Who's Counting?

Who's Counting?

AN INTRODUCTION TO ACCOUNTING

CDU BUSINESS SCHOOL

Charles Darwin University
Darwin

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Introduction

Are you interested in a possible career in Accounting? Or maybe you want to run your own small business and need to learn the basics to keep your finances and book keeping in good order? Or are you beginning a degree or studies in Accounting? This book is designed to introduce you to the world of accounting. After completing the videos and interactive resources contained in this book, you will have the foundational knowledge necessary to discuss principles of accounting and prepare basic financial statements.

This book has been adapted from Charles Darwin University's MOOC titled **"Who's Counting: An Interactive Introduction to Accounting."**

Meet the accountant

In this book we:

- Discuss the fundamental concepts and principles of accounting.
- Describe the effect of business transactions on the elements of accounting.
- Demonstrate the basic techniques used in the preparation of financial statements.

Click on the video below to meet the accountant!

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Who needs accounting?

As an accountant, you'll need a solid grasp of:

- who is using the information that you provide, and
- what they are using the information for.

Many different people will depend on the information that you provide to them in order to make important decisions!

Accounting information is designed to meet the needs of both **internal users** and **external users.**

Internal users of information will use what is generally termed “**Management Accounting**“. External users will generally use “**Financial Accounting**” information.

INTERNAL AND EXTERNAL USERS

In this section we take a look at some examples of internal and external users of accounting information.

INTERNAL USERS

- **Marketing**
  These users need to know what prices to charge for goods and services to maximise company profits and to project income from new sales campaigns.
- **Human Resources**
  These users use accounting information to make decisions about training, recruitment, staffing, incentives and performance evaluation in terms of cost and dollar benefit to the organisation.
- **Management**
  These users need to compare product profits, make operations decisions and determine asset capacity.
- **Employees**
  These users want to know about possible pay rises, bonuses, job security and promotion opportunities.
- **Finance Directors**
  These users want to know if there is sufficient company cash flow to pay dividends and to forecast cash needs.

EXTERNAL USERS

- **Community**
  These users are concerned with the company's contribution to economic growth in the community.
- **Government Authorities**
  These users need to determine the amount of tax the company should pay.
- **Banks**
  These users need to know the company can repay its loans.
- **Investors**
  These users want to know about company profits and to compare the company to other companies.
- **Consumers**
  These users want to know about the company's sustainability and consistent quality of goods and services.
- **Special interest groups**
  These users are interested in the environmental, social, and industrial issues of the company's operations.

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The basic functions of accounting

There are two main ‘functions’ of accounting that you need to know and understand:

1. The Accounting Function
2. The Oversight (or Stewardship) Function

THE ACCOUNTING FUNCTION

The Accounting Function basically covers everything to do with representing business activities in monetary ($) terms, and providing that information to the people who need it.

This is done through a process of:

- Recognition
- Measurement
- Recording
- Reporting

THE OVERSIGHT (OR STEWARDSHIP) FUNCTION

The Stewardship Function is about supervising.

This Function is about using accounting information to strictly inspect and supervise the activities of the business with certain goals in mind. This is to make sure the business is achieving specific targets.

The **Accounting Function** and the **Oversight Function** are "mutually interdependent", meaning they are basically inseparable.

Reliable accounting requires oversight, or supervision, and strict supervision ensures reliability!

NEW ACCOUNTING FUNCTIONS

Due to rapid changes in technology, economic development, and the introduction of scientific management methods into the accounting arena, these functions and the role of an accountant have changed dramatically.

Additionally, new functions of accounting have resulted, including:

- the **decision-making function,** which involves the use of predictive data to inform decision making
- the **control function,** which involves using activity-based costing and other tools of responsibility accounting to control each step of a company's economic activities, and
- the **evaluation function**, which refers to using accounting data to assess and analyse the outcome of an economic activity.

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The process of accounting

Accounting can be defined as the process of **identifying, measuring and communicating** economic information about an entity to a variety of users for decision-making purposes

There are 4 steps in the process of accounting:

1. Identifying
2. Measuring
3. Communicating
4. Decision Making

1. IDENTIFYING

Identifying business transactions

A business transaction is an event that affects the financial position of an entity and can be reliably measured and recorded.

Business transactions can include such events as:

- withdrawals of cash by the owner
- payment of wages and salaries
- earning of fees revenue
- purchase of an office photocopier or stationery

- capital contribution by owners
- incurring of interest on a bank loan

2. MEASURING

Measuring refers to the analysis, recording and classifying of business transactions.

