Introduction to Accounting

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Definition

Accounting is an information system that measures, processes, and communicates financial information about an economic entity. An economic entity is a unit that exists independently, such as a business, a hospital, or a governmental body.

Accountants focus on the needs of decision-makers who use financial information, whether those decision-makers are inside or outside a business or other economic entity. Accountants provide a vital service by supplying the information decision-makers need to make "reasoned choices among alternative uses of scarce resources in business and economic activities."

1. Accounting measures business activities by recording data about them for future use.
2. The data are stored until needed and then processed to become useful information.
3. The information is communicated through reports to decision-makers.

In other words, data about business activities are the input to the accounting system and helpful information for decision-makers in the output.

Fields/ Branches of Accounting

Accounting is generally sub-divided into the following fields:

1. Financial accounting.
2. Management accounting.
3. Tax accounting.
4. Social accounting.

Financial accounting versus Management accounting

Management accounting provides internal decision-makers who pursue profitability and liquidity goals with information about operating, investing, and financing activities. Managers and employees who conduct the business activities need information that tells them how they have done in the past and what they can expect in the future. Management accountants' information includes the cost of producing new products, break-even analysis, make or buy decisions, and performance reports of the various departments in an organization.

Financial accounting generates reports and communicates them to external decision-makers so they can evaluate how well the business has achieved its goals. These reports are called financial statements, e.g. The statement of comprehensive incomes (Profit and Loss Accounts), The Statement of Financial Position (Balance Sheet), The Statement of Cash flows, and the statement of changes in equity.

As part of assignment 1, research and develop a discussion of the other branches of accounting.

Ethical Financial Reporting

Ethics is a code of conduct that applies to everyday life. It addresses the question of whether actions are right or wrong. Whether ethical or unethical, right or wrong, actions are the product of individual decisions. Thus, when an organization acts unethically by using false advertising, cheating customers, polluting the environment, or mistreating employees, it is not the organization responsible—it is the members of Management and other employees who have made a conscious decision to act in this manner. Ethics is especially important in preparing financial reports because users of these reports must depend on the good faith of the people involved in their preparation. Users have no other assurance that the reports are accurate and fully disclose all relevant facts.

The intentional preparation of misleading financial statements is called fraudulent financial reporting.6 It can result from the distortion of records (e.g., the manipulation of inventory records), falsified transactions (e.g., fictitious sales), or the misapplication of various accounting principles. There are several motives for fraudulent reporting—for instance, to cover up a financial weakness to obtain a higher price when selling a company; to meet the expectations of investors, owners, and financial analysts; or obtain a loan. The incentive can also be personal gains, such as additional compensation, promotion, or avoidance of penalties for poor performance. List other organizations caught up in Fraudulent financial reporting in Kenya.

Historical Development of Accounting: An Overview

Accounting is an ancient discipline. Forms of it have been essential to commerce for more than 5,000 years. In a version close to what we know today, accounting gained widespread use in the 1400s, especially in Italy, where it was instrumental in the development of shipping, trade, construction, and other forms of commerce. The famous Italian mathematician, scholar, and philosopher Fra Luca Pacioli documented this double-entry bookkeeping system. In 1494, Pacioli published his most important work, Summa de Arithmetica, Geometrica, Proportions et Proportionalita, which contained a detailed description of accounting as practised in that age. This book became the most widely read book on mathematics in Italy and firmly established Pacioli as the "Father of Accounting."

As part of assignment 2, identify the various users of accounting information (categorizing them as either internal or external users).

Objectives of Accounting

A business is an economic unit that aims to sell goods and services to customers at prices that provide an adequate return to its owners. Businesses have similar goals and engage in similar activities; the two primary goals of all businesses are profitability and liquidity.

Profitability is the ability to earn enough income to attract and hold investment capital. Liquidity is the ability to have enough cash to pay debts due.

