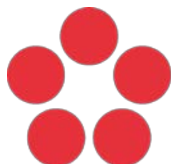

Jihočeská univerzita
v Českých Budějovicích
University of South Bohemia
in České Budějovice

FINANCIAL STATEMENTS
– study text

INTRODUCING TO ACCOUNTING

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1 INTRODUCTION TO ACCOUNTING

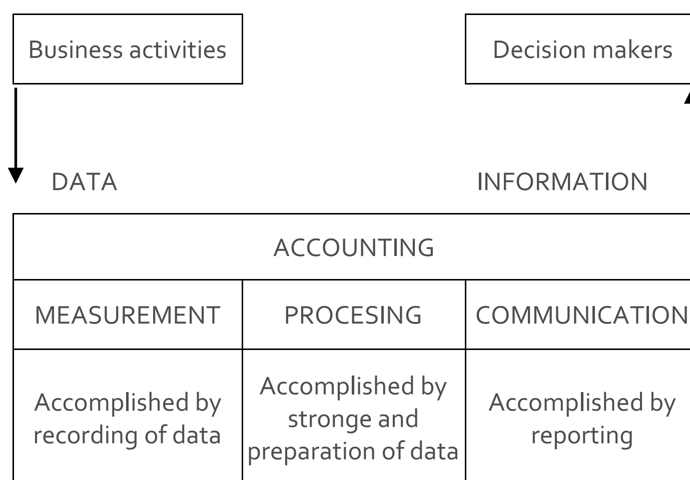
Accounting is an information system that captures the results of complex business activities and reports them. It is a language of business. Reporting should provide information that is useful to the investors, creditors and other users in making decisions about investment, credit, and other similar decisions. The information should be comprehensible.

Accounting is a very old discipline. Forms of it have been essential to commerce for more than five thousand years. Accounting, in a version close to what we know today, came into widespread use in the 1400s, especially in Italy, where it was instrumental to the development of shipping, trade, construction, and other forms of commerce. This system of double-entry bookkeeping was documented by the famous Italian mathematician, scholar, and philosopher Fra Luca Pacioli.

Today´s accountant focuses on the ultimate needs of decision makers who use accounting information, whether those decision makers are inside or outside the business. Accounting is an information system that measures processes, and communicates financial information about identifiable economic entity. An economic entity is a unit that exists independently; for example: a business, a hospital, or governmental units.

Accounting provides a vital service by supplying the information that decision makers needs to make reasoned choices among alternative uses of scare resources in the conduct of business and economic activities. As shown in Figure 1, accounting is a link between business activities and decision makers. First, accounting measures business activities by recording data about them for the future use. Second, the data are stored until needed and then processed become useful information. Third, the information is communicated, through reports, to decision makers. We can say, that data about business activities are input to the accounting system and that useful information for decision makers is the output.

Figure 1: Accounting as an Information System



Source: Peterson, P.A, 1994

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1.1 The essence and functions of accounting

Accounting is concerned with collecting, analysing and communicating financial information. This information is useful for people who need to make decisions and plans about businesses and for people who need to monitor their businesses. The information for decisions should be for example:

- increasing or decreasing the price or quantity of products,
- developing new products,
- borrowing money to help finance the business,
- increasing or decreasing the capacity,
- changing the methods of purchasing, production or distribution, and others.

Accounting has an important role in the economic and social system of the Czech Republic. The accounting system consists of the methods and devices used by a company to keep track of its activities and to summarize these activities in a manner useful to decision makers. The basic elements of accounting are information, recording, evaluation and reporting.

The **users of information from accounting** are:

- managers - information that will assist them in their decision making and control activities,
- shareholders - information on the value of their investment and the income that is derived from their shareholding,
- employees - information on the ability of the firm to meet wage demands and avoid redundancies.
- creditors and providers of loan capital - information on a firm's ability to meet its financial obligations.
- government agencies – collection of accounting information and required information.

Various users can be divided into two categories. These are internal parties within the organization and external parties outside the organization.

It is possible to distinguish between two branches of accounting that reflect the internal and external users. These are financial accounting and management (or managerial) accounting. Management accounting is concerned with people within the organization and financial accounting is concerned with external parties outside the organization. The main areas of difference between financial and management accounting are:

- the nature of the reports produced,
- the level of detail,
- regulations,
- reporting intervals,
- time orientation,
- the range and quality of information.

