

**TECHNICAL UNIVERSITY OF MOMBASA**  
**MBA**  
**BAC 5101: FINANCIAL ACCOUNTING**

**NATURE AND SCOPE OF ACCOUNTING**

**1.1 INTRODUCTION**

Accounting has rightly been termed as the language of the business. The basic function of a language is to serve as a means of communication. Accounting also serves this function. It communicates the results of business operations to various parties who have some stake in the business viz., the proprietor, creditors, investors, Government and other agencies. Though accounting is generally associated with business but it is not only business which makes use of accounting. Persons like housewives, Government and other individuals also make use of accounting. For example, a housewife has to keep a record of the money received and spent by her during a particular period. She can record her receipts of money on one page of her "household diary" while payments for different items such as milk, food, clothing, house, education etc. on some other page or pages of her diary in a chronological order. Such a record will help her in knowing about :

- (i) The sources from which she received cash and the purposes for which it was utilized.
- (ii) Whether her receipts are more than her payments or vice-versa?
- (iii) The balance of cash in hand or deficit, if any at the end of a period.

In case the housewife records her transactions regularly, she can collect valuable information about the nature of her receipts and payments. For example, she can find out the total amount spent by her during a period (say a year) on different items say milk, food, education, entertainment, etc. Similarly she can find the sources of her receipts such as salary of her husband, rent from property, cash gifts from her relatives, etc. Thus, at the end of a period (say a year) she can see for herself about her financial position i.e., what she owns and what she owes. This will help her in planning her future income and expenses (or making out a budget) to a great extent. The need for accounting is all the more great for a person who is running a business. He must know : (i) What he owns? (ii) What he owes? (iii) Whether he has earned a profit or suffered a loss on account of running a business? (iv) What is his financial position i.e. whether he will be in a position to meet all his commitments in the near future or he is in the process of becoming a bankrupt.

**1.2 ORIGIN AND GROWTH OF ACCOUNTING**

Accounting is as old as money itself. However, the act of accounting was not as developed as it is today because in the early stages of civilisation, the number of transactions to be recorded were so small that each businessman was able to record and check for himself all his transactions. Accounting was practiced in India twenty three centuries ago as is clear from the book named "Arthashastra" written by Kautilya, King Chandragupta's minister. This book not only relates to politics and economics, but also explains the art of proper keeping of accounts. However, the modern system of accounting based on the principles of double entry system owes its origin to Luca Pacioli who first published the principles of Double Entry System in 1494 at Venice in Italy. Thus, the art of accounting has been practised for centuries but it is only in the late thirties that the study of the subject 'accounting' has been taken up seriously.

### 1.3 MEANING OF ACCOUNTING

The main purpose of accounting is to ascertain profit or loss during a specified period, to show financial condition of the business on a particular date and to have control over the firm's property. Such accounting records are required to be maintained to measure the income of the business and communicate the information so that it may be used by managers, owners and other interested parties. Accounting is a discipline which records, classifies, summarises and interprets financial information about the activities of a concern so that intelligent decisions can be made about the concern. *The American Institute of Certified Public Accountants* has defined the Financial Accounting as **"the art of recording, classifying and summarising in as significant manner and in terms of money transactions and events which in part, at least of a financial character, and interpreting the results thereof"**. *American Accounting Association* defines accounting as **"the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information."**

From the above the following attributes of accounting emerge :

- (i) **Recording** : It is concerned with the recording of financial transactions in an orderly manner, soon after their occurrence In the proper books of accounts.
- (ii) **Classifying** : It Is concerned with the systematic analysis of the recorded data so as to accumulate the transactions of similar type at one place. This function is performed by maintaining the ledger in which different accounts are opened to which related transactions are posted.
- (iii) **Summarising** : It is concerned with the preparation and presentation of the classified data in a manner useful to the users. This function involves the preparation of financial statements such as Income Statement, Balance Sheet, Statement of Changes in Financial Position, Statement of Cash Flow, Statement of Value Added.
- (iv) **Interpreting** : Nowadays, the aforesaid three functions are performed by electronic data processing devices and the accountant has to concentrate mainly on the interpretation aspects of accounting. The accountants should interpret the statements in a manner useful to action. The accountant should explain not only what has happened but also (a) why it happened, and (b) what is likely to happen under specified conditions.

### 1.4 DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

Book-keeping is a part of accounting and is concerned with the recording of transactions which is often routine and clerical in nature, whereas accounting performs other functions as well, viz., measurement and communication, besides recording. An accountant is required to have a much higher level of knowledge, conceptual understanding and analytical skill than is required of the book-keeper.

An accountant designs the accounting system, supervises and checks the work of the book-keeper, prepares the reports based on the recorded data and interprets the reports. Nowadays, he is required to take part in matters of management, control and planning of economic resources.

