Accounting Principles and the Financial Statements

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SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

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Accounting Principles and the Financial Statements

What Is Accounting?

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- Accounting is the language of business.
- It is the language companies use to tell their financial story.
- Accounting is a system of maintaining records of a company´s operations and communicating that information to decision makers.
- Using accounting to maintain a record of multiple transactions allowed for better exchange among individuals and aided in the development of more complex societies.
- In total, accounting involves ***the entire proces of identifying, recording, and communicating economic events.***

What Is Accounting?

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- Accounting consists of three basic activities – it
  - identifies,
  - records,
  - communicates the economic events of an organization to interested users.

Identifies

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- As a starting point to the accounting proces, a company **identifies the economic events relevant to its business.**

- Examples of economic events are the sale:
  - of food and snacks by Unilever,
  - the providing of telephone services by Telecom,
  - and the manufacture of motor vehicles by Tata Motors.

Records

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- Once a company identifies economics events, it **records** those events in order to provide a history of its financial activities.
- Recording consists of keeping a **systematic, chronological diary of events**, measured in monetary units.
- In recording, Unilever also classifies and summarizes economic events.

Communicates

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- Finally, Unilever communicates the collected information to interested users by means of accounting reports.
- The most common of these reports are called financial statements.
- To make the reported financial information meaningful, Unilever reports the recorded data in a standardized way.
- It accumulates information resulting from similar transactions.

Communicates

- For example, Unilever accumulates all sales transactions over a certain period. Of time and reports the data as one amount in the company´s financial statements.

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- Such data are said to be reported in the aggregate.

- A vital element in communicating economic events is the accountant´s ability to analyze and interpret the reported information.

Communicates

- Analysis involves use of
  - ratios,
  - percentages,
  - graphs,
  - and charts to highlight significant financial trends and relationships.
- Interpretation involves **explaining the uses, meaning, and limitations of reported data**.

Accounting Process

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- Accounting process includes the bookkeeping function.
- Bookkeeping usually involves only the recording of economic events.
- It is therefore just one part of the accounting process.

People Make Decisions About Companies

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- **Investors** decide whether to invest in stock.
- **Creditors** decide whether to lend money.
- **Customers** decide whether to purchase products.
- **Suppliers** decide the customer´s ability to pay for supplies.
- **Managers** decide production and expansions.
- **Employees** decide employment Opportunities.
- **Competitors** decide market share and profitability.
- **Regulators** decide on social welfare.
- **Tax authorities** decide on taxation policies.
- **Local communities** decide on environmental issues.

Who Uses Accounting Data?

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- The specific financial information that a user needs depends upon the kinds of decisions the user makes.

- There are two broad groups of users of financial information:
  - **internal users**
  - **external users**

Internal users

- Internal users of accounting information are managers who plan, organize, and run the business.
- These include marketing managers, production supervisors, finance directors, and company officers.
- In running a business, internal users must answer many important questions such as:
    - Is cash sufficient to pay dividends to Nokia shareholders? (Finance)
    - What price for a Nokia cell phone will maximize the company´s net income? (Marketing)
    - Can we afford to give Nokia employees pay raises this year? (Human Resources)
    - Which Nokia product line is the most profitable? Should any product lines be eliminated? (Management)

Internal users

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- To answer and other questions, internal users need detailed information on a timely basis.
- **Managerial accounting** provides internal reports to help users make decisions about their companies.
    - Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

External users

- External users are individuals and organizations outside a company who want financial information about the company.

- The two most common types of external users are:
  - **investors**
  - **creditors**.

External users - Investors x Creditors

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- **Investors** (owners) use accounting information to make decisions to buy, hold, or sell ownership shares of a company.
- **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money.
- There are some questions that investors and creditors may ask:
  - Is Nokia earning satisfactory income? (Investors)
  - How does Nokia compare in size and profitability with Siemens? (Investors)
  - Will Nokia be able to pay its debts as they come due? (Creditors)

External users

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- **Financial accounting** answers the questions.
  - It provides economic and financial information for investors, creditors, and other external users.
  - The information needs of external users vary considerably:
    - **Taxing authorities** want to know whether the company complies with tax laws.
    - **Regulatory agencies** want to know whether the company is operating within prescribed rules.
    - **Customers** are interested in whether a company will continue to honor product warranties and support its product lines.
    - **Labor unions** want to know whether the companies have the ability to pay increased wages and benefits to union members.

