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# INTRODUCTION TO BUSINESS & ACCOUNTING

## CAF - 01

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# Business Entity

A group of two or more people (or even one person) can create a new “person” or “entity” under the law that does business, has rights, has limits, can create liability etc.

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# Constituents

- Owners
- Managers
- Employees
- Customers
- Partners, contractors, and others
- The Public
- Government

# Characteristics of business

- All businesses share certain characteristics.
- Businesses exist to make profits.
- Businesses make profit by supplying goods or services to others (customers).
- Businesses that supply goods might make those goods or buy them from other parties (for example, food retailers buy food off food producers and sell it to their customers).

- Profit is the reward for accepting risk. For example, a food retailer might buy 100 kgs of bananas but might not be able to sell them all. In other words, he runs the risk of paying for bananas that he will have to throw away. He is willing to run the risk because if he does not buy bananas he has no chance of selling them for a profit.
- The profit of a business belongs to its owners. A share of the profits might be paid to the owners periodically.

# Types of Business Entity

1. Sole trader
2. Partnership
3. Single member company [SMC (Pvt) Limited]

4. Companies

Limited liability

Public

Listed (Quoted)

Unlisted (Un-quoted)

Private

Unlimited company

# Sole Trader

- *Easiest form of business to start-needs only the occasional licenses and fees*
- Ease of start up
- Relative ease of management
- Decisions can be made quickly

# Merits

- Owner enjoys the PROFITS of successful management without having to share
- No separate business income taxes
  - Not recognized as a separate legal entity
  - *Owner must pay individual income taxes on profits*
  - *Business is exempt from any tax on the income*
- Psychological satisfaction
- Easy to get out of business

# Demerit

- **Unlimited liability**
  - *Owner is personally and fully responsible for all loses and debts of the business*
  - *If business fails, the owner's personal possessions may be taken away to satisfy business debts*
- **Difficult to raise capital**
  - *Personal financial resources are limited*
- **Size and efficiency:** <u>Inventory</u> is any unused stock of finished goods/parts in reserve

- **Limited Managerial Skills**
- **Difficulty of attracting qualified employees**
  - *<u>Fringe benefits</u>- Employee benefits such as vacation, sick leave, retirement, medical, and health insurance may not be available*
- **Limited lifespan:** The firm legally ceases to exist when the owner dies, quits, or sells the business

# Partnership

**Partnership Act 1932 (Section : 4)**

"Partnership" is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.

- Owned by 2 or more persons
- Least numerous business organization
- *Smallest proportion of sales and net income*

# Articles of Partnership

1. Name, purpose, location
2. Duration of the agreement
3. Authority and responsibility of each partner
4. Character of partners (i.e., general or limited, active or silent)
5. Amount of contribution from each partner
6. Division of profits or losses
7. Salaries of each partner

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# Articles of Partnership (Contd)

8. How much each partner is allowed to withdraw
9. Death of partner
10. Sale of partnership interest
11. Arbitration of disputes
12. Required and prohibited actions
13. Absence and disability
14. Restrictive covenants
15. Buying and selling agreements

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# Merits

- **Ease of start up.**

*Articles of Partnership involves attorney fees and filing fee for the state.*

- **Ease of management:**

Each partner usually brings different areas of expertise to the business.

- **Lack of special taxes:**

Partners draw profits from the firm and then pay individual income taxes at the end of the year

- **Usually attract financial capital *more easily* than a sole proprietorship**
- **Slightly larger size = greater efficiency**

*Lawyers, doctors, accountants*

- **Usually attract top talent to their organizations**

# Demerits

- **Unlimited Liability:** Each partner is fully responsible for the acts of all partners
- **Limited Partnership:** The *limited partner* has limited liability
  - *Investor's responsibility for the debts of the business is* ***limited*** *by the size of their investment in the firm*
  - *If business fails with a large debt, the limited partner (investor) only loses their original investment, leaving the* ***general partners*** *to make up the rest*
- **Limited Life:** When a partner leaves or dies, the partnership **must** be dissolved and reorganized.
  - *The new partner may try to keep an agreement to keep its name*
- **Potential for Conflict:** "Why can't we all just get along?"

