

# Accounting - Self Study Guide for Staff of Micro Finance Institutions

## LESSON 1

### DEFINITION OF ACCOUNTING

**Objectives:** The purpose of this lesson is to introduce the concepts of accounting, what it is used for and who uses it. You will develop a basic understanding of the role accounting plays and why it is important to create accounting records and how they aid in the financial management of a credit operation. Basic accounting principles and the most widely used financial statements -- the Balance Sheet, the Income Statement and the Statement of Changes in Financial Position are introduced. Topics include:

- Definition of accounting
- Role of accounting
- Basic accounting concepts
- Financial statements



#### Definition of Accounting

*Accounting is the process of financially measuring, recording, summarizing and communicating the economic activity of an organization.* It is often referred to as "the language of business" and, like any other language, it has its own unique vocabulary and rules. Some people think of accounting as a highly technical field understood only by professional accountants. However, technical accounting terms such as assets, liabilities, equity, revenue, expense, income and cash flow are widely used throughout the micro-finance field. Thus it is important that anyone involved in making business decisions understands the basic accounting concepts which form the basis of financial management.

Accounting is a service activity. It provides financial information about an organization's economic activities which is intended to be used as a basis for decision making. It provides the information required to answer questions such as: What are the resources of the organization? What debts does it owe? Are its operating expenses too high relative to revenue? Are the organization's current lending activities generating enough income for it to be sustainable?

Not everyone needs to understand the intricate details of an organization's accounting system; however, it is helpful for employees to understand the framework within which accounting operates. Managers, in particular, need to know how to interpret the information accounting provides. Based on this information, managers can analyze the financial status of their organization and manage the organization's finances to ensure future financial stability.

## Role of Accounting

Accounting falls into two general categories: financial accounting and management accounting. *Financial accounting presents a summary view of the financial results of past operations.* Financial accounting reports are aimed at external audiences although they are widely used internally as well.

*Management accounting information is tracked and presented at a much more detailed level, such as by programme or branch.* Projected financial information is also a part of management accounting and is aimed primarily at internal audiences. Management reports are prepared frequently and report on an ongoing basis the differences between planned and actual results.

This training covers aspects of both financial and management accounting while focusing primarily on management accounting.

## Basic Accounting Concepts

Accounting rules vary from country to country. It is important to understand that the numbers seen on financial statements are affected by the set of rules used to compile them. In most countries, there are some basic principles which do not change which make up the rules of accounting and influence how the financial activities of an organization are recorded.

Review each of the Accounting Principles below, noting that some will be described in greater detail later in the text. You will not necessarily understand the principles now. The purpose of introducing them here is simply to allow you to begin to familiarize yourself with accounting concepts.

1. **The Business Entity Concept** - every business is a separate entity, distinct from its owner and from every other business. Therefore, the records and reports of a business should not include the personal transactions or assets of either its owner(s) or those of another business.

Example: Nina has \$1,500 invested in her carpentry business. She also has a \$500 balance in her personal savings account at the bank. The Balance Sheet of Nina's business shows \$1,500 as equity in the business. The \$500 in Nina's personal bank account is not reflected on the books of the business. If Nina withdraws \$700 from her business and deposits it in her personal savings account, the equity of her business will be reduced to \$800. The fact that she has put the funds into her personal account has no effect on the Balance Sheet of her business.

2. **The Cost Principle** - all assets must be recorded on the books of a business at their actual cost. This amount may be different from what it would cost today to replace them or the amount for which the assets could be sold.

Example: If a business buys two flats in a building for Rd400,000, the asset is recorded on the books as Rd400,000, even though its market value might have increased to Rd500,000.

3. **The Going Concern Concept** - the Balance Sheet of a business is developed with the assumption that the business will continue to operate indefinitely and thus the assets used in carrying out operations will not be sold.

[Note: Since the assets of the business cannot be sold without disruption of the business' operations, the current market value of its assets is not relevant. For example, if a micro-finance organization owns the buildings in which its branches are located, it would not consider the market value of the buildings in their financial statements. This is based on the assumption that the branches will continue to operate and the buildings will not be sold.]

