
Accounting Is a Kid's Game

INTRODUCTION TO THE DYNAMICS OF
FINANCIAL STATEMENTS



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Ada - Appui au
Développement
Autonome

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Introduction to the Dynamics of Financial Statements
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Introduction

We all carry out economic activities; we earn money, buy, invest, take loans, repay our debts or at least try to do so. But we do not always know the exact value of our net assets, our income or our expenditure.

Accounting helps us to manage these operations. Lack of accounting knowledge is akin to being illiterate in the world of money management. Accounting is necessary for decision-making, managing a household or job, and for reporting on monetary operations involving other people's money or our own.

This is a web version of a book prepared by ADA (Appui au Développement Autonome), a Luxembourg based NGO, and Alternativas, an NGO based in Mexico. ADA supports microfinance institutions in developing countries and helps to promote better financial management by microentrepreneurs. Alternativas is a non-profit private institution that promotes the development of the poorest rural population through water projects, agro-industrial cooperatives and development finance, with an educational approach.

The authors have set out to demystify accounting and to convey an understanding of the usefulness of basic accounting instruments by showing how they are produced and how they are to be interpreted through the eyes of children.

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1. What is a Financial Statement?

When we want to know the state of our personal health, we go to a doctor, who gives us a physical check-up.

The doctor examines us and does some tests, then gives us the results, which shows us the state of our health.



Similarly, to know the state of our business's economic health, we go for a check-up which tells us its financial statement.

The financial statement is presented through two main documents:

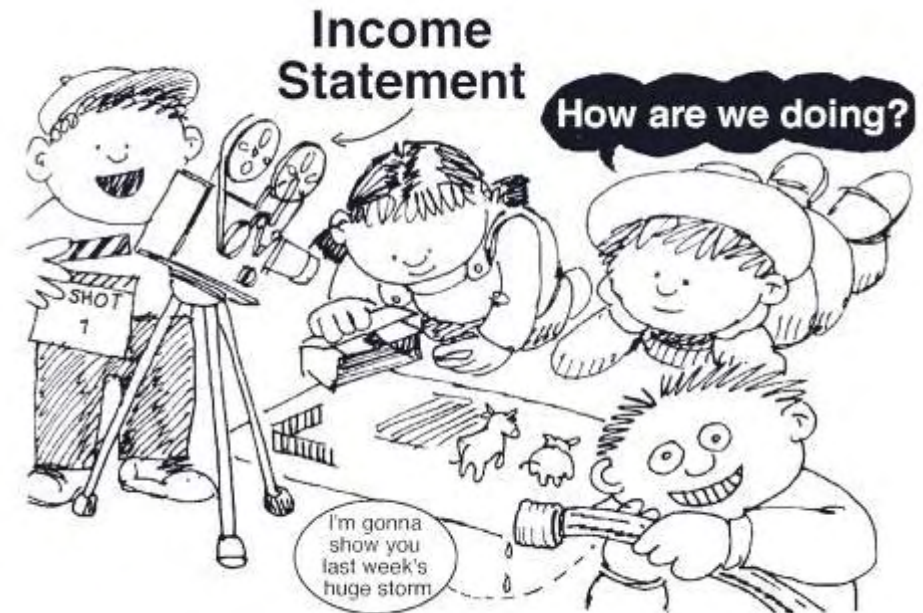
- The Balance Sheet and
- The Income Statement

The Balance Sheet is the document that shows us all the things we work with in our business.



It is like a photograph taken at a specific time that shows what resources we have built up since we began.

The Income Statement, also known as the Profit and Loss Account, is the document that tells us what we have managed to obtain through the work of our business.



It is like a film telling us what we have gained and what we have spent during a certain period of time. It also gives us the "bottom line" - how much we are making or losing.

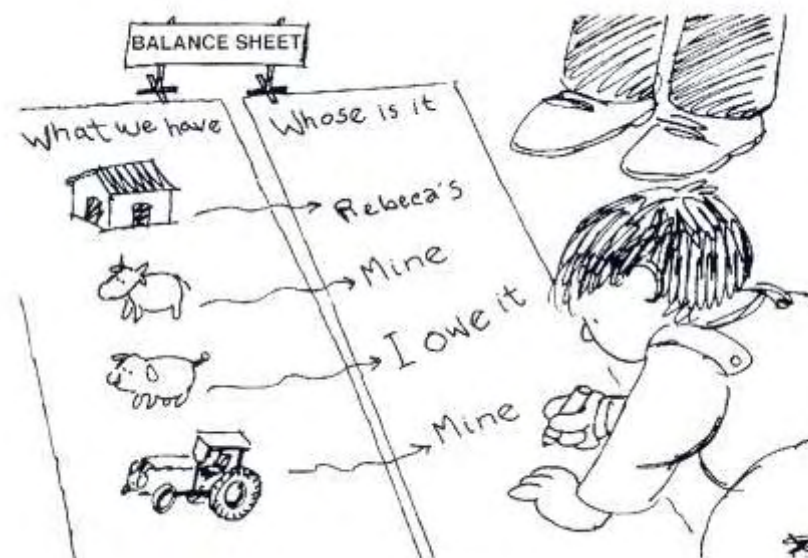


These two documents, the Balance Sheet and the Income Statement, are complementary and must be analysed together. In this way we will be able to understand their inter-relationship as well as the general financial situation of our business.

If we understand the Financial Statement of our business, we can make appropriate economic decisions.

2. The Balance Sheet

The balance sheet has two columns to show us all the things we work with:



In the left-hand column we are going to record what we have and how much it is worth.

In the right-hand column, we will record who owns what we have.

We are going to imagine these columns as filing cabinets.



We refer to all we have as assets; that is, all the things we work with and which we use.

Our assets could be money, land, animals, machinery, equipment, facilities, etc.





But who finances all these things? Who do these assets belong to?

All that we have has an owner - it is either ours or someone else's.



Everything that belongs to someone else - what we owe, our debts, everything that is not ours - is a Liability.

All that is ours - what we own - we call Equity or Net Capital.

As everything has an owner, the total in the assets column should be equal to the sum of Liabilities plus Equity; and that is why it is called a Balance Sheet - because the two columns are balanced.

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Balance Sheet

What we have

ASSETS

CURRENT

WHAT WE TRADE

FIXED

WHAT WE USE TO WORK WITH

DEFERRED

ADVANCE PAYMENTS

Whose is it

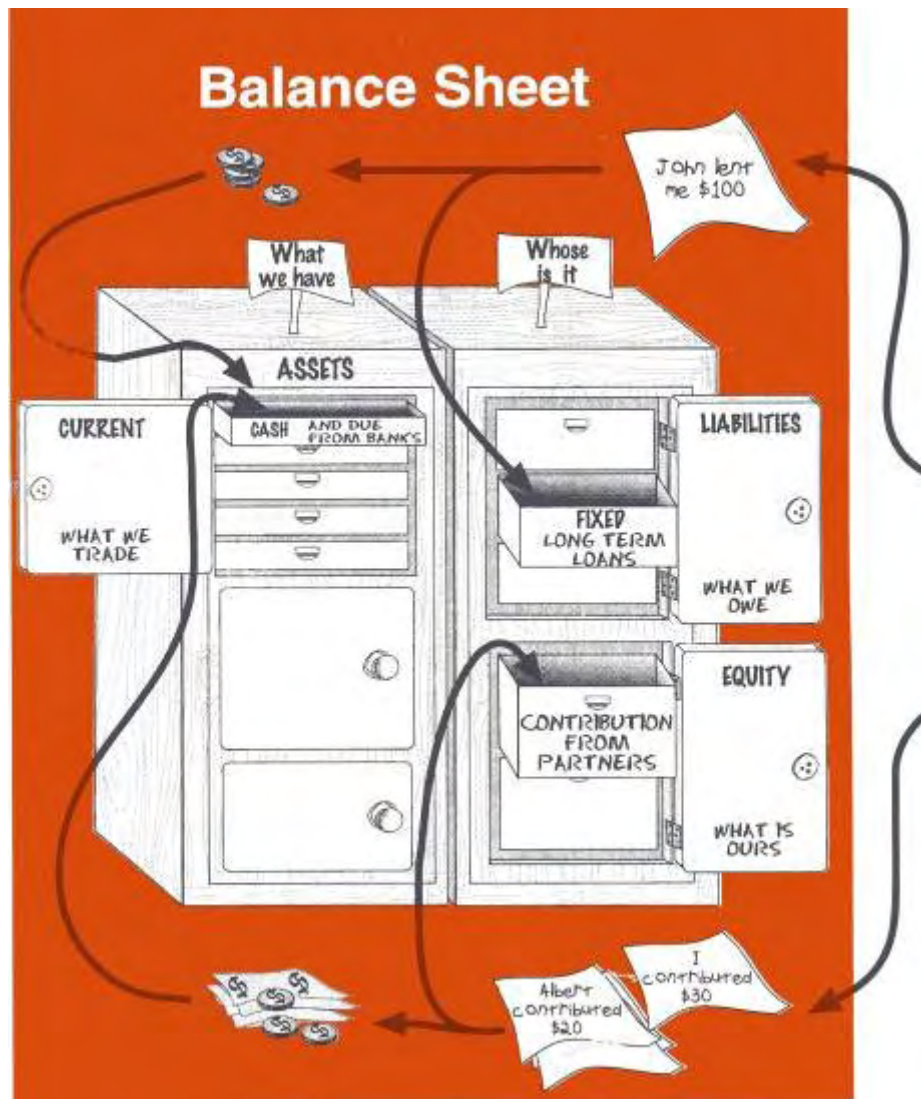
LIABILITIES

WHAT WE OWE

EQUITY

WHAT IS OURS

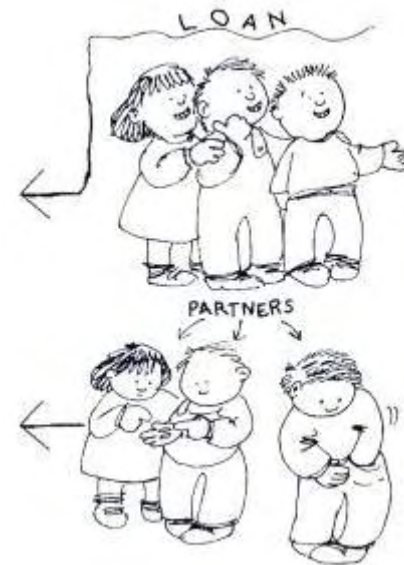
ASSETS **EQUAL TO** **LIABILITIES PLUS EQUITY**



3. How to start accounts in a business

Let's pretend we are starting a business enterprise with our friends.

