ACC 201: Financial Accounting

Reference: Financial Accounting, BBA/BIM/BBM, KEC Publication Book

Unit 1: Basic Understanding of Financial Accounting LH2

- Financial accounting: concept, features, objectives and scope;
- Book-keeping, accounting and accountancy;
- Nature of accounting; Qualitative features of accounting information; Users and uses of accounting information: internal users and external users;
- Elements and components of financial statement;
- Limitations of financial accounting.

- **Financial Accounting**
- Financial Accounting is concerned with the process of identifying recording classifying, summarizing, analyzing and interpreting the financial information in such a way that the true and fair position of the business as well as the actual net profit earned or loss incurred during the given period can be known very clearly and preparing the report there of and communicating the save to the different users.

Financial accounting is the process of recording, summarizing and reporting the financial transactions resulting from business operations over a period of time. These transactions are summarized in the preparation of financial statements, including the balance sheet, income statement and cash flow statement, that encapsulate the company's operating performance over a specified period.

FEATURES OF FINANCIAL ACCOUNTING

1) **Monetary Transactions:**
2) **Historical Nature:**
3) **Legal Requirement:**
4) **External Use:**
5) **Disclosure of Financial Status:**
6) **Periodic Reporting**
7) **Financial Accounting Process:**
8) **Accrual Basis**: etc.

OBJECTIVES OF FINANCIAL ACCOUNTING

Main objectives of financial accounting can be described as follows:

1. **To systematic recording of transactions**:

   Basic objective of accounting is to systematically record the financial aspects of business transactions. These recorded transactions are later on classified and summarized logically for the preparation of financial statements and for their analysis and interpretation.

2. **To ascertainment of result:**

   Accountant prepares profit and loss account to know the result of business operations for a particular period of time. If expenses exceed revenue then it is said that the business is running under loss. The profit and loss account helps the management and different stakeholders in taking rational decisions. For example, if business is not proved to be remunerative or profitable, the cause of such a state of affairs can be investigated by the management for taking remedial steps.

3. **To ascertainment of the financial position of business**:

Businessman is not only interested in knowing the result of the business in terms of profits or loss for a particular period but is also to know that what he owes (liability) to the outsiders and what he owns (assets) on a certain date. To know this, accountant prepares a financial position statement of assets and liabilities of the business at a particular point of time and helps in ascertaining the financial health of the business.

4. **To providing information to the users for rational decision-making:**

Accounting as a ‘language of business’ communicates the financial result of an enterprise to various stakeholders by means of financial statements. Accounting aims to meet the financial information needs of the decision makers and helps them in rational decision-making.

5. **To prevention and Detection of Errors:**

A systematic financial accounts are maintained, a proper trial and error is conducted as a result of which no errors are committed and even the future errors are corrected.

Scope of Financial accounting:

1. **Recording of Financial Transactions**:
2. **Preparation of Financial Statements**:
3. **Compliance with Accounting Standards**:
4. **Regulatory Reporting**:
5. **External Auditing**:
6. **Internal Controls**:
7. **Analysis and Interpretation of Financial Data**:
8. **Communication with Stakeholders**:
9. **Budgeting and Forecasting**:
10. **Performance Measurement** etc.

