

UNIT 1 – INTRODUCTION TO ACCOUNTING

DEFINITION OF ACCOUNTING

A – ACCA Lynchpins

There are two elements wrapped under the broad label of Accounting

- i. **Recording** the transactions of a business to provide information for day-to-day management
- ii. **Summarising** the transactions of a period to provide information about the performance and position of a business to interested parties.ⁱ

B – Frank Wood

The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.ⁱⁱ

C – Needles and Powers

An information system that measures, process and communicates financial information about an identifiable economic entity.ⁱⁱⁱ

ROLE OF ACCOUNTING

The purpose of Accounting varied based on the user of the information. Therefore, to understand the purpose of Accounting, one must first appreciate the users of the information produced by the Accounting function.

USERS OF ACCOUNTING INFORMATION

- i. Management – to monitor existing activities, plan future activities and to make capital investment decisions.
The attempt to use the heading “management” as a category is misleading as the need for Accounting information will vary between Managers at differing levels on the organisation chart.
- ii. Shareholders and Potential investors – to determine proper stewardship of existing assets, to determine past performance and to assess prospective performance. (Prospectus and Final Accounts)
- iii. Government agencies – as a basis for taxation and to assist with Industry planning
- iv. Employees and Trade Unions – to determine security of employment and to assist in wage negotiations
- v. Financial Organisations – to assess the entity’s current and prospective debt service capability
- vi. General Public – customers such as Travel Agencies may use the statements to determine an entity's long term viability particularly when negotiating contracts, Students and Analysts may use the data for research purposes and to assess the impact of the entity on the economy and environment.

CHARACTERISTICS OF USEFUL INFORMATION

- i. **Relevant:** should satisfy the needs of users.
- ii. **Understandable:** Providers of accounting information must attain the delicate balance of detail. While explanatory notes should be provided where necessary, accounting information should make sense to the specific user. Use of jargon should be limited.
- iii. **Complete:** The Accounts should permit the user to make information decisions about the entity as a whole (based on the circumstance. What about Departmental accounts?)
- iv. **Unbiased:** While it is impossible to eliminate the use of judgement, the data should be as objective as reasonably possible
- v. **Timely:** Information is required quickly by both management and shareholders to make decisions and the allocated timelines should be honoured (Stock exchange requirements, Office of the Registrar of Companies and for tax purposes)
- vi. **Comparable:** Users of the data should be in a position to make comparisons of departments within and entity and between entities. This is facilitated by the use of standards such as the International Accounting Standards.

ACCOUNTING PROFESSIONS

Accounting Professions can be placed in six broad groups:

1. **Financial Accounting** – Accounting for revenues, expenses, assets and liabilities with the view to prepare reports for external users of the Accounting information. This branch of Accounting is historical in nature as Professionals in this branch of accounting seek to capture data about past events.
2. **Cost Accounting** – Professionals in this group record, classify, allocate and report on current and prospective costs. Cost Accountants determine costs by departments, functions, responsibilities, products and services. The main role of this branch of accounting is to help operations personnel control operations.
3. **Management Accounting** – This branch of Accounting is designed to provide information to various management levels for the purpose of enhancing controls. These accounts prepare performance reports, including reports that seek to determine deviations from budgets. The aim of this branch of Accounts is not to capture past data but to help in the making of decisions and hence reports tend to provide projections about possible outcomes.
4. **Tax Accounting** – Professionals in this group undertake activities relating to the preparation and filing of tax forms with government agencies. Tax Accountants may also be employed to identify legal methods to reduce a company's tax liability.
5. **Auditing** – This branch of Accounting has evolved into an independent discipline. Auditors review and evaluate documents, records and control systems with the view to provide recommendations or statements about the accuracy of the recording and reporting mechanisms used by an entity. Internal Auditors are employed by organisations to test and enhance internal control mechanisms while the services of External Auditors are normally engaged to assist with providing an objective perspective about the accuracy of an entity's records.
6. **Accounting Information Systems** – Increased dependency on information technology to assist with the various accounting processes has stimulated the growth of this field. Professionals in this branch of Accounting are usually employed to assist with administration of computerized accounting models.

