FAC1502

PART A

THE BASIC PRINCIPLES AND SPHERES OF ACCOUNTING

Financial Accounting I:

Financial Accounting Concepts, Principles and Procedures

TOPIC A

THE BASIC CONCEPTS, PRINCIPLES AND OBJECTIVES OF ACCOUNTING

Learning outcome

You should be able to describe, to calculate and to record the financial performance and the financial position of a sole proprietor, using the basic accounting equation and the double-entry system of accounting to record the various types of transactions.

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CONTENTS

STUDY UNIT

1

The basic concepts, principles and objectives of accounting

Learning outcome

You should be able to explain the nature of accounting, as well as accounting principles, policy, practices and procedures.

Contents

KEY CONCEPTS
• financial information • decision-making • nature of accounting • unit of measurement • forms of ownership • fields of accounting • accounting principles • international financial reporting standards • accounting statements • accounting policy • going concern • qualitative characteristics • elements of financial statements

1.1 Introduction

This module will introduce you to the concepts, principles and procedures of accounting. The first two study units are mainly intended to give you some background knowledge. The information may appear to be rather confusing at first, but if you follow the study guide step by step, working through all the examples and exercises, the various methods and procedures will become clear. To master this subject, you must get as much practice as you can – so start early in the semester.

Accounting developed in conjunction with, and as part of the economic system over the centuries and it performs an extremely useful and important function in society.

Through the ages, records have been kept by hand; nowadays, computers are used increasingly for this purpose. Whichever method is used, the basic principles remain the same since all activities in a business are still expressed in terms of money and are recorded. Nonetheless, it is necessary to know the procedures used in a manual system in order to understand how a computerised accounting system works.

GOLDEN RULE

Accounting **cannot** be studied by merely reading/memorising information. You need to practice, practice and practice!

1.2 What is accounting?

1.2.1 Definition

Accounting can be defined as the orderly and systematic recording of the monetary values of financial transactions of individuals or business enterprises and the reporting of the results of such recording by way of the preparation and presentation of financial statements (section 1.15.2.3) to enable the users of the information obtained in this way (section 1.8) to make decisions.

Accounting is therefore a process that consists of the following three activities:

- Identifying those events that are evidence of economic activity (transactions) relevant to the particular business or entity.
- Recording the monetary value of economic events (transactions) in order to provide a permanent history of the financial activities of the business or entity. Recording involves keeping a chronological diary of measured events in an orderly and systematic manner and classifying and summarising economic events.
- Communicating the recorded information to interested users. This information is communicated through the preparation and distribution of accounting reports, the most common of which are known as financial statements.

GOLDEN RULE

Accounting involves the recordings of transactions in order to provide useful information for decision-making.

The objectives of accounting are therefore to enable the users of financial information to ascertain the financial results and the financial position of an entity readily. With this statement we mean that accounting provides the users of financial information with answers to the following questions:

a) Did the entity trade at a profit or a loss?
b) What was the income of the entity and what expenses were incurred in producing that income?
c) How much does the entity owe to other entities?
d) How much do customers owe to the entity?
e) What is the nature of the assets that the entity possesses and what is the amount (in value) of the various kinds of property and other assets that the entity possesses?
f) What is the amount of the entity’s capital (equity)?

It is important to distinguish between the concepts “accounting” and “bookkeeping” which are often erroneously regarded as synonymous.

Bookkeeping

Bookkeeping is concerned with the daily recording of business transactions from source documents in such a way that entities or individuals can determine their exact financial position. It is therefore mainly confined to the recording of financial transactions. If this definition is compared to the one of accounting given above, it becomes apparent that accounting includes bookkeeping, but bookkeeping does not include accounting.

In brief, accounting includes bookkeeping, and if we talk about bookkeeping, we include only those aspects of accounting that can be classified as bookkeeping (basically the first two of the abovementioned activities).

1.2.2 The nature of accounting

Accounting is a specialised means of communication that conveys a specialised message about an entity’s finances. The recipient of this specialised message (that is, the user of financial information) must understand it, otherwise the information that is conveyed has no value.

In accounting, words and figures are used to convey financial information to the users of that information. As you progress with your study of accounting, you will become familiar with the meaning of these words and figures, which are also known as the concepts, principles and procedures of accounting. This knowledge will ultimately help you understand the message contained in financial statements.

