Chapter 1

Introduction to Accounting
1. Introduction

Welcome to the Astranti notes for the CIMA C02 paper: Fundamentals of Financial Accounting! The aim of this chapter is to give you a better idea what accounting is and why it is done. We also want to bring you up to speed with some of the technical terminology and definitions. So, let's get started!

2. What is accounting?

Broadly speaking, accounting has two main features: measurement and management.

- **Measurement**: This concerns the collection of past data about a company. So, for example, calculating the net profit of a business for the previous financial year.

- **Management**: This is the process of using the past data to make decisions about the current and future plans of a business. So, let’s say the business make a large net profit, they will be able to use this profit to invest in expanding the business!

Therefore, an important part of accounting is being able to correctly interpret the measurements so that good management decisions can be made.

Thus, a good accountant must ultimately be able to record, report, and forecast.

- **Record**: to be able to classify and store data in a useful way.

- **Report**: to provide the company with up-to-date information on their financial position and activities.

- **Forecast**: to be able to make good business decisions based on the financial information they have.

Therefore, the main objective of an accountant is to provide a business (management, investors, shareholders, etc.) with relevant information about the financial activity of that business.

In order to achieve this, it is vital that the information be reliable, easy to use, and consistent.

Consistency is very important because it allows for comparisons between businesses, as well as different time periods for the same business.

This has lead to a lot of standardisation with respect to general practices of accounting.
3. **Who uses financial statements?**

The people who use financial statements generally fall into one of the groups in the following section. That being said, these groups are not the be all and end all, and there is some overlap between groups.

**Investors**

**Who:** Existing and potential shareholders.

**Why:** Investors (or shareholders) use financial statements to look at the overall performance and profitability of the company. As owners of shares of the company, it's only natural that they should be interested in seeing how much of that profit is coming their way!

Investors may also take an interest in the social or economic policies of the company. For instance, if you were to invest in a clothing manufacturer such as Nike, you may be pleased by the potential profits, but disagree with their policies on exporting labour to third world countries.

**Lenders**

**Who:** This group contains anyone who has lent, or wishes to lend, money to a business.

**Why:** Lenders will want to know that the business they are lending money to will be able to pay them their money back in the long term. This one is quite obvious.

If a friend asks to borrow £20, but he doesn't currently have a job, and a history of not paying back his friends, then you might think twice about reaching for your wallet!

**Employees**

**Who:** Past, present and prospective employees of the company.

**Why:** Employees are primarily concerned with their employer's ability to pay their wages and pension, but may also be concerned with their future job prospects and security at the company.

**Analysts/Advisers**

**Who:** Specialists who generally work on behalf of investors or employees.

**Why:** This will depend on the needs of the clients. However, analysts/advisers usually have more technical knowledge than their client, and so this group essentially acts as the 'middle man' between another group and the business.
Business Contacts

Who: Customers and suppliers of a business.

Why: Customers will want to ensure that a product or service can be provided in the future. You wouldn't buy a 12-month gym membership if it looked like gym might go bankrupt!

Suppliers will want to make sure that the product or service they provide can be paid for by the business. So, a cleaning company may think twice before becoming a supplier of their service to the gym.

Government

Who: Primarily taxation authorities, and also any other government body that needs information for their purposes. For example, taking information about all national business to evaluate the economy.

Why: Companies have a legal obligation to provide financial information so that the government can tax the businesses appropriately.

Public

Who: Tax-payers, consumers and other special interest groups.

Why: This group is generally more interested in the policies of the business. For example, certain public groups have shown increasing interest in promoting fair trade between large corporations and local/developing suppliers.

Internal

Who: The management, which is divisible into 3 sub-groups:

- **Strategic:** Top level of management (members of the board).
- **Tactical:** Middle management (departmental heads).
- **Operational:** Lower management (supervisors/team leaders).

Why:

- **Strategic:** Top level management deal with long-term plans for the business.
- **Operational:** Middle management deal with short-term plans, such as meeting scheduled targets and deadlines.
- **Tactical:** Lower management deal with day-to-day activity and running of the company.
4. Terminology

Internal information

Internal information is produced regularly and is primarily used to measure the company's performance against its targets. So, this means that the information is designed to aid management in making decisions about the company.

Since managers are not necessarily trained accountants, internal information tends to be a mixture of financial and non-financial information that management may be more familiar with (such as raw material usage, or labour output).

External information

External information differs to internal information in that it is primarily produced for groups outside of the company, such as the public and other organisations.

So, for this reason, external information strictly follows a set of rules and legislation that creates an accounting standard across all business.

Given that this information is publicly accessible, it tends to be less detailed (with regard to the specifics of the company), so that their competitors don't use this information their advantage. It would not be very smart for Coca-Cola to publish information about the specifics of their production!

Bookkeeping

Bookkeeping is the practice of recording monetary transactions for a business. In order for a business to run efficiently it is absolutely essential for them to keep tabs on all of their past, present and future financial activity.

Bookkeeping is like a financial history of a business, and so good bookkeeping must be precise, accurate, and thorough.

Financial accounting

Financial accounting is the practice of providing financial information to an external source, according to legal requirements.

For this reason, then, financial accounting is done in accordance with standard rules of accounting, so that the information provided is consistent and comparable across multiple industries.

For example, imagine two completely different businesses: a record shop and a commercial airline. A financial accountant will compile and present financial information about these two businesses, so that their financial activity can be measured against universal standards.
Management accounting

Management accounting differs from financial accounting in that it provides financial information for internal use. That is, management accounting deals with providing management with information about the business.

Therefore, this means that it is not necessary for it to adhere to the same general standards as financial accounting, since generally the information is only going to be used by the business itself.

5. Types of business

So, what exactly is a business? Well, we can define it quite generally as an organisation that takes part in transactions with the aim of making a monetary reward, or a profit.

Different types of business may have different organisational structures, and this is often related to the size of the business. In this section we will look at the 3 main types of profit-making businesses.

Sole trader

As you probably guessed from the name, this is quite simply a business that is owned by just one individual. For this reason they are usually quite small, since they can only spend as much money as the single owner has!

Examples of common sole traders might include: self-employed tradesmen, independent shops - essentially any business owned by a single proprietor!

Partnership

Once again, as the name suggests, this one is also quite self-explanatory. A partnership is a business owned by two or more people. That's right: not just 2 owners, but any number of owners greater than, or equal to, 2.

The financial resources of a partnership, as you might expect, will generally increase with the number of owners, since the business has access to a larger pool of money.

Limited company

A limited company is a little bit different. You may have heard about companies being legally recognised as persons. Well, that's what a limited company is! A company that is viewed as a 'person' through the eyes of the law.

Limited companies are classified in this way because they will carry out business in their own name, and not just under the names of the individual owners.

We can further divide limited companies into two sub-groups:
• **Public limited company**: Generally the owners have little to do with the day-to-day running of the business. If the company is listed on the stock market, then the public (as shareholders) are entirely uninvolved with the management.

• **Private limited company**: Here, the owners play a big role in running the company (like sole traders and partnerships).

**The concept of separate identity**

When it comes to limited companies, it is very important to separate the company from the owners. This is why the business is recognised as a 'person' in its own right.

This distinction is a legal requirement for limited companies, and ensures that the financial activity of the owner is never mixed with the financial activity of the business.

**6. Summary**

So, in this section we have covered:

• **What accounting is and who uses it**

• **Different aspects of accounting**

• **Some accounting terminology**

• **Different types of business**

Hopefully now you have a learnt a bit about what accounting is and what it is used for, as well as clarifying some of the more technical aspects and definitions within the discipline!
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