RABBI ZIDNI 'ILMA

YENEPOYA
(DEEMED TO BE UNIVERSITY)

Accounting for Business

Unit-01
Introduction to Financial

Semester-01

Bachelor of Business Administration

UNIT

01

Introduction to Financial Accounting

Names of Sub-Units

Meaning and objectives of Financial Accounting, types of accounting users of financial statements, types of business entities, Users of financial statements (Internal and External)

Overview

In this unit, firstly, you will study the concept of financial accounting. Then, you will gain insight into Meaning of Financial Accounting. The chapter will also shed light on Objectives of Financial Accounting, and Types of Accounting. In the end, you will be acquainted with the study of Users of Financial Statements and Types of Business Entities.

Learning Objectives

In this unit, you will learn to:

⌘ Discuss the Meaning and objectives of financial accounting

⌘ Classify the Various branches of accounting

⌘ Describe the Users of financial statements

⌘ Extent the Different types of business entities

Learning Outcomes

At the end of this unit you would:

- ⌘ Assess the accounting and why is accounting needed
- ⌘ Appraise the different branches of accounting
- ⌘ Evaluate the various users of financial statements
- ⌘ Analyse the different types of business entities

Pre-Unit Preparatory Material

- ⌘ http://www.ddegjust.ac.in/studymaterial/mba/cp-104.pdf
- ⌘ https://www.ccs.edu/cms/lib/NY01913591/Centricity/Domain/199/CHAPTER%201%20SUPA%20MY%20NOTES.pdf

1.1 INTRODUCTION

An accountant's main function has always been to provide owners managers of an organisation with accurate and timely financial information. This information serves as the foundation from which