INTRODUCTION TO ACCOUNTING (BOOKKEPING) AND THE CONCEPTUAL FRAMEWORK

Definition of Accounting

Accounting is defined as a process of identifying, recording, classifying, summarizing, reporting and keeping of financial information.

OBJECTIVES OF ACCOUNTING AND BOOK KEEPING

1. To have permanent record of all the business transactions.
2. To keep records of incomes and expenses in such a way that the net profit or net loss may be calculated.
3. To keep records of assets and liabilities in such a way that the financial position/wealth of the business may be ascertained.
4. To keep control on expenses with a view to minimize the same in order to maximize the profit.
5. To have important information for legal and tax purpose.
6. For credit purposes (Determining borrowing capacity)

Stakeholders/users of Financial Information

Stakeholders are users of financial information. They are organizations or individuals who are affected by the information generated by an organisation. The stakeholders are divided into two categories as follows;

- **Internal Stakeholders – people within the organisation**
- **External stakeholders –users outside the organisation**

Internal Stakeholders

These are the stakeholders who are directly affected by the activities of an organisation. The stakeholders in this category include;

i. **The Management:** These are the people who are entrusted with stewardship management of an enterprise. They manage the organisation by putting the capital of that organisation for the best interest of the capital providers (Owners).

ii. **The Owner (s):** These are the individuals/organisations who provide equity for starting up an organisation. They are interested in seeing the organisation improve in terms of profitability (profit maximisation) and wealth (shareholders wealth maximisation)

iii. **The Employees:** These are the people who work for an organisation. They perfume duties assigned to them by the management.

External Stakeholders

These are the stakeholders who do not directly affect the operations of an organisation. The stakeholders include;

i. **Investors:** These are the individuals or organisations that commit funds for a return. They are interested in seeing that the organisation give them high returns for their investments

ii. **Suppliers:** These are the stakeholders who supply to an organisation goods for sale or use on cash or credit (creditors). They are interested on the liquidity of an organisation so as to determine whether the organisation can make prompt payment to them

iii. **Customers:** These are the stakeholders who buy goods or services from an organisation. They are also known as debtors when they buy the goods on credit. They are interested on being charged fairly low prices, being given quality products e.t.c

iv. **Competitors:** These are the firms that deal in similar products or services. They are interested in strategy bench marking

v. **Financial Institutions:** These are the institutions that are responsible regulating the industry of operation like the capital markets authority or banking institutions the provide capital. They are interested in ensuring that the organisation complies with set rules and regulations for practice.

vi. **The Government:** The government is responsible for providing enabling environment for business operation. As such, governments will require corporate tax to assist in its activities among other requirements

vii. **The Public:** This represents the general public that is affected by the environment around which the organisation operates. The public expects an organisation to extend its corporate social responsibility to them. This include areas such as development of infrastructural facilities, providing employment opportunities, providing education e.t.c

Conceptual Framework of Accounting -

A conceptual framework of accounting is a coherent system that describes the nature purpose of accounting and how certain transactions are treated in accounting. It has the following advantages;

i. Assist in development of coherent set of standards built upon same foundation
ii. Assist in resolution of new and emerging issues of accounting
iii. Assist in quick resolution of practical problems in accounting by reference to the basic theory
iv. It is a guide for the development of future financial accounting standards
v. It assists users of financial reports in interpreting information contained in the financial statements prepared through consistency

Overview of Conceptual Framework

1 KEY ACCOUNTING PRINCIPLES AND CONCEPTS

There are a number of accounting principles that underpin the preparation of financial statements. They include

1 The business entity concept – (A business is different from the owner) –

A shopkeeper cannot mix their business rent with his home rent

A business owner cannot mix the office electricity expense with their own home electricity expense.

The reason why drawings is recorded as a transaction is because of the business entity principle

The rent expense for the law firm is Ksh 15,000 and the home rent is 12,000. The advocate pays a total of Ksh 27,000 and records it as a law firm expense,

this will be wrong, (it will be considered that the 12,000 paid for home rent that does not belong to the law firm is a drawing of cash from the law firm/business by the owner)

This concept means that the financial accounting information presented in the financial statements relates only to the activities of the business (law firm) and not to those of the owner. From an accounting perspective the business is treated as being separate from its owners. Thus the transactions of the owner should not be mixed with the transactions of the business.

e.g if the owner pays his home rent from and shop rent together from the money of the shop, then they will have disobeyed the business entity concept.

2 The going concern assumption

This principle states that Financial statements are prepared on the basis that the entity (the law firm) will continue to trade for the foreseeable future (i.e. it has neither the need nor the intention to liquidate or significantly stop its operations). The foreseeable future is usually considered to be at least 12 months forward.

e.g *If we are reading the financial statements of a company, on 31st Dec 2020, we will assume the information is presented in a way that shows the company will still be operation as at 31st Dec 2021.*

3 The accruals basis of accounting (accrual concept)

This means that transactions are recorded when revenues are earned and when expenses are incurred regardless whether the payment has been made or not. For example if a business sales goods on November on credit but only receives the money in December, the sale transaction will still be recognized in November. (**We shall look at this in a further topic of adjustments**).

