Study Unit 1: Introduction to Accounting

Learning objectives

By the end of the chapter, the learner should be able to;

1. Understand the concept of Accounting and its role
2. Understand the different disciplines of accounting
3. Discuss the categories of persons who use accounts and their information needs
4. Explain and discuss the accounting principles and concepts
5. Explain the Qualitative characteristics of financial statements and the extent to which accounting statements display such characteristics
6. Generally, appreciate the theoretical framework of accounting

Introduction

Like any other profession, accountancy has rules that govern its practice. These are normally, in order for the consistency to be exhibited, enshrined in a framework. Every system has users; likewise the outputs of the process of financial accounting have interested users. These outputs must have characteristics that make them useful. These together with the components of the accounting system are exemplified below.

What is Financial Accounting?

Financial Accounting is the art and science of recording and classifying financial transactions in the books, summarizing and communicating financial information through production of financial statements/reports, and 'interpretation of the operating results portrayed in financial statements/ reports to facilitate decision-making (Omonuk, 1999),

Financial Accounting is the process of identifying, measuring and communicating economic information to permit informed and rational decisions to be made. Rational decisions made by the organization include for example; working capital decisions, capital budgeting decisions. investment decisions, etc. It is beyond the scope of this book to go into details of these decisions.

Without limiting accounting to finances, in general use, accounting means explaining and defending or justifying actions or results of those actions. All those who have been entrusted with safe custody of others resources are usually required to account or submit accountability to the owners of the resources.

By what means can we provide Financial Accountability?

Managers and accountants are required to show evidence of good financial management by submitting accountability of money received and spent. The following are methods of accountability;

1. **Production of documentary evidence**

This involves producing documents as evidence of money received and well spent. The key accountability documents are receipts, vouchers, invoices, etc.

- Receipt - is a document prepared as evidence of money received
- Voucher - is a document that shows details and supports payment
- Invoice - is a document submitted by suppliers demanding payment for goods and service provided on credit

2. **Books of accounts**

After documenting transactions, these transactions should be recorded into books of accounts. In case of a query or even in the normal monitoring of transactions by owners of the wealth, examination of books of account is normally carried out. In order to account properly, transactions must be accurately recorded into books of accounts e.g. a cashbook.

3. **Financial statements / reports**

Financial statements (also called final accounts) are prepared to show results of the operations for the year ended. The major financial statements are the income statement, the balance sheet and the cash flow statements. Some monthly statements such as bank reconciliation statements, budget performance reports and monthly trial balance are also required for accountability purposes in many organisations.

4. **Output / result**

Apart from paper accountability, there is need for tangible outputs and concrete results to show evidence of money well utilized. For example, if someone is given UGX 500 million for building classroom blocks, the first accountability to be Looked at are the classrooms themselves.

Why accounting'?

The ultimate role of accounting is to provide information to decision makers. Besides that preparation of accounts plays the following roles:

1. **Ascertainment of profit and loss**

One of the main purposes of any business is to make profits. For this reason, accurate and complete recording of all business transactions is essential because this information will be helpful to determine whether there was a profit or loss in any trading period.

2. **Assessment of tax**

Governments in all countries impose taxes. For the accurate assessment of tax, accurate records must be maintained properly; otherwise, a business enterprise may be required to pay high taxes to the government. Accounting therefore forms an objective and reliable basis of computing taxes.

3. **To facilitate the credit transactions**

Most business transactions are made on credit basis. In this case, goods are purchased or sold without cash payment. These transactions are made on the basis of promises to make payments in future. Without credit transactions, business cannot be expanded beyond certain limits. If goods are purchased from a supplier on credit basis, then this supplier is known as the creditor. Similarly, if goods are sold to a customer on credit then this customer is known as a debtor. Accounting records facilitate such credit transactions because these records will determine the amounts due to creditors and due from debtors. For easy monitoring of debtors and creditors, proper accounting records must be maintained. It also acts as a Base for credit facilities for example, a loan. A business enterprise can be able to acquire credit from financial institution once it has proper and accurate accounting records.

4. **A tool for control**

A business enterprise can maximize its profits by increasing the gap between income and expenses. Proper control of unnecessary expenses and misappropriation of funds is essential. A proper and accurate accounting system will be helpful to maintain this control.

