

ACCT 2301 June 17: Review of some fundamentals

Accounting information doesn't always measure what one might intuitively expect... knowing accounting fundamentals can be extremely important in terms of forming 'baseline' thoughts. For example:

Assets = Liabilities + Equity

We talked a good bit about a small bank. We talked about how the bank's assets aren't worth the amounts listed on the balance sheet. After making some intuitive adjustments, equity became negative.

Equity is simply a marker... it is book value. In theory, it's what owners would have left if assets were used to pay off liabilities... in reality, that's not what is shown on the bank's balance sheet. A reason equity frequently doesn't measure "what would be left for owners" is that many large assets are not recorded at economic value (e.g., land). There are legitimate reasons for historical cost accounting; however, simply assuming what you see is 'real' depends on your definition of reality. Thinking about how financial figures are recorded is important for many business decisions.

Revenue – Expense = Profit

We talked about the balance sheet being like a picture and the income statement being like a movie that can be connected to the next picture. The key is picking out 'important' information... what is important depends on the decision you are making.

The Debit / Credit System

This 500 (or so) year old system keeps the balance sheet and income statement working together. If you know how a few basic entries 'work' (e.g., borrowing from a bank, selling a product) and if you can categorize basic accounting elements (Assets, Liabilities, Equity, Revenue, and Expense), then you can generalize these basic transactions. For example, all assets 'work' the same way cash 'works' (debits increase, credits decrease). The opposite is true for liabilities (debits decrease, credits increase).

Revenue – Variable Cost – Fixed Cost = Profit

If you split expenses into "things that move" (VC) and "things that don't move" (FC), you have the foundation of CVP analysis... a basic planning tool. To use the tool, you need something to 'solve'... often this is a sales quantity (units or dollars of sales). You also need a way to estimate fixed and variable costs (regression analysis is quick if you have data).

Fixed Costs require thought

Fixed resources present measurement and decision problems. Loosely speaking, it's good advice to think hard about what fixed costs represent. Certainly, in the long run, a business must 'cover' all costs (Revenue > Expense); however, extra cash can be made – at times – by ignoring fixed costs (e.g., depreciation). If you have an underutilized fixed resource, think hard about ignoring fixed costs if that will allow the resource to be utilized more fully. Note well: companies typically do (and should) focus on revenue (if you go around ignoring fixed costs in a willy-nilly fashion, you'll go out of business).

Accounting Numbers Drive Behavior (Incentive Issues)

In spite of the many problems associated with accounting numbers, businesspeople pay attention to them because they are the standard 'scorecard' in business. Many businesspeople measure success based on accounting metrics such as ROI, residual income, profit, etc. Think hard about why and when these metrics can cause perverse incentives. We discussed basic accounting metrics in a blue-collar manufacturing setting (standard vs. actual costs)... like other settings, accounting numbers are used as both targets and scorecards. Workers typically prefer that their targets be set conservatively and their performance be measured liberally (low targets are easy to hit). In large companies, different workgroups can have opposing incentives... think hard about whether this can cause a problem.

Projections aren't perfect (even if the math looks impressively rigorous)

Understanding how to estimate long term value is extremely important. Understanding what makes a model (e.g., NPV, Black Scholes) change projections is important... even if you don't fully understand the math underlying the model. Keep in mind, models make assumptions... at times, model results offer little intuition (e.g., the magnitude of a long term NPV calculation); however, you should 'stress test' models that you work with. In other words, if you make some minor changes to model inputs, do the results change a good bit? If so, think hard about how much you trust the model.

June 17 & 18: Frequently, companies (and workers) don't know what their products cost (because the product cost 'rules' are subjective).

Like much that we've seen this semester, calculating unit cost can be extremely subjective... but this subjectivity is cleverly hidden in impressive looking calculations that make things appear quite objective. We'll discuss why calculating product cost (i.e., the 'stuff' your company sells) is subjective. We'll also discuss why you likely won't be able to do much about it... although determining costs might be subjective, the process ('rules') of cost determination are typically quite objective. Regardless, understanding the process can be valuable information (understanding the process might very well change your behavior).

Next week: "Operational Budgets" (often simply "Budgets").