Financial Accounting	Cost & Management Accounting
Required by law for external reporting purposes (JSE, ORC and Inland Revenue)	Not usually mandatory because reports are used internally
Mainly concerned with profits	Mainly concerned with cash flow and business management
Mainly historical records	Based on estimates and predictions
Information must be prepared and prepared in accordance with specific standards	Not fixed method to compute results

INTERNATIONAL ACCOUNTING STANDARDS

Objective of IAS 1

The objective of IAS 1 (2007) is to prescribe the basis for presentation of general purpose financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. IAS 1 sets out the overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. [IAS 1.1] Standards for recognising, measuring, and disclosing specific transactions are addressed in other Standards and Interpretations. [IAS 1.3]

Objective of Financial Statements

The objective of general purpose financial statements is to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. To meet that objective, financial statements provide information about an entity's: [IAS 1.9]

- assets
- liabilities
- equity
- income and expenses, including gains and losses
- contributions by and distributions to owners
- cash flows

That information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

Components of Financial Statements

A complete set of financial statements should include: [IAS 1.10]

- a statement of financial position (balance sheet) at the end of the period
- a statement of comprehensive income for the period (or an income statement and a statement of comprehensive income)
- a statement of changes in equity for the period
- a statement of cash flows for the period
- notes, comprising a summary of accounting policies and other explanatory notes

When an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements, it must also present a statement of financial position (balance sheet) as at the beginning of the earliest comparative period

Accounting Standards, Principles and Concepts

Cost principle

This concept is closely related to the going concern concept. According to this concept, an asset is ordinarily recorded in the books at the price at which it was acquired i.e., at its cost price. This cost serves the basis for the accounting of this asset during the subsequent period. The 'cost' should not be confused with 'value'. It must be remembered that as the real worth of the assets changes from time to time, it does not mean that the value of such an asset is wrongly recorded in the books. The book values of the assets as recorded do not reflect their real value. They do not signify that values noted therein are the values for which they can be sold.

Though the assets are recorded in the books at cost, in course of time, they are reduced in value on account of depreciation charges. The idea that the transactions should be recorded at cost rather than at a subjective or arbitrary value is known as cost concept. With the passage of time, the market value of fixed assets like land and buildings vary greatly from their cost. These changes in the value are generally ignored by the accountants and they continue to value them in the balance sheet at historical cost. The principle of valuing the fixed assets at cost and not at market value is the underlying principle in cost concept. According to them the current values alone will fairly represent the cost to the entity.

The cost principle is based on the principle of objectivity. There is no room for personal assessment in showing the figures in accounting records. If subjectivity is allowed in records the same assets will be valued at different figures by different individuals. Everybody will have his own views about various assets. The cost concept is helpful in making truthful records. The records become more reliable and comparable.^{iv}

Business Entity

Accounting and Financial Statements are prepared on the basis that each firm is a business entity that maintains its independent set of Accounts and these accounts are separate from the other financial interest of the owners. This permits the Accountants to determine the viability of the entity. This concept is the main reason assets are reported at their historical cost pending their revaluation. (Look at problem with small properties and separating owner from business).

Going Concern or Continuity of the Business Unit

According to **going concern concept** it is assumed that the business will exist for a long time to come. Transactions are recorded in the books keeping in view the going concern aspect of the business unit. A firm is said to be going concern when there is neither the intention nor necessity to wind up its affairs. In other words, it should continue to operate at its present scale in the future. On account of this concept the fixed assets are shown in the balance sheet at a diminishing balance method i.e., going concern value. There is no need to show assets at market value because these have been purchased for use in future and earn revenues and for sale purpose. If the business is not to continue then market value will have significance. Since business is to continue, fixed assets will be shown at cost less depreciation basis. It is due to the concept that the fixed assets are depreciated on the basis of their expected life than on the basis of market value. The concept also necessitates distinction between expenditure that will render benefit over a long period and that whose benefit will be

exhausted quickly, say within one year. The going concern concept also implies that existing liabilities will be paid at maturity.