Step 1: Acquiring funds



Initially there are two basic ways to acquire funds:

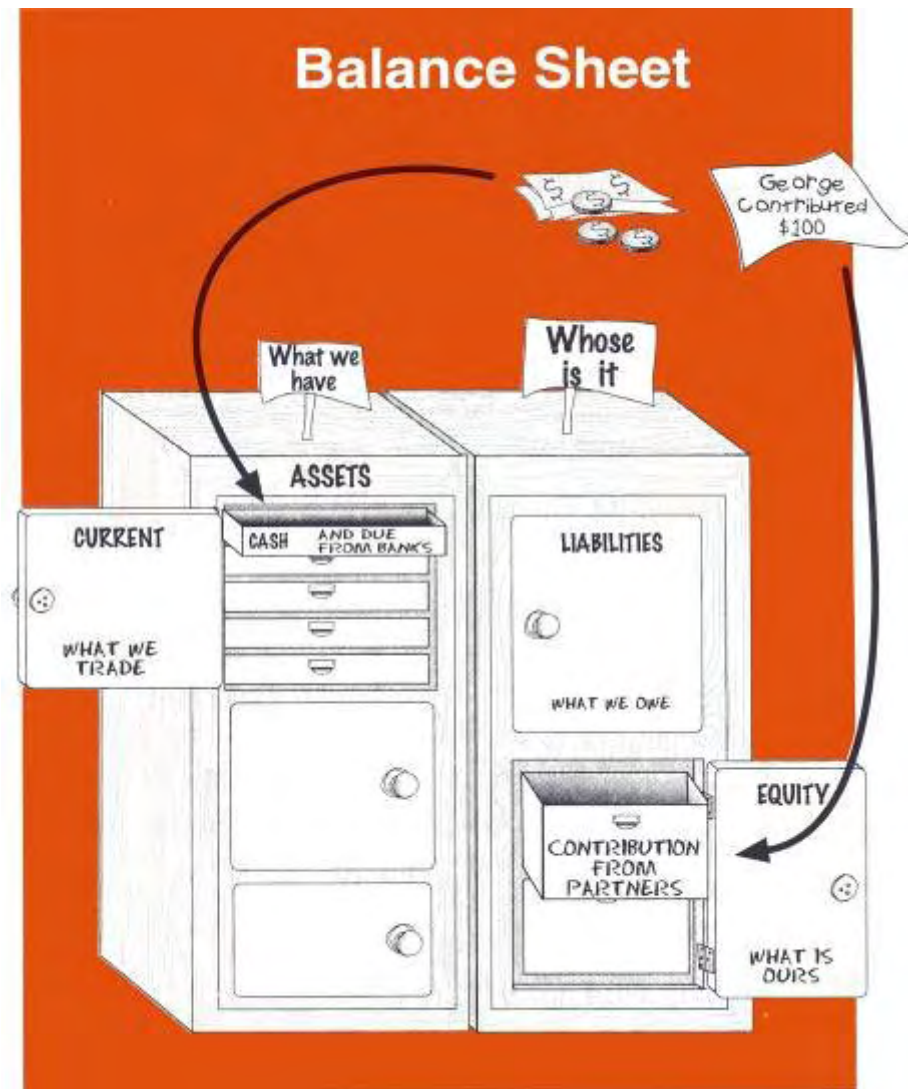
- 1) either we get a loan or
- 2) we, the associates, put up our own money as a capital contribution.

If we get the funds in the form of a loan, then we record them under Liabilities.

If we get them in the form of a contribution from our associates, then we record them under Equity.

When the funds are received, we enter them under Current Assets, as cash and due from banks.

CURRENT ASSETS include things that are in circulation in our business, like money and goods.



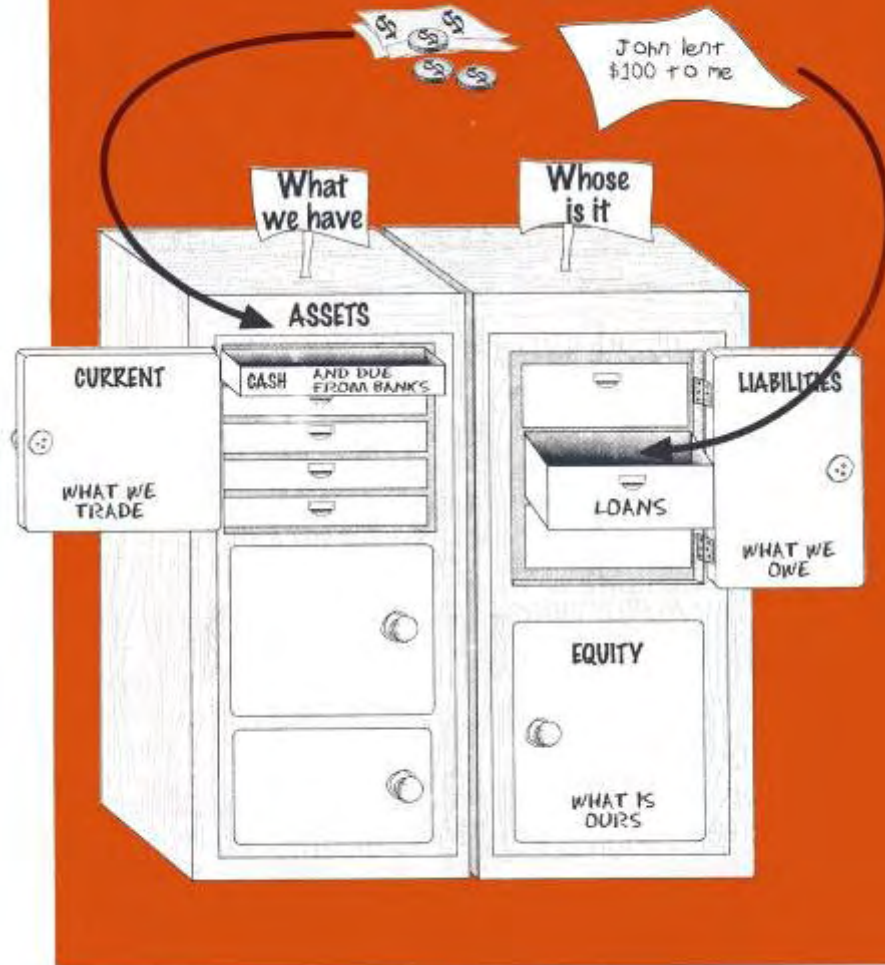
All economic transactions are entered twice: once to show where the money went and once to show where it came from, like the two tips of an arrow.



In order to become owners of a business, the partners must make capital contributions. This information is recorded in these two places:

1. in Current Assets - cash and due from banks; this is where the money is, and
2. in Equity - contribution from partners; which shows where it came from.

Balance Sheet



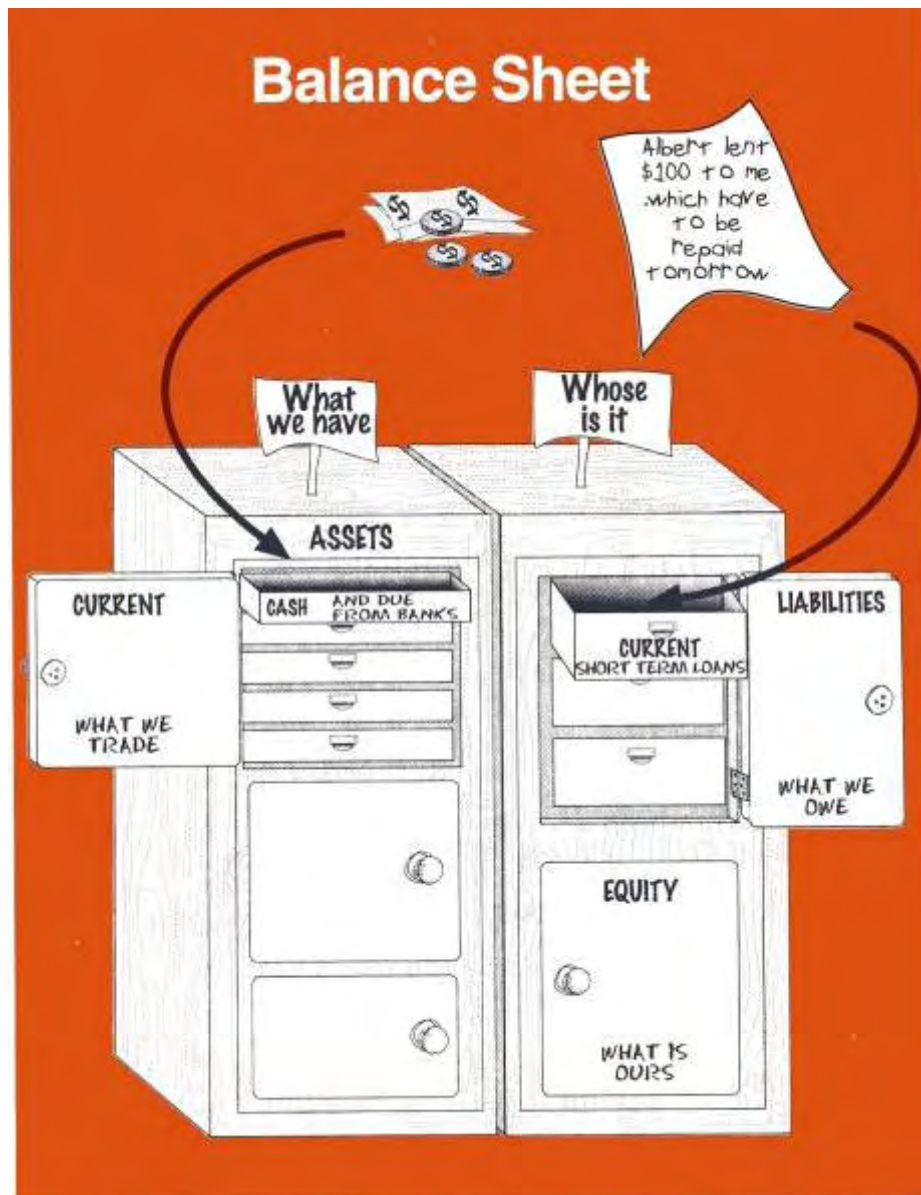
If it is not possible to get enough contributions from partners for the production projects, we need to get a loan.



Loans are recorded like this:

1. in Current Assets - cash and due from banks; where the money is deposited, and
2. in Liabilities - loans; which tells us where it came from.

In this way we can answer two questions: "where is the money?" and "how much do we owe people?"



Not all loans are the same.

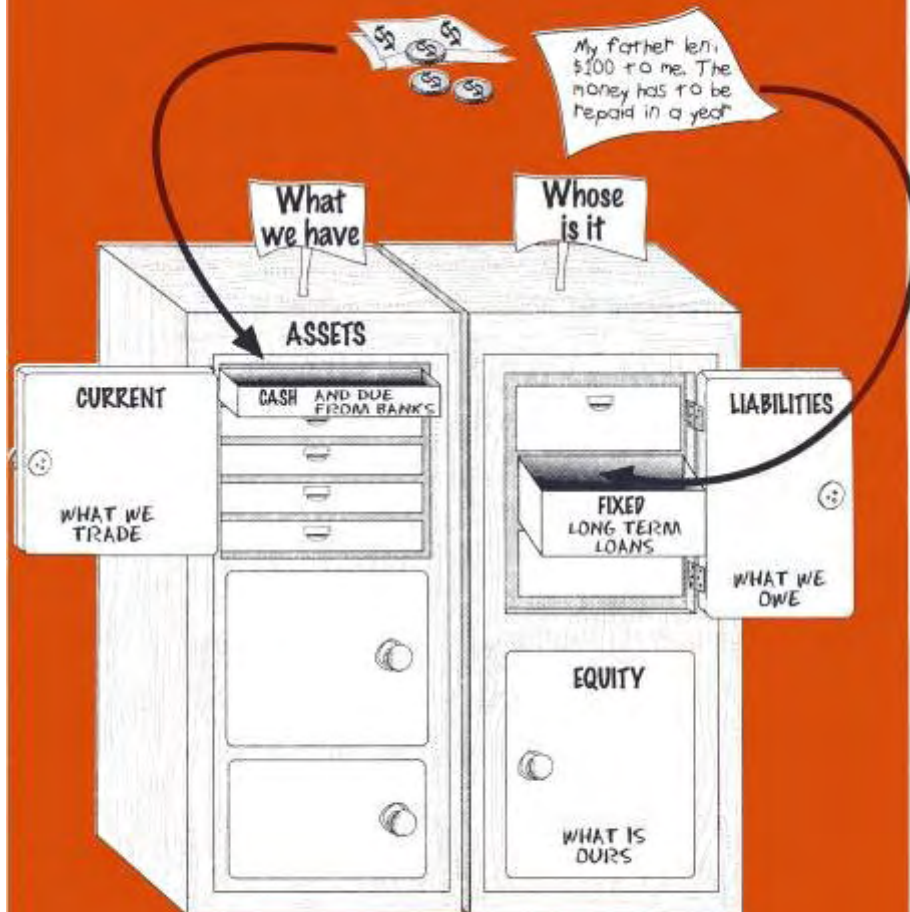


Short term loans are those we have to repay in the same production cycle - usually in a year or even less; and they are recorded as current liabilities.