Transactions are recorded in the books when they occur not when cash received e.g A business sells goods on May 2021 on credit. However, the customer pay for those goods on July 2021. When will the sale transaction be recognized by the business? On May 2021. (*The accrual concept arises because of periodicity- in that the performance and financials of a business are reported in periodic intervals –usually one year)*

Note – There is also a cash Basis of Accounting but this is not within the scope of private entities.

4. **Consistency**

This is the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities.' Consistency enhances comparison from one entity to another or comparisons over a period of time.

E.g. if a chair is recognized as equipment rather than furniture in 2019, then it should continuously be recognized as furniture even in future years.

Consistency enhances Comparability over periods

5. **Double entry (duality concept) - The King of accounting**

This states that each transaction in the books has two equal effects, a credit entry and the other an equal debit entry. (*We shall look at this into detail in our next chapters*)

6 **Materiality- a relative concept which differs from one company to another**

Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. Materiality is relative from one organisation to another. E.g. 10,000 can be a material for a shopkeeper, but it is immaterial for a big company like Safaricom. Thus financial statements are not completely accurate always but they should not omit material items.

7. **Historical cost accounting- transactions are recorded at the amount they happened at,**

Assets are recorded at the amount of cash… paid… to acquire them at the time of their acquisition and Liabilities are recorded at the amount of proceeds received in exchange for the obligation. E.g. it assumed that if a vehicle was bought at 100,000 in the 2007 that is the amount it will be shown in the books even in 2015 as its purchase cost (but its reporting value will change according its change

8. **Prudence concept-** states that an entity must not overestimate its revenues, assets and profits, besides this it must not underestimate its liabilities, losses and expense. Thus incomes and profits should not be recognized in the books until they have been earned. However, losses and liabilities should be immediately recognized when they are foreseen.

e.g if a customer owes you money and they die , what will you do? Write it off as a bad debt, when we use assets they wear out, so how do we recognize this in the books? We depreciate - all this are examples of prudence concept

Also assume a company has been sued for damages, even though they do not know what the outcome of the case will be, they may need to provide for the worst case scenario

9. **Substance over form Concept:** This requires that transactions are accounted for in their substance and economic reality and not legal forms

(e.g in law a business owner is not different from the business. But in accounting we treat them as different as per the business entity concept). If you buy a bus on loan, and after completion of the loan, the bus will be yours even though currently the logbook is not in your name, the bus will still be shown as an asset in your books)

10. **Monetary Concept**: Accounting uses money as a unit of measurement. Therefore only transactions to which monetary value can be attributed are recorded (if a transaction cannot be measured reliably in monetary value, then it cannot be recognized in the financial statements.)

Qualitative characteristics of accounting

In order for the financial statements to be useful to the stakeholders of a business they must embody certain qualitative characteristics. They are defined as follows:

The fundamental (main) qualitative characteristics:

i. Relevance – financial information is regarded as relevant if it is capable of influencing the decisions of users.
ii. Faithful representation – this means that financial information must be ***complete, neutral and free from error.***

The enhancing/ (supporting the fundamental) qualitative characteristics:

i. **Comparability** – it should be possible to compare an entity over time and with similar information about other entities. (comparability is made possible by consistency)

ii. **Verifiability** – if information can be verified (e.g. through an audit) this provides assurance to the users that it is both credible and reliable. (confirming that transactions recorded in the financial statements actually happened and they belong to the business)

iii. **Timeliness** – information should be provided to users within a timescale suitable for their decision making purposes.

iv. **Understandability** – information should be understandable to those that might want to review and use it. This can be facilitated through appropriate classification, characterization and clear presentation of information.

ELEMENTS OF THE FINANCIAL STATEMENTS

A - Assets

L - Liabilities

I – Income

C – Capital/Equity

E – Expenses

ALICE – The Queen of Accounting

Sometimes we add the Word (D-Drawings) to smoothen the queen

DALICE

Element	Explanation
Assets	These are resources that are owned by business e.g. cash, buildings, furniture, cash owed by debtors, motor vehicles e.t.c.
Liabilities	What the business owes to third parties/obligations of the business e.g. a Bank loan, owing to creditors, expenses which have not been settled at the end of the reporting period, bank overdraft e.t.c

Equity/Capital	These are the resources (assets) which the owner invested in the business or what remains as resources to the owners after all liabilities have been settled/paid. The capital of a business can increase through profits or reduce if the company makes losses or the owner withdraws some resources from the business
Income	These are activities that generate resources for the business e.g. sales, rental income, interest income
Expenses	Activities that consume resources of the business or support the income generating activities e.g. Purchases of goods for resale, rent expenses, insurance expense, salaries and wages e.t.c.
Drawings (not an element)	The action of withdrawing some resources from the business in form of goods, cash or other assets

When the King of Accounting (double entry) and the queen of accounting (ALICE) interact, they form the foundation of recording transactions in accounting.

In our next chapter we shall focus on this foundation of recording the business transactions