For example, TOYOTA may meet the goal of profitability by selling many cars at a price that earns a profit. However, suppose its customers do not pay for their cars quickly enough to enable Toyota to pay its suppliers and employees. In that case, the company may fail to meet the goal of liquidity. If a company is to survive and be successful, it must meet both goals. All businesses pursue their goals by operating, investing, and financing activities.

Operating activities include selling goods and services to customers, employing managers and workers, buying and producing goods and services, and paying taxes. Investing activities involve spending the capital a company receives in productive ways to help it achieve its objectives. These activities include buying land, buildings, equipment, and other needed resources to operate the business and selling them when they are no longer needed.

Financing activities involve obtaining adequate funds or capital to start operations and continue operating. These activities include obtaining capital from creditors, such as banks, suppliers, and owners. They also include repaying creditors and paying a return to the owners. An essential function of accounting is to provide performance measures, which indicate whether managers are achieving their business goals and whether the business activities are well managed. Financial analysis is the evaluation and interpretation of financial statements and related performance measures. For financial analysis to be helpful, performance measures must be well aligned with the two primary goals of business—profitability and liquidity.

Although it is vital to know the amounts of earnings and cash flows in any given period and whether they are rising or falling, ratios of accounting measures are also useful tools of financial analysis.

Accounting Assumptions and the Generally Accepted Accounting Principles (GAAPs)

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

Assumptions

The Economic entity assumption.

The management must maintain financial records for each economic entity. Economic entities include businesses, governments, school districts, churches, and other social organizations. Although accountants combine information from many different entities 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, a stable currency should be the basis of accounting records. Businesses in Kenya usually use Kenya Shillings for this purpose.

The Time-Period assumption.

Most businesses exist for long periods, so accountants use artificial periods to report business results. Depending on the type of report, the period maybe a day, a month, a year, or another arbitrary period. Using artificial periods leads to questions about when we should record certain transactions. 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. In subsequent years the company may appear unreasonably profitable. Once the management establishes the reporting period, accountants use GAAP to record and report that accounting period's transactions.

The Going concern assumption.

Managers assume that the company will remain in business indefinitely when preparing financial statements unless otherwise noted. Therefore, there is no need to sell assets or settle debt before maturity. This principle allows for classifying assets and liabilities as short-term (current) and long-term. Long-term assets benefit the firm for at least one year. Long-term liabilities are not due for more than one year.

The Principles

The Full disclosure principle.

Financial statements typically 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 describe the company's policies to record and report business transactions.

Accrual basis accounting.

In most cases, GAAP requires 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. Cash basis accounting recognizes revenues only when the company receives cash or its equivalent, and expenses are recognized when paid with cash.

The Revenue recognition principle.

Revenue is earned and recognized upon product delivery or service completion, without regard to cash flow timing. 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 money changes hands. Similarly, if a lawyer receives a KSh.100 retainer from a client, the lawyer does not recognize the money as revenue until he or she performs KSh.100 in services for the client.

The Matching principle.

This principle asserts the need to capture business costs 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 to determine the profit from the sale.

The Cost principle (Historical Cost Principle).

This principle states that the management should record assets at cost, which equals the value exchanged at their acquisition. The principle does not allow for the revaluation of assets even where they appreciate over time. Note, however, that there is an emergence of fair value accounting that allows for the 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-per cent return rate for product X during the past two years. However, the company's Engineering Department insists this return rate is just a statistical anomaly, and less than one per cent 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-per cent return rate. Losses and costs—such as warranty repairs—are recorded when probable and reasonably estimated. Gains are recorded when realized.

The Materiality principle (SIGNIFICANT).

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. Indeed, 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 General Motors, but that exact 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 decide whether to launch a new product, hire or fire employees, mechanize operations or not; helpful information has specific desirable characteristics outlined below. Note that there may be a trade-off between the characteristics. Striving to have very relevant accounting information may lead to reduced reliability and consistency. Please do more research on these trade-offs.

