MAKERERE UNIVERSITY BUSINESS SCHOOL

PRINCIPLES OF ACCOUNTING NOTES

TOPIC 1: Introduction to accounting and accounting concepts

Definition:

Accounting can be defined in several ways.

i) It can be defined as an art and a science of recording, classifying transactions in the books, summarizing and communicating financial information through the production of financial statements and reports and the interpretation of the operating results to facilitate decision making.
ii) It is the process of identifying, measuring, and communicating economic information to the users to allow rational decisions to be made.
iii) Accounting is a language of business through which business information is communicated to the users to aid them make informed decisions.
iv) It is explaining and defending (justifying) actions and effect or results of those actions. These actions must be of financial character.

From the above definitions, accounting is a process that involves the following:

- Capturing business events (transactions) using various source documents like receipts, invoices etc. The transaction may be; sale of goods, expenses incurred, purchase of goods among others
- Recording transactions in books of account (accounting records) like the cash book.
- Summarizing the financial information for a period in financial reports. Accounting information mainly includes financial information.
- Communicating (reporting) the financial information to interested users of the financial information (called stakeholders) to enable them make informed decisions about the entity.
- The financial information relates to the:

- Financial position at a point in time – this shows assets, the liabilities and capital of the entity (shown in a statement of financial position or balance sheet).
- Performance over a period of time – this shows how much profit or loss has been made by the business (shown in a statement of income or profit and loss).

Accounting Vs Accountability.

The role of accountants goes beyond the payment and receipt of money. They must defend and justify their actions. Ancient merchants had stewards who were required to give them accountability regarding the changes in their wealth that was in their custody.

Therefore since accountants deal with money, they, together with the management must justify and defend their financial statements to the owners of wealth; shareholders, and other interested parties like the customers.

Financial accountability methods.

Managers and accountants are required to show qualities of good financial management by submitting accountability of money received and spent to the owners. The following are the methods of accounting:

1- Production of documentary evidence: This involves producing documents as evidence of money received and spent. It is one of the popular methods of accountability. Some of the documents include;

- Receipts
- Vouchers
- Invoices
- Debit notes
- Credit notes
- Purchase orders
- Etc
- These are called source documents and are supposed to be attached and submitted to the auditors for examination.

2- Books of accounts: When the accounting period ends, financial statements/reports/or final accounts are prepared to show the result of the operation of the ended period. Major reports include:

i) The income statement (the profit &loss a/c) now called ***the statement of comprehensive incomes and expenses.***

ii) The balance sheet ***/the statement of financial position*** and

iii) The cash flow statements

Accountants and managers should be ready to defend these statements. Other supplementary statements such as bank reconciliation statements, trial balances and budget performance reports are also required.

3- Output/results. Today, the focus of accounting has moved from paper accounting to value for money. Results are emphasized to show the evidence of money well utilized.

NB: The first stage of accounting that involves recording of transactions is called **Book keeping.** The work of the book keeper stops at the preparation of the trial balance. An accountant has a responsibility of analyzing the transactions.

Types of Business Entities

Sole proprietorship: this is a business owned and managed by one person, he/she is fully and personally liable for business losses. There may be other employees

Partnership: this is a business jointly owned by partners (two or more people), they are jointly and severally liable for any business losses.

Company: this is a business owned by many people (called shareholders or members), their capital is divided into shares and they elect directors to manage the company. There is separate legal entity of the business from its owners, most companies are limited liability companies

The shareholders provide resources (capital) to management and expect efficient use from them through proper management and running of the business (good corporate governance) for their wealth to be maximized. The management (directors) in turn prepare financial statements which are audited by independent auditors (to provide assurance to users, shareholders inclusive) that the statements are true and fair to be relied on to make informed decisions. The statements show the performance and position of the business

Note. Read about features, advantages, disadvantages and formation

USERS OF ACCOUNTING INFORMATION.

These are persons or organizations who/which are interested in the accounting information of the given entity. They are either internal or external.

User	Main information needs
Management (Internal)	• Assess profitability of the whole business, branch, product etc • Control the business e.g. by comparing the budget with actual results • Plan for the future e.g. budgets, cash requirements etc. • Information must be detailed and up to date e.g. monthly
Investors	• Profitability of the firm by examining past and future performance • Security of their investments e.g. the financial strength shown by the balance sheet
Lenders	• The cash position and solvency of the business to establish whether the loans and interest will be • The value of assets for security for loans in the balance sheet
Shareholders	• Examine performance of the company and decide either to remain with the current holding, buy more or divest (sell shares) • Possible dividends
Suppliers	Ability to pay debts by examining the financial position
Customers	Want to know whether the business will continue to supply them in the future, going concern issues, sales growth, new product development, investment in the business e.g. production capacity
Competitors	Performance of others in order to make strategic plans

Employees (Internal)	• Secure employment • Possible pay rises by looking at the profitability of the business • Salaries and benefits enjoyed by senior management
Government	• Performance of the companies in order to formulate economic policies • Tax authorities use financial statements for tax assessment • Regulation of competition, takeovers, grants • Environment issues
The public	• Provision of local employment by examining profitability and expansion plans • Corporate social responsibility programmes • Product / service quality • Environmental issues

Generally, users are interested in three main areas:

- Profitability
- Solvency / liquidity
- Risks of operation

Role of Accounting

The ultimate role of accounting in business is to help interested parties, both internal and external make informed business decisions. Besides that, preparation of accounts plays the following roles;

- Communication of financial position
- Ascertainment of profit or loss
- Assessment of tax
- A tool for management control
- To facilitate credit transactions
- Base for further planning
- Business evaluation and decision making

Roles of an accountant

- preparing accounts and tax returns
- auditing financial information
- compiling and presenting reports, budgets, business plans, commentaries and financial statements
- analysing business plans
- providing tax planning services based on current legislation
- financial forecasting and risk analysis

- dealing with insolvency situations
- negotiating the terms of business deals with clients
- meeting and interviewing clients
- managing colleagues.
- Budgeting
- Processing Payroll
- monitoring cash flow
- tax complianceregulatory adherence

Code of ethics of an accountant.

- The fundamental principles within the Code are:-
- integrity,
- objectivity,
- professional competence and due care,
- confidentiality and
- professional behavior – establish the standard of behavior expected of a professional accountant (PA) and it reflects the profession's recognition of its public interest responsibility.

BRANCHES OF ACCOUNTING:

There are three broad categories. namely:

1). Private accounting
2).Public accounting
3).Government accounting.

PRIVATE ACCOUNTING.

This is the type of accounting that exist in a particular entity or organization usually a business firm though non-profit making organizations also have to use private accounting. It includes the following disciplines:

i).Financial accounting
ii).Cost accounting
iii).Management accounting and
iv).Social responsibility/environmental/green accounting.

FINANCIAL ACCOUNTING.

This is a branch of accounting that is concerned with the classification, measurement and recording of business transactions of an entity in monetary terms and in accordance with GAAP (Generally Accepted Accounting Principles). After a specified period of time (accounting /trading period), normally a year, accounting information is disclosed/communicated to the interested parties through financial statements i.e. the income statement, the balance sheet, and the cash flow statements.

The focus of financial accounting is to provide information to the outsiders (stakeholders). In order to protect the interests of the stakeholders, the preparation and presentation of financial statements is regulated by the Accounting regulations, and financial accounts must be subjected to Audit.

The information in financial accounts is summarized and historical, hence not very convenient for managerial decisions which are most of the time futuristic. However, the govt needs it for assessing tax.

COST ACCOUNTING.

It is primarily concerned with cost determination and allocation of costs to products and services in accordance with costing principles, methods, and techniques. Determining product costs and assigning costs to products is called *COSTING.*

Costing products with a view of setting selling price is very crucial. Costs should determine the least price to be charged to a product; unless the environment is too competitive in which case we may have to use the ruling market price. Cost control is also crucial.

MANAGEMENT ACCOUNTING.

The emphasis of management accounting is to provide the information to management for execution of their functions aimed at facilitating planning, control, and decision making. Management accounting is primarily concerned with *data gathering, processing, analysis, interpretation, and communication* of the resulting information to mgt so that they can more effectively plan, control operations, and make decisions.

There is no clear dividing line between cost accounting and Mgt accounting. Cost accounting is an important source of information for mgt purposes.

Mgt accounting arose when there was a need to bring an accountant closer to the mgt. i.e. advice received from an accountant is important in that situation.

SOCIAL RESPONSIBILITY ACCOUNTING.

This is the new phase in accounting and it widens the scope by considering social effects of business activities as well as their economic effects. The demand for social responsibility accounting stems from an increasing awareness and concern for undesirable by-products of economic activities that degrade the environment. A company might have made huge profits but when we consider the costs to the environment, the overall effect might be in a negative.

Companies are supposed to pursue their profit objectives but leaving the environment green (green revolution).

PUBLIC ACCOUNTING:

The certified public accountants (CPAs), offer a variety of services to the public. These are professional, qualified, certified and chattered accountants, and belong to a governing body that regulates standards of performance. Practicing members do adhere to a code of ethics. Before one is accepted to enroll as a public accountant, he must possess CPA(K), CPA(U), ACCA, CIMA, e.t.c Public accountant do auditing work, provide tax consultancy services such as preparing tax returns, provide Mgt with advisory services such as designing and installing accounting systems and budgetary procedures.

Auditing. This is the most familiar role of the CPAs. Auditing is the examination of financial statements and underlying books of accounts and documents of an organization with a view to reporting whether the financial statements show a true and fair view of the financial stand/position. Auditing gives financial statement credibility and protects users from manipulated accounts. Auditors check whether the accounts prepared and the financial statements are in accordance with Generally Accepted Accounting Principles (GAAP).

GOVERNMENT ACCOUNTING:

Government needs accountants to develop and maintain accounting system. Government accounts are quite unique from accounts of other organizations. Government accounting emphasize budget discipline, by spending according to the amount voted (allocated). The types of accounts to be maintained and reports to be prepared are spelt out in the financial regulations or accounting manuals. In Uganda, central govt accountants refer to treasury accounting instructions while their counterparts in local govt refer to the local govt regulations.

THE ACCOUNTING REGULATORY FRAMEWORK (accounting rules).

The accounting information must be of good quality (credible) and objective especially for the interest of several users.

Therefore, they are prepared according to given regulatory or legal framework. This is to ensure that accountants report objectively without window dressing/doctoring the accounts. The accounting rules are imposed on the accountants in order to make sure that their reporting is free from bias. Accounting legislation requires that external financial accounts be prepared and presented in conformity with GAAP.

