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Introduction to Financial Accounting

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1. Concept of Financial Accounting

Today we are going to discuss various topics on financial accounting.

Let us start our discussion with the concept of Financial Accounting.

Accounting is thousands of years old; the earliest accounting records, which date back more than 7,000 years, were found in the Middle East. The people of that time relied on primitive accounting methods to record the growth of crops and herds. Accounting evolved, improving over the years and advancing as business advanced.

DEFINITION OF ACCOUNTING

Accounting is defined by the **AICPA** as "The art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof."

The analysis of the definition brings out the functions of accounting as:

1. Accounting has been described as the **art of recording** the financial transactions for a particular period of time in a significant manner. Recording is done in the books of “Journal”. This book is further sub-divided into subsidiary book such as cash book; purchase book sales book sales book; etc. the number of subsidiary books to be maintained will be according to the nature and size of the business.

2. Accounting involves the **art of classifying** the transactions recorded in a journal. This is done by maintaining accounts in the book called "Ledger". This book contains individual account head under which all financial transactions of similar nature are recorded.

3. Accounting is also said to be the **art of summarising** business transactions in the form of a statements:

- Trial Balance
- Trading and Profit and loss account or Income and expenditure account.
- Balance Sheet as on particular date to know the financial performance of a particular organization.

4. The accounting records, only those **transactions and events in terms of money**, which are, of financial character. Transactions, which are non-financial in nature, are not recorded in the books of accounts.

5. The recorded financial data is **analysed and interpreted** in a manner that the end-users can take meaningful judgment about the financial condition and profitability of the business operations.

6. Analysis and Interpretation are complimentary to each other. Interpretation requires analysis, while Analysis requires interpretation.

7. The accounting information after being meaningfully analysed and interpreted has to be **communicated** to the interested parties.

Now let us discuss types of Accounting

There are basically three branches of accounting: Financial Accounting, Cost Accounting and management accounting

1) Financial Accounting

Financial Accounting deals with recording, classifying, summarizing the monetary transactions and communicating them to the interested parties. Financial Accounting is mandatory for all types of organization small or large. The preparation of accounts is done on twelve months bases, for company form of organization and also for tax purpose the accounting year ends on 31st March every year.

2) Cost Accounting

Cost Accounting deals with calculation of cost per unit or service rendered by adopting various costing methods for different nature of business. Such accounts are tailor made and are prepared for internal purpose only. They are not mandatory in nature i.e. small firms may not install costing system in their firm. There are different types of costing methods, costing techniques which can be used by the organization as per their requirement.

3) Management Accounting

When Financial Accounting and Cost accounting ends, management accounting starts. Management accounting deals with the analysis and interpretation of the results of financial accounting and cost accounting. This accounting is also called decision making accounting.

Now let us move on to next topic of Accounting as an Information System

The accounting starts from the evidence in the form of transaction which has occurred in the business, it is followed by recording the same in the books of original entry i.e. journal entry, classified in ledgers and summarized in the trial balance and followed by preparation of financial statements. The financial statement consists of Trading account, Profit and Loss Account and Balance Sheet. The total profit of the business organization arise in trading account which is known as Gross Profit of a particular period, which is then transferred to profit and loss account. All the administrative and selling and distribution expenses are recorded on debit side of Profit and loss account and Incomes and gains are recorded on the credit side of Profit and loss account. The Profit and loss account gives the Net profit i.e. the actual profit of the business for a particular period; which is transferred to balance sheet. The Balance sheet gives the information about all the Assets and Capital-Liabilities of the business organization as on the particular date. It is compulsory for company form of organization to prepare balance sheet as per Schedule III of Companies Act 2013.

The Companies, who publish their annual reports to general public, has to mandatory prepare Cash flow statement as per Accounting standard -3, Cash flow statement gives the information of Cash Inflow and Cash Outflow for a particular period which is based on Operating Activity, Investing Activity and financial activity of the organization.

The growth of the business can be known through analyzing the financial statements by computing different ratios.

Do you have any idea of who are the users of accounting?

Various parties use accounting information to serve their purpose. These parties are Proprietors or Owners, Mangers, Creditors, Prospective investors, Government, Employees, Customers, Students and general public. These

users use accounting information for forecasting, decision making and strategy formulation.

Now let us move on to next topic of qualitative characteristics of financial accounting. The qualitative characteristics of financial accounting are Understandability, Relevance, Reliability and Comparability.