5. **Base for further planning**

For further expansion, a business enterprise has to formulate its plans based on the present and past achievements. Accounting records can provide sufficient data relating to sales, profit, investments etc, for making decision about the future programme.

6. **Monitoring of management**

Preparation of accounts helps shareholders to monitor management and other stakeholders to evaluate the performance of the organisation. The managers are not the owners of the business and therefore accounting forms an objective basis for monitoring the actions of managers by the owners of the business.

USERS/INTERESTED PARTIES IN ACCOUNTING INFORMATION?

It is easy to assume that the only users of accounting information are shareholders- since it is a requirement of the company law that shareholders must receive periodic accounting statements. However, in reality there are many users of accounting. Every organisation whether profit making or not has people or parties interested in it. These interested parties (stakeholder) have to make decisions connected with the organisation. Accounting information is very necessary if decisions are to be made accurately and rationally. Various parties are interested in accounting information to facilitate their decision-making.

Accounting information is in form of financial statements/ reports, entries in books of accounts and business documents. The users or decision makers interested in accounting information are broadly divided; into two groups, i.e. internal users and external users.

Internal users

These are involved in the day 'to day running of the organisation.

1. **Management**

The managers of the business will want to know how things are going. They need financial information in order to plan for the future; they then need more up-to-date information in order to check whether actual performance is on target. This process is known as controlling the costs and finances. In accounting it is known as management accounting. So, management accounting is done by the managers, for the managers, for the purposes of planning and control.

2. **Employees**

Employees (and organizations that represent them - e.g. trade unions) require information about the stability and continuing profitability of the business. They are crucially interested in information about employment prospects and the maintenance of pension funding and retirement benefits. They are also likely to be interested in the pay and benefits obtained by senior management. Employees will, therefore look for information on:

- Revenue and profit growth
- Levels of investment in the business
- Overall employment data (numbers employed, wage and salary costs)
- Status and valuation of company pension schemes / levels of company pension contributions.

External users

They are external in the sense that they are not involved in the day to-day running of the organisation. However they are interested in financial accounting information, because such information forms a basis of decision making.

1. **Shareholders**

These are the primary stakeholders-of the business because they invest capital in the business. Investors are concerned about risk and return in relation to their investments. They require information to decide whether they should continue to invest in (J business. They also need to be able to assess whether a business wilt be able to pay dividends, and to measure the performance of the business' management overall. The key accounting information for an investor is therefore:

- Information about growth - sales, volumes
- Profitability (profit margins, overall level of profit)
- Investments (amounts invested, assets owned)
- Business value (share price)
- Comparative information of competitors

2. **Potential investors**

These need accounting information in order to be able to decide whether investing in a company is worthwhile. This may be with the help of an analyst who analyses the company's past and projected financial performance before they can buy shares in it.

The key accounting information for a potential investor is therefore:

- Information about growth - sales, volumes
- Profitability (profit margins, overall level of profit)
- Investments (amounts invested, assets owned)
- Business value (share price)
- Comparative information of competitors

3. **Creditors**

Suppliers and trade creditors require information that helps them understand and assess the short- term liquidity of a business. They need accounting information to establish the credit worthiness of the customers or clients i.e. is the business able to pay short-term debt when it falls due? Creditors will therefore, be Looking for information on:

- Cash flow
- Management of working capital
- Payment policy

4. **Lenders**

Banks and financial institutions who lend money to a business require information that helps them determine whether loans and interest will be paid when they fall due. The key accounting information for lenders therefore:

- Cash flow
- Security of assets against which the lending may be secured
- Investment requirements in the business

5. **Debtors**

Customers and trade debtors require information about the ability of the business to survive and prosper. As customers of the company's products, they have a long-term interest in the company's range of products and services. They may even be dependent on the business for certain products or services. Customer will be particularly interested in:

- Sales growth
- New product development
- Investment in the business (e.g. production capacity)
- Donor/funding agencies

Non profit making organizations like NGOs get funding from donor agencies. These agencies are always interested in making sure that the money they donate is used to achieve the objectives for which it was released. They monitor utilization of their money by examining accounting records i.e. financial reports, books of accounts and documents of the organisation that they support.