GAAP refers to accounting principles or practices that are regarded as permissible by the accounting profession and has substantial authoritative support. The boundaries of GAAP extend far beyond the accounting principles contained in the accounting standards. GAAP includes; the requirements of the companies act, stock exchange and other acceptable accounting treatment not incorporated in the official literature.

Accounting principles, bases, standards, policies and GAAP

Accounting principles / concepts

These are:

- Basic rules that are followed in accounting.
- Broad assumptions underlying the financial statements.

These are the foundation of accounting.

Accounting bases

These are methods used in applying the accounting concepts to arrive at amounts to be included in the financial statements.

They show how we measure figures to be included in the financial statements.

The bases follow the accounting concepts. There are a number of accounting bases e.g.

- Historical costs i.e. the amount that was paid to acquire an asset
- Fair value i.e. the current market price for an item

Accounting standards

These are authoritative statements issued by a professional accounting body containing rules to be followed when accounting for transactions to be included in financial statements.

Accounting standards are now called financial reporting standards.
The standards explain how specific business transactions are measured and disclosed in financial statements.

The standards are based on accounting concepts.
In Uganda, the Institute of Certified Public Accountants of Uganda (ICPAU) issues the standards (they adopted the International financial reporting standards (IFRSs)).
For example, there is a standard on inventories (IAS 2) that shows how to account for inventories.

Accounting policies

These are the specific principles, bases, standards, rules and practices applied by an entity in preparing and presenting financial statements.

The accounting policies adopted should be the most appropriate for the entity.

Policies deal with specific matters like the depreciation methods, valuation of inventory etc. Accounting policies must be disclosed in the annual financial statements.

Generally accepted accounting principles (GAAP)

This is widely accepted set of rules, principles, standards and procedures that accountants follow in recording and summarizing transactions and in the preparation of financial statements in a country.

These are generally accepted practices that have substantial authoritative support. In a country, GAAP is a combination of:

- The relevant laws of Uganda e.g. the Companies Act
- The International Financial Reporting Standards (IFRSs)
- Accounting principles
- The capital market regulations for listed companies
- Other acceptable accounting practices in various industries

Accounting principles / concepts, their relevance and limitation

Below are several accounting concepts that are generally recognized by the accounting profession as being essential for recording accounting transactions and preparing financial statements.

- ❖ **Fair presentation (true and fair view)**

Fair presentation means that the financial information:

- Complies with the relevant financial reporting standards, laws and regulations.
- Is relevant to users when making economic decisions.
- Is reliable and has no material errors.
- Can easily be compared with that of the prior periods and other businesses
- Is clearly understood by the users

Financial statements should show fair presentation of the financial position and the performance of the business

Example – when a company supplies goods on credit to several customers, some may not pay their debts. Therefore, accountants normally make provision for such debts and the amount not expected to be collected is deducted from total amount outstanding (called receivables or debtors) in the balance sheet. The provision for the debts is shown as a loss in the income statement. Failure to do so would overstate the receivables and overstate the profit for the period.

Relevancy – the concept makes accounting information more reliable and more useful in decision making. When financial statements do not fairly present the business financial position and performance, they are likely to mislead the users who may make wrong decisions.

Limitation – some managers use creative accounting to prepare misleading financial statements. For example, some banks understate their bad debts in-order to maintain public confidence.

- **Going concern concept**

The going concern assumption means that financial statements are prepared on the basis that the business will continue in operation for a foreseeable future without significantly reducing its activity or being liquidated.

Example – assets like land and buildings are shown as long term in the balance sheet as it is assumed that they will be used by the business for a long time in future. Such assets are valued at cost less depreciation, rather than at their immediate sale value because they are held to be used rather than immediate sale

Relevancy – businesses would not buy long term items like land or get loans repayable over a long time, if they were not to assume that they would continue to operate

Limitation – some businesses have failed soon after their financial statements have been prepared on a going concern basis, making the asset values in the balance sheet impossible to realize when assets are sold e.g. Enron. In practice, managers may give misleading information in order to safeguard their jobs or there may be some unforeseen circumstances.

- **Accruals concept**

The accruals concept requires that income and expenses are recognized in the period to which they relate and not in the period in which they are paid. The concept is also called the matching concept, incomes for the period are matched with expenses incurred in earning those incomes. This creates accrued expenses (liability) or prepaid expenses (asset)
Example – when a business incurs (uses) electricity of shs 10m in a period and they pay only shs 5m during the period, shs 10m should be recognized in the income statement because it's the incurred expense

Relevance – the concept enables the matching of income and expenses for the period which is important in the calculation of profit. It ensures that all income and expenses for the period are included in the income statement whether they are paid or not. The income statement would be meaningless if only cash transactions were considered. This leads to fair presentation of the financial statements.

Limitation – a company may include some income not earned in order to increase profit when there has been poor performance or an expense may be treated as an asset in order to improve reported performance. This led to the collapse of WorldCom when such practices were discovered.

- **Consistency concept**

The accounting policies used in the preparation of financial statements should be consistent from year to year. Where accounting policies are changed, businesses should disclose this fact and explain the impact of the change. The policies should be changed if it results in better presentation of financial information or if this is a requirement of new financial reporting standards or laws.

