# ACCOUNTING

1. **NATURE OF ACCOUNTING**

Accounting is defined as the process of identifying, measuring and reporting economic information to the users of this information to permit informed judgment

Many businesses carry out transactions. Some of these transactions have a financial implication i.e. either cash is received or paid out. Examples of these transactions include selling goods, buying goods, paying employees and so many others.

Accounting is involved with identifying these transactions measuring (attaching a value) and reporting on these transactions. If a firm employs a new staff member then this may not be an accounting transaction. However when the firm pays the employee salary, then this is related to accounting as cash involved. This has an economic impact on the organization and will be recorded for accounting purposes. A process is put in place to collect and record this information; it is then classified and summarized so that it can be reported to the interested parties.

1. **USERS OF ACCOUNTING INFORMATION**

Accounting information is produced in form of financial statement. These financial statements provide information about an entity financial position, performance and changes in financial position.

Financial position of a firm is what the resources the business has and how much belongs to the owners and others.

The financial performance reflects how the business has performed, whether it has made profits or losses. Changes in financial positions determine whether the resources have increased or reduced.

The users of accounting information have an interest in the existence of the firm. Therefore the information contained in the financial statements will affect the decision making process.

The following are the users of accounting information:

1. **Owners:**

They have invested in the business and examples of such owners include sole traders, partners (partnerships) and shareholders (company). They would like to have information on the financial performance, financial position and changes in financial position.

This information will enable them to assess how the managers of the business are performing whether the business is profitable or not and whether to make drawings or put in additional capital.

1. **Customers**

Customers rely on the business for goods and services. They would like to know how the business is performing and its financial position.

This information would enable them to assess whether they can rely on the firm for future supplies.

**Suppliers**

They supply goods or services to the firm. The supplies are either for cash or credit. The suppliers would like to have information on the financial performance and position so as to assess whether the business would be able to pay up for the goods and services provided as and when the payments falls due.

1. **Managers**

The managers are involved in the day-to-day activities of the business. They would like to have information on the financial position, performance and changes in financial position so as to determine whether the business is operating as per the plans.

In case the plan is not achieved then the managers come up with appropriate measures (controls) to ensure that the set plans are met.

1. **The Lenders**

They have provided loans and others sources of capital to the business. Such lenders include banks and other financial institutions. They would like to have information on the financial performance and position of the business to assess whether the business is profitable enough to pay the interest on loans and whether it has enough resources to pay back the principal amount when it is due.

1. **The Government and its agencies**

The Government is interested in the financial performance of the business to be able to assess the tax to be collected in the case there are any profits made by the business.

The other government agencies are interested with the financial position and performance of the business to be able to come with National Statistics. This statistics measure the average performance of the economy.

1. **The Financial Analyst and Advisors**

Financial analyst and advisors interpret the financial information. Examples include stockbrokers who advise investors on shares to buy in the stock market and other professional consultants like accountants. They are interested with the financial position and performance of the firm so that they can advise their clients on how much is the value their investment i.e. whether it is profitable or not and what is the value.

Others advisors would include the press who will then pass the information to other relevant users.

1. **The Employees**

They work for the business/entity. They would like to have information on the financial position and performance so as to make decisions on their terms of employment. This information would be important as they can use it to negotiate for better terms including salaries, training and other benefits.

They can also use it to assess whether the firm is financially sound and therefore their jobs are secure.

1. **The Public**

Institutions and other welfare associations and groups represent the public. They are interested with the financial performance of the firm. This information will be important for them to assess how socially responsible is the firm.

This responsibility is in form the employment opportunities the firm offers, charitable activities and the effect of firm’s activities on the environment.

# Accounting Concepts, Principles and Basic Terms

#### Definition and introduction

The worldview of accounting and accountants may certainly involve some unhelpful characters poring over formidable figures stacked up in indecipherable columns.

However, a short and sweet description of accounting does exist:

*Accounting is the language of business efficiently communicated by well-organised and honest professionals called accountants.*

A more academic definition of accounting is given by the American Accounting Association:

*The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information.*

The American Institute of Certified Public Accountants defines accounting as:

*The art of recording, classifying, summarising in a significant manner and in terms of money, transactions and events which are, in part at least of financial character, and interpreting the results thereof.*

Accounting not only records financial transactions and conveys the financial position of a business enterprise; it also analyses and reports the information in documents called “financial statements.”