6. **Government**

There are many government agencies and departments that are interested in accounting information.

For example, the Inland Revenue needs information on business profitability in order to levy and collect corporation tax and Value Added Tax; local government need similar information to levy Local taxes and rates. The government also needs accounting information from state owned public companies existing alongside private ones, to monitor their performance. It also needs accounting information from business entities to enable it analyze the effect its policies have on business. This enables formulation of policies that promote sector development.

7. **Competitors**

These need accounting information of firms in the same industry so as to judge whether they are performing poorly or fairly in comparison with other players in the same business.

8. **General public**

These include individuals and organisations which ensure that businesses make their profits in a socially acceptable manner without damage to the environment and consumers. They have specific interest in the activities and performance of businesses. Environmental pressure groups push for minimization of pollution of the environment while consumer groups like Uganda National Bureau of Standards (UNBS) try to ensure that businesses offer safe products and don't charge high prices for poor quality products.

Desirable qualitative characteristics of accounting information

Having identified the users of financial reports, the problem arises as to what are the qualities of useful accounting information? These characteristics are the attributes that make the information in financial statements useful to investors, creditors, and others. Four principal qualitative characteristics identified i.e.:

- Understandability
- Relevance
- Reliability
- Comparability

Understandability

This implies the expression, with clarity, of accounting information in such a way that it will be understandable to users - who are generally assumed to have a reasonable knowledge of business and economic activities. In other words, the information should be in a form which is understandable to user groups. However, this poses problems. Users have very different levels of financial sophistication addition: the very complexity of business transactions makes it difficult to prove adequate disclosure whilst maintaining simplicity.

Relevance

This implies that, to be useful, accounting information must assist a user to form, confirm or maybe be a view - usually in the context of making a decision (e.g. should I invest in this business?) should I lend money to this business? Should I work for this business?). Relevant accounting information is capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations. Information can make a difference to decisions by improving decision makers' capacities to predict or by providing feedback on earlier expectations. The problem is how to identify these needs given the variety of users.

Materiality is a component of relevance. Information is material if its omission or misstatement could influence the economic decisions of users. A decision not to disclose certain information may be made, say, because investors have no need for that kind of information (it is not relevant) or because the amounts involved are too small to make a difference (they are not material).

Timeliness is another component of relevance. To be useful, information must be provided to users within the time period in which it is most likely to bear on their decisions, If information is not available when it is needed or becomes available so long after the reported events that it has no value for future action, then it lacks relevance and is of little or no use, Timeliness alone cannot make information relevant, but a lack of timeliness can rob information of relevance it might otherwise have had.

Reliability

Information in financial reports is reliable if it is free from material error and bias and can be depended upon by users to represent events and transactions faithfully. Information is not reliable when it is purposely designed to influence users' decisions in a particular direction. This implies that the accounting information that is presented is truthful, accurate, complete (nothing significant missed out) and capable of being verified (for instance, by a potential investor). The complexities of modern business make reliability difficult to achieve in all cases.

Objectivity; This implies that accounting information is prepared and reported ill a "neutral" way. Financial statements should not be inclined (biased) towards the needs of one user; they should be objective. The problem here is that financial reports are prepared by one user group, management. An external audit (an audit is an independent examination of the books of accounts to ascertain the degree of correspondence between assertions and the truth and fairness of financial reports in order to form an opinion on these statements) is designed to remove this bias, but some authorities question the effectiveness of the audit in this respect.

Comparability and consistency

Information about a particular organization gains greatly in usefulness if it can be compared with similar information about other organizations; and with similar information about the same organization for some other period at some other point ill time. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark.

Much of the work that goes into setting accounting standards is based around the need for comparability. The main problem has been the use of accounting policies (These will be explained later in the chapter) by different organizations. Accounting standards (also explained later in the chapter) have reduced, but not eliminated, this problem.

In order to have useful financial information presented to the users, the following generally accepted accounting principles should be followed. These are explained here under.

ACCOUNTING CONCEPTS/ PRINCIPLES/ POSTULATES/ ASSUMPTIONS/ CONVENTIONS.

