

1.1 INTRODUCTION TO FINANCIAL ACCOUNTING

1.1.1. Meaning and Definition of Financial Accounting
Account is a summary of relevant business transactions at one place relating to a person, asset, expense or revenue named in the heading. An account is a brief history of financial transactions of a particular person or item. An account has two sides called **debit side** and **credit side**.

Financial Records of an organization that register all financial transactions, and must be kept at its principal office or place of business. The purpose of these records is to enable anyone to appraise the organization's current financial position with reasonable accuracy.

Accounting includes the presentation and interpretation of the results of the financial activity so that financial performance can be assessed. Accounting provides the economic information necessary for making investment decisions.

According to American Institute of Certified Public Accountants (AICPA), accounting is "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 a financial character and interpreting the results thereof".

With greater economic development, the meaning of the term 'accounting' gradually became broader.

According to American Accounting Association (AAA), accounting is, "The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information".

According to the Accounting Principles Board of AICPA, "The function of accounting is to provide quantitative information, primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions".

According to Smith and Ashburne, "Accounting is a means of measuring and reporting the results of economic activities".

According to Bierman and Derbin, "Accounting may be defined as the identifying, measuring, recording and communicating of financial information".

According to R.N. Anthony, "Accounting system is a means of collecting, summarizing, analyzing, and reporting in monetary terms the information of the business".

The above definition contains four essential characteristics of accounting:

- 1) Economic events,
- 2) Identification, measurement, recording, classification, analyzing and communication,
- 3) Organization, and
- 4) Interested users of information.

1.1.2. Nature of Financial Accounting

Following are the nature of financial accounting:

- 1) **Monetary Transactions:** In financial accounting only transactions in monetary terms are considered. Transactions not expressed in monetary terms do not find any place in financial accounting, howsoever important they may be from business point of view.
- 2) **Historical Nature:** Financial accounting considers only those transactions which are of historical nature i.e., the transaction which have already taken place. No futuristic transactions find any place in financial accounting, howsoever important they may be from business point of view.
- 3) **Legal Requirement:** Financial accounting is a legal requirement. It is necessary to maintain the financial accounting and prepare financial statements there from. It is also obligatory to get these financial statements audited.
- 4) **External Use:** Financial accounting is for those people who are not part of decision making process regarding the organization like investors, customers, suppliers, financial institutions etc. Thus, it is for external use.
- 5) **Disclosure of Financial Status:** It discloses the financial status and financial performance of the business as a whole.
- 6) **Interim Reports:** Financial statements which are based on financial accounting are interim reports and cannot be the final ones.
- 7) **Financial Accounting Process:** The process of financial accounting gets affected due to the different accounting policies followed by the accountants. These accounting policies differ mainly in two areas: Valuation of inventory and Calculation of depreciation.

1.1.3. Scope of Financial Accounting

The scope of financial accounting is as follows:

- 1) **Business Forecasting:** Every business tries to forecast its future activities on the basis of the past experience and present practices. It wants to determine the policies and programmes well in advance. For example, a business may like to know the quantity and quality of goods to be manufactured in future. Accounting provides this facility to the business.

- 2) **Correct Decision-Making:** Every business house has to take many economic and financial decisions, for example, determination of price on the basis of cost, imports-exports, increase, or decrease in investments, distribution of dividend, bonus, etc. All such decisions should be taken with utmost care. Any wrong decision taken may bring in many difficulties and problems. An appropriate and consistent accounting system helps in taking various decisions in the business.
- 3) **Correct Taxation:** A business house has to pay many taxes such as income-tax, sales tax, excise duty, customs, etc. The quantum of all taxes depends on the results shown by the financial accounts. A proper accounting system followed in the business helps in determining correct amount of taxes.
- 4) **Helpful in Solving Business Disputes:** The accounts maintained as per rules are documentary proof in courts of law. On the basis of the accounts a business house can sue the other and can defend itself in case of any dispute between the two. A concern can also proceed for getting declared insolvent in case its liabilities exceed its assets. Accounting helps the concern in all disputes and in the situation of insolvency.
- 5) **Replacing Memory:** Business transactions are innumerable, varied, and complex, as such it is quite impossible to memorize each and every transaction. Accounting records these transaction in writing and thus it is not necessary that the businessman should memorize all the transactions.
- 6) **Assessing the Performance of the Business:** Accounting keeps proper and systematic record of all business transactions. Income statements are prepared with these records and one is able to know the profit earned and the loss suffered by the business.
- 7) **Assessing the Financial Status of the Business:** Financial position of the business is displayed through position statement, i.e., balance sheet of the business. The statement is prepared at the end of the accounting year and reflects the true position of assets and liabilities of the business on a particular date.
- 8) **Documentary Evidence:** Accounting records can also be used as evidence in the court to substantiate the claim of the business. These records are based on documentary proof. Every entry is supported by authentic vouchers. That is why; the court accepts these records as evidence.
- 9) **Assisting in Realization of Debts:** We, in 'Accounts' prepare personal ledger accounts of all the parties. The personal account shows the exact amount due from the debtors. One can send the debtors their statement of accounts and thus enable them to verify entries and also to make early payment of the amount due. The account can also be used to prove the claim of the business against the debtors in the court.
- 10) **Preventing and Detecting Frauds:** The proper accounting system and effective arrangement of internal check prevents leakage of goods and cash.

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In case cheating takes place, theft or embezzlement is made committed, accounting helps in detection of these losses and responsibility for it. Proper accounting prevents employees from fraud.

- 11) **Helpful to Management:** Accounting is useful to the management in many ways. It enables the management to assess the achievement of performance. Actual performance can be compared with budgeted performance or with the performance of previous years. The weaknesses of the business can be identified and corrective measures can be taken to remove them. Various profitability, sales, and liquidity ratios can be calculated, the actual performance can be evaluated and effective action can be decided for the future. Funds flow statement can be prepared to understand the additional funds earned during the period of application.

1.1.4 Objectives of Financial Accounting