Recording every financial transaction is important to a business organisation and its creditors and investors. Accounting uses a formalised and regulated system that follows standardised principles and procedures.

The job of accounting is done by professionals who have educational degrees acquired after years of study. While a small business may have an accountant or a bookkeeper to record money transactions, a large corporation has an accounts department, which supplies information to:

* Managers who guide the company.
* Investors who want to know how the business is doing.
* Analysts and brokerage firms dealing with the company’s stock.
* The government, which decides how much tax should be collected from the company.

## Accounting Principles

Obviously, if each business organisation conveys its information in its own way, we will have a babel of unusable financial data.

Personal systems of accounting may have worked in the days when most companies were owned by sole proprietors or partners, but they do not anymore, in this era of joint stock companies.

These companies have thousands of stakeholders who have invested millions, and they need a uniform, standardised system of accounting by which companies can be compared on the basis of their performance and value.

Therefore, accounting principles based on certain concepts, convention, and tradition have been evolved by accounting authorities and regulators and are followed internationally.

These principles, which serve as the rules for accounting for financial transactions and preparing financial statements, are known as the “Generally Accepted Accounting Principles,” or GAAP.

The application of the principles by accountants ensures that financial statements are both informative and reliable.

It ensures that common practices and conventions are followed, and that the common rules and procedures are complied with. This observance of accounting principles has helped developed a widely understood grammar and vocabulary for recording financial statements.

However, it should be said that just as there may be variations in the usage of a language by two people living in two continents, there may be minor differences in the application of accounting rules and procedures depending on the accountant.

For example, two accountants may choose two equally correct methods for recording a particular transaction based on their own professional judgement and knowledge.

Accounting principles are accepted as such if they are (1) objective; (2) usable in practical situations; (3) reliable; (4) feasible (they can be applied without incurring high costs); and (5) comprehensible to those with a basic knowledge of finance.

Accounting principles involve both accounting concepts and accounting conventions. Here are brief explanations.

## Accounting Concepts

1. **Business entity concept:** A business and its owner should be treated separately as far as their financial transactions are concerned.
2. **Money measurement concept:** Only business transactions that can be expressed in terms of money are recorded in accounting, though records of other types of transactions may be kept separately.
3. **Dual aspect concept:** For every credit, a corresponding debit is made. The recording of a transaction is complete only with this dual aspect.
4. **Going concern concept:** In accounting, a business is expected to continue for a fairly long time and carry out its commitments and obligations. This assumes that the business will not be forced to stop functioning and liquidate its assets at “fire-sale” prices.
5. **Cost concept:** The fixed assets of a business are recorded on the basis of their original cost in the first year of accounting. Subsequently, these assets are recorded minus depreciation. No rise or fall in market price is taken into account. The concept applies only to fixed assets.
6. **Accounting year concept:** Each business chooses a specific time period to complete a cycle of the accounting process—for example, monthly, quarterly, or annually—as per a fiscal or a calendar year.
7. **Matching concept:** This principle dictates that for every entry of revenue recorded in a given accounting period, an equal expense entry has to be recorded for correctly calculating profit or loss in a given period.
8. **Realisation concept:** According to this concept, profit is recognised only when it is earned. An advance or fee paid is not considered a profit until the goods or services have been delivered to the buyer.

## Accounting Conventions

There are four main conventions in practice in accounting: conservatism; consistency; full disclosure; and materiality.

**Conservatism** is the convention by which, when two values of a transaction are available, the lower-value transaction is recorded. By this convention, profit should never be overestimated, and there should always be a provision for losses.

**Consistency** prescribes the use of the same accounting principles from one period of an accounting cycle to the next, so that the same standards are applied to calculate profit and loss.

**Materiality** means that all material facts should be recorded in accounting. Accountants should record important data and leave out insignificant information.

**Full disclosure** entails the revelation of all information, both favourable and detrimental to a business enterprise, and which are of material value to creditors and debtors.

## Basic Accounting Terms

Here is a quick look at some important accounting terms.