# Keys for success in partnership

- Keep profit sharing and ownership at 50-50
- Partners should have different & complementary skill sets
- Honest is critical
- Maintain face-to-face communications
- Transparency – sharing information
- Awareness of funding constraints and limited resources
- To be successful, you need experience
- Family is priority; limit associated problems
- Do not become too infatuated with “the idea” think implementation
- Couple optimism with realism in sales and growth expectations

# Company

A business that is chartered by a state and legally operates apart from its owners.

Owned by stockholders who have purchased units or shares of the company

# Major Legal Documents

## Memorandum of Association (MOA)

Constitution of company

## Article of Association (AOA) - Table "A"

Rules of the company

# Merits

- **Ease of raising financial capital**
- **Ease of finding professional managers**
- **Limited liability** for its owners
- *Corporation is **fully responsible** for its debts and obligations*
- **Unlimited life:** Corporation continues to exist even when ownership changes
  - Because the corporation is a legal entity, the **name** of the company remains the same, and the corporation continues to do business
- **Ease of transferring ownership:** If a shareholder no longer wants to be an owner, they can sell the stock

# Demerits

- **Difficult to get a charter**
  - *Depending on the state, attorneys' fees and filing expense can cost several thousand PKR*
- **Owners/shareholders have little say in business affairs** after voting for board of directors
- **Double Taxation:** Corporate profits
  - *Stockholders' dividends are taxed twice: once as corporate **profit** and again as **personal income***
- **Lots of Government regulation:**

# Trends in Business Ownership

*Merger*

- The combination of two companies (usually corporations) to form a new company

*Acquisition*

- The purchase of one company by another, usually by buying its stock and/or assuming its debt.

*Leveraged buyout (LBO)*

- A purchase in which a group of investors borrows money from banks and other institutions to acquire a company (or a division of one) using the assets of the purchased company to guarantee repayment of the loan.

# Going Public

- Don’t confuse “going public” with creating a corporation.
- When you offer the public investment in the corporation for the first time you are said to be “going public”
- This marks a significant change in the way a company will be operated and the obligations of the directors and officers.
- Rarely will happen at time of creation but can and occasionally does.

# Accounting

The art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least of financial character, and interpreting the results thereof

# Types of Accounting

### Financial accounting

financial reporting, is the process of producing information for external use usually in the form of financial statements.

### Management accounting

produces information primarily for internal use by the company's management.

### Governmental accounting

also known as public accounting or federal accounting, refers to the type of accounting information system used in the public sector.

### Tax accounting

refers to accounting for the tax related matters.

## Forensic accounting

use of accounting, auditing and investigative techniques in cases of litigation or disputes. Forensic accountants act as expert witnesses in courts of law in civil and criminal disputes that require an assessment of the financial effects of a loss or the detection of a financial fraud.

## Project accounting

refers to the use of accounting system to track the financial progress of a project through frequent financial reports.

## Social accounting

*Corporate Social Responsibility Reporting and Sustainability Accounting*, refers to the process of reporting implications of an organization's activities on its ecological and social environment. Social Accounting is primarily reported in the form of Environmental Reports accompanying the annual reports of companies.

# Accounting System

An **accounting system** is the **system** used to manage the income, expenses, and other financial activities of a business.

# Financial Statements

A financial **statements** (or **financial report**) is a formal record of the financial activities and position of a business, person, or other entity.

# Business Entity Concept

It means that personal transactions of owners are treated separately from those of the business.

