UNIT-5 Introduction Financial Accounting

Definition of Financial Accounting: Financial accounting is a branch of accounting that focuses on the recording, summarizing, and communication of financial information about an organization to external stakeholders. It involves the preparation of financial statements, adherence to accounting standards, and compliance with legal and regulatory requirements. Financial accounting provides stakeholders with relevant and reliable information for decision-making, evaluating financial performance, and assessing the financial position of the organization.

Scope of Financial Accounting: Financial accounting encompasses the process of recording, summarizing, and reporting financial transactions and information of an organization. It involves the preparation of financial statements, such as the balance sheet, income statement, cash flow statement, and statement of changes in equity. The scope of financial accounting extends to both internal and external stakeholders, including investors, creditors, regulators, and management.

Objective of Financial Accounting: The primary objective of financial accounting is to provide relevant, reliable, and timely financial information about an organization's financial performance, position, and cash flows. The objective is to assist stakeholders in making informed economic decisions by assessing the entity's financial health and performance. The following are the key objectives of financial accounting:

1. Recording Transactions: Financial accounting aims to accurately record and classify financial transactions in the organization's books of accounts. This involves identifying and capturing relevant financial data, such as sales, purchases, expenses, and investments, in a systematic and organized manner.
2. Preparation of Financial Statements: Financial accounting involves the preparation of financial statements, which present a summary of the organization's financial performance, position, and cash flows during a specific period. These statements provide stakeholders with an overview of the entity's financial health and enable them to evaluate its profitability, liquidity, and solvency.
3. Compliance with Accounting Standards: Financial accounting follows established accounting standards and principles, such as Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). These standards ensure consistency, comparability, and transparency in financial reporting, allowing stakeholders to make meaningful comparisons across different organizations.
4. Communicating Financial Information: Financial accounting aims to effectively communicate financial information to stakeholders through financial statements, disclosures, and accompanying notes. The information should be clear, understandable, and relevant, enabling stakeholders to make informed decisions and assess the entity's financial performance and prospects.
5. Decision-Making Support: Financial accounting provides stakeholders with information to support their economic decisions. Investors, creditors, and other users rely on financial statements to assess the profitability, risk, and return on investment of the organization. Management utilizes financial accounting information for strategic planning, budgeting, and evaluating performance.

What is a Bookkeeping System?

If you are planning to become a accountant or bookkeeper, you will need to familiarize yourself with bookkeeping systems to attract clients or to be recruited as an employee. In a world where virtually every business task is performed on a computer, it is no surprise that most bookkeeping is now done electronically. With all of the advantages of using a computer system comes the pain of learning a sometimes complex system and all of its features.

Bookkeeping systems are technically defined as single or double-entry software systems that are programmed with a set of rules that are specifically for recording financial information and various financial transactions that occur in business. Some systems are much more advanced than others, but any system that will aid in the recording of financial transactions is defined as bookkeeping software system. Read on, and learn more about the types of systems you may work with and how they can help you be the best bookkeeper or accountant.

What is a Single-Entry System?

Single-entry systems, which are most commonly used in small business where the entity does not have many transactions, is a very informal type of system. The system will record the cash disbursements, sales, purchases and also cash receipts on accounts receivables. Anything else, like equipment investments or stocks, will be recorded only in the notes section of the program.

The basic single-entry system will only report to one single account when any transaction is recorded, hence the name. While this is very simplistic for those who are inexperienced with bookkeeping, it can present problems when you start to balance accounts or construct financial statements.

What is a Double-Entry System?

A double-entry system is a far more advanced type of bookkeeping system that is used by most companies, bookkeepers and also by accountants with their own firms. With a double-entry system, there are fields for debits and credits so that every time that a transaction is recorded on one statement it is recorded on the corresponding account. With these systems, there are fields for everything from basics like cash receipts and sales to other transactions like the purchase of stock or buildings. It also includes tools that help with constructing the most detailed financial statements. This will help any company get fair valuation, file taxes, or secure funding for more cash flow.

Why is Computerized Bookkeeping so Popular?

In the past, the only way that records could be recorded and maintained was manually. Now, paper-based bookkeeping is a thing of the past. With computerized systems, recording all business transactions is easier than ever. When a credit is reported, the corresponding debit can be recorded as well. The only drawback is the time it takes to get technical training on the system, but once you learn you can be much more efficient.

Terms used in Accounting

In accounting, there are several key terms and concepts that are commonly used to describe and analyze financial transactions and information. Here are some important terms used in accounting:

1. Assets: Assets are economic resources owned by a company that have future value and can be measured in monetary terms. Examples of assets include cash, accounts receivable, inventory, property, and equipment.