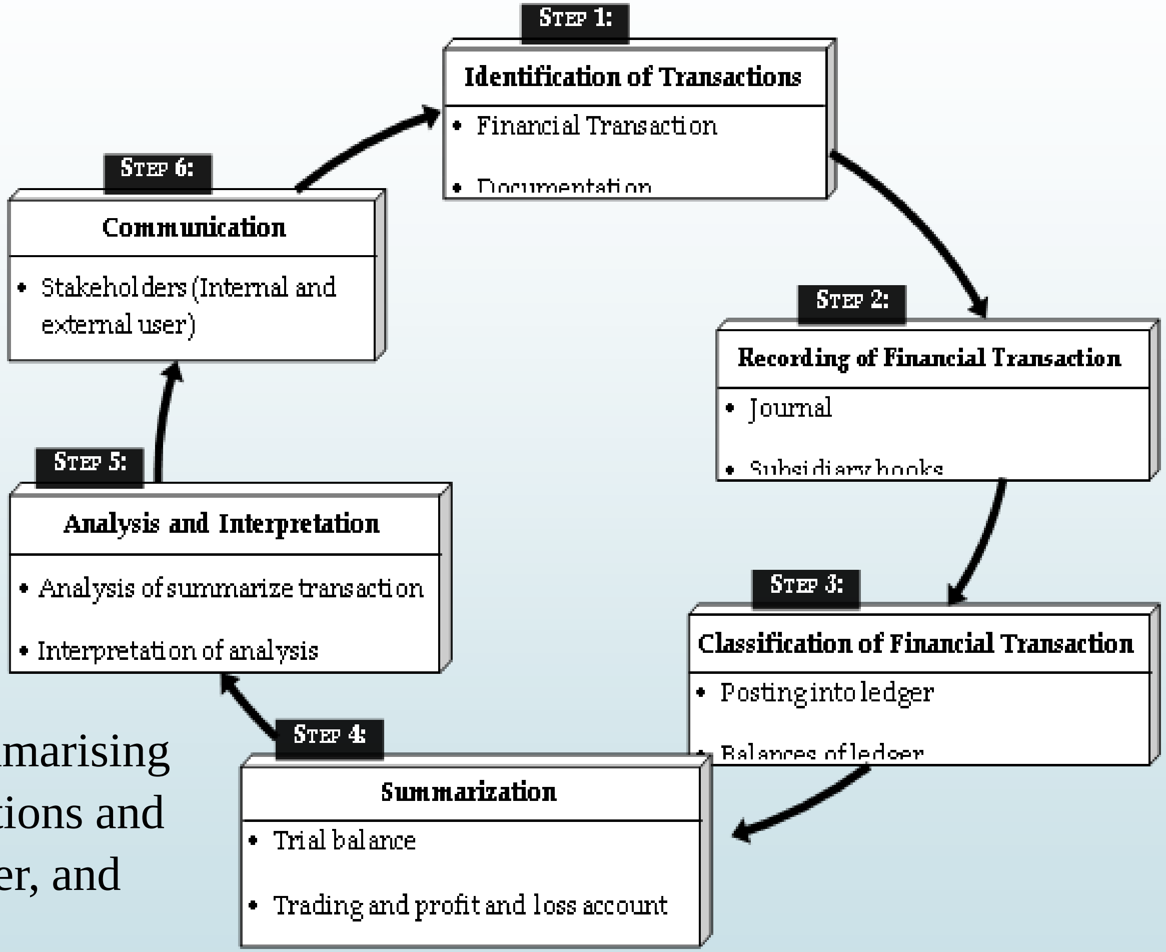
Book-Keeping:

Book keeping is that branch of knowledge which tells us how to keep the records of financial transactions. Double entry book keeping system was introduced by *Luca Pacioli of Italy in 1494 AD* . This system is based on two aspects of every transaction. This system makes a proper and full record of all transactions. There are two systems of recording such financial transactions (a) single entry book-keeping system (b) Double entry book-keeping system. Under single entry book-keeping system, only one aspect is recorded for most of the transactions but in double entry book-keeping system, every financial transaction has two aspects and is a complete recording system. In other words, the system of making two entries for recording a transaction in the books of each contracting party is called double entry system of book-keeping.

Bookkeeping is the systematic recording, organizing, and maintaining of financial transactions for a business. It's a fundamental part of accounting, ensuring that financial records are accurate and up-to-date.

Accounting

✍ Accounting is a board term which includes recording and measuring of financial transaction, posting them into ledger account, summarizing the ledger balance, interpreting the result and communicating them to interested persons and institutions that are directly or indirectly related with organizations.



Accounting is the art of recording, classifying and summarising 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.

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An accounting system is a means of collecting, summarizing, analyzing and reporting in monetary terms , information about the business.

Accounting may be defined as the identifying, measuring, recording, classifying, summarizing and communicating of financial information about business

Objectives of Accounting:

a. **To identification and keep systematic recording of transaction**
b. **To ascertain the operating profit or loss**
c. **To ascertain the financial position of business**
d. **To analyze and interpret the financial records**
e. **To communicate the result of business operation**

Importance/ advantages/Functions of accounting:

a. **Complete and systematic record:**

b. **Arithmetical accuracy:**

c. **Ascertainment of profit or loss:**

d. **Need for financial information:**

e. **Showing the financial position:**

f. **Fulfillment of legal requirement:**

Branches of Accounting

a. Financial accounting

b. Cost accounting

c. Management accounting

Accountancy

Accountancy is the practice of recording, classifying, and reporting on business transactions for a business organization. It provides feedback to management regarding the financial results and status of an organization. The key accountancy tasks are noted below.

Recordation

Classification

Reporting

Accountancy is the field or profession that encompasses both bookkeeping and accounting. It refers to the overall practice and body of knowledge in the field of managing financial records and providing financial information.

Comparison

- **Bookkeeping:** The basic recording of financial transactions.
- **Accounting:** The broader process of managing and interpreting financial data.
- **Accountancy:** The profession and field encompassing both bookkeeping and accounting.

In summary, bookkeeping is the initial step in the financial process, focusing on recording transactions. Accounting builds on bookkeeping by analyzing and reporting on these transactions to provide insights and ensure compliance. Accountancy is the overarching profession that includes both of these activities and involves the application of standards and principles to manage financial information effectively.