An example of a short term loan is an agricultural loan for working capital such as seeds or fertiliser.

Short term loans can be granted by a bank, a supplier or even a partner in the business.

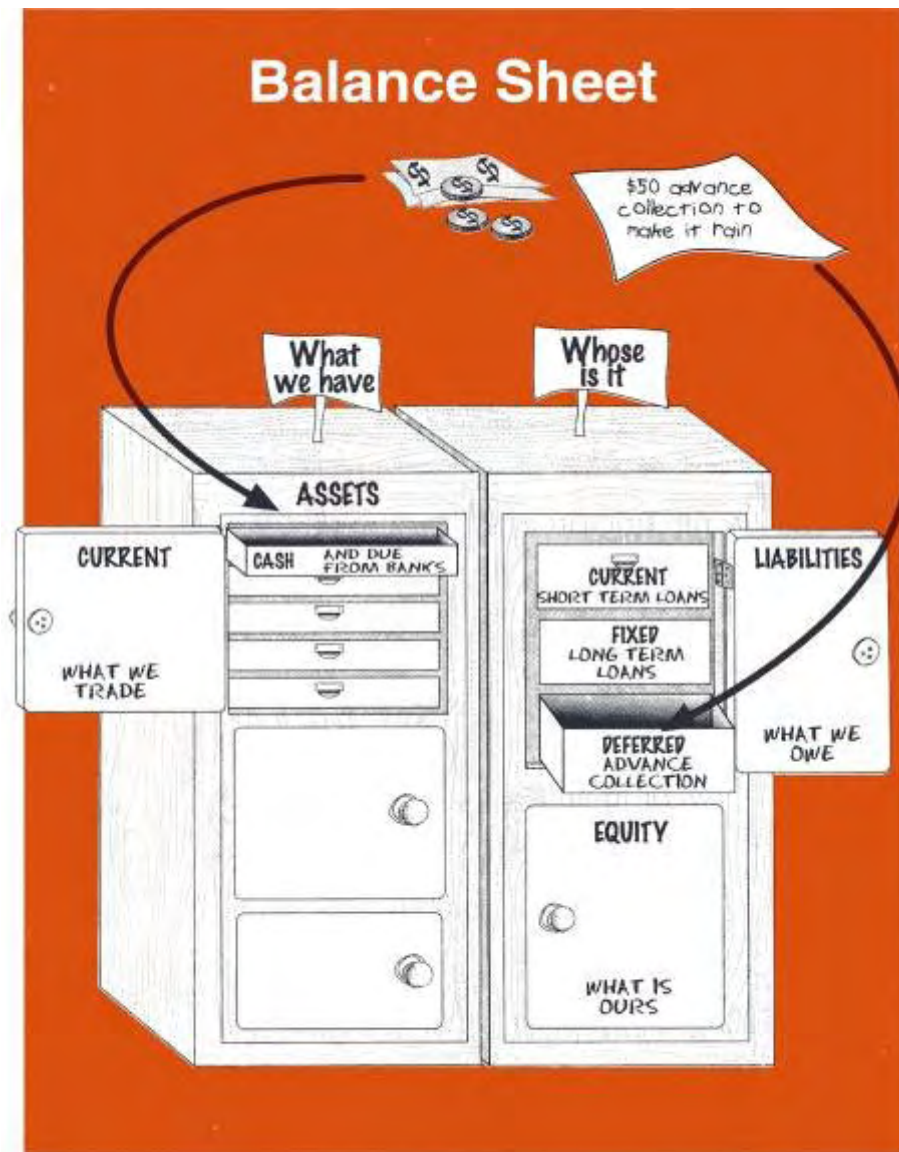
Balance Sheet



Long term loans which have to be repaid in a different production cycle are referred to as fixed liabilities or long term debt.



An example of a long term loan is an agricultural loan with which we purchase machinery or equipment. This has to be repaid over a number of years.



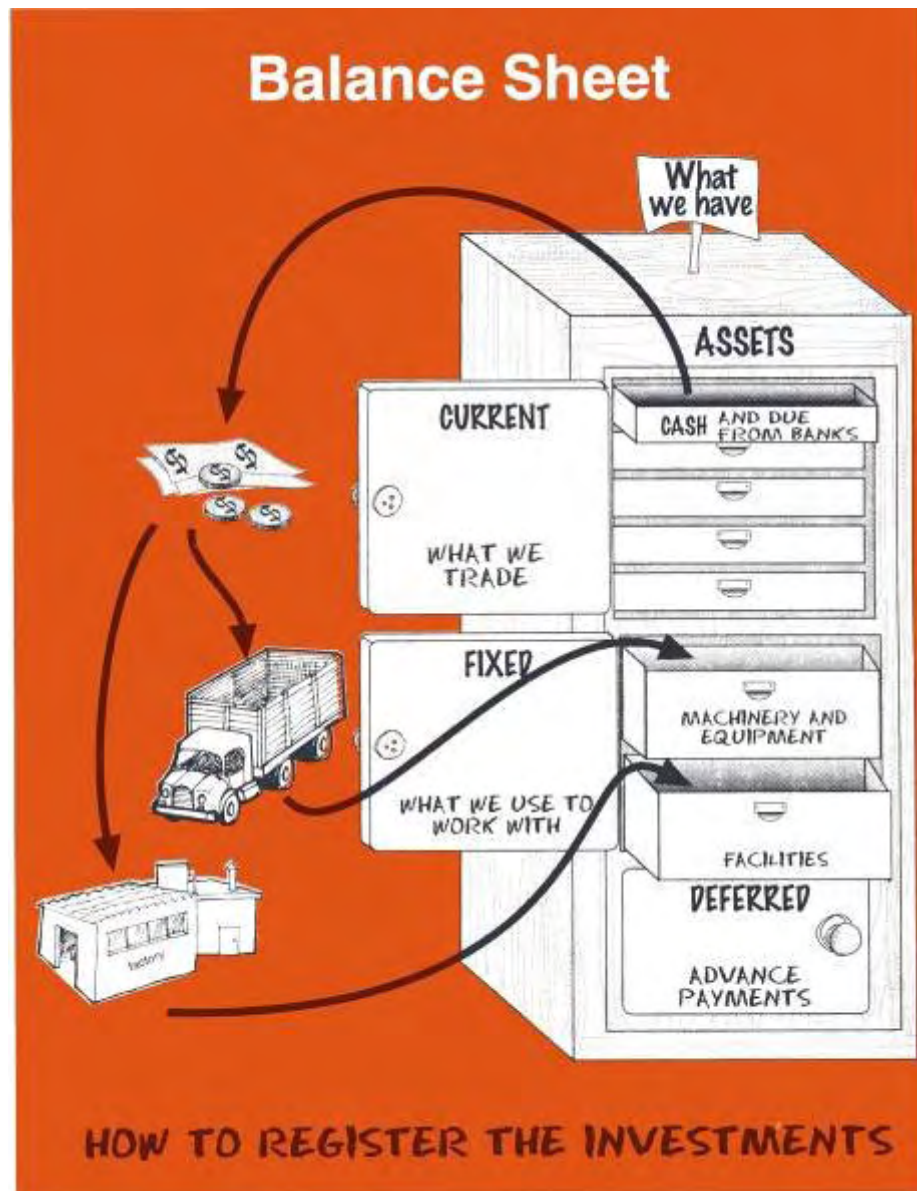
Another way of getting money is to charge in advance for products not yet delivered and services not yet provided.

For example, we may demand advance payment of rent for something or we may ask a client to pay in advance for some products he has ordered from us.

We can use the money of an advance payment when we get it but it is not really ours because we still have not earned it. That is why we consider it a debt until we deliver the products or the services for which we have been paid.

These advance payments are called deferred liabilities. They differ from other liabilities because we do not pay them off in cash but in goods and services.





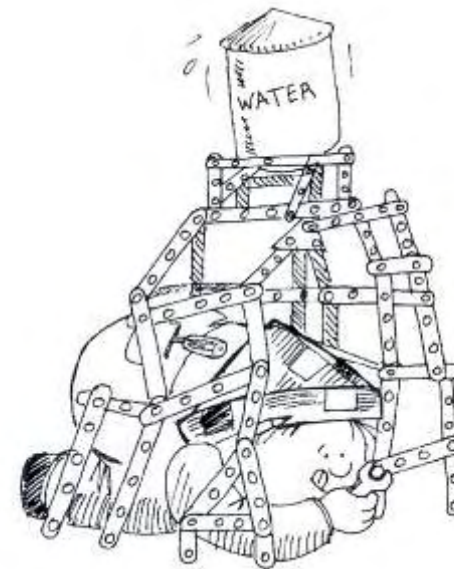
Step 2: Setting up the enterprise

When we have some money we can begin to invest.

To prepare for production we invest money in things we need in order to produce.

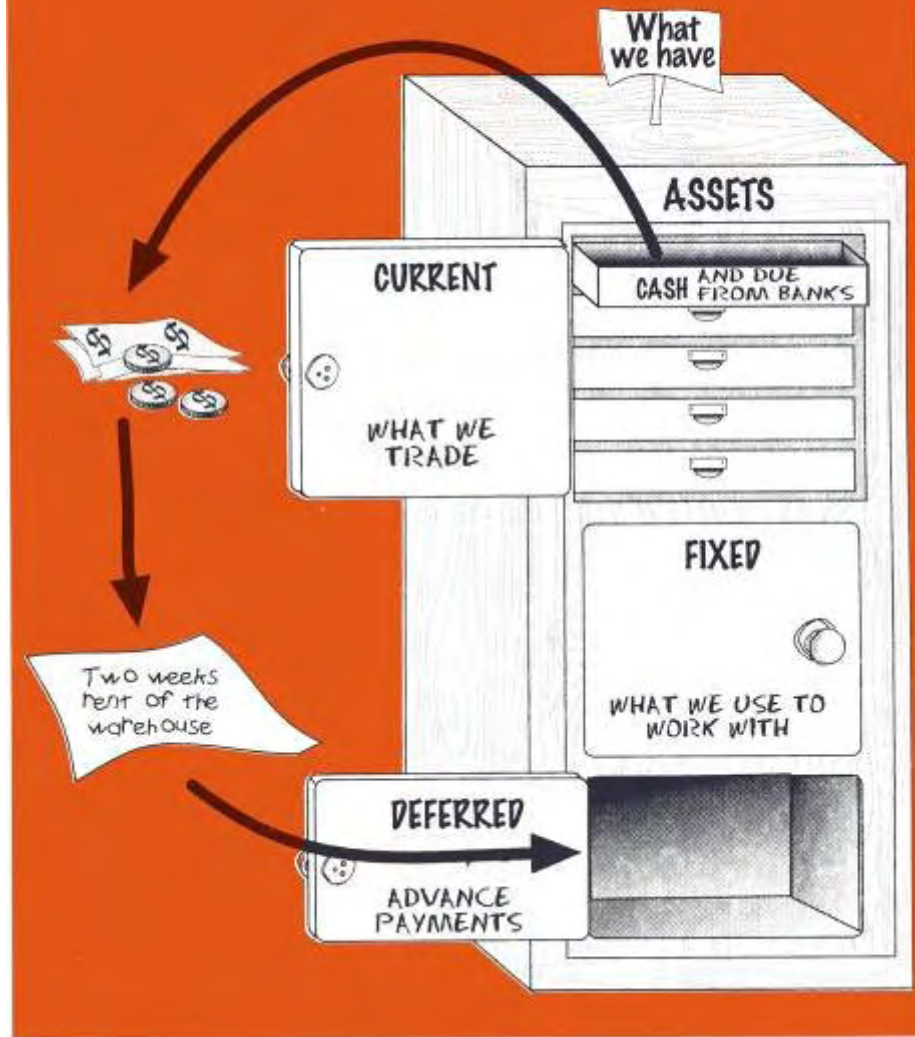
We invest in machinery, equipment and facilities, things that usually last a long time; these are called fixed assets.