Relevance, reliability, comparability and consistency.

Financial information must be relevant, reliable, and prepared consistently to be helpful. Relevant information helps a decision-maker understand a company's past performance, present condition, and future outlook to make informed decisions on time. 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 for each accounting period, which allows meaningful comparisons (comparability) to be made between different accounting periods and between the financial statements of different companies that use the same methods. The financial statements must be prepared in such a manner as to ensure that comparisons can be made with earlier periods. This requires accounting policies to be consistently applied and an outline of what policies have been used and any changes that are made to such policies. Understandability is also an essential quality of accounting information.

Review Questions

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. Using diagrammatic expression, discuss the conceptual framework of accounting. Discuss in detail the accounting cycle.

FRAUDULENT FINANCIAL REPORTING: COOKING BOOKS. THE FIGURES ARE NOT TRUTHFUL. ALSO CALLED MANAGEMENT FRAUD. PRESENTING MISLEADING FINANCIAL REPORTS.

The Conceptual Framework of Accounting

The figure below shows the conceptual framework of financial reporting/ accounting. Accounting revolves around the terminology included. We look at each term below.

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Accounting principles and assumptions: Refer to topic one for a thorough review of the principles and assumptions. Financial reporting objectives are 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 a 'faithful representation' of facts about the entity. Materiality and cost limit relevance, and reliability are limited. Relevant and reliable information enhances timeliness, comparability, understandability, and verifiability. Refer to topic one for more details.