**Accounting equation:** The accounting equation, the basis for the double-entry system (see below), is written as follows:

Assets = Liabilities + Stakeholders’ equity

This means that all the assets owned by a company have been financed from loans from creditors and from equity from investors. “Assets” here stands for cash, account receivables, inventory, etc., that a company possesses.

**Accounting methods:** Companies choose between two methods—cash accounting or accrual accounting. Under cash basis accounting, preferred by small businesses, all revenues and expenditures at the time when payments are actually received or sent are recorded. Under accrual basis accounting, income is recorded when earned and expenses are recorded when incurred.

**Account receivable:**The sum of money owed by your customers after goods or services have been delivered and/or used.

**Account payable:**The amount of money you owe creditors, suppliers, etc., in return for goods and/or services they have delivered.

**Accrual accounting:** See “accounting methods.”

**Assets (fixed and current):**Current assets are assets that will be used within one year.

For example, cash, inventory, and accounts receivable (see above). Fixed assets (non-current) may provide benefits to a company for more than one year—for example, land and machinery.

**Balance sheet:**A financial report that provides a gist of a company’s assets and liabilities and owner’s equity at a given time.

**Capital:**A financial asset and its value, such as cash and goods. Working capital is current assets minus current liabilities.

**Cash accounting:** See “accounting methods.”

**Cash flow statement:** The cash flow statement of a business shows the balance between the amount of cash earned and the cash expenditure incurred.

**Credit and debit:** A credit is an accounting entry that either increases a liability or equity account, or decreases an asset or expense account. It is entered on the right in an accounting entry. A debit is an accounting entry that either increases an asset or expense account, or decreases a liability or equity account. It is entered on the left in an accounting entry.

**Double-entry bookkeeping:** Under double-entry bookkeeping, every transaction is recorded in at least two accounts—as a credit in one account and as a debit in another.

For example, an automobile repair shop that collects Rs. 10,000 in cash from a customer enters this amount in the revenue credit side and also in the cash debit side. If the customer had been given credit, “account receivable” (see above) would have been used instead of “cash.” (Also see “single-entry bookkeeping,” below.)

**Financial statement:** A financial statement is a document that reveals the financial transactions of a business or a person. The three most important financial statements for businesses are the balance sheet, cash flow statement, and profit and loss statement (all three listed here alphabetically).

**General ledger:**A complete record of financial transactions over the life of a company.

**Journal entry:** An entry in the journal that records financial transactions in the chronological order.

**Profit and loss statement (income statement):**A financial statement that summarises a company’s performance by reviewing revenues, costs and expenses during a specific period.

**Single-entry bookkeeping:** Under the single-entry bookkeeping, mainly used by small or businesses, incomes and expenses are recorded through daily and monthly summaries of cash receipts and disbursements. (Also see “double-entry bookkeeping,” above.)

**Types of accounting:** Financial accounting reports information about a company’s performance to investors and credits. Management accounting provides financial data to managers for business development

1. **THE ACCOUNTING EQUATION**

A business owns properties. These properties are called **assets**. The assets are the business resources that enable it to trade and carry out trading. They are financed or funded by the owners of the business who put in funds.

These funds, including assets that the owner may put is called **capital**. Other persons who are not owners of the firm may also finance assets. Funds from these sources are called liabilities.

The total assets must be equal to the total funding i.e. both from owners and non-owners. This is expressed inform of accounting equation which is stated as follows:

**ASSETS = LIABILITIES + CAPITAL**

Each item in this equation is briefly explained below.

**Assets**:

An asset is a resource controlled by a business entity/firm as a result of past events for which economic benefits are expected to flow to the firm.

An example is if a business sells goods on credit then it has an asset called a debtor. The past event is the sale on credit and the resource is a debtor. This debtor is expected to pay so that economic benefits will flow towards the firm i.e. in form of cash once the customers pays.

Assets are classified into two main types:

1. Non current assets (formerly called fixed assets).
2. Current assets.

Non current assets are acquired by the business to assist in earning revenues and not for resale. They are normally expected to be in business for a period of more than one year.

