

Academic Year 2009/2010

www.AccountingTechniciansIreland.ie



**Accounting
Technicians
Ireland**

Financial Accounting



CHAPTER 1: INTRODUCTION TO ACCOUNTING

LEARNING OUTCOMES

Upon completion of this chapter you should be able to:

1. Understand and define accounting
2. Explain the different types of business entity
3. List the users of the financial statements and their information needs
4. Differentiate between Financial and Management accounting
5. Understand and explain Accounting concepts
6. Understand Accounting terminology
7. Understand the role of the accountant

REVISION RESOURCES

SEMINAR: This topic will be reviewed and discussed in **Revision Seminar 1**.

EXAM QUESTIONS: **Pilot and Past papers** are available from the website of Accounting Technicians Ireland and are essential aides when studying Financial Accounting I topics.

Welcome to Financial Accounting I. The objective of Financial Accounting I is to provide students with the knowledge to enable them to prepare a set of financial statements for a sole trader. The objective of financial statements as we will see throughout this manual is to provide information about the reporting entity's performance and financial position that is useful to a wide range of users. It is important to note that for Financial Accounting I that we follow **the UK/Ireland professional regulations and not the international professional regulations.** The Accounting Standards Board (ASB) is the standard setting authority for Accounting Standards in the Republic of Ireland and the United Kingdom, the aim of the ASB is to establish and improve standards of financial accounting and reporting for the benefit of users, preparers and auditors of financial information. You will explore this area in more detail in Financial Accounting II. The main difference between UK/Ireland and international regulations is mainly in the terminology used, for example Stock will be referred to as Inventory in international terms.

The Financial Accounting I syllabus (and this manual) by the Accounting Technicians Ireland has been written and will be examined under UK/Ireland professional regulations. As a student of the Accounting Technicians Ireland you are training for a professional qualification and therefore using the appropriate terminology and format, in this case **UK/Ireland Accounting Standards and terminology, is expected by your examiner.** This is an important point to note as you prepare to commence your studies.

It is not easy to provide a concise definition of accounting since the word has a broad application within business. Accountancy or accounting is the art of communicating financial information about a business entity to users such as the owners of the business and the government. The information is generally in the form of financial statements that show in money terms the economic resources under the control of management. In this chapter we will explore the concept of accounting, the different types of business entities and the users of these financial statements, in addition to their information needs. We will also define the key accounting concepts and their importance in preparing financial statements.

Accounting

Accounting can be defined as “the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information”. This definition is a good place to start, let’s look at the key words in the definition.

- It suggests that accounting is about providing **information** to others. Accounting information is economic information – it relates to the financial or economic activities of the business or organisation.
- Accounting information needs to be **identified and measured**. This is done by way of a “**set of accounts**”, based on a system of accounting known as **double-entry bookkeeping**. The accounting system identifies and records “**accounting transactions**”.
- The “**measurement**” of accounting information is not a straight forward process. It involves making judgments about the value of **assets** owned by a business or **liabilities** owed by a business. It is also about accurately measuring how much profit or loss has been made by a business in a particular period. As we will see, the measurement of accounting information often requires **subjective judgment** to come to a conclusion.
- The definition identifies the need for accounting information to be **communicated**. The way in which this communication is achieved may vary. There are several forms of accounting communication (e.g. annual reports and accounts, management accounting reports) each of which serve a slightly different purpose. The communication need is about understanding **who** needs the accounting information, and **what** they need to know.

Accounting information is communicated using “financial statements”.

What is the purpose of financial statements?

1. To report on the financial position of an entity (e.g. a business, an organisation).
2. To show how the entity has performed (financially) over a particular period of time (an “accounting period”).

The most common measurement of “performance” is profit.

It is also important to remember that the financial statements can be historical or relate to the future.

Accountability

Accounting is about accountability.

Most organisations are externally accountable in some way for their actions and activities. They will produce reports on their activities that will reflect their objectives and the people to whom they are accountable.

The following table provides examples of different types of organisations and how accountability is linked to their differing organisational objectives:

Organisation	Objectives	Accountable to – examples
Private/Public company (e.g. Tesco)	- Making a profit - Creation of wealth	- Shareholders - Other stakeholders (e.g. employees, suppliers)

Charities (e.g. Concern)	<ul style="list-style-type: none"> - Achievement of charitable aims - Maximise spending on activities 	<ul style="list-style-type: none"> - Charity commissioners - Donors
Local authorities (e.g. Local county council)	<ul style="list-style-type: none"> - Provision of local services 	<ul style="list-style-type: none"> - Government departments

All of the above organisations have a significant role to play in society and have multiple stakeholders to whom they are accountable.

All require systems of financial management to enable them to produce accounting information.