1. **Understandability**: - the financial information must be easy to understand by the users of financial statements. It must be clearly presented supposed with foot notes wherever required.
2. **Relevance**: - The information must be relevant to the needs of the users. The information which are helpful to the users to take financial decisions are all relevant information.
3. **Reliability**: - The information must be free of material error and bias, and not misleading. Thus, the information should faithfully represent transactions and other events, and prudently represent estimates and uncertainties through proper disclosure.
4. **Comparability**: - The information must be comparable to the financial information presented for other accounting periods, so that users can identify trends in the performance and financial position of the reporting entity.

Now let us discuss the important topic of what are the functions of financial accounting. The main functions of financial accounting are:

1. It deals with the financial transactions
2. It is concerned with recording of the financial information in the books of Journal
3. Classification of the accounts in books of ledger

4. Summarizing the accounts in trial balance and preparation of balance sheet
5. Analysis and Interpretation of financial transactions
6. Communicating it to the interested parties.

Let us discuss next topic of advantages of financial accounting. The advantages of financial accounting are:

1 **To keep systematic records:** Accounting is done to keep systematic records of financial transactions, like purchase of goods, sale of goods, cash receipts , cash payments. Systematic records of various assets and liabilities of the business is also to be maintained.

2 **To ascertain the net effect of the business operations i.e. profit or loss of business:** We know that the primary objective of business is to make profit and businessman is very much interested in knowing the same. A proper record of income and expense facilitates the preparation of the profit and loss account (income statement). The profit and loss account reveals the profit earned or loss incurred by the business firm during a particular period.

3 **To ascertain the financial position of the business:** The businessman is not only interested in knowing the operating results, but also interested in knowing the financial position of his business i.e., where it stands. In other words he wants to know what the business owes to others and what it owns, and whether his capital has increased or decreased or remain constant. A systematic record of various assets and liabilities facilitates the preparation statement known as 'balance sheet' which reveals such information.

4 **To provide accounting information to interested parties:** apart from owners, there are various other parties who are

interested in knowing about the business firm, such as the management, the bank, financial institution, creditors, tax authorities etc. For the purpose the accounting has to systematically done.

The next topic is limitations of financial accounting

Financial Accounting suffers from following limitations:

1. Financial Accounting is strictly is based on historical events which are for a particular period. It does not record expected future transactions but note them.
2. Financial accounting does not classify the expenses into direct and indirect or fixed and variable and does not follow any method or technique of how to control them.
3. Financial Accounting is not useful for fixing selling price of a product.
4. It does not help to determine the variations in the cost which occurs due to seasonal changes or idle time and working hours of an organization.
5. It is not helpful in evaluating the best alternative for any capital expenditure on hand like purchase of plant or equipment.
6. It fails to provide product wise profit and its cause and effect relationship.

Now let us discuss basis of accounting

There are basically two systems of accounting: **Cash system of accounting and Mercantile or Accrual system of accounting**

1. Cash system of accounting

In a system in which accounting entries are made only when cash is received or paid. No entry is made when a payment or receipts is merely due. Government system of accounting is mostly on the cash system. Certain professional people record their income on cash basis.

2. Mercantile or Accrual system of accounting

It is a system accounting entries are made on the basis of amounts having become due for payment or receipt. This system recognizes the fact that if a transaction or an event has occurred; it becomes due for payment or receipt. The 'mercantile system' is considered better since it takes into account the effects of all transactions already entered into. This system is followed by most of the industrial and commercial firms.

2. Accounting principles

Let move on to next topic of accounting principles

Accounting principles can be classified into two categories:

1) Accounting Concepts
2) Accounting Conventions

ACCOUNTING CONCEPTS

The accounting concepts are ground rules in common language that govern accounting. The term concept means 'accounting postulates'. The important Accounting Concepts are:

1) Business Entity Concept
2) Money Measurement Concept
3) Going concern Concept
4) Cost Concept
5) Realisation
6) Accrual Concept
7) Periodicity
8) Matching Concept
9) Dual Aspect Concept

1. **Business Entity Concept**

This concept is also known as Separate Entity Concept. It is based on the assumption that the unit or entity is treated as different and distinct from its 'owners' in the eyes of accounting. All transactions of the business are recorded in the books of accounts from the view point of the business and not from the view point of the owner.

E.g. In case of sole proprietary 'capital 'and 'drawings' account are prepared to make a distinction between personal transactions and business transactions.

2. **Money Measurement Concept**

According to this concept, only the monetary transactions, which are capable of being expressed in terms of money, are included in the accounting records. Events or transactions, which cannot be expressed in terms of money, are not recorded at all in the books of accounts though they may be very much relevant to the business activity. For example, dedication of employees may be very important for the enterprise, but these facts are not recorded in accounting records.