**Examples**

- A CA has 3 rooms in a house he has rented for PKR 3,000 per month. He has setup a single-member accounting practice and uses one room for the purpose. Under the business entity concept, only 1/3rd of the rent or PKR 1,000 should be charged to business, because the other 2 rooms or PKR 2,000 worth of rent is expended for personal purposes.
- The CA received PKR 900 bill for utilities. He paid the whole amount using his business account. PKR 600 is to be considered a withdrawal because only PKR 300 (1/3rd) related to business and the other $600 was for domestic purpose.
- Assuming each public accounting business is required to pay PKR 100 to a local association of CPAs each month. If the CPA pays that amount from a personal bank account the amount shall be considered additional capital.

# Financial Reporting

**Financial reporting** includes the following:

External **financial** statements

1. balance sheet,
2. income statement,
3. statement of cash flows, and
4. statement of stockholders' equity
5. notes to the **financial** statements.

Press releases

Conference calls regarding quarterly earnings and related information.

# Regulations for Financial Reporting

## GAAP

**GAAP** (generally accepted accounting principles) is a collection of commonly-followed accounting rules and standards for financial reporting.

## IFRS

**International Financial Reporting Standards** (IFRS) are designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries.

# Components of Financial Statements

A full set of financial statements would include the following:

1. a statement of financial position;
2. a statement of comprehensive income;
3. a statement of changes in equity (not in this syllabus);
4. a statement of cash flows (not in this syllabus) and
5. notes to the financial statements (not in this syllabus).

# Users of Financial Statements

- Investors
- Lenders
- Suppliers
- Government
- Employees
- Customers
- Managers

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# Business Transaction

A business transaction is an interaction between a business and customer, supplier or any other party with whom they do business.

It is an economic event that must be recorded in the business's accounting system.

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# Classification of business transactions

1. Simple transactions and complex transactions
2. One-off transactions and ongoing transactions
3. Capital transactions and revenue transactions

# Capital & Revenue Expenditure

A distinction is made between 'capital' and 'revenue' items:

- Items of a **long-term nature**, such as property, plant and equipment used to carry out the operating activities of the business, are 'capital items'.
- Items of a **short-term nature**, particularly items that are used or occur in the normal cycle of business operations, are 'revenue items'.

# Capital Expenditure

Capital expenditure is incurred when a business spends money either to buy non-current assets or add to the value of an existing non-current asset.

Included is:

- Buying the asset and bringing it into the business
- Any associated legal costs
- Carriage inwards
- Any costs needed to ready the asset for use
    1. Acquire an asset and bring it into working condition
    2. Improve the efficiency or substantial working life of the asset
    3. Improve the performance of the business

# Revenue Expenditure

Revenue expenditure is expenditure incurred in running the business on a day-to-day basis.

Examples

1. Repairs of furniture
2. Painting of building
3. Purchase of stationery
4. Salaries

# Differences between capital and revenue expenditure

| Expenditure | Types of Expenditure |
|---|---|
| Buying Van | Capital |
| Petrol costs for van | Revenue |
| Repairs to van | Revenue |
| Buying machinery | Capital |
| Putting extra headlights on van | Capital |
| Electricity costs of using machinery | Revenue |
| Painting outside of new building | Capital |
| We spend PKR 1500 on machinery: PKR 1000 was for an item (improvement) added to machine & PKR 500 for was repairs | Capital PKR 1000<br>Revenue PKR 500 |

# Incorrect treatment of expenditure

If expenditure is treated incorrectly and classified wrongly, whether revenue as capital or capital as revenue, then both the income statement and statement of financial position figures will be wrong.

# Revenue income & capital receipts

**Revenue income** is income arising from the normal operations of a business from its investments.

Examples include:

- Revenue from the sale of goods.
- Commissions and fees received and receivable from the provision of a service.
- Interest received and receivable from savings.
- Rent received and receivable from letting out property.

Revenue is reported in the statement of profit or loss in the statement of comprehensive income.

- **Capital receipts** are receipts of ‘long term’ income, such as money from a bank loan, or new money invested by the business owners (which is called ‘capital’).
- Capital receipts affect the financial position of an entity, but not its financial performance. Capital receipts are therefore excluded from the statement of comprehensive income.