Chapter 1

Accounting fundamentals

Objectives

At the end of this chapter you will be able to:

- describe the nature, scope and limitations of financial accounting
- describe the steps of the accounting cycle
- discuss accounting methods for recording financial information
- justify the use of standards in accounting
- discuss why the IFRS for SMEs was developed
- discuss the conceptual framework of accounting.

The development of accounting

Recording and communicating economic events occurred through the ages in narrative form in many of the early civilisations. In 1494, Luco Pacioli, an Italian, described the double entry system of debit (Dr) and credit (Cr) to be recorded in journals and ledgers. That system has remained basically the same today. 'Financial accounting deals with recording, summarising and communicating economic events of entities based on established principles, standards and legislation.' (Caribbean Examination Council, 2012, p. 1) These established principles, standards and legislation (unique to each jurisdiction) are referred to as Generally Accepted Accounting Principles (GAAP).

Significance of accounting information

The focus of financial accounting is to report to external users a summary of past economic events of the recently concluded financial period, reflecting the entity's financial performance and financial position. This should be done in a timely manner to allow the users to make effective economic decisions. These reports are called general purpose financial statements.

Limitations of accounting information

The limitations of accounting information are as follows:

1. Assumptions, subjective judgements and estimates are required in the measurement and reporting of business activity.
2. Non-financial events or factors may contribute to the entity's success but cannot be measured monetarily; for example, good working employees or suitable distribution location.
3. Reports are based on historic cost and not the fair market value (current value).

Users and their needs

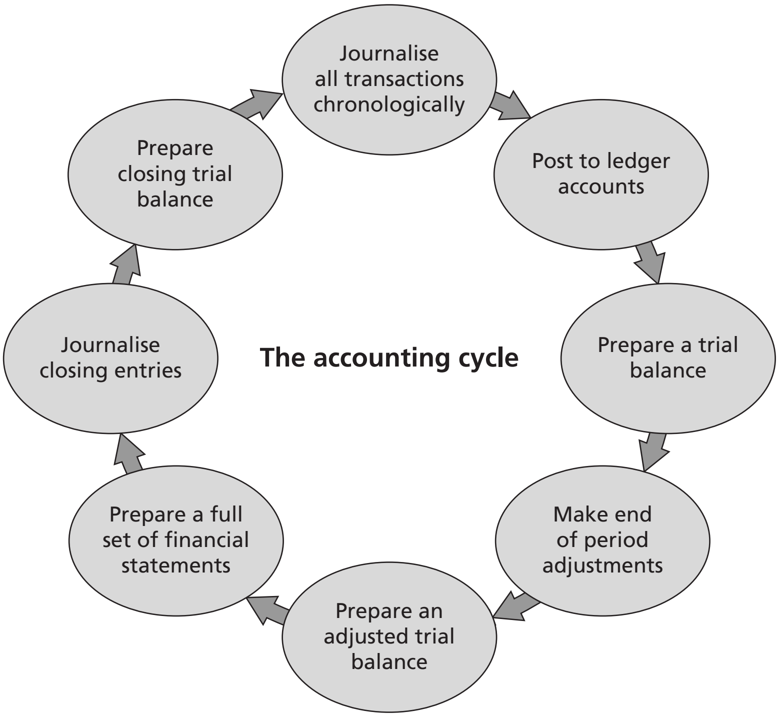
Users' needs for financial reporting are set out in Table 1.1.

Table 1.1 Users and their needs for financial reporting

User	Need for financial reporting to
Shareholders	• Assess management's stewardship • Determine distributable profits and dividends
Potential investors	• Determine whether to make equity investments
Trade unions/ Employees	• Assess the company's ability to pay employees for effective negotiation
Banks and other financial lending agencies	• Assess the security of money lent or to be lent to the company
Government	• Determine tax to be levied on the company • Determine taxation policies • Include in the country's national income statistics
Securities Exchange Commission	• Regulate activities of enterprises
Financial analysts	• Analyse the company in relation to other companies
Trade creditors	• Assess the company's ability to pay its short-term obligations
Managers	• Assess their own stewardship and for planning ahead

The accounting cycle is illustrated in Figure 1.1.