Unit of Measure

Financial Statements are based on transactions being expressed in monetary terms. The monetary unit is assumed to be a stable unit of value so that transactions from past periods and the current period can be included in the same statement.

Consistency

Once an accounting method has been adopted it should be followed from period to period unless a change is warranted and disclosed. The application of this principle facilitates comparisons within firms and across firms both locally and internationally.

Matching or Accruals Concept

The application of this concept ensures that expenses incurred in a financial period are matched with the revenues generated in the same accounting period. Therefore, the cost of a central cooling system for a hotel is recorded as a fixed asset in the year of purchase. The gradual loss in the asset's value is therefore written off as depreciation throughout the estimated life of the asset.

Conservatism or Prudence Concept

This convention means a caution approach or policy of "play safe". This convention ensures that uncertainties and risks inherent in business transactions should be given a proper consideration. If there is a possibility of loss, it should be taken into account at the earliest. On the other hand, a prospect of profit should be ignored up to the time it does not materialise. On account of this reason, the accountants follow the rule 'anticipate no profit but provide for all possible losses'. On account of this convention, the inventory is valued 'at cost or market price whichever is less.' The effect of the above is that in case market price has gone down then provide for the 'anticipated loss' but if the market price has gone up then ignore the 'anticipated profits.' Similarly a provision is made for possible bad and doubtful debt out of current year's profits

Therefore the potential sale of a block of hotel rooms to be marketed by a Travel Agency cannot be immediately recognised as revenue as this inflates the hotel's sales figure. Conservatism is also apparent in the valuation of inventory at the lower of cost or current market value and the recognition of non-refundable deposits for future banquets as a liability until the banquet is catered. ***This concept is the underlying principle for establishing Provisions, such as Provision for Doubtful Debt.***

Materiality

Events or information must be accounted for if they influence the interpretation of the information revealed in Accounting reports. This principle is often applied to fixed assets where tangible items with useful lives beyond a year are usually recorded as fixed assets. However, when such items cost less than a certain amount (such as a box of paper clips) they are expensed because the cost is deemed immaterial. International Accounting Standards also help to govern what items should be revealed in the notes supporting the financial statements.

DEFINITION AND EXPLANATION OF ACCOUNTING EQUATION:

Dual aspect may be stated as "for every debit, there is a credit." Every transaction should have twofold effect to the extent of the same amount. This concept has resulted in **accounting equation** which states that at any point of time the assets of any entity must be equal (in monetary terms) to the total of equities. In other words, for every business enterprise, the sum of the rights to the properties is equal to the sum of the properties owned. The properties of the business are called "assets". The rights to the properties are called "equities". Equities may be sub-divided into two principle types: The rights of the creditors and the rights of the owners. The equity of the creditors represents debts of the the business and are called liabilities. The equity of the owner is called capital, or proprietorship or owner's equity.

The **formula** know as the **accounting equation**, thus arrived at is as follows:

$$\text{Assets} = \text{Equities}$$

OR

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

Another method of demonstrating the mathematical relationship involves a simple variation in the form of equation. Again it begins with the position that every business owns or has interest in certain assets. It also owes certain amounts to its creditors. The difference between what it owns and what it owes represents the owner's capital or proprietorship. Thus the original equation is changed into:

$$\text{Assets} - \text{Liabilities} = \text{Proprietorship}$$

EFFECTS OF TRANSACTIONS ON THE ACCOUNTING EQUATION:

Each and every business transaction affects the elements of accounting equation. The effect is shown by the use of (+) or (-) placed against the elements affected. Note particularly that the equation remains in balance after each transaction. The accounting equation can be understood with the help of the

For additional information, please visit -

http://www.accountingformanagement.com/accounting_equation.htm

ⁱ Paper 1 – Accounting Framework, pg. 1, AT Foulks Lynch Limited, Middlesex, England © 1999

ⁱⁱ Wood, F and Sangster, A., "Business Accounting 1, Pitman Publishing, London England © 1999

ⁱⁱⁱ Needles, B and Powers, M., Houghton Mifflin Company, Boston, MA, USA © 2002

^{iv} http://www.accountingformanagement.com/accounting_concepts.htm