To facilitate the explanation of phenomena, some factors must be taken for granted (all other things being equal) as the platform or basis from which the explanation can proceed. The factors taken for granted in explaining the conceptual structure of accounting are the fundamental assumptions whose acceptance as such, and use in the systematic explanation are assumed. In the science and art of accounting, these have come to be called "fun rental accounting principles".

Again in drawing up accounting statements, whether they are external "financial accounts" or internally, focused "management accounts", a clear objective has to be that the accounts fairly reflect the true "substance" of the business and the results of its operation, The theory of ,accounting has, therefore developed concept of a true and fall' view'. The true and fan view is applied in ensuring and assessing whether accounts do indeed portray accurately the business' activities.

To support the application of the "true and fair view" accounting has adopted certain concepts and conventions which help to ensure that accounting information is presented accurately and consistently. Attention is now to be focused on the fundamental postulates from which rational accounting judgments proceed.

There are two types of accounting concepts ie fundamental and procedural.

FUNDAMENTAL ACCOUNTING CONCEPTS

Business Entity Concept

This convention seeks to ensure that private financial transactions and matters relating to the owner of a business is recorded and separated from financial transactions that relate to the business. It should be noted that a business exists separate from its owner. A business owner usually owns personal items as well as business items. The business; financial records and reports should not be mixed with the owner's personal records and reports. For instance: a business owner may incur rent for his home and rent for the business. Only the rent related to the business should be recorded in the business financial records while the home rent is recorded in the personal financial records. The business entity concept ensures that the amount invested by the owners in the business is defined (capital) and allows a return on capital employed to be computed to show whether the investment is worthwhile.

Limitation: The main limitation of concept is the owner and the businesses are actually inseparable. For instance if a sole trader sells and dwells on the same premises, then rent and utilities paid will be difficult to apportion between the owner and the business especially if there are no clear appointment bases.

Monetary measurement concept

According to this concept, all transactions to be recorded must be quantified in monetary terms, since money is a common denominator for all transactions e.g. cost, sales, the value of stocks, machinery, dents and investments. This is because a record of transactions IS qua nut led and assessed in a monetary unit. Thus it -is assumed that the monetary unit is capable of acting as the common denominator of the values to the point of determining exchange equivalents.

Financial data is generally quantified and the measurements expressed in units of money. Presentation involves adding, subtracting, multiplying and dividing numbers depicting economic things of value and events.

Limitations

- It assumes money has a stable value over time, yet actually money may lose value with time.
- It limits recognition of transactions to those that can be quantified and leaves out qualitative factors that can have a direct impact on the business e.g. workforce skill, morale, market leadership, brand recognition, quality of management etc

<u>Procedural Accounting Concept</u>

Going Concern concept

This requires the accounting records to be maintained in such a way that the business is seen to continue in its foreseeable future. That 15, the financial reports are prepared with the expectation that a business will remain in operation indefinitely. This makes it possible for the accountant to prepare or project estimates for a long period into the future.

For example, a business bought machinery for UGX 25,000,000. This machinery is expected to last for 10 years. The yearly depreciation therefore is recorded and reported based on the expected life of the machinery. At the end of every year, the book value (cost less accumulated depreciation) is reported.

A business is expected to continue indefinitely even if the owner retires or sells the business. If a business is sold, the new owner is expected to continue the business' operations. Continuity of operations facilitates the allocation of both revenues and expenses to the pertinent accounting periods. Without this presumption, Accrual Accounting (to be discussed here under) would have no foundation. As the accounting entity stops being a going concern, the accounting approach changes from accrual to realization and liquidation.

Periodicity concept

This concept requires a company to prepare and disclose financial reports at the end of every accounting or financial year. This enables comparability, timely performance measurement and tax computations.

Of course, the impact of transactions is measured for a specific time period usually known as the financial year. Thus, it is assumed that the continuous life time of the entity (see going concern assumption) can be broken down into specific time periods. Then the results of operation for each time period can be measured. At the end of each period, a "static" picture of the resources and claims to those resources is taken. This depicts the financial position of the entity at that specific point in the lifetime of the entity. In practice, this financial year has come to be 12 months period and in Uganda, this principle has been enshrined in law (see companies' Act of Uganda).