Objectives of Financial Accounting

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- Financial accounting should provide information that:
  - 1. Is useful to investors and creditors in making decisions.
  - 2. Helps to predict cash flows.
  - 3. Tells about economic resources, claims to resources, and changes in resources and claims.

Accounting Standards

- In order to ensure high-quality financial reporting, accountants present financial statements in conformity with accounting standards that are issued by standard-setting bodies.

- Presently, there are two primary accounting standard-setting bodies:
    - **the International Accounting Standards Board (IASB)**
    - **the Financial Accounting Standards Board (FASB)**

- More than 130 countries follow standards referred to as **International Financial Reporting Standards (IFRS).**

- IFRS are determined by the IASB.

Accounting Standards

- The IASB is headquartered in London, with 15 board members drawn from around the world.

- Most companies in the United States follow standards issued by the FASB, referred to as **generally accepted accounting principles (GAAP).**

Cost Principles

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- There are two cost principles in accounting:
  - **historical cost principle**
  - **fair value principle**

Historical Cost Principle

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- The historical cost principle (or cost principle) dictates that companies record assets at their cost.

- This is true not only at the time the asset is purchased, but also over the time the asset is held.

  - For example, if Nokia purchases land for $ 300 000, the company initially reports it in its accounting records at $ 300 000.

  - But what does Nokia do if, by the end of the next year, the fair value of the land has increased to $ 400 000?

  - Under the historical cost principle, it continues to report the land at $ 300 000.

Fair Value Principle

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- The fair value principle states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability).
- Fair value information may be more useful than historical cost for certain types of assets and liabilities.
  - For example, certain investment securities are reported at fair value because market value information is usually readily available for these types of assets.

Fair Value Principle

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- In determining which measurement principle to use, companies weigh the factual nature of cost figures versus the relevance of fair value.
- In general, even though IFRS allows companies to revalue property, plant, and equipment and other long-lived assets to fair value, most companies choose to use cost.
- Only in situations where assets are actively traded, such as investment securities, do companies apply the fair value principle extensively.

Assumptions

- Assumptions provide a foundation for the accounting process.
- Two main assumptions are:
  - **the monetary unit assumption**
  - **and the economic entity assumption.**

Monetary Unit Assumption

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- The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in money terms.

- This assumption enables accounting to quantify (measure) economic events.

- The monetary unit assumption is vital to applying the historical cost principle.

- This assumption prevents the inclusion of some relevant information in the accounting records.

    - For example, the health of a company´s owner, the quality of service, and the morale of employees are not included.

    - The reason: Companies cannot quantify this information in money terms. Though this information is important, companies record only events that can be measured in money.

Economic Entity Assumption

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- An economic entity can be any organization or unit in society.

- It may be a company Nokia, a governmental unit (the city-state), a municipality (Toronto, Canada), a school district, or a church.

- The economic entity assumption requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

Business Organizations

- We can recognize 3 types of business organizations:
    - **proprietorship**
    - **partnership**
    - **corporation**

Proprietorship

- A business owned by one person is generally a proprietorship.
- the owner is often the manager/operator of the business.
- Small service-type businesses *(plumbing companies, beauty salons, and auto repair shop), farms, and small retail stores (antique shops, clothing stores, and used-book stores)* are often proprietorships.
- **Usually only a relatively small amount of money (capital) is necessary to start in business as a proprietorship.**
- **The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.**
  - There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

Partnership

- A business owned by two or more persons associated as partners.
- In most respects a partnership is like a proprietorship except that more than one owner is involved.
- Typically a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner.
- Each partner generally has unlimited personal liability for the debts of the partnership.
- **Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.**
- Partnerships are often used to organize retail and service type business, including professional practices *(lawyers, doctors, architects, and chartered public accountants).*

Corporation

- A business organized as a separate legal entity under corporation law and having ownership divided into transferable shares.

- The holders of the shares (shareholders) **enjoy limited liability**; that is, they are not personally liable for the debts of the corporate entity.

- Shareholders **may transfer all or part of their ownership shares to other investors at any time.**

- The ease with which ownership can change adds to the attractiveness of investing in a corporation.

- Because ownership can be transferred without dissolving the corporation, the corporation **enjoys an unlimited life.**

Corporation

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- Although the combined number of proprietorships and partnerships in the world significantly exceeds the number of corporations, the revenue produced by corporations is much greater.

- Most of the largest companies in the world are for example:
  - ING (Netherlands)
  - Royal Dutch Shell (United Kingdom of Great Britain and Netherlands)
  - Apple Inc. (United States of America)
  - Fortis (Belgium)
  - Toyota (Japan)

Thank you for your attention.