2. Liabilities: Liabilities are obligations or debts owed by a company to external parties. They represent claims on the company's assets and must be settled in the future. Examples of liabilities include accounts payable, loans, and accrued expenses.

3. Equity: Equity represents the ownership interest in a company. It is calculated as the difference between the company's assets and liabilities. Equity can be further classified into various components, such as common stock, retained earnings, and additional paid-in capital.

4. Revenue: Revenue refers to the income earned by a company from its primary business activities, such as sales of goods or services. It represents inflows of economic benefits to the company.

5. Expenses: Expenses are the costs incurred by a company in generating revenue. They include various operating expenses, such as salaries, rent, utilities, and supplies. Expenses reduce the company's net income.

6. Income Statement: The income statement, also known as the statement of profit and loss or statement of operations, summarizes the company's revenue, expenses, and resulting net income or net loss for a specific period. It shows the company's financial performance.

7. Balance Sheet: The balance sheet provides a snapshot of a company's financial position at a specific point in time. It lists the company's assets, liabilities, and equity, showing the relationship between these elements.

8. Cash Flow Statement: The cash flow statement presents the inflows and outflows of cash and cash equivalents over a specific period. It classifies cash flows into operating, investing, and financing activities and shows the company's ability to generate and manage cash.

9. Accounts Payable: Accounts payable represents the amount owed by a company to its suppliers or vendors for goods or services received but not yet paid for.

10. Accounts Receivable: Accounts receivable is the amount owed to a company by its customers for goods or services sold on credit. It represents the company's right to receive payment in the future.

11. Depreciation: Depreciation is the systematic allocation of the cost of an asset over its useful life. It recognizes the decline in value of long-term assets, such as buildings, machinery, and vehicles, due to wear and tear or obsolescence.

12. Accruals: Accruals refer to revenues earned or expenses incurred by a company but not yet recorded in the financial statements. They are recorded to ensure that financial statements reflect the appropriate financial position and performance.

These are just a few of the many terms used in accounting. Understanding these concepts is essential for interpreting financial statements, analyzing financial data, and making informed business decisions.

Three rules for book keeping

In bookkeeping, there are three fundamental rules known as the "Golden Rules" that govern the recording of financial transactions. These rules are based on the double-entry system of accounting and ensure that the accounting equation remains in balance. The three rules are as follows:

1. Debit what comes in, credit what goes out:

- According to this rule, when an asset or an expense account increases, it is debited (recorded on the left side of the account).
- Conversely, when an asset or an expense account decreases, it is credited (recorded on the right side of the account).

2. Debit the receiver, credit the giver:
   - This rule applies to transactions involving liabilities, equity, and revenue accounts.
   - When a liability, equity, or revenue account increases, it is credited.
   - When a liability, equity, or revenue account decreases, it is debited.

3. Debit expenses and losses, credit income and gains:
   - Expenses and losses are recorded as debits since they decrease equity.
   - Income and gains are recorded as credits since they increase equity.

These rules ensure that each transaction is recorded in a balanced manner, maintaining the equality of debits and credits. In other words, the total debits must always equal the total credits.

It's important to note that these rules apply to the traditional double-entry bookkeeping system. In certain specialized cases, such as contra accounts or specific industry practices, exceptions to these rules may exist. However, the fundamental concept of balancing debits and credits remains the same.

Rules for Journalisation

When journalizing financial transactions in bookkeeping, there are a few key rules to follow to ensure accurate and consistent recording. These rules help maintain the integrity and reliability of financial records. Here are the general rules for journalizing transactions:

1. Identify the Accounts Involved: Determine the accounts that are affected by the transaction. Each transaction typically involves at least two accounts, with one being debited and the other credited. Identify the specific accounts based on the nature of the transaction.

2. Apply the Double-Entry Principle: Journal entries must adhere to the double-entry system, where each transaction affects at least two accounts with equal debits and credits. Debits and credits should be recorded in a way that keeps the accounting equation (Assets = Liabilities + Equity) in balance.

3. Debits on the Left, Credits on the Right: In the journal entry, the debited account is recorded on the left side (debit) and the credited account on the right side (credit). This maintains consistency and clarity when reviewing the journal entries.

4. Record the Date: Each journal entry should include the date of the transaction. This ensures the entries are properly sequenced and can be easily referenced later.

5. Use Descriptive Narration: Provide a brief but clear description of the transaction in the narration column. The narration should provide enough information to understand the nature and purpose of the transaction.