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Figure 2 Difference between financial and management accounting

ITEM	Management accounting	Financial accounting
Nature of the reports produced	Tend to be for a specific purpose	Tend to be general purpose
Level of detail	Often very detailed	Usually broad overview
Regulations	Unregulated	Usually subject to accounting regulation
Reporting interval	As short as required by managers	Usually annual
Time horizon	Often based on projected future info as well as past info	Almost always historical
Range and quality of information	Tend to contain financial and non-financial info, use info that cannot be verified	Focused on financial info, great emphasis on objective verifiable evidence

Source: author

The specific branch concerns evidence of tax on incomes and expenditures. This evidence can be used only by physical persons who are not entered in a trade register and whose turnover does not exceed the amount of 25 mil CZK per year. Tax evidence is regulated by the Law of Income Taxes and it is not considered as a real accounting system.

Accounting units are:

- corporations,
- physical persons doing business entered in the trade register,
- physical persons doing business with a turnover exceeding the amount of 25 mil CZK per year,
- physical persons doing business who keep accounts voluntarily,
- physical persons doing business associated in a so-called association without legal subjectivity under the condition that any person associated in the association is an accounting unit.

1.2 General principles

A number of basic accounting principles have been developed through common usage. They form the basis upon which modern accounting is based. The best-known of these principles are as follows:

Accrual principle. This is the concept that accounting transactions should be recorded in the accounting periods when they actually occur, rather than in the periods when there are cash flows associated with them. This is the foundation of the accrual basis of accounting. It is important for the construction of financial statements that show what actually happened in an accounting period, rather than being artificially delayed or accelerated by the associated cash flows. For example, if you ignored the accrual principle, you would record an

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expense only when you paid for it, which might incorporate a lengthy delay caused by the payment terms for the associated supplier invoice.

Conservatism principle. This is the concept that you should record expenses and liabilities as soon as possible, but to record revenues and assets only when you are sure that they will occur. This introduces a conservative slant to the financial statements that may yield lower reported profits, since revenue and asset recognition may be delayed for some time. Conversely, this principle tends to encourage the recordation of losses earlier, rather than later. This concept can be taken too far, where a business persistently misstates its results to be worse than is realistically the case.

Consistency principle. This is the concept that, once you adopt an accounting principle or method, you should continue to use it until a demonstrably better principle or method comes along. Not following the consistency principle means that a business could continually jump between different accounting treatments of its transactions that makes its long-term financial results extremely difficult to discern.

Cost principle. This is the concept that a business should only record its assets, liabilities, and equity investments at their original purchase costs. This principle is becoming less valid, as a host of accounting standards are heading in the direction of adjusting assets and liabilities to their fair values.

Economic entity principle. This is the concept that the transactions of a business should be kept separate from those of its owners and other businesses. This prevents intermingling of assets and liabilities among multiple entities, which can cause considerable difficulties when the financial statements of a fledgling business are first audited.

Full disclosure principle. This is the concept that you should include in or alongside the financial statements of a business all of the information that may impact a reader's understanding of those financial statements. The accounting standards have greatly amplified upon this concept in specifying an enormous number of informational disclosures.

Going concern principle. This is the concept that a business will remain in operation for the foreseeable future. This means that you would be justified in deferring the recognition of some expenses, such as depreciation, until later periods. Otherwise, you would have to recognize all expenses at once and not defer any of them.

Matching principle. This is the concept that, when you record revenue, you should record all related expenses at the same time. Thus, you charge inventory to the cost of goods sold at the same time that you record revenue from the sale of those inventory items. This is a cornerstone of the accrual basis of accounting. The cash basis of accounting does not use the matching the principle.

Materiality principle. This is the concept that you should record a transaction in the accounting records if not doing so might have altered the decision making process of someone reading the company's financial statements. This is quite a vague concept that is difficult to quantify, which has led some of the more picayune controllers to record even the smallest transactions.

Monetary unit principle. This is the concept that a business should only record transactions that can be stated in terms of a unit of currency. Thus, it is easy enough to record the purchase of a fixed asset, since it was bought for a specific price, whereas the value of the quality control system of a business is not recorded. This concept keeps a business from engaging in an excessive level of estimation in deriving the value of its assets and liabilities.