Major examples include:

* Land and buildings
* Plant and machinery
* Fixtures, furniture, fittings and equipment
* Motor vehicles

Current assets are not expected to last for more than one year. They are in most cases directly related to the trading activities of the firm. Examples include:

* Stock of goods – for purpose of selling.
* Trade debtors/accounts receivables – owe the business amounts as a resort of trading.
* Other debtors – owe the firm amounts other than for trading.
* Cash at bank.
* Cash in hand.

**Liabilities:**

These are obligations of a business as a result of past events settlement of which is expected to result to an economic outflow of amounts from the firm. An example is when a business buys goods on credit, then the firm has a liability called creditor. The past event is the credit purchase and the liability being the creditor the firm will pay cash to the creditor and therefore there is an out flow of cash from the business.

Liabilities are also classified into two main classes.

1. Non-current liabilities (or long term liabilities)
2. Current liabilities.

Non-current liabilities are expected to last or be paid after one year. This includes long-term loans from banks or other financial institutions. Current liabilities last for a period of less than one year and therefore will be paid within one year. Major examples:

* + Trade creditors/

or accounts payable – owed amounts as a result of

business buying goods on credit.

* + Other creditors - owed amounts for services supplied to the firm

other than goods.

* + Bank overdraft - amounts advanced by the bank for a short-term

period.

**Capital:**

This is the residual amount on the owner’s interest in the firm after deducting liabilities from the assets.

The Accounting equation can be expressed in a simple report called the **Balance Sheet**. The basic format is as follows:

**Name**

**Balance sheet as at 31.12.**

Sh Sh Sh Sh

Capital xx **Non Current Assets**

Land & Buildings xx

**Non Current Liabilities** Plant & Machinery xx

Loan xx Fixtures, furniture & fittings xx

Motor vehicles xx

**Current liabilities** xx

Overdraft xx **Current Assets**

Creditors xx xxStocks xx

Debtor’s xx

Capital and Liabilities Cash at bank xx

Cash in hand xx xx

xx Total assets xx

The above format of the balance sheet is the horizontal format however currently the practice is to present the Balance Sheet using the vertical format which is shown below.

**Name**

**Balance sheet as at 31.12.**

**Non Current Assets** Sh Sh Sh

Land & Buildings xx

Plant & Machinery xx

Fixtures, furniture & fittings xx

Motors vehicles xx

xx

**Current Assets**

Stocks/inventories xx

Debtors/ trade receivables xx

Cash at bank xx

Cash in hand xx

**Current Liabilities**

Bank Overdraft xx

Creditors/trade payables xx (xx)

Net Current Assets xx

Net assets xx

**Capital** xx

**Non Current Liabilities**

Loan (from bank or other sources) xx

xx

Please pay attention to the format. The **Non Current assets are listed in order of permanence** as shown i.e. from Land and Buildings to motor vehicles. The **Current Assets are listed in order of liquidity** i.e. which asset is far from being converted into cash. Example ,stock is not yet sold, (i.e. not yet realised yet) then when it is sold we either get cash or a debtor (if sold on credit). When the debtor pays then the debtor may pay by cheque (cash has to be banked) or cash.

The Current Liabilities are listed in order of payment i.e. which is due for payment first. Bank overdraft is payable on demand by the bank, then followed by creditors.

Note that in the vertical format, current liabilities are deducted from current assets to give net current assets. This is added to Non Current assets, which give us net assets.

Net assets should be the same as the total of Capital and Non Current Liabilities.

**Example 1.1**

B Kelly has a business that has been trading for some time. You are given the following information as at 31.12.2002

£

Buildings 11,000

Furniture & Fittings 5,500

Motor Vehicles 5,800

Stocks 8,500

Debtor 5,600

Cash a bank 1,500

Cash in hand 400

Creditors 2,500

Capital 30,800

Loan 5,000

You are required to prepare a Balance Sheet as at 31 December 2001

**B Kelly**

**Balance Sheet as at 31 December 2001**

**Non Current Assets** £ £ £

Buildings 11,000

Furniture & Fittings 5,500

Motor Vehicles 5,800

22,300

**Current Liabilities**

Stock 8,500

Debtors 5,600

Cash at bank 1,500

Cash in hand 400

16,000

**Creditors** (2,500)

Net Current Assets 13,500

Net Assets 35,800

**Capital** 30,800

**Non-Current Liabilities**

Loan 5,000

35,800