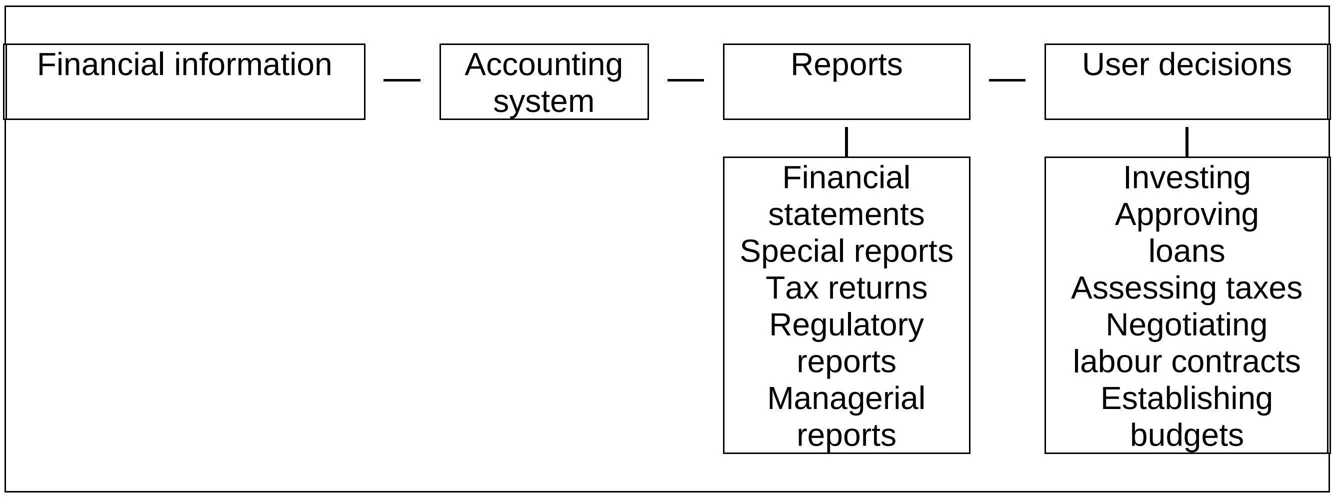
Each and every person who is involved in an entity uses financial information to a greater or lesser degree. Each of us also needs to know something about accounting to manage our personal financial affairs. Financial resources are limited or scarce, and if we are going to spend them, we must plan properly. Knowledge of accounting is therefore also useful in this area.

Accounting is therefore a ‘‘language’’ that is used to convey financial information to interested parties.

1.2.3 The purpose of accounting

Accounting provides financial information to users which is illustrated in diagram 1.1.

Diagram 1.1: The supply of information by accounting



Accounting is a specialised medium for communicating financial information. In the business world, it is essential that useful financial information be presented truly and fairly. Users of financial information expect it to be accurate and comprehensive, and accounting has been developed to satisfy this specific requirement.

The aim of accounting is to provide quantitative information that is primarily financial in nature to provide answers to questions such as the following:

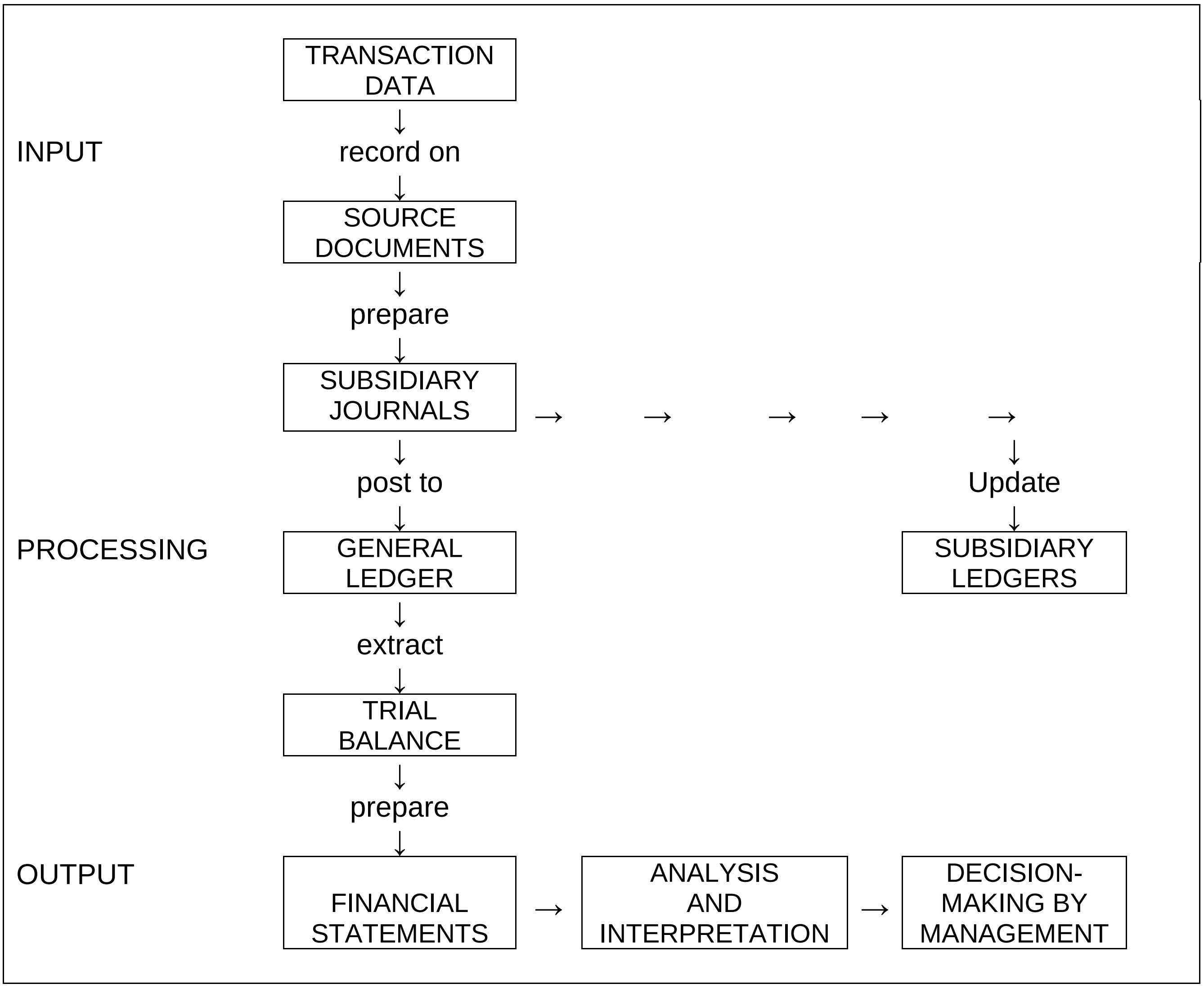
- Can the entity generate enough income to exist?
- What are the entity’s expenses in relation to its sales?
- Is too little or too much inventory being kept?
- Should the entity expand its operations?
- Is the entity’s pricing policy correct?

