ISBN: 978-36284-1-0

LEADING ISSUES IN GENERAL STUDIES:

HUMANITIES AND SOCIAL SCIENCES

Edited by:

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First Published: 2002

Reprinted 2003

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ISBN: 978-36284-1-0

Printed at
UNILORIN PRESS
UNIVERSITY OF ILORIN, NIGERIA

ACKNOWLEDGMENTS

The contributors to this book and the Coordinators of GNS courses wish to acknowledge with thanks the initiative of Prof. Musbau Akanji (Former Director of GNS) for starting this book project. Thanks are due to others who participated in proof-reading, typesetting, and in editing the manuscript. The institutional cooperation and the enabling support of the University of Ilorin Administration is acknowledged as well.

Prof. E. Teju Jolayemi
Director GNS
May 20, 2002.

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BASIC PRINCIPLES AND CONCEPTS OF ACCOUNTING

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INTRODUCTION

This chapter discusses the basic principles and concepts of Accounting. Specifically, the chapter covers the following areas:

- Definition of Accounting
- Various areas of Accounting discipline
- Basic concepts and conventions of accounting
- The principle of double entry in Accounts and classifications of Accounts;
- Sources of financial information;
- Purposes of Accounting information; and
- Users of Accounting information.

DEFINITION OF ACCOUNTING

One of the earliest definitions of Accounting was given by the Committee on Terminology of the American Institute of Certified Public Accountants (AICPA), in 1961 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 result thereof" (A.I.C.P.A, 1961).

Perhaps, a wider definition of accounting is the one given by the committee of American Accounting Association on "the Basic concepts of Accounting" as "the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information" (A.A.A., 1966).

This definition is broader than the first one and places emphasis on the use of accounting information for evaluating the results of past activities and for decision concerning future activities.

The above two definitions bring out the following main components of accounting work.

(1) **Accounting encompasses the recording of financial transactions by an entity.** This is called "Book-keeping".
Financial transactions are those involving money or money worth and occur between an entity and someone outside it. Financial transactions mean business

activities such as sales of goods, purchase of goods, payment and receipt of money, the incurring of an expense, etc. "Events which are at least partly of a financial character" can be interpreted as covering the transfer of resources within the entity (i.e. from one division to another).

The recording must be systematic.

(2) Classification of financial data.
Transactions recorded may not be of much use until they have been properly classified into their distinctive groups.

(3) Summarizing the mass financial data that have been classified.
This is done in such a way that the owners or others who have interest in the business can see the overall effect of all the transactions. The statement produced by the summarizing process will show the profit (or loss) made by the business over a period of time and the total capital employed in the business.

This is the communicating aspect of Accounting. As a matter of fact, accounting is truly an information system.

(4) Analysis and interpretation of accounting report.
This is to ensure that accounting information are used for evaluation and decision making by the management of an enterprise.

SUBDIVISION OF ACCOUNTING DISCIPLINE

Accounting as a discipline can be classified into the following areas of specialization.

1. **Financial Accounting**
This is also called "enterprise accounting". It is the type of accounting applied in all organizations that are involved in buying and selling of goods and services. Since all business enterprises prepare financial statements, they all apply financial accounting.

The purpose of financial accounting is to determine the profit (or loss) made by an enterprise at the end of its financial year. The result of this type of accounting is the preparation of the trading, profit and loss account, and the Balance sheet. The information that is disclosed by these financial statements are not only available for the internal consumption of an enterprise, but also available to the public at large.

2. **Cost Accounting**
This branch of accounting deals with the ascertainment, recording, analysis, interpretation and reporting of cost data. It studies and determines the cost of

production of a product or service. It is employed in manufacturing companies, engineering service enterprise as well as in hospitals for costing of bed spaces.

The purpose of cost accounting is to determine the cost of production of goods or rendering of services in order to enable the management control the costs involved. Thus cost information are only meant for the management and not for outsider's use.

3. **Management Accounting**
This is the advance of cost accounting which provides accounting information to help management discharge its role of directing, forecasting, planning, controlling and decision-making. Management Accounting is the application of professional knowledge and skill in generating and preparing information for use within the organization so that management can more effectively plan, make decisions and control operations.

This type of Accounting is found in large business enterprises.

4. **Government Accounting**
This is the type of accounting that is applicable in government ministries and parastatals. Information generated from Government Accounting is useful to the government and its agencies for taking decisions relating to the rendering of essential public services. Government accounting, especially as practised in ministries and other agencies, is on cash basis rather than on accrual basis as we have in enterprise accounting.

5. **Oil and Gas Accounting**
This type of accounting is applied in oil and gas industry. This is a special area of accounting which takes care of the peculiarity of the petroleum sector. Of recent, the Nigeria Accounting Standard Board (NASB) promulgated statements of Accounting Standard (S.A.S.) No.14 and 17 to regulate the accounting activities in petroleum industry, due to the special nature of this sector.

6. **Taxation**
This is an area of accounting profession which deals with Tax computation, administration and management. Accountants are Tax experts who could assist the government in tax collection and private organization in tax education, administration and management.

