CHAPTER I
INTRODUCTION TO ACCOUNTING

Introduction: Accounting is one of the key functions in management which entails recording of business transactions and deriving financial reports there from. In this lesson we shall consider a deeper meaning of accounting and explain its importance to different stakeholders within the organization.

Learning outcomes;

By the end of this lesson you should be able to
Define accounting by its functions
Identify different users of accounting and explain their information needs
Explain the limitations of accounting

Lecture outline

1.1 Introduction
1.2 Definition of accounting
1.3 Users of accounting information
1.4 Branches of accounting
1.5 Limitations of accounting
1.6 Elements of financial statements
1.7 Summary
1.8 Activities

1.2 Accounting: Definition

The American institute of Certified public Accountants (AICPA) defines accounting as follows:
"Accounting is the art of recording, classifying and summarizing in a significant manner in terms of money, transactions and events which are in part or at least of financial character and interpreting the results thereof"
An analysis of the above definition brings out the following functions of accounting.

Recording: This is the most basic function of accounting. It is essentially concerned with not only ensuring that all transactions of financial character are in fact recorded but also that they are recorded in a orderly manner. Recording is done in the books of original entry known as the "journals".

Classifying: Classifying is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place. The work of classifying is done in the ledger. This book contains on different pages individual account heads under which all transactions of similar nature are collected.

Summarizing: This involves presenting the classified data in a manner which is understandable and useful to the internal as well as the external end users of accounting statements. This process leads to preparation of the following statements;

- Trial balance
- Income statement/ statement of financial performance
- Statement of financial position

Dealing with financial transactions, accounting records only those transactions and events in terms of money which are of financial character. Transactions which are not of financial character are not recorded in the books of accounts.

Analyzing and interpreting: The recorded financial data is analyzed and interpreted in a manner that the end users can make a meaningful judgment about the financial condition and profitability of the business operations. The data is also for preparing the plans and framing policies of executing such plans. Analysis means methodical classification of the data given in the financial statements. Eg. Classification of current assets, current liabilities etc. Interpreting means explaining the meaning and significance of the data so simplified.

Communication: The accounting information after being meaningfully analyzed and interpreted has to be communicated in a proper form and manner to the proper person. This is done through preparation and distribution of accounting report which include the income statement, statement of cash flows, Balance sheet, and notes to the financial statements.

1.3 Branches of accounting

1.3.1 Financial accounting

This is the original form of accounting. It is mainly confined to the preparation of financial statements for the use of outsiders like the shareholders, debenture holders, financial institutions etc. The financial statements show the manner in which the operations of the business have been carried out in a specific period

1.3.2 Management accounting It is accounting which provides necessary information to the management for discharging its functions. Chartered institute of management accountants, London define management accounting as the application of professional information in such a way as to assist the management in the planning and control of the operations of the undertaking. Management accounting covers various areas such as cost accounting, budgetary control, inventory control, statistical methods, internal auditing etc.

1.4 USERS OF ACCOUNTING INFORMATION

Accounting information is produced in form of financial statement. These financial statements provide information about an entity financial position, performance and changes in financial position.
Financial position of a firm is what the resources the business has and how much belongs to the owners and others.
The financial performance reflects how the business has performed, whether it has made profits or losses. Changes in financial positions determine whether the resources have increased or reduced.
The users of accounting information have an interest in the existence of the firm. Therefore the information contained in the financial statements will affect the decision making process.

The following are the users of accounting information:

1.4.1Internal users

i. **Owners:**

They have invested in the business and examples of such owners include sole traders, partners (partnerships) and shareholders (company). They would like to have information on the financial performance, financial position and changes in financial position.
This information will enable them to assess how the managers of the business are performing whether the business is profitable or not and whether to make drawings or put in additional capital.

ii. **Managers**

The managers are involved in the day-to-day activities of the business. They would like to have information on the financial position, performance and changes in financial position so as to determine whether the business is operating as per the plans.
In case the plan is not achieved then the managers come up with appropriate measures (controls) to ensure that the set plans are met.

iii. Employees

They work for the business/entity. They would like to have information on the financial position and performance so as to make decisions on their terms of employment. This information would be important as they can use it to negotiate for better terms including salaries, training and other benefits.
They can also use it to assess whether the firm is financially sound and therefore their jobs are secure.

1.4.2 External users

i. Customers

Customers rely on the business for goods and services. They would like to know how the business is performing and its financial position.
This information would enable them to assess whether they can rely on the firm for future supplies.

ii. Suppliers

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

iii. The Lenders

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

iv. The Government and its agencies

The Government is interested in the financial performance of the business to be able to assess the tax to be collected in the case there are any profits made by the business.
The other government agencies are interested with the financial position and performance of the business to be able to come with National Statistics. This statistics measure the average performance of the economy.

v. The Financial Analyst and Advisors

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

vi. The Public

Institutions and other welfare associations and groups represent the public. They are interested with the financial performance of the firm. This information will be important for them to assess how socially responsible is the firm.
This responsibility is in form the employment opportunities the firm offers, charitable activities and the effect of firm's activities on the environment.