Example – if the policy is to depreciate a certain class of Non-current Assets using straight line method, this should be done year to year.

Relevancy – consistency improves comparability of financial information of the business over time and this improves decision making.

Limitation – some businesses have changed their accounting policies in order to improve their reported performance.

- **Materiality**

Information is material if its omission or misstatements could be expected to influence the economic decisions of the users.

All information that is material should be given in the financial statements and information that is not material need not be given. Materiality depends on the size and nature of the item and the size of the business.

Example – all non-current assets should be included in the balance sheet as each is considered material.

Relevancy – materiality ensures that all important information is included in the financial statements and unnecessary details are excluded in order not to distract the users' attention.

Limitation – what is considered material may be subjectively arrived at.

- **Business entity concept**

The business entity concept states that the business entity should be treated as separate from the owners. Business transactions should be included in its accounting records and transactions of the owners should be left out.
Example – property of the owner should not be included in the balance sheet of the business as the two are separate entities.

Relevancy – the concept ensures that the business is accounted for as a separate economic unit so that its financial position and performance are not distorted by including personal transactions. Otherwise, the business financial statements would become meaningless.

Limitation – some businesses are so complex that it may not be easy to clearly identify different entities or separate the entities. For example, where a sole trader uses the business car for his private journeys, it may be difficult to apportion the car expenses between the two.

- **Substance over form**

Substance over form means that the economic substance (financial and economic reality) of a transaction should be recorded rather than simply its legal form.

Example – where one buys a car using a loan from a bank (on hire purchase/finance lease – i.e. the bank pays the seller of the car directly, the car is registered in the names of the bank and keeps the car log book till the loan is fully paid by the buyer), the car should be shown as an asset and the loan as a liability in the books of the buyer. The substance of the transaction is that the buyer enjoys the benefits from the car and controls it, although there is no legal ownership till full payment for it.

Relevancy – the concept enhances fair presentation and its application improves the usefulness of the financial statements by preventing certain creative accounting practices.

Limitation – at times distinguishing the real substance from legal form may be difficult especially in a series of related transactions. Management may opt for an alternative that shows better performance.

- **Prudence**

Prudence means that accountants should be cautious when estimating figures to be included in the financial statements under conditions of uncertainty. Prudence is also called conservatism.

Example – it requires accountants to provide for future costs arising from present obligations when they are likely to be incurred. If there is a court case that you are likely to lose, you should include the estimated legal costs in the expenses for the period when the case arose.

Relevancy – prudence improves the reliability of information in the financial statements by ensuring that assets and income are not overstated and expenses and liabilities are not understated.

Limitation – some businesses overstate profit in order to get loans from banks or to sell their shares on the stock market.

- **Historical cost convention**

This convention requires transactions to be recorded at the prices ruling at the time they occurred.

Example – assets are usually recorded at their original cost less depreciation and not at market (realizable) value or at current (replacement) cost.

Relevancy – the concept makes accounting more objective and makes the figures verifiable. The figures used are for transactions that have already occurred and are supported by business documents.

Limitation – the concept may understate the values of assets in the balance sheet where their value has increased. Historical cost may be unrelated to market or replacement value especially when there is inflation. The balance sheet therefore does not show the correct value of the business. For example, if you bought a machine at Shs 10 million a year ago and now the same machine costs Shs 12 million, keeping it at historical cost understates its value.

- **Money measurement concept**

This concept means that all transactions that are recorded in accounting are expressed in only in monetary terms.

Example – assets bought, income earned and expenses incurred are recorded in the monetary terms e.g. in Uganda shillings.

Relevancy – the concept makes the measurement of transactions more objective as all transactions are expressed in the same measurement unit.

Limitation – Accounting only shows only financial information. Non-financial indicators of performance like customer satisfaction and product / service quality are excluded. Assets which are not purchased like internally generated goodwill and human resource skills are not recognized in the financial statements. This eliminates some important assets of the business.

The concept also assumes that money has stable value over time and yet in practice, it may lose value.

- **Realization**

The concept states that a transaction should be recognized when the event from which it arises has taken place and the receipt of cash from the transaction is reasonably certain and not when cash is paid.

Example – when goods are delivered and an invoice issued, the supplier should recognize the income is it is realized at point of sale.

Relevancy – it ensures that revenue unrealized (unearned) is not included in the income statement. One must have provided the goods or services in order to record the transactions in the accounting records.

Limitation – it may be abused to manipulate performance e.g. goods on sale or return basis may be included as sales to improve performance even when the sale has not been done.

- **Accounting period convention**

The concept ensures that the lifetime of the business is divided into accounting periods usually of one year for accounting purposes. Financial statements are prepared for each period for the managers to fulfill their stewardship role.

Example – the accounting period of government runs from 1st to 30th June every financial year.

Relevancy – the concept ensures accountability and provides information for decision making.
Limitation – the period end may be arbitrary and may not show true profitability in particular periods as it may not match with the business cycle.