### 1.5 DISTINCTION BETWEEN ACCOUNTING AND ACCOUNTANCY

Although in practice Accountancy and Accounting are used interchangeably yet there is a thin line of demarcation between them. The word Accountancy is used for the profession of accountants - who do the work of accounting and are knowledgeable persons. Accounting is concerned with recording all business transactions systematically and then arranging in the form of various accounts and financial statements. And it is a distinct discipline like economics, physics,

astronomy etc. The word accounting tries to explain the nature of the work of the accountants (professionals) and the word Accountancy refers to the profession these people adopt.

## 1.6 OBJECTIVES OF ACCOUNTING

The following are the main objectives of accounting :

1. **To keep systematic records:** Accounting is done to keep a systematic record of financial transactions. In the absence of accounting there would have been terrific burden on human memory which in most cases would have been impossible to bear.

2. **To protect business properties:** Accounting provides protection to business properties from unjustified and unwarranted use. This is possible on account of accounting supplying the following information to the manager or the proprietor:

(i) The amount of the proprietor's funds invested in the business.

(ii) How much the business have to pay to others?

(iii) How much the business has to recover from others?

(iv) How much the business has in the form of (a) fixed assets, (b) cash in hand, (c) cash at bank,

(d) stock of raw materials, work-in-progress and finished goods?

Information about the above matters helps the proprietor in assuring that the funds of the business are not necessarily kept idle or underutilized.

3. **To ascertain the operational profit or loss:** Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business. This is done by keeping a proper record of revenues and expense of a particular period. The Profit and Loss Account is prepared at the end of a period and if the amount of revenue for the period is more than the expenditure incurred in earning that revenue, there is said to be a profit. In case the expenditure exceeds the revenue, there is said to be a loss. Profit and Loss Account will help the management, investors, creditors, etc. in knowing whether the business has proved to be remunerative or not. In case it has not proved to be remunerative or profitable, the cause of such a state of affairs will be investigated and necessary remedial steps will be taken.

4. **To ascertain the financial position of the business:** The Profit and Loss Account gives the amount of profit or loss made by the business during a particular period. However, it is not enough. The businessman must know about his financial position i.e. where he stands? what he owes and what he owns? This objective is served by the Balance Sheet or Position Statement. The Balance Sheet is a statement of assets and liabilities of the business on a particular date. It serves as barometer for ascertaining the financial health of the business.

5. **To facilitate rational decision making:** Accounting these days has taken upon itself the task of collection, analysis and reporting of information at the required points of time to the required levels of authority in order to facilitate rational decision-making. The American Accounting Association has also stressed this point while defining the term accounting when it says that accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information. Of course, this is by no means an easy task. However, the accounting bodies all over the world and particularly the

International Accounting Standards Committee, have been trying to grapple with this problem and have achieved success in laying down some basic postulates on the basis of which the accounting statements have to be prepared.

**6. Information System:** Accounting functions as an information system for collecting and communicating economic information about the business enterprise. This information helps the management in taking appropriate decisions. This function, as stated, is gaining tremendous importance these days.

## **1.7 USERS OF ACCOUNTING INFORMATION**

The basic objective of accounting is to provide information which is useful for persons inside the organization and for persons or groups outside the organization. Accounting is the discipline that provides information on which external and internal users of the information may base decisions that result in the allocation of economic resources in society.

**I. External Users of Accounting Information:** External users are those groups or persons who are outside the organization for whom accounting function is performed. Following can be the various external users of accounting information:

1. **Investors,** Those who are interested in investing money in an organization are interested in knowing the financial health of the organization to know how safe the investment already made is and how safe their proposed investment will be. To know the financial health, they need accounting information which will help them in evaluating the past performance and future prospects of the organization. Thus, investors for their investment decisions are dependent upon accounting information included in the financial statements. They can know the profitability and the financial position of the organization in which they are interested to make that investment by making a study of the accounting information given in the financial statements of the organization.

2. **Creditors.** Creditors (i.e. supplier of goods and services on credit, bankers and other lenders of money) want to know the financial position of a concern before giving loans or granting credit. They want to be sure that the concern will not experience difficulty in making their payment in time i.e. liquid position of the concern is satisfactory. To know the liquid position, they need accounting information relating to current assets, quick assets and current liabilities which is available in the financial statements.

3. **Members of Non-profit Organizations.** Members of non-profit organizations such as schools, colleges, hospitals, clubs, charitable institutions etc. need accounting information to know how their contributed funds are being utilized and to ascertain if the organization deserves continued support or support should be withdrawn keeping in view the bad performance depicted by the accounting information and diverted to another organization. In knowing the performance of such organizations, criterion will not be the profit made but the main criterion will be the service provided to the society.