The information needed for answering questions like these is contained in accounting reports.

1.2.4 The accounting process

Financial accounting functions as an information system. Since far-reaching decisions are taken on the basis of the results reported in financial statements, business transactions have to be measured, classified, summarised and recorded continuously. We call these actions the financial accounting cycle. This cycle is demonstrated in diagram 1.2.

Diagram 1.2: The financial accounting cycle



Financial accounting is the systematic recording of the financial transactions of an entity in such a manner that any information required by the entity is readily available. The systematic recording of the financial information is called a financial accounting cycle, which consists of the elements listed in diagram 1.2.

The processing stage entails the recording of transactions and this process is known as bookkeeping. The ultimate goal of the input stage and the processing stage is to prepare financial statements.

1.3 Why study accounting?

Accounting is the study of methods that enable the orderly and systematic recording of all proceedings or activities in an entity. These proceedings or activities are called transactions. The monetary value of transactions is recorded in the accounting records of an entity, the aim of which is to enable the businessperson or the owner of the entity to ascertain the financial position and the financial results of the entity at all times.

The advantages to be gained from studying accounting can be described as follows:

The advantages for an individual are as follows:

- It enables a person to understand business terms and concepts and to apply them.
- It promotes logical thought processes.
- It teaches a person to plan and systematise his/her own finances.
- It teaches a person to work accurately.
- It develops a person’s sense of responsibility.
- It teaches a person the value of money.

The advantages for an entity are as follows:

- It communicates financial information to the users of such information.
- It enables an entity to keep an accurate record of its daily business activities.
- It enables an entity to determine whether it made a profit or suffered a loss.
- It enables an entity to calculate the total value of its assets and liabilities.
- It enables an entity to function effectively and efficiently.

1.4 Developments in Accounting

Ordinary people, entities, and other organisations, for example schools, churches, hospitals and clubs are constantly engaged in economic activities like working, trading and providing services. These economic activities are largely based on transactions between interested parties. If, for example, you buy bread from your local baker, you engage in a business transaction. The baker has something that you need, and you are willing to pay him/her money (the price of the bread) in order to get the product (bread). The baker, in order to bake and sell bread, must also enter into transactions. He/she must buy flour and other ingredients to bake bread. Some of these transactions can be conducted in cash while others may be on credit (i.e., payment in cash is made sometime in the future).

In accounting, we refer to a business as an entity. The average size entity can enter into a large volume of transactions in a single day. The owner of an entity cannot keep all the transactions in his/her head and must write them down in order to keep a record of them. The owner or somebody who has the necessary knowledge and who has been appointed by the owner must capture the essential data of transactions on business documents. The data on these documents is then captured in accounting records used specifically for this purpose by the process known as bookkeeping.

Accounting is relevant to individuals (you) as well as entities. Entities need to keep a record of and control over their business transactions. The main concern of accounting is to keep a record of and to report the financial transactions of an entity, which must be done in such a way that the management of the entity can rely on the accuracy of the accounting data when making financial decisions that concern the financial affairs of the entity.

The ever-changing economic and social circumstances influenced the historical development of accounting. Clay tabloids from Babylonia and records reserved from Greek and Roman civilisations are proof that financial records were kept in order to record details of transactions and the financial relationship between parties.

Trading activities increased through the centuries, which brought about stronger competition and resulted in lower profits for traders. In order to stay successful, traders had to improve their methods of recording financial information to enable them to make better business decisions so that they could maximise their profits.