7. **Auditing and Investigation**
This is a semi-discipline but a branch of accounting profession which ensures that people relying on accounting information for taking decisions have confidence in it, that it is true and fair. Auditing ensures that accounting information are correct and not misleading. It adds value to accounting information, by making it credible and reliable in its entirety.

Generally, it is believed that practitioners of this sub-discipline (Auditors) are usually called upon to detect fraud.

BASIC CONCEPTS AND CONVENTION OF ACCOUNTING

Accounting concepts and conventions are the fundamental rules, principles and assumptions which form the basis for the preparation of financial statements.

These concepts and conventions which are contained in the Statement of Accounting Standard (S.A.S.) No. 1, are explained below:

1. **Business Entity Concept**
   In Accounting, every economic unit regardless of its legal form of existence, is treated as a separate entity from parties having proprietary or economic interest in it.

   The concept stipulates that the assets and liabilities (be it sole trading, partnership or registered company) of the business must be kept separate from that of its owner(s).

2. **Going Concern Concept**
   The assumption is that the business unit will operate in perpetuity; that is, the business is not expected to be liquidated in the foreseeable future. A business is considered a going concern if it is capable of earning a reasonable net income and there is no threat from any source to curtail significantly its line of business in the foreseeable future. If the accountant perceives that the business will fold up in a near future, he must prepare the accounts to suit the purpose of winding up, as assets will be valued at liquidation values.

3. **Periodicity**
   This concept holds that the entire life of a business enterprise is divided into financial periods (usually in years) called financial years and accounts are prepared relating to these periods.

4. **Realization**
   This concept establishes the rule for the period recognition of revenue on the following conditions:

   (a) The revenue is capable of objective measurement; and
   (b) The value of asset received or receivable in exchange is reasonably certain.

It is possible to recognize revenue at a variety of points e.g. point of procuring raw material for manufacture when goods are produced; point of delivery or when transaction is completed. In these cases the point of realization will depend on the industry norm and the appreciation of 'critical event' theory.

Normally, sales are realized when a sale has taken place, whether or not cash has been received.

5. **Matching Concept**
This states that for any accounting period, the earned revenue and all costs incurred in generating that revenue must be matched and reported together for that period. If there is any cause to postpone any revenue, the associated costs incurred for its generation must also be postponed.

6. **Money Measurement Concept**
In accounting, it is those transactions that are conducted in money (e.g. in ₦, £, $, ¢, etc.) that are recorded in the financial accounts of a firm.

7. **Historical Concept**
This holds that cost is the appropriate basis for initial recognition of all assets acquisitions, services rendered or received, expenses incurred; and it also holds that subsequent to acquisition, cost values are retained through the accounting process.

8. **Consistency Convention**
This holds that when a company selects a method of accounting, it should continue (unless condition warrants a change) to use that method in subsequent periods so that a comparison of accounting figures over time is meaningful.

9. **Prudency Convention**
It states that the accountant should exercise great care in the recognition of profit, while all known losses are adequately provided for. Profit should not be overstated while possible losses must be provided for.

10. **Materiality Convention**
This holds that only items of material values are accorded their strict accounting treatment. An item will be considered material if its omission or misstatement could distort the financial statement such that it influences the economic decisions of users taken on the basis of the financial statement.

THE PRINCIPLE OF DOUBLE ENTRY AND CLASSES OF ACCOUNTS

An account is a ledger record, in a summarized form, of all transactions that have taken place with the particular person or value e.g. Osayinro s A/C plant A/C, Wages and salaries A/C, etc., while a larger ledger is the principal book of accounts. An account has a "T" shape with the left hand side called the debit (Dr) side and the right hand side called the credit (Cr) side.

The principle of double entry which was formulated by a mathematician, Rev. Father Lucas Pacioli in 1494, stipulates that for every transaction, there must be a debit entry in one account and a corresponding credit entry in another account and vice versa. The debit side is the receiving side, while the credit side is the giving side. What is being received or given could be money, goods or services.

Examples of Accounts

(i) Rent of N₦50,000.00 was paid by Mr. Peter to his landlord on 1st April 1999 by cash; the double entry in the accounts are:

Dr.	Rent		A/C	Cr	Dr	Cash	A/C		Cr
		₦							₦
1/4/99	cash	50 000.00					1/4/99	Rent	50,000.00

(ii) Goods worth ₦600,000.00 were sold by cash on 1st July 1999.

Dr.	Cash		A/C	Cr	Dr	Sales	A/C		Cr
		₦							₦
1/7/99	Sales	600,000.00					1/4/99	cash	600,000.00

Accounts can be classified mainly into:

(I) Personal Accounts and (II) Impersonal accounts.

