Concepts and Principles of Accounting

Accounting plays an important role in our economic and social system. Sound decisions made by individuals, businesses, governments, and other entities are essential for the efficient distribution and use of the nation's scarce resources. To make such decisions, these groups must have reliable information provided by the accounting system. The objective of accounting, therefore, is to record, summarize, report, and interpret economic data for use by many groups within our economic and social system.

ACCOUNTING AS AN INFORMATION SYSTEM

Accounting is often called the "language of business." This language can be viewed as an information system that provides essential information about the financial activities of an entity to various individuals or groups for their use in making informed judgments and decisions. As such, accounting information is composed principally of financial data about business transactions, expressed in terms of money. The recording of transaction data may take various forms, such as pen or pencil markings made by hand, printing by mechanical and electronic devices, or magnetic impressions on tape or disks.

The mere records of transactions are of little use in making informed judgments and decisions. The recorded data must be sorted and summarized and then presented in significant reports. The usefulness of reports is often improved by various kinds of percentage and trend analyses.

USERS OF ACCOUNTING INFORMATION

Accounting provides the techniques for gathering economic data and the language for communicating these data to different individuals and institutions. Investors in a business enterprise need information about its financial status and its future prospects. Bankers and suppliers appraise the financial soundness of a business organization and assess the risks involved before making loans or granting credit. Government agencies are concerned with the financial activities of business organizations for purposes of taxation and regulation. Employees and their union representatives are also vitally interested in the stability and the profitability of the organization that hires them.

The individuals who depend upon and make the most use of accounting are those charged with the responsibility for directing the operations of enterprises. They are often referred to collectively as "management." Management relies upon many types of accounting data in conducting day-to-day operations, in evaluating current operations, and in planning future operations.

FINANCIAL AND MANAGERIAL ACCOUNTING

As a result of rapid technological advances and accelerated economic growth, a number of specialized fields in accounting have evolved. The two most important accounting fields, financial and managerial accounting, are briefly described in the following paragraphs.

Financial accounting is concerned with the measuring and recording of transactions for a business enterprise or other economic unit and the periodic preparation of various reports from such records. The reports, which may be for general purposes or for a special purpose, provide useful information for managers, owners, creditors, governmental agencies, and the general public.

Managerial accounting employs both historical and estimated data, which management uses in conducting daily operations and in planning future operations. For example, in directing day-to-day operations, management relies upon accounting to provide information concerning the amount owed to each creditor, the amount owed by each customer, and the date each amount is due. The treasurer uses these data and other data in the management of cash. Accounting data may be used by top management in determining the selling price of a new product. Production managers, by comparing past performances with planned objectives, can take steps to accelerate favorable trends and reduce those trends that are unfavorable.

Managerial accounting overlaps financial accounting to the extent that management uses the financial statements or reports in directing current operations and planning future operations. However, managerial accounting extends beyond financial accounting by providing additional information and reports for management's use. In providing this additional information, the managerial accountant is not governed by generally accepted accounting principles, International accounting standards and the Czech legislation. Since these data are used only by management, the accountant provides the data in the format that is most useful for management. The principle of "usefulness," then, is dominant in guiding the accountant in preparing management reports.

DEVELOPMENT OF FINANCIAL ACCOUNTING CONCEPTS AND PRINCIPLES

The historical development of the practice of accounting has been closely related to the economic development of the country. In the earlier stages of the Czech economy, a business enterprise was very often managed by its owner, and the accounting records and reports were used mainly by the owner-manager in conducting the business. Bankers and other lenders often relied on their personal relationship with the owner rather than on financial statements as the basis for making loans for business purposes. If a large amount was owed to a bank or supplier, the creditor often participated in management decisions.

As business organizations grew in size and complexity, "management" and "outsiders" became more clearly differentiated. Outsiders demanded accurate financial information. In addition, as the size and complexity of the business unit increased, the accounting problems involved in the issuance of financial statements became more and more complex. With these developments came an awareness of the need for a framework of concepts and generally accepted accounting principles to serve as guidelines for the preparation of the basic financial statements.

Accounting principles have been developed by individuals to help make accounting data more useful in an ever-changing society. They represent guides for the achievement of the desired results, based on reason, observation, and experimentation. The selection of the best method from among many alternatives has come about gradually, and in some areas a clear consensus is still lacking. These principles are continually reexamined and revised to keep pace with the increasing complexity of business operations. General acceptance among the members of the accounting profession is the criterion for determining an accounting principle.