- ❖ **The Duality concept**

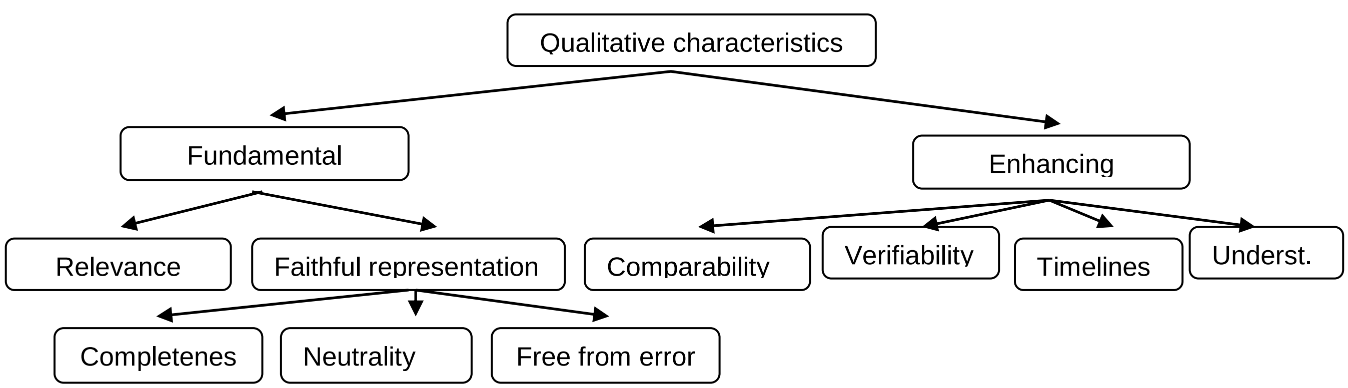
This concept states that every transaction has a double (dual) effect on the position of a business as recorded in the accounts.

Example – for a cash sale, the cash account is debited to show increase in cash and the sales account credited to show increase in sales revenue

Relevancy – it makes the balance sheet which summarizes assets and claims balance giving a true and fair view of the business

Limitation – errors in double entry make the books not to balance and may communicate a wrong picture

Qualitative characteristics of useful financial information



The qualitative characteristics are a set of attributes which together make the information in financial statements useful to users. Accounting information should have these qualities if the financial statements are to show proper business position and performance.
Financial information is useful when it is relevant and represents faithfully what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

Fundamental qualitative characteristics

Relevance and faithful representation are the fundamental qualitative characteristics of useful financial information.

- ***Relevance***

Accounting information in financial statements should be relevant to the needs of users and capable of making a difference in the decisions made by users.

Information is relevant if:

- ✓ It influences the economic decisions of users
- ✓ It is provided in time to influence those decisions.
- ✓ It can be used to assess the past, present or future events (has predictive value).
- ✓ It can be used to confirm or correct past evaluations and assessments (has confirmatory value).

Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report.

- ***Faithful representation***

General purpose financial reports represent economic phenomena in words and numbers, To be useful, financial information must not only be relevant, it must also represent faithfully the phenomena it purports to represent. This fundamental characteristic seeks to maximise the underlying characteristics of **completeness (**includes all necessary descriptions and explanations for users to understand items), **neutrality** (free from bias) and **freedom from error**. Information must be both relevant and faithfully represented if it is to be useful.

- ***Enhancing qualitative characteristics***

Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

Comparability

Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Comparability enables users to identify and understand similarities in, and differences among, items.

Verifiability

Verifiability helps to assure users that information represents faithfully the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

Timeliness

Timeliness means that information is available to decision-makers in time to be capable of influencing their decisions.

Understandability

Classifying, characterising and presenting information **clearly** and **concisely** makes it understandable. While some phenomena are inherently complex and cannot be made easy to understand, to exclude such information would make financial reports incomplete and potentially misleading.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information with diligence.

Applying the enhancing qualitative characteristics

Enhancing qualitative characteristics should be maximized to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or not faithfully represented.

Sometimes, one enhancing qualitative characteristic may be diminished to maximize another qualitative characteristic.

The cost constraint on useful financial reporting

Cost may limit the information that is provided by financial reporting and it is important that those costs are justified by the benefits of reporting that information.

TYPES OF BUSINESS TRANSACTIONS; a transaction is a dealing between two or more parties involving an exchange of goods and services for a consideration which is always money. Transactions are of two types ie cash and credit transaction. These transactions may include:-

1. Purchase- Buying goods/stock/inventory with the purpose of re-selling at a profit. This is for both cash and on credit.
2. Sales- A **sale** is a transaction between two or more parties that involves the exchange of tangible or intangible goods, services, or other assets for money. This is also for cash or on credit

3. Payments- these are monies the organization pays out specifically for the services such as labour (salaries), rent, water, electricity, etc the transactions and processes through which companies exchange money for goods, services, debts, or other financial obligations.

4. Receipts- Receipts are the amount of money that is received by a business during a particular period of time.

5. Returns- these are goods bought that has been returned for some reasons eg demage, wrong type etc. they are returns inwards (sales returns) or returns outwards (purchase returns..

6. Discounts- this is the reduction in the amount to be paid/collected by an organization. They are discount received, allowed, cash discounts, trade discounts, etc

7. Drawings- the action of taking funds from an account or company holdings for individual.

TOPIC 2: The fundamental accounting equation and the double entry accounting system.

The accounting equation is the basis of the entire recording system. The preparation of the balance sheet is based on it. It is the recognition of the dual concept of accounting. Every transaction has a double (dual) effect or two equal opposite reactions and this also has an effect on the financial position of a business as recorded in the accounts.