6. Apply the Accounting Equation: Ensure that the total debits equal the total credits in each journal entry. This confirms that the accounting equation remains in balance.

7. Include Supporting Documentation: Attach relevant supporting documents, such as invoices, receipts, or other evidence, to substantiate the transaction and provide additional information.

8. Maintain Consistency: Follow consistent formatting and layout for journal entries. This helps with organization and readability of the journal.

By adhering to these rules, you can accurately journalize financial transactions and create a reliable record of the organization's financial activities. Consistency and accuracy in journalizing transactions are essential for preparing accurate financial statements and ensuring the integrity of financial information.

Posting in a ledger

Posting in a ledger is the process of transferring the information from the journal to the respective ledger accounts. It involves recording individual transactions in the appropriate ledger accounts to maintain a detailed record of each account's activity. Here are the steps involved in posting to a ledger:

1. Identify the Ledger Accounts: Determine the ledger accounts related to the transactions recorded in the journal. Each account represents a specific asset, liability, equity, revenue, or expense.

2. Locate the Ledger Account: Find the appropriate page or section in the ledger where the account is recorded. Each account typically has a dedicated page or section for tracking its activity.

3. Record the Date: Write the date of the transaction in the date column of the ledger account. This helps in chronological organization and provides a reference for future analysis.

4. Record the Journal Entry Details: Copy the relevant details from the journal entry to the respective ledger account. This includes the account title, the journal page number, and the debit or credit amount.

5. Debits and Credits: Determine whether the transaction involves a debit or credit entry for the account being posted. Debit entries increase assets and expense accounts, while credit entries increase liabilities, equity, and revenue accounts.

6. Enter the Amount: Write the amount of the transaction in the appropriate debit or credit column of the ledger account, depending on the account being posted.

7. Calculate Account Balances: Update the running balance of the account by adding or subtracting the amount of each transaction. Maintain separate columns for debit and credit balances to track the account's overall balance.

8. Cross-Reference: Note the corresponding journal page number in the ledger account and vice versa. This helps in easily tracing back to the original journal entry for reference or verification.

9. Repeat for Each Transaction: Repeat the above steps for all transactions recorded in the journal, ensuring that each entry is accurately posted to the respective ledger accounts.

By posting transactions to the ledger, you create a centralized record of all account activities, allowing for easy tracking, analysis, and preparation of financial statements. The ledger serves as a comprehensive source of information for monitoring individual accounts and provides a foundation for financial reporting and decision-making.

Subsidiary books

Subsidiary books, also known as subsidiary ledgers, are specialized books or records used to record and track specific types of transactions in accounting. They provide a detailed breakdown of transactions related to particular accounts, allowing for efficient organization and analysis of financial data. Subsidiary books are commonly used alongside the general ledger to maintain accurate and comprehensive accounting records. Here are some common types of subsidiary books:

1. Sales Journal: Also known as the Sales Day Book or Sales Book, this subsidiary book records all credit sales made by a business. It includes details such as the date of the sale, customer's name, invoice number, description of the goods sold, and the sales amount.

2. Purchases Journal: The Purchases Journal or Purchases Day Book is used to record all credit purchases made by a business. It captures information such as the date of purchase, supplier's name, invoice number, description of the purchased items, and the purchase amount.

3. Cash Receipts Journal: The Cash Receipts Journal records all cash received by a business. It includes details of the cash received, such as the date, source of the cash (e.g., customer payments, interest income), and the amount received.

4. Cash Payments Journal: The Cash Payments Journal is used to record all cash payments made by a business. It includes information such as the date of the payment, payee's name, purpose of the payment, and the amount paid.

5. General Journal: While not a subsidiary book in the strictest sense, the General Journal is used to record transactions that do not fit into any of the other subsidiary books. It includes items such as adjusting entries, opening entries, closing entries, and other non-routine transactions.

These subsidiary books serve the purpose of categorizing and organizing transactions based on their nature, making it easier to track and analyze specific types of financial activities. At the end of an accounting period, the information recorded in the subsidiary books is summarized and posted to the general ledger, ensuring that the general ledger reflects the overall financial position and performance of the business.

Preparation of Trial balance

The trial balance is a key step in the accounting cycle that helps ensure the accuracy of the recorded transactions and the balance of accounts. It is prepared after all transactions have been journalized and posted to the respective ledger accounts. The trial balance summarizes the balances of all accounts, including assets, liabilities, equity, revenue, and expense accounts. Here are the steps involved in preparing a trial balance:

1. Collect the Ledger Balances: Gather the ending balances of each account from the general ledger. These balances should reflect the total of all debit and credit entries recorded in the ledger for each account.