Accounting information and economic decision

✍ Accounting information is that information in which it has been communicating by the accounting system to the concern users that is required by the users for measuring performance and make better economic decisions. Accounting information is economic information, as it relates to financial or economic activities of a business organization. Several types of people utilize accounting information, they are generally classified into two types i.e. internal and external users.

Qualitative features of accounting information

Qualitative features of accounting information refer to the characteristics that make financial information useful, relevant, and reliable for decision-making purposes. Here are some key qualitative features of accounting information:

- **Relevance:** Accounting information should be relevant to the decision-making needs of users. It should have the ability to influence their decisions by providing timely and useful information.(predictive value , Feedback value ,Timeliness)

- **Reliability:** The information should be reliable and free from bias or material error. It should be accurate, complete, and verifiable, allowing users to rely on it with confidence.

- **Comparability:** Accounting information should be presented in a way that allows for meaningful comparisons. This means using consistent accounting principles and standards across different periods and entities, enabling users to identify similarities and differences.

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- **Understandability:** Accounting information should be presented in a clear and understandable manner. It should be communicated in a language and format that can be comprehended by users who have a reasonable knowledge of business and accounting concepts.

- **Materiality:** Materiality refers to the importance or significance of an item or event in influencing the decisions of users. Accounting information should disclose all material information that could impact the assessment of a company's financial position, performance, or cash flows.

- **Consistency:** Accounting information should be presented consistently over time, allowing users to compare financial statements from different periods and assess trends and changes in a company's financial performance.

Users of Accounting Information:

There are many different users of accounting information and the users may be inside or outside the organization. The users may be classified into Internal and external users.

a. Internal users:

Management- Management uses accounting information for evaluating and analyzing organization's financial performance and position.

Owners: They need accurate financial information to know what they have earned or lost during a particular period of time

b. External Users:

Investors: Investors use accounting information to decide whether or not a particular corporation is suitable for their investment needs.

Lenders: Lenders are individuals or financial institutions that normally provide money to businesses and earn interest income on it. They need accounting information to assess the financial performance and position.

Suppliers: Suppliers are business individuals or organizations that normally sell merchandise or raw materials to other businesses on credit. They use accounting information to have an idea about the future creditworthiness of the business.

Government agencies: Government agencies use financial information of businesses for the purpose of imposing taxes and regulations.

Customers: Accounting information provides important information to customers about current position of a business organization and to make a judgment about its future.

Employee: Employees use accounting information to assess company's profitability and its consequence on their future remuneration and job security.

General public: Anyone outside the company such as researchers, students, analysts and others are interested in the financial information of a company.

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Elements and Components of Financial Statement

Financial statements are important tools used by businesses to communicate their financial performance and position to various stakeholders, such as investors, creditors, and regulators. The key components of financial statements include:

- Income Statement (Profit and Loss Statement or Statement of Comprehensive Income):
- Statement of Changes in Equity (Statement of Shareholders' Equity):
- Statement of Financial Position(Balance Sheet):
- Statement of Cash Flows:
- Notes to Financial Statements:

The primary elements and components of financial statements include

The primary elements and components of financial statements include:

While maintaining the records and preparing financial statement , different accounting terms are frequently used in practice. They are known by basic accounting terminologies.

i. **Capital**

The amount of money or money's worth invested by the investors (business men) to start and during life time of business is called capital The amount invested by the proprietor/owner in the business organization either in the form of cash or in any form of assets for the purpose of doing business is regarded as capital. It is also known as owner's equity or net worth. It means the owner's claim against the assets.

i. **Drawings**

It is the amount of money or the value of goods/assets which the proprietor taken/withdrawn by the proprietor/owner for his/her domestic/personal use. Whenever any drawing is made by the proprietor, it leads to decrease the amount of capital and hence it is subtracted from capital.

iii. **Assets**

All those economic resources which are owned/possessed and used by the business organization for the purpose of generating certain revenue are called the assets. In other words, these are the non trading types of goods. It means that these are not allocated by the business for the reselling purposes. Cash balance, bank balance, land and building, plant and machinery, furniture etc. are the examples of assets. These may be of two types as under:

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a) **Fixed assets**: Fixed assets are those types of assets which are used by the business for more than one year for the purpose of generating revenues. These types of assets can be further classified as tangible fixed assets and intangible fixed assets. **Tangible fixed assets** are those types of fixed assets which have certain physical form. Land and building, plant and machinery, furniture etc. are the different examples of tangible fixed assets. On the other, **Intangible fixed assets** are those types of fixed assets which do not have any physical form but have certain financial values and also use to contribute in generating revenues to the business as the tangible fixed assets use to do. Goodwill, trademarks, patent rights etc. are the different examples of intangible fixed assets.

b) **Current assets:** Current assets are those types of assets which are expected to be used up or convertible into cash or cash equivalents within one year. The main feature of such type of assets is that they use to change their physical form at every use. Cash in hand, bank balance, stock of goods, account receivables, bills receivables, prepaid expenses ,accrued income etc. are the examples of current assets.