3. **Going Concern Concept**

This concept assumes that business will continue to exist for a long period of time. It presumes the life of the business to be perpetual and there is neither the intention nor the necessity of closing or liquidating business in the foreseeable future.

4. **Cost Concept**

The concept is purely related to going concern concept. According to this concept an asset is recorded at the price paid to acquire it, and this cost is the basis for all subsequent accounting for the assets.

If a business buys a plot of land for Rs. 500,000 the asset would be recorded in the books at Rs. 500,000 even if its market value at that time may be Rs. 600,000.

The asset is recorded at cost at the time of its purchase but it may systematically be reduced in its value by charging depreciation.

5. Realisation Concept

According to this concept revenue is recognized when the transaction of sale is entered into and the obligation to receive the amount is entered into. Sale is considered to be made at the point when the ownership of goods passes to the buyer and he becomes legally liable to pay the seller.

E.g sales is made in the month of March and amount is received in the month of April, the revenue of sales is recognized in March.

6. Accrual Concept

Accrual concept implies that revenue is recognized, when it is realized irrespective of whether cash is received or not. Similarly, expenses are recognized in the period in which they accrue, irrespective of whether cash is paid or not. It requires that revenue is recognized when realized and expenses are recognized when they become due and payable without regard to actual time of receipt or payment of cash. For example, if electricity service is taken in the month of March and its bill is paid in the month of April, it is recorded in the books of accounts as an expense for the month of March and not for April.

7. Periodicity or Accounting Period Concept

According to this concept the life of a business entity is divided into smaller period of time to measure financial performance at regular interval of time. Generally the accounting period is of one year. Due to this concept accounts are closed at the end of every year and profit or loss of the business is calculated and position of assets and liabilities is extracted.

8. Matching Cost with Revenue Concept

To know the correct profit or loss of an accounting period it is necessary to match expenses incurred during that accounting period with the revenues earned during the same period. Thus NET INCOME or PROFIT = REVENUE – EXPENSES

As per this concept all expenses incurred during an accounting period to earn the revenues earned during that accounting period must be considered while determining net income or loss.

9. Dual Aspect Concept

This is one of the most fundamental concept of accounting. It may be stated as “for every debit, there is a credit”. Every business transaction has dual effect and the entry made for the transaction is recorded on the debit side of one account as well as on the credit side of other account by the same amount. E.g. Goods sold of Rs. 10,000. Cash is received Rs. 10,000 is debited while goods given at sales price; Rs. 10,000 is credited.

It may be expressed in the form of an equation:
Assets = Liabilities + Capital

3. Accounting Conventions

Now let us discuss Accounting Conventions

Accounting Conventions means customs or traditions established after a long usage of guide the preparation and presentation of accounting statements. Accounting conventions are more flexible as compared to accounting concepts. The important accounting conventions are:

1. Convention of 'Consistency'
2. Convention of 'Conservatism'
3. Convention of 'Materiality'
4. Convention of 'Full Disclosure'

1. Convention of Consistency

This convention emphasizes the use of uniform accounting practices from one period to another. It means that same accounting methods will be used for similar items over a period of time. Only when the accounting practices are followed consistently from year to year, the result disclosed in the financial statements will be comparable. For example, if depreciation is charged on fixed assets according to Written down Value Method, the same method should be followed from year after year.

2. Convention of Conservatism

According to this convention, the accountant should follow the rule of 'Anticipate no profits but provide for all probable losses.' This convention requires that profits should neither be overstated nor anticipated. On account of this convention 'stock is valued at cost price or market price whichever is less'. Similarly a provision is made for possible bad or doubtful debts out of current year's profits. Provision is created against fluctuations in the price of investments.

3. Convention of Materiality

According to this convention the accountant should attach importance to material details and ignore insignificant details. For example, each stationery items should not be mentioned separately but can be clubbed together under one head printing and stationery.

4. Convention of Full Disclosure

It requires the financial statements should reveal all the relevant and reliable information fully and fairly. Accountants should not conceal any fact which they purport to represent. It implies that there should be sufficient disclosure of information which is of material interest to proprietors, present and potential investors and creditors. This convention becomes more relevant in the company form of organization where management and ownership is in separate hands.

4. Accounting Standards

The last topic of this session is Accounting Standards

Financial statements are prepared to summarize the end-result of all the business activities by an enterprise during an accounting period in monetary terms. These business activities vary from one enterprise to other. To compare the financial statements of various reporting enterprises poses some difficulties because of the divergence in the methods and principles adopted by these enterprises in preparing their financial statements. In order to make these methods and principles uniform and comparable to the extent possible – accounting standards are evolved.

