PRINCIPLES OF ACCOUNTING

CHAPTER FOUR

THE ACCOUNTING PROCESS

THE ACCOUNTING PROCESS

After studying this chapter you should be able to:

- explain the nature and importance of accounting information
- describe the uses of accounting information
- discuss the concepts underlying the accounting process
- explain the steps in the accounting process
- design and explain the importance of the Chart of Accounts
- understand the objectives of internal control

WHAT IS ACCOUNTING?

Accounting was defined by Paul F. Grady as:

- … the body of knowledge and functions concerned with systematic originating, authenticating, recording, classifying, processing, summarizing, analyzing, interpreting, and supplying of dependable and significant information covering transactions and events which are, in part at least, of a financial character, required for the management and operation of an entity and for the reports that have to be submitted thereon to meet fiduciary and other responsibilities.

WHAT IS ACCOUNTING?

The four facets of the accounting process:

- Design of the accounting information system
- Operation of the accounting information system
- Reporting the economic activities of the entity and accountability of management
- Verification of the accounting system, data, and information reports

WHY IS FINANCIAL INFORMATION IMPORTANT?

Financial information:

- Measures the economic health of a business
- Provides information to enable management and stakeholders to make decisions
- No business can succeed without this information

WHO USES THE INFORMATION?

- **Internal users:**
  - Those working within the business who create the information
- **External users:**
  - Those outside the business who are affected by its business operations

INTRODUCTION TO THE ACCOUNTING PROCESS

The entity concept

- The affairs of a business entity are kept separate from those of its owner(s).

The business entity requires finance to create wealth for the owners. Financing is a combination of:

- funds from the owners,
- funds borrowed from financiers and creditors, and
- profits retained in the business.

INTRODUCTION TO THE ACCOUNTING PROCESS

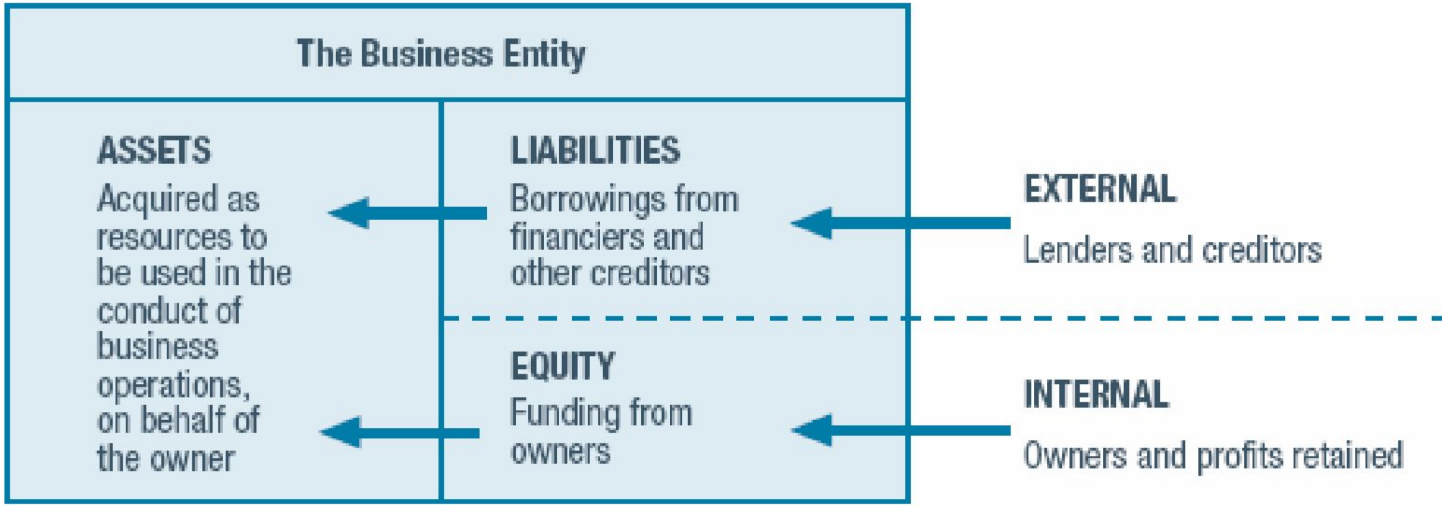

Figure 4.1 Simple model of funding flow for a business entity

INTRODUCTION TO THE ACCOUNTING PROCESS

The accounting equation

- Assets = Liabilities + Equity
- Benefits = Obligations
- or
- Assets – Liabilities = Equity

PRINCIPLE OF DOUBLE ENTRY

For each transaction there must be balancing debit and credit entries made to *accounts* in the *ledger.*

Ledger – a book containing accounts to which debits and credits are posted from journals (the books of original entry).

THE BASIS FOR RECORDING FINANCIAL TRANSACTIONS

Monetary convention – the expressing of financial transactions in a common currency.

Historical cost concept – the practice of recording transactions at their original cost or value.

CONTROLLABLE AND NON-CONTROLLABLE EVENTS

Controllable events

- Transactions undertaken by the business that have an impact on the accounting elements.

Non-controllable events

- They affect a business, but they are not recorded as *actual business transactions*.

The accounting process deals only with controllable events.

THE ROLE OF SOURCE DOCUMENTS

A source document identifies the transaction and gives it a monetary value.

Source documents include:

- purchase and sales invoices,
- cheque butts,
- receipts,
- cash sales dockets,
- credit and debit notes, and
- internal adjustment notes.