How accounting information helps businesses be accountable:

As we have said in our introductory definition, accounting is essentially an “**information process**” that serves several purposes:

- Providing a record of assets owned, amount owed to others and monies invested.
- Providing reports showing the financial position of an organisation and the profitability of its operations.
- Helps management actually manage the organisation.
- Enables potential investors to evaluate an organisation and make decisions.

There are many potential **users of accounting information**, including shareholders, lenders, customers, suppliers, government departments (e.g. Revenue), employees and their organisations, and society at large. Anyone with an interest in the performance and activities of an organisation is traditionally called a **stakeholder**.

For a business or organisation to communicate its results and position to stakeholders, it needs a language that is understood by all in common. Hence, accounting has come to be known as the "**language of business**".

There are two broad types of accounting information:

1. Financial Accounting: geared towards external users of accounting information.
2. Management accounting: geared more at internal users of accounting information.

Although there is a difference in the type of information presented in financial and management accounts, the underlying objective is the same – to satisfy the information needs of the user. These needs can be described in terms of the following overall information objectives:

Collection: Collection in money terms of information relating to transactions that have resulted from business operations.

Recording and classifying: Recording and classifying data into a permanent and logical form. This is usually referred to as "Book-Keeping".

Summarising: Summarising data to produce statements and reports that will be useful to the various users of accounting information – both external and internal.

Interpreting and Communicating: Interpreting and communicating the performance of the business to the management and its owners.

Forecasting and Planning: Forecasting and planning for the future operation of the business by providing management with evaluations of the viability of proposed operations. The key forecasting and planning tool is the "**Budget**".

The process by which accounting information is collected, reported, interpreted and actioned is called “**Financial Management**”. Taking a commercial business as the most common organisational structure, the key objectives of financial management would be to:

1. Create wealth for the business.
2. Generate cash.
3. Provide an adequate return on investment bearing in mind the risks that the business is taking and the resources invested.

In preparing accounting information, care should be taken to ensure that the information presents an accurate and true reflection of the business performance and position. To impose some order on what is a subjective task, accounting has adopted certain conventions which should be applied in preparing accounts (all of which we will explore later).

For financial accounting, the regulation or control of what kind of information is prepared and presented goes much further. Ireland, the UK and international companies are required to comply with a wide range of **Accounting Standards** which define the way in which business transactions are disclosed and reported. These are applied by businesses through their **Accounting Policies**.

The main financial accounting statements

The purpose of financial accounting statements is mainly to show the financial position of a business at a particular point in time and to show how that business has performed over a specific period.

For Financial Accounting I purposes the two main financial accounting statements that help to achieve this aim are:

1. The profit and loss account for the reporting period.
2. A balance sheet for the business at the end of the reporting period.

A balance sheet shows at a particular point in time what resources are owned by the business (“assets”) and what it owes to other parties (“liabilities”). It also shows how

much has been invested in the business and what the sources of that investment finance were.

It is often helpful to think of a balance sheet as a “**snap-shot**” of the business – a picture of the financial position of the business at a specific point. Whilst this is a useful picture to have, every time an accounting transaction takes place, the “snap-shot” picture will have changed.

By contrast, the profit and loss account provides a perspective on a longer time-period. The detail of what financial transactions took place in a particular period – and (most importantly) what the overall result of those transactions was. It provides details of the financial performance of the business within a specific accounting period. Not surprisingly, the profit and loss account measures “profit”.

What is profit?

Profit is the amount by which sales revenue (also known as “turnover” or “income”) exceeds expenses (“or costs”) for the period being measured.

Let’s now look at the different types of business entity.

Types of business entity

A business can be organised in one of several ways:

- Sole Trader – a business owned and operated by one person.
- Partnership – a business owned and operated by two or more people.
- Company – a business owned by many people and operated by many (though not necessarily the same) people.

Sole trader

The simplest form of business is the sole trader, a sole trader is a business that is owned by one person. It may have one or more employees. It is the most common form of ownership in Ireland. A sole trader is fully and personally liable for any losses that the business might endure.

The main advantages of setting up as a sole trader are:

- Total control of the business by the owner.
- Cheap and easy to start-up - there are few forms to fill in and to start trading, the sole trader does not need to employ any specialist services, other than setting up a bank account and informing the tax authorities.
- Keep all the profit – as the owner, all the profit belongs to the sole trader.
- Business affairs are private – competitors cannot see what you are earning, so will know less about how the business works and how it succeeds.
- No obligation to produce a set of published financial statements.

The legal requirements of a sole trader are to:

- Keep proper business accounts and records for the Revenue Commissioners (who will collect the tax on profits) and if necessary VAT accounts.
- Comply with legal requirements that concern the protection of the customer (e.g. Sale of Goods Act).

