Unit 1

Basic principles of Accounting

Glossary
COMPLEMENTARY – each activity depends on the other
INTEGRATED – treated as a combined whole

What is accounting? Accounting is concerned with two separate but COMPLEMENTARY business activities:

- The detailed recording of all the financial transactions of the business (called **bookkeeping**).
- The preparation of periodic statements (or accounts) which summarise the detailed information, so that the financial performance of a business can be measured.

Recording of the financial details follows certain procedures and these records – bookkeeping's end product – become the raw material for the production of the final accounts of the business.

This module deals primarily with the first of these two aspects of accounting, covering in depth the purposes and conventions of accounting, the sources and recording of information and the ways in which records are verified. However, as the subject is treated in an INTEGRATED way over three modules, reference will sometimes be made in this module to topics dealt with fully in Modules 2 and 3.

This unit is divided into five sections:

Section 1:	Introduction to Accounting
Section 2:	The accounting equation
Section 3:	The double entry system
Section 4:	The Ledgers
Section 5:	The Trial Balance

Section 1 Introduction to Accounting

By the end of this section, you should be able to:

- explain the meaning of the term "accounting"
- explain the objectives of Accounting
- explain the importance of Accounting information to various users
- identify the branches of Accounting
- explain the principles of business entity and money measurement and illustrate with examples
- discuss ethics in the job, the combating of fraud, and financial risk management
- explain the application of computers in accounting records and their usefulness in business situations
- explain the advantages of a computerised system vs. a manual system of Accounting
- explain the application and advantages of computers as a tool for communication technology

The term Accounting

Accounting is termed as the analysis, classification and recording of financial transactions, and the ascertainment of how such transactions affect the performance and financial position of a business.

Accounting is therefore concerned with:

- recording of data
- classification and summary of data
- communicating what has been learned from the data.

Objectives of Accounting

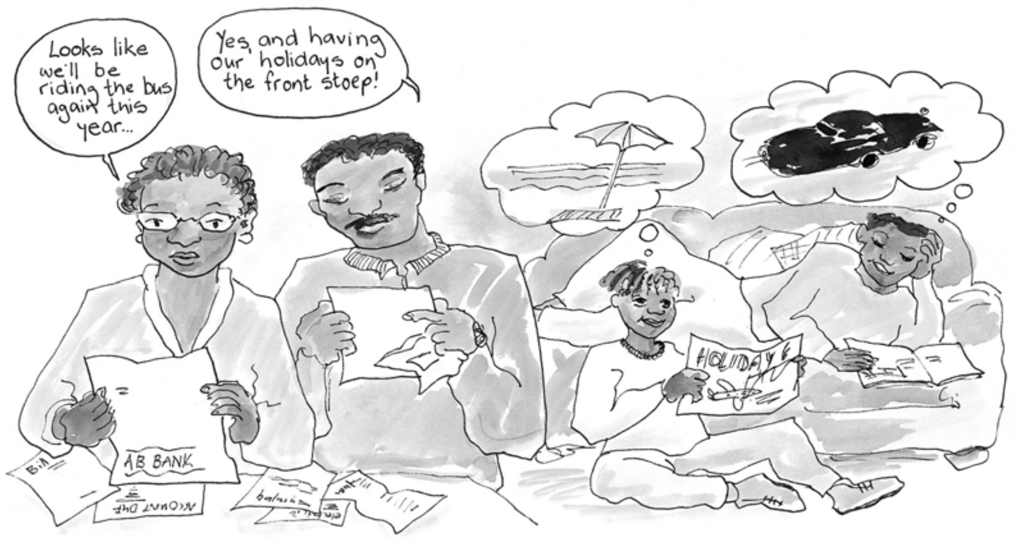
The following are some of the objectives that you should achieve while studying this subject:

- use the accounting rules or concepts to analyse case studies and real business events
- interpret and evaluate accounting statements, systems and reports
- providing a means of developing a critical and analytical approach to quantative problems
- apply numeric skills required for Accounting
- use Accounting to assist in decisionmaking and
- describe the impact of computers on Accounting.

Recording financial information

Who needs financial information?

The day-to-day records of financial transactions are a vital part of running any kind of business. Of course individuals also have some financial records. Payslips show wages received like the Kumalo family in the picture below, bills show a person's spending, and regular statements tell customers how much they have in the bank. So not only can the Kumalo's gain a clear picture of their present financial position, they can also use such information to plan for the future – to see if they can afford a family vacation or, perhaps next year, a new car.



