FOUNDATIONS OF ACCOUNTING

DIPLOMA LEVEL III

DICT
DCM

STUDY TEXT
SYLLABUS

PAPER NO 10: FOUNDATIONS OF ACCOUNTING

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to account for various basic financial transactions, prepare and analyse financial statements.

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Prepare books of original entry and basic ledger accounts under double entry system
- Prepare basic financial statements of sole traders, partnerships, companies and manufacturing entities and not for profit organisations
- Comply with the regulatory framework in the accounting field
- Account for assets and liabilities
- Analyse financial statements by use of ratios and statement of cash flows

CONTENT

1. Introduction to Accounting
   - The nature and purpose of accounting
   - Objectives of accounting
   - Users of accounting information and their respective needs
   - The accounting equation
   - Regulatory framework of accounting (regulatory bodies such as ICPAK, IFAC, IASB, Accounting standards (IAS/IFRS), their importance and limitations and professional ethics)
   - Accounting concepts/principles
   - Qualities of useful accounting information

2. Recording transactions
   - Source documents (quotations, purchases order, statement of account, remittance advice, receipts, petty cash vouchers, sales and purchase invoices, credit notes and debit notes, bank statements)
   - Books of original entry: sales journal, purchases journal, returns inward, returns outward journal, cashbook, petty cashbook and general journal
   - Double entry and the ledger; general ledger, sales ledger, purchases ledger
   - The trial balance
   - Manual versus computerized accounting systems

3. Accounting for assets and liabilities

3.1 Assets
   - Property, plant and equipment — recognition, capital and revenue expenditure, measurement (depreciation and revaluation), disposal and disclosures — property, plant and equipment schedule
- Intangible assets — recognition, measurement (amortisation, impairment and revaluation), disposals and disclosures
- Inventory - recognition, measurement and valuation using specific cost method (FIFO and weighted average cost)
- Trade receivables - bad debts and allowance for doubtful debts and receivables control accounts
- Accrued income and prepaid expenses
- Cash at bank -- cashbook and bank reconciliation statement
- Cash in hand - cash book and petty cash book

3.2 Liabilities

- Bank overdraft - cash book and bank reconciliation
- Trade payables - payables control accounts
- Loans - accounting treatment of repayment of principal and interest
- Prepaid income and accrued expenses

4. Correction of errors and suspense account

5. Financial statements of a sole trader

- Income statement
- Statement of financial position

6. Financial statements of a partnership

- Partnership agreement
- Distinction between current and fixed capital
- Income statement
- Statement of financial position

7. Financial statements of a company

- Types of share capital - ordinary shares and preference shares
- Issue of shares (exclude issue by instalment and forfeiture)
- Types of reserves share premium, revaluation reserve, general reserves and retained profits
- Income tax -Accounting treatment and presentation (exclude computation)
- Financial statements - Income statement and statement of financial position
- Published financial statements -description of a complete set of published financial statements only

8. Financial statements of a not-for-profit organisation

- Features
- Types of funds and their accounting treatment
- Income and expenditure account
- Statement of financial position
9. Financial statements of a manufacturing entity
   - Features of a manufacturing entity
   - Classification and apportioning costs between manufacturing and selling and administration
   - Financial statements - manufacturing account, income statement and statement of financial position

10. Analysing financial statements
   - Statement of cash flows (categories of cash, methods of preparing statement of cash flows and the importance)
   - Financial ratios — definition, categories, analysis and interpretation, application and limitations

11. Emerging issues and trends

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TOPIC 1

INTRODUCTION TO ACCOUNTING

NATURE AND PURPOSE OF ACCOUNTING

Accounting is considered the language of business. It has evolved throughout the years as information needs changed and became more complex. After finishing this article, the reader should be able to have a general understanding about accounting, be acquainted with the different definitions, know the different types of information found in accounting reports, and know the different uses of accounting information.

Some say that accounting is a **science** because it is a body of knowledge which has been systematically gathered, classified, and organized. It could be influenced by a lot of factors, specifically by economic, social and political events. Some say that accounting is an **art** because it requires creative skill and judgment. Furthermore, accounting is also considered as an **information system** because it is used to identify and measure economic activities, process the information into financial reports, and communicate these reports to the different users of accounting information.

To further understand what accounting is, we must take a look at the different definitions.

