Discipline: BS(CS/IT)
Subject: Financial Accounting [NEW Course]

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Financial Accounting

Financial accounting is a specific branch of accounting involving a process of recording, summarizing, and reporting the myriad of 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 record the company's operating performance over a specified period.

How Financial Accounting Works

Financial accounting utilizes a series of established accounting principles. The selection of accounting principles to use during the course of financial accounting depends on the regulatory and reporting requirements the business faces. For U.S. public companies, businesses are required to perform financial accounting in accordance with generally accepted accounting principles (GAAP). The establishment of these accounting principles is to provide consistent information to investors, creditors, regulators, and tax authorities.

Purpose of Accounting:

The primary purpose of accounting is to provide the information that is needed for sound economic decision making. The main purpose of financial accounting is to prepare financial statements that provide information about organization. Financial accounting is performed according to generally acceptable accounting principles (GAAP) in America and IAS/IFRS in rest of countries with in the laws and rules of particular country.

Preparation of statement is basic to financial accounting; they are also called General Purpose Financial Statements, because they serve the purpose of several users of financial statement. Accountants basically prepare four financial statements for meeting decision makers need.

Following are four financial statements:

1. Income Statement
2. Statement of Retained Earning
3. Balance Sheet
4. Statement of Cash Flow

Nature of Financial Accounting

Accounting Is First Step
Accounting is start when a financial transection takes place. It records the financial transection after that communicates this information to its users and then the user use this information for their decision making.

Accounting Is An Art And Science:
Accounting is an Art and Science as well. Accounting is an art of recording, classifying and summarizing of financial transactions. Accounting is science as well as it requires certain principles (accounting principle).

Accounting Is a Process
Accounting is a process of recording of financial transaction, summarizing, analyzing, and reporting to the user of accounting information.

Accounting Deals With Financial Transactions Only

Financial accounting is considering only monetary transactions. It does not take into account various non-financial aspects such as market competition, economic conditions, government rules, and regulations, etc.

Historic In Nature

Financial accounting considers only those transactions which are of historic nature. day-to-day activities transactions are recorded and the information is provided after a period of time. All financial decisions of the future are taken on the basis of this past information

Records Actual Cost

Financial accounting records the actual cost of the transaction and does not consider the price fluctuations taking place from time to time. It records the historical cost or the actual cost of the assets or liability.

Objectives of Accounting:

Following are main objectives of accounting.

1. To Maintain Accounting Record

Written record are always better than oral records, since written records can be used by different persons for different decision-making purposes and serve as evidence of transactions. Nowadays, the volume of transactions is so large; a human memory cannot absorb each and every transaction. Accounting is done to keep a systematic record of all transactions.

2. To Calculate the Results of Operations

To measure the financial performance of an enterprise, the results of operations are ascertained by preparing an Income Statement (also called trading and profit and loss account), which shows the matching of current costs with current revenues during a particular accounting period. A systematic record of income and expenses facilitates the preparation of the income statement.

3. To Ascertain the Financial Position

To evaluate the financial strength and weakness of an enterprise, the financial position is ascertained by preparing a Statement of Financial Position (also called balance sheet), which shows assets owned by enterprise and the sources of financing those resources. A businessman wants to know what

4. To Communicate the Information to the Users

Accounting communicates information to internal user and external users. The internal users include all the organizational participants at the levels of management i.e. top, middle and lower management. Top level management requires information for planning, middle level management requires information controlling the operations. For internal user, the information is usually provided in the form of reports, for instance cash budget report, production report, idle time report etc.

Since the external users e.g. banks and creditors etc. don't have direct access to the records of an enterprise, they have to rely on financial statement as source information. External users are basically interested in the solvency and profitability of enterprise.

Functions of Financial Accounting

Since the process of financial accounting is composed of some necessary functions, they are outlined herein:

Recording: Recording of economic information which is of financial character is the primary function of financial accounting. It involves analyzing individual business transaction as and when it occurs, such as, what has taken place? Identifying the nature of account that involves. Ascertaining the rules of debits and credits etc. After the business transactions being analyzed, they are to be recorded systematically in a book called the book or original entry. The whole process of recording a business transaction is called Journalizing. When used separated journals, they are referred as subsidiary journals.

Classifying: Classifying of financial information is concerned with systematic analysis of the recorded data. It involves posting of journalized transactions in the concerning ledger accounts by grouping them into the accounts that are of similar nature and balancing thereof. It is worth mentioning here, the advent of computers has aided this process significantly. Ledger accounts are balanced automatically when using a particular program developed for financial accounting purpose.