Stock/ inventory

That type of goods which is remained unsold at the particular date is regarded as the stock/inventory. If there is some stock at the end of the accounting year, it is said as the closing stock. Such type of closing stock will be the opening stock for the subsequent year.

Debtors or account receivables or trade debtors

Debtors refer those types of customers/clients who use to purchase goods on credit from the business organization. In other words, debtors are those types of customers from whom the amount of money is receivable on account of credit sales of goods. It can be regarded as a component of assets.

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Bill receivable

Bill receivable is a bill of exchange accepted by a debtor or is received in way of endorsement from them. The amount which is due to be received on a specific date is mentioned in the bill. It forms a part of current assets of the business entity.

c) **Investment**

Amount spent on purchasing of different financial assets like shares, debentures, bonds and other marketable securities is called the investment. It may be of two types. They are: Long term investment and short tem investment. Utilizing the money in purchasing of long term securities like shares, debentures, bonds etc. which have more than one year of maturity period, are called the long term investment. Like wise, utilizing the money in purchasing of short term securities like marketable securities which have a maturity period of within one year, is called the short term investment.

iv. Liabilities

The amount of money payable by a business organization within a certain period of time is called the liabilities. liabilities are the amount to be paid to outsider by an organization after certain period of time. Credit purchase of goods, outstanding salaries and wages (i.e. salaries and wages payable), loan taken from bank or from others etc. are the different examples of liabilities. These may be of two types as under:

a) **Long term liabilities:** The amounts of money payable by a business organization normally after one year are regarded as the long term liabilities. These are also known by long term obligations. Long term bank loans, debentures, bonds etc. are the different examples of long term liabilities.

b) **Short term liabilities(Current Liabilities):** The amounts of money payable by a business organization normally within one year are regarded as the short term liabilities. These are also known by short term obligations. Short term bank loans, creditors(account payable), bills payable, outstanding salaries and wages (i.e. salaries and wages payable) advance income etc. are the different examples of short term liabilities. Cont…

Creditors or account payables

Creditors refer to those types of suppliers who use to supply the goods on credit to the business organization. In other words, creditors are those types of suppliers from whom the amount of money is payable on account of credit purchase of goods. It can be regarded as a component of current liabilities.

Bill payable

Bill payable is a bill of exchange accepted by a business the amount for which will be payable on the specific date mentioned in the bill. It forms a part of current liabilities of the business entity.

v.Revenue

It is the amount received or receivable on account of selling of goods or rendering any service to the customers. Increasing revenue leads to increase the amount of profit to be earned which ultimately leads to increase the owner’s equity. Sales, interest received, commission received, dividend received etc. are the examples of different revenues.

vi.Expenses

Expenses refer to the amount paid or payable by a business organization in the process of earning revenues. Purchase of goods, carriages, wages and salaries, advertisement etc. are the different examples of expenses.

vii.Goods

All those commodities which are collected/assembled by the business for reselling purposes are regarded as goods. In general, these are purchased from one market at low price and sold them in another market at higher price. The differential figure obtained in this way is called the profit/loss.

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viii. Purchases:

It is the amount paid or payable on account of acquiring the commodities/goods on which the business organization deals. It is the main function of trade. It may be of two types; viz: cash purchases and credit purchases. If cash is paid immediately for the goods acquired, then it is called the cash purchases. Again, if the payment is postponed, it is called the credit purchases.

ix.Sales:

It is the amount received or receivable on account of selling of goods to customers. In a sense, it is an act of transferring the ownership of goods from business to its customers. It is also known by business turnover or sales proceeds. It can be of two types; viz: cash sales and credit sales. If the sale is for immediate cash payment, it is called the cash sales. Again, if the payment for sales is postponed, then it is called the credit sales.

x. Profit:

profit is the difference between the revenue and expenses of a particular period. The excess of revenue over expenses is profit.

xi.Loss:

loss is the difference between expenses and revenue of a particular period. The excess of expenses over revenue is loss.

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limitations of financial accounting

Financial accounting, despite its usefulness, has several inherent limitations. Here are some of the key limitations:

- Records Historical Information:
- Records Monetary Measurement:
- Lack of Future Orientation:
- No considerations for price level change:
- Difficult in knowing the behavior of cost:
- No proper system of controlling materials and supplies:

The end