I. Nature and function of accounting

After studying this chapter you should be able to:
- Discuss the history and development of accounting;
- Discuss the role of Luca Pacioli in the development of accounting;
- Explain the duality concept;
- Define accounting;
- Explain the aim of accounting;
- Explain the entity concept;
- Discuss the domains of accounting;
- Identify the different users of financial information;
- Explain the underlying assumptions of financial statements;
- Discuss the qualitative characteristics of financial statements;
- Discuss the measurement bases applicable to financial statements;
- Discuss the limiting factors of financial statements;
- Explain the role of money as a common accounting unit; and
- Explain and illustrate the accounting cycle.

Recommended reading

Conduct an internet search on the history and development of accounting. One source that can be made use of is Wikipedia.

Think tank questions

1. Who is believed to be the first people to employ writing, also for accounting purposes?

2. Who were the first people to use the accounting system that is still currently in use?

3. Can Luca Pacioli really be viewed as the “Father of Accounting”? Motivate your answer critically.
1.1. History and development of accounting

Accounting is thousands of years old. The earliest accounting records date back more than 7,000 years. These records were found in Mesopotamia. In the Suhag province in Egypt, clay tablets were found in a tomb of an Egyptian king, Scorpion I. The people of that time relied on primitive accounting methods to record the growth of crops and herds. German archaeologists have placed the origin of these records at somewhere between 3,300 BC and 3,200 BC. More than two thirds of the translated hieroglyphic writing is tax accounting records.

However, the Smithsonian Museum has an engraved plaque from the Blombos Cave in South Africa with marks on that researchers believe was used for counting purposes as these marks are clearly organised.

This plaque is about 76,000 years old and could mean that accounting is far older than previously thought.
(Source: http://humanorigins.si.edu/evidence/behavior/blombos-ocher-plaque)

As business enterprises developed, accounting evolved and improved over the years.

1.1.1. Luca Pacioli and the double-entry system

As accounting developed, one important breakthrough took place during the 13th century namely the introduction of the double-entry accounting system. This system was defined as an accounting system in which there was a debit and a credit entry for each transaction. “Debitum” (Debit) is Latin for ‘he owes you’ and “Promeritum” (Credit) is Latin for ‘he trusts you’.

Although Luca Pacioli did not invent the double-entry accounting system, he did publish the first full description of the double-entry system. The double entry system is summarised in diagram 1.1
It is important to remember that assets, equity and liabilities will have both a debit and credit side. From diagram 1-1 we can deduce that each type of asset, equity and liability will have its own account (that will appear in a general ledger). The purpose of these accounts is to summarise all transactions that will have an influence on them. In order to ensure that the double entry system is adhered to, for every debit entry there will be a corresponding credit entry. These entries will then correspond with the influence that the transactions have on assets, equity and liabilities. It is very important to remember that the accounting equation must always be in balance! The afore-mentioned is illustrated below and also indicates on which side assets, equity and liabilities will increase and decrease.

### Diagram 1-1 – The double entry system

<table>
<thead>
<tr>
<th>Dr Assets</th>
<th>Cr Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactions that will increase assets will be recorded on the debit side.</td>
<td>Transactions that will decrease liabilities will be recorded on the debit side.</td>
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<table>
<thead>
<tr>
<th>Dr Equity</th>
<th>Cr Assets</th>
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<tbody>
<tr>
<td>Transactions that will decrease equity will be recorded on the debit side.</td>
<td>Transactions that will increase assets will be recorded on the credit side.</td>
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Assets, equity and liabilities are discussed in detail in chapters 2 and 3.
Example 1.1

Jack Carter decided to start his own computer shop, called **Gigabyte Computers**. He took R120 000 of his own savings and deposited into the business’s bank account to design a website and to purchase computer equipment.

**REQUIRED**

How will the above-mentioned information influence the employment and the generation of funds?

**SOLUTION**

<table>
<thead>
<tr>
<th>Employment of funds</th>
<th>Generation of funds</th>
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<tr>
<td>+ R120 000 Money deposited into business’s bank account</td>
<td>+ R120 000 The owner, Jack made a capital contribution</td>
</tr>
<tr>
<td>to design a website and to purchase computer equipment</td>
<td>to the business. The owner, Jack made a capital contribution to the business by taking the money from his own savings and giving it to the business.</td>
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</table>

According to Luca Pacioli, accounting could be seen as an ad hoc ordering system developed by business. Luca Pacioli further recommended that the Venetian method of double-entry bookkeeping be used. Three books of account are used as basis of this system: The memorandum (for example invoices and receipts), the journal (for example the documents used to enter the transactions in the books of the entity) and the ledger (the general ledger which served as the main source for the preparation of financial statements).