Before 1494 there was no systematic or uniform accounting method. Modern accounting had its origin in Italy during the Renaissance when Lucas Pacioli, an Italian mathematician, published his well-known work *Sūma de arithmetica, geometria, proportioni et proportionalita* (*Summary of arithmetic, geometry, proportions and proportionality*) in Venice in 1494. It contained the first description of the principle of double entry on which modern accounting is based.

Originally, accounting records were kept by hand. Today, computers are increasingly being used for this purpose due to their ability to process a very large number of transactions very quickly. Whichever method is used, the basic principles remain unchanged, since all activities in an entity are still expressed in terms of money and are recorded as such. However, it is important to know and understand the procedures used in a manual system in order to understand the operations of a computerised accounting system. It is not possible to develop computerised accounting systems without expert accounting knowledge.

It would be problematic if each entity kept individualised records of its transactions since that would make it difficult to compare the performance of an entity with the performance of other similar entities. Consequently, the accounting profession has standardised the way in which entities are required to keep a record of their transactions.

The South African Statements of Generally Accepted Accounting Practice (SA GAAP) was introduced to improve uniformity. In 1995, SA GAAP was fully harmonized with the International Financial Reporting Standards (IFRS). SA GAAP is now identical to the IFRS. Financial reporting standards, in terms of the Companies Act 71 of 2008 (Companies Act, 2008), allow entities that meet the scope requirements of the conceptual framework for small and medium-sized entities to use the IFRS for Small and Medium-sized Entities (IFRS for SMEs), which is a scaled-down version of the complete IFRS.

In South Africa, international financial reporting standards as set by the Financial Reporting Standards Council (FRSC) govern the recording and reporting of financial information. The purpose of these financial accounting standards is to ensure that the same type of transaction is recorded by different entities in more or less the same way. This will eventually ensure that the financial statements of different entities conducting the same type of business are comparable and that an entity's financial statements will be comparable to those prepared in previous years.

1.5 The function of accounting

Accounting can be defined as the orderly and systematic identification and recording of the monetary values of financial transactions of an individual or a business entity and the reporting of the results of these transactions by way of the preparation and presentation of financial statements to enable interested users to use the information obtained in these financial statements as a basis for decision-making. Accounting is a specialised method of communicating financial information about an entity and its activities to those persons or entities that have an interest in the activities of the entity.

Accounting is a process that involves three activities:

- The first activity is identification, which involves selecting those events that are evidence of economic activity (transactions) relevant to the particular entity.
- The second activity is to record the monetary value of the economic events (transactions) so as to provide a permanent history of the financial activities of the entity. Recording consists of keeping a chronological diary of measured events in an

orderly and systematic manner. Recording also implies that economic events are classified and summarised.

- The third activity encompasses the communication of the recorded information to interested users. The information is communicated through the preparation and distribution of accounting reports, the most common of which are known as financial statements, that consist of:

  - a statement of financial position
  - a statement of profit or loss and other comprehensive income
  - a statement of changes in equity
  - a statement of cash flow
  - notes, comprising a summary of significant accounting policies and other explanatory notes.

The word “entity” does not necessarily refer to a business entity - it can also refer to an educational institution, a religious institution or a private household.

1.6 Universal accounting denominator

The common unit of measurement in accounting is money. The currency used in the Republic of South Africa is known as the rand. All of an entity’s transactions are converted into monetary values before they are processed. Using money as the common denominator, however, has two important limitations:

- Not all events can be expressed in monetary terms.
- The value of money is unstable and is influenced by many economic factors such as inflation.

1.7 The entity concept

Basically, all business entities can be narrowed down to two types namely, service entities and trading entities:

Service entities

These types of entities render services (sell their skills and knowledge) for a fee. Examples are firms that render services like transport and storage, repairs and/or maintenance (e.g., electricians, plumbers and carpenters) and personal services (e.g., hairdressers, bookkeepers, accountants, estate agents, medical doctors, dentists, lawyers and photographers).

Trading entities

These types of entities specialise in the buying and selling of merchandise. Examples are florists, ladies and gent’s outfitters, butchers, grocers, cafes, hardware stores and general merchants.

It is, however, important to note that some business entities not only render a service but also sell merchandise, that is, they are also traders. An example of such an entity is a hairdressing salon that renders a service and sells hair-care products. Usually, the product complements the service.

A business is seen as an entity that is completely separate from its owner(s). The different forms of business ownership are set out below.

Forms of ownership

Forms of business ownership refer to the way in which businesses are owned and managed – how the original funds for starting the businesses were raised and how the profits, losses and risks in the businesses are divided.

The following forms of ownership exist in South Africa:

- a sole trader
- a partnership
- a close corporation
- a profit company, like a state-owned company (SOC Ltd), a private company ((Pty) Ltd), a personal liability company (Inc) and a public company (Ltd).
- a non-profit company (NPC) for public benefit or for an object relating to social or cultural activities. (Koppeschaar et al 2018:4)

1.8 Users of financial information

Financial statements are prepared and presented at least once a year and are directed towards the common information needs of a wide range of users who analyse the information for various decision-making purposes.