Reliability principle. This is the concept that only those transactions that can be proven should be recorded. For example, a supplier invoice is solid evidence that an expense has been recorded. This concept is of prime interest to auditors, who are constantly in search of the evidence supporting transactions.

Revenue recognition principle. This is the concept that you should only recognize revenue when the business has substantially completed the earnings process. So many people have skirted around the fringes of this concept to commit reporting fraud that a variety of standard-setting bodies have developed a massive amount of information about what constitutes proper revenue recognition.

Time period principle. This is the concept that a business should report the results of its operations over a standard period of time. This may qualify as the most glaringly obvious of all accounting principles, but is intended to create a standard set of comparable periods, which is useful for trend analysis.

These principles are incorporated into a number of accounting frameworks, from which accounting standards

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govern the treatment and reporting of business transactions.

In accordance with the Act on accounting, there are several **basic valuation possibilities**:

- acquisition cost – it is used for assets and equities acquired by purchase,
- own costs – it is used for assets acquired by one's own activity,
- executant acquisition cost – it is used for assets and equities acquired for free,
- face value – it is the nominal value used for cash, checks, stamps.

1.3 Accounting rules

The basic Czech **accounting legislation** is:

- Act No. 563/1991 Coll., on Accounting – constitutes the obligation to keep accounting files for Czech enterprises and defines basic conditions and procedures for the keeping of accounting evidence.
- Edict of Ministry of Finance No. 500/2002 – constitutes the methods and principles of accounting as well as valuation rules.
- Czech Accounting Standards – describe in detail concrete accounting principles for concrete economic transactions.

The company is obliged to keep records of the date of its creation until the day of its death. The reporting period is continuous consecutive periods of twelve months, unless stated otherwise. The accounting period is either the calendar year or economic year. The economic year as an accounting period can begin only on the first day of any month, except in January. The period may be longer than 12 months when the establishment of an entity is in a period of 3 months before the end of the calendar year or when the dissolution of the entity is in a period of 3 months after the end of the calendar year or economic year.

The basic rules and regulations are set out in Act No. 563/1991 Coll., on Accounting. The companies are obliged to follow, in particular, the accounting chart of accounts, the classification and identification of financial statements plus consolidated financial statements, the contents of statements, accounting methods, conditions of readmission accounting records and other conditions. Implementing legislation for each group entity adjusts especially:

- the scope and method of preparing the financial statements and annual reports,
- the arrangement, description and definition of property and other assets, liabilities and other liabilities in the financial statements, including the layout, content labelling and definition of off-balance sheet accounts,
- the arrangement, description and definition of costs, revenues and results of operation in the financial statements,
- the layout and definition of explanatory and supplementary information in the Annex to the financial statements, including information on the management of the state budget and budgets of local governments,
- the layout and definition of cash flow statements and statements of changes in equity,
- the guiding chart,
- the accounting methods, particularly the methods of measurement and their application files including the valuation of assets, processes of creation and use of provisions, depreciation methods, procedures and use of reserves,
- the methods of transition from simple accounting or tax records,
- the organization, tagging, and content of the consolidated financial statements,
- methods of consolidating financial statements,
- processes including entities in consolidated groups,

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- the rules for the format, structure, transmission and security of accounting records in technical form of selected entities,
- the requirements for technical and mixed forms of accounting records, including those for relevance, transmission and storage,
- the extent and frequency of transmission of the accounting records of selected entities to the central system of state accounting information,
- the requirements of the organization and how to perform an inventory of selected entities.

The basic principle is that companies are required to keep records so that their financial statements give a true and fair view of the accounting and financial situation of the entity. The presentation of this information is true if the content of the financial statements corresponds to the actual state that is displayed while in accordance with accounting methods, and the uses by an entity imposed under this Act. The presentation of information is honest when the accounting method is used in a way that leads to achieving loyalty. Where an entity can choose between several options and the accounting method chosen would paper over the real situation, then the entity shall select another option that corresponds to the actual state.

Companies are required to keep records in an accurate, complete, conclusive, clear, and transparent way that ensures sustainability of accounting records. Accounting is correct if the company shall keep accounts in a way that is not contrary to the Act on accounting. Accounting is complete if the company has recorded all transactions that it has recognized in the books for an accounting period. The accounts are conclusive, if all of the accounting records are significant and made an inventory of the entity. Accounting is understandable if the context allows an individual to reliably and unambiguously identify:

- at least the contents of accounting transactions using accounting methods,
- the contents of accounting records using the tools.