The nature of double-entry can be understood by recognising that this system did not only record the goods that were traded with, but also for a business to keep track of assets and liabilities and to calculate profits and losses. The double entry system also had other effects such as honesty and accuracy.

1.1.2. **Further development of accounting**

As businesses evolved and grew, accounting also evolved and grew. Businesses started to trade and deliver services globally. Businesses also merged and took over other businesses globally. It was therefore necessary to bring some order in accounting to ensure the uniformity of standards. This is also known as the Conceptual Framework which is the source of the following standards.

In South Africa, financial information had to adhere to the South African Standards of Generally Accepted Accounting Practice (known as GAAP). Because of globalisation, a set of accounting standards were developed internationally by an independent, non-for-profit organisation called the International Accounting Standards Board (IASB). This is jointly known as International Financial Reporting
Standards (IFRS), which South African accounting bodies are also adhering to. In January 2005, South Africa decided to adopt the International Financial Reporting Standards (IFRS) unchanged. The two most prominent South African accounting bodies are: The South African Institute of Chartererd Accountants (SAICA), found in 1980, and the South African Institute of Professional Accountants (SAIPA), formerly known as CFA and CPA).

The goal of IFRS is to provide a global framework for how entities prepare and disclose their financial statements. IFRS provides general guidance for the preparation of financial statements. Having an international standard is very important for large entities that have subsidiaries in different countries. Adopting a single set of world-wide standards will simplify accounting procedures by allowing an entity to use one reporting language throughout. A single standard will also provide investors and auditors with a consistent view of finances.

1.2. What is an entity?

An entity is:

- An economic unit;
- That operates separately from other units; and
- Whose financial statements are recorded separately from any other unit.

An entity can be a person, partnership, close corporation, company or non profit (charitable) organisation.

1.3. What is accounting?

To account for something means to give a satisfactory explanation of why something has happened or why you did something.

Accounting is therefore seen as the production of financial information about an entity and the communication of this information to those who may need this information.

Accounting can thus be defined as:

- A continuous scientific process;
- That not only involves the bookkeeping of transactions;
- But also involves the reporting on the financial activities of an entity;
- Through financial statements to the users thereof.

Accounting is a science because every transaction that is recorded can be analysed. It is a continuous process because transactions happen on a daily basis and the
communication of financial activities will take place each financial year. Management statements, for internal use, depending on managements’ needs, can also be prepared monthly (refer to par. 1.1.4).

1.3.1. The aim of accounting

The aim of accounting is:

- To provide financial information about the economic activities of an entity;
- To current and future interested parties;
- To enable them to make informed decisions about the entity.

This information is communicated through financial statements.

Complete exercise 1.5 (format available at end of chapter)

1.3.2. The domains of accounting

Accounting can be divided into two domains as is illustrated in diagram 1-2.

**Diagram 1-2 – The two domains of accounting**

*Financial accounting* is a medium through which financial information is communicated to interested parties of the entity by means of three primary statements, namely the statement of profit or loss and other comprehensive income, the statement of financial position and the statement of cash flows. Financial accounting caters thus mainly for external users of financial information.

*Management accounting* on the other hand, is concerned with reporting on specific activities inside the entity and caters mainly for internal users of financial information. Financial statements for the use of management accounting can be compiled on a weekly, monthly, quarterly of half yearly basis.
Financial statements are considered a communication medium through which financial information is communicated to various people who make economic decisions. The financial information must be presented in such a way that it is most useful in helping these people to make their respective economic decisions. It is therefore important to remember that the financial information must be accurate and comparable.