Historical cost

This principle requires transactions to be recorded at the price ruling at the time, and for assets to be valued at their original cost. That is, the actual amount paid for items bought is recorded. The actual amount paid for an item in a business transaction maybe different from the value. For instance, office furniture is valued at UGX 12,000; business arranges to buy the furniture at UGX9, 000,000.

The amount recorded in the accounting records for the office furniture is the historical cost - UGX 9,000,000 the actual amount paid.

In the process of acquiring assets by a business, entity, such assets are valued and recorded in books of accounts at the cost at which they were acquired i.e., the price paid. The assets are entered in accounting records at their cost. This is generally called historical cost basically because it is always the valuation of a consummated transaction.

Limitation

During inflation, historical cost will not reflect the true value of the assets of the business. e.g. asset was bought at UGX 1,000,000 at the beginning of the year, and the annual inflation 90%, its value at the end of the year will be UGX 1,900,000. The historical cost concept will require UGX 1, 000,000 and not UGX 1, 900,000 to be recorded.

Realization concept

This concept requires that transactions (and any profits arising from them) are recognized and recorded at the point of sale or transfer of legal ownership - rather than just when cash actually changes hands. A company that makes a sale to a customer can recognize that sale as income at the point of contract. The actual payment due from the customer may 110t arise until several weeks (or months) later - if the customer has been granted some credit terms. .

For example, a business sells goods for UGX 2,500,000. The business agrees to an initial payment of UGX 1,000,000 with the remaining balance to be paid in two monthly installments of UGX 750,000 each. The fun amount of UGX 2,500,000 of revenue should be recorded at the time of sale though UGX 1,500,000 will be paid tater.

Note that a realization is when a sale is made to a customer. The basic rule is that revenue is created at the moment a sale is made, and not when the price is later paid in cash. Profit can be taken to the profit and loss account on sates made even though the money has not been collected.

The gist of this concept is that in order to determine the nature and magnitude of the impact of transactions on the financial position of the accounting entity, inflowing revenues or incomes are recognized if and when the earning effort is substantially expended or completed. Revenues represent actual or expected cash inflows or the equivalent from the ongoing or central operations of the enterprise during the accounting period. Realization in the most precise sense means the process of converting non-cash resources and rights into money and most precisely used ill financial accounting and reporting to refer to sales of assets for cash cr claims to cash. Recognition is the process of formally recording or incorporating an item into the financial reports of all entity.

Materiality

This requires the recognition of only material items and excluding immaterial or trivial items. Information is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial reports. Financial statements should therefore show material items separately, but immaterial items may be aggregated with amounts of a similar nature. For example buying furniture for UGX 14,000,000 represents an amount large enough to significantly affect the amount of net income reported if recorded as an expense. Therefore, the furniture should be recorded as an asset and depreciated each year of its useful life.

Consistency

According to this concept, transactions and valuation methods are treated the same way from year to year, or period to period. Business decisions are often made by comparing current financial reports with previous financial reports. Users of accounts can therefore make more meaningful comparisons of financial performance from year to year. Accounting information recorded and reported differently each accounting period makes comparisons from one accounting period to another impossible. Where accounting policies are changed, companies are required to disclose this fact and explain the impact of any change.

Prudence/ conservatism concept

This concept requires that the profits are not recognized until a sale has been completed. In addition, a cautious vie should be taken for future losses or costs of the business as soon as there is a, reasonable chance that such costs will be incurred in the future i.e. provide for all possible losses, for example, provision for bad debts. The concept can be summarized by the phrase 'anticipate no profit and provide for all possible losses and costs'. Further still, the concept tends to undervalue assets i.e. whenever there are alternative methods of valuing an asset, an accountant should choose the one that leads to a lower value or profit and a higher liability. This stems from the accountants' fear that if they prepare the financial reports with too much optimism they may overstate profits and cause dividends to be paid out of capital if these profits are not realized.

Accrual concept

This requires the recognition of items at the occurrence of the transaction and not when cash is received or paid. For example, Income is recorded as earned even though it might have not been received. The portion of income that has not been received is recorded as an asset (accrued income or debtors). Expenses or costs should be recorded as incurred although cash may not have been paid. For example, if rent expenses paid by the year close was UGX 1,500,000 and yet some rent equivalent to UGX 200,000 was used but not paid for, the amount of total rent expense be considered should be UGX 1700,000 (i.e. 1,500,000 + 200,000). The unpaid UGX 200,000 should be recorded as an expense. It should be recorded as current liability in the balance sheet.

