commission	Cr. Cash	Account	Dr. Amount	Cr. Amount	Control
3-Jan-12	1000001	Salaries paid	5,000						(5,000)				0
4-Mar-12	1000002	Bought stationeries and supplies			300				(300)				0
7-Jun-12	1000003	Electricity bills paid				1,000			(1,000)				0
9-Aug-12	1000004	Water bills paid				200			(200)				0
11-Aug-12	1000005	Long distance calls paid to PLDT				200			(200)				0
12-Aug-12	1000006	Cash advance to employee A							(1,000)	Advances	1,000		0
13-Sep-12	1000007	Purchase of goodks for resale		5,000					(5,000)				0
14-Sep-12	1000008	Salesmen's commissions paid						1,000	(1,000)				0
17-Oct-12	1000009	Bought Office Fixtures							(5,000)	Fixed Assets	5,000		0
20-Oct-12	1000010	Purchase of 1 calculator			500				(500)				0
21-Oct-12	1000011	Purchase of ballpens and pencils			200				(200)				0
24-Nov-12	1000012	Purchase of goodks for resale		3,000					(3,000)				0
20-Dec-12	1000013	Partial payment of loan to the bank							(8,000)	Loan Payable	8,000		0
21-Dec-12	1000014	Bus fares of messenger					250		(250)				0
23-Dec-12	1000015	Lunch with customer B					1,000		(1,000)				0
23-Dec-12	Accrual	To record depreciation exp. For 2012								Depreciation Exp.	1,000		1,000
23-Dec-12	Accrual	To record depreciation exp. For 2012								Accu. Depreciation		(1,000)	(1,000)
23-Dec-12	Accrual	Accrual of Income Tax Payable								Prov. for Inc. Tax	1,300		1,300
23-Dec-12	Accrual	Accrual of Income Tax Payable								Accr. I/T Payable		(1,300)	(1,300)
		Total for 2012	5,000	8,000	1,000	1,400	1,250	1,000	(31,650)		16,300	(2,300)	0
		<u>Summary of Journal Entries</u>	<u>Dr.</u>	<u>Cr.</u>									
		Dr. Salaries	5,000										
		Dr. Purchases	8,000										
		Dr. Office Supplies	1,000										
		Dr. Utilities	1,400										
		Dr. Transportation/Meals	1,250										
		Dr. Sales Commission	1,000										
		Dr. Advances to Employees	1,000										
		Dr. Fixed Assets	5,000										
		Dr. Loan Payable	8,000										
		Dr. Depreciation Expense	1,000										
		Dr. Prov. For Income Tax	1,300										
		Cr. Income Tax Payable		(1,300)									
		Cr. Accumulated Depr.		(1,000)									
		Cr. Cash		(31,650)									
		Control Totals	33,950	(33,950)	0								

Note: Figures in parenthesis are Credits

ANNEX A.3

General Ledger										
	Cash		Advances to Empl.		Fixed Assets		Loans Payable		Capital Stock	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Beg. Balance	100		0		1,900			0		(2,500)
Cash Receipts	35,715									(5,000)
Check Disb.	-	(31,650)	1,000	-	5,000	-	8,000	(10,000)	-	-
Total Debits/Credits	35,815	(31,650)	1,000	-	6,900	-	8,000	(10,000)	-	(7,500)
Ending Balance	4,165		1,000		6,900			(2,000)		(7,500)
	Sales		Sales Returns		Purchases		Salaries		Office Supplies	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Beg. Balance										
Cash Receipts		(22,000)	700							
Check Disb.	-	-	-	-	8,000	-	5,000	-	1,000	-
Total Debits/Credits	↓	(22,000)	700	-	8,000	-	5,000	-	1,000	
Ending Balance		(22,000)	700		8,000		5,000		1,000	
	Utilities		Transport/Meals		Sales Commission		Interest Income		Other Income	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Beg. Balance										
Check Disb.	1,400		1,250		1,000					
Cash Receipts	-	-	-	-	-	-	-	(185)	-	(1,230)
Total Debits/Credits	1,400	-	1,250	-	1,000	-	-	(185)	-	(1,230)
Ending Balance	1,400		1,250		1,000			(185)		(1,230)
	Provision for Income Tax		Income Tax Payable		Depreciation Exp.		Accum. Depreciation		Retained Earnings	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Beg. Balance	0			0	0			0	500	0
Accrual	1,300			(1,300)	1,000		-	(1,000)		
Closing entry	-	-	-	-	-	-	-	-	-	(2,765)
Total Debits/Credits	1,300	-	-	(1,300)	1,000	-	-	(1,000)	500	(2,765)
Ending Balance	1,300			(1,300)	1,000			(1,000)		(2,265)
	Acct. Rec'ble									
	Dr.	Cr.							Debit	Credit
Beg. Balance	0									
Cash Receipts	2,000									
	-	-	Control Totals:				Closing Journal Entry:			
Total Debits/Credits	2,000	-	Total Debi	34,715			Dr. Profit & Loss Summ	2,765		
Ending Balance	2,000		Total Cred	(37,480)			Cr. Retained Earnings		(2,765)	
			Net Income for 2012 ==>				* The net amount after closing all the debit and credit balances of all Income Statement accounts.			
			(2,765)							