Financial statements consist of:

- A **statement of profit or loss and other comprehensive income** – to report on the financial performance of an entity in terms of income and expenses and the resulting profit or loss for a particular period;
- A **statement of changes in equity** – to report on how the equity of the entity has changed from one financial year to another by reconciling the equity at the beginning of the financial year with that at the end of the financial year;
- A **statement of financial position** – to report on the financial position of an entity and to reconfirm the duality concept at a specific point in time (refer to figure 1.1);
- A **statement of cash flows** – to report on the inflow and outflow of cash and for what purpose the cash of the entity was used;
- The **notes to the financial statements** – to explain the accounting policy and certain items’ movements and calculations; and
- The **director’s report** – to provide a general overview of what an entity has accomplished during a financial year.
1 Nature and function of accounting

1.4.1. Who will use the financial information of an entity?

The users of financial information is summarised in diagram 1-3:

External users are persons and institutions who exist outside of the entity and are not directly involved in the management and operations of the entity. These users are interested in the financial information of an entity to base their decision-making process on, for example, as to whether to extend credit to the entity or not and whether to invest in the entity or not.

Internal users require internal financial information of the entity in order to manage the entity on a day-to-day basis.

Complete exercise 1.6 (format available at end of chapter)

1.4.2. The reporting period

The regularity of the preparation of financial statements depends on the needs of the users of financial statements.

A reporting period is the period in respect of which the financial performance is determined and at the end of which the financial position of the entity is determined.

The financial performance of an entity refers to whether an entity has made a profit or a loss during a reporting period whilst the financial position refers to the
employment of funds which must be equal to the generation of funds at any specific point in time, usually at the end of a reporting period.

Reporting usually takes place at the end of a financial year. A financial year consists of any 12 months following one another that does not necessarily coincide with a calendar year.

The reporting periods in relation to the statement of profit or loss and other comprehensive income as well as the statement of financial position is displayed in diagram 1-4:


1.4.3. Underlying assumptions of financial statements

Two assumptions underlie the financial statements, namely:

- The **accrual** concept; and
- The **going concern** concept.

The **accrual** concept states that transactions should be recorded in the financial period in which they occur and not when the cash is received or paid.

According to the **going concern** concept, it is assumed that the entity will continue to operate in the foreseeable future. It is therefore assumed that the entity, when publishing its financial statements, has neither the intention nor the need to liquidate or curtail its operations.
1.4.4. **Qualitative characteristics of financial statements**

The qualitative characteristics of financial statements are those characteristics that make financial statements useful to the users (see par. 1.3). The following characteristics can be distinguished:

- **Relevance**: Relevant information is information that influences the economic decisions of users by helping them to evaluate the past, present and future events of an entity.

- **Faithful representation**: Information included in financial statements must be a faithful representation of what happened in an entity. Faithful representation implies that the information must be:
  - Complete;
  - Neutral; and
  - Free from errors.

The usefulness of information that is relevant and faithfully represented is enhanced by the **enhanced qualitative characteristics**:

- **Comparability**: The information presented in the financial statements should be comparable with information from prior periods as well as information in the statements of other role players in the same industry.

- **Verifiability**: Verifiability helps assure users that the information faithfully represents the economic activities it purports. It means that different observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

- **Timeliness**: The longer it takes to make the information available, the less useful this information becomes. It is sometimes necessary to report on information before all the aspects of a transaction are known in order to supply the information timeously. Because all the information is not always available at financial year-end, it will be necessary to make adjustments in order to prepare the financial statements. With such disclosure the reliability of the information may be questioned.

- **Understandability**: The financial statements of an entity should be of such a nature that they are understandable to the users thereof, otherwise they serve no purpose.

1.4.5. **Limiting factors to financial statements**

The following are limiting factors to financial reporting through financial statements:

- **Materiality**: Materiality is judged in relation to the nature and extent of the activities of the entity. For example, if a cell phone operator decides to expand its network to a neighbouring country, it will imply certain costs and also
possible future economic benefits that can be generated. This will have an impact on prospective and current investors’ decision on whether they want to invest in this entity. Because of this impact on the decision-making process, the entity must disclose its intention to expand its network.

- **Cost effectiveness:** Another constraint on the presentation of financial statements is the cost involved in supplying the information. If the costs of preparing the information exceed the benefits derived to receive the information, the information should not be reported.

### Complete exercise 1.7

#### 1.4.6. Measurement of elements of financial statements

Measurement is the process by which the amount at which an element will be shown in the financial statements is determined. The following measurement bases are applied:

- **Historical cost:** The amount in cash or cash equivalents paid at acquisition for an asset or other benefit in cash.