Matching concept

This concept requires that revenues from business activities and expenses associated with earning that revenue are recorded in the same accounting period. Business activities for an accounting are summarized in financial reports. To adequately report how a business performed during an accounting period, all revenue earned as a result of business operations must be recorded. Likewise all expenses incurred during the same accounting period in producing the revenue must be recorded.

Matching expenses with revenue gives a true picture of business operations for an accounting period. For example, if income of UGX50, 000,000 was earned during a particular accounting period and rent of UGX 1,800,000 had been paid for one and half years, not the whole UGX1,800,000 should be written off or subtracted from the UGX 50,000,000 because part of the rent belongs to the next year. The correct amount to be subtracted from the income UGX 50, 000,000 is UGX 1, 200,000 (i.e. (1,800,000/18) x 12) and not UGX 1, 800,000. The difference is recorded as prepaid rent.

Likewise if electricity expenses paid was UGX 500,000 but some electricity equivalent to UGX 200,000 was used but not paid, that amount should as well be matched against the income i.e. the amount of electricity expense to be subtracted from income of UGX 50,000,000 should be UGX 700,000 (i.e. 500,000 + 200,000). The unpaid UGX 200, 000 should be recorded as an accrual.

In determining whether, during the accounting period of concern, the accounting entity has had an excess of in flowing values over the out flowing values or vice versa, the inflowing values – revenues are matched against out flowing values - expenses or expired costs. Thus, earned revenues are matched against the costs incurred to earn such revenues whether cash payments or cash receipts are involved or not. This guideline is generally known as accrual accounting. In order to develop this principle fully, let us refer back to historical cost convention and focus specifically on expense s

Expenses are outflows. They represent actual or expected cash outflows or equivalents that have occurred or will occur as a result of the ongoing major or central operations of the enterprise during the period. Depending on the kind of operation and the manner in which expenses are recognized, they are variously referred to as cost of sales, cost of services provided, depreciation, interest, rent, salaries and wages, etc. They are essentially out flowing values as a result of business activity. They reflect the effort to earn revenues.

Accrual accounting records the financial effects of transactions and other events and circumstances in the period in which they-take place rather than only in the periods in which cash is receive or paid. The accounting process recognizes that the buying, producing, selling and other operations of the enterprise during a period, as well as other events that affect enterprise performance, often do not coincide with cash receipts and payments of the period.

Precisely then, the recognition of revenue, expenses, gains and losses and related increments and decrements in assets and liabilities including matching of costs and revenues, allocation and amortization - is the essence of using accrual accounting to measure performance of commercial enterprises.

Subsistence over form

This states that transactions and other events should be recorded in accordance with financial and economic reality (substance) other than their legal form. E.g. in a hire purchase transaction, the buyer takes possession and use of the asset but does not become the legal owner until the last installment has been paid. Though he is not the legal owner, he has to recognize this transaction in his books.

Duality concept (dual aspect)

This is the basis of double entry book keeping and stems from the fact that every transaction has a double (dual) effect on the position of a business as recorded in the accounts. The duality concept explains the fact that in accounting, every business transaction has two (dual) effects on the records of the business.

For example, when an asset is acquired, either another asset (e.g. cash) is reduced, or a liability (promise to pay) is acquired, at the same time. When a business borrows money, a liability to the lender is created, and at the same time an asset (cash) is increased. It follows that the assets of the business are equalled by claims on the business, either by creditors or owners for the funds they have invested in the business and which have been translated into assets for use by the business. The balance sheet which summarizes assets and claims must therefore balance. The double entry system is further explained in chapter three.

Recapitulation

We can state that the foregoing postulates or concepts do provide a comprehensible conceptual structure of the discipline of accounting that is rational and internally consistent. It can, therefore, serve as a "road map" in the accounting process, thereby providing guidelines regarding the qualities to be sought when accounting choices are made. The conceptual frame work of accounting made up of the fundamental accounting assumptions and the generally accepted accounting principles provides guidance in the process of choosing between alternative ways of representing economic transactions.