This component identifies how transactions will affect the entity's position, and groups together similar items such as expenses and income.

Throughout the accounting period, individual assets, expenses, income, equity and liabilities will be grouped (classified) together to summarise the information.

For example, land, buildings, machinery, equipment and vehicles will be grouped together under the subheading 'property, plant and equipment'.

3. COMMUNICATING

Communicating relevant information through accounting reports, such as the income statement and the balance sheet, for decision-making purposes.

This component of the Process of Accounting requires extensive training, experience and judgement.

4. DECISION MAKING

The information reported in the entity's financial statements should be relevant and reliable for users of accounting information to make sound business decisions.

The different users require accounting information for making important decisions such as:

- whether to invest in a business

- whether the entity should continue to manufacture a product or outsource this process
- whether the business has the resources to pay debts on time

All of these decisions involve making the most of the scarce resource – money.

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Assumptions of financial statements

Accountants make four assumptions in the preparation of financial statements

1. **The economic entity**
   The financial statements are prepared under the economic entity assumption, meaning that the business itself is separate from the owners of the business and any other businesses.
2. **Accrual basis**
   The financial statements are prepared under the accrual basis, which is a method of financial reporting that measures all cash relating to the business as it comes in and as it goes out, called 'cash accounting'.
3. **Going concern**
   The financial statements are prepared under the going concern basis, which assumes that the business will continue its operations as normal into the foreseeable future.
4. **The period assumption**
   This assumption describes the time interval between financial statement reports.

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Qualitative Characteristics of Accounting Information

FINANCIAL REPORTING

The primary objective of financial reporting is to provide useful information for making business decisions.

Useful accounting information should possess **two fundamental qualitative characteristics**:

1. **Relevance**
   Relevance means that the information can influence the economic decisions made by users. For example, the information may help users to predict future events, such as future cash flows, and help determine alternative courses of action under consideration. Information is also relevant if it is able to help decision makers evaluate past decisions. Thus, information that is relevant is said to have a predictive role and a confirmatory or feedback role.
2. **Reliability**
   Reliability means that the user is assured that the information presented represents faithfully, without bias, the transactions and events being reported.

This is a major reason that accountants record assets at their original historical cost. For accountants to record current market values requires the use of estimates, appraisals or opinions, all of which are more unreliable.

Additionally, there are **enhancing qualities.**

- **Timeliness**
  For accounting information to be relevant, it must be timely, i.e. it must be available to the decision makers before it loses its capacity to appropriately inform decisions.
- **Comparability**
  Comparability results when different companies use the same accounting principles.
- **Materiality**
  It is important that users are not overwhelmed with so much detail that they cannot clearly understand the message. The concept of materiality relates to the extent to which information can be omitted, misstated or grouped with other information without misleading the statement users when they are making their economic decisions.
- **Verifiability**
  Information is verifiable if independent observers, using the same methods, obtain similar results.
- **Consistency**
  A company uses the same accounting principles and methods from year to year.
- **Understandability**
  When information is included in general purpose financial reports, there is an obvious need for the users of those reports to be able to comprehend

their meaning.

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Measurement Standards Used in Accounting

Measurement is all about determining the value of transactions in order to record them properly on financial reports.

There are five methods for determining value:

1. **historical cost**
   Assets of a company are recorded at the price for which they were originally acquired. For example, if a business bought a block for $250,000, this asset would be entered into the accounts at its purchase price of $250,000.
2. **fair value**
   A measure of an item's market price on a particular date in the normal course of business, hence it is sometimes called "market value". Fair value can be objectively determined at any time. It is just an estimate, upon which people may have differing views.
3. **replacement cost**
   The cost to a business of acquiring an asset identical to, or with the same functions, as an existing asset. It is a type of present value, because at the time of purchase, the replacement cost is

equivalent to the original cost. This value will change with time as prices for that item fluctuate.

4. **net realisable value**
   The value of a product after subtracting the expected costs of production, transaction costs and taxes related to the sale of the item. Net realisable value is usually used in measuring the value of inventory assets following a depreciation in value.
5. **present value**
   The value at the present time of a payment or cash flow occurring in the past or future. Measuring present value involves taking future cash flows and discounting them at an appropriate rate. It is a measurement that takes into account the changing value of money over time.

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Structure of business organisations

It is important that the business organisation is structured to meet its needs.

There are three main business structures:

1. Sole trader or sole proprietor
2. Partnership
3. Company or corporation

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This brings you to the end of An Introduction to Accounting.