FINANCIAL ACCOUNTING

WEEK 1 (LECTURE ONE)

INTRODUCTION TO FINANCIAL ACCOUNTING

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Learning Objectives:

Upon completion of this chapter, you will be able to:

1. Appreciate what financial accounting is.
2. Understand the scope of financial accounting
3. Understand key elements of financial accounting

LECTURE ONE

INTRODUCTION TO FINANCIAL ACCOUNTING

1 Meaning of Accounting

Financial Accounting is a fundamental concept in the world of finance and business. It serves as the backbone of any organization's financial management, allowing for the effective tracking, reporting and analysis of economic activities and prudent decision-making.

As an information system, accounting provide quantitative information primarily financial in nature that is intended to be useful in making economic decisions by the users of financial information,

1.1 Definition of Accounting:

Accounting is the systematic and comprehensive process of identifying, recording, measuring, and communicating economic information about an entity to a wide range of users for making informed decisions.

Simply put, accounting is the process of recording, classifying, summarizing, analysing and preparing financial reports, and interpreting financial information about the economic activities of an organization. This information is used by stakeholders for decision-making.

Therefore, accounting as a concept is a:

- **Systematic and comprehensive process:** Accounting is not a haphazard activity; it follows a structured and organized approach. It covers all financial aspects of an entity, ensuring that nothing important is left out.
- **Identifying:** This step involves recognizing and documenting all financial transactions and events that affect the entity's financial position.
- **Recording:** Once identified, these transactions and events are recorded in a standardized manner to create a permanent financial record.
- **Measuring:** Accounting assigns numerical values to these transactions, allowing for meaningful comparisons and analysis.
- **Communicating:** The information is then conveyed to various stakeholders, both internal and external, who rely on it for decision-making.

1.2 Objectives of Financial Accounting

Financial accounting serves a critical role in the world of business by providing a structured framework for capturing, summarizing and communicating financial information. Its objectives are multifaceted, catering to the diverse needs of stakeholders within and outside an organization:

1. **Recording Business Transactions**: At its core, financial accounting is about recording all financial transactions that occur within an organization. This involves systematically documenting events like sales, purchases, expenses, investments and borrowings.
2. **Preparing Financial Statements**: Financial accounting aims to produce essential financial statements, such as the income statement, Statement of Financial Position (balance sheet), and cash flow statement. These statements provide a snapshot of the organization's financial performance, position and liquidity.
3. **Reporting Financial Position**: Another vital objective is to communicate the financial position of the organization accurately. This means presenting data on assets, liabilities, and equity, allowing stakeholders to assess the entity's health.
4. **Comparative Analysis**: Financial accounting enables entities to compare their performance with other players in the industry. Benchmarks and industry standards can be derived from financial statements.
5. **Disclosure of Accounting Policies and Contingent Liabilities**: Stakeholders appreciate transparency. Disclosures about accounting policies help stakeholders understand how financial data is prepared. Information about contingent liabilities helps stakeholders assess potential risks.
6. **Facilitating Decision-Making**: Management relies on financial data to make informed decisions about resource allocation, expansion, cost control and other strategic initiatives.

7. **Meeting Legal Requirements**: Regulatory authorities often require organizations to adhere to specific accounting standards and practices. Meeting these legal requirements is essential to avoid penalties and maintain compliance. For instance, as will be discussed in later topics, there are accounting requirements such as Generally Accepted Accounting Practices (GAAP) and International Financial Reporting Standards (IFRS) that require accounts to be prepared according to laid out guidelines

1.3 Distinction between Bookkeeping and Accounting:

While bookkeeping and accounting are related, they serve different functions within an organization:

• **Bookkeeping**: Bookkeepers are responsible for the day-to-day recording of financial transactions. They maintain ledgers, journals and other accounting records, ensuring that every transaction is accurately documented. Bookkeeping is more focused on data entry and record-keeping.

• **Accounting**: Accounting encompasses a broader set of activities. Accountants not only record transactions but also analyse, interpret and report on financial data. They prepare financial statements, perform financial analysis and provide insights to support decision-making. Accounting involves a deeper understanding of financial principles and often requires higher-level skills than bookkeeping.

