Principles of Financial Accounting

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Dedication

I dedicate this book to the Lord God Almighty for
His Supremacy over all human affairs.

Preface

Accounting is among the subjects that cannot be mastered merely by memorizing the basic principles. It requires, in addition to a sound theoretical knowledge, an intensive practice in the application of the principles.

The book Principles of **Financial Accounting** is a product of several years of teaching experience in the University environment. It has been planned with a three-fold purpose in mind: to provide a conceptual framework within which key financial accounting concepts are discussed; to demonstrate to students the way to tackle various aspects of accounting problems; and to provide students with a wealth of graded practice materials.

The book is primarily intended to be an introductory text for students taking a degree in accounting, finance, business or management sciences with a substantial element of accounting. The textbook is also relevant to students preparing for the following examinations among others:

- Basic Accounting Processes and Systems of the Part One of Accounting Technicians Scheme for West Africa (ATSWA) examination.
- Principles and Practice of Financial Accounting of the Part Two of Accounting Technicians Scheme for West Africa (ATSWA) examination.
- Financial Accounting of the Knowledge Level of the Institute of Chartered Accountants of Nigeria (ICAN) Professional examination.
- Financial Accounting and Financial Statement Analysis of Level One of the Institute of Stock Brokers (CIS) examination.

The extensive use of examples and illustrations of specific concepts and techniques are scattered throughout the body of most chapters. At the end of each chapter there are revision questions with solutions. These questions are intended for students to attempt on their own.

Readers will definitely find this textbook an essential tool for "self-study".

Akinyomi O. John

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Introduction to Accounting

1.1 Introduction

Accounting has been rightly described as the language of business. This is due to the fact that the underlying purpose of accounting is to provide financial information about an economic entity. The information is provided periodically, to shareholders and others connected with the organization to enable them decide the extent to which they want to continue to associate with the organization. The need for accounting is more pronounced in a business where a lot of finance, risk and energy have been involved. Financial information is needed to plan and control the finance and operation of a business.

1.2 The History of Accounting

The history of accounting is closely linked to the development of human society and commerce. In fact, accounting has made significant contribution to both the human society and commerce over the years. The origin of accounting can be traced back to at least 3600BC when trade between tribes in the region of Mesopotamia required records to be kept on stone and clay tablets. In those times, the 'scribes' who possessed a knowledge of writing also served as book-keepers.

It is believed that many of the first examples of what we call 'writing' were actually records of transactions carried out more than 5000 years ago. Such scholars believe that even then there were accounting systems in use that had counterparts for our modern ledgers and receipts.

1.2.1 Accountants and Auditors in Ancient Egypt

The ancient Egyptians had a far more sophisticated system, due largely to their having advanced systems of distribution that required quantities of various commodities to be stored in warehouses and disbursed over periods of time as required. To keep track of where goods were, and what had been consumed, there was one set of scribes that recorded amounts brought into warehouse and another set of scribes that recorded outward movements.

A third set of scribes functioned as auditors, comparing both sets of records and checking them against the quantities remaining in the warehouses. It was a simple way to ensure that the Pharaoh was not being cheated in the transactions that were carried out. Rulers of that period also required accounting records to be compiled for the purpose of taxation. The Roman Empire was run for profit and needed to identify the location and ownership of wealth so that a share could be extracted and returned to finance the expenses and extravagances of its emperors.

1.2.2 Lucia Pacioli and the Contemporary Double Entry Book-keeping

Modern form of double entry book-keeping is traceable to Lucia Pacioli, an Italian monk. In his book titled "Summa de Arithmetical Geometrica, Proportioni et Proportionalita," published in 1494AD on Arithmetic, Geometry and Proportion, he devoted a chapter to expound the principles of the double entry system. It became necessary for managers to report to the owners of businesses during the period under review. Such report would include mainly the following:

- How the financial resources of the business have been invested during the period.
- The profit earned or loss incurred during the period; and
- The assets, liabilities and the owners' equity at the end of the period under review.

After this development, a lot of changes have been witnessed in accounting. These changes were informed by sophistication and complexity of businesses, industrial and political environments which placed more responsibilities on management of business to disclose more information to owners and other interested parties.

1.3 Meaning and Objectives of Book-keeping

Book-keeping includes recording of journals, posting in ledgers and balancing of accounts. All the records before the preparation of trial balance represent the whole subject matter of book-keeping. Thus, book-keeping could be defined as the science and art of recording transactions in money or money's worth so accurately and systematically, in a certain set of books, regularly, that the true state of business' affairs can be correctly ascertained. Furthermore, Book-keeping has also been defined as the art of recording business transactions in a systematic manner.

The objectives of book-keeping include the following:

(a) Book-keeping provides a permanent record of each transaction.

(b) The soundness of a business can be evaluated from the records of assets and liabilities on any particular date.

(c) It enables the preparation of a list of customers and suppliers to ascertain the amount to be received or paid.

(d) It provides opportunities for the review of business policies in the light of past records.

(e) It facilitates the ascertainment of the profitability or otherwise of a business venture.

1.4 Meaning, Objectives and Scope of Accounting

1.4.1 Meaning of Accounting

Accounting is the process of identifying, measuring and communicating the economic information of an organization to its users who need the information for decision making. The American Institute of Certified Public Accountants (AICPA) defines accounting as "the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the results thereof".

