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978-0-521-70116-7 - Accounting for CAPE

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Unit One

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Module One

Accounting Theory, Recording and Control Systems

1 The nature and scope of financial accounting

Objectives

- discuss the development of accounting
- identify the users of accounting information and their needs
- discuss the significance and limitation of accounting information
- illustrate the accounting cycle

1.1 The development of accounting

Prior to the development of the double-entry system of accounting by Luca Pacoli in 1494, the recording of business activity was performed very crudely. As businesses grew in number and in size, there was also a need for recording procedures to keep pace with these changes. Hence, the initial **stewardship** role of simply securing cash developed into a system of accounting, which involves the recording, summarizing, and analysing of data on which the efficient operation of a business depended.

Even though the number of services in accounting expanded, there was still a need to concentrate on certain aspects of business activities, which give rise to two common branches of accounting, namely financial accounting, and cost and management accounting and tax accounting. The simple stewardship task of securing and recording cash is now encompassed in financial accounting. Cost and management accounting was identified as a tool to help managers in making business decisions.

The data collected by early accountants merely reflected receipts and payments of cash. Today, the practice is to **match** income earned with the expenses incurred (expenses) in earning said income.

In the quest for consistency in how businesses record and present their financial information the accounting profession has developed and instituted organized **rule-making authorities**. The Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) are two such regulatory bodies instituted to ensure consistency and understandability of accounting information.

The functions of such agencies deal with all issues in accounting. Their role ensured that they consider public opinion on accounting matters; settle controversies;

interpret and clarify accounting policies; set standards and ensure compliance.

The function ranges from creating generally accepted accounting principles (GAAP) and concepts to adhering to state laws. GAAP are broad guidelines, conventions, rules and procedures of accounting designed to promote good accounting practices and reduce illegal or unethical practices. So stringent are standards that there is even an official procedure for instituting them.

As businesses expand and financial relationships with customers and suppliers change, cash basis accounting had to be enhanced with accrual basis accounting. The widespread use of credit facilities demanded that accounting take this aspect of business transactions into consideration.

Even the trend of simple **reports** to determine profit or loss or statements of ownership of property and liability has mushroomed into complicated Income Statements; detailed Balance Sheets; explanatory cash flow statements and summarized statements of owner's equity. The preparation of these reports demand manipulation of basic information and reflect the sophisticated level to which accounting has developed.

So complex is accounting that the efforts of the untrained custodian will not suffice. Today accounting is a profession requiring **accreditation** and **certification** of individuals and is important to the growth and development of businesses. In many countries Accounting Professionals are organized into groups that oversee the practice of accounting.

Examples of professional accounting organizations in the Caribbean are

- Institute of Chartered Accountants of Antigua and Barbuda (ICAAB)
- Bahamas Institute of Chartered Accountants (BICA)
- Institute of Chartered Accountants of Barbados (ICAB)

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- Institute of Chartered Accountants of Guyana (ICAG)
- Institute of Chartered Accountants of Jamaica (ICAJ)
- Institute of Chartered Accountants of Trinidad and Tobago (ICATT)
- St. Kitts/Nevis Association of Chartered Accountants

These organizations are part of the Institute of Chartered Accountants of the Caribbean (ICAC) and the International Federation of Accountants (IFAC).

1.2 Users of accounting information

Internal	External				
Management	Those with direct financial interest	Government	Regulatory agencies	Economic planners	Other groups
Owners	Present investors	Inland Revenue	Stock exchanges	Financial advisors	Employees
Partners	Potential investors	Value added tax	Securities and Exchange Commission	Stock brokers	Labour unions
Board of directors	Creditors	Government planners		Financial press	Customers
Managers	Banks				General public
Department heads	Other lending agencies				
Supervisors					

1.3 Questions asked by users

Internal	External
<ul style="list-style-type: none"> • Can we afford to hire new employees or increase wages? • Is there sufficient cash to honour obligations? • How much does it cost to produce one unit? • Can we invest in new equipment? 	<ul style="list-style-type: none"> • Is the business making profits? • Can the company afford to pay dividends? How much? • Will the business be able to meet its obligations when they fall due? • How is the business performing in comparison to its competitors? • Is this merger, acquisition or takeover of any benefit to us? • Is the company following accepted standards when preparing its financial statement?

1.4 The significance of accounting information

The importance of accounting information is to facilitate planning and decision-making. Although the accounting process uses previous economic activities of an entity, the information is still useful in

