

Class: MSc

Subject : Business finance

Chapter: Unit 3 Chapter 1

Chapter Name: Accounting terminology

Today's Agenda

1. Introduction
 1. Types of Accounting statements
 2. Users
 3. Sources of regulation
 4. Reporting requirements
 5. True & fair view in audit
2. Accounting concepts
 1. Cost concept
 2. Money measurement
 3. Business entity concept
 4. Realisation concept
 5. Accrual concept
 6. Matching concept
 7. Dual aspect concept
 8. Materiality
 9. Prudence
 10. Going concern concept
 11. Consistency

1 Introduction

Translating normal language into record keeping by way of certain prescribed accounting principles.
Any business transaction, which has a value assigned to it, needs to be recorded as per the principles of accounting

1.1 Types of Accounting Statements

Statement of Profit and Loss – Incomes and Expenses for the year particular period for which P&L is created = Whether the company is Profitable or Loss Making

Balance Sheet – Track of Long term financial standing of the company – Assets (something that we own) and Liabilities (something that we owe); Working Capital

Statement of changes in Equity (Owners Capital) – Should be a Liability (Amount owed to outsiders) – Forms part of the Balance Sheet and shown with other Liabilities but shown as Owners Capital

Cash Flow Statement – Record any money transactions that happen – Incoming or Outgoing

1.2 Users

- Users
 - Equity Investors
 - Creditors
 - Employees
 - Customers, Suppliers and Other Business Contacts
 - Stock Exchange
 - Management of the Company
 - Tax Authorities
 - **Stock Analysts**
 - Credit Rating Agencies

1.2 Users

1. Equity investors

Investment decisions require information about profits (including dividend policy) cashflows. Analysts are constantly preparing and updating forecasts of performance. The annual report provides an opportunity to 'fine tune' these forecasts. Existing shareholders also require information about the transactions authorised by the directors for stewardship purposes.

2. Loan creditors

Lending decisions involve the measurement of the risk of default. A lender wants to know whether a business can generate sufficient cash to repay any loan. The lender will also wish to ensure that the business has an adequate asset base to meet its obligations in the event of failure. To this end, loan agreements often contain restrictive covenants which are based on figures from the accounts.

3. Employees

Employees are interested in the enterprise's ability to pay salaries and offer job security.

4. Business contacts

Business contacts are interested in continuity of sales (to customers) and of materials and services (from the suppliers). Their interest is, therefore, similar to that of the shareholders. They may also use accounting information to try to gain some insight into the company's pricing and trading policies.

1.2 Users

5. Management of company:

It's important to have a method for tracking the impact your efforts have on your company's bottom line. Financial statements are also useful when managing and planning budgets. Being able to see your company's expenses line by line on both the income and cash flow statements can highlight areas where it's possible to cut costs.

6. Tax authorities:

Financial statements are important to tax authorities to ensure the accuracy of taxes and additional duties declared and paid by your company.

7. Credit rating agencies :

At the time of calculating the rating, credit rating agencies take into consideration several factors like the financial statements, level and type of debt, lending and borrowing history, ability to repay the debt, and past debts of the entity before rating them.

