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.

Accounting as a Science	**Accounting as an Art**	**Accounting as an Information System**
Accounting is the process of identifying, measuring, and **communicating** economic information to permit informed judgment and decisions by users of information.	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 **interpreting** the results thereof to interested users.	Accounting is a service activity, which functions to **provide** quantitative information, primarily financial in nature, about economic entities that is intended to to be useful in making economic decisions.

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.

a. Buying extra equipment means that the equipment balance will increase by Sh 5,520 and the creditors will also increase by the same amount.
b. Buying extra stock by cheque means that the level of stock goes up by Sh 2,280 and the balance at bank reduces by the same.
c. Paying creditors by cheque reduces the balance on the creditors account and also reduce the amount at the bank.
d. Debtor paying the firm reduces the debtors balance by Sh 3,600 and increases the cash at bank and cash in hand by Sh 3,360 and Sh 240 respectively.
e. Additional cash of Sh 1,000 increases the cash in hand balance by Sh 1,000 and the capital balances.

This is also summarized as follows:

Assets/Liabilities	**Opening Balance**	**Adjustment Increase / Decrease**	**Closing Balance**
Equipment	46,000	5,520	51,520
Motor Vehicle	25,160		25,160
Stock	24,600	2,280	26,880
Debtors	23,080	-3,600	19,480
Cash at bank	29,120	(-2,280 - 3,160 + 3,360)	27,040
Cash in hand	160	(+240 + 1000)	1,400
Creditors	15,800	(+5,520 - 3,160)	18,160
Capital	132,320	1,000	133,320

The balance sheet will therefore be prepared as follows:

Mwangi
Balance sheet as at 1st May 2012

	Sh	**Sh**
Non-Current Assets		
Equipment		51,520
Motor vehicle		25.160
		76,680
Current Assets		
Stock	26,880	
Debtors	19,480	
Cash at bank	27,040	
Cash in hand	1,400	74 800
		151,480
Current Liabilities		
Creditors		18,160
Capital		133,320
		151,480

distinct principle in their respective frameworks due to the difficulty of defining it separately from other accounting principles particularly reliability and faithful representation.

Comparability/Consistency

Financial statements of one accounting period must be comparable to another in order for the users to derive meaningful conclusions about the trends in an entity's financial performance and position over time. Comparability of financial statements over different accounting periods can be ensured by the application of similar accountancy policies over a period of time.

A change in the accounting policies of an entity may be required in order to improve the reliability and relevance of financial statements. A change in the accounting policy may also be imposed by changes in accountancy standards. In these circumstances, the nature and circumstances leading to the change must be disclosed in the financial statements.

Financial statements of one entity must also be consistent with other entities within the same line of business. This should aid users in analyzing the performance and position of one company relative to the industry standards. It is therefore necessary for entities to adopt accounting policies that best reflect the existing industry practice.

Example:

If a company that retails leather jackets valued its inventory on the basis of FIFO method in the past, it must continue to do so in the future to preserve consistency in the reported inventory balance. A switch from FIFO to LIFO basis of inventory valuation may cause a shift in the value of inventory between the accounting periods largely due to seasonal fluctuations in price

Comparability/Consistency

Financial statements of one accounting period must be comparable to another in order for the users to derive meaningful conclusions about the trends in an entity's financial performance and position over time. Comparability of financial statements over different accounting periods can be ensured by the application of similar accountancy policies over a period of time.

A change in the accounting policies of an entity may be required in order to improve the reliability and relevance of financial statements. A change in the accounting policy may also be imposed by changes in accountancy standards. In these circumstances, the nature and circumstances leading to the change must be disclosed in the financial statements.

Financial statements of one entity must also be consistent with other entities within the same line of business. This should aid users in analyzing the performance and position of one company relative to the industry standards. It is therefore necessary for entities to adopt accounting policies that best reflect the existing industry practice.

elearninginkenya@gmail.com Whatsapp: 0705437337