Fixed assets are bought with the idea of working with them, not with the idea of selling them, although this does not mean that they cannot be sold. These investments in fixed assets give us production capacity.



We record these investments in fixed assets - the machinery or the facilities account - and we record the withdrawal of money from the cash account.

Balance Sheet



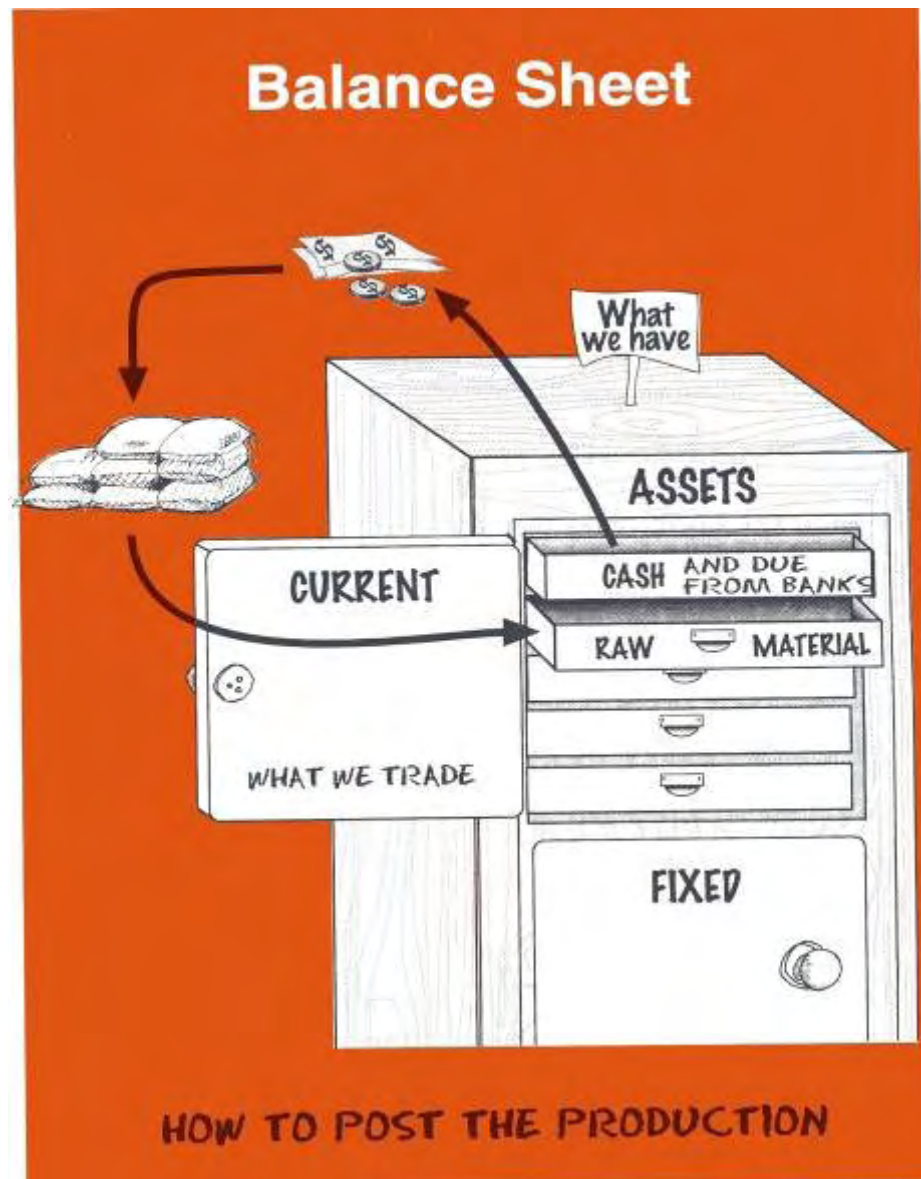
Sometimes it is not convenient to buy facilities or equipment because it takes a lot of money and we prefer to rent; and sometimes we are asked to pay in advance the rent of several months.

We refer to the payments we make in advance as deferred assets.

When we make these advance payments, we have not really spent all the money; it is spent little by little, as time goes by, but the disbursement takes place in a single moment. So it is still an investment that we must record as an asset.

We record the advance payment as a deferred asset and note the withdrawal of funds from the cash account.





Step 3: Starting production

When we are ready to start production, we invest some of the funds in raw materials, taking them from the available funds in the cash account and due from banks.

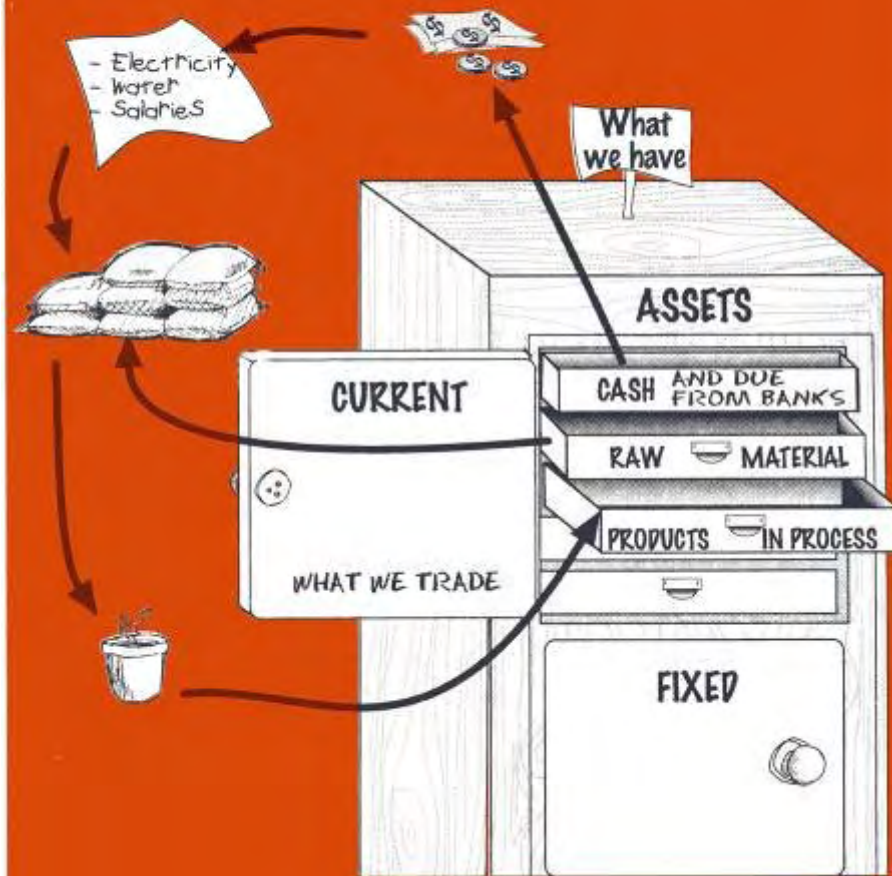
This transaction is a withdrawal of funds to invest in raw materials. Withdrawing money is not the same as spending money.

The money is not spent, it is invested. If we want to recover the funds, we could sell the raw materials.

Withdrawals can be made for investment purposes or spending purposes. If it is possible to recover our money in the future, we are making an investment, not an expense.



Balance Sheet



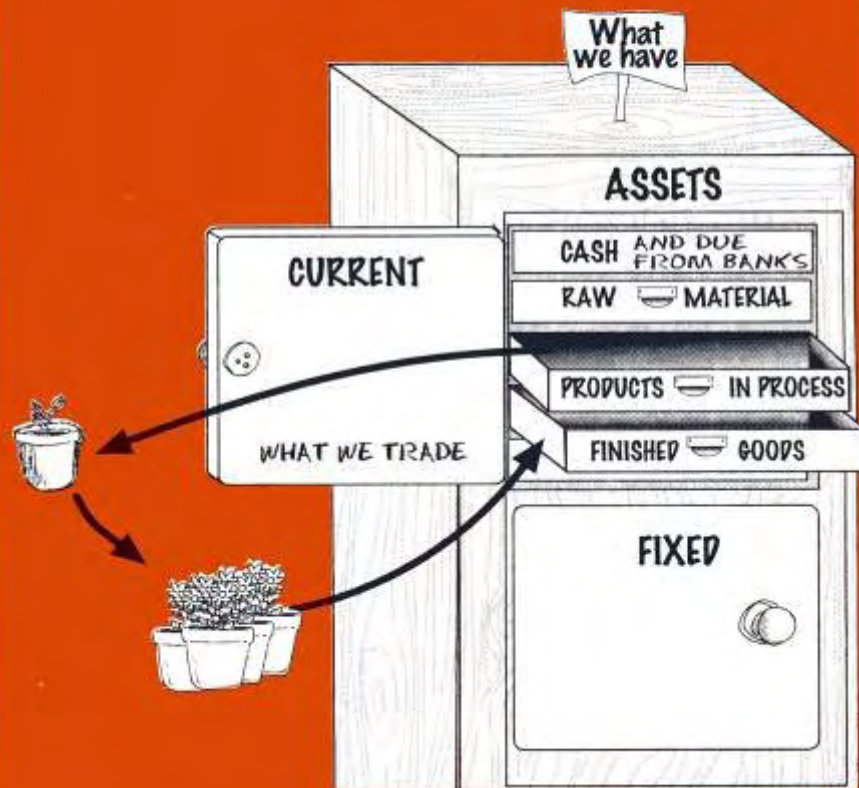
Now we begin the process of producing goods to sell, using raw material, labour and inputs such as water, fuel, light, etc. That means we will have goods in various stages of production.

In an agricultural business, our goods in production will be growing crops, animals or trees.



Goods in production are also an investment - the money is not spent, because we will recover it later by selling our goods.