The following categories of users, and their need for accounting information, have been identified:

User	Information needs
Clients/customers of an entity …	need accounting information to assess the ability of the entity to continue as a going concern.
Employees …	need accounting information to assess the ability of their employer to provide stable employment and remuneration.
Government and its agencies …	need accounting information to regulate activities of enterprises, to compile statistics and to determine resource allocation and tax policies.
Investors …	need accounting information to assess the risk of investing in an enterprise and the expected return on their investment.
Lenders …	need accounting information to assess the ability of an enterprise to pay interest on loans and to repay loans.
Suppliers and other trade creditors …	need accounting information to assess the ability of an enterprise to pay amounts owing.
Management of an enterprise …	need accounting information for planning purposes, that is, determining future actions to be taken, or for the exercise of control, that is, evaluating the current situation of the enterprise and taking corrective steps, if necessary.
The public …	requires information such as a particular entity's contribution to the economy, the creation of work opportunities, taxes and charitable causes.

Although the employees of an entity are considered to be part of the entity, not all of them have the same access or unlimited access to its accounting records.

Users of financial statements need information on whether the reporting entity has made efficient and effective use of the resources provided to it through the respective equity and/or debt investments. This is known as the stewardship concept. In recent times this notion has manifested itself in concepts such as corporate governance and accountability.

1.9 The fields of accounting

Users of financial information can be subdivided into the following two categories:

- internal users – for example, management and employees
- external users – for example, investors, creditors and government

Two fields of accounting have developed as a result of this distinction between the users of financial information. *Financial accounting* is concerned with the provision of financial information to external parties for the most part, while *management accounting* is concerned with the provision of financial information to people within an entity.

1.9.1 Financial accounting

This field of accounting is concerned with the measurement and recording of transactions for an entity and the periodic preparation of various reports on the basis of records of transactions in the form of financial statements. The reports provide useful information concerning the entity as a whole for managers, owners, creditors, financial institutions, governmental agencies and the public. These reports are called financial statements and they contain information regarding the financial position of the entity and the result of its activities. Financial accounting is governed by international financial reporting standards, which consist of external standards that must be adhered to. These standards ensure the comparability of financial statements between entities.

1.9.2 Management accounting

Management accounting concerns historical and estimated data that the management of an entity use in conducting and evaluating current operations and planning future operations. In other words, management accounting provides specific information about specific aspects of an entity's activities. An accountant, in preparing an entity's management reports, incorporates information that will be useful in helping managers make relevant decisions concerning the entity. It would be difficult for management to manage the entity effectively without this financial information.

Financial and management factors within an entity are both components of the same information system. In practice, these two aspects of accounting often overlap. For example, information needed for future planning by management will be extracted from the historical data contained in financial accounting reports.

In this course, we concern ourselves with financial accounting. **When we refer to accounting, we mean financial accounting.**

GOLDEN RULE

Financial statements must give a fair presentation of the financial position, the financial performance and the cash flow of an entity.

1.10 The objective of general-purpose financial reporting

The objective of general-purpose financial reporting is to provide information about the financial position, the financial performance and changes in the financial position of an entity that is useful to a wide range of users in making economic decisions relating to the provision of resources to the entity.

Users' decisions involve decisions about (2018 IFRS Conceptual Framework Project Summary, p 5)

buying, selling or holding equity or debt instruments	providing or settling loans and other forms of credit	voting, or otherwise influencing management's actions

To make these decisions, users assess (2018 IFRS Conceptual Framework Project Summary, p 5)

prospects for future net cash inflows to the entity	management's stewardship of the entity's economic resources

To make both these assessments, users need information about both (2018 IFRS Conceptual Framework Project Summary, p 5)

• the entity's economic resources, claims against the entity and changes in those resources and claims
• how efficiently and effectively management has discharged its responsibilities to use the entity's economic resources

The information is usually provided in the following components of financial statements:

- **Statement of financial position as at the end of a financial period**

  Information on an entity's economic resources and the claims against these resources, as well as information on its liquidity and solvency, is recorded at a specific date in the statement of financial position (Assets = Equity + Liability). The information on liquidity and solvency is necessary to determine whether the entity will be able to meet its commitments when they become due.

- **Statement of profit or loss and other comprehensive income for the period**

  Information on the **financial performance** (Income – Expenses) of an entity in a specified period is provided in the statement of profit or loss and other comprehensive income. The financial performance of an entity should be reflected by the **concept of accrual accounting**. In accordance with this concept, the effects of transactions are recognised when they occur (and not as cash is received or paid) and they are recorded in the accounting periods and reported in the financial statements of the periods to which they relate.