4. **Government.** Central and State Governments are interested in the accounting information because they want to know earnings or sales for a particular period for purposes of taxation. Income tax returns are examples of financial reports which are prepared with information taken directly from accounting records. Governments also need accounting information for compiling statistics concerning business which, in turn helps in compiling national accounts.

5. **Consumers.** Consumers need accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction of the prices of goods they buy. Sometimes, prices for some goods are fixed by the Government, so it needs accounting information to fix reasonable prices so that consumers and manufacturers are not exploited. Prices are fixed keeping in view fair return to manufacturers on their investments shown in the accounting records.

6. **Research Scholars.** Accounting information, being a mirror of the financial performance of a business organisation, is of immense value to the research scholars who want to make a study of the financial operations of a particular firm. To make a study into the financial operations of a particular firm, the research scholar needs detailed accounting information relating to purchases, sales, expenses, cost of materials used, current assets, current liabilities, fixed assets, long term liabilities and shareholders' funds which is available in the accounting records maintained by the firm.

**II Internal Users of Accounting Information.** Internal users of accounting information are those persons or groups which are within the organisation.

Following are such internal users :

1. **Owners.** The owners provide funds for the operations of a business and they want to know whether their funds are being properly used or not. They need accounting information to know the profitability and the financial position of the concern in which they have invested their funds. The financial statements prepared from time to time from accounting records depict the profitability and the financial position.

2. **Management.** Management is the art of getting work done through others, the management should ensure that the subordinates are doing work properly. Accounting information is an aid in this respect because it helps a manager in appraising the performance of the subordinates. Actual performance of the employees can be compared with the budgeted performance they were expected to achieve and remedial action can be taken if the actual performance is not upto the mark. Thus, accounting information provides "the eyes and ears to management".

The most important functions of management are planning and controlling. Preparation of various budgets, such as sales budget, production budget, cash budget, capital expenditure budget etc., is an important part of planning function and the starting point for the preparation of the budgets is the accounting information for the previous year. Controlling is the function of seeing that programmes laid down in various budgets are being actually achieved i.e. actual performance ascertained from accounting is compared with the budgeted performance, enabling the manager to exercise controlling case of weak performance. Accounting information is also helpful to the management in fixing reasonable selling prices. In a competitive economy, a price should be based on cost plus a reasonable rate of return. If a firm quotes a price which exceeds cost plus a reasonable rate of return, it probably will not get the order. On the other hand, if the firm quotes a price which is less than its cost, it will be given the order but will incur a loss on account of price being lower than the cost. So, selling prices should always be fixed on the basis of accounting data to get the reasonable margin of profit on sales.

3. **Employees.** Employees are interested in the financial position of a concern they serve particularly when payment of bonus depends upon the size of the profits earned. They seek accounting information to know that the bonus being paid to them is correct.

## **1.8 BRANCHES OF ACCOUNTING**

To meet the ever increasing demands made on accounting by different interested parties such as owners, management, creditors, taxation authorities etc., the various branches have come into existence. There are as follows:

1. **Financial accounting.** The object of financial accounting is to ascertain the results (profit or loss) of business operations during the particular period and to state the financial position (balance sheet) as on a date at the end of the period.

2. **Cost accounting.** The object of cost accounting is to find out the cost of goods produced or services rendered by a business. It also helps the business in controlling the costs by indicating avoidable losses and wastes.

3. **Management accounting.** The object of management accounting is to supply relevant information at appropriate time to the management to enable it to take decisions and effect control. In this lesson we are concerned only with financial accounting. Financial accounting is the oldest and other branches have developed from it. The objects of financial accounting, as stated above, can be achieved only by recording the financial transactions in a systematic manner according to a set of principles. The art of recording financial transactions and events in a systematic manner in the books of account is known as book-keeping. However, mere record of transactions is not enough. The recorded information has to be classified, analyzed and presented in a manner in which business results and financial position can be ascertained.

## **1.9 ROLE OF ACCOUNTING**

Accounting plays an important and useful role by developing the information for providing answers to many questions faced by the users of accounting information:

- (1) How good or bad is the financial condition of the business?
- (2) Has the business activity resulted in a profit or loss?
- (3) How well the different departments of the business have performed in the past?
- (4) Which activities or products have been profitable?
- (5) Out of the existing products which should be discontinued and the production of which commodities should be increased?
- (6) Whether to buy a component from the market or to manufacture the same?
- (7) Whether the cost of production is reasonable or excessive?
- (8) What has been the impact of existing policies on the profitability of the business?
- (9) What are the likely results of new policy decisions on future earning capacity of the business?
- (10) In the light of past performance of the business how should it plan for future to ensure desired results?

