**THE CONCEPTUAL FRAMEWORK OF ACCOUNTING**

The figure below summarizes what is generally agreed as the conceptual framework of financial reporting/ accounting. Accounting revolves around the terminology included. We look at each term below.

**Accounting principles and assumptions:** Refer to topic one for a thorough review of the principles and assumptions.

**Objectives of financial reporting:** To provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. Again refer to topic one and the assignments for an overview of this.

**Qualitative characteristics of information:** The fundamental qualitative characteristics of financial information are **relevance** and **reliability**. Reliability is a by-product of **‘faithful representation’** of facts about the entity. Relevance and reliability are limited by materiality and cost. Relevant and reliable information enhances timeliness, comparability, understandability, and verifiability. Refer to topic one for more details.

**Key terms used in financial reporting/ accounting:**

There are key terms used in financial reporting, that are essential for the understanding of the field. The key terms are:

* Asset.
* Liability (Including capital, though capital may be classified separately).
* Income/ revenue.
* Expense

We discuss each of the terms below.

**ASSET**

**Assets** are economic resources with probable future benefits owned or controlled by an entity as a result of past transactions. In other words, they are the acquired resources the entity can use to operate in the future. To be reported, assets must have a measurable, verifiable value, usually based on the purchase price. However, subsequent to acquisition, so as not to mislead users by reporting a value for the assets that is too high, managers use judgment (and past experience) to determine an acquired asset’s most likely future benefit. For example, a company may have a list of customers who owe Ksh. 1,000,000 in total. History suggests, however, that only Ksh. 980,000 is likely to be collected. The lower, more probable, and more conservative figure is reported to users for purposes of projecting future cash flows. In future chapters, we discuss the estimation process to determine the amount to report. Assets are measured initially under the **historical cost principle** (or cost principle). That is, on the acquisition date, cash paid plus the value of all noncash considerations (any assets, privileges, or rights) given in the exchange become the historical cost of a new asset (i.e., its fair market value on the exchange date). For example, what would be the measured historical cost of a new delivery van when trading in an old delivery van with a market value of Ksh. 200,000 and paying Ksh.1, 500,000 cash? The new van’s cost would be Ksh. 1,700,000 (the sum of what was exchanged). Thus, in most cases, cost is relatively easy to determine and can be verified due to the arm’s length exchange.

Most companies list assets in order of liquidity, or how soon an asset is expected by management to be turned into cash or used. Notice that several of Papa John’s assets are categorized as current assets. Current assets are those resources will be used or turned into cash within one year (the next 12 months). Note that inventory is always considered a current asset, regardless of how long it takes to produce and sell the inventory. Current assets include Cash, Accounts Receivable, Supplies, Prepaid Expenses, and Other Current Assets (a summary of several current assets with individually smaller balances). These are typical titles utilized by most entities.

All other assets are considered long term (or noncurrent). That is, they are to be used or turned into cash beyond the coming year. They include Long-Term Investments, Property and Equipment (net of amounts used in the past), Notes Receivable, Intangibles (such as trademarks and patents), and Other Assets.

NOTE: The normal account balance for assets, both current and non-current is **debit** i.e. the debit side is usually greater than the credit side.

**Unrecorded but valuable assets**: Many very valuable intangible assets, such as trademarks, patents, and copyrights that are developed inside a company (not purchased) are not reported on the balance sheet. For example, General Electric’s balance sheet reveals no listing for the GE trademark because it was developed internally over time through research, development, and advertising (it was not purchased). Likewise, the Coca-Cola Company does not report any asset for its patented Coke formulae, although it does report more than $2 billion in various trademarks that it has purchased.

**LIABILITIES**

**Liabilities** are probable debts or obligations (claims to a company’s resources) that result from a company’s past transactions and will be paid with assets or services. Entities that a company owes money to are called **creditors.** Liabilities include: Accounts Payable (creditors), Accrued Expenses Payable, Unearned Franchise Fees, Long-Term Notes Payable, bank overdrafts, loans, and Other Long-Term Liabilities.

Just as assets are reported in order of liquidity, liabilities are usually listed on the balance sheet **in order of maturity** (how soon an obligation is to be paid). Liabilities that will need to be paid or settled within the coming year (with cash, services, or other current assets) are classified as **current liabilities.** Distinguishing current assets and current liabilities assists external users of the financial statements in assessing the amounts and timing of future cash flows.

**Capital**

Capital is a special type of liability. It is the finance that is provided by the owners. In a sole proprietorship, we commonly use the term capital, but in companies the term stockholders’ equity is commonly used in place of capital. Note that the two terms are synonymous.

**Stockholders’ equity** (also called **owners’ equity** or **shareholders’ equity)** is the financing provided by the owners and by business operations. Owner-provided cash (and sometimes other assets) is referred to as **contributed capital.** Owners invest in the business and receive shares of stock as evidence of ownership. Mutual funds, pension funds, corporate employees, directors, and the general public may purchase and hold stock. Owners who invest (or buy stock) in a company hope to benefit from their investment in two ways: receipts of **dividends,** which are a distribution of a company’s earnings (a return on the shareholders’ investment), and gains from selling the stock for more than they paid (known as **capital** **gains)**. Earnings that are not distributed to the owners but instead are reinvested in the business by management are called **retained earnings.** Companies with a growth strategy often pay little or no dividends to retain funds for expansion. Thus stockholders equity comprises of contributed capital and retained earnings.

NB: the normal account balance for liabilities (including capital) is credit. That is, the credit side is usually larger than the debit side.

**REVENUE/ INCOME**

**Revenues** are defined as increases in assets or settlements of liabilities from **ongoing operations** of the business. Operating revenues result from the sale of goods or services.

When revenue is earned, assets, usually Cash or Accounts Receivable, often increase. Sometimes if a customer pays for goods or services in advance, a liability account, usually Unearned (or Deferred) Revenue, is created. At this point, no revenue has been earned. There is simply a receipt of cash in exchange for a promise to provide a good or service in the future. When the company provides the promised goods or services to the customer, the revenue is recognized and the liability settled.

Note that revenue can either be operating revenue or other revenue. When a company that deals in motor vehicles sells a car that is operating revenue. When the same company receives dividends from shares of stock in a company, then that is not operating revenue, but rather other revenue.

**Operating Expenses**

Some confuse the terms **expenditures** and **expenses.** Expenditure is any outflow of cash for any purpose, whether to buy equipment, pay off a bank loan, or pay employees their wages. **Expenses** are decreases in assets or increases in liabilities from **ongoing operations** incurred to generate revenues during the period. Therefore, while **not all cash expenditures** **are expenses, expenses are necessary to generate revenues.**

The following are some primary operating expenses:

**Cost of Sales**

In companies with a manufacturing or merchandising focus, Cost of Goods Sold (or Cost of Sales) representing the cost of inventory used in generating sales is usually the most significant expense.

**Salaries Expense**

When employees work, the company incurs an expense, although salaries will be paid later. In purely service-oriented companies in which no products are produced or sold, the cost of using employees to generate revenues is usually the largest expense.

**All other operating expenses**

The remaining large expenses include Rent Expense, Advertising Expense, General and Administrative Expenses (for insurance, executive salaries, and rental of headquarters facilities), and Depreciation Expense, reflecting the use of a part of long-lived assets such as buildings and equipment.

Subtracting operating expenses from operating revenues gives **Operating Income** (also called Income from Operations)—a measure of the profit from central ongoing operations.

**Other Items**

As mentioned earlier, not all activities affecting an income statement are, however, central to ongoing operations. Any revenues, expenses, gains, or losses that result from these other activities are not included as part of operating income, but are instead categorized as Other Items. Typically, these include:

**Investment Income** (or **Investment, Interest,** or **Dividend Revenue)**

Using excess cash to purchase stocks or bonds in other companies is an investing activity Therefore, any interest or dividends earned on the investment are not included as operating revenue.

**Interest Expense**

Likewise, since borrowing money is a financing activity, any cost of using that money (called interest) is not an operating expense. Except for financial institutions, incurring interest expense or earning investment income are **not** the central operations of most businesses. We say these are peripheral (normal but not central) transactions.

**Gains (or Losses) on Sales of Assets**

Companies sell property, plant, and equipment from time to time to maintain modern facilities. Selling land for more than the original purchase price does not result in earning revenue because the transaction is not the central operating focus for the business. **Gains** (with an account called Gain on Sale of Assets) result in an increase in assets or decrease in liabilities from a **peripheral** transaction. **Losses** are decreases in assets or increases in liabilities from **peripheral** transactions