1.5 Distinction between accounting and bookkeeping

Book keeping is the science and art of correctly recording in the books of accounts all those business transactions that result in transfer of money or money's worth. Book keeping is recording of the financial transactions of a business in a methodological manner so that information on any point may be obtained quickly. Much of the work of a book keeper is clerical in nature and can be accomplished through the use of mechanical or electrical equipment.

On the other hand accounting is primarily concerned with the design of the system of records and preparation of reports based on the recorded data, the interpretation of the reports and finally communicating results of the interpretation to those who are interested in such results. Accountants often direct and review the work of book keepers. The work of accountants may include some bookkeeping but accountants must possess a much higher level of conceptual understanding and analytical skill than is required of the book keepers.

1.6 Limitations of accounting

i. Records of only monetary transactions- accounting records only those transactions which can be measured in monetary terms. Those transactions which cannot be measured in monetary terms such as benefit from loyal employees, conflicts between production and marketing director, efficient management e.t.c may be very important for the entity but are not recorded in financial statements.
ii. Effect of price level changes are not considered except in accounting for price level changes under inflationary trends. Accounting transactions are recorded at cost in the books, the effects of price level changes not brought in the books which make comparison of results from previous periods difficult.
iii. No realistic information- accounting information may not be realistic as accounting statements are prepared by following accounting assumptions and conventions
iv. Personal bias of accountants- Accounting statements are influenced by the personal judgment of the accountant. The accountant is free to select the method of depreciation or valuation of assets. The Generally acceptable accounting principles(GAAPs) permit alternative treatment
v. No real test of managerial performance- Profit earned during an accounting period is not the test of managerial performance. Profit may be shown in excess by manipulating the accounts by suppressing the expenses and earlier recognition of revenue.

vi. Historical in nature- Financial accounting supplies information in the form of profit and loss account and the balance sheet. This is usually a postmortem analysis of the past performance.

1.7 Elements of financial statements

(The quantitative aspects)

The most common elements include:

i. Assets
ii. Liabilities
iii. Equity (Capital)
iv. Revenues
v. Expenses
vi. Gains
vii. Losses

1.7.1 ASSETS

These are resources, tangible or intangible from which probable future economic benefits are obtained and the right to which have been acquired by a particular entity a s a result of past transactions or events.

This definition points toward the following characteristics

An asset:

i. Embodies probable future benefits that increases the capacity to contribute directly or indirectly to the future cash flows.
ii. must be owned by the business
iii. It is the result of past transactions and events i.e the transaction giving rise to the claim or control of the benefit must already have occurred
iv. The probable future benefits must be measurable in monetary terms

Assets are classified into four groups:

i. Fixed assets:

These can be defined as assets that have been acquired for retention by the business entity to be used for retention in the business entity to be used for provision of services and not held for resale in the course of trading.

Property plant and equipment are intangible in nature and are relatively long lived resources in the business. They are used in production of goods and service and are intended to used beyond one accounting period. Examples; Land and buildings, plant and machinery, motor vehicles, office equipment, furniture and fittings etc.

ii. Current assets

These are cash or other assets held for conversion into cash or consumed in the normal course of trading. The essence of their distinction from fixed assets is time.

Current assets are resources that are owned by the business generally for not more than one year. Examples: Inventories, debtors, cash at bank cash in hand.

iii. **Fictitious Assets**

These are intangible properties which are not presented by anything concrete e.g Preliminary expenses, accumulated losses e.t.c

iv. **Intangible assets:**

These are **assets** with no physical existence but whose value is on the rights their possession confers upon the owner. They represent material rights, privileges and competitive advantages owned by the business.

1.7.2 LIABILITIES

These are obligations, which arise from transactions, or events that have already occurred. A liability involves an entity in a probable future transfer of funds, goods or services or the foregoing a cash receipt in future.

Liabilities are claims of outsiders against the business by a person other than the owner of the business. A liability need not to be a legally enforceable claim and may take either of the following forms.

i. Those with fixed amounts and date of payment

ii. Those with fixed amounts and the date of payment is estimated
iii. Those for which the amount and the date of payment is estimated
iv. Those arising from advances made by customers

Liabilities are further classified as follows;

i. **Long-term liabilities**

These are generally redeemed after long period of time. Their redemption period normally extends beyond one accounting period i.e one year. Examples include long-term bank loans, and debentures

ii. **Current liabilities**

These are liabilities, which fall due for payment within one year or are obligations which the business has to meet in the near future, usually within the next accounting period. Current liabilities also include long-term loans that are due for repayment within one year. They also include other liabilities, which are not related to the production cycle. E.g. short-term loans arising from acquisition of non-current assets.
Examples of non-current liabilities include, creditors, bill for payment, liability for taxes, outstanding expenses, unearned incomes etc.

iii. **Contingent Liabilities**

These are conditions existing at the balance sheet date the outcome of which can be confirmed by the occurrence or non occurrence of one or more uncertain future events. They do not include uncertainties connected with accounting estimates. The situation must exist currently hence future losses from fire floods natural calamities are not contingent liabilities.