- **Statement of changes in equity for the period**

  Information about changes in the structure of an entity's equity, as well as information on capital transactions and other distributions made to owners, is provided in the statement of changes in equity for the period.

- **Statement of cash flows for the period**

  Information on **changes in the financial position** of an entity, is provided in order to assess the entity's investing, financing and operating activities and the way in which the entity **acquires and distributes cash and cash equivalents**. Information can also be gathered on the entity's ability to generate cash and cash equivalents, and the need to utilise cash flows.

- **Notes to the financial statements for the period**

  Additional information and information on the accounting policies applied are provided for a **better understanding of the financial statements**.

1.11 Accounting principles

In this study unit we turn our attention to the theory of accounting. You may well ask: ''Why? Accounting is supposed to be a practical subject.'' This is true, but no subject that is logically structured can exist without a theoretical foundation.

The **techniques used in the practice of accounting are based on conceptual and theoretical ideas**. These techniques are generally known as accounting principles.

1.12 Accounting policy

Some situations that occur in our everyday lives are repetitive (i.e., they are always the same), but they would each have a different outcome if we were to act differently each time. If we do not have some kind of **guideline** on how we should act in such situations, our actions would probably be inconsistent. Our friends would think we were unreliable. If we **lay down a guideline so that we always act the same way in a particular situation**, we can say that we are determining a **policy** for our actions, which will result in our actions being consistent.

In accounting, transactions of a repetitive nature occur frequently, and the requirement of consistency means that an entity has to establish an accounting policy to determine exactly how such transactions should be treated. Accounting policy is therefore a set of decisions about how an entity will handle transactions of the same type in order to achieve a consistent result.

1.13 Disclosure of accounting policy

Since an accounting policy represents an entity's decisions about situations that it could deal with in various ways, it has to disclose its accounting policy in its financial statements. For example, an entity has to indicate what basis it has used to deal with the depreciation of property, plant and equipment.

1.14 International Financial Reporting Standards (IFRS)

The IFRS is the next important concept that you will encounter in your accounting studies.

If everyone were to develop his or her own language and grammatical rules, communication would break down. We therefore **have generally applicable language and grammar rules**.

Accounting, as a specialised medium of communication, has precisely the same problem. If each entity were to prepare financial reports according to its own accounting rules and its interpretation of accounting theory and principles, chaos would result in the world of economics and business.

1.15 Accounting standards and statements

1.15.1 Introduction

The objective of creating accounting standards for particular issues (e.g., the treatment of taxation in financial statements) is **to limit the variety of available accounting practices**, but without striving for strict uniformity or creating a set of rigid rules for all circumstances. The ultimate aim of accounting standards is **to encourage widespread use of particular standards in financial reporting and to eliminate undesirable alternatives**.

1.15.2 The Conceptual Framework for Financial Reporting 2018

Bear in mind that the Conceptual Framework is not a standard. It **sets out the objectives and concepts which underlie the preparation and presentation of financial statements**''.

1.15.2.1 The objective of financial statements

Refer to section 1.10 on page 16.

1.15.2.2 Underlying assumption

According to the Conceptual Framework, the **going concern concept** is an underlying assumption in the preparation of financial statements.

The financial statements of an entity are normally prepared on the assumption that the entity is a going concern and **will continue to operate for the foreseeable future**.

1.15.2.3 The qualitative characteristics of useful financial information

For information to be useful, it must both be relevant and provide a faithful representation of what it purports to represent. Relevance and faithful representation are the fundamental qualitative characteristics of useful financial information and the guiding concepts that are applied throughout the revised Conceptual Framework.

The **fundamental qualitative characteristics** are as follows:

(1) Relevance

To be useful, information must be **relevant to the decision-making needs of users** with respect to an asset or a liability and any related income and expense. Information has the quality of being relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or helping them confirm, or correct, their past evaluations. Therefore, relevant information has one or both of the characteristics of **predictive value and confirmatory value**.

Materiality plays an important role when the relevance of information is evaluated. Information is considered to be material if its omission or misstatement could influence the decisions of users that are based on that information.

(2) Faithful representation

All items that have an influence on the financial position and/or the financial performance of an entity must be reported in an appropriate manner in the financial statements. Information must faithfully represent the substance of what it purports to represent.

According to the Conceptual Framework, faithful representation has the following three characteristics:

- completeness
- neutrality (lack of bias)
- the absence of errors

A faithful representation is affected by the level of measurement uncertainty.

For information to be useful, it must be both relevant and faithfully represented.

Enhancements to the qualitative characteristics of financial information are as follows:

(1) Comparability

Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and financial performance. Therefore, the aim of this quality is to **introduce a common language into the presentation of financial statements** so that users can compare information about an entity for different periods, or with information of other similar entities.