Figure 1.1. The accounting cycle



Accrual vs Cash basis accounting

Cash basis accounting is a method in which revenue is recorded when cash is received, and expenses are recorded when cash payments are made. Accrual basis accounting is a method in which revenue is recorded when it is earned and expenses are recorded when they are incurred rather than when cash is received or disbursed. Accrual basis accounting is required in the preparation of general purpose financial statements as it takes into account all the economic activity of the entity that *has occurred* during the financial period under review. This gives a true and fair view of the entity's performance, allowing for greater ability to predict future cash flows.

Use of standards in preparation of financial statements

Accounting standards are guidelines of best accounting practice in the treatment of accounting information and for financial reporting. They are not rules. The IASB (International Accounting Standards Board) is the standard-setting body of the IASC (International Accounting Standards Committee), an independently run private-sector organisation. The IASB consists of 14 members, of which 3 may be part-time. The IASB consists of representatives from four basic groups:

1. preparers of general purpose financial statements
2. users of general purpose financial statements
3. the auditing profession
4. academia.

The IASB is responsible for the approval of IFRSs (International Financial Reporting Standards) and related documents. The standard-setting process called 'Due Process' is as follows:

1. The IASB sets up a steering committee.
2. The steering committee identifies issues.
3. The steering committee studies national and regional requirements and practice in relation to the issues.
4. The steering committee prepares and presents a Point Outline to IASB.
5. The Point Outline is converted to an Exposure Draft and sent out to member organisations for discussion/ feedback.
6. After comments are received and revisions are approved by the IASB, the revised Exposure Draft is adopted and issued as an IFRS.

Small and medium-sized entities (SMEs) make up more than 95 per cent of the world's companies.[1] As a result, there has always been a dire need for standards for SMEs financial reporting. The *International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)* was developed giving consideration to, complying with and borrowing from current IASs and IFRSs and is in line with the IASB's *Conceptual Framework of Accounting*. As the development of this standard had gone through **due process**, on 09 July 2009 the IASB issued the IFRS for SMEs.[2] Most businesses in the Caribbean are SMEs and jurisdictions have adopted the IFRS for SMEs as part of their GAAP.
Issuing the IFRS for SMEs:

1. makes it simpler for SMEs to comply with the requirements of the one standard than adhering to the full set of IFRSs and IASs and many national GAAPs requirements
2. reduces the cost associated with meeting the requirements of the full set of IFRSs and IASs
3. simply meets the needs and capabilities of SMEs.

Member institutes of the Institute of Chartered Accountants of the Caribbean (ICAC), incorporated on 28 October 1988 with headquarters in Jamaica, are listed below:

- Bahamas Institute of Chartered Accountants
- Institute of Chartered Accountants of Barbados
- Institute of Chartered Accountants of the Eastern Caribbean
  - St. Kitts Nevis Branch
  - St. Lucia Branch

[1] IASB's website: http://www.ifrs.org
[2] Deloitte website: www.iasplus.com

    - Antigua/ Barbuda Branch
    - Dominica Branch
    - Grenada Branch
    - Montserrat Branch
    - St. Vincent and the Grenadines Branch
- Institute of Chartered Accountants of Guyana
- Institute of Chartered Accountants of Jamaica
- Institute of Chartered Accountants of Trinidad and Tobago

Test Your Knowledge

1. What comprises GAAP in any jurisdiction? **[3 marks]**
2. Name five institute members of ICAC. **[5 marks]**
3. What are the steps involved in the IASB's **due process**? **[6 marks]**
4. Explain the difference between cash basis and accrual basis accounting. **[4 marks]**
5. List four users of financial statements and explain their needs for financial statements. **[12 marks]**
6. Who makes up the IASB? **[8 marks]**
7. Why do SMEs need the IFRS? **[5 marks]**
8. List the steps in the accounting cycle **[4 marks]**