1.7.3 CAPITAL

This is money contributed by the owner(s) to an organization to enable it function. It is represented by the excess of assets over liabilities. It can be introduced in business in cash or in kind.

Capital in a business increases when:

- The owner brings more capital in business
- The owner does not consume the entire periodic income

A capital account is the account that shows the interest of the owner in the net assets of the business he runs.

SUMMARY

In our discussion above we have learned that accounting is a process of collecting financial data and extracting there from information that is relevant to the many stakeholders of the organization. We have also introduced the elements of financial statements which we shall invariably refer to in this course.

ACTIVITIES

Activity 1.1

i. Identify the input (data) – processing- output (information) components in the financial accounting cycle (relate the accounting definition to the basic information processing model)

ii. Identify **and** describe four desirable characteristics of accounting information.

Activity 1.2

Explain the difference between the following terms

i. Management accounting and financial accounting

ii. Assets and liabilities

iii. Current assets and noncurrent assets

iv. Internal and external users of accounting information

Suggested further readings

Wood, Frank & Sangster, A: **Business Accounting 1** – 9th ed. – New Delhi: Pearson Education, 2002.

Maheshwari, SN. & Maheshwani, SK – **An Introduction to Accountancy** – 7th ed. – New Delhi; Vikas Publishing House, 2003.

Sutherland, Jonathan and Canwell, Diane: **Key Concepts in Accounting and Finance** – London: Palgrave Macmillan, 2004.

CHAPTER II
THE ACCOUNTING EQUATION AND BUSINESS TRANSACTIONS

2.1 INTRODUCTION

In our previous lecture we defined the terms Assets, liabilities and Capital. For assets to come in to being, they must be provided by the owner and/or be borrowed from outsiders. In accounting we say whatever exists to being must be equal to what has brought it in to being. This will be demonstrated in the accounting equation. We shall further demonstrate that the accounting equation remains unchanged irrespective of the number of transactions.

Learning outcomes
By the end of this lesson, you should be able to
i. Demonstrate the relationship between assets liabilities and capital
ii. Prove that the accounting equation is unchanged by transactions

2.2 THE ACCOUNTING EQUATION

For a new business, resources supplied by the owner are known as capital while the actual resources are assets. The accounting equation is given as follows
CAPITAL = ASSETS

Resources supplied by other people other than the owners are liabilities. If these are considered the accounting equation becomes;

CAPITAL + LIABILITIES= ASSETS

ACCOUNTING EQUATION AND BUSINESS TRANSACTIONS

Let us consider the illustration given below

Illustration 2.1

Henry Mugo started business on 1st January 2013 with Kshs 100,000 in cash

2nd January: Transferred Kshs 80,000 to a newly opened bank account

3rd January: Received a cheque for Kshs 200,000 from his uncle Ben as a loan

4th January bought office furniture for Ksh 120,000 paying by cheque

5th January bought computers worth Ksh 150,000 on credit from TKL dealers

6th January Issued a cheque for Kshs 50,000 in part payment of TKL's debt

Demonstrate the effect of these transactions on the accounting equation

Solution

Date	**Asset**	**Liabilities**	**Capital**
1 Jan	Increase (Ksh.100,000)	Nil	Increase 100,000
2 Jan	Increase and Decrease (*Bank increases by 80,000 while cash reduces to 20,000*)		
3 Jan	Increase *(bank by 200,000)*	Increase *(Uncle Ben a debt by 200,000)*	Nil
4th	Increase and Decrease (*Furniture increase but the payment reduces the bank balance Assets Total remain unchanged so do the liabilities and capital)*	Nil	Nil
5th	Increase *(computers by 150,000)*	Increase *(TKL dealers increase by 150,000)*	Nil
6th	Decrease *(bank will decrease by 50,000)*	Decrease *(TKLs debt will decrease by 50,000)*	Nil

As demonstrated above business transactions will affect the assets, liabilities and capital balance but will leave the accounting equation unchanged. Assets = Capital + liabilities

Activity 2.1

Complete the gaps in the following table:

	Assets Kshs.	Liabilities Kshs.	Capital Kshs.
(a)	12,500	1,800	?
(b)	28,000	4,900	?
(c)	16,800	?	12,500
(d)	19,600	?	16,450
(e)	?	6,300	19,200
(f)	?	11,650	39,750

Activity 2.2

Complete the columns to show the effects of the following transactions:

		Effect upon		
		Assets	**Liabilities**	**Capital**
(a)	We pay a creditor Kshs.70 in cash			
(b)	Bought fixtures Kshs.200 paying by cheque			
(c)	Bought goods on credit Kshs.275			
(d)	The proprietor introduces another Kshs.500 cash into the firm			
(e)	J Walker lends the firm Kshs.200 in cash			
(f)	A debtor pays us Kshs.50 by cheque			
(g)	We return goods costing Kshs.60 to a supplier whose bill we had not paid.			
(h)	Bought additional shop premises paying Kshs.5,000 by cheque			

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Wood, Frank & Sangster, A: **Business Accounting 1** – 9th ed. – New Delhi: Pearson Education, 2002.

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