Let us see the meaning of Accounting Standards

Accounting Standards are the statements of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements. In layman terms, accounting standards are the written documents issued by the expert institutes or other regulatory bodies covering various aspects of measurement, treatment, presentation and disclosure of accounting transactions. In India Accounting Standards are issued by Institute of Chartered Accountants of India (ICAI)

Next topic relating to accounting standards is concept and benefits of Accounting Standards

The basic concept of Accounting Standards is to remove variations in the treatment of several accounting aspects and to bring about standardization in presentation of accounts. The intent is to harmonize the diverse accounting policies followed in the preparation and presentation of financial statements by different reporting enterprises and to facilitate intra-firm and inter-firm comparison. It helps to achieve the following:

a) It helps in establishing a framework for the presentation of financial statements in a uniform manner.

b) It ensures comparison and makes the financial statements comparable and prevents the chances of manipulation.

c) It Increases the credibility and reliability of financial statements.

d) The Uniformity of accounting practices and policies can mitigate the occurrence of frauds and bring transparency in accounting data.

e) To reduce the alternatives of accounting in the preparation of financial statements, thereby ensuring that the financial statements of different enterprises could be compared with a view to provide meaningful information to various users of financial statements so that they can make economic decisions.

Do you have any idea about who frames the accounting standards in India and what is its process? Let us understand this issue.

The Institute of Chartered Accountants of India (ICAI) recognizing the need to harmonize the diverse accounting policies and practices at present in use in India constituted Accounting Standards Board (ASB) on April 21, 1977. The primary function of ASB is to formulate accounting standards after taking into consideration the laws, customs, usages and business environment. It also gives due consideration to International Accounting Standards. It suggests areas in which accounting standards need to be developed. It publicizes the accounting standards and persuades the concerned parties to adopt them in the preparation and presentation of financial statements. The accounting standards are issued under the authority of the council. ASB has been entrusted with the responsibility of issuing clarifications on issues arising from standards. ASB also review the accounting standards at periodical intervals.

Now let us understand the Procedure for issue of accounting standards

Accounting Standards are issued by certain procedure as:

1. It determines the areas in which accounting Standards need to be formulated and prioritize it.
2. It takes assistance of the study group to consider specific subjects. It holds a dialogue with the representatives of the government, public sector undertakings, industry and other organizations for ascertaining their views.
3. It issues the exposure of draft of the proposed standard for comments by members of the institute and public at large on the basis of draft prepared by a study group.
4. The draft of the proposed standard is finalized after taking into consideration the comments received.

5. The final draft of the proposed standard is issued to the council of the institute. The council of the Institute reconsiders the proposed statements and makes necessary changes in consultation with ASB. Accounting Standards are then issued under the authority of the council.

   Accounting Standards when issued is recommendatory in nature for a certain period. After sometime, it becomes mandatory, then it becomes the duty of the members of the institute to ensure that the accounting standards have been followed in the preparation of financial statement and adequate disclosure have been made for the users of financial statements.

The last topic of the session is salient features of Accounting Standard 1 that is Disclosure of Accounting Policies

1. It refers to specific accounting principles and methods of which are applied for preparation of financial statements.
2. It ensures proper understanding of financial statements.
3. Both inter –firm and intra -firm comparison of Financial Statements is possible.
4. All significant accounting policies disclosed at one place would be helpful to the reader of financial statements.
5. It is based on the fundamental accounting assumptions like

- Going Concern: - The business organization is going to run for a long period of time and has a long life.
- Consistency: - The method of valuation of depreciation, expenditures, and inventories are consistently followed same year after year.
- Accrual: - Revenue and Cost are recorded in the financial statements on accrual basis.

6. It follows the Accounting concepts like

- Prudence: - it makes the estimates which are required to be made under uncertainties
- Form v/s Substance: - Accounting treatment must consider substance of transaction and not merely a legal form.
- Materiality: - Financial Statements should record all the financial information which are of material importance.

7. Example:

- Method of Depreciation
- Treatment of expenditure
- Valuation of Inventory
- Valuation of Fixed Assets

5. Summary

That is all about today's session regarding introduction to financial accounting. Today we discussed Concept of Financial Accounting, Branches of Accounting, Accounting as an Information System, Qualitative characteristics of Accounting Information, Advantages and Limitations of Financial Accounting, Basis of accounting, Accounting concepts and Conventions and primary information regarding Accounting standards.