The primary criterion of choice involves asking which alternative produces- that is, more useful, information. Therefore the alternative is one which produces "more useful information",

ACCOUNTING REGULATORY FRAMEWORK (ACCOUNTING RULES)

Having looked at the accounting principles, qualitative characteristics, users anti so forth, we now have to summarize a number of rules that underlie accounting practice.

Accounting rules are imposed on accountants in order to make sure that their reporting is free from bias. Accounting legislation -requires financial accounts be prepared and presented in conformity with GAAP (Generally Accepted Accounting Principles). GAAP refers to accounting principles or practices that are regarded permissible by the accounting profession. It includes requirements of the company acts, stock exchange etc. the key terms used in accounting regulatory framework include;

- Accounting principles/concepts/conventions
- Accounting bases
- Accounting policies
- Accounting standards
- Accounting principles

Also known accounting concepts, conventions or postulates, are basic ground rules which must be followed when financial accounts are being prepared and presented. They are also referred to as assumptions or prepositions that underlie the preparation and presentation of financial reports. Most of these have already been discussed earlier.

Accounting bases

These are methods developed for applying fundamental concepts to financial transactions and items for the purpose of final accounts and in particular:

- For determining the accounting periods in which revenue and costs should be recognized in the profit and loss account.
- For determining the amounts at which material items should be stated in the balance sheet.

Accounting policies

These are the specific accounting bases selected and consistently followed by a business enterprise as being in the opinion of management, appropriate to its circumstances and best suited to present fairly its results and financial position.

Accounting standards

These are guideline statements or rules issued by professional accounting bodies governing accounting practice, relating to how accounts should be prepared and presented. In Uganda the professional body responsible for issue of accounting standards is the Institute of Certified Public Accountants of Uganda (ICPAU).

Fields of Accounting

Having looked at the major part of the conceptual framework of accounting, let us now look at the particular fields of accounting. There are several accounting fields as a result of varied uses of accounting information. The common fields are financial accounting, managerial accounting, cost accounting, tax accounting, environmental accounting and auditing.

Financial accounting

This is a field of accounting that is concerned with the classification, measurement and recording of business transactions of an entity in monetary terms and in accordance with Generally Accepted Accounting Principles. The major focus of financial accounting is to provide information to external users. External users of financial accounting information include shareholders, creditors, government, financial institutions, and the public.

Managerial accounting

This deals with the analysis and interpretation of accounting information. Managerial accounting provides management with information for internal decision making concerning daily operations as well as planning and control of future operations.

Cost accounting

The determination and allocation of costs to products and services of a business organization is called Cost Accounting. This field of accounting provides information for internal decision making concerning the costs of operating service and manufacturing businesses.

Tax accounting

This is the preparation of tax returns as well as tax planning. Tax accountants use financial statement information to prepare tax returns. These tax returns are filed with the tax authorities like Uganda Revenue Authority in case of Uganda.

Environmental accounting

This is the reporting of environmental activities undertaken by an organisation. Environmental accounting provides information for external users concerning environmental achievements.

Auditing

The independent reviewing and issuing of an opinion on the reliability of accounting records is called Auditing. This is usually the duty of an auditor. The auditor is supposed to check whether the books of accounts are prepared and presented according to the generally accepted accounting principles and whether policies and procedures prescribed by management are being followed. The auditor's opinion enables external users to be confident of the information reported in the financial reports.

Accounting Profession

Accounting is d growing profession worldwide. Accounting employment is usually in:

- Private accounting
- Public accounting
- Government accounting

Private Accounting

This is where qualified accountants are engaged in accounting work of individuals, corporations, non - profit making organizations and or otherwise. Persons employed in private accounting work for only one business. These persons may perform a variety of duties. In small organizations they do all of the summarizing, analyzing and interpreting of financial information for management. In large organizations, accountants typically specialize in one field of accounting such as Financial accounting. Cost accounting, Management accounting, Tax accounting and Social responsibility /environmental/ green accounting

Public accounting

This is the provision of accounting services by highly qualified Certified Public Accountants to various clients, which may include individuals, corporations and government. Persons employed in public accounting may work independently or as a member of a public accounting firm. Public accountants sell services to individuals, businesses, government units and non-profit making organizations. These services include; auditing work, providing management advisory services, providing tax consultancy services such as preparing income tax returns, etc.

