**NATURE, PURPOSE AND SCOPE OF ACCOUNTING**

**DEFINITIONS**

**Accounting** is the process of measuring and recording the financial value of the assets and liabilities of a business and monitoring these values as they change with the passage of time.  When we refer to a **business** we could be referring to an individual, a company or any other entity for which accounting records are to be kept (for example a church, club or other non-profit organisation). It is also defined as the process of identifying, measuring, classifying and accumulating, summarizing and communicating information about economic entities that is primarily quantitative and is useful to decision makers.

The **assets** of a business are those things that belong to the business that have a positive financial value i.e. items that could be sold by the business in exchange for money.  Examples of assets include land, buildings, vehicles, stock, equipment, rare gold coins, bank accounts with positive balances and money owed to the business by its debtors. **Current assets** are those assets from which an entity is expected to derive benefits for a period of one accounting period or less, like cash, accounts receivable e.t.c.. **Non-current assets** are assets owned or controlled by the firm whose benefits accrue to the entity for more than one accounting period.

The **liabilities** of a business are those things that belong to the business but unlike assets have a negative financial value i.e. items that will require the payment of money by the business at some point in the future.  Examples of liabilities include unpaid bills, unpaid taxes, unpaid wages, rusty motor vehicles, stock that has passed its use-by date, overdrawn bank accounts and money owed by the business to its creditors. **Current liabilities** are liabilities due to be paid/ settled in one accounting period or less. **Non-current liabilities** are long term in nature, i.e. not due in one one year/ operating cycle. Note that **capital or equity** is a liability, being claim on the entity by the owners.

The **equity** of a business is defined as the value of the assets minus the value of the liabilities.  In other words the equity is the financial value that would be left if all the assets were sold and the money from the sale was used to pay off all the liabilities.  Another way of expressing this is to say that the equity is the amount of money that would be released if the business was to be wound up.

The assets, liabilities and equity of a business are all financial measurements that relate to a particular point in time.  The financial statement that is used to present this information is known as **the statement of financial position** formerly known as the **balance sheet**.  This is a statement of the assets, liabilities and equity of a business as they exist at a particular point in time.

The relationship between the assets, the liabilities and the equity can be represented algebraically by what is commonly known as the **accounting equation**.  If we use the letter A to represent the assets, the letter L to represent the liabilities and the letter C to represent the equity (Capital) then the accounting equation is

C = A - L

This equation states that the equity is the value of the assets minus the value of the liabilities.  This equation is more commonly written as

A = L + C

This equation states that the value of the assets is equal to the value of the liabilities plus the equity.  This is just another way of saying the same thing.  Because the equity is defined as the value of the assets minus the value of the liabilities then this equation is always true by definition.

A balance sheet is commonly divided into two sections.  One section shows the value of the assets and the other section shows the value of the liabilities and the equity.  Each section will be broken down into more or less detail depending on the intended use of the balance sheet.  Because the accounting equation is always true the totals of each of the two sections of the balance sheet should always be the same i.e. the balance sheet should always be in balance.

The financial measurements we have looked at so far are used to describe the financial position of a business at a particular point in time.  For this reason the balance sheet is also known as the **statement of financial position**.  It presents a summary of the business' financial position at a particular point in time.  However in order to gain a complete financial picture of a business we need to recognise that the financial position of the business is undergoing constant change.

As a business engages in various commercial activities such as buying, selling, manufacturing, maintaining equipment, paying rent and other expenses, borrowing, lending or investing then the value of the assets, liabilities and equity will change and these changes will have an effect on the balance sheet.  The only thing we can be sure about at any point in time is that the accounting equation A = L + P will always apply.  In other words even though the balance sheet is always changing from day to day we can be certain that it will always balance or should do so if it has been prepared correctly.

Recognising that the financial position of a business is constantly changing leads us to the definition of two additional financial measurements that relate to a period of time (unlike assets, liabilities and equity that relate to a particular point in time.)

The **income** of a business is the sum of those things that increase the value of the assets without any corresponding increase in the liabilities or any new investment by the owners of the business.  Examples include revenue from the sale of goods, equipment or services supplied, rent or interest received and capital gains.