ANNEX A.4

Balance Sheet			Income Statement		
As of Dec. 31, 2012 and 2011			For the Years ended Dec. 31, 2012 and 2011		
	<u>2012</u>	<u>2011</u>		<u>2012</u>	<u>2011</u>
Cash	4,165	100	Sales	22,000	
Advances to Employees	1,000	-	Less Sales Returns	<u>(700)</u>	
Accounts Receivable	<u>2,000</u>	<u>-</u>	Net Sales	21,300	-
Current Assets	7,165	100			
			Cost of Goods Sold	<u>8,000</u>	
Fixed Assets	6,900	1,900			
Less Accumulated Depreciation	<u>(1,000)</u>	<u>-</u>	Gross Profit	13,300	-
Net Fixed Assets	5,900	1,900			
			Depreciation Expense	1,000	
			Salaries	5,000	
Total Assets	<u>13,065</u>	<u>2,000</u>	Office Supplies	1,000	
			Utilities	1,400	
Loans Payable	2,000	-	Transportation/Meals	1,250	500
Income Tax Payable	<u>1,300</u>	<u>-</u>	Sales Commissions	<u>1,000</u>	<u>-</u>
Total Current Liabilities	3,300	-	Total Operating Expenses	10,650	500
Capital Stock	7,500	2,500	Net Operating Profit (Loss)	2,650	(500)
Retained Earnings:			Interest Income	(185)	
Beg. Retained Earnings	(500)	0	Other Income	<u>(1,230)</u>	<u>-</u>
Net Profit for the period	<u>2,765</u>	<u>(500)</u>			
Retained Earnings - End	2,265	(500)	Pre-Tax Income	4,065	(500)
Stockholders' Equity	9,765	2,000	Provision for Income Tax	<u>1,300</u>	<u>-</u>
Total Liabilities & Equity	<u>13,065</u>	<u>2,000</u>	Net Profit (Loss)	<u>2,765</u>	<u>(500)</u>
Control Total =====	0	0			

ANNEX “B”

Sample A Company, Inc.				
Income Statement				
For the Years ended December 31, 2012 and 2011				
	2012		2011	
Gross Sales	23,200,000		21,500,000	
Less: Returns/Discounts	(1,200,000)		(1,100,000)	
Net Sales	22,000,000	100.00%	20,400,000	100.00%
Cost of Goods Sold	16,400,000	74.55%	15,400,000	75.49%
Gross Income	5,600,000	25.45%	5,000,000	24.51%
Selling, Gen., & Adm. Exp.	2,800,000	12.73%	2,650,000	12.99%
Depreciation Expense	600,000	2.73%	550,000	2.70%
Operating Income	2,200,000	10.00%	1,800,000	8.82%
Other Expenses				
Interest Expense	270,000	1.23%	300,000	1.47%
Other Income				
Interest Income	100,000	0.45%	80,000	0.39%
Income before Taxes	2,030,000	9.23%	1,580,000	7.75%
Provision for Income Tax	960,000	4.36%	730,000	3.58%
Net Income (Loss)	1,070,000	4.86%	850,000	4.17%

ANNEX "C"

		Sample A Company, Inc.			
		Balance Sheets			
		As of December 31, 2012 and 2011			
	2012	2011		2012	2011
Assets			Liabilities		
Current Assets			Current Liabilities		
Cash	900,000	600,000	Accounts Payable	2,700,000	2,680,000
Maketable Securities	1,700,000	920,000	Accrued Expenses Payable	1,660,000	1,600,000
Accounts Receivable (net of Res. for Bad Debts)	4,000,000	3,800,000	Income Tax Payable	640,000	380,000
Inventories	5,400,000	6,000,000	Curr. Portion of L-T Debt	400,000	400,000
Total Current Assets	12,000,000	11,320,000	Current Liabilities	5,400,000	5,060,000
			Long-Term Debt	5,000,000	5,400,000
Property, Plant & Equipment			Total Liabilities	10,400,000	10,460,000
Land	900,000	900,000			
Buildings & Machinery	9,700,000	9,090,000	Owners' Equity		
Less: Accumulated Depr.	(3,600,000)	(3,000,000)	Capital Stock	5,600,000	5,600,000
Total Prop., Plant & Equip.	7,000,000	6,990,000	Ret. Earnings Beg.	2,630,000	1,980,000
			Net Income for the period	1,070,000	850,000
Other Assets			Dividends paid	(300,000)	(200,000)
Deferred Charges	400,000	380,000	Total Owners' Equity	9,000,000	8,230,000
Total Assets	19,400,000	18,690,000	Total Liab. & Owners' Equity	19,400,000	18,690,000

ANNEX "D"