A balance sheet (statement of financial position) is a detailed presentation of items making up the accounting equation. It is a financial statement showing what a business owns, what it owes and the owner's net investment into the business.

The accounting equation and indeed the balance sheet define the relationship between **assets, liabilities** and **owners' equity.**

A	**=**	**C/OE**	**+**	**L**
ASSETS		**CAPITAL/OWNERS'EQUITY**		**LIABILITIES**

a) ASSETS:

These are resources owned by the organization that aid in the income generating process. Anything of economic value **owned** by the organization or an individual is an asset; except human beings. Assets are resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

1- **Current assets.** These are short term assets, which have a useful life of only one financial year, though some can be carried forward like stock (inventory). They can be easily turned into cash (liquidated). Examples are:
- Cash at hand (Cash)
- Cash at bank (Bank)
- Debtors (accounts receivable)
- Stock (Inventory)
- Pre-payments/payments made in advance eg prepaid rent, unused stationery, etc

2- **Non-current assets.** These are long term assets. They benefit more than one accounting periods. They cannot be easily turned into cash. Some are subjected to reduction in value (Depreciation with the exception of land which depletes). They are divided into two **intangible assets** and **fixed assets.**

Intangible assets. These are assets that cannot be seen with eyes, touched or felt but of importance to the organization. They include:
- Good will
- trade marks
- patent rights
- royalties etc

Fixed assets. These are tangible and can be seen and touched. They include:
- land
- machinery
- motor vehicles
- computers
- furniture/fixtures/fittings
- equipments
- plant etc

b) LIABILITIES:

These are debts/obligations of the organization that are to be discharged. The claim of outsiders against the assets of the organization. The present obligation of the entity arising from the past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. They are divided into two **current liabilities** and **long-term liabilities.**

1- Current liabilities. These are short term debts which are to be discharged/paid with in a year of incurring them. They include:
- Creditors (accounts payable)
- Bank overdraft
- Accruals/un paid expenses/payables eg rent payable, salaries due, dividends owing, water bills outstanding, etc

- Un paid tax
- Proposed dividends
- Prepaid income

2- **Long term liabilities.** These are long term debts. They are to be settled anytime after one financial year. They usually carry an interest. Examples are:
- Bank loan
- Debentures
- Bonds etc

c) OWNERS' EQUITY/CAPITAL/PROPRIETORSHIP.

This is the owners' net investment into the business. The amount of money he/she has put into the business thus his claim. The resources he/she uses in purchasing assets of the business.

Capital can be raised through personal savings/investment, borrowing from outside, trade credits and amalgamation.

Capital can be increased through

- Additional investment and
- Profit capitalization.

It can be decreased through

- Loss incurred from a bad trading period
- Drawings (removals/withdrawals) in form of cash and in kind (goods) for personal use.

Working capital is what remains after using the current resources to meet the current obligations.

WORKING CAPITAL (WC) =CURRENT ASSETS (CA) less: **CURRENT LIABILITIES**

WC = CA - CL

Current assets are always changing the form. This gives us circulating capital.

Illustration/ Example

Mukasa is a sole trader who set up his business in Kisenyi .The following were the transactions that took place in the month of January. Amounts are in UGX

i) Started business with cash of 10,000,000and cash at bank of 20,000,000
ii) Purchased stock of goods on credit of 3,000,000
iii) Bought a Motor vehicle for business operations using the cash at bank of 2,000,000
iv) Sold goods to James for 600,000cash which had cost him 500,000

v) Paid the shopkeeper 50,000cash as salary
vi) Bought more stock of goods for 500,000 cash
vii) Used business cash of 300,000 to buy for his wife and children Christmas clothes

Required Construct an accounting equation for each of the transactions above and extract prepare a simple balance sheet at the end.

i)

Assets =	**Liabilities**	**+ Owners equity**
Bank 20,000,000	---------------	Capital 30,000,000
Cash 10,000,000		
30,000,000		**30,000,000**

ii)

Assets =	**Liabilities**	**+ Owners equity**
Stock 3,000,000	Trade creditors 3,000,000	Capital 30,000,000
Bank 20,000,000		
Cash 10,000,000		
33,000,000		**33,000,000**

iii)

Assets =	**Liabilities**	**+ Owners equity**
M/vehicle 2,000,000		
Stock 3,000,000	Trade creditors 3,000,000	Capital 30,000,000
Bank 18,000,000		
Cash 10,000,000		
33,000,000		**33,000,000**

iv)

Assets =	**Liabilities**	**+ Owners equity**
M/vehicle 2,000,000		
Stock 2,500,000	Trade creditors 3,000,000	Capital 30,000,000
Bank 18,000,000		Profit 100,000
Cash 10,600,000		
33,100,000		**33,100,000**

v)

Assets =	**Liabilities**	**+ Owners equity**
M/vehicle 2,000,000		
Stock 2,500,000	Trade creditors 3,000,000	Capital 30,000,000
Bank 18,000,000		Profit 50,000
Cash 10,550,000		
33,050,000		**33,050,000**

vi)

Assets =	**Liabilities**	**+ Owners equity**
M/vehicle 2,000,000		
Stock 3,000,000	Trade creditors 3,000,000	Capital 30,000,000
Bank 18,000,000		Profit 50,000
Cash 10,050,000		
33,050,000		**33,050,000**

vii)

Assets =	**Liabilities**	**+ Owners equity**
M/vehicle 2,000,000		
Stock 3,000,000	Trade creditors 3,000,000	Capital 30,000,000
Bank 18,000,000		Profit 50,000
Cash 9,750,000		Drawings (300,000)
32,750,000		**32,750,000**

Mukasa's Balance Sheet as at……..