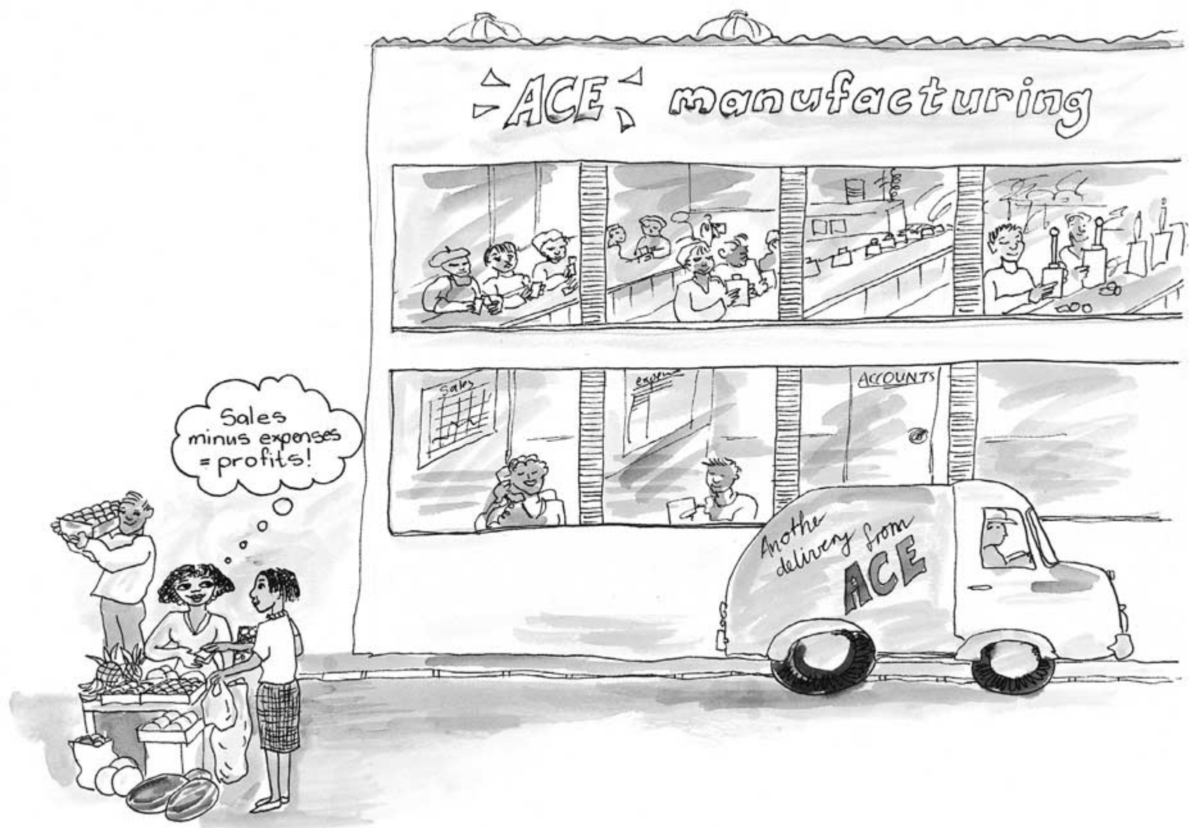
Financial information for businesses

Businesses operate in a similar way to the Kumalo's, but with more formal systems for recording and using their financial information. Even in a small business the owner could not remember the details of every transaction, so some form of record is needed.

The development of monetary systems (gradually replacing direct exchange, known as barter) allowed the results of trade and commerce to be measured more exactly, but FORMAL recording methods followed only slowly. By the end of the fifteenth century, however, DOUBLE ENTRY BOOKKEEPING had become an established method of recording and remains the basis of today's accounting systems.

The nature of the financial records kept will depend on the type of business being considered. For example, the owner of a retail shop will need details of daily sales receipts, assistants' wages and other expenses such as rent and insurance. A manufacturing business, on the other hand, will include records of its raw material purchases, finished product sales, equipment and machinery and a detailed analysis of its expenses.