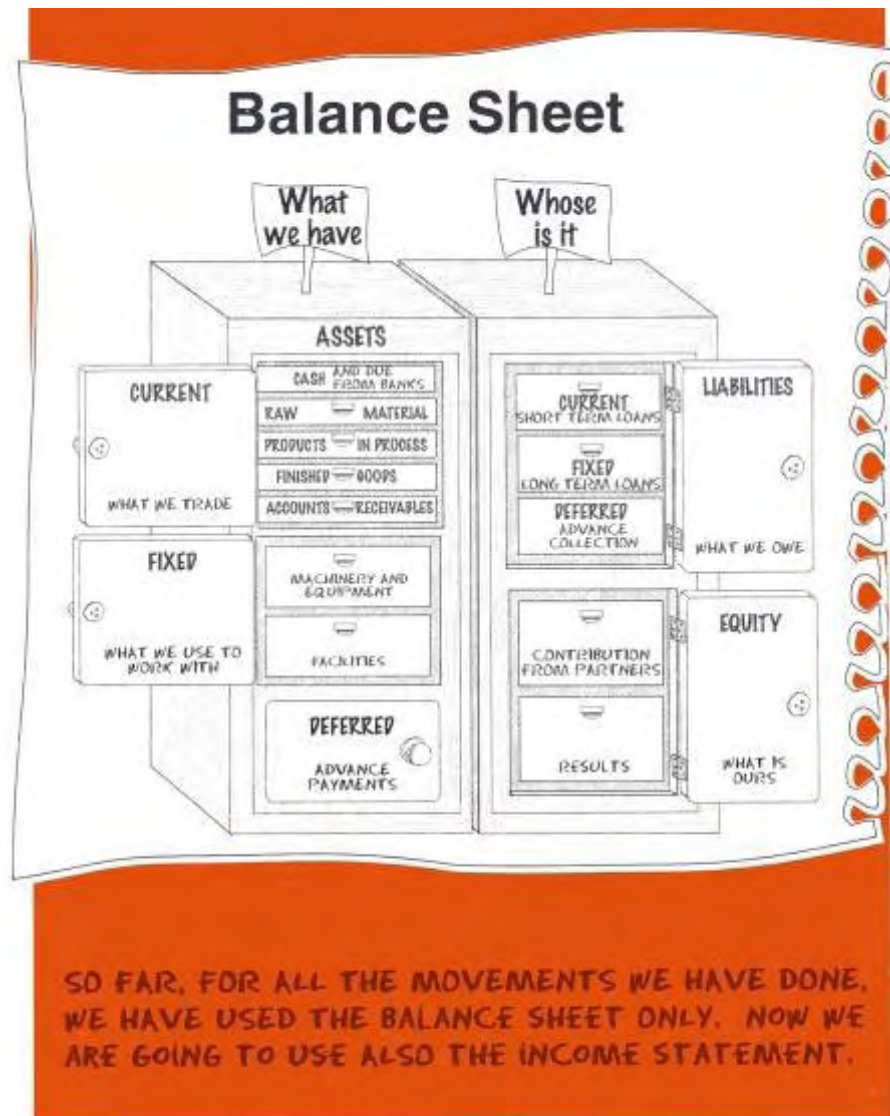
Balance Sheet



When we have finished production, we place our finished goods in the commodity warehouse.

Our finished goods could be harvested grain, eggs, flowers, fruit, milk, etc. which are ready for sale.





4. The Income Statement

The owners of a business may have various objectives.

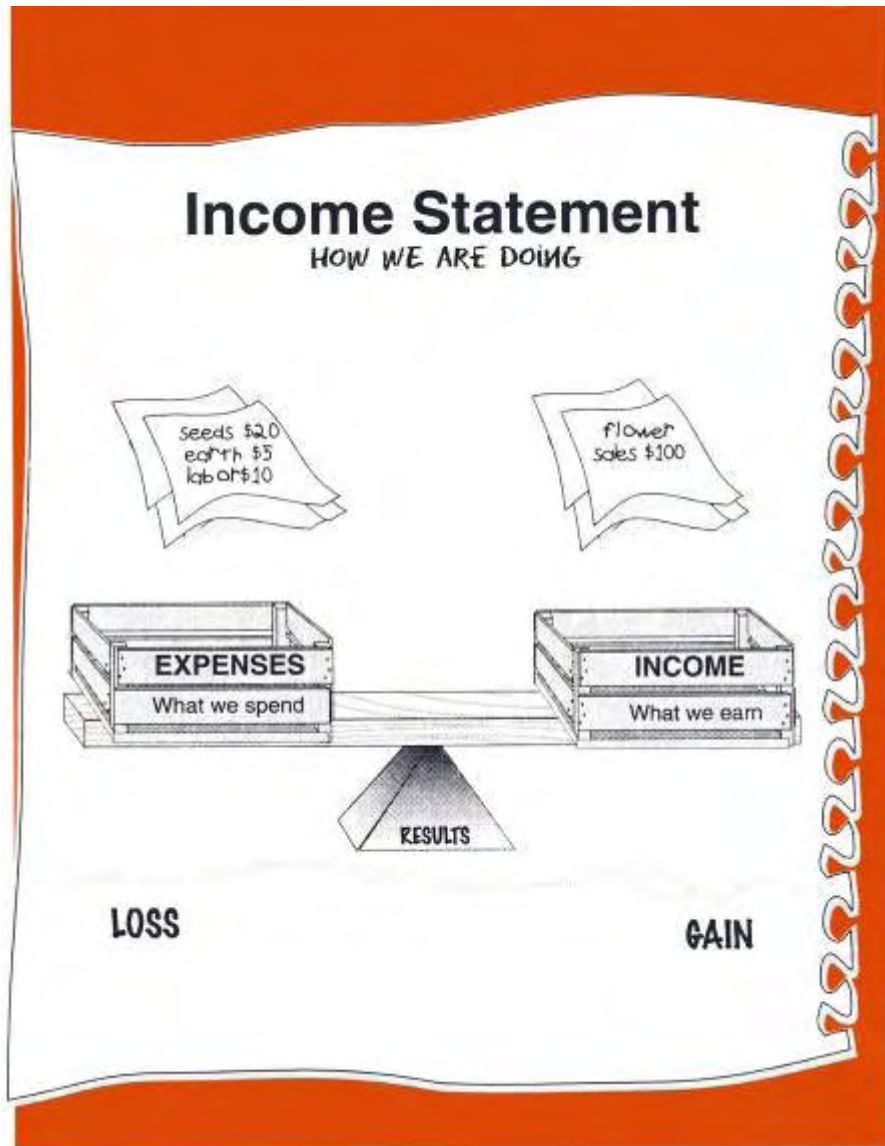
They may have a social objective in terms of the service they provide to society, e.g. producing food or creating productive employment.

They are sure to have an economic objective, however, to generate profits and earn sufficient money to enable the business to survive and grow.



We can see whether we have achieved our economic objectives for our business in the Income Statement - how much we are earning or losing.

That is why it is sometimes called the profit and loss account.



Our economic results depend on how much we are earning and how much we are spending.

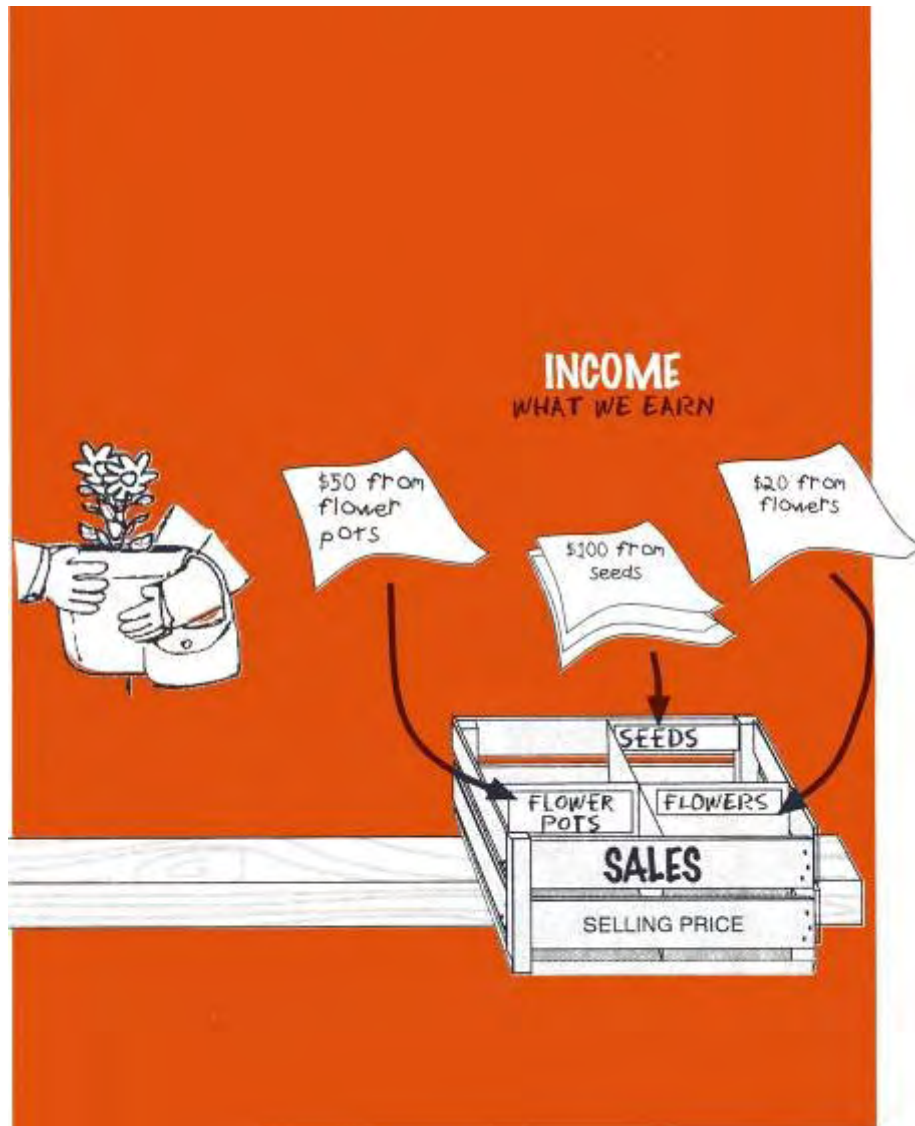
- Income is what we earn.
- Expenses are what we spend.

The result is what is left when we subtract what we spend from what we earn.



When we earn more than we spend, the result is a gain or profit.

When we spend more than we earn, the result is a loss.