- **Current cost:** The amount an entity currently would have to pay with cash or cash equivalents to acquire an asset similar to that purchased previously.

- **Realisable value:** The amount in cash or cash equivalents which can be obtained by selling an asset in an orderly disposal.

- **Present value:** Discounted value of the expected net cash flow which the asset should generate in the future. The discounted value is the present value at a specified interest rate of a future amount over a specific period.

- **Settlement value:** Amount in cash or cash equivalents currently needed to pay off (settle) a debt.

- **Market value:** The amount in cash or cash equivalents which can be obtained from the sale of an asset on an active market where the selling price of the asset is known.
1.5. Money as a common accounting unit

A thought to ponder on: Formerly trading consisted of bartering. A cow was for example exchanged for two bags of maize meal. Why can we not use such a trading system in this current day and time?

As the aim of accounting is to provide financial information about the economic activities of an entity, this information is expressed in monetary terms (Rand and Cents in South Africa). The three most important international currencies are the US dollar, the British pond and the Euro. What currencies are used in other countries, such as Botswana or China?

The financial information is the information on the financial performance and financial position of an entity (refer to par. 1.4.2 for a short description of the afore-mentioned terminologies). The economic activities include all the activities that use resources to create value.

Two shortfalls exist in using money to measure the economic activities of an entity which limits the usefulness of the information prepared namely:

- Only facts which are measurable in terms of money are taken into account, for example the impact of a pending case of negligence against the entity; and
- The instability of the value of money, for example the volatility of the Rand and the US dollar exchange rate.

Complete exercise 1.4
1.6. A basic accounting cycle

The accounting process is the methods and procedures followed for the recording of financial transactions to provide the information necessary for the preparation of the financial statements to be used by interested parties. This is schematically represented in diagram 1.5:

Accounting entails bookkeeping and reporting the economic activities on a continuous basis. This continuous basis is also known as an accounting cycle that is illustrated in diagram 1.6:
Diagram 1-6 – A basic accounting cycle

1 Nature and function of accounting
List of terminologies used in this chapter

<table>
<thead>
<tr>
<th>Terminology</th>
<th>Description</th>
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<tbody>
<tr>
<td>Duality concept</td>
<td>The total funds applied, must be equal to the total of the funds generated, whether it was generated internally or externally.</td>
</tr>
<tr>
<td>Double entry system</td>
<td>For each debit transaction, there must be a corresponding credit transaction.</td>
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<tr>
<td>Entity</td>
<td>An economic unit that functions separately from other units and whose financial statements are prepared separately from any other unit.</td>
</tr>
<tr>
<td>Accounting</td>
<td>A continuous process that does not only include bookkeeping but also reporting on the financial activities to the users thereof by using financial statements.</td>
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<td>Financial accounting</td>
<td>Provides financial information of an entity to external users.</td>
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<tr>
<td>Management accounting</td>
<td>Provides financial and management information of an entity to internal users.</td>
</tr>
<tr>
<td>Financial statements</td>
<td>A communication medium through which financial information is communicated to various people that make economic decisions.</td>
</tr>
<tr>
<td>Accrual concept</td>
<td>Transactions must be recorded in the financial year it occurs and not when the cash is received or paid.</td>
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<tr>
<td>Going concern concept</td>
<td>It is accepted that an entity will be in operation for the foreseeable future.</td>
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<td>Relevance</td>
<td>Relevant information is information that influences the economic decisions of the users by helping them to evaluate past, current and future events of an entity.</td>
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<td>Timeliness</td>
<td>The longer it takes to make information available, the less useful it becomes.</td>
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<tr>
<td>Materiality</td>
<td>Information that has an influence on the decision-making process is regarded as material to disclose.</td>
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<tr>
<td>Cost effectiveness</td>
<td>Limiting factor on the presentation of financial statements.</td>
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1.7. Conclusion

In this chapter, you have been provided with an overview of what accounting is all about. This chapter looked at the history and development of accounting, the definition and aim of accounting as well as financial statements. A basic overview of the accounting process and a basic accounting cycle were also provided. In the following chapter, the elements of the statement of financial position are discussed. These elements are also present in the double entry system.
1 Nature and function of accounting

Exercise 1.5

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## Exercise 1.6

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