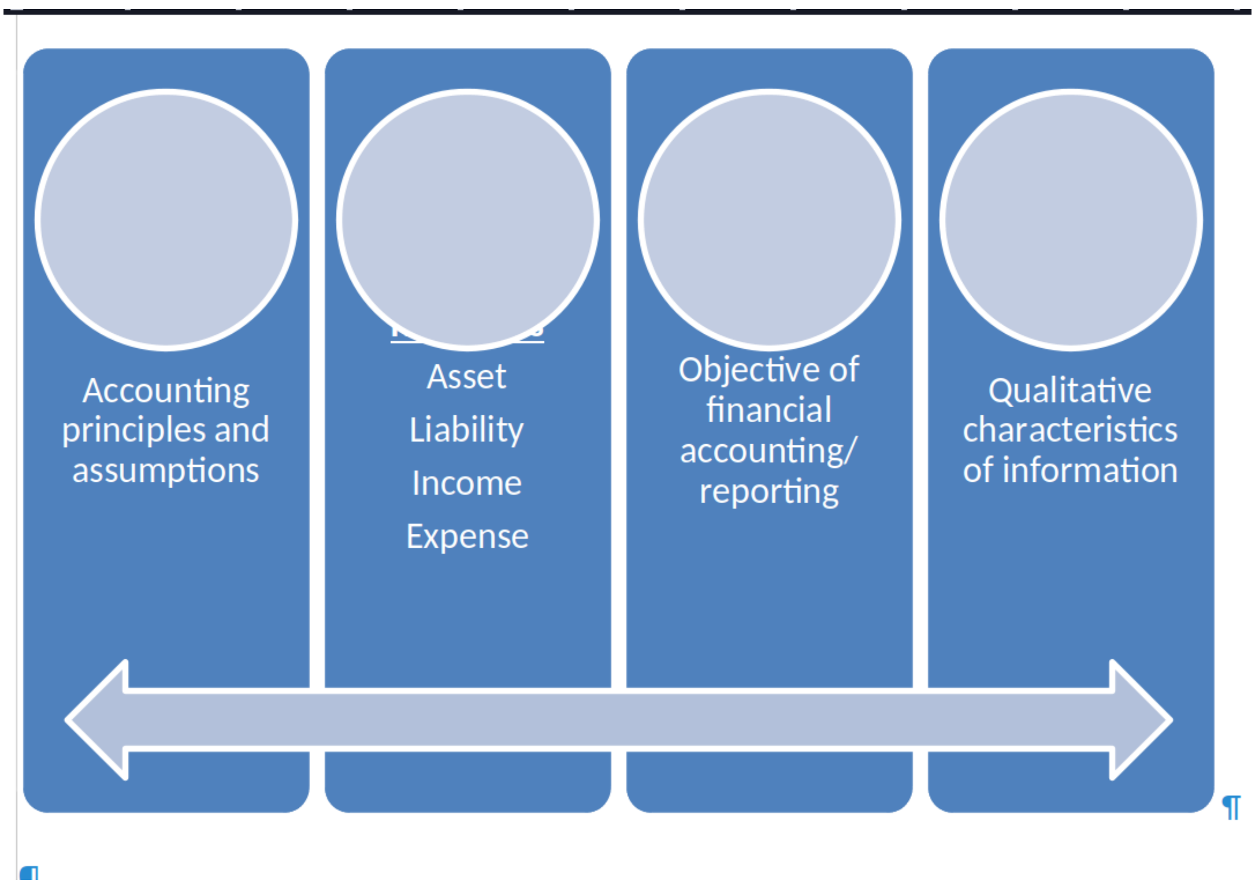

Figure 1: Conceptual Framework of Accounting

Key terms used in financial reporting/ accounting: There are key terms used in financial reporting that are essential for understanding the field. The key terms are:

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

We discuss each of the terms below.

Assets

Assets are economic resources with potential future benefits owned or controlled by an entity due to 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, after the acquisition, managers use judgment (and experience) to determine an acquired asset's most likely future benefit not to mislead users by reporting a value for the assets that are too high.

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. Accountants will report the lower, more probable, and more conservative figure to users to project 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). On the acquisition date, cash paid plus the value of all noncash considerations (any assets, privileges, or rights) given in the exchange becomes 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 exchanged). Thus, the cost is relatively easy to determine in most cases easy to verify 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 categorised as current assets. Current assets are those resources that will be used or turned into cash within one year (the next 12 months). Note that inventory is 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 utilised by most entities.

All other assets are considered long term (or non-current). 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 usual account balance for assets, both current and non-current, is debit; that is, the debit side is usually greater than the credit side.

Unrecorded but valuable assets: Many precious 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 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 the owners provide. In a sole proprietorship, we commonly use the term capital, but the term stockholders' equity is commonly used in place of capital in companies. 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 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 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 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 increases in assets or settlements of liabilities from ongoing operations of the business. Operating revenues result from the sale of goods or services. When a company earns revenue, assets, usually Cash or Accounts Receivable, 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, the company has earned no revenue. This transaction is a cash receipt in exchange for a promise to provide a good or service in the future. The company settles the liability by providing the promised goods or services to the customer, . Revenue is then recognised, 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, that is not operating revenue but other revenue.

Operating Expenses

Some confuse the terms expenditures and expenses. Expenditure is an 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, the Cost of Goods Sold (or the Cost of Sales) representing the cost of inventory used in generating sales is usually the most significant expense.

- Salaries Expense

The company incurs an expense when employees work, although it will pay the salaries 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 most significant expense.

- All other operating expenses

The remaining significant 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 from these other activities do not fall under operating income. A company will instead categorise them 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, many companies will not recognise interest or dividends earned on the investment 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, interest expenses or earning investment income are not the significant operations of most businesses. We say these are peripheral (regular but not central) transactions.

Gains (or Losses) on Sales of Assets

Companies sell property, plants, and equipment from time to time to maintain modern facilities. The sale of land for more than the original purchase price does not earn 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.

Components of a Financial Report

Typically, a financial report for a company will consist of:

- The Chair Person's Report.
- The Auditor's Report.
- Statement of Comprehensive Incomes and Expenses.
- Statement of Financial Position.
- The Statement of Cash Flows.
- Statement of Changes in Equity.

Please get familiar with the components and formats of each of the reports.