Comparability in the accounting treatment should be consistent for:

- the same items over time
- the same items in the same period
- similar items of different but similar entities over time and in the same period

(2) Verifiability

This characteristic of financial information is related to users' ability to confirm that **the information presented does, in fact, faithfully present the events or transactions it is supposed to present.** There are two ways in which information can be verified, namely,

- direct verification, whereby the cash balance can be verified by counting the cash
- indirect verification, whereby the closing balance on inventories can be confirmed by physically counting the quantities and recalculating the cost value by using the same valuation method used by the reporting entity.

(3) Timeliness

Recent and reliable information increases the usefulness of the financial statements. Usually, older information is less useful and may only be useful to identify and assess certain trends.

(4) Understandability

An essential quality of the information provided in financial statements is **that it is**

readily understandable to the average user. The Conceptual Framework (par 25) indicates that users are assumed to have

- a reasonable knowledge of business and economic activities
- a willingness to study the information with reasonable diligence.

The Conceptual Framework adds that information of a complex nature should not be excluded from the financial statements (where relevant to users' decision-making) merely because it may be too difficult for certain users to understand. However, information should be included only if **the benefits are considered to outweigh the costs of providing the information**.

Earlier, we said that the aim of financial statements is to report on the financial position, changes in the financial position and the financial performance of an entity. We use three different financial statements to do just that. They are as follows:

- The **statement of financial position** is used to report on the **financial position** of a business entity.
- The **statement of cash flows** reports on **change in the financial position of an entity**.
- The **statement of profit or loss and other comprehensive income** reports on **financial performance**.

Each of these statements consists of different elements. It is important to get to know these elements as quickly as possible.

1.15.2.4 Financial statements and the reporting entity

A reporting entity is

- an entity that is required, or chooses, to prepare financial statements.
- not necessarily a legal entity – it could be a portion of an entity or comprise of more than one entity. (2018 IFRS Conceptual Framework Project Summary, p 7)

Financial statements are:

a particular form of financial reports that provide information about the reporting entity's assets, liabilities, equity, income and expenses (2018 IFRS Conceptual Framework Project Summary, p 7)

1.15.2.5 The elements of financial statements

GOLDEN RULE

The elements of financial statements are as follows:

- Elements that measure the financial position (assets = equity + liabilities):

  (1) assets
  (2) liabilities
  (3) equity

- Elements that measure profitability (profit or loss = increase or decrease in equity):

  (4) income
  (5) expenses

The elements of financial statements are set out below.

- **The statement of financial position**

  The statement of financial position reports on the financial position of an entity. At the end of the financial period, it summarises all the assets, liabilities and equity accounts of the entity. The Conceptual Framework (par 49) defines these elements as follows:

  Assets

  Assets are present economic resources controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits

  Further on in this study guide you will learn that assets can be classified into two categories, namely, current assets and non-current assets.

  Equity

  Equity is the residual interest in the assets of the entity after all its liabilities have been deducted.

  Equity is also described as the part of the entity that **belongs to the owners of the entity**, which could be one person (sole trader), two to twenty partners (partnership), one to ten members (close corporation) or numerous shareholders (companies). Changes that occurred in respect of equity in a financial period will be disclosed in the statement of changes in equity.

  Liabilities

  Liabilities are present obligations of the entity to transfer economic resources as a result of past events.

  An obligation is a duty or a responsibility that the entity has no practical ability to avoid.

  Similar to assets, liabilities can also be classified into two categories, namely, current liabilities and non-current liabilities.

- **The statement of profit or loss and other comprehensive income**

  The statement of profit or loss and other comprehensive income reports on the **financial performance** of an entity. At the end of the financial year all income and expense accounts are closed off to the statement of profit or loss and other comprehensive income. The Conceptual Framework (par 70) defines these elements as follows:

  Income

  Income refers to increases in assets or decreases in liabilities that **result** in increases in equity, other than those relating to contributions from holders of equity claims.

  Income accounts include, among others, sales, rental income, commission income and credit losses recovered.

  Expenses

  Expenses refers to decreases in assets or increases in liabilities that **result** in decreases in equity, other than those relating to distributions to holders of equity claims.

  Expense accounts include, among others, cost of sales, water and electricity, salaries and wages, interest expenses, stationery, credit losses, depreciation and other operating expenses.

Once you are able to define the different elements of financial statements, you must be able to recognise them in financial statements.

1.15.2.6 Recognition and measurement of the elements of financial statements

Recognition is the process of incorporating in the statement of financial position or the statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the criteria for recognition.

An item that meets the definition of an element should be recognised in the statement of financial position or the statement of profit or loss and other comprehensive income if

- it is probable that any future economic benefit associated with the item will flow to or from the entity
- the item has a cost or a value that can be measured with reliability

The following measurement bases are identified in paragraph 4.55 of the Conceptual Framework:

Historical cost measurement bases (2018 IFRS Conceptual Framework Project Summary, p 12)

- Historical cost provides information derived, at least in part, from the price of the transaction or other event that gave rise to the item being measured.
- The historical cost of assets is reduced if the assets become impaired and the historical cost of liabilities is increased if the liabilities become onerous.
- One way to apply a historical cost measurement basis to financial assets and financial liabilities is to measure them at amortised cost (cost after subtracting depreciation).