The main disadvantages of being a sole trader are:

- Unlimited Liability – A sole trader is liable for any debts that the business incurs. This means that any money that the owner has put into the business could be lost, but most importantly, if the business continues to incur further costs then the owner has to pay these as well. In some cases they may have to sell some of their own possessions to pay suppliers, etc. Such a risk often puts potential sole traders off setting up businesses, and also makes them consider the other forms of business structure.
- Can be difficult to raise finance, because they are small, banks will not lend to them large sums and they will not be able to use any other form of long-term finance unless they change their ownership status.
- Can be difficult to enjoy economies of scale, i.e. lower cost per unit due to higher levels of production. A sole trader, for instance, may not be able to buy in bulk and enjoy the same discounts as larger businesses.
- There is a problem of continuity if the sole trader retires or dies – what happens to the business?

The reasons for being a sole trader are often a balance between business and personal costs and benefits. Many will prefer the satisfaction of running a business with little paper work against the risks, pressure and probable long working hours.

Partnership

A partnership is a business where there are two or more owners of the enterprise. Most partnerships are between two and twenty members though there are examples like accountancy firms and solicitors firms where there are more partners.

A partnership is normally set up using a Deed of Partnership. This contains:

- Amount of capital each partnership should provide (i.e. starting capital).
- How profits and losses should be divided.
- How many votes each partner has (usually based on the proportion of capital invested).
- Rules on how to take on new partners.
- How the partnership is brought to an end, or how a partner leaves.

In the absence of this deed of partnership, the Partnership Act of 1890 will apply to avoid any disputes in the future. The act states that:

- No interest is paid on capital of the partners.
- No remuneration is paid to partners for acting in the business.
- Profits and losses are to be shared equally between partners.
- Interest at the rate of 5% per annum is paid on loans made by the partners to the partnership in excess of their agreed capitals.

The main advantages of a sole trader becoming a partnership are:

- Spreads the risk across more people, so if the business gets into difficulty then there are more people to share the burden of debt.
- Partner may bring money and resources to the business (e.g. better premises to work from).
- A new partner may bring other skills and ideas to the business, complementing the work already done by the original partner.

- Increased credibility with potential customers and suppliers – who may see dealing with the business as less risky than trading with just a sole trader.

For example, a builder, working originally as a sole trader, may team up with an architect or carpenter to form a partnership. Either would bring added expertise, but also might bring added capital and/or contacts. Of course the builder could team up with another builder as well – sharing the risk, and potentially the workload.

The main disadvantages of becoming a partnership are:

- Have to share the profits.
- Less control of the business for the individual.
- Disputes over workload.
- Problems if partners disagree over the direction of the business.

The next step for a partnership is to move towards becoming a private limited company. However some partnerships do not want to move to this stage.

The advantages of remaining a partnership rather than becoming a private limited company are:

- Costs money to set-up a limited company (may need to employ a solicitor to set up the paper work).
- Company accounts are filed so the public can view them (and competitors).
- May need to spend money on an auditor to check the accounts before they are filed.

When a partnership finishes, depending on how the Deed of Partnership is set up, each partner has an agreed portion of the business.

Partnership accounts are not examinable in the Financial Accounting I examination.

Limited company

A Limited company is a business that is owned by its shareholders, run by directors and most importantly its liability is Limited. There can be one shareholder or many thousands of shareholders. Shareholders are also known as members. Each shareholder owns part of the company. As a group they select the directors who run

the business. Directors often own shares in the company, but not all shareholders are directors.

Limited Liability means that investors can only lose the money they have invested and no more. This encourages people to finance the company, and/or set up such a business, knowing they can only lose what they have put in, if the company fails.

For people or businesses who have a claim against the company, “limited liability” means that they can only recover money from the existing assets of the business. They cannot claim the personal assets of the shareholders to recover amounts owed by the company.

A Limited company has to possess a “**separate legal entity**” from its shareholders, meaning that the company is seen as separate from its shareholders. To set up a limited company, a company has to register with the “**Registrar of Companies**”, who maintains a separate file for every company, and is issued with a “Certificate of Incorporation”. It also needs to have a “**Memorandum of Association**” which sets out what the company has been formed to do, and “**Articles of Association**” which are internal rules including what the directors can do and voting rights of the shareholders.

The distinguishing factor that differentiates a limited company from a sole trader and a partnership is that a limited company has to prepare annual “statutory accounts”; this is the price to be paid for the benefit of limited liability. Limited companies must produce such accounts annually and must appoint an independent person to audit and report on them. Once prepared, a copy of the accounts must be sent to the Registrar of Companies which maintains a separate file for every company. The file for any company can be inspected at the Companies Registration Office for a nominal fee by a member of the general public. This is why the statutory accounts are often referred to as the published accounts.

Limited companies are governed very tightly by company’s legislation, namely the Companies Acts. Limited companies can either be private limited companies or public limited companies.

The difference between the two is:

Shares in a **Public limited company (Plc)** can be traded on the Stock Exchange and be bought by members of the general public. Shares in a **Private limited company** are not available to the general public.

The issued share capital of a Plc (the initial value of the shares put on sale) must be greater than €38,092.14 (of which at least 25% must have been paid for) in an Irish plc.