The Czech accounting legislation

The Czech accounting system is regulated by several juridical laws.
The basic law is law nr. 563/1991 – LAW OF ACCOUNTING, that constitutes the obligation to keep accounting files for the Czech enterprises.
This law is next developed by edict nr. 500/2002, that constitutes the methods and principles of accounting as well as valuation rules.
The edict nr. 500/2002 is next developed by so called Czech accounting standards valid since the beginning of the year 2004, that in detail describe concrete accounting principles for concrete economic transactions.

These three basic laws regulate directly accounting procedures. But there are a lot of other laws and regulations in the Czech Republic that are connected with accounting indirectly – for example law of income taxes, law of health and social insurance, etc.

Accounting systems in the Czech Republic

There are two basic accounting systems in the Czech Republic:

1. **Tax evidence of incomes and expenditures**
2. **Double-entry accounting**

Tax evidence of incomes and expenditures can be used only by smaller enterprises whose turnover does not exceed amount 6 mil. CZK per year (turnover means amount of total revenues). The tax evidence is regulated primarily by law of income taxes.

All other enterprises must obligatory keep accounting files in according with double-entry accounting system. Double-entry accounting system means that all economic transactions are charged on two different accounts.

Accounting documents

All economic transactions in double-entry accounting system must be charged on the base of accounting document in written form. The accounting document must meet conditions determined by law of accounting nr. 563/1991. These conditions are:

1. **The accounting document (AD) must be marked as an accounting document (title, number, etc.),**
2. **AD must contain a record of the value of transaction (in money)**
3. **AD must contain a date of creation**
4. **AD must contain a date of realization of the economic transaction**
5. **AD must contain a description of the economic transaction**
6. **AD must contain signatures of the person responsible for the transaction and of the person responsible for charging of the transaction.**

Valuation in the Czech accounting

The methods of valuation are described by law of accounting and edict nr. 500/2002. In according with this regulation there are three basic valuation possibilities in double-entry accounting system in the Czech Republic. These are:

1. **Acquiring costs (used for assets and equities acquired by purchase)**
2. **Own costs (used for assets acquired by own activity)**

3. **Executant acquiring costs (used for assets and equities acquired for free – presents, dotations, etc.). This value is calculated as the value common in the market or as an expert estimation.**

Some other assets and liabilities are valuated by another value – face (nominal) value (used for valuation of cash, checks, stamps, etc.).

The first valuation is made in the moment of creation of assets and equities (so called historical costs principle). But in accordance to valid accounting legislation, there are some cases when it is necessary to revaluate some assets – this revaluation is made in the moment of financial statements compilation. To be revaluated must be securities held for trade and capital shares.
Securities held for trade must be revaluate by <u>fair value</u>. The fair value is found out as the market value and if it is not possible to find out the market value, it is again necessary to use an expert estimation.
Capital shares must be revaluated by <u>method of equivalency</u>. The new value is calculated as a share on owner's equity of controlled company.

Example nr. 1:
Our enterprise bought securities held for trade for 10 000 CZK and capital shares in company ABC, plc. for 1 000 000 CZK. These capital shares based a share on equity of company ABC in amount 50%. On December 31 the market value of the securities held for trade was 8 000 CZK and the equity of ABC was 3 000 000 CZK. Revaluate both securities held for trade and capital shares to the date of December 31.

Solution: It is necessary to revaluate securities held for trade by fair value and capital shares by methods of equivalency. The new value of securities held for trade would be 8 000 CZK and the new value of capital shares would be 0,5 x 3 000 000 = 1 500 000 CZK. The differences in valuation would be charged on special accounts.

ASSETS, LIABILITIES, AND OWNER'S EQUITY

Assets, liabilities and owner's equity are the basic accounting terms. The properties owned by a business enterprise are referred to as assets and the rights or claims to the properties are referred to as equities. If the assets owned by a business amount to 100 000 CZK, the equities in the assets must also amount to 100 000 CZK. The relationship between the two may be stated in the form of an equation, as follows:

Assets = Equities

Equities may be subdivided into two principal types: the rights of creditors and the rights of owners. The rights of creditors represent debts of the business and are called liabilities. The rights of the owner or owners are called owner's equity. Expansion of the equation to give recognition to the two basic types of equities yields the following, which is known as the accounting equation:

Assets = Liabilities + Owner's Equity

It is customary to place "Liabilities" before "Owner's Equity" in the accounting equation because creditors have preferential rights to the assets. The residual claim of the owner or owners is sometimes given greater emphasis by transposing liabilities to the other side of the equation, yielding:

Assets - Liabilities = Owner's Equity

The Balance Sheet

The balance sheet is the most important financial statement. It provides information about the structure of assets and equities. The structure of the balance sheet valid in the Czech Republic is as follows:

Assets	**Equities**
1. Fixed assets - intangible assets - tangible assets - long-term financial assets **2. Current assets** - inventories - long – term receivables - short – term receivables - short – term financial assets	**1. Owner's equity** - common stocks - capital funds - funds created by net profit - economic results **2. Liabilities** - reserves - long – term debts (liabilities) - short - term debts (liabilities) - bank credits
Σ Assets	**Σ Equities**

Definition: Σ Assets or Σ Equities is called <u>The balance sheet amount.</u>

Once more: Σ Assets = Σ Equities

Very important:
This equation must stay in balance after the charging of every transaction!!!!!