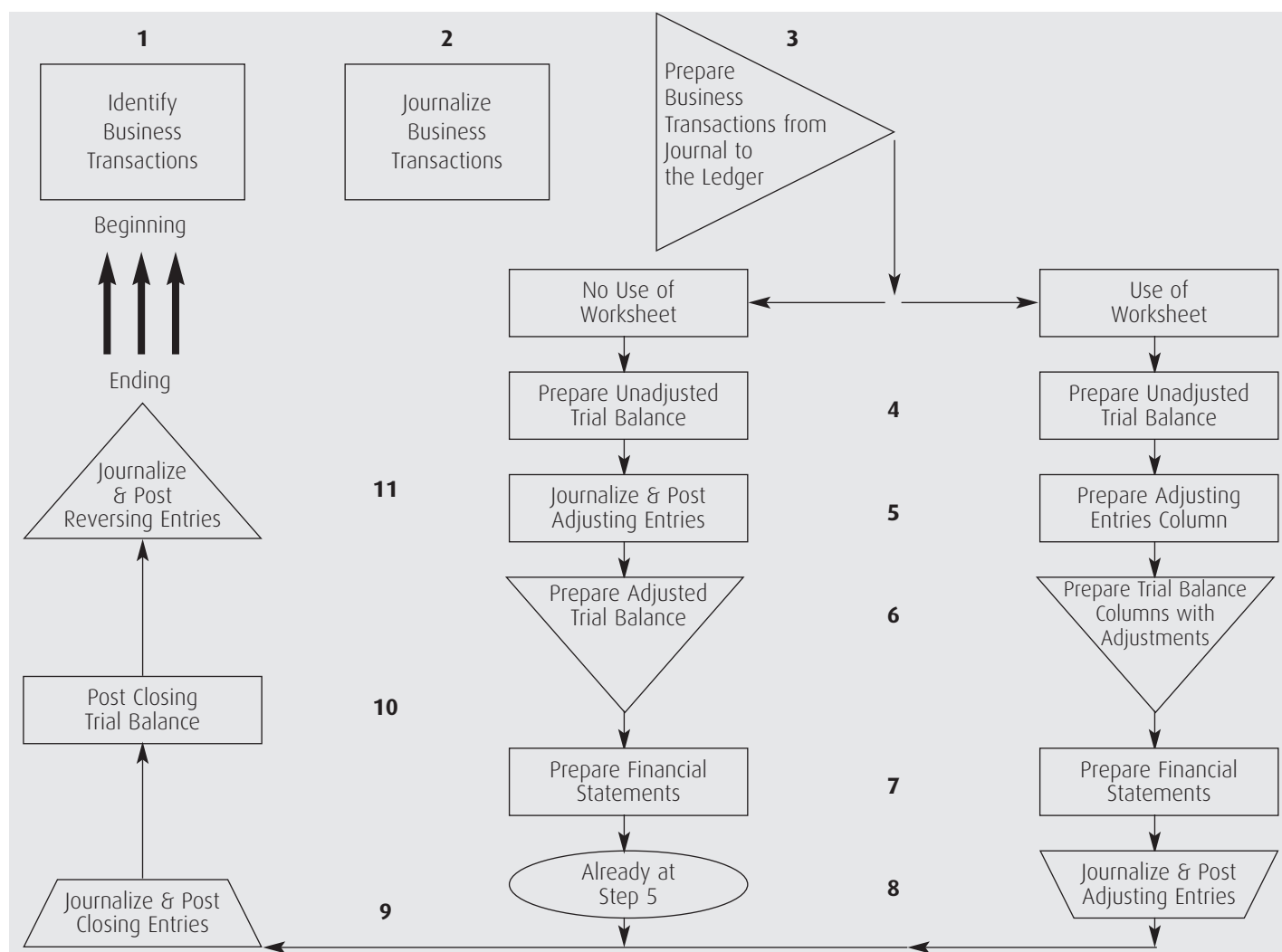
1. deciding how resources are to be allocated;
2. evaluating the potential of the entity to earn profits; and
3. calculating the risks involved.

1.5 The limitations of accounting information

Despite the usefulness of accounting information, there are some limitations:

1. An accounting system can only record items that can be given a monetary value and so fails to give a complete picture of the business.
2. The accounting process uses previous economic activities of the business to form the basis of accounting records.
3. The accounting process cannot reflect the mood of the business.
4. Many items on the financial statement are the result of estimates, e.g. provision for depreciation and doubtful debts.
5. Analysing aggregated information is difficult.
6. Preparation of the financial statement at a particular date may not reflect the trend for the year. For example, a firm may experience low sales throughout the year but in the last month of the year there was a sales increase.
7. Accounting policies differ between firms and this makes comparison difficult.

1.6 The accounting cycle



1.7 Explanation of the accounting cycle

During the accounting period	End of the accounting period	Beginning of the accounting period
Steps 1. Gathering of information on economic events.	Steps 4. Listing all the accounts and their balances to check the equality of debits and credits.	Step 11. Reopening of all real and personal accounts with balances.
2. Condensing the information in chronological order in day books.	5. Recording those economic events not supported by business documents.	
3. Transferring information to the ledger from day books.	6. Making final checks on accuracy before preparing the financial statements.	
	7. Preparing the financial statements for external users.	
	8. Recording adjusting entries in the journal and the ledger.	
	9. Closing the temporary accounts and recording the net income in retained earnings.	
	10. Making a further check on the equality of debits and credits after including the closing entries.	

1.8 Extended questions

- 1 Which of the following groups has only external users of accounting information?
 - (a) Owners Present investors Stock Exchange
 - (b) Potential investors Government planners Stock Brokers
 - (c) Managers Board of Directors Partners
 - (d) Government planners Partners Supervisors
- 2 Which of the following is **not true** about accounting information?
 - (a) It reflects the mood of the business.
 - (b) Only events with monetary value are recorded.
 - (c) Different policies make comparison between companies easy.
 - (d) Aggregated information is difficult to analyse.

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- 3 (a) Using the graphic below, enter the users of accounting information.
- (b) Indicate which are external users and which are internal users.
- (c) Indicate the direction of flow of information by using either a one-headed arrow or a two-headed arrow.
- (d) State briefly the purpose of each user-group's interest.
- Note.** Provide key to diagram.
- 4 Modern day accounting has developed beyond mere stewardship of cash. Discuss.
- 5 Financial statements are prepared mainly with external users in mind. Discuss.
- 6 Discuss the statement: 'accounting information is too historical to be of any use'.
- 7 Discuss some of the limitations of accounting information.
- 8 Present the accounting cycle in the form of a diagram giving the correct sequence of steps with explanations.