Glossary
FORMAL – following an agreed method
DOUBLE ENTRY BOOKKEEPING – a system of recording financial information which recognises that there are two aspects to every business transaction



But remember: Whatever the size and type of business, the principles of the system are the same:

Recording the day-to-day financial transactions → BOOKKEEPING

↓

Enabling preparation of periodic financial summaries and interpretation of it → ACCOUNTING

Importance of Accounting to various information users

Information needs to be communicated to interested parties. No business can operate in isolation. It needs other people and businesses to operate. Let us look at each of the external and internal users of the data and how the books of the business will be important to them.

Internal users

- **Owner**: The owner obviously needs to see whether his/her investment has made a profit or a loss.

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- **Employees**: As the employees are working for the business, they have a direct interest in the financial affairs of the business.

External users

- **Banks and other financial institutions**: They will be interested in whether the business will be able to repay loans, or whether its financial position is sound when loans are requested.
- **Potential investors/Prospective buyers of the business**: They want to see whether their investment will be worthwhile and will also be interested in the progress the business has made, or whether the business is making a profit.
- **The government (Receiver of Revenue)**: The government will need bank statements in order to calculate the taxes that the business needs to pay, namely VAT and tax on profits.
- **Customers and suppliers**: They want to ensure that a business is solvent prior to entering a trading relationship. This includes actual and potential customers and suppliers.
- **The local community**: They may be concerned about the effects of redundancy, closing down of factories, etc.
- **Business competitors**: They measure their own performance against that of their rivals.
- **Economic analysts**: They attempt to establish trends by an analysis of the results of particular businesses.
- **Members of the general public**: They may require information relating to environmental, ecological or other attitudes revealed in annual company reports.
- **Future partners**: They want to see whether their investment will be worthwhile and will also be interested in the progress the business has made, or whether the business is making a profit.

Using financial information – the key questions

It is essential to know two things about a business

1. Is it making a PROFIT?
2. What are its ASSETS, and are they enough to meet its LIABILITIES ?

In any business, financial records are the main source of information providing answers to these key questions.

The profit (or loss) of the business is measured over a certain time period and is shown in the **Trading** and **Profit and Loss accounts.**

The summary of the business' financial position on a certain date is contained in the **Balance Sheet**.

Glossary
PROFIT – sales revenue less expenses (running costs) over a given time period
ASSETS – any item of property a business owns or is owed
LIABILITIES – what a business owes to others

Branches of Accounting

The subject Accounting covers a very broad range of relevant and related topics. It is divided into the following three branches:

Cost and Management Accounting

That part of Accounting that has to do with the provision of information to interested parties inside the business, especially to managers, to help them with decisionmaking, planning, management and control, is called cost and management accounting.

Financial Accounting

Financial Accounting is that part of Accounting that has to do with the provision of information to interested parties outside the business. We know that parties like prospective buyers, the Receiver of Revenue, banks, future partners and investors will need information that will be provided by the financial accountants.

Auditing

Auditing is that part of Accounting that determines whether recorded information is a true reflection of the business transactions that took place during an accounting period. Auditing is done in two ways. It can be done internally, that is when the business itself does it, or externally – when the business contracts an outside company to do it. Most companies make use of both methods.

The business entity principle

The business entity principle distinguishes between the accounting aspects of a business and those of the owner(s), which are regarded as quite separate from the business. That means that the business' financial records will always be treated separately from the owners' records – thus a sole trader's private bank account is kept completely separate from his or her business bank account.

Money measurement

Only that information which can be expressed in terms of money is recorded in accounting statements. The many other factors that affect a business' performance, but which cannot be measured or expressed in monetary terms, are ignored.

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Ethics in the job, combating fraud and financial risk management

Ethics

The word "ethics" refers to a set of moral principles or values that are embraced by a certain community. The business community, as part of the total community, also abides by certain written and unwritten laws. Some of these laws – or rather norms and values that can be taught (not inherited) – are:

- honesty
- self-control
- trustworthiness
- concern for others
- keeping promises
- respect for legitimate authority
- fairness
- civility
- discipline
- morality
- accountability
- integrity.

The purpose of ethics in business is to direct businessmen and women to abide by a code of conduct that facilitates and encourages public confidence in their products and services.

Professional accounting organisations recognise the accounting profession's responsibility to provide ethical guidelines to its members.

A code of ethics is a crucial element in the forming of a professional person.

Ethical guidelines are there to support the decisionmaking process in situations that involve ethical questions.

When social values deteriorate, it becomes increasingly difficult to maintain high ethical standards in accounting and business.

Businesses need to know that the profit motive, generally accepted knowledge and recognised standards of achievement are not the only driving forces towards success, but that business also has a moral and social obligation towards the community from within which it operates.