A private limited company may wish to become a Plc because:

Shares in a private limited company cannot be offered for sale to the general public, so restricting the availability of finance, especially if the business wants to expand. Therefore, it is attractive to change status.

It is also easier to raise money through other sources of finance, e.g. from banks. It is important to note that a “Plc” does not necessarily mean that the company is quoted on the Stock Exchange. To do that, the company must do a “flotation”.

The disadvantages of being a public limited company (Plc) are:

- Costly and complicated to set up as a Plc – you need to employ specialist bankers and lawyers to help organise the converting to the Plc.
- Certain financial information must be available for all parties, competitors and customers included (would you want them to know how much profit you are making?)
- Shareholders in public companies expect a steady stream of income from dividends, which might mean that the business has to concentrate on short term objectives of creating profit, whereas it might be better to work on longer term objectives, such as growth and investment.
- The threat of takeover, because another company can buy up a large number of shares because they are traded publicly (can be sold to anyone). If they buy enough, they can then persuade other shareholders to join with them to vote in a new management team.

Shareholders own the company. They buy shares because:

- Shares normally pay dividends, which is a share of the profits at the end of the year. Companies on the Stock Exchange usually pay dividends twice each year.
- Over time the value of the share might increase and can be sold for a profit – this is known as a “capital gain”. Of course, the price of the shares can go down as well as up, so investing in shares can be risky.
- If they have enough shares they can influence the management of the company. A good example is a “venture capitalist” that will often buy up to 80% of the shares of a company and insist on choosing some of the directors.

Flotation

A company may float on the stock market. This means selling all or part of the business to outside investors. This generates additional funds for the business and can be a major form of fundraising. When shares in a “Plc” are first offered for sale to the general public the company is given a “listing” on the stock exchange.

Corporate Governance

As a business becomes larger, the ownership and control of the business may become separated. This is because the shareholders may have the money, but not the time or management skills to run the company. Therefore, the day-to-day running of the business is entrusted to the directors, who are employed for their skills, by the shareholders. This agency relationship between the shareholders and the directors is referred to as Corporate Governance.

The shareholders are therefore “divorced” from the running of the business for 364 days of the year. They will have their say at the Annual General Meeting (AGM) of the company, where the directors present the accounts and the results.

In practice directors tend to have at least a modest shareholding in the company. This provides the director with an incentive to achieve good dividends and capital growth for the share (an increase in the share price).

Company accounts are not examinable in the Financial Accounting I examination.

In summary for all three types of entity, the money put up by the individual, the partners or the shareholders, is referred to as the business **capital**. In the case of a company, this capital is divided into shares (**Share Capital**).

Users of financial statements

It is easy to assume that the only users of accounting information are shareholders – since it is a requirement of company law that shareholders must receive financial statements. However, in reality there are many users of accounts. The following summarises the main users groups and provides examples of their areas of interest in accounts:

Investors

Investors are concerned about risk and return in relation to their investments. They require information to decide whether they should continue to invest in a business. They also need to be able to access whether a business will be able to pay dividends, and measure the performance of the business' management team.

The key accounting information for an investor is therefore:

- Information about growth, sales, volumes.
- Profitability (profit margins, overall level of profit).
- Investment (amounts invested, assets owned).
- Business value (share price).
- Comparative information of competitors.

Lenders

Banks and loan stockholders who lend money to a business require information that helps them determine whether loans and interest will be paid when due.

The key accounting information for lenders is therefore:

- Cash flow.
- Security of assets against which the lending may be secured.
- Investment requirements in the business.

Creditors

Suppliers and trade creditors require information that helps them understand and assess the short-term liquidity of a business. For example is the business able to pay short-term debt when it falls due?

The key accounting information for creditors is therefore:

- Cash flow.
- Management of working capital.
- Payment policy.

Debtors

Customers and trade debtors require information about the ability of the business to survive and prosper. As customers of the company's products, they have a long-term interest in the company's range of products and services. They may even be dependent on the business for certain products and services.

The key accounting information for debtors is therefore:

- Sales growth.
- New product development.
- Investment in the business (e.g. production capacity).

Employees

Employees (and organisations that represent them – e.g. trade unions) require information about the stability and continuing profitability of the business. They are very interested in information about employment prospects and the maintenance of pension funding and retirement benefits. They are also likely to be interested in the pay and benefits obtained by senior management.

The key accounting information for employees is therefore:

- Revenue and profit growth.
- Levels of investment in the business.
- Overall employment data (numbers employed, wages and salary costs).

- Status and valuation of the company pension schemes/levels of company contributions.

Government

There are many government agencies and departments that are interested in accounting information. For example, the revenue commissioners need information on business profitability in order to levy and collect Corporation Tax. Customs and Excise need accounting information to verify Value Added Tax (VAT) returns; local government need similar information to levy local taxes and rates. Various regulatory agencies (i.e. the Environment Agency) need information to support decisions about grants, for example.