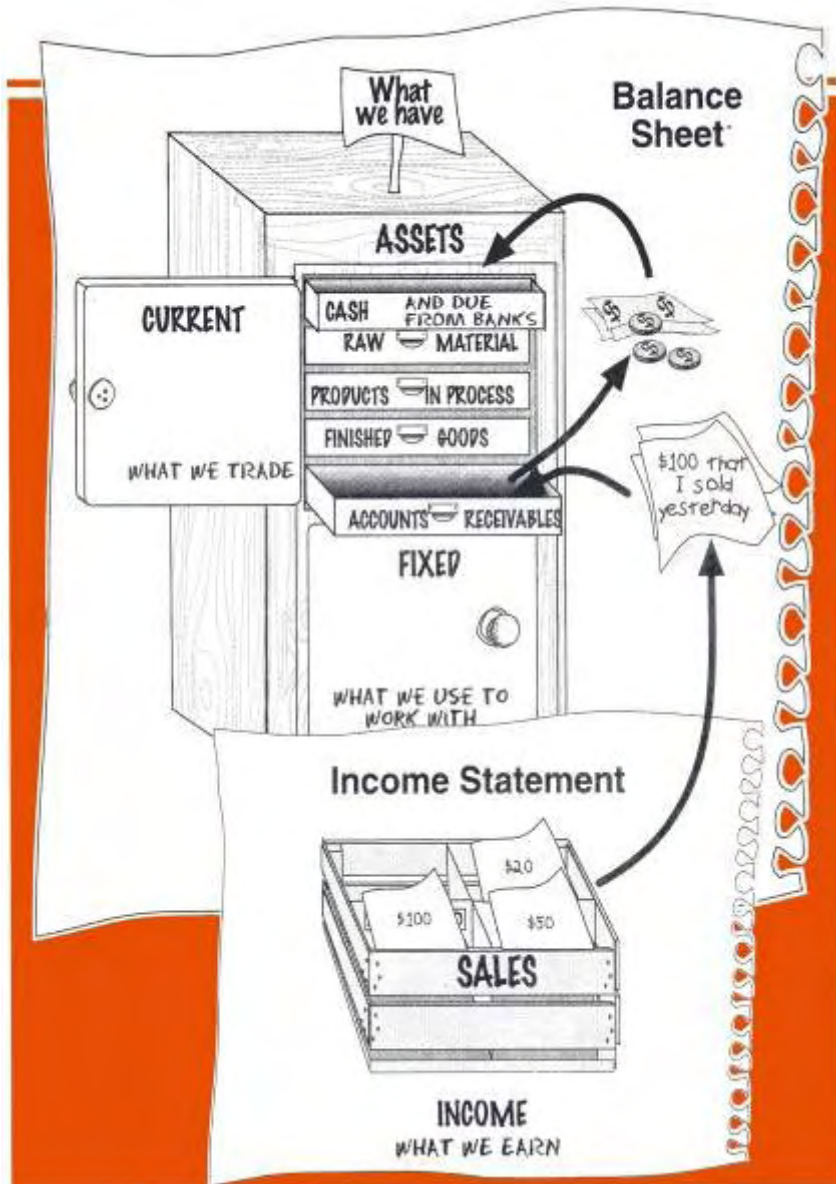


Our main income originates from the sale of our products. When we sell our products, we record the amount we sold in the section for income, without caring if the sale was on cash or credit terms.



We can separate the records of what we have sold according to the different types of product. This helps us to see what we sell more of, e.g. flowers, cereal or feed for animals, for example.

We record what we sell and the price at which we sell it, which is called the selling price.



When we sell, we record the amount in the customers' accounts receivable so that we know how much we have sold to each person.

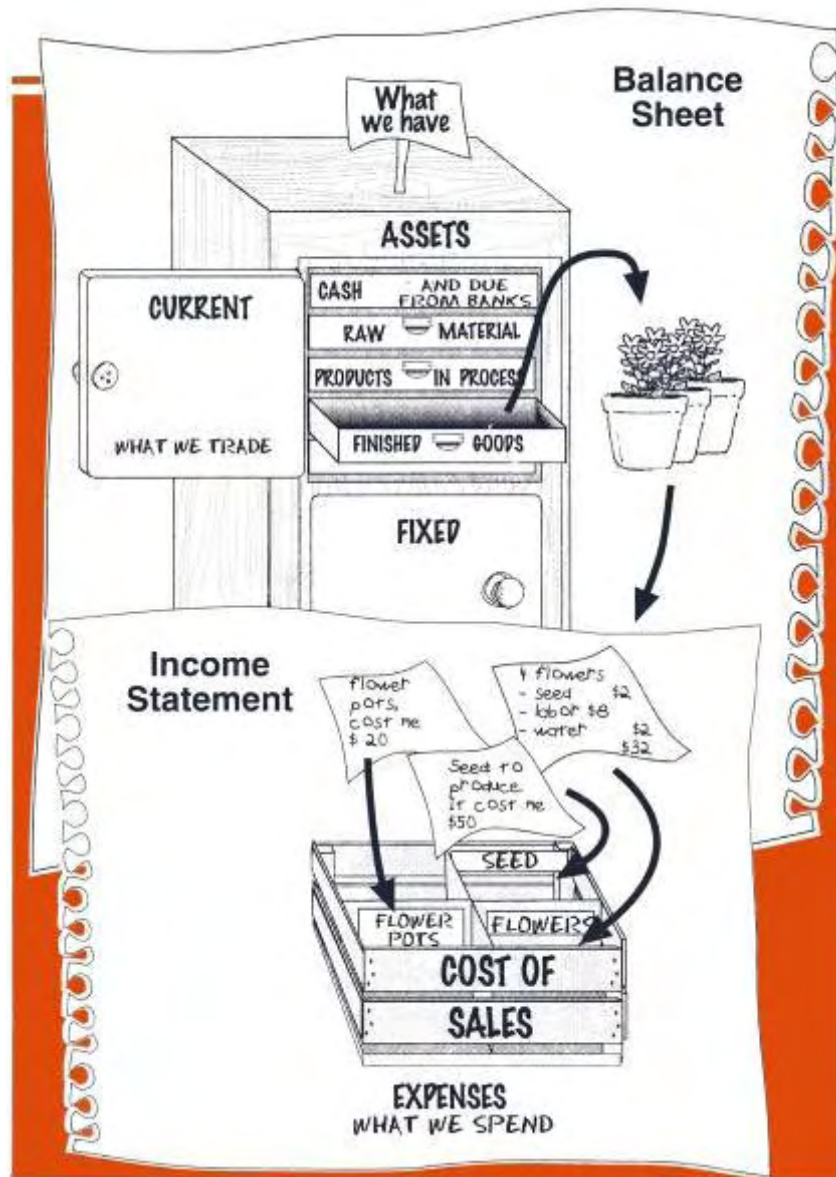


This is always done whether the sale is a cash sale or a credit sale. In this way we can easily tell how much we have sold to each client.

When the client pays us, the money is recorded in the cash account.

If the sale is a cash sale, the money goes immediately into the cash account. If it is a credit sale, the money will arrive later.

The balance of the customers' accounts receivable tells us at any moment how much each person owes.



When we sell, the goods leave our warehouse and are delivered to the client, so we must deduct the amount sold from the inventory of finished products.

At this point we should know how much the production of the goods cost us; in other words, the amount we have invested in the product. We call this the cost price.

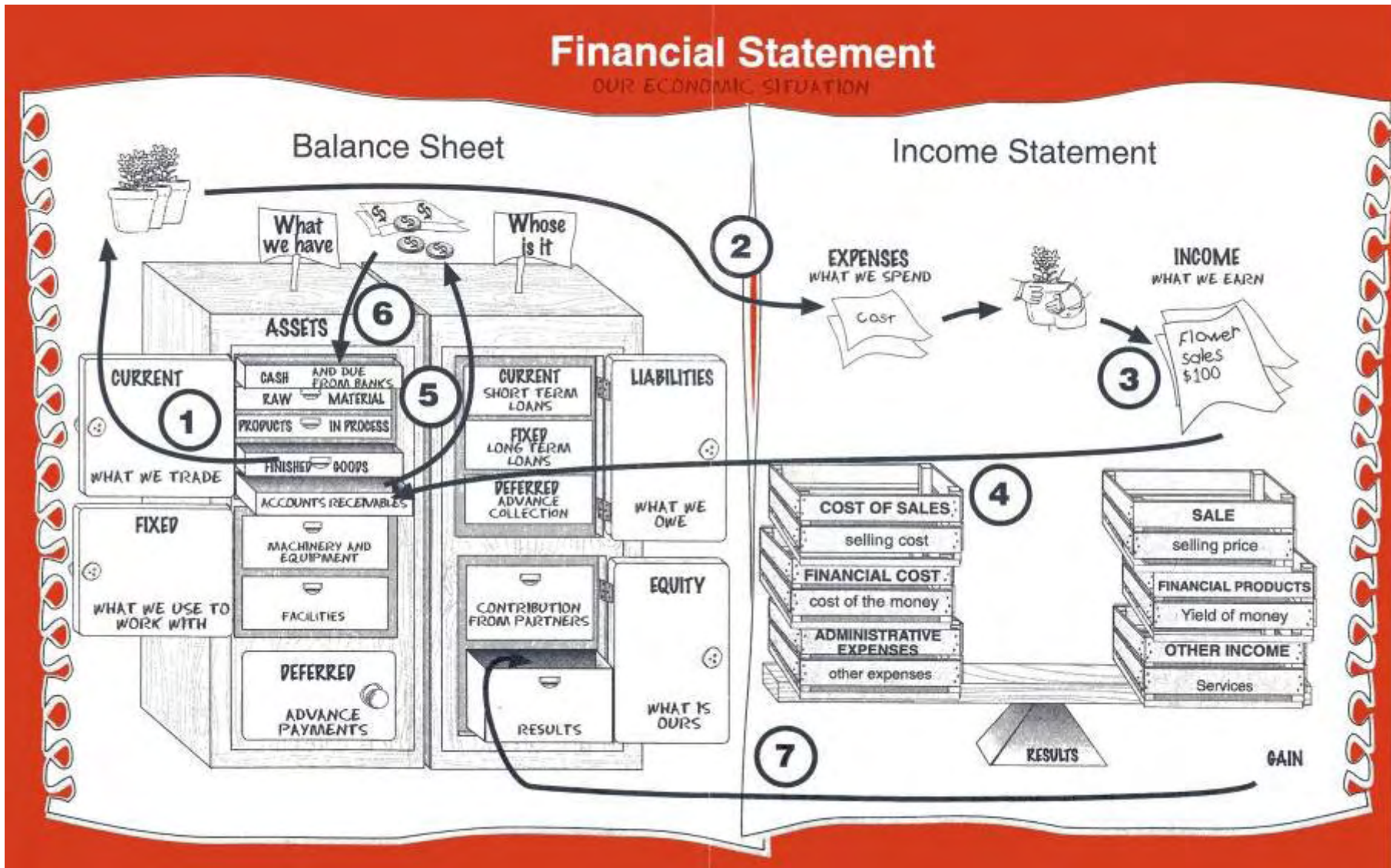
So in the income statement under expenses we record what we sell and the cost price.