Ethics are essential for the efficiency of an organisation. People need to know that what they are doing is socially meaningful and worthwhile. Ethics are also essential for interpersonal relationships, trustworthiness and honesty.

Combating fraud

Fraud is at present one of the major causes of business failure. It involves deliberate deception. Employees, managers, directors and international crime syndicates are all potential white-collar criminals.

Fraud is defined as "unlawful and intentional misrepresentation which causes actual prejudice, or which is potentially prejudicial to another."

Fraud comprises the following elements:

Unlawfulness – The action must be seen to be wrong in the eyes of the law, and of society.

Misrepresentation – A false statement made by one person to another. The misrepresentation may take the form of word, words and conduct, or just conduct. A misrepresentation may also be a failure to disclose certain information in circumstances where there is a duty to do so.

Intent – The person making the misrepresentation must have intended or foreseen that the victim would be deceived.

Prejudice – The victim would have suffered prejudice by reason of altering his position to his detriment after relying upon the misrepresentation. Potential prejudice is also sufficient if it is reasonably possible that the victim, relying on the misrepresentation, would have suffered harm.

Fraud is a punishable crime.

Areas where fraud can occur in a business:

- Asset misappropriation
  - cash/inventory supplies/assets can be stolen
  - misuse of fixed assets
- Fraudulent financial statements
- Cheque fraud
- Computer crime

Fraud can be combated by means of the following:

- good staff development programmes
- sound mutual inter- and intra-personal relationships between employers and employees
- regular stocktaking
- internal audit
- external audit
- anti-corruption laws

- solid presentation techniques and procedures
- appropriate reaction planning

Fraud prevention: A four-step approach

Step 1: Screen out fraudsters before hiring them

Step 2: Reduce opportunities for fraud

Step 3: Create an "anti-fraud" environment

Step 4: Prosecute all fraudsters

Financial Risk Management

The main aim of any business is to make profit. In order to achieve this, a company needs to have clear objectives. However, no matter how clear your objectives are, with human beings around there will always be unwanted activities like theft, dishonesty, fraud and corruption. It is therefore important to anticipate and keep to the minimum as far as possible the occurrence of this type of unwanted activity.

These risks are called financial risks and can be minimised through **financial risk management**. Companies should identify and manage these risks in such a way that they may not derail any progress towards achieving their objectives. Risks not known and managed leave loopholes for theft, fraud etc.

The main question to be asked with regard to financial risk management is this:

"What could cause my company to lose assets (money, stock, time) or what will make my business vulnerable to lose these assets?"

The following are guidelines in how to manage financial risks:

1 Assess and analyse the systems in use.

2 Determine or forecast what might go wrong.

3 Assess the point of entry of assets. How are they recorded?

4 Close down the risks by doing the following:

- Define the risks in order to avoid them.
- Be pro-active. People are out to beat any system. Try to beat them at their own game.
- Design systems, policies, rules, procedures and regulations to limit risks of fraud, theft, corruption, etc.
- All employees of the company should understand and comply with the abovementioned.
- These systems, policies, rules and procedures should be transparent and objective.

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Computers and Accounting

Application of computers in Accounting records and their usefulness in business situations

Computers are used in every sphere of society – and all over the world. Therefore, as Accounting is an integral part of the world out there, computers are used to record, store and retrieve Accounting information efficiently and effectively.

In Accounting, computers are used for the following applications:

- Computerised ledgers and sets of books (source documents to financial statements)
- Spreadsheets
- Data base
- Stock handling
- Reports

Advantages of a computerised system versus a manual accounting system

- accurate and time-saving, providing the system is mastered
- processing of transaction much quicker than manual
- information can easily be stored and retrieved
- saves space, compared to many cumbersome files used in manual operations
- back-up copies assure that information cannot be lost
- comparisons with previous years can be done
- programs with built-in controls can easily detect errors
- assures better supervision when computers are linked
- better decision-making, as detailed reports are instantly available.

Application and advantages of computers as tools for communication technology, for example electronic banking and e-mail

- time-saving, as staff members need not to go to the bank for bank statements, for example, because statements can be drawn at any time
- making use of the Post Office is minimised, because e-mails can be sent more quickly and an answer received almost immediately
- credit transfers can be done electronically at any time of the day – no need to go to the bank
- only necessary to write out a limited number of cheques, as payments are done electronically.