4. **Double-entry Accounting** - is based on the concept that every transaction affects and is recorded in two or more accounts on a business' books (referred to as the *Dual Aspect Concept*) and thus requires entries in two or more places ("double-entry"). Each transaction affects either Assets, Liabilities and/or Equity (sometimes through Revenue or Expenses - explained in Session 3: The Income Statement). The accounting equation states that:  $ASSETS = LIABILITIES + EQUITY$ . For every account affected by a transaction there is an equal effect on other accounts which keeps the accounting equation balanced. Therefore, an increase in a business' assets must be offset by either a decrease in another asset, or an increase in liabilities or equity.

Example: a Loan Fund disburses a loan of Bs. 300 to a client. This transaction would be recorded in the books by first decreasing the Asset (Cash) by Bs. 300 and then increasing the Asset (Loans Outstanding) by the same amount. Similarly, if the Loan Fund purchased equipment on credit, the Asset (Equipment) would be increased and the Liability (Short-term Borrowings) would be increased by the same amount. Each transaction in these examples affects at least two accounts and each time the accounting equation remains balanced.

5. **The Realization Principle** - requires that revenue be assigned to the accounting period in which it is earned rather than to the period it is collected in cash.

Example: an organization purchases a T-Bill for 90 days on Dec. 1st. On Dec. 31st the organization has earned 30 days worth of Interest Revenue on the T-Bill. However, it will not actually receive this revenue until the T-Bill matures on Feb. 1st. When reporting its Revenue to December 31st, the organization includes the portion of Interest Revenue it has earned on the T-Bill (i.e.: 30 days) as accrued Revenue.

6. **The Matching Principle** - requires that revenues and expenses be matched in the same accounting period. An organization incurs expenses in order to earn revenues. Therefore expenses should be reported on the Income Statement during the same period as the revenues they generated.

*Example:* an organization developed a funding proposal which it submitted to a granting Foundation. Upon receiving the proposal, the Foundation informed the organization that they were very interested and requested several meetings with the organization to discuss the proposal. The organization incurred expenses around these meetings in the form of salaries and travel expenses. Six months later, the organization received a \$500,000 grant from the Foundation. The organization must report the salaries and travel expenses incurred in generating the \$500,000 Grant Revenue in the same accounting period as the Grant Revenue itself.

7. **The Consistency Principle** - organizations must consistently apply the same accounting principles from period to period. This ensures that reports from various periods may be compared to produce meaningful conclusions on the financial position of the organization and the results of its operations.
8. **The Conservatism Principle** - when presented with a choice, accountants must choose the method of presenting information on financial statements which ensures that assets, revenues and gains are not overstated and, conversely, that liabilities, expenses and losses are not understated. It should be noted that conservatism cannot be used to intentionally understate assets, revenues and gains or overstate liabilities, expenses and losses. It is intended to result in fair presentation of information from period to period.

## Financial Statements

The preparation of financial statements is virtually the last step in the accounting process but it is an appropriate point to begin studying accounting in order to understand what will be produced. Financial statements are the primary means through which an organization communicates information about its economic activities. The purpose of these statements is to provide useful financial information to parties such as banks, investors, suppliers, governments, etc., who may make decisions affecting the organizations' operations or otherwise influence the direction of its activities.

Financial statements are a means of conveying a concise picture of the financial position of the organization. An individual who has a clear understanding of these statements will be better able to understand the purpose of earlier steps in the process.

The three most widely used financial statements are the Balance Sheet, the Income Statement and the Statement of Changes in Financial Position.

The **Balance Sheet** is a summary of the economic resources of an organization and the claims against those resources at a specific point in time.

The **Income Statement** reports the organization's economic performance *over* a specified period of time.

The **Statement of Changes in Financial Position** reports the organization's sources and uses of funds (also referred to as the Statement of Changes in Sources and Uses of Funds or the Cash Flow Statement). It explains how an organization obtains cash (sources of funds) and how it spends cash (use of funds) including the borrowing and repayment of debt, capital transactions, and other factors that may affect the cash position.

[Note: the Statement of Changes in Financial Position is not described until after the recording and summarizing of economic transactions is explained. The first two Statements are explained earlier.]

Together, these statements summarize all of the information contained in the organization's accounts. In order to analyze financial statements, it is necessary to know how the statements are created. This will be covered in the following sessions.

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## EXERCISES

Complete the "Definition of Accounting" Exercises on the next page.



4. Name five of the Basic Accounting Principles:

i.

ii.

iii.

iv.

v.

5. Write the meaning of the following Principles:

i. Cost Principle

ii. Consistency Principle

iii. Business Entity Concept