Historical cost measures are entry values and provide monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other event that gave rise to them. Transaction costs are taken into account if they are incurred in a transaction or other event giving rise to an asset or a liability (2018 Descriptive Accounting IFRS Focus paragraph 2.7.1.1, p 19).

The historical cost of an asset is updated over time to depict, if applicable,

- the consumption of part or all of the economic resources that constitute the asset (depreciation)
- payments received that extinguish part or all of the assets
- the effect of events that cause part or all of the historical cost of the asset to be no longer recoverable (impairment)
- the accrual of interest to reflect any financing component of the asset

The historical cost of a liability is updated over time to depict, if applicable,

- fulfilment of part or all of the liability
- the effect of events that increase the value of the obligation to transfer the economic resources needed to fulfil the liability to such an extent that the liability becomes onerous (it is onerous if the historical cost is no longer sufficient to depict the obligation to fulfil the liability)
- the accrual of interest to reflect any financing component of the liability

For financial assets and financial liabilities, a way to apply the historical cost basis is to measure the items at amortised cost. The amortised cost of a financial asset or financial liability is updated over time to depict subsequent changes.

Current value measurement bases (2018 IFRS Conceptual Framework Project Summary, p 12)

Assets should be recorded at the amount paid, or the fair value of the consideration given, to acquire the assets at the time of their acquisition. Liabilities should be recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business (Conceptual Framework, par 4.55(a)).

- Current value provides information updated to reflect conditions at the measurement date.
- Current value measurement bases include) fair value, value in use (for assets), fulfilment value (for liabilities) and current cost.

Fair value

- Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.
- Fair value reflects market participants' current expectations about the amount, the timing and the uncertainty of future cash flows.

Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business (Conceptual Framework, par 4.55(d)).

A basis that is not mentioned in the Conceptual Framework is the fair value basis, which is frequently referred to in the IFRS. Fair value is defined in the IFRS as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (IFRS 13, "*Fair Value Measurement"*).

Currently, the most commonly adopted method is the historic cost method. This method is sometimes used in combination with other methods such as fair value.

Value in use (for assets) and fulfilment value (for liabilities)

This value reflects entity-specific current expectations about the amount, the timing and the uncertainty of future cash flows. It is therefore the present value of the cash flows, or other economic benefits that an entity expects to derive from the use of an asset and from its ultimate disposal. An exit value.

Assets are carried at the amount of cash or cash equivalent that could currently be obtained by selling the assets in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalent expected to be paid to satisfy the liabilities in the normal course of business (Conceptual Framework, par 4.55(c)).

Current cost

Current cost reflects the current amount that would be

- paid to acquire an equivalent asset
- received to take on an equivalent liability

Assets are carried at the amount of cash or cash equivalent that would have to be paid if the same or equivalent assets were acquired currently. An entry value. Liabilities are carried at the undiscounted amount of cash or cash equivalent that would be required to settle the obligation currently (Conceptual Framework, paragraph 4.55(b)).

Assets are carried at the amount of cash or cash equivalent that could currently be obtained by selling the assets in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalent expected to be paid to satisfy the liabilities in the normal course of business (Conceptual Framework, par 4.55(c)).

1.16 Exercise and solution

We end this study unit with a few revision questions. It is in your own interest to try to answer these by referring to the study unit.

EXERCISE

(1) Discuss the nature of accounting.
(2) What is the common unit of measurement in accounting?
(3) Name the four main forms of ownership in South Africa.
(4) Discuss the different users of financial information.
(5) Differentiate between financial accounting and management accounting.
(6) Name the qualitative characteristics of financial information.
(7) Define the concept of accounting policy.
(8) What is meant by disclosure of accounting policy?
(9) Describe the concept of international financial reporting standards.
(10) Discuss the underlying assumption in the preparation of financial statements.
(11) Name the fundamental qualitative characteristics of financial statements.
(12) Name the elements of financial statements.

SOLUTION

(1) Refer to section 1.2.2.

(2) The common unit of measurement in accounting is money.

(3) Sole trader
Partnership
Close corporation
Company

(4) See section 1.8.

(5) See section 1.9.

(6) See section 1.15.2.3.

(7) See section 1.12.

(8) See section 1.13.

(9) See section 1.14.

(10) See section 1.15.2.2.

(11) Relevance
Faithful representation

(12) Assets
Liabilities
Equity
Income
Expenses

SELF-ASSESSMENT

Now that you have studied this study unit, can you

	• describe the importance of financial information as a basis for decision-making? • discuss the different users of financial information and their needs? • state the different forms of ownership? • discuss the nature of accounting? • explain the difference between financial and management accounting? • name the qualitative characteristics of financial statements? • explain what is meant by accounting policy? • explain what is meant by the disclosure of accounting policy? • explain what is meant by international financial reporting standards? • explain what is meant by accounting standards and statements?