1.2 Users

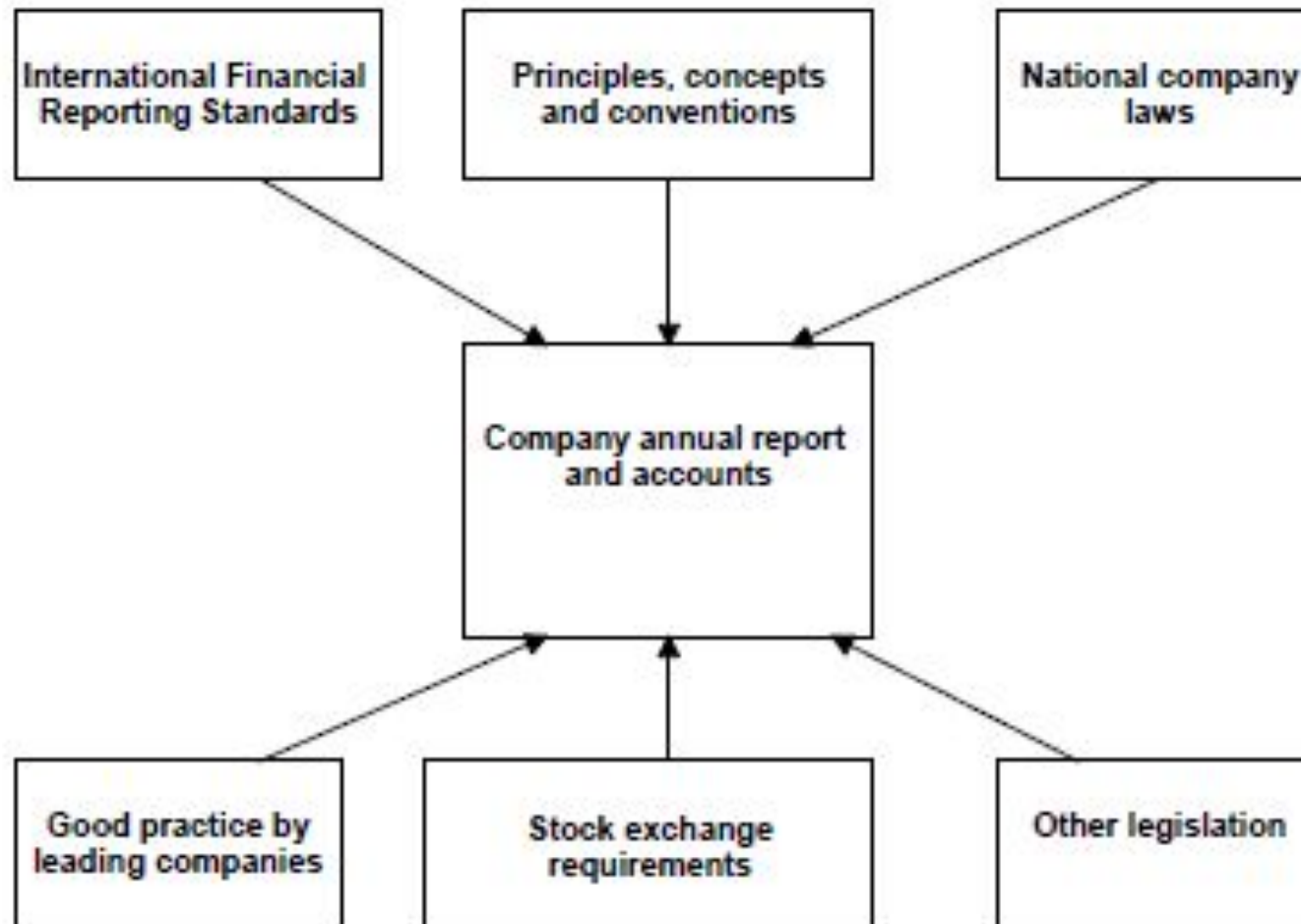
The annual report of a large company will, therefore, have a wide readership. In addition to the 'legitimate' users described above, the financial statements will also be read by:

1. government agencies (including the tax authorities)
2. competitors
3. potential predators.

The relationship between the management of a company and the various users listed above can be complex. At best there is likely to be a degree of mistrust. For example, shareholders might be concerned that the directors will act in their own best interests even when this would be to the detriment of the company.

1.3 Sources of regulation

The credibility of published financial statements is protected by regulations from a number of sources.



1.4 Reporting Requirements

Statutory Reporting

1. a statement of financial position showing the financial position on the last day of the company's financial year (International Financial Reporting Standards require that this be entitled the 'statement of financial position')
2. a statement of profit or loss for the financial year (International Financial Reporting Standards require that an extended form of this statement be entitled the 'statement of comprehensive income')
3. detailed disclosures which are normally presented as a series of notes to the accounts
4. a directors' report
5. an auditors' report.

1.5 True and Fair View in an Audit

Running a business involves a large human element, which cannot be mathematically or scientifically prescribed. The director must make his own assessment of the likelihood of default and take all possible steps to ensure that his decision is based on all the available information.