Summarizing: The transactions, having been posted and classified in accordance with the concerning ledgers, are then summarized in a particular manner in order to prepare the following statements. *Trial Balance, Income Statement and Balance sheet.*

Interpreting: This function involves analysis and interpretation of financial data. Since accounting is regarded as a business language, it provides necessary and the required information to its users through which the profitability and the financial position of a business may be ascertained, which in turn will be very much useful for planning and establishing various policies.

Communicating: After having been analyzed and well interpreted, the financial information is communicated to the intended users. The process undertakes preparing various reports including chief financial statements, *such as, cash flow, funds flow, ratio analysis and presentations with graphs etc.*

Financial Accounting, being known as the language of business, is of great value and importance to any business to provide a methodological approach in describing the financial activities of a business enterprise. As for any business, ascertaining the operating results during a period of time and the financial position at a specific point in time is necessary that in turn may lead to determine the performance as well as the value of a business, these objectives are accomplished with the help of Financial accounting process involving the aforementioned functions.

Users of Financial Accounting

Financial accounting data of companies are used by different users in different ways. Therefore, to reduce the complexity, regulatory authorities have set common rules and accounting standards known as GAAP (Generally Accepted Accounting Principles) those companies must follow. Now let's take a look at different users of financial accounting.

- **Auditors.** Third-party auditors need to audit company books and accounts and require an accurate depiction of financial statements to carry successful audits.
- **Shareholders**. Before investing, shareholders would ideally want a clear depiction of the company's value. Financial accounting can be used to assess a company's financial health and make calculated decisions.
- **Suppliers.** Balance sheets & income statements are assessed by suppliers before selling product on credit. These statements help suppliers deduce whether a company has enough liquidity to pay off its debt.
- **Brokers.** Most people buy & sell company stocks based on the advice of brokers and brokerage houses. These brokers constantly develop complex financial models using financial statements to predict and assess the true picture of the company.
- **Government and regulators.** Regulatory bodies also make use of financial information to assess whether companies are complying with laws set by regulatory bodies. Moreover,

governments can also use financial accounting to anticipate & forecast tax revenue from companies.

Conclusion

Financial accounting information is generally used by external users of the company. These users have limited or no knowledge about companies. The general idea is that these users are better able to comprehend the financial position of companies.

As mentioned before, public companies or companies that raise money by issuing shares need to disclose financial data. The general idea is that shareholders should know where they are putting their money into and be able to view the internal information of a company to be able to make better decisions.

Types of Accounting:

Just as there are many types of economic decisions, so there are many types of accounting information. Financial Accounting, Management Accounting and Tax accounting often are describing three types of accounting information that are widely used business decisions.

Financial Accounting

The accounting system, as developed originally, concerned only the financial state of affairs and the financial results of operations. This is called financial accounting. It includes preparation of accounts, generally on historical basis, so as to enable the management to prepare the financial statements showing result of operations and the financial state of affairs, to exercise full control over their property and assets if the firm or the institution concerned and to prepare returns and statement concerning taxation.

Financial accounting refers to information describing the financial resources, obligations and activities of an economic entity. It is the maintenance of daily record of all financial transactions in such manner that it would help in the preparation financial statements. This information is designed primarily to assist investors and creditors. Accounting information is also used for preparation of income tax return. Financial accounting information is used for so many purposes that it often is called "General-Purpose Accounting".

End results of financial accounting are financial statement. These statements must comply with accounting rules published by the various advisory and regulatory bodies. In other words, an organization does not have a completely free hand. This accounting is partly concerned with summarizing the transactions of a period and presenting the summary in a coherent form. This again is because financial statements are intended for outside consumption. The outsiders who have a need for and a right to information are entitled to receive it at defined intervals, and not at the whim of management.

Cost and Management Accounting

Cost and management accounting developed because of the limitations of financial accounting in respect of information relating to the cost of individual jobs, products, etc. this information is needed for purpose of making numerous decision like price to be quoted to a special customer.
Cost and management accounting is meant specifically to assist the management in its operational and strategic planning. This objective is achieved through preparation periodic reports about product, activities, departments and individuals. Cost accounting and responsibility accounting are the two significant parts of management accounting. The most important role of management accounting is to set targets in the form of functional budgets or standards, measure the actual performance and then make variance. It is specific purpose accounting.

Cost and Management accounting can be described as:

"This process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of information used by management to plan, evaluate and control within an entity and to assure appropriate use of and accountability for its resources".

Tax Accounting

The financial statements are prepared according to the General Accepted Accounting Principles (GAAP), International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and/or prevailing rules of country. Since these rules and regulation allow flexibility in the accounting treatment of different items, some of them may not be acceptable to tax authorities. Taxable profit must be calculated according to the tax laws of country, based on information provided by the financial statements. The preparation of tax returns has therefore become a specialized field. Every enterprise would like to minimize tax return. This required tax planning.