Analysts

Investment analysts are an important user group – specifically for companies quoted on the Stock Exchange. They require very detailed financial and other information in order to analyse the competitive performance of a business and its sector. Much of this is provided by the detailed accounting disclosures that are required by authorities such as the London Stock Exchange. However, additional accounting information is usually provided to analysts via informal company briefings and media interviews.

Public at large

Interest groups, formed by various groups of individuals who have a specific interest in the activities and performance of businesses, will also require accounting information.

Financial accounting and Management accounting

As stated earlier there are two broad types of accounting information:

Financial accounting is geared towards external users of accounting information. External users are, as discussed above, investors, creditors, debtors, lenders and the government. Such reporting is usually done in the form of financial statements. In order to facilitate comparison, financial accounts are prepared using accepted

accounting conventions and standards. International Accounting Standards (IAS's) help to reduce the differences in the way companies draw up their financial statements. The financial statements are public documents, and therefore they will not reveal details about product profitability.

Management accounting is geared towards internal users of accounting information. Internal users are, as discussed above, management and employees. Such reporting is accomplished through custom designed reports. Management need much more detailed and up-to-date information in order to control the business and plan for the future. They need to be able to cost products and production methods, assess profitability and so on. In order to facilitate this, management accounts present information in any way which may be useful to management, for example by operating unit or by product line. You will study Management Accounting as a complete subject in Second Year.

Management accounting is an integral part of management activity concerned with identifying, presenting and interpreting information used for:

- Formulation of strategy.
- Planning and controlling activities.
- Decision making.
- Optimising the use of resources.

Let's compare the types of accounting briefly:

Financial accounting

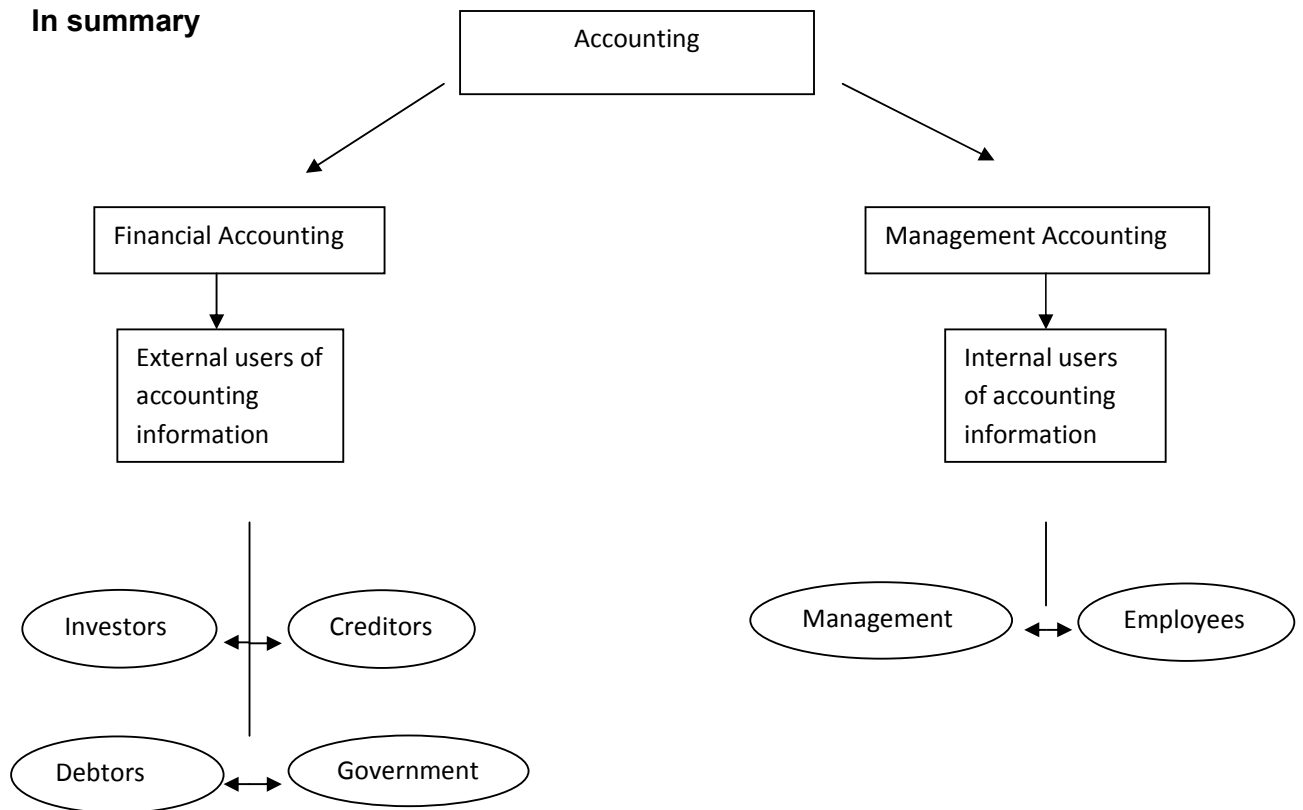
- Production of summary financial statements for external users.
- Prepared annually.
- Required by law.
- Reflects past performance and current position.
- Information is calculated and presented in accordance with strict legal and accounting requirements.