Importance of an Organized Record-Keeping System:

It ensures that financial data is captured, classified and stored systematically. Here is why it is crucial:

Compliance: An organized record-keeping system helps a business adhere to regulatory requirements. It facilitates the preparation of tax returns, financial statements and other compliance-related documents.

Decision-Making: Access to organized financial records empowers decision-makers. Whether it is evaluating the feasibility of a new project, assessing the profitability of a product line or managing cash flow, organized records provide the necessary data.

Auditing and Accountability: During auditing, an organized record-keeping system simplifies the process for auditors. It allows them to trace transactions, verify accuracy and assess compliance with accounting principles.

Historical Data: Financial records, when organized, serve as a historical archive of a company's financial journey. This historical data can inform strategic planning, trend analysis and performance evaluation.

1.4 Accounting system

This is the field that designs and implements the system of record keeping. An important segment of accounting system is electronic data processing and can be something as simple as MS Excel spreadsheet that can be used to trace accounting transactions or a purpose-built software platform.

Here is why it is crucial:

a) **Compliance**: An articulate and elaborate system facilitates the preparation of tax returns, financial statements and other compliance-related documents.

b) **Decision-making**: Access to organised financial records empowers decision makers, whether it is evaluating the feasibility of a new project, assessing the profitability of a product line or managing cash flow, organised records provide the necessary data.

c) **Auditing and Accountability:** During auditing, an organised record-keeping system simplifies the process for auditors. It allows them to trace transactions, verify accuracy and access compliance with accounting principles.

d) **Historical data:** Financial records, when organised, serve as a historical archive of a company's financial journey, this historical data can inform strategic planning, trend analysis and performance evaluation.

1.5 Accounting and its purpose

Accounting plays an important role in the success of an organization. An organization is started for a particular purpose. For an organization to fulfil its mandate, all transactions must be accounted for.

Every institution or project is treated as a separate unit by its owners for accounting purposes. Accounting principles are applied by all organizations to achieve their objectives. The main functions of accounting are:

a) **Evaluation of Assets and Liabilities**

Every organization has some assets and liabilities. Assets are economic resources owned by an organizational entity and expected to provide economic benefits in future. Liabilities on the other hand are amounts due to other parties who transact business or provide goods and services to the organization on credit.

A statement of assets, liabilities and equity that is prepared on a particular date is known as a statement of financial position or an accounting equation.

ASSETS = LIABILITIES + EQUITY

b) Ascertainment of Income

The main purpose of any organization is either to make profit/income or provide services that add value to its stakeholders. For this purpose to be realised, accurate and complete recording of all financial transactions is essential because this information will be helpful in determining whether there was profit at any trading period or whether services were rendered.

No organization can survive in the long period without making reasonable returns or meeting its cost (break-even point).

c) To facilitate the Credit Transactions

Most of the organization's transactions are made on credit basis. In this case, goods are purchased or sold without cash payment and for services, services are rendered on credit and payment done at a later date.

Without credits transactions, an organization cannot be expanded beyond certain limits because financial resources are always a constraint to many organizations. If goods are purchased from a supplier on credit basis, then this supplier is known as the creditor (payable). Similarly, if goods are sold to a customer on credit, then this customer is known as a debtor (referred as a receivable in the financial records).

d) Assessment of Tax

Taxes are imposed by a government's national or local authorities where the organization is domiciled. These taxes can be classified as Income Tax, Value Added Tax, Excise Tax or Custom Duty. For accurate assessment of tax, accounting records must be maintained properly, otherwise an organization may be required to pay higher taxes in form of penalties by the government.

e) Accounting records can provide sufficient data relating to sales, profit, investments, etc. for the purpose of making decisions about future programs. Institutions are expected to maintain primary and secondary controls to safeguard the organization's resources. Thus, sound financial accounting ensures good

1.6 BUSINESS TRANSACTIONS

ENTITY CONCEPT

For one to appreciate accounting principles well, it is imperative to appreciate the entity concept clearly. Entity concept stipulates that once an organization is formed and is fully and legally registered, it acquires a legal personality which is separate from the owners. Thus, it can own assets, it can transact business, it can sue and be sued, and it can get into a contractual obligation with another entity or organization as well.