1. ***Personal Accounts (Personal Ledger)***

These are accounts of persons or entities e.g. Mr. Daniel's A/C, Oseka Plc. A/C, etc. Personal accounts can further be sub-classified into the following:

i) *Debtors A/C*: Accounts of persons or entities owing the (Sales ledger) business.

ii) *Creditors A/C*: Accounts of people or entities which (Purchase ledger) the business is owing money.

iii) *Private A/C*: These are accounts that are confidential e.g. Capital A/C, Bank A/C, Drawings, etc.

2. ***Impersonal Accounts (Impersonal Ledger)***
These are the accounts of revenue and expenses, e.g. sales A/C, motor vehicle A/C, etc. These can further be subdivided into:

(i) *Real A/Cs (Real Ledger)* – These are the accounts of tangible assets e.g. Building A/C, Machinery A/C, Motor Vehicle A/C, etc.

(ii) *Nominal A/Cs (Nominal or General Ledgers)* – These are the accounts for revenue and expenses e.g. sales A/C, purchases A/C, wages and salaries A/C, etc.

SOURCES OF FINANCIAL INFORMATION

The following are the major sources of financial information:

i. Profit and Loss Account: This account is prepared to determine the amount of profit or loss made by an enterprise at the end of its trading year. It is usually prepared at the end of 12 months.

ii. Balance Sheet: This is a statement of affairs and it is meant to show the financial position of an organization at any particular date. It is usually prepared at the end of the financial year after the preparation of the profit and loss account. It shows the assets, liabilities and the net worth of the enterprise at the date of the balance sheet.

iii. Statement of Cash flow: According to S.A.S. 18, it is a statement, which provides information about the cash receipts and cash payments of an enterprise over a given period. It indicates the pattern of cash generation and utilization. It is designed to shed light on an enterprise's financial strength.

iv. Value added Statement: It reports on wealth created by an enterprise during the period covered by the financial statement (S.A.S. 2). It usually shows how the wealth created is distributed among various interest groups (e.g. employees, government, creditors and proprietors).

PURPOSE OF ACCOUNTING INFORMATION

Accounting information serves the following purposes.

1. **Measurement of Performance**
Accounting provides information for measurement of the past performance and current financial position of an enterprise. This will indicate whether profit or loss is being made. Financial accounting provides this 'score-keeping' information.

2. **Stewardship Reporting**
Where an enterprise is not managed by its owners as in the case of limited liability companies, the preparation of financial statements is a means of rendering accounts by the Board of Directors (who are stewards) to the shareholders who are owners of the company and appointed them to such position. The information given in the financial statements will show the level of accountability shown by the management (Board of Directors).

3. **Decision Making**
As given in one of the definitions of accounting, it is meant to communicate information to users thereof to permit an informed decision making by them. The management can use financial, cost and management accounting information for management decisions, while the investors (current and potential) use information generated from financial accounting for investment decision (i.e. to decide whether or not to invest).

4. **Planning and Forecasting**
Information can aid a business organization in effectively estimating future performance. Future events can be predicted with the use of information generated from cost and management accounting systems. With such accounting information, an enterprise can make budget for its business activities.

5. **Information for Control Purpose**
Management accounting information are relevant to management for the purpose of controlling the enterprise activities. Control requires the taking of corrective action where there is a deviation from plan (budget). Budgetary control tool becomes relevant in controlling the activities of an enterprise.

6. **Evaluation**
Information generated from accounting system can be used in assessing the performance that has been achieved.

USERS OF ACCOUNTING INFORMATION

The question is: Who needs accounting information?

The following people or group of people need accounting information:

1. **Owners/Shareholders**
Owner(s) or shareholders need information regarding the performance of their firm. They want to know whether there is enough return on their capital. They are also interested in the profitability of their firm.

2. **Management of Enterprise**
The management of companies requires accounting information for planning organizing and controlling of the activities of the organizations. Without accounting information, the managers cannot discharge their roles efficiently.

3. **Bankers/Lenders**
Banks and others who lend money to the firm are primarily concerned with information regarding the ability of the business to generate the liquid resources to make necessary interest payments and repayment of principal. Such information can be obtained from financial statements.

4. **Customers**
The information requirements of customers relate to product prices, quality and reliability; they are also interested in knowing whether or not the firm is financially sound so as to ascertain whether or not to continue to rely on the firm for the supply of their goods or services. These information can be found in the financial statements.

5. **Suppliers**
The suppliers require information on the liquidity of their customers as to determine the firm's ability to pay for goods supplied to it on credit. The financial statement provides these pieces of information.

6. **Employees**
Employees of an enterprise are interested in the financial statements of their organization so as to be properly armed with information (about its profitability and liquidity) for wages and salary negotiation.

7. **Financial Analysts**
This group uses financial information to earn a living by analyzing financial statements of companies and other economic data and offer expert opinions based on the analysis made.

8. **Government Agencies**
The following government agencies require financial information about companies.

   (i) ***Tax authority*** – they require financial statements for assessing and determining the amount of tax to charge a taxpayer.
   (ii) ***Corporate Affairs Commission (C. A. C.)*** – The CAC requires every public company to file with it the annual financial statements.
   (iii) ***Federal Office of Statistics, CBN and other bodies*** use accounting information.

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