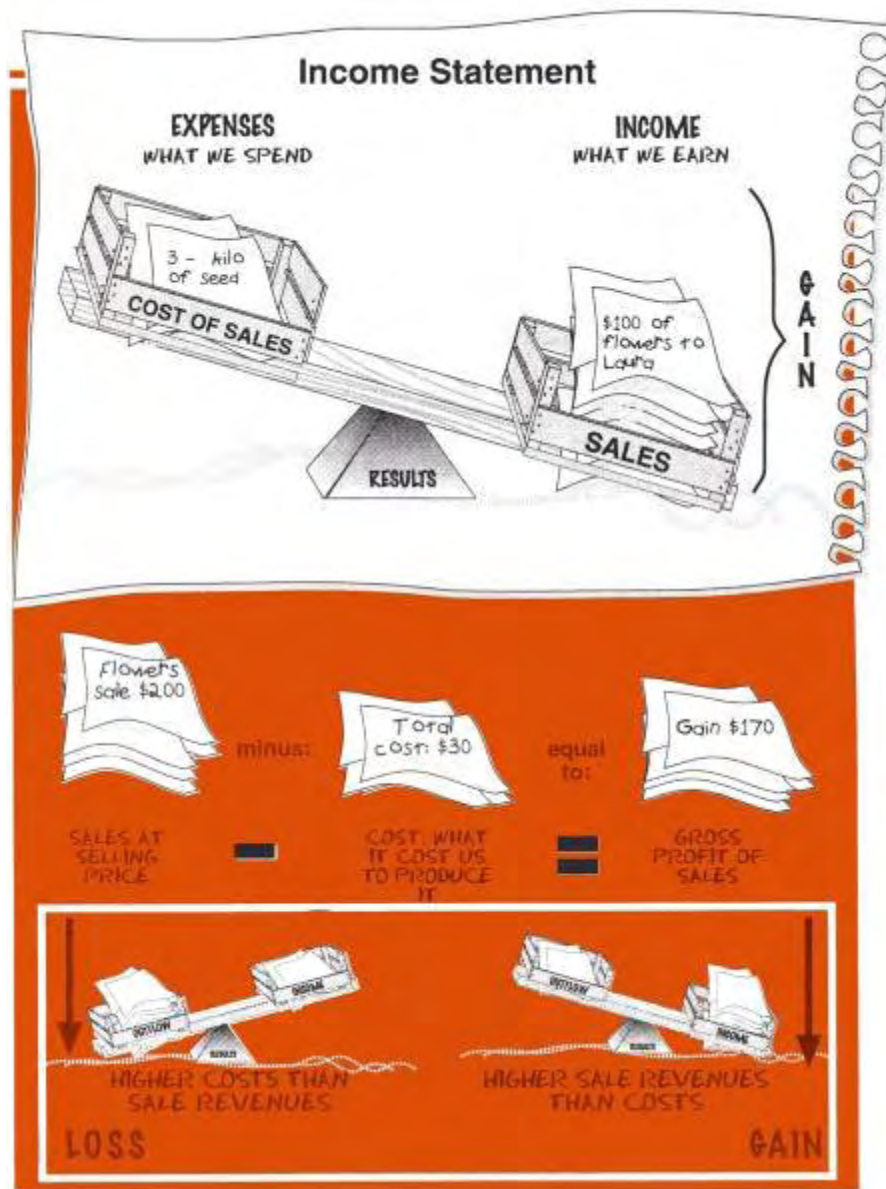
On the next page you can follow the complete sequence of movements when something is sold:

1. The product is withdrawn from the stock of Finished Goods.
2. The value of the product is recorded at cost price in Expenses.
3. The sale is recorded in Income at the sales price.
4. The sale is also recorded in customer's Accounts Receivable.
5. When the client pays, the debt is withdrawn from Accounts Receivable and
6. The money inflow is recorded in the Cash Account.
7. At the end the difference between sales price and cost price should yield a profit in the Income Statement, which will increase our equity in the Balance Sheet.

Financial Statement

OUR ECONOMIC SITUATION





The difference between what we got for what we sold and what it cost us to produce it is called the gross profit from sales.

The money inflow is not the same as profit.

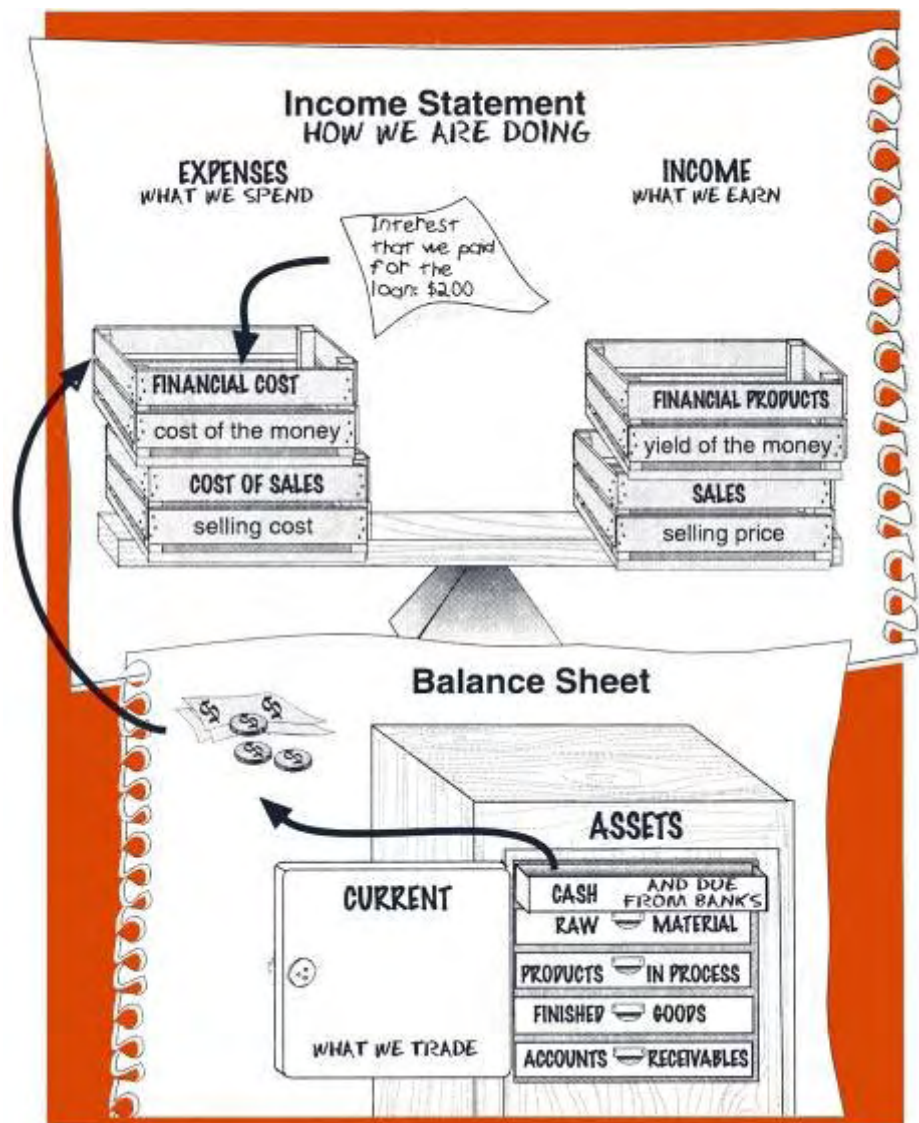
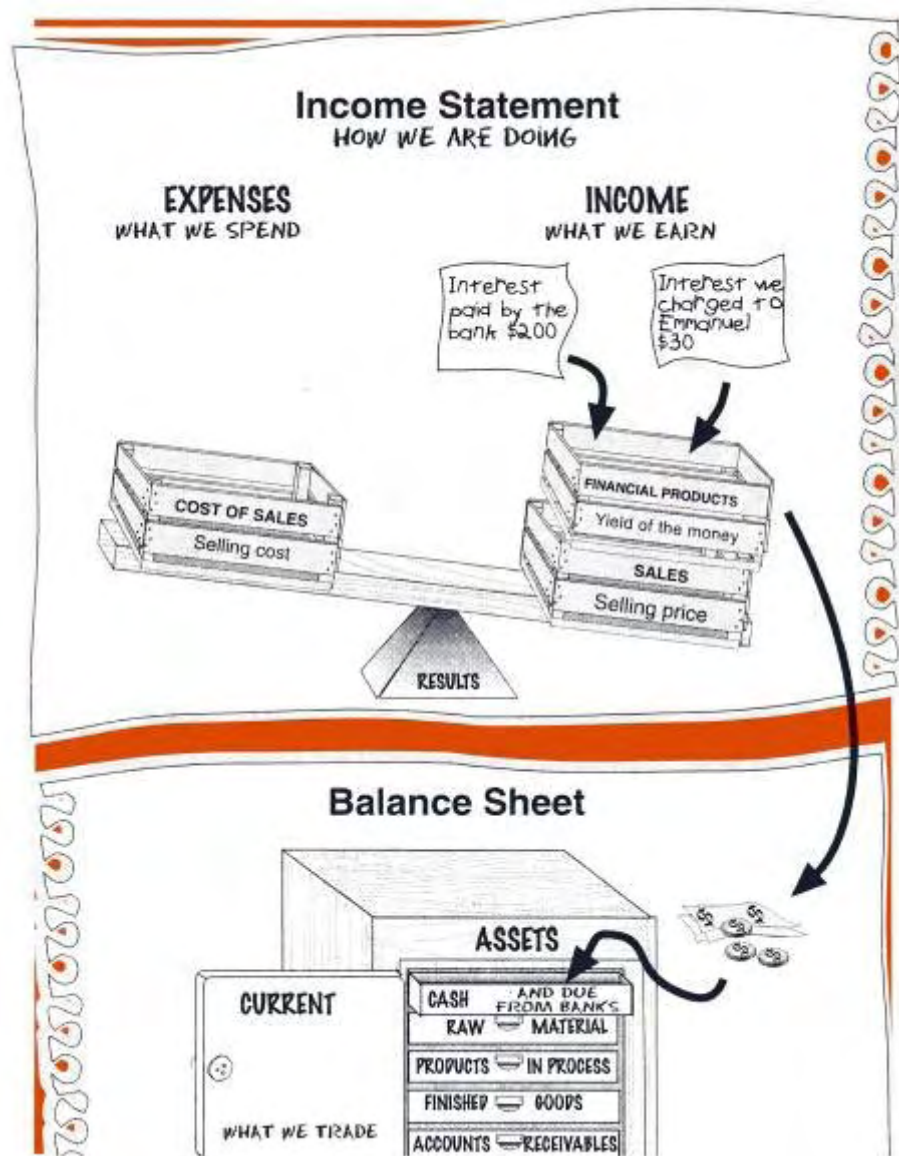


We may get income from other sources apart from the sales which are our main income. For example we may get interest paid by the bank for the funds which we deposit there or we may collect interest from the people to whom we give credit.

Interest is the price we pay for a financial service. When we are lending money, interest is an income or financial return.

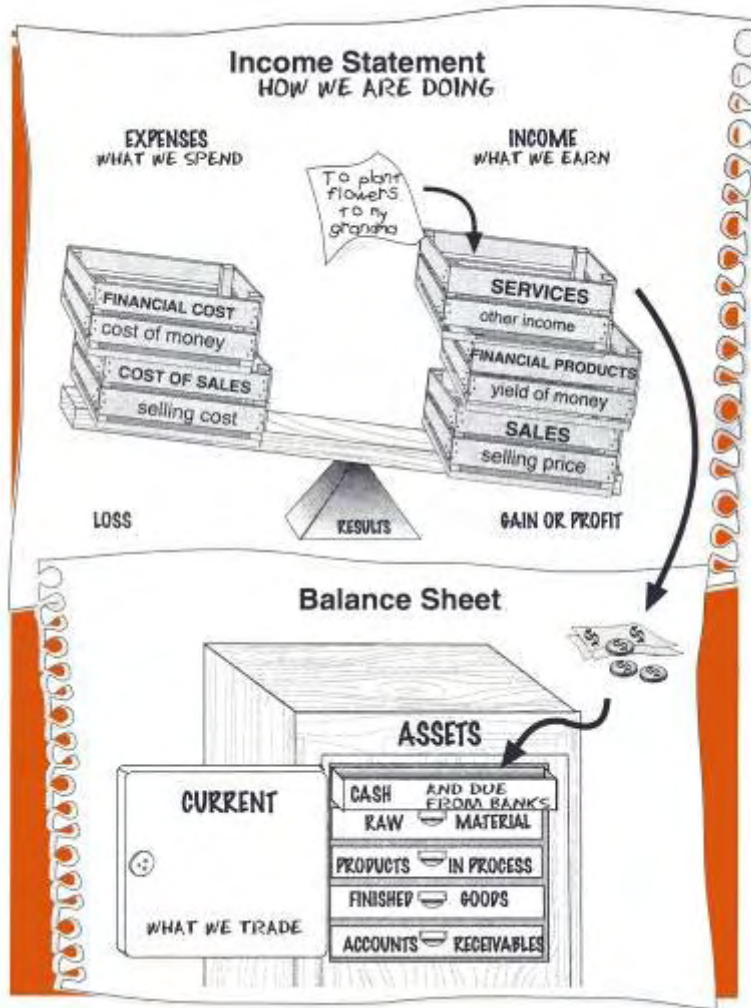
When we pay interest to someone who lends us money, it is a financial cost or fee we are paying to use the money.