Accounting has also been defined as the systematic process of identifying, recording, measuring, classifying, verifying, summarizing, interpreting and communicating financial information. It reveals the profit or loss for a given period, and the value and nature of a business' assets, liabilities and owners' equity. Similarly, accounting can be defined simply as the systematic recording, reporting and analysis of financial transactions of a business.

The American Accounting Association (AAA) defines accounting as the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information. This particular definition provides some key concepts associated with accounting which should be discussed further.

- The definition suggests that accounting is about providing **information** to others. Accounting information is **economic information**. It relates to the financial or economic activities of the business or organization.
- Accounting information needs to be identified and measured. This is done by way of a **'set of accounts'**, based on a system of accounting known as double-entry book-keeping. The accounting system identifies and records '**accounting transactions**'.
- The '**measurement**' of accounting information is not a straight forward process. It involves making judgements about the value of **assets** owned by a business or **liabilities** owed by a business. It is also about accurately measuring how much profit or loss has been made by a business in a particular period. The measurement of accounting information may sometimes require **subjective judgement** to come to a conclusion.
- The definition identifies the need for accounting information to be communicated. The way in which this communication is achieved may vary. There are several forms of accounting communication (e.g. annual report and accounts, management accounting reports) each of which serve a slightly different purpose. The communication need is about understanding who needs the accounting information, and what they need to know.

Generally, however, accounting information is communicated using 'financial statements'.

1.4.2 Objectives of Accounting

The objective of accounting may differ from one business to another depending upon their specific requirements. However, the following are the general objectives of accounting.

(i) **To keep systematic record:** It is very difficult to remember all the business transactions that take place by heart. Accounting serves this purpose of record keeping by promptly recording all the business transactions in the books of account.

(ii) **To ascertain the results of the business operations:** Accounting helps in ascertaining the profit earned or loss suffered in the business during a particular period. For this purpose, business organizations do prepare income statement which shows the profit or loss of the business by matching the items of revenue and expenditure of the period under review.

(iii) **To ascertain the financial position of the business:** In addition to profit, a businessman must know his financial position (i.e., availability of cash, position of assets and liabilities, etc). This helps in the ascertainment of the business financial strength. Financial statements are barometers of health of a business entity.

(iv) **To portray the liquidity position:** Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, cash dividends and other distributions of resources by the enterprise to owners and about other factors that may affect an enterprise's liquidity and solvency.

(v) **To protect business properties:** Accounting provides up-to-date information about the various assets that the business possesses and the liabilities the business owes, so that no one can claim a payment which is not due to him.

(vi) **To facilitate rational decision making:** Accounting records and financial statements provide financial information which help the business in making rational decisions about the steps to be taken in respect of various aspects of business.

(vii) **To satisfy the requirements of law:** Organizations such as private and public limited liability companies are required by law to maintain accounts of their operations.

1.4.3 Scope of Accounting

Although the starting point of accounting is the Financial Accounting, over the years, the scope has become broadened to include: Cost Accounting, Management Accounting, Public Sector Accounting, Taxation Accounting, and Auditing.

1.4.3.1 Financial Accounting

Financial accounting involves an accounting process that starts with book-keeping and ends with the preparation and interpretation of financial statements. The components of financial statements are comprehensive income statement, income statement and statement of financial position. For limited liability companies other statements required by the company laws or standards are; Chairman's Report, Directors Report, Auditors Report, Group Financial Statements, Statement of Accounting Policies, Notes on the Accounts. The financial statements enable owners of the business to assess how efficiently management has run the business.

1.4.3.2 Cost Accounting

Cost accounting is a branch of accounting that provides information to help the management of an organization evaluate production costs and efficiency. It is the branch of accounting which measures, classifies, and records costs. It is also a procedure for accumulating data to provide information for managerial action. Cost accumulation is the collection of cost data in some organized ways by means of accounting systems. The cost accumulated will be related to specific products and departments for planning, control and decision making by management.

1.4.3.3 Management Accounting

Management accounting represents an application of professional skills and knowledge in the area of cost analysis towards solving management problems. It is a field of study, specifically designed for cost analysis and cost reporting for the purpose of equipping management with the requisite information for decision making. It focuses primarily on data gathering, analysing, processing, interpreting and communicating the resulting information for use within the organization so that management can effectively plan, make decisions and control operations.

1.4.3.4 Public Sector Accounting

Public sector accounting is the process of recording, communicating, summarizing, analyzing and interpreting government financial statements and statistics in aggregate and details; it is concerned with the receipts, custody, disbursement and rendering of stewardship on public funds entrusted.

1.4.3.5 Taxation Accounting

The accounting profits generated in the financial statements provide the basis for determining the taxable profits of a company. The taxable profits are different from the accounting profits because certain expenses and income are allowable for accounting purpose but disallowable for tax purpose. A good understanding of the knowledge of these taxable incomes and expenses and non-taxable incomes and expenses would help a business in its tax management. Taxation accounting is that field of accounting which deals with the process of determining the taxable profits of a business or an individual.

1.4.3.6 Auditing

Only complete and reliable financial statements can be of any use to the creditors, investors, government agents and other interested parties. To guarantee these, the accounts must be audited by an independent person called *an Auditor*. Auditing is the independent examination of the books of accounts and records of the company. The professional