CONTROL DOCUMENTS

Control documents establish authorisation to initiate business events and source documents.

They provide an audit trail – a sequence of paperwork that proves the validity of transactions.

STEPS IN THE ACCOUNTING PROCESS

There are four essential steps in the accounting process.

- Collection
- Processing
- Storing
- Reporting

THE CHART OF ACCOUNTS

Chart of Accounts:

- is a numerical list of all the ledger accounts a business uses to record transactions
- classifies transactions into broad financial reporting categories:

1-xxxx	ASSETS	6-xxxx	EXPENSES
2-xxxx	LIABILITIES	7-xxxx	VACANT CATEGORY
3-xxxx	EQUITY	8-xxxx	OTHER INCOME
4-xxxx	INCOME	9-xxxx	OTHER EXPENSES
5-xxxx	COST OF SALES	0-xxxx	VACANT CATEGORY

THE CHART OF ACCOUNTS

Links the four principle accounting statements:

- Balance sheet,
- Income statement,
- Statement of changes in equity, and
- Cash flow statement.

THE CHART OF ACCOUNTS

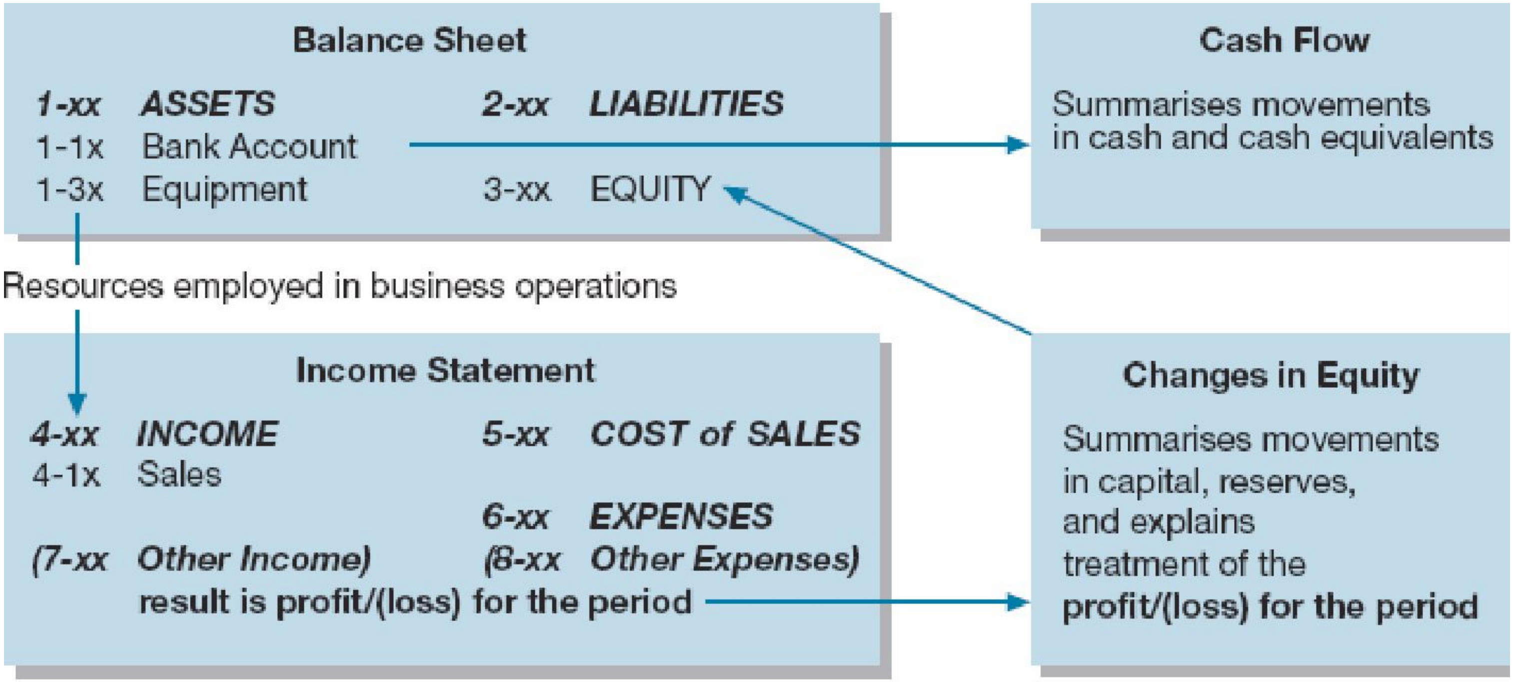

Figure 4.6 Schematic interaction of general purpose financial statements

INTERNAL CONTROL

Internal control - policies and procedures that inform management as to whether operational objectives are being met.

Focuses on three broad elements:

- Compliance
- Operations
- Reporting

INTERNAL CONTROL

For internal control strategies to work as intended, five principles:

- Attitude,
- Assessment,
- Activity,
- Advice, and
- Audit

must be followed.

INTERNAL CONTROL

Practical internal control measures include:

- Establishment of responsibility
- Segregation of duties
- Documentation procedures
- Physical, mechanical and electronic controls
- Independent internal verification (internal audit)
- Rotation of duties

INTERNAL CONTROL

Problems with internal control:

- Small businesses do not have the necessary staff numbers
- The costs of many internal control procedures could outweigh the advantages
- Must identify the likely risk areas, and concentrate control measures in those areas