Fundamentals of accounting

1. Basics of accounting (for economists)

What is accounting?

Financial reporting can be thought of as a lens through which you can view a business. Accounting serves to represent the numbers and activities generated from business activity as economic activity, for decision makers of the businesses, shareholders, etc. This is done through financial statements, which are prepared using accounting principles that try best to fairly represent the business.

Managerial interests in accounting and the need for adequate disclosure

Managers have the incentive to make the company look strong in financial statements and may be motivated to engage in 'window dressing'. So, while financial statements are fair representations of the financial position and economic activities of the company, they may not describe the *typical* financial situation of the business throughout the entire period. Having more frequent financial statements helps to address this as managers are less able to window dress.

Adequate disclosure means that the users of financial statements are informed of all information necessary for the proper interpretation of financial statements.

Types of business organisations

<u>Sole proprietorships</u>

- A business owned by one person
- In accounting, business entity is regarded as separate from the financial activities of the owner
- Legally, they are considered as a single entity – owner is personally liable for the debts of the businesses

<u>Partnerships</u>

- A business owned by multiple people
- In accounting, business entity is regarded as separate from the financial activities of the owners
- Legally, they are considered as a single entity – owners are personally liable for the debts of the businesses

<u>Corporations</u>

- Legally, the business is separate from its owners, and they can lose no more than the amounts they have invested in the businesses – known as limited liability
- Ownership of a corporation is divided into shares, and owners are called shareholders

2. Assets, liabilities and equity

Assets

<u>What is an asset?</u>

- Resources controlled by a business from which future economic benefits are expected to flow to the business
- Can be definite and physical (e.g. cash, machinery, land)
- Can be intangible (e.g. amounts due from customers, investments in bonds, patents)

<u>Valuation of assets: four principles</u>

- **The cost principle**: non-liquid assets should be presented at their *historical cost* (what was paid to acquire the asset). Only liquid assets should be valued at their market or net-realisable value. The dollar amounts listed for non-liquid assets thus do not indicate prices at which they could be sold or replaced.
- **The going-concern – why we value at cost #1:** non-liquid assets are acquired for use and not resale – assuming that the business will continue (going-concern), there is no need to factor resale or replacement values in financial statements.
- **The objectivity principle = why we value at cost #2:** accounting for the value of assets is the need for a definite, factual basis. Costs (already incurred) are factual and backed by objective evidence, while estimates are subjected to personal judgement and market fluctuations.
- **Usefulness of asset valuation – the stable-dollar assumption:** a limitation of measuring assets at historical cost is that the value of the dollar is not always stable – inflation or deflation could over- or under-estimate the value of assets.

Liabilities & equity – financiers and claims to assets

<u>Liabilities</u>

- Financial obligations or debts that represent negative future cash flows for the enterprise
- The entity to whom the debt is owed is called a creditor
- Represent claims against borrower's assets – creditors' claims take legal priority over those of owners

<u>Equity</u>

- The owner's claims on the assets of the businesses
- Made up of share capital (injections from shareholders) and retained earnings (profits)
- Because liabilities have a legal priority over the claims of the owners, owners are entitled to assets that are *left over*, thus leading to the accounting equation
- Decreases or increases are from transfer of assets between the business and shareholders, or profits and losses from business operations

<u>Business organisations and the recording of equity</u>

The accounting equation

Assets = liabilities + equity

- Listing of assets shows us what things the business owns; listing of liabilities and equities tell us who and how much each group supplied to the business
- All assets are financed by liabilities (debts) or equity (owner's money), thus the total claims of the financiers equal the assets of the business

3. Profit, revenue and expenses: recognising economic activity

Revenue & expenses

<u>Revenue</u>

- The price of goods and services sold during a given accounting period
- Indicates the *gross* increase in equity resulting from the operation of businesses – ceteris paribus, the inflow of cash and receivables from operation increases assets, thus increasing equity
- Recognised when it is probable

<u>Expenses</u>

- Costs of the goods and services used up in the process of earning revenue
- Indicates the *gross* decrease in equity – due to a decrease in assets or increase in liabilities

When to recognise revenue and expenses: the recognition and matching principles

Revenue and expenses should be recognised at the time the goods or services are sold – because at that point, the business has completed the earnings process and the sales value of the good or service can be measured objectively.

- Revenue is recognised at the point where it is earned – independent of when a contract is signed or when cash is paid. Most often when good or service is transferred to buyer at delivery, or if probable that future economic benefits will flow to the entity and it can be reliably measured
- Expenses are incurred for the purposes of producing revenue – and so revenue should be offset by the expense it incurs on the basis of cause and effect

The critical question to decide *when* it is recognised is: at what point is the good or service rendered? And where/when does the expense help to produce that revenue?