Non Current Assets	**UGX**	**Equity and liabilities**	**UGX**
Motor vehicle	2,000,000	Capital	30,000,000
Current assets		Profit	50,000
Stock	3,000,000	less drawings	(300,000)
Bank	18,000,000	**Current liabilities**	
Cash	9,750,000	Trade creditors	3,000,000
Total Assets	**32,750,000**	Total Equity & Liabilities	**32 ,750,00**

What Are International Financial Reporting Standards (IFRS)?

International Financial Reporting Standards (IFRS) are a set of accounting rules for the financial statements of public companies that are intended to make them consistent, transparent, and easily comparable around the world.

The IFRS is issued by the International Accounting Standards Board (IASB).

The IFRS system is sometimes confused with the International Accounting Standards (IAS), which are the older standards that the IFRS replaced in 2001.

IFRS currently has complete profiles for 168 jurisdictions, including those in the European Union. The United States uses a different system, the generally accepted accounting principles (GAAP).

- International Financial Reporting Standards (IFRS) were created to bring consistency and integrity to accounting standards and practices, regardless of the company or the country.
- They were issued by the London-based Accounting Standards Board (IASB) and address record keeping, account reporting, and other aspects of financial reporting.
- The IFRS system replaced the International Accounting Standards (IAS) in 2001.
- IFRS fosters greater corporate transparency.
- IFRS are not used by all countries; for example, the U.S. uses generally accepted accounting principles (GAAP).
- IFRS specify in detail how companies must maintain their records and report their expenses and income. They were established to create a common accounting language that could be understood globally by investors, auditors, government regulators, and other interested parties.
- The standards are designed to bring consistency to accounting language, practices, and statements, and to help businesses and investors make educated financial analyses and decisions.

IFRS vs. GAAP

Public companies in the U.S. are required to use a rival system, the generally accepted accounting principles (GAAP). The GAAP standards were developed by the Financial Standards Accounting Board (FSAB) and the Governmental Accounting Standards Board (GASB).

Standard IFRS Requirements

IFRS covers a wide range of accounting activities. There are certain aspects of business practice for which IFRS set mandatory rules.

- **Statement of financial position**: This is the balance sheet. IFRS influences the ways in which the components of a balance sheet are reported.
- **Statement of comprehensive income**: This can take the form of one statement or be separated into a profit and loss statement and a statement of other income, including property and equipment.
- **Statement of changes in equity:** Also known as a statement of retained earnings, this documents the company's change in earnings or profit for the given financial period.
- **Statement of cash flows**: This report summarizes the company's financial transactions in the given period, separating cash flow into operations, investing, and financing.

In addition to these basic reports, a company must give a summary of its accounting policies. The full report is often seen side by side with the previous report to show the changes in profit and loss.

List of the *International Accounting Standards* (*IAS*) and the *International Financial Reporting Standards* (*IFRS*)

N°	Title	Originally issued	Effective	Fully withdrawn	Superseded by
IAS 1	Disclosure of Accounting Policies (1975) Presentation of Financial Statements (1997)	1975	January 1, 1975	January 1, 2027	IFRS 18
IAS 2	Valuation and Presentation of Inventories in the Context of the Historical Cost System (1975) Inventories (1993)	1976	January 1, 1976		
IAS 3	Consolidated Financial Statements	1976	January 1, 1977	January 1, 1990	IAS 27 and IAS 28
IAS 4	Depreciation Accounting	1976	January 1, 1977	July 1, 1999	IAS 36
IAS 5	Information to Be Disclosed in Financial Statements	1976	January 1, 1977	July 1, 1998	IAS 1
IAS 6	Accounting Responses to Changing Prices	1977	January 1, 1978	January 1, 1983	IAS 15
IAS 7	Statement of Changes in Financial Position (1977) Cash Flow Statements (1992) Statement of Cash Flows (2007)	1977	January 1, 1979		

N°	Title	Originally issued	Effective	Fully withdrawn	Superseded by
IAS 8	Unusual and Prior Period Items and Changes in Accounting Policies (1978) Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies (1993) Accounting Policies, Changes in Accounting Estimates and Errors (2003)	1978	January 1, 1979		
IAS 9	Accounting for Research and Development Activities	1978	January 1, 1980	July 1, 1999	IAS 38
IAS 10	Contingencies and Events Occurring After the Balance Sheet Date (1978) Events After the Balance Sheet Date (1999) Events after the Reporting Period (2007)	1978	January 1, 1980		
IAS 11	Accounting for Construction Contracts (1979) Construction Contracts (1993)	1979	January 1, 1980		IFRS 15
IAS 12	Accounting for Taxes on	1979	January 1,		