Management accounting

- Production of detailed accounts, used by management to control the business and plan for the future.
- Normally prepared monthly.
- Not mandatory.
- Included budgets and forecasts of future activities, as well as reflecting past performance.
- Information is computed and presented in order to be relevant to managers.

Although there is a difference in the type of information presented in financial and management accounting, the underlying objective is the same – to satisfy the needs of the user.

In summary



Accounting concepts and conventions

In drawing up financial statements, whether they are external “financial accounts” or internally focused “management accounts”, a clear objective has to be that the accounts fairly reflect the true “substance” of the business and the results of its operation.

The theory of accounting has, therefore, developed the concept of a “**true and fair view**”. The true and fair view is applied in ensuring and assessing whether accounts do indeed portray accurately the business’ activities.

To support applications of the “true and fair view”, accounting has adopted certain concepts and conventions which help to ensure that accounting information is presented accurately and consistently.

Accounting concepts

Five important accounting concepts underpin the preparation of any set of accounts:

Dual aspect

Dual aspect may be stated as “for every debit, there is a credit”. Every transaction should have a two sided effect to the extent of the same amount. This concept has resulted in the Accounting Equation which we will fully explore in Chapter 2, it states that at any point of time the assets of any entity must be equal (in monetary terms) to the total of the owner’s capital and outsider’s liabilities. This maybe expressed as:

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

Going Concern

Accountants assume, unless there is evidence to the contrary, that a company is not going broke and that it will continue in operational existence for the foreseeable future and there is no intention to put the company into liquidation. This has important implications for the valuation of assets and liabilities. Financial statements have to be prepared in accordance with the going concern concept.

Consistency

Transactions and valuation methods are treated the same way year to year, or period to period. Users of accounts can, therefore, make more meaningful comparisons of financial performance from year to year. Where accounting policies are changed, companies are required to disclose the fact and explain the impact of the change.

Prudence

Profits are not recognised until a sale has been completed. In addition, a cautious view is taken for future costs of the business (they are provided for in the accounts as soon as there is reasonable chance that such costs will be incurred). It is the exercise of sound judgment in practical affairs.

Matching or “Accruals”

This is the matching of expenses with revenue for the relevant accounting period. The effects of transactions and other events are recognised when they occur (and not as is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods in which they relate. An example of this is to include sales and purchases when the transaction occurs rather than when they are paid for.

Accounting conventions

The most common convention is the “**historical cost convention**”. This requires transactions to be recorded at the price ruling at the time, and for assets to be valued at their original cost. Under the “historical cost convention” no account is taken of changing prices in the economy.

The other conventions in a set of accounts can be summarised as follows:

Monetary measurement

Accountants do not account for items unless they can be quantified in monetary terms. Items that are not accounted for (unless someone is prepared to pay

something for them) include things like workforce skill, morale, market leadership, brand recognition and quality of management.

Separate Entity

This convention seeks to ensure that private transactions and matters relating to the owners of a business are segregated from transactions that relate to the business. In accounting, a business entity is treated as a separate entity from the owners. Therefore, any capital injections made by the owner are recorded as capital contribution from owners in the books of the business entity. The owner's private expenditure/spending are not recorded in the books of the business entity.

Materiality

An important convention. As we will see in later chapters the preparation of accounts involves a high level of judgment. Where decisions are required about the appropriateness of a particular accounting treatment, the "materiality" convention suggests that this should only be an issue if the judgement is "significant" or "material" to a user of the accounts. The concept of "materiality" is an important issue for auditors of financial accounts.

Key characteristics of accounting information

There is a general agreement that, before it can be regarded as useful in satisfying the needs of various user groups, accounting information should satisfy the following criteria:

Understandability

This implies the expression, with clarity, of accounting information in such a way that it will be understandable to users – who are generally assumed to have a reasonable knowledge of business and economic activities.

Relevance

This implies that, to be useful, accounting information must assist a user to form, confirm or maybe revise a view – usually in the context of making a decision (e.g.

should I invest, should I lend money to this business? Should I work for this business?).

Consistency

This implies consistent treatment of similar items and application of accounting policies.

Comparability

This implies the ability for users to be able to compare similar companies in the same industry group and to make comparisons of performance over time. Much of the work that goes into setting accounting standards is based around the need for comparability.

Reliability

This implies that the accounting information that is presented is truthful, accurate, complete (nothing significant has been omitted) and capable of being verified (e.g. by a potential investor).