<u>Expenditure over more than one accounting period: purchasing an asset or an expense?</u>

There must be objective evidence that an expenditure will produce revenue in future periods before it can be viewed as creating an asset (that is used to earn revenue). If no such evidence exists, it will be recorded as an expense.

Profit, dividends and retained earnings

Profit

Profits = change in equity (retained earnings) = revenue/income – expenses

- The increase in equity resulting from the profitable operation of a businesses
- Does not consist of cash or any specific assets – no direct relationship to the types or amounts of assets on hand
- Computation of the overall effects of businesses transactions on equity
- Causes the balance in retained earnings account to increase

Dividends

- A distribution of assets by a corporation to its shareholders
- Not an expense – does not generate revenue, but a distribution of profits to owners of a businesses
- Linked to retained earnings account

Retained earnings

Equity = share capital + retained earnings – dividends

- The total profits of corporation over entire lifetime less dividends
- Retained earnings represent the earnings retained to finance growth

Cash vs. accrual basis of accounting

Cash accounting

- Records only inflows and outflows of cash, revenue and expenses are recognised according to cash flows
- Does not accurately capture economic activity (decisions and production) within a time period

Accrual accounting

- Recognises revenue it is earned and expenses when the related goods or services are used
- Accurately captures economic activity within period of time by acknowledging timing differences in business transactions

4. Financial statements

The three primary financial statements are **statement of financial position (balance sheet)**, **income statement**, and **statement of cash flows.**

Financial statements

Statement of financial position (balance sheet)

- The balance sheet indicates where the company stands in financial terms *at a specific point in time*
- It consists of three distinct sections: assets, liabilities and equity

Income statement

- A summarisation of the company's revenue and expense transactions *over a period of time*
- Each entry is dated

Statement of cash flows

- Classifies the various cash flows *over a period of time,* each entry is dated
- Consists of three sections: operating, investing and financing cash flows, and relates them to the beginning and ending cash balances
    - Operating cash flows: cash effects of revenue and expense transactions *included in the income statement*
    - Investing cash flows: cash effects of purchasing and selling assets
    - Financing cash flows: cash effects of owners investing, creditors loaning and the repayment of either or both

Accounting period: time period covered by the income statement and statement of cash flows

Relationship between financial statements

- Balance sheet – gives a static look in financial terms of where the company stands
- Income statement and statement of cash flows help to explain the financial position on that date by showing how the revenues, expenses and cashflows have changed to result in that combination of assets, liabilities and equity
    - Income statement: specific focus on revenue and expenses; link to operating cash flows in statement of cash flows
    - Statement of cash flows: explains any changes in assets, liabilities and equity that are not explained by operating transactions of revenue and expenses

5. Accounting in practice: the accounting cycle and double entry accounting

The accounting cycle

An accounting system includes a separate record for each item that appears in the financial statements, known as a *ledger account*. The entire group of accounts is kept together in an accounting record called a *ledger*. Information about each business transaction is initially chronologically recorded in a record called the *journal* – indicating which accounts to debit, credit and a brief description. It is then posted to the ledger.

The accounting cycle is the sequence of procedures used to record, classify and summarise accounting (and thus economic) information in financial reports at regular intervals. Basic steps consist of:

- Journalising (recording) transactions:
- Posting journal entries to the appropriate ledger accounts
- Trial balance, adjustments, preparation and finalising

Double entry accounting

An account accumulates in one place all the information about changes in a specific financial statement item – and consists of three elements – title, left/debit side, right/credit side.

Debit and credit entries

Depending on the account type, when there is an increase or decrease, there will be a debit or credit recorded.

Determining the balance of a T account

The balance is simply the difference between the debit and credit entries in an account. If debit > credit entries, there is a debit balance, and vice versa.

The equality of double debits and credits: double entry accounting

The phrase *double entry* refers to the need for both debit and credit entries, equal in dollar amount, to record every transaction.

The rules for debits and credits are designed based on the accounting equation: asset accounts have debit balances, and liabilities and equity accounts will have credit balances. For the equation to balance, each debit (increase in what is financed by and thus owed to someone) must be paired by a corresponding credit (increase in financing by someone).

Recording transactions

How to record transactions:

1. What category is the item in? Does it increase or decrease? → debit/credit
2. Which category does that 'value' go? → credit/debit

Account	Increase	Decrease
Assets	Debit	Credit
Liabilities	Credit	Debit
Equity	Credit	Debit
Revenue	Credit	Debit
Expense	Debit	Credit