Above mentioned are few examples of the types of questions faced by the users of accounting information. These can be satisfactorily answered with the help of suitable and necessary information provided by accounting. Besides, accounting is also useful in the following respects :

- (a) Increased volume of business results in large number of transactions and no businessman can remember everything. Accounting records obviate the necessity of remembering various transactions.
- (b) Accounting records, prepared on the basis of uniform practices, will enable a business to compare results of one period with another period.
- (c) Taxation authorities (both income tax and sales tax) are likely to believe the facts contained in the set of accounting books if maintained according to generally accepted accounting principles.
- (d) Accounting records, backed up by proper and authenticated vouchers, are good evidence in a court of law.
- (e) If a business is to be sold as a going concern, then the values of different assets as shown by the balance sheet helps in bargaining proper price for the business.

### **1.11 LIMITATIONS OF FINANCIAL ACCOUNTING**

Advantages of accounting discussed in this lesson do not suggest that accounting is free from limitations. Any one who is using accounting information should be well aware of its limitations also. Following are the limitations :

- (a) Financial accounting permits alternative treatments. No doubt accounting is based on concepts and it follows "generally accepted accounting principles", but there exist more than one principle for the treatment of any one item. This permits alternative treatments within the framework of generally accepted accounting principles. For example, the closing stock of a business may be valued by any one of the following methods : FIFO

(First-in-first-out); LIFO (Last-in-first-out); Average price, Standard price etc., Application of different methods will give different results but the methods are generally accepted. So, the results are not comparable.

- (b) Financial accounting is Influenced by personal judgements. In spite of the fact that convention of objectivity is respected in accounting but to record certain events estimates have to be made which requires personal judgement. It is very difficult to expect accuracy in future estimates and objectivity suffers. For example, in order to determine the amount of depreciation to be charged every year for the use of fixed asset it is required to estimate (a) future life of the asset, and (b) scrap value of the asset. Thus in accounting we do not determine but measure the income. In other words, the income disclosed by accounting is not authoritative but approximation.

- (c) Financial accounting ignores important non-monetary information. Financial accounting takes into consideration only those transactions and events which can be described in money. The transactions and events, however important, if non-monetary in nature are ignored i.e., not recorded. For example, extent of competition faced by the business, technical innovations possessed by the business, loyalty and efficiency of the employees etc. are the important matters in which management of the business is highly interested but accounting is not tailored to take note of such matters. Thus any user of financial information is, naturally, deprived of vital information which is of non-monetary character.

- (d) Financial accounting does not provide timely information. Financial accounting is designed to supply information in the form of statements (Balance Sheet and Profit and Loss Account) for a period, normally, one year. So the information is, at best, of historical interest and only postmortem analysis of the past can be conducted. The business requires timely information at frequent intervals to enable the management to plan and take corrective action. For example, if a business

has budgeted that during the current year sales should be Ksh. 12,000,000 then it requires information – whether the sales in the first month of the year amounted to Ksh. 1,000,000 or less or more? Traditionally, financial accounting is not supposed to supply information at shorter intervals than one year.

(e) Financial accounting does not provide detailed analysis. The information supplied by the financial accounting is in reality aggregate of the financial transactions during the course of the year. Of course, it enables to study the overall results of the business activity during the accounting period. For proper running of the business the information is required regarding the cost, revenue and profit of each product but financial accounting does not provide such detailed information product-wise. For example, if a business has earned a total profit of, say, Ksh. 5,000,000 during the accounting year and it sells three products namely petrol, diesel and mobile oil and wants to know profit earned by each product. Financial accounting is not likely to help him.

(f) Financial accounting does not disclose the present value of the business.

In financial accounting the position of the business as on a particular date is shown by a statement known as balance sheet. In balance sheet the assets are shown on the basis of going concern concept. Thus it is presumed that business has relatively longer life and will continue to exist indefinitely, hence the asset values are going concern values. The realised value of each asset if sold today can't be known by studying the balance sheet.

## 1.12 SYSTEMS OF ACCOUNTING

The following are the main systems of recording business transactions:

(a) **Cash System.** Under this system, actual cash receipts and actual cash payments are recorded. Credit transactions are not recorded at all until the cash is actually received or paid. The Receipts and Payments Account prepared in case of non-trading concerns such as a charitable institution, a club, a school, a college, etc. and professional men like a lawyer, a doctor, a chartered accountant etc. can be cited as the best example of cash system. This system does not make a complete record of financial transactions of a trading period as it does not record outstanding transactions like outstanding expenses and outstanding incomes. The system being based on a record of actual cash receipts and actual cash payments will not be able to disclose correct profit or loss for a particular period and will not exhibit true financial position of the business on a particular day.

(b) **Mercantile (Accrual) system.** Under this system all transactions relating to a period are recorded in the books of account i.e., in addition to actual receipts and payments of cash income receivable and expenses payable are also recorded. This system gives a complete picture of the financial transactions of the business as it makes a record of all transactions relating to a period. The system being based on a complete record of the financial transactions discloses correct profit or loss for a particular period and also exhibits true financial position of the business on a particular day.