Accounting (Basics) - Lecture 1

SUBSTANCE AND FUNCTIONS OF ACCOUNTING, GENERAL ACCOUNTING PRINCIPLES. BALANCE SHEET, ITS FUNCITON, SYSTEM AND UTILIZATION.

Content

- Substance and functions of accounting
- General accounting principles
- Balance sheet
- Function, system and utilization of balance sheet

What is accounting

- System of recording, categorizing, summarizing and communicating financial information about an organization
- Often called the „language of business“
- Helps decision-makers make good economic decisions
- Communicates financial consequences of business decision

Accounting as an information system

- Accounting can be viewed as an information system that provides essential information about the financial activities of an entity to various individuals or groups for their use in making informed judgments and decisions.
- Accounting information is composed principally of financial data about business transactions, expressed in terms of money.
- The recording of transaction data may take various forms, such as pen or pencil markings made by hand, printing by mechanical and electronic devices, or magnetic impressions on tape or disks.

Accounting as an information system

- Special accounting softwares for accounting evidence have been used by most enterprises in all developed countries. Markings made by hand have become a history.
- The mere records of transactions are of little use in making informed judgments and decisions.
- The recorded data must be sorted and summarized and then presented in significant reports.
- The usefulness of reports is often improved by various kinds of percentage and trend analyses.

Users of accounting information

- Accounting provides the techniques for gathering economic data and the language for communicating these data to different individuals and institutions.
- **Investors** in a business enterprise need information about its financial status and its future prospects.
- **Bankers and suppliers** appraise the financial soundness of a business organization and assess the risks involved before making loans or granting credit.
- **Government agencies** are concerned with the financial activities of business organizations for purposes of taxation and regulation.

Users of accounting information

- **Employees and their union representatives** are also vitally interested in the stability and the profitability of the organization that hires them.
- **Management** needs reliable information for effective managing.
- The individuals who depend upon and make the most use of accounting are those charged with the responsibility for directing the operations of enterprises.
- They are often referred to collectively as "management."
- Management relies upon many types of accounting data in conducting day-to-day operations, in evaluating current operations, and in planning future operations.

Development of financial accounting concepts and principles

- The historical development of the practice of accounting has been closely related to the economic development of the country. In the earlier stages, a business enterprise was very often managed by its owner, and the accounting records and reports were used mainly by the owner-manager in conducting the business.
- Bankers and other lenders often relied on their personal relationship with the owner rather than on financial statements as the basis for making loans for business purposes. If a large amount was owed to a bank or supplier, the creditor often participated in management decisions.

Development of financial accounting concepts and principles

- As business organizations grew in size and complexity, "management" and "outsiders" became more clearly differentiated.
- Outsiders demanded accurate financial information.
- In addition, as the size and complexity of the business unit increased, the accounting problems involved in the issuance of financial statements became more and more complex.
- With these developments came an awareness of the need for a framework of concepts and generally accepted accounting principles to serve as guidelines for the preparation of the basic financial statements.

Development of financial accounting concepts and principles

- Accounting principles have been developed by individuals to help make accounting data more useful in an ever-changing society.
- They represent guides for the achievement of the desired results, based on reason, observation, and experimentation.
- The selection of the best method from among many alternatives has come about gradually, and in some areas a clear consensus is still lacking.

Development of financial accounting concepts and principles

- These principles are continually reexamined and revised to keep pace with the increasing complexity of business operations.
- General acceptance among the members of the accounting profession is the criterion for determining an accounting principle.

Practical keeping of accounting evidence

- The practical keeping of accounting evidence can be divided into 2 basic groups:

- 1. Hand-making evidence
- 2. Computerized accounting system

- The hand-making accounting evidence has started to be a history.
- This system of evidence of accounting files is able only in case of smaller accounting units or businessmen.