Objectivity

This implies that accounting information is prepared and reported in a “neutral” way. In other words, it is not biased towards a particular user group or vested interest.

Qualitative characteristics of accounting information

Qualitative characteristics can be broken down into two components, relating to:

- Content (Relevance and Reliability)
- Presentation (Comparability and Understandability)

Accounting terminology

Reporting to the owners and user groups is done by means of financial statements, primarily the Trading, Profit and Loss account and the Balance Sheet.

Precise terminology is important in book-keeping and accounting.

A Trading, Profit and Loss account will show a profit or loss earned for the accounting period for which the report was prepared, it is a performance statement. This report shows two forms of profit as follows:

Gross profit is the difference between revenue/sales and the cost of making the product or service.

Net profit is calculated by subtracting a company's total expenses from the gross profit figure.

Sales – the exchange of goods and services for money, this includes both cash and credit sales.

Purchases – buying goods for resale or consumption, this includes both cash and credit purchases.

Income – a more general term than sales including also interest received and rent received from letting part of the business premises.

Expenses - An expense is any cost of doing business resulting from revenue-generating activities. They are the cost of carrying on a trade or business. There are two main types of costs:

- Costs of purchases for resale, which are included in the cost of sales of the trading account.
- Other costs such as wages, rent and light & heat.

We will be exploring these concepts in later chapters.

The Balance Sheet is a statement of position at the end of the accounting period. It represents the financial position of a company at a defined point in time. It lists the assets and liabilities, including the capital invested by the owner/owners, of the business at that time.

Assets

In business and accounting, assets are economic resources owned by the business or company. An asset is anything of value that the business owns – including cash. Assets get recorded in the Balance Sheet in terms of their monetary value. There are **current assets**, which can be readily turned into cash within a twelve month period (e.g. stock, debtors, bank, cash) and **fixed assets** which the business owns and uses in the business for economic benefit (e.g. Land & Buildings, Motor Vehicles, Premises, Computers and Fixtures & Fittings). Thus anything that belongs to the business or is due to the business is an asset of that business.

Liabilities

Anything a company owes to people or businesses other than its owners is considered a liability. There are two types of liability, **current liabilities**, which must be paid within a year (e.g. creditors, Bank overdraft) and **long-term liabilities**, which are debts that extend beyond one year (e.g. Long-term loans).

Owners' equity

Owners' equity, also called capital, is any debt owed to the business owners. For example, if you invested €50,000 to start a business, the amount recorded is recorded in a capital account, in the Balance Sheet.

Drawings

When a business is set up, the owner injects money into the business in the form of capital and as we have seen earlier the business is a separate legal entity from the owner of the business.

Drawings is any money taken out of the business for the owners own personal use. These are shown in the accounts but **are not treated as a business expense, instead they are treated as a reduction to capital in the Balance Sheet.** Drawings can be in the form of assets, stock or cash withdrawals.

Debtors

Debtors are customers who own money to the business as a result of credit sale transactions, the goods have been sold with payment terms being specified on the invoice. We treat these as current assets as we anticipate getting paid for these goods within the next twelve months.

Creditors

Creditors are suppliers who the business owes money to as a result of credit purchase transactions, the business has purchased goods on credit, only to pay for them at a later date (within the payment terms on the invoice). We treat these as current liabilities as we anticipate paying for these goods within the next twelve months.

Introduction to financial statements

Trading, profit and loss account for year ended December 31st 2008

	€
Sales	X
Less cost of sales	<u>(X)</u>
Gross profit	X
Less expenses	<u>(X)</u>
Net profit	<u>X</u>

Balance sheet as at December 31st 2008

	€	€	€
<u>Fixed assets</u>			
Plant & Machinery			X
<u>Current assets</u>			
Stock		X	
Debtors		X	
Bank		<u>X</u>	
		X	
<u>Less current liabilities</u>			
Creditors	X		
Bank overdraft	<u>X</u>	(X)	
Current assets less current liabilities			<u>X</u>
Net assets			X
<u>Less long-term liabilities</u>			
Long-term loan			(X)
			<u>X</u>
<u>Financed by</u>			
Capital		X	
Net profit		<u>X</u>	
		X	
Less drawings		(X)	<u>X</u>

The accountant's role and function in an organisation

It is the primary role of the accountant to support financial and management accounting reporting in the business. As discussed earlier accounting can be defined as the process of collecting, recording, **presenting** and **analysing/interpreting** financial information for the users of financial statements.

Accounting refers to the process of book-keeping that are involved in making the financial statements. This is a very important process in an organisation.

Book-keeping is the process of recording the financial effect of business transactions and managing such records.

This book-keeping process is the primary role of the accountant, to ensure that all business transactions are recorded correctly in the financial statements, in addition to ensuring that the transactions have been accounted for in compliance with the appropriate accounting rules and principles. Once the transactions have been recorded it is then the role of the accountant to interpret and communicate these results to the senior management structure of the organisation.