Government Accounting

This is the accounting for government institutions e.g. central government, local government, etc. government accounts are unique from private companies and other organizations. Government officials rely on financial information to help them direct affairs of their agencies.

Uganda Revenue Authority; IS one of the government agencies that performs extensive accounting work. It handles income tax returns filed by individuals and corporations, and frequently performs auditing functions relating to these income tax returns and the accounting records on which they are based.

Uganda Securities Exchange Commission is also another government agency involved in accounting. USEC establishes the requirements regarding the content of financial reports and the reporting standards, and the rules and regulations to be followed in order to be listed on the exchange market.

Conclusion

The different financial reports accounts are produced and used by different users for a variety of reasons. Such financial reports must be capable of assuring consistency and comparability _ which is not possible unless every accountant is following the same framework. In short, the desire to provide the same set of accounts for many different parties, and thus to provide a measure that gains their consensus of opinion, means that objectivity is sought in financial accounting.

TUTOR MARKED QUESTIONS

a) Objective type questions.

1. The most important function of financial reports is.

(a) Communication (b) production of documentary evidence

c) Ascertainment of profits (d) None of the above.

2. One of the following is a fundamental accounting assumption. Which is it?

a) Money measurement (b) Realization (c) Matching (d) Duality

3. ………………………….. is the process of formally recording or incorporation of an item into the financial statements of an enterprise.

(a) Realization (b) matching (c) recognition (d) adaption

4. Which of the following does not form part of accounting regulatory framework?

(a) Accounting standards (b) local regulations (c) accounting principles

(d) None of the above

5. The following but one gives the predictive and confirmatory roles of financial statements

a) Consistence (b) Relevance (c) reliability d) Understandability

6. Which of the following concepts requires the practice of crediting closing stock to the trading account?

a) Conservatism b) Consistence c) Matching d) Continuity e) None

(b) Essay type questions:

1) Do you consider accounting to be more of an art than a science? Why?

2) What purpose does accounting serve to society?

3) What is the meaning and significance of the "realization concept" in the accounting process?

4) Between relevance and reliability, which do you consider to be more important? Why?

5) Explain the aspects in which the accounts of a business are affected by the operation of;

a) The "consistency" concept.
b) The "going concern" concept
c) The "prudence" concept

6) The following terms are usually encountered in the preparation of accounts:

a) Fundamental accounting concepts
b) Accounting bases
c) Accounting policies
d) You are required to:

i. Define the above terms

ii. Indicate three fundamental accounting concepts, which are regarded as having a general acceptability; and

iii. Write a short note on two of the three.

7) Discuss the significance of the going concern in accounting. How would you determine whether a business is a going concern?

8) Discuss accounting concepts clearly showing their ability to aid in providing useful information to users.

9) Identify users of accounts clearly bringing out their informational requirements.

10) Is it true that qualitative characteristics alone lead to useful financial statements? Why?

How do you attempt to link these characteristics to postulates of accounts?

11) The Historical cost convention looks backwards but the going concern convention looks forwards"

You are required to:

a) To explain clearly what is meant by

i. The historical cost convention
ii. The going concern convention

b) Does traditional financial accounting, using the historical cost convention, make the going concern principle unnecessary? Explain your answer fully.

c) Which do you think a shareholder is likely to find more useful - a report on the past or an estimate of the future? Why?

12) Explain the qualitative characteristics of financial statements that help in provision of useful financial statements.

Self-review Question -study unit 1

a) State and explain any twelve accounting principles.
b) Exhaustively explain the users of accounting information.

Self-review Answer -study unit 1

a) Accounting principles
    - Entity
    - Money measurement
    - Going concern
    - Materiality
    - Prudence
    - Subsistence

- Accrual
- Duality
- Matching
- Periodicity
- Historical cost
- Consistency
- Realization
- Recapitulation

b) Users of accounting information

- Internal users
  - Management
  - Employees
- External users
  - Shareholders
  - Banks
  - Lenders
  - Creditors
  - Potential investors
  - Debtors
  - Government
  - Donors
  - General public