Practical keeping of accounting evidence

- Only the computerized accounting system is the leading form of keeping of accounting in bigger companies.
- Since the electronic computer was first used to process business data in the middle of the twentieth century, it has played an ever increasing role in the design of accounting systems and the processing of accounting data.
- It has generally enabled interested users of accounting information to receive relevant economic data on a more timely basis at a lower cost.

Practical keeping of accounting evidence

- The integration of the electronic computer into accounting systems has created both opportunities and challenges for accountants.
- The computer provides opportunities for accountants to analyze efficiently a greater quantity of economic data for reporting to users.
- As the use of computers in business continues to accelerate, there will be an increasing demand for accountants to aid the analysis, design, and implementation of these systems.

Practical keeping of accounting evidence

- This responsibility will create ever greater challenges for accountants to obtain a complete understanding of business operations and the principles of designing systems that will gather all accurate, relevant data on a timely basis.
- *A lot of software companies develop special accounting software used for keeping of accounting evidence.*
- *The latest sophistic versions of accounting software (but of course the most expensive versions) allow to the business entities not only to keep the accurate accounting evidence but also to use the accounting data effectively for better managing of the business.*

Financial statements

- A set of financial statements include:
  - The statement of financial position (sometimes named as The balance sheet)
  - The statement of profit or loss and other comprehensive income (sometimes named as The income statement)
  - The statement of changes in equity
  - The statement of cash flows
  - The notes

The statement of financial position – balance sheet

- This summarises the assets, liabilities and equity balances of the business at the end of the reporting period.
- Balance sheet

The statement of profit or loss – income statement

- This statement summarises the revenues earned and expenses incurred by the business throughout the whole of the reporting period
- Income statement

The statement of changes in equity

- This statement summarises the movement in equity balances (share capital, share premium, revaluation reserve, retained earnings) from the beginning of the reporting period to the end

The statement of cash flows

- It summarises the cash physically paid and received throughout the reporting period

The notes

- These comprise the accounting policies disclosures and any other disclosures required to enable to the shareholders to make informed decisions about the business

Qualitative characteristics

- These are the attributes that make information provided in financial statements useful to others
- We split the qulitative characteristics into two groups
- 1) Fundamental qualitative characteristics
- 2) Enhancing qualitative characteristics

Fundamental qualitative characteristics

- Relevance
  - Information is relevant if it has the ability to influence the economic decisions of users
  - and is provided in time to influence those decisions
- Faithful representation
  - If information is to represent faithfully the transactions and other events that it purports to represent, they must be accounted for and presented in accordance with their substance and economic reality and not merely their legal form

Enhancing qualitative characteristics

- Comparability
- Verifiability
- Timeliness
- Understandability

Enhancing qualitative characteristics

- Comparability

  Users must be able to:

  - compare the financial statements of an entity over time to identify trends in its financial position and performance
  - compare the financial statements of different entities to evaluate their relative financial performance and financial position

Enhancing qualitative characteristics

- Verifiability
  - Direct – verifying an amount or other representation through direct observation (i.e. counting cash)
  - Indirect – checking the inputs to a model, formula or other technique and recalculation the outputs using the same methodology

Enhancing qualitative characteristics

- Timeliness
  - Means having information available to decision makers in time to be capable of influencing their decisions
  - Generally the older the information is, the less useful it becomes

Enhancing qualitative characteristics

- Understandability
  - Depends on the way in which information is presented and the capabilities of users
  - It is assumed that users have a reasonable knowledge of business and economic activities and are willing to study the information provided with reasonable dilligence
  - For information to be understandable users need to be able to perceive its significance

Other important accounting principles

- There are numbers of other accounting principles that underpin the preparation of financial statements. The most significant ones include
  - The business entity concept
  - The accruals basis of accounting
  - The going concern assumption
  - Substance over form
  - Consistency

Other important accounting principles

- The business entity concept
  - This principle means that the financial accounting information presented in the financial statements relates only to the activities of the business and not to those of the owner
  - From an accounting perspective the business is treated as being separate from its owners

Other important accounting principles

- The accruals basis of accounting
  - The transactions are recorded when revenues are earned and when expenses are incurred
  - This pays no regard to the timing of the cash payment or receipt
  - For example if a business enters into a contractual arrangement to sell goods to another entity, the sale is recorded when the contractual duty has been satisfied – that is likely when the goods have been upplied and accepted by the customer. The payment may not be received for another month but in accounting terms the sale has taken place and should be recognised in the financial statements.