N°	Title	Originally issued	Effective	Fully withdrawn	Superseded by
	Income (1979) Income Taxes (1996)		1981		
IAS 13	Presentation of Current Assets and Current Liabilities	1979	January 1, 1981	July 1, 1998	IAS 1
IAS 14	Reporting Financial Information by Segment (1981) Segment reporting (1997)	1981	January 1, 1983	January 1, 2009	IFRS 8
IAS 15	Information Reflecting the Effects of Changing Prices	1981	January 1, 1983	January 1, 2005	N/A
IAS 16	Accounting for Property, Plant and Equipment (1982) Property, Plant and Equipment (1993)	1982	January 1, 1983		
IAS 17	Accounting for Leases (1982) Leases (1997)	1982	January 1, 1984	January 1, 2019	IFRS 16
IAS 18	Revenue Recognition (1982) Revenue (1993)	1982	January 1, 1984	January 1, 2018	IFRS 15
IAS 19	Accounting for Retirement Benefits in	1983	January 1, 1985		

N°	Title	Originally issued	Effective	Fully withdrawn	Superseded by
	Financial Statements of Employers (1983) Retirement Benefit Costs (1993) Employee Benefits (1998)				
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	1983	January 1, 1984		
IAS 21	Accounting for the Effects of Changes in Foreign Exchange Rates (1983) The Effects of Changes in Foreign Exchange Rates (1993)	1983	January 1, 1985		
IAS 22	Accounting for Business Combinations (1983) Business Combinations (1993)	1983	January 1, 1985	April 1, 2004	IFRS 3
IAS 23	Capitalisation of Borrowing Costs (1984) Borrowing Costs (1993)	1984	January 1, 1986		
IAS 24	Related Party Disclosures	1984	January 1, 1986		
IAS 25	Accounting for Investments	1986	January 1, 1987	January 1, 2001	IAS 39 and IAS 40

N°	Title	Originally issued	Effective	Fully withdrawn	Superseded by
IAS 26	Accounting and Reporting by Retirement Benefit Plans	1987	January 1, 1988		
IAS 27	Consolidated Financial Statements and Accounting for Investments in Subsidiaries (1989) Consolidated and Separate Financial Statements (2003) Separate Financial Statements (2011)	1989	January 1, 1990		
IAS 28	Accounting for Investments in Associates (1989) Investments in Associates & ASSOCIATES (2003) Investments in Associates and Joint Ventures (2011)	1989	January 1, 1990		
IAS 29	Financial Reporting in Hyperinflationary Economies	1989	January 1, 1990		
IAS 30	Disclosures in the Financial Statements of Banks and Similar Financial Institutions	1990	January 1, 1991	January 1, 2007	IFRS 7
IAS 31	Financial Reporting of Interests in Joint Ventures	1990	January 1, 1992	January 1, 2013	IFRS 11 and IFRS

N°	Title	Originally issued	Effective	Fully withdrawn	Superseded by
	(1990) Interests in Joint Ventures (2003)				12
IAS 32	Financial Instruments: Disclosure and Presentation (1995) Financial Instruments: Presentation (2005)	1995	January 1, 1996		
IAS 33	Earnings per Share	1997	January 1, 1999		
IAS 34	Interim Financial Reporting	1998	January 1, 1999		
IAS 35	Discontinuing Operations	1998	July 1, 1999	January 1, 2005	IFRS 5
IAS 36	Impairment of Assets	1998	July 1, 1999		
IAS 37	Provisions, Contingent Liabilities and Contingent Assets	1998	July 1, 1999		
IAS 38	Intangible Assets	1998	July 1, 1999		
IAS 39	Financial Instruments: Recognition and Measurement	1998	January 1, 2001	January 1, 2018	IFRS 9
IAS 40	Investment Property	2000	January 1,		

N°	Title	Originally issued	Effective	Fully withdrawn	Superseded by
			2001		
IAS 41	Agriculture	2000	January 1, 2003		
IFRS 1	First-time Adoption of International Financial Reporting Standards	2003	January 1, 2004		
IFRS 2	Share-based Payment	2004	January 1, 2005		
IFRS 3	Business Combinations	2004	April 1, 2004		
IFRS 4	Insurance Contracts	2004	January 1, 2005	January 1, 2023	IFRS 17
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	2004	January 1, 2005		
IFRS 6	Exploration for and Evaluation of Mineral Resources	2004	January 1, 2006		
IFRS 7	Financial Instruments: Disclosures	2005	January 1, 2007		
IFRS 8	Operating Segments	2006	January 1, 2009		
IFRS 9	Financial Instruments	2009 (updated 2014)	January 1, 2018		

N°	Title	Originally issued	Effective	Fully withdrawn	Superseded by
IFRS 10	Consolidated Financial Statements	2011	January 1, 2013		
IFRS 11	Joint Arrangements	2011	January 1, 2013		
IFRS 12	Disclosure of Interests in Other Entities	2011	January 1, 2013		
IFRS 13	Fair Value Measurement	2011	January 1, 2013		
IFRS 14	Regulatory Deferral Accounts	2014	January 1, 2016		
IFRS 15	Revenue from Contracts with Customers	2014	January 1, 2018		
IFRS 16	Leases	2016	January 1, 2019		
IFRS 17	Insurance contracts	2017	January 1, 2023		
IFRS 18	Presentation and Disclosure in Financial Statements	2024	January 1, 2027		
IFRS 19	Subsidiaries without Public Accountability: Disclosures	2024	January 1, 2027		