Remember:
There is no economic transaction that could evoke an imbalance in this equation!!!

Definitions of the balance sheet components

a) Fixed assets

1. **Intangible assets – assets of an intangible nature with a term of usage longer than 1 year with a value exceeding a limit chosen by an enterprise in according with so called "common traditions". As the "common traditions" is usually respected the amount of 60 000 CZK. But this amount is not obligatory given. Assets of an intangible nature with a term of usage longer than 1 year with a value which do not come to a limit chosen by an enterprise are charged as costs immediately in the moment of their acquirement. As examples of intangible assets can be mentioned - valuable rights, licenses, software, know – how, goodwill, etc.**
2. **Tangible assets - assets of a tangible nature with a term of usage longer than 1 year with a value exceeding a limit chosen by an enterprise in according with so called "common traditions" and buildings and parcels regardless to their value. As the "common traditions" is in this case usually respected the amount of 40 000 CZK. Again - from the accounting point of view this amount is not obligatory given. But from the tax point of view the amount of 40 000 CZK is obligatory determined by the law of income taxes. As examples of tangible assets can be mentioned – buildings, parcels, cars, hardware, equipment, machinery, etc.**
3. **Long-term financial assets – assets of a financial nature with a term of payment longer than 1 year regardless to their value. As examples of long-term assets can be mentioned long-term investment, capital shares, long-term bills of exchange, etc.**

b) Current assets

4. **Inventories – merchandise (goods) held for sale in the normal course of business and materials in the process of production or held for such use.**

5. **Receivables – include all money claims against people, organizations, or other debtors. Receivables are acquired by a business enterprise in various kinds of transactions, the most common being the sale of merchandise or services on a credit basis. The receivables can be divided into 2 parts – long-term receivables with term of payment longer than 1 year and short-term receivables with term of payment shorter than 1 year.**
6. **Short-term financial assets - assets of a financial nature with a term of payment shorter than 1 year. As example of short-term financial assets can be mentioned securities held for trade, stamps, cash on bank accounts, cash, etc.**

c) Owner's equity

7. **Common stocks – is a number of shares (in face values) issued by an enterprise.**
8. **Capital funds – the funds created by other resources than net profit (dotations, gifts, etc.)**
9. **Funds created by net profit – the funds created by net profit. The net profit is a profit after taxes.**
10. **Economic results – economic results of an enterprise achieved by business activities. The economic results can be divided into 2 parts – economic results achieved in previous accounting periods and economic result achieved in present accounting period. The economic result achieved in present accounting period is primarily calculated in the second basic financial statement – The Profit and Loss Statement (International Accounting Standards use the term The Income Statement).**

d) Liabilities

11. **Reserves – represent the liabilities created due to covering potential business risks (losses). Reserves are also created due to covering future debts to creditors. The creation of reserves is charged as a cost, the usage of reserves is charged as a revenue.**
12. **Debts – debts owed by an enterprise to its creditors. Money claims against a firm may originate in many ways, such as purchases of merchandise or services on account, purchases of equipment and marketable securities on a credit basis, etc. At any particular moment, an enterprise may also owe its employees for wages or salaries accrued, other creditors for interest accrued on notes, governmental agencies for taxes, etc.**
13. **Bank credits – debts owed by an enterprise to its banks.**

TRANSACTIONS AND THE ACCOUNTING EQUATION

All business transactions, from the simplest to the most complex, can be stated in terms of the resulting change in the three basic elements of the accounting equation. In all cases, the recording of the effects of transactions on the elements of the accounting equation must be such that the equality of the equation is maintained. For example, if a business organizes as a corporation by selling shares of ownership interests, generally referred to as capital stock, for 50,000 CZK, the asset cash will increase by 50,000 CZK and the owner's equity will increase by 50,000 CZK. The effect of this transaction on the accounting equation is as follows:

Assets	**=**	**Liabilities + Owner's Equity**
Cash		**Capital Stock**
+50 000 CZK		**+ 50 000 CZK**

Summary:

There are four types of economic transactions in double-entry accounting system according to their impact on assets and equities:

1. **Transactions which increase both assets and equities (A+E+). An example of this transaction can be a purchase of goods paid by bank credit. This type of transaction increases the balance sheet amount.**
2. **Transactions which decrease both assets and equities (A-E-). An example of this transaction can be a payment of credit by cash. This type of transaction decreases the balance sheet amount.**
3. **Transactions which increase some asset item and decrease another asset item (A+A-). An example of this transaction can be a purchase of goods paid by cash. This type of transaction does not change the balance sheet amount.**
4. **Transaction which increase some equity item and decrease another equity item (E+E-). An example of this transaction can be a payment of trade liabilities by bank credit. This type of transaction does not change the balance sheet amount.**

The transactions completed by an enterprise during a specific period may number into the thousands and may cause increases and decreases in many different asset, liability, and owner's equity items. To provide timely reports on the effects of these transactions, accountants must record them in a systematic manner.

The Profit and Loss Statement (The income statement)

Except recording of assets and equities the financial accounting has still another purpose – to record the economic result of an enterprise. The economic result of the enterprise under double-entry accounting conditions in the Czech Republic is calculated in according with the following equation:

Economic result = Revenues – Costs

The excess of the revenue over the costs incurred in earning the revenue is called <u>net profit</u>. If the costs of the enterprise exceed the revenue, the excess is a <u>net loss</u>.

The revenue is defined as the result (output) of the economic activity of the enterprise achieved by spending of costs. Revenues give the sense to economic existence of the enterprise. The revenue can influence assets (increasing of assets) or equities (decreasing of equities). <u>But not every increasing of assets or decreasing of equities must be automatically revenue!!!</u>

The cost is defined as the input into the economic activity of the enterprise with the aim to achieve revenues (outputs). The cost can influence assets (decreasing of assets) or equities (increasing of equities). <u>But again not every decreasing of assets or increasing of equities must be automatically cost!!!</u>

Costs and revenues are charged on special accounts in the system of double-entry accounting system. Systematically they are recorded in the profit and loss statement (income statement) (P/L Statement).

The structure of P/L statement is a little bit more complicated than the structure of the balance sheet. The P/L statement is composed gradually with the aim to calculate several partial indicators which represent single parts of economic activity of the enterprise. The concrete structure of the P/L statement is as follows:

1. **<u>Commercial margin</u> (is calculated as the difference between revenues from merchandise sale and costs on this sale),**
2. **<u>Value added</u> (is calculated as commercial margin + some other revenues (revenues from products sale, changes in the amount of own inventories and so called activation) – some other costs (consumption of material and energy and consumption of services),**

3. **<u>Operating result</u> (is calculated as value added + other operating revenues (for example revenues from long-term property sale) – other operating costs (especially wages, depreciation costs and creation of operating reserves),**
4. **<u>Financial result</u> (is calculated as the difference between financial revenues (revenue interests, revenues from securities sale, dividends, etc.) – financial costs (cost interests, costs on securities sold, financial payments, etc.),**
5. **<u>Result from common activity</u> (is calculated as operating result + financial result – income tax from common activity),**
6. **<u>Extraordinary result</u> (is calculated as the difference between extraordinary revenues (for example payments from insurance companies) – extraordinary costs (for example deficits, damages, etc.) – income tax from extraordinary activity),**
7. **<u>Net result</u> (is calculated as a sum of result from common activity + extraordinary result),**
8. **<u>Result before taxes</u> (is calculated as net result + income taxes from common and extraordinary activity).**

The P/L statement is - after the balance sheet - the second basic financial statement that must be obligatory compiled to the date of accounting shutter (so called financial statements compilation date).

It is necessary to differentiate terms costs versus expenditures and revenues versus incomes.

Expenditure is a decrease of money. Income is an increase of money. Incomes and expenditures are shown in next financial statement – <u>cash-flow statement</u>. This statement in not obligatory to compile in the Czech Republic. If the cash-flow statement is compiled, then it is usually a part of appendix.

<u>Appendix</u> is the third obligatory compiled statement as a part of an accounting shutter in the Czech Republic. It provides complementing information about financial situation of the enterprise.

NATURE OF AN ACCOUNT

The simplest form of an account has three parts: (1) a title, which is the name of the item recorded in the account and usually also the number of account; (2) a space for recording increases in the amount of the item, in terms of money; and (3) a space for recording decreases in the amount of the item, also in monetary terms. This form of an account, illustrated below, is known as a T account because of its similarity to the letter T.

Number (usually 3 fingers) - Title

Active side	**Passive side**
Debit side	**Credit side**