Other important accounting principles

- The going concern assumption
  - Financial statements are prepared on the basis that the entity will continue to trade for the foreseeable future
  - i. e. it has neither the need nor the intention to liquidate its operations

Other important accounting principles

- Substance over form
  - If the information is to be presented faithfully the economic reality must be accounted for and not just the legal form
  - Example: accounting treatment of redeemable preference shares – on legal form these are shares, there is an obligation to repay the preference share holders and so they are accounted for as debt

Other important accounting principles

- Consistency
  - Users of the financial statements need to be able to compare the performance of a company over a number of years.
  - Therefore it is important that the presentation and classification of items in the financial statements is retained from one period to the next, unless there is a change in circumstances or a requirement of a new IFRS

The elements of the financial statements

- Assets
- Liabilities
- Equity
- Revenues
- Expenses

The elements of the financial statements

- Assets
  - An asset is a property controlled by the entity as a result of past events from which future economic benefits are expected to flow to the entity
  - For example a building that is owned and controlled by a business and that is being used to house operations and generate revenues would be classed as an asset

The elements of the financial statements

- Liabilities
  - A liability is an obligation to transfer economic benefit as a result of past transactions or events
  - For example an unpaid tax obligation is a liability

The elements of the financial statements

- Equity
  - This is the residual interest in a business and represents what is left when the business is wound up, all the assets sold and all the outstanding liabilitites paid
  - It is effectively what is paid back to the owners (shareholders) when the business ceases to trade

  - **Assets = Liabilities + (Owner's) Equity**

The elements of the financial statements

- Revenue
  - This is the recognition of the inflow of economic benefit to the entity in the reporting period
  - This can be achieved, for example, by earning sales revenue or through the increase in value of an asset

The elements of the financial statements

- Expenses
  - This is the recognition of the outflow of economic benefit from an entity in the reporting period
  - This can be achieved, for example, by purchasing goods or services off another entity or through the reduction in value of asset

The balance sheet

- The balance sheet is the most important financial statement compiled in the system of double – entry accounting.
- It provides information about the structure of assets and equities (liabilities + equity).

The balance sheet

Assets **Equities**

1. Fixed assets - intangible assets - tangible assets - long-term financial assets **2. Current assets** - inventories - long – term receivables - short – term receivables - short – term financial assets	**1. Owner's equity** - common stocks - capital funds - funds created by net profit - economic results **2. Liabilities** - Reserves (provisions) - long – term debts (liabilities) - short - term debts (liabilities) - bank credits (loans)
Σ Assets	**Σ Equities**

The balance sheet

- **Definition:** Σ Assets or Σ Equities is called <u>The balance sheet amount.</u>
- **Σ Assets = Σ Equities**
- **Very important:**
  - This equation must stay in balance after the charging of every transaction!
- **Remember:**
  - There is no economic transaction that could evoke an imbalance in this equation!!!

Components of the balance sheet

- The balance sheet components can be divided into two basic sides – into assets recorded on assets side of the balance sheet and on equities recorded on the equity side of the balance sheet.
- The asset side of the balance sheet is divided into next two parts – the fixed assets and the current assets.
- The equity part of the balance sheet is also divided into two basic parts – into the owner's equity and the liabilities.

Components of the balance sheet

- Assets
  - Fixed assets
  - Current assets
- Equities
  - Owner's equity
  - Liabilities