The diagrams on the next pages show how interest is recorded when it is an income, and when it is a cost.

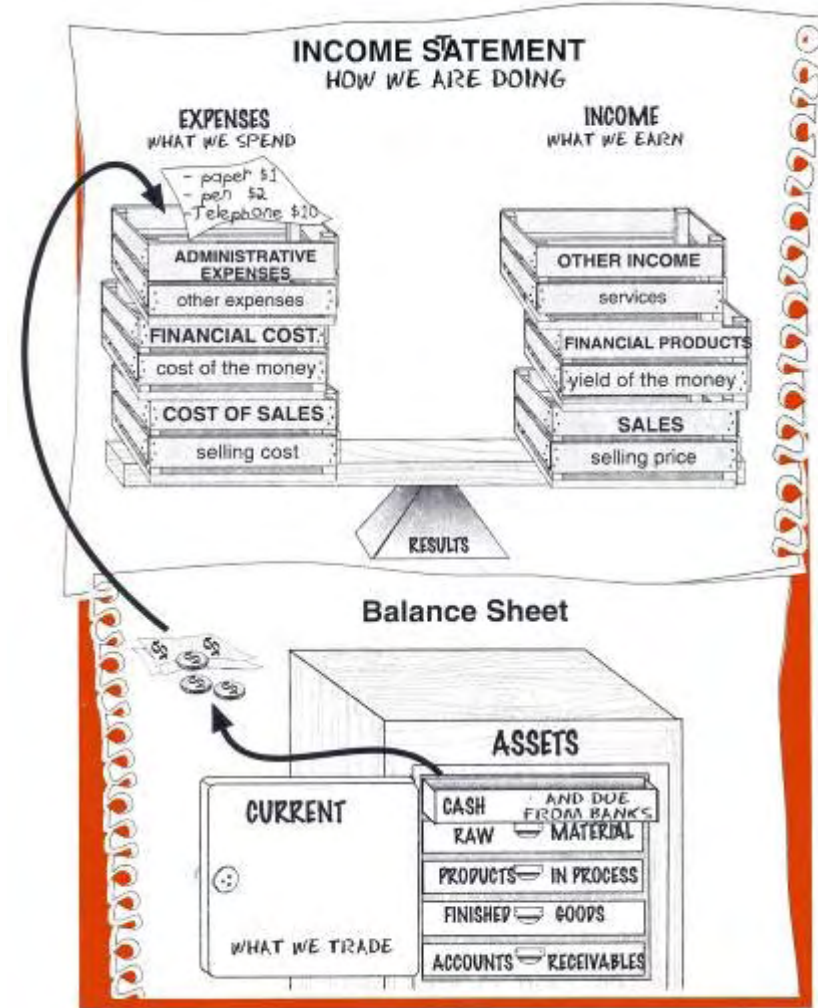


Other types of income might include charging for services such as renting out machinery or equipment, or processing things.

These small sources of income are grouped under other income.

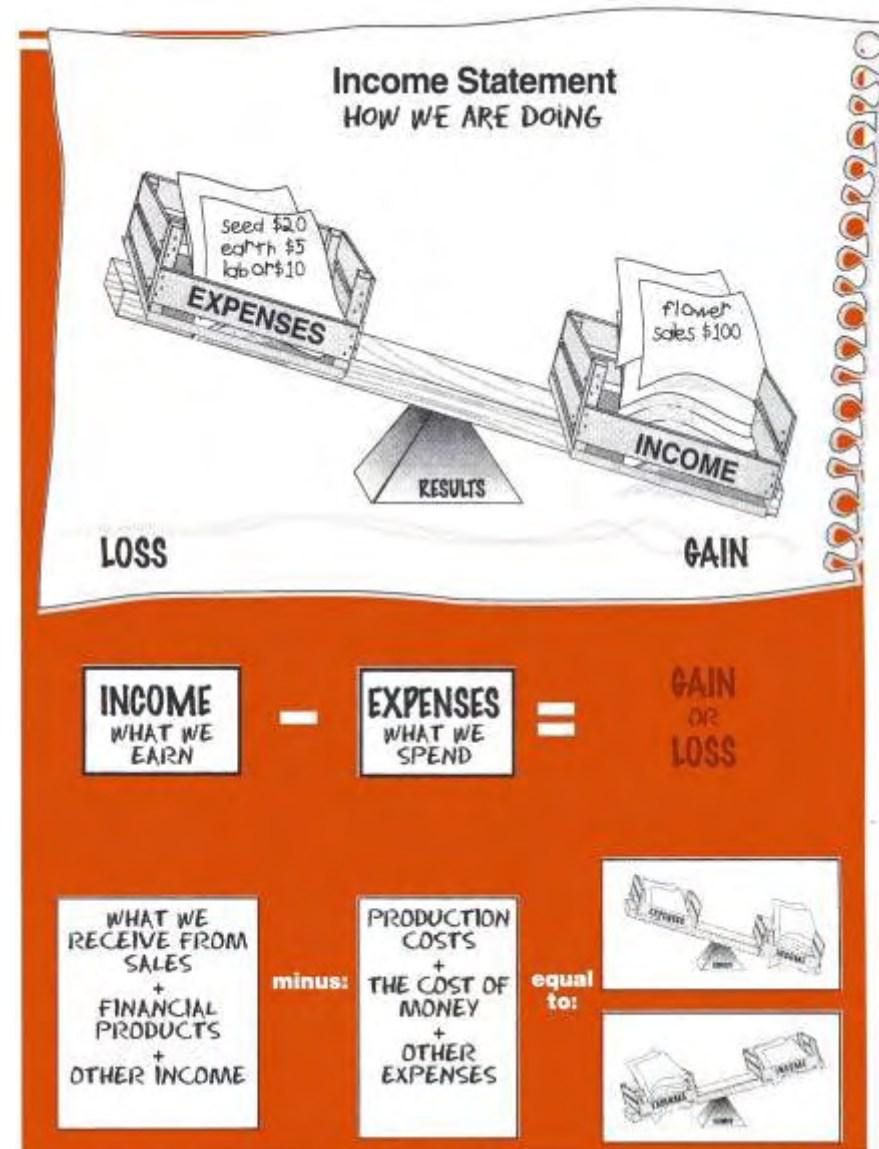


In addition to the cost of sales and financial costs, we may have other types of costs such as administrative expenses. This might include office expenses like paper, telephone, electricity and rent for example.





If we add up all our income and deduct all our outgoings, including costs and expenses, we get our result, which we hope will be a profit but sometimes might be a loss.



5. The Balance Sheet and the Income Statement

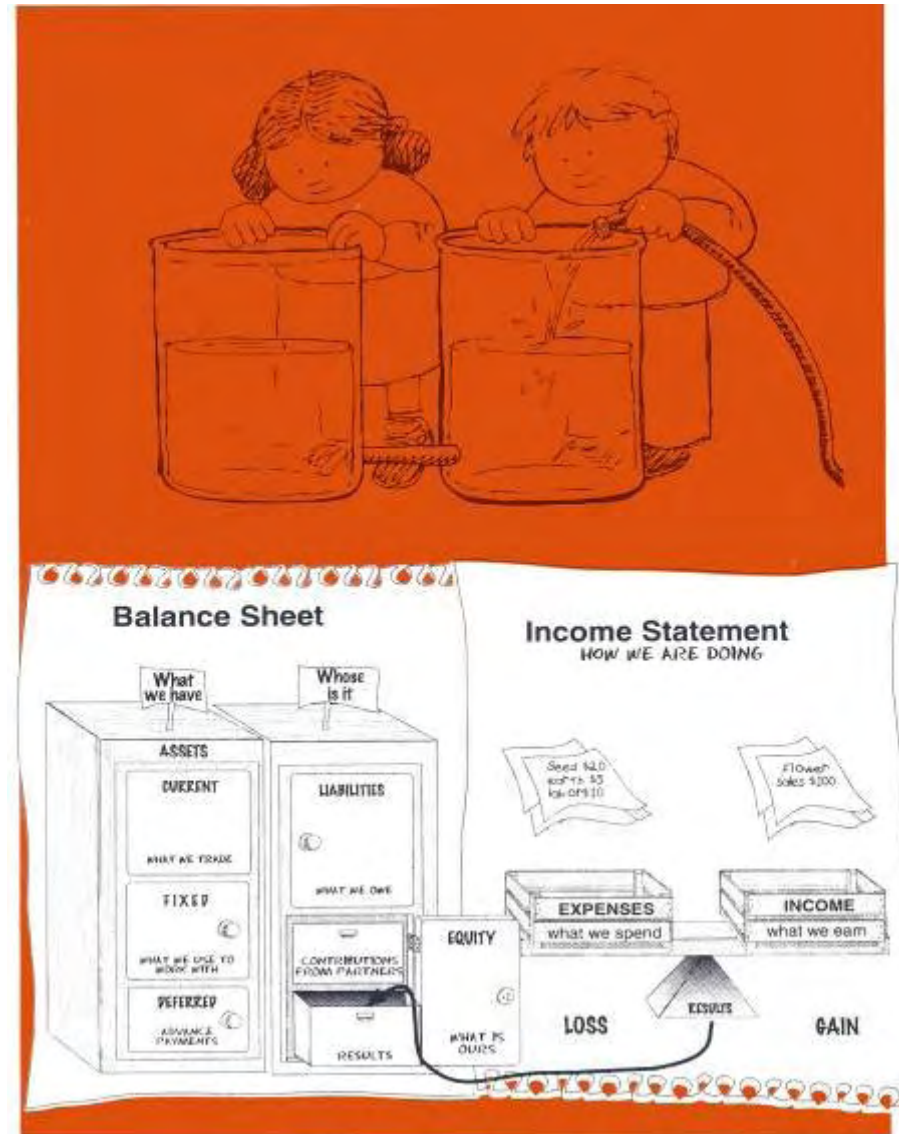
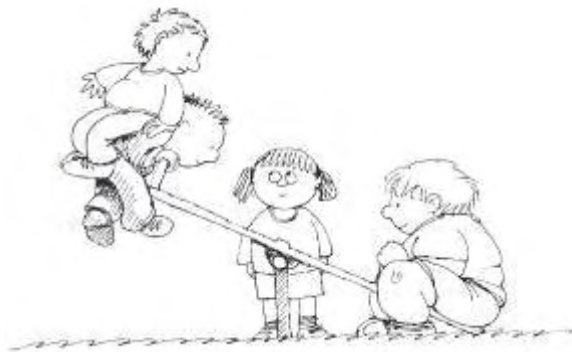
The income statement is connected to the balance sheet by the results or profit calculation.

Depending on the results we get, our equity either grows or diminishes:

- If we have a profit, our equity grows
- If we have a loss, our equity diminishes.

It's as if we had two tanks of water connected by a pipe at the bottom. If we add water to the one on the right, we also raise the level of the one on the left. When we empty water out of the one on the right, we also lower the level of the one on the left.

Thus the income statement is the document that shows us why our equity is either increasing or diminishing.



Here is a final picture of our financial statement. You understand it now don't you?