		Sample A Company, Inc.	
		Cash Flow Statement	
		For the Year ended December 31, 2012	
		Cash Flows from Operating Activities:	
		Net Income	1,070,000
		Depreciation	600,000
		Decr (Incr) in Accts. Rec'ble	(200,000)
		Decr (Incr) in Inventories	600,000
		Incr (Decr) in Accts. Payable	20,000
		Incr (Decr) in Accr. Exp. Payable	60,000
		Incr (Decr) in Tax Payable	260,000
		Net Cash flow from Operations	2,410,000
		Cash Flows from Investing Activities:	
		Decr (Incr) in Marketable Securities	(780,000)
		Decr (Incr) in Fixed Assets	(610,000)
		Decr (Incr) in Deferred Charges	(20,000)
		Net cash Flow from Invest. Activities	(1,410,000)
		Cash Flows from Financing Activities:	
		Incr (Decr) in Long-term Debt	(400,000)
		Incr (Decr) in Capital Stock	-
		Dividends Paid	(300,000)
		Net Cash flows from Fin. Activities	(700,000)
		Net Change in Cash	300,000

Annex E.1

Sample of Chart of Accounts

Current Assets

- 1010 Cash in Bank - Regular Checking
- 1020 Cash in Bank - Other Accounts
- 1025 Cash on Hand
- 1060 Petty Cash Fund
- 1210 Accounts Receivable
- 1250 Reserve for Doubtful Accounts
- 1310 Finished Goods Inventory
- 1350 Other Merchandise Inventory
- 1410 Prepaid Supplies
- 1530 Other Prepaid Expenses

Property, Plant, and Equipment

- 1700 Land
- 1710 Buildings
- 1715 Accumulated Depreciation - Buildings
- 1730 Equipment
- 1740 Accumulated Depreciation - Equipment
- 1770 Vehicles
- 1775 Accumulated Depreciation – Vehicles
- 1800 Other Fixed Assets
- 1815 Accumulated Depreciation – Other Fixed Assets

Other Assets

- 1900 Goodwill
- 1910 Other Non-current Assets

Current Liabilities

- 2010 Accounts Payable
- 2020 Taxes Payable
- 2030 Salaries Payable
- 2040 Accrued Expenses
- 2050 Interest Payable

Annex E.2

Current Liabilities (continued)

- 2060 Notes/Loans Payable
- 2100 Current Deferred Credits
- 2200 Other Current Deferred Revenues

Long-term Liabilities

- 2510 Mortgage Loan Payable
- 2540 Bonds Payable
- 2560 Discount on Bonds Payable
- 2580 Other Long-term Debt

Stockholders' Equity

- 2710 Capital Stock
- 2720 Preferred Stock
- 2750 Retained Earnings
- 2760 Dividends
- 2790 Treasury Stock

Operating Revenues

- 3100 Gross Sales Revenue
- 3200 Sales Returns & Allowances
- 3250 Trade Discounts
- 3300 Gross Sales Revenues - Others
- 3400 Sales Returns & Allowances - Others
- 3450 Trade Discounts - Others

Cost of Goods Sold (COGS)

- 4110 COGS – Direct Materials
- 4120 COGS – Materials Purchases
- 4130 COGS – Direct Labor
- 4210 COGS – Indirect Materials
- 4215 COGS – Indirect Labor
- 4220 COGS – Other Manufacturing Overhead

Annex E.3

Operating Expenses

- 5010 Advertising
- 5015 Amortization
- 5020 Bad Debts
- 5025 Bank Charges
- 5030 Charitable Contributions
- 5035 Commission Expense
- 5040 Contract Labor
- 5045 Computer Repairs
- 5050 Delivery Expenses
- 5055 Dues & Subscription
- 5060 Electricity & Other Utilities
- 5065 Freight Charges
- 5070 Gas, Fuel, Oil
- 5075 Income Tax
- 5080 Insurance
- 5085 Interest Expenses
- 5090 Maintenance & Repairs – Buildings
- 5095 Maintenance & Repairs – Equipment
- 5110 Maintenance & Repairs – Vehicles
- 5115 Maintenance & Repairs – Other Fixed Assets
- 5120 Maintenance & Repairs – Office Premises/Others
- 5125 Miscellaneous Expenses
- 5130 Mailing/Postage
- 5135 Office Supplies
- 5140 Other Operating Supplies
- 5145 Overtime & Premiums
- 5150 Payroll Taxes - Others
- 5155 Permits & Licenses
- 5160 Professional Fees
- 5165 Property Taxes
- 5170 Rental Expenses
- 5175 Repairs - Miscellaneous
- 5180 Salaries

Annex E.4

Operating Expenses (continued)

- 5185 SSS/Pag-ibig/Philhealth/EC
- 5190 Taxes & Licenses
- 5195 Telephone
- 5210 Training
- 5220 Transportation Expenses
- 5230 Travel & Trips
- 5240 Wages

Other Gains (Losses)

- 9180 Interest Income
- 9190 Gain (Loss) on Sale of Assets
- 9210 Miscellaneous Income (Loss)
- 9220 Other Non-operating Expenses



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