Accordingly, the accountant's role in the organisation can be analysed as follows:

1. Preparation and presentation of timely accurate financial/management accounts to management to help management interpret the financial information.
2. Identification of areas of inefficiency and wastages of resources in the business.
3. Treasury functions: The accountant also plays the role of the treasury functions in such a way that they raise finance, cash management, etc.
4. Setting up an effective system of internal and accounting controls.
5. Preparation of feasibility reports: These reports assist management in assessing the viability/profitability or otherwise of proposed capital expenditure such as the opening of a new factory or branch.
6. Investigation of the performance/operations of competing business organisations to assist management in policy formulation.

7. Investigation of fraud within the organisation, this is a key role of the accountant in preparation of an audit at year-end.
8. The accountant assists the organisation to avoid rather than evade tax by using his/her knowledge of the tax laws. (Tax evasion is illegal.)

Auditing

As discussed, in relation to limited companies, after preparation of the financial statements it is necessary to have a “Statutory Audit” depending on the size of the company. This is where the accountant hires an independent auditor to report on the financial statements – an auditor completes an independent check on the financial statements to ensure that the financial statements give a “true and fair view” of the business. Under company’s legislation, an auditor must be a member of a recognised body of accountants, for example, the Institute of Chartered Accountants in Ireland.

Auditors are bound by an ethical and technical framework to ensure they remain independent and to ensure that they carry out their work with due skill and care. In Ireland, the regulatory framework governing auditors is essentially comprised of:

- Ethical standards – These are intended to ensure the objectivity, integrity and independence of the auditor.
- International Standards on Auditing (ISA’s) – These are intended to ensure that the work of the auditor is conducted in accordance with international standards of best practice.

Once the audit is completed, the financial statements are signed off by the auditors with an audit report on their findings. This must then be presented by the directors at the annual general meeting of the shareholders of the company.

Not all companies are required to carry out a “statutory audit”, small companies who wish to be exempt must satisfy the following criteria:

- Turnover must not exceed €7.3m.
- Gross assets must not exceed €3.65m.

- 90% of the shareholders of the company must approve the removal of the annual audit requirement.

Ethics and the accounting technician

Ethics in accounting is of utmost importance to accounting professional and those who rely on their services. Accounting professionals know that people who use their services, especially decision makers using financial statements, expect them to be highly competent, reliable and objective. Those who work in the field of accounting must not only be well qualified but must also possess a high degree of professional integrity.

People need to have confidence in the quality of the complex services provided by accountants and accounting technicians. Because of these high expectations, accountants have adopted a code of ethics, also known as codes of professional conduct. These ethical codes call for their members to maintain a level of self-discipline that exceeds the requirements of laws and regulations.

Codes of ethics

By joining professional organisations, like ATI and CIMA, accountants and accounting technicians agree to uphold the high ethical standards of their profession.

Independence can sometimes be an issue for accountants. Maintaining integrity and objectivity calls for avoiding both actual and apparent conflicts of interest. Being independent in fact and in appearance means that one not only is unbiased, impartial, and objective but also is perceived to be that way by others. While applying to all accounting professionals, independence is especially important in the audit profession, to ensure that he or she has no interest or ties to the company that they are auditing.

Whistle blowing

A whistle blower is a person who alleges misconduct in the workplace and it covers all methods of reporting by employees of any criminal practices within their company. Whistle blowers make their allegations internally (for example, to other people within the accused organisation) or externally (to law enforcement agencies, to the media or to groups concerned with the issues). This practice may cause discontent in the work place as it involves a clash between loyalty and confidentiality.

SAMPLE QUESTIONS & SOLUTIONS PROGRAMME

The following questions examine the key areas you are expected to know for this particular subject, and will assist you significantly in your preparation for your examination in May/August 2010. In addition to the questions below, please also refer to the Summer 2009 examination paper which is contained in this manual for your reference. Pilot papers for this subject can be downloaded from www.AccountingTechniciansIreland.ie

Question 1:

Identify and explain three characteristics that make accounting information useful.

Question 2:

Distinguish between Financial and Management Accounting.

Question 3:

Discuss the Business Entity concept.

Question 4:

Identify four users of financial information, and include the type their information needs.

Question 5:

Discuss the role of the accountant in an organisation.

Solutions to the chapter questions above will be available online for students from January 2010 (in order to have provided you with sufficient time to have covered certain parts of the course.)

For those of you of wish to attempt any of the above chapter questions (and without looking at the solutions online!), you can email your answers to solutions@accountingtechniciansireland.ie from January 11th, 2010. Detailed feedback* will be provided to you within 3 working weeks of receipt. (These questions will not in any way count towards your summer examination marks.) This is a free service to our students and you are strongly advised to avail of it as past students have noted the benefits.

**** Proof of purchase of this manual may be required.***