Accounting is conducted in a manner that ensures the sustainability of accounting records, if the company is able to fulfill obligations associated with their storage and processing.

1.4 Accounting documents

The accounting documents are conclusive accounting records, which must include:

a) Identification of the accounting document,
b) the content of the financial case and its participants,
c) a sum of money or information about the price per unit and number of observations,
d) an instant copy of the accounting document,
e) time of the transaction,
f) signature.

The unit charge provides:

- the diary (diaries) in which the accounting entries are arranged in terms of time (in chronological order) and which demonstrates the accounting of all accounting transactions in the accounting period,
- the general ledger in which accounting entries are arranged in terms of material (systematic),
- analytical accounts in the books, which detail the elaborate accounting ledger entries,
- off-balance sheet accounts.

The book includes accounts by a synthetic chart of accounts.

Storage of **accounting records**:

- the financial statements and Annual report for 10 years beginning with the end of the reporting period to which they relate,

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- the accounting documents, ledgers, depreciation schedules, inventory lists, chart of accounts, and reports for 5 years beginning with the end of the reporting period to which they relate,
- the accounting records which demonstrate the leadership entity Accounting, for a period of 5 years beginning with the end of the accounting period to which they relate.

1.5 The chart (list) of accounts

The chart of accounts consists of these classes and groups:

Account class 0 - Fixed assets

01-Intangible assets

02-Tangible assets

03-Tangible assets non-depreciated

04-Accounts of acquisition

05-Unfinished assets – advances

06-Long- term financial assets

07-Accumulated depreciation on intangible assets

08-Acumulated depreciation on tangible assets

09-Rectifying items on fixed assets

Account class 1 - Inventories

11-Material

12-Inventories of one's own production

13-Merchandise

15-Advance payments provided on inventories

19-Rectifying items on inventories

Account class 2 – Financial accounts

21-Cash

22-Bank accounts

23 -Short-term bank accounts

24-Other short-term financial substitutes

25-Short-term financial assets

26-Transfers between financial accounts

29-Rectifying items on short-term financial assets

Account class 3 – Receivables and short-term liabilities

31-Receivables

32-Liabilities (short-term)

33-Clearing with employees and institutions

34-Clearing of dotations and taxes

35-Recevables for partners and members of associations

36-Liabilities to partners and members of associations

37-Other receivables and liabilities

38-Transitive accounts of assets and equities

39-Rectifying items on receivables and internal clearing

Account class 4 – Capital accounts and long term liabilities

41-Common stocks and capital funds

42-Funds created from net profit and the economic result of previous periods

43-Economic result

45-Reserves

46-Long-term bank credits

47-Long-term liabilities

48-Postponed tax liability and receivables

49-Individual businessman

Account class 5 – Costs

50-Consumed purchases

51-Consumed services

52-Personal costs

53-Taxes and fees

54-Other operating costs

55-Depreciation, creation of reserves, complex

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costs of other periods and creation of rectifying items in operating activities

56-Financial costs

57-Creation of reserves and creation of rectifying items in financial activities

58-Change in inventory and activation

59-Income taxes and transitive accounts

Account class 6 – Revenues

60-Revenues for one's own products and merchandise

64-Other operating revenues

66-Financial revenues

69-Transitive accounts

Account class 7 – Shuttering accounts

70-Balance sheet accounts

71-Account of profit and loss

Account class 8 – Managerial accounting

1.6 Inventory of assets and liabilities

The companies discover the real state of the inventory of all assets and liabilities and verify that the observed state corresponds to the actual state of assets and liabilities in the accounts. A continuous inventory entity can only be carried out on stocks which are accounted for by species, by storing sites or materially responsible persons, and in cases of tangible, movable property which has no permanent place to belong. The date of the inventory should be adopted by the entity. Each type of inventory and fixed asset that requires it must be inventoried at least once per accounting period.

The companies discover the real state of the **inventory of assets and liabilities** and these are recorded in the inventory records. In these records are found:

- the physical inventory of assets, in which you can visually determine its existence, or
- the book inventory for liabilities and assets of which you cannot visually determine the existence, including other assets, other liabilities and facts charged in off-book accounts.

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