The Companies Act's accounting requirements run to dozens of pages of detailed rules. There is, however, one overriding requirement. That is that the financial statements must give a 'true and fair view'. The Act does not define truth and fairness and so the phrase must be interpreted in terms of normal English usage. There is, however, a growing body of evidence that this is a term of art and that it has a technical meaning for accountants.

To a large extent, the truth and fairness of the statements can be determined by whether they comply with the rules and regulations outlined above.

It is, however, necessary to exceed the formal disclosure requirements or to deviate from the rules governing calculation if doing so would enable the company to give a true and fair view. This requirement to look beyond the codified rules appears to give the concept of truth and fairness an independent existence.

2 Accounting concepts

Accounting standards are based on concepts and conventions which have gradually come together and evolved over many years since bookkeeping and accountancy came into being. In more recent years accounting standards bodies have attempted to put more cohesion behind these concepts and conventions.

For example, the International Accounting Standards Board published IAS 1 'Presentation of Accounting Statements' and IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

Accounting Standards have placed greater emphasis on neutrality, rather than prudence, and there has also been a move away from historical cost towards 'fair values'.

2.1 Cost concepts

Under that concept, non-current assets generally appear in the statement of financial position at their original cost less depreciation to date, subject to a possible impairment write-down.

The cost concept is being gradually phased out to provide more scope for realism in the financial statements. For example, tangible non-current assets such as property, plant and equipment can be shown at their fair value rather than their historical costs.

2.2 Money Measurement

Accounting statements restrict themselves to matters which can be measured objectively in money terms.

Again, this simplifies accounting enormously. It also means that a statement of financial position will rarely give even a rough approximation of the value of the business because it will exclude such items as the values of the company's customer base, its workforce and its brand names.

2.3 Business Entity Concept

Affairs of the business are kept separate from those of the owners.

This is perfectly valid in the case of a limited company, which has its own legal identity. It would, however, also apply to sole traders and partnerships where the business does not have a separate legal form.

2.4 Realisation Concept

Income is recognised as and when it is 'earned'. It is not, therefore, necessary to wait until the customer settles his or her bill. This avoids the fluctuations in reported income which might arise if everything was accounted for on a cash basis.

May also create the impression that the business is performing well when, in fact, it is in danger of running out of cash.

2.5 Accrual concept

Expenses are recognised as and when they are incurred, regardless of whether the amount has been paid.

Again, this avoids the random allocation of costs to periods depending on whether the bill happens to have been paid or not.

2.6 Matching concept

Income and expenses which relate to each other should be matched together and dealt with in the same statement of profit or loss.

2.7 Dual Aspect concept

Dual aspect concept recognises that every transaction or adjustment will affect two figures. For example, the purchase of inventory for cash will increase the asset of inventory and reduce the asset of cash.

This concept forms the basis for the double entry bookkeeping system

2.8 Materiality

There is very little point in making minute adjustments which have no real effect on the overall picture portrayed by the financial statements.

Accountants might report rough approximations for certain costs rather than waste time calculating more precise figures.

2.9 Prudence

Lowest reasonable figure should be stated for profit or for any of the assets. The highest reasonable figure should be stated for any liabilities.

This means that there is very little danger of the figures lulling anybody into a false sense of security by overstating the company's strengths.

To be applied in *situations of uncertainty*

2.10 Going Concern Concept

Assumed that a business will continue indefinitely in its present form

To support the cost concept of accounting

2.11 Consistency

Figures published by the company should be comparable from one year to the next.

Accounting policies should not, therefore, be changed from one year to the next unless there is a very good reason for doing so. Any changes should be highlighted and their impact explained, which may involve restating prior year figures in the accounts.

2 Questions

1. Depreciation is an application of which of the following concepts?
 - A. Going Concern
 - B. Accrual
 - C. Prudence
 - D. Matching

2. Which accounting concept states that “the lowest reasonable figure should be stated for profit or for any of the assets and the highest reasonable figure should be stated for any liabilities, without including deliberate margins, when there is uncertainty”?
 - A. Materiality concept
 - B. Prudence concept
 - C. Realization concept
 - D. Accruals concept

3. Stocks are valued at lower of cost or market value. This is the result of which accounting concept –
 - A. Materiality concept
 - B. Cost concept
 - C. Prudence concept
 - D. Realization concept