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<td>Accounting is the process of identifying, measuring, and <strong>communicating</strong> economic information to permit informed judgment and decisions by users of information.</td>
<td>Accounting is the art of recording (journalizing), classifying (posting to the ledger), summarizing in a significant manner and in terms of money, transactions and events which are, in part, at least of a financial character, and <strong>interpreting</strong> the results thereof to interested users.</td>
<td>Accounting is a service activity, which functions to <strong>provide</strong> quantitative information, primarily financial in nature, about economic entities that is intended to to be useful in making economic decisions.</td>
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The first definition emphasizes the following:

- **Identifying** - in accounting, this is the process of recognition or non-recognition of business activities as accountable events. Stated differently, this is the process which determines if an event has accounting relevance.
- **Measuring** - in accounting, this is the process of assigning monetary amounts to the accountable events.
- **Communicating** - As we could notice with the above definitions, one main similarity between the three is the impact of communication. In order to be useful, accounting information should be communicated to the different decision makers. Communicating accounting information is achieved by the presentation of different financial statements.
The second definition emphasizes the following:

- **Recording** - The accounting term for recording is journalizing. All the accountable events are recorded in a journal.
- **Classifying** - The accounting term for recording is posting. All accountable events that are recorded in the journal are then classified or posted to a ledger.
- **Summarizing** - the items that are journalized and posted are summarized in the five basic financial statements.

The third definition emphasizes that accounting is a service activity and that Information provided by accounting could be classified into 3 types:

- **Quantitative information** - this is information that is expressed in numbers, quantities or units
- **Qualitative information** - this is information that is expressed in words
- **Financial information** - this information is expressed in terms of money

Therefore, given the definitions, accounting is a service activity that is all about recording, classifying and summarizing accountable events in order to communicate quantitative, qualitative, and financial economic information, to different users in order to make relevant decisions.

**OBJECTIVES OF ACCOUNTING**

The objectives of accounting can be given as follows:

- **Systematic recording of transactions** - Basic objective of accounting is to systematically record the financial aspects of business transactions i.e. book-keeping. These recorded transactions are later on classified and summarized logically for the preparation of financial statements and for their analysis and interpretation.

- **Ascertainment of results of above recorded transactions** - Accountant prepares profit and loss account to know the results of business operations for a particular period of time. If revenue exceeds expenses then it is said that business is running profitably but if expenses exceed revenue then it can be said that business is running under loss. The profit and loss account helps the management and different stakeholders in taking rational decisions. For example, if business is not proved to be remunerative or profitable, the cause of such a state of affair can be investigated by the management for taking remedial steps.

- **Ascertainment of the financial position of the business** - Businessman is not only interested in knowing the results of the business in terms of profits or loss for a particular period but is also anxious to know that what he owes (liability) to the outsiders and what he owns (assets) on a certain date. To know this, accountant prepares a financial position statement popularly known as Balance Sheet. The balance sheet is a statement of assets and liabilities of the business at a particular point of time and helps in ascertaining the financial health of the business.
• **Providing information to the users for rational decision-making** - Accounting like a language of commerce communes the monetary results of a venture to a variety of stakeholders by means of financial reports. Accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making.

• **To know the solvency position**: By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise, but also it gives the information regarding concern's ability to meet its liabilities in the short run (liquidity position) and also in the long-run (solvency position) as and when they fall due.

### USERS OF ACCOUNTING INFORMATION AND THEIR NEEDS

Users of accounting information could be divided into 7 major groups which could be easily be remembered using the acronym **GESCLIP**. This stands for Government, Employees, Suppliers (trade creditors), Customers/Clients/Consumers, Lenders, Investors, and Public. Let us then discuss each user and find out why they need accounting information.

1. **Government** – the government needs accounting information during its day-to-day operations. The government needs accounting information to assess the amount of tax to be paid by a business or an individual (like the Bureau of Internal Revenue or the Internal Revenue Service when assessing income tax, estate tax, donor’s tax or other taxes); accounting information is needed when determining the fees to be charged in acquiring a business permit or a mayor’s permit; when the Securities and Exchange Commission determines the legality of the amount of share capital subscribed, accounting information is used; when the government deals with certain economic problems like inflation, still accounting information is used. Of course, this list could go on and on.

2. **Employees** – if you are an employee working in the accounting, finance or sales department, definitely, accounting information is essential. However, the use of accounting information is not delimited to employee working under accounting related departments. Employees need accounting information to know if the business could provide the necessary benefits that is due to them. Through accounting information, employees would not be in the dark with regards to the operations of the firm that they are working for.

3. **Suppliers and Other Trade Creditors** – suppliers and trade creditors are providers of merchandise on account to different business establishments. Some examples of suppliers are Coca-Cola and Pepsi. Coca-Cola and Pepsi products that are sold to different fast-food chains and supermarkets but are not paid in cash immediately. Before extending credit to customers, Coca-Cola and Pepsi should look into the accounting records of an entity to determine if they would sell their products on account or not. Telecommunication providers like Smart Telecom, Globe, and At&t, could also be considered as suppliers. Before getting a plan from these telecommunication providers, they ask for different proofs of income from the clients availing of a plan. This is because suppliers could determine from the accounting information if a business or an individual has the ability to pay accounts on time.

4. **Customers/ Clients/Consumers** - Customers need accounting information in order to determine the continuity of a business, most especially when there is a long-term engagement between the parties or if the customer is dependent on the enterprise. For instance, students...