2. Determine the Account Types: Categorize each account as an asset, liability, equity, revenue, or expense account. This classification is important for the layout and presentation of the trial balance.

3. List the Accounts: Create a two-column table with one column for account names and another for their corresponding balances. Start by listing all the accounts, grouping them based on their type and maintaining their order from the chart of accounts.

4. Enter Debit and Credit Balances: Enter the balances of asset and expense accounts on the debit side of the table and the balances of liability, equity, and revenue accounts on the credit side. Debit balances are entered as positive amounts, while credit balances are entered as negative amounts within parentheses.

5. Calculate Total Debits and Credits: Calculate the total of the debit column and the total of the credit column separately.

6. Verify Equality: Check that the total debits equal the total credits. If they are equal, it indicates that the books are in balance. If they don't match, it indicates an error in recording or posting transactions.

7. Investigate and Rectify Errors: If the debits and credits don't balance, review the ledger accounts and journal entries for any errors in recording or posting. Common errors include transposition errors, omitted entries, or incorrect account balances. Rectify any errors found and update the trial balance accordingly.

8. Prepare the Final Trial Balance: Once the trial balance is in balance, prepare the final trial balance report. It typically includes the account names, their respective balances, and the total debits and credits.

The trial balance serves as a preliminary check before preparing financial statements. Although it helps identify mathematical errors, it does not guarantee the accuracy of individual transactions. It is important to investigate any discrepancies and rectify them before proceeding with the financial statement preparation.

Preparation of Trading and Profit and Loss Account and Balance Sheet for a Proprietary Firm in Final Accounts:

1. Trading and Profit and Loss Account:

a. Start with the opening inventory: Determine the value of the inventory at the beginning of the accounting period.

b. Record purchases: Summarize all purchases made during the accounting period.

c. Calculate total purchases: Add the opening inventory to purchases to calculate the total goods available for sale.

d. Deduct closing inventory: Determine the value of the closing inventory and deduct it from the total goods available for sale to calculate the cost of goods sold.

e. Calculate gross profit: Calculate the difference between net sales and the cost of goods sold to arrive at the gross profit.

f. Record operating expenses: Summarize all operating expenses, such as rent, salaries, utilities, etc.

g. Calculate net profit: Deduct the total operating expenses from the gross profit to arrive at the net profit.

h. Transfer net profit: Transfer the net profit to the owner's capital account or retained earnings account.

2. Balance Sheet:

a. Determine assets: List all assets owned by the proprietary firm, including cash, accounts receivable, inventory, equipment, etc.

b. Determine liabilities: List all liabilities owed by the proprietary firm, such as accounts payable, loans, etc.

c. Calculate owner's equity: Calculate the owner's equity by subtracting total liabilities from total assets.

d. Prepare the Balance Sheet: Present the assets, liabilities, and owner's equity in a classified format, typically with assets listed first followed by liabilities and owner's equity.

Preparation of Trading and Profit and Loss Account and Balance Sheet for a Partnership Firm in Final Accounts:

1. Trading and Profit and Loss Account:

a. Prepare the Trading Account: Similar to a proprietary firm, calculate the cost of goods sold by determining the opening and closing inventory and recording purchases.

b. Calculate gross profit: Calculate the difference between net sales and the cost of goods sold to arrive at the gross profit.

c. Allocate profit and losses: Distribute the gross profit or loss among partners based on the agreed profit-sharing ratio as per the partnership agreement.

d. Record interest on drawings and salary: Deduct interest on partners' drawings and any agreed-upon salaries to arrive at the net profit or loss.

e. Transfer net profit or loss: Transfer the net profit or loss to the partner's capital accounts.

2. Balance Sheet:

a. Determine assets: List all assets owned by the partnership firm, including cash, accounts receivable, inventory, equipment, etc.

b. Determine liabilities: List all liabilities owed by the partnership firm, such as accounts payable, loans, etc.

c. Prepare partner's capital accounts: Prepare separate capital accounts for each partner, showing their respective contributions, share of profits, drawings, and closing balances.

d. Prepare the Balance Sheet: Present the assets, liabilities, and partner's capital accounts in a classified format.

In both cases, the Trading and Profit and Loss Account summarizes the trading activities of the firm, including sales, purchases, and expenses, resulting in the calculation of net profit or loss. The Balance Sheet, on the other hand, provides a snapshot of the firm's financial position, showing the assets, liabilities, and owner's equity or partner's capital. The final accounts provide crucial information for evaluating the profitability and financial health of the business.