Every time a business transaction takes place from the time an organization or an entity is legally created or formed, it affects or impacts any of following accounts:

1. ASSETS

The Financial Accounting Standards Board (FASB) defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.”

Loosely defined, assets mean anything of economic value owned by an entity that can be used to generate revenue or used in production or provision of services. They may be broadly classified as Non-Current Assets (NCA) and Current Assets (CA).

Assets account have DEBIT balances

2. LIABILITIES

The Financial Accounting Standards Board (FASB) defines Liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”

Liabilities can be broadly classified as Current Liabilities and Long-Term Liabilities.

Liabilities account has CREDIT balances

3. EQUITY

Equity is defined as the residual interest in the assets of the entity after deducting all its liabilities. Equity is made up of owners’ capital and accumulated reserves.

Equity account has CREDIT balances

4. REVENUE

The core principle of International Financial Reporting Standard number 15 is that revenue is recognized when the goods or services are transferred to the customer at the transaction price, whether cash is received on not.

The reason why businesses are created is to provide goods or services that meet customers’ expectations. For a services oriented company, they provide service such as banking services or education services, whereas for a manufacturing or processing company, they provide products or goods. When such goods are sold, they generate revenue.

Revenue increases the owners’ equity.

Revenue account has credit balance.

5. EXPENSES

An expense is the cost of operations that an entity incurs to generate revenue or to provide a service.

This simply means that an organization has to incur a cost to provide a service or to produce a product.

Expenses decrease owners' equity.

Expenses have a debit balance.

DOUBLE ENTRY

A double-entry is a method of recording transactions whereby every business transaction is recorded in at least two accounts, either as a debit entry or a credit entry. The amounts recorded as debits must be equal to amounts recorded as credits.

When those accounts with debit balances increase, they are debited and when they decrease they are credited.

Example 1

When company ABC buys an organization car for US $ 50,000, in its books of account, Motor Vehicle account is debited with US $ 50,000. Since the organization's cash is used to buy the car, then cash account is credited with US $ 50,000.

ACCOUNTING ENTRIES

Dr. Motor Vehicle Account	**US $ 50,000**	
Cr. Cash account		**US $ 50,000**

Narration: Recognition of Purchase of Motor Vehicles using US $ 50,000

When those accounts with credit balances increase, you credit, but when they decrease you debit.

Example 2

When a company pays its supplier XYZ for goods supplied at the beginning of the year worth US $ 1, 000 by cheque.

ACCOUNTING ENTRY

Dr. XYZ	**US $ 1,000**	
Cr. Bank account		**US $ 1,000**

Narration: Recognition of payment to XYZ by cheque.

Example 3

3 labourers are employed and paid at the end of the month. Each labourer is paid US $ 300 per month. By the end of the month two labours.

Required: Indicate how this situation will be recorded in the books of account.

Dr. Salary (Wages) expense account US $ 900

Cr. Bank account (Wages already paid) US $ 600

Cr Accrual (Salary Outstanding US $ 300

Narration: Recognition of salary paid and recognising outstanding salary payment.

Example 4

Samsong Ltd sold 4 computer tablets worth $ 2,000 on credit to Evergreen Ltd. Indicate how this transaction will be captured in the books of Samsong Ltd.

Dr. Evergreen Ltd (Receivable/Debtor) US$ 2,000

Cr. Sales Revenue US $ 2,000

Narration: Recognizing sales of 4 Computer tablets worth US $ 2,000 on credit to Evergreen Ltd

1.7 CONCLUSION OF LESSON ONE

In a summary, financial accounting helps to address the following key issues:

- What the organization is worth;
- How much cash and cash equivalence that the organization has;
- Assets utilization efficiency;
- What transaction(s) were worth;
- How well an organization is performing relative to established targets;
- How well an organization is performing compared to past years and relative to other firms or companies in the same sector or industry.
- How much an organization owes other parties (debt);
- How much an organization's stakeholders owe it;
- How resources are available for distribution to Ordinary Shareholders.

The above issues are addressed through Statement of Financial Position (Balance Sheet), Comprehensive Income Statement and Cash Flow Statement.

References

McCallig, J. (2008). Introductory financial accounting: Using international financial reporting standards. John McCallig.

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