The **expenses** of a business are those things that reduce the value of the assets without any corresponding reduction in the liabilities or any capital drawings by the owners.  Examples include the cost of stock and raw materials, rent or interest paid, electricity bills, telephone, wages, taxes, dividends, depreciation and donations to charity.

The income and expenses of a business are financial measurements that relate to a specified period of time rather than a specific point in time.  The financial statement that is used to present this information is known as the **income statement.** The recommended term is **statement of comprehensive income**.  The income statement is a statement of the income and expenses of a business as they occur during a specific period.

If we use the letter I to represent the income over a specified period of time and the letter E to represent the expenses over that same period we can represent the relationship between the assets, the liabilities, the equity, the income and the expenses by using a modified form of the accounting equation as follows

A = L + C + (I - E)

This equation states that the value of the assets is equal to the value of the liabilities plus the equity plus the excess of income over expenses.  Another way of writing this equation is

A + E = L + C + I

This equation states that the value of the assets plus the expenses is equal to the value of the liabilities plus the equity plus the income.  This is just another way of saying the same thing.  However it is helpful to express it in this way when we come to consider the practice of bookkeeping below.

The income statement is commonly divided into two sections in a similar fashion to the balance sheet.  One section shows the total income and the other section shows the total expenses.  Like the balance sheet each section will be broken down into more or less detail depending on its intended use.  However unlike the balance sheet the totals of each of the two sections are unlikely to be the same.  The difference will usually be shown as a separate item at the bottom of the income statement and if the total income exceeds the total expenses it will be given a title such as **retained earnings**, **net profit** or **excess of income over expenditure**.  If the total expenses exceed the total income it will instead be called something like **retained loss**, **net loss** or **excess of expenditure over income**.

Income and expenses are financial measurements that relate to the performance of a business during a specified period of time.  For this reason the income statement is also known as the **statement of Comprehensive Income**.  It describes the performance of a business during a specified period.  It is sometimes also referred to as the **profit and loss statement or income statement**.

In order to produce a balance sheet or an income statement it is necessary to have a systematic method of recording all the activities or events that have an effect on the financial measurements (A, L, P, I and E) described above.  Traditionally these events were entered by hand into a set of **books** or **accounts**.  More recently it has become common practice to enter these into a computer accounting system.  Each entry is referred to as an **entry** and the practice of maintaining these entries in the accounts is referred to as **bookkeeping**.  The act of placing a particular entry into an account is known as **posting**.  The total of all the entries in an account is known as the **balance** of that account.  The accounts themselves are referred to collectively as **the general ledger** or sometimes just **the ledger**.

Because each business will have different assets, liabilities, income, expenses and equity categories the accounts it uses to record its activities will vary from one business to another.  This set of accounts that a business creates in the general ledger is known as the **chart of accounts**.

Each account in the ledger will be categorised into one of the five types of financial measurements described above (A, L, P, I or E.)  Because the accounting equation

A + E = L + P + I

is always true the total of all the A and E account balances in the ledger must be equal to the total of all the L, P and I account balances if the ledger is to represent a logically correct picture of the finances of the business.  If this is the case then we say that the accounts are **in balance** or that the ledger is in balance.  For the ledger to remain in balance whenever an entry is posted to an account matching account entries must be posted at the same time to ensure that the total of the A and E account balances remain the same as the total of the L, P and I account balances.  For this reason bookkeeping is often referred to as **double-entry bookkeeping**.

Most postings consist of two entries but there is no reason why there cannot be three or more entries posted at the same time provided that the ledger remains in balance.

Traditionally a report was prepared showing the total of the A and E account balances and the total of the L, P and I account balances to ensure that these totals were the same.  This report was known as a **trial balance**.  Because most computer accounting systems will not allow entries to be posted unless the accounts remain in balance this has in many ways obviated the need for a trial balance.

An entry that increases the balance of an A or E account or reduces the balance of an L, P or I account is known as a **debit**.  An entry that reduces the balance of an A or E account or increases the balance of an L, P or I account is referred to as a **credit**.  Traditionally hand-written books were divided into two columns.  Debits were entered into the left-hand column and credits into the right.  In fact the traditional definition of a debit is an entry on the left-hand side of an account.  Conversely a credit was defined as an entry on the right-hand side of an account.  In order for the ledger to remain in balance the total debits must equal the total credits.

It is interesting to note that neither of these definitions of debit and credit are intuitive or immediately obvious.  Neither can they be deduced easily from their commonly understood meanings.  This partly explains why students who are learning accounting for the first time have difficulty understanding the meaning of debits and credits.  The traditional definitions come from the commonly established practice of manual double-entry bookkeeping that puts debits on the left and credits on the right.

It is worthwhile repeating the more precise definitions of debit and credit given above as they are derived from the accounting equation since familiarity with them is essential for a proper application of accounting practice to the process of setting up and maintaining a general ledger.

A **debit** is an entry in a general ledger account that increases its balance if it is an A or E account and reduces its balance if it is an L, P or I account.

A **credit** is an entry in a general ledger account that reduces its balance if it is an A or E account and increases its balance if it is an L, P or I account.

## ASSUMPTIONS AND THE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAPS)

The current set of principles that accountants use rests upon some underlying assumptions and principles. The basic assumptions and principles presented on the next several pages are considered GAAPs and apply to most financial statements.

1. **THE ASSUMPTIONS**

**The Economic entity assumption**.

Financial records must be separately maintained for each economic entity. Economic entities include businesses, governments, school districts, churches, and other social organizations. Although accounting information from many different entities may be combined for financial reporting purposes, every economic event must be associated with and recorded by a specific entity. In addition, business records must not include the personal assets or liabilities of the owners.

**The Monetary unit assumption**.

An economic entity's accounting records include only quantifiable transactions. Certain economic events that affect a company, such as hiring a new chief executive officer or introducing a new product, cannot be easily quantified in monetary units and, therefore, do not appear in the company's accounting records. Furthermore, accounting records must be recorded using a stable currency. Businesses in the Kenya usually use Kenya Shillings for this purpose.

**The Time period assumption**.

Most businesses exist for long periods of time, so artificial time periods must be used to report the results of business activity. Depending on the type of report, the time period may be a day, a month, a year, or another arbitrary period. Using artificial time periods leads to questions about when certain transactions should be recorded. For example, how should an accountant report the cost of equipment expected to last five years? Reporting the entire expense during the year of purchase might make the company seem unprofitable that year and unreasonably profitable in subsequent years. Once the time period has been established, accountants use GAAP to record and report that accounting period's transactions.

**The Going concern assumption**.

Unless otherwise noted, financial statements are prepared under the assumption that the company will remain in business indefinitely. Therefore, assets do not need to be sold, and debt does not need to be paid off before maturity. This principle allows for the classification of assets and liabilities as short-term (current) and long-term. **Long-term assets** are expected to be held for more than one year. **Long-term liabilities** are not due for more than one year.

1. **THE PRINCIPLES**

**The Full disclosure principle**.

Financial statements normally provide information about a company's past performance. However, pending lawsuits, incomplete transactions, or other conditions may have imminent and significant effects on the company's financial status. The full disclosure principle requires that financial statements include disclosure of such information. Footnotes supplement financial statements to convey this information and to describe the policies the company uses to record and report business transactions.

**Accrual basis accounting**.

In most cases, GAAP requires the use of accrual basis accounting rather than cash basis accounting. **Accrual basis accounting,** which adheres to the revenue recognition, matching, and cost principles discussed below, captures the financial aspects of each economic event in the accounting period in which it occurs, regardless of when the cash changes hands. Under cash basis accounting, revenues are recognized only when the company receives cash or its equivalent, and expenses are recognized only when the company pays with cash or its equivalent.

**The Revenue recognition principle**.

Revenue is earned and recognized upon product delivery or service completion, without regard to the timing of cash flow. Suppose a store orders five hundred compact discs from a wholesaler in March, receives them in April, and pays for them in May. The wholesaler recognizes the sales revenue in April when delivery occurs, not in March when the deal is struck or in May when the cash is received. Similarly, if a lawyer receives a KSh.100 retainer from a client, the lawyer doesn't recognize the money as revenue until he or she actually performs KSh.100 in services for the client.

**The Matching principle**.

The costs of doing business are recorded in the same period as the revenue they help to generate. Examples of such costs include the cost of goods sold, salaries and commissions earned, insurance premiums, supplies used, and estimates for potential warranty work on the merchandise sold. Consider the wholesaler who delivered five hundred CDs to a store in April. These CDs change from an asset (inventory) to an expense (cost of goods sold) when the revenue is recognized so that the profit from the sale can be determined.

**The Cost principle**.

Assets are recorded at cost, which equals the value exchanged at the time of their acquisition. even if assets such as land or buildings appreciate in value over time, they are not revalued for financial reporting purposes. Note, however that there is an emergence of what is called **fair value accounting** that allows for valuation of assets and liabilities at market rates.

**The Principle of conservatism**.

Accountants must use their judgment to record transactions that require estimation. The number of years that equipment will remain productive and the portion of accounts receivable that will never be paid are examples of items that require estimation. In reporting financial data, accountants follow the **principle of conservatism,** which requires that the less optimistic estimate be chosen when two estimates are judged to be equally likely. For example, suppose a manufacturing company's Warranty Repair Department has documented a three-percent return rate for product X during the past two years, but the company's Engineering Department insists this return rate is just a statistical anomaly and less than one percent of product X will require service during the coming year. Unless the Engineering Department provides compelling evidence to support its estimate, the company's accountant must follow the principle of conservatism and plan for a three-percent return rate. Losses and costs—such as warranty repairs—are recorded when they are probable and reasonably estimated. Gains are recorded when realized.

**The Materiality principle**.

Accountants follow the **materiality principle**, which states that the requirements of any accounting principle may be ignored when there is no effect on the users of financial information. Certainly, tracking individual paper clips or pieces of paper is immaterial and excessively burdensome to any company's accounting department. Although there is no definitive measure of materiality, the accountant's judgment on such matters must be sound. Several thousand Kenya Shillings may not be material to an entity such as Safaricom or EABL, but that same figure is quite material to a small, family-owned business.

**USEFUL ACCOUNTING INFORMATION**

**Accounting information has many users. For example, an investor will use financial accounting information to decide whether or not to buy shares in the corporation. Managers use management accounting information to make decisions such as whether to launch a new product, hire or fire employess, mechanize operations or not, e.t.c. useful information has certain desirable characteristics outlined below. Note that there may be a tradeoff between the characteristics. Striving to have very relevant accounting information may lead to reduced reliability and consistency. Please do more research on these tradeoffs.**

**Relevance, reliability, and consistency**.

To be useful, financial information must be relevant, reliable, and prepared in a consistent manner. **Relevant information helps** a decision maker understand a company's past performance, present condition, and future outlook so that informed decisions can be made in a timely manner. Of course, the information needs of individual users may differ, requiring that the information be presented in different formats. Internal users often need more detailed information than external users, who may need to know only the company's value or its ability to repay loans. **Reliable information** is verifiable and objective. **Consistent information** is prepared using the same methods each accounting period, which allows meaningful comparisons to be made between different accounting periods and between the financial statements of different companies that use the same methods. In addition information needs to be **understandable** and **comparable**.

ASSIGNMENT

1. Explain SIX differences between financial accounting and managerial accounting.
2. List a minimum of eight users of accounting information and explain the decisions they may make using the information.
3. Discuss the different types of ledgers that are maintained by a business (Hint: Start with general ledger).

**THE NATURE OF ACCOUNTING INFORMATION**

Accounting information is used to make important financial decision by a wide variety of stakeholders. The following are the distinguishing factors between accounting information and other types of information. Accounting information is:

* Designed to be used to make financial decisions.
* Primarily quantitative/ financial in nature.
* In relation to a specific entity.

**The conceptual framework of financial accounting and reporting**

**INFORMATION AND ACCOUNTING PROCESS**

**The accounting cycle**

This refers to the steps in preparing financial statements. It is a cycle because the steps are repeated each accounting period. The cycle is illustrated below.

1. **Identification**

Those attributes of the greatest interest to the users of accounting information have to be identified and measured. Accounting aims at providing information for decision makers and thus only relevant information should be disclosed.

1. **Measurement**

The relevant aspects of an organization identified must be measured.

1. **Classification and accumulation**

The resulting information must be classified and accumulated to provide relevant reports to decision makers. Accumulation may be into categories such as Sales, cost of sales, rent, salaries, and interest on loans e.t.c.

1. **Summarization**

This allows decision makers to concentrate on factors and relationships that are important for their decision making. Thus financial information is summarized into financial reports such as the income statement, statement of financial position, e.t.c.

1. **Communication**

The accounting information is finally communicated to the users in the form of a financial report.

The exhibit below shows the cycle in full. Note that some of the steps in the diagram have not been highlighted above:

**THE BASIC FINANCIAL STATEMENTS**

1. **The statement of financial position**

The statement of financial position, formerly called the balance sheet, lists all of entities assets and the claims against those assets. The claims against those assets are capital and liabilities. The statement takes the form

Assets= Capital + Liabilities.

1. **Statement of comprehensive Incomes**

Formerly the income statement shows the profit/ loss made by a firm in a given period.

1. **The statement of cash flows**

Lists the types and the amounts of cash received (inflows) and paid out (outflows)

1. **Statement of changes in owners’ equity**

This shows the specific elements of the owner’s interest in the firm (capital) and how it has changed over a given period.

**MAKING ACCOUNTING ENTRIES**

Before we look at making of accounting entries it is important that you appreciate that the following documents are required/ prepared in the order provided.

* **SOURCE DOCUMENTS:** source documents or business papers identify and describe transactions and events entering the accounting process. They could be in hard copy or in electronic form. Examples are sales tickets, checks, and purchase orders, bills from suppliers, invoices, and e.t.c. This is the reason why organizations prepare documents in duplicate e.g. a sales invoice for a customer and another copy for the organization as a source document.
* **THE JOURNAL**

Transactions are first recorded in a journal before they are recorded in the accounts. As such the journal is referred to as the **book of original entry.** The journal gives a complete record of all transactions in one place, linking directly the debits and credits for each transaction**.** The process of recording transactions in a journal is called journalizing.

* **The general journal**

The general journal shows the debit and credit for transactions. It can be used to record any transaction and is thus **general.** It has columns for date of transaction, titles of affected accounts, and amounts. An explanation for each entry is given at the bottom of each entry.

* **Computerized journals**

These look and serve the same purpose as manual journals but are computerized.

* **The Double entry accounting**

To be able to post entries in a journal, it is important to internalize the double entry book keeping methods.

|  |  |  |
| --- | --- | --- |
|  | INCREASE | DECRAESE |
| ASSET | Dr | Cr |
| LIABILITY | Cr | Dr |
| INCOME | Cr | Dr |
| EXPENSE | Dr | Cr |

**DISCUSSION QUESTIONS**

1. You open a small business, ABC training centre. The following transactions take place during the period.

* You transfer the following assets to the business: Cash Ksh. 80,000; Furniture Ksh. 24000; Microcomputer Ksh. 52000.
* You paid one month rent for a storefront: Ksh. 2800
* Purchased computer software on credit Ksh. 7500.
* Made advertisement in the newspaper Ksh. 1000.
* Received applications and fees from 5 students for a course going for Ksh. 20,000 per student.
* Paid wages for an employee Ksh. 1500.
* Paid electricity bill Ksh. 1100.
* Paid part of the software expense Ksh. 2500.
* Purchased a second computer Ksh. 47000.
* Transferred cash to personal account Ksh. 3000.

Required:

* Journalize the transactions.
* Post the journal entries into relevant ledger accounts.
* Extract a trial balance for the business.
* Draw a statement of comprehensive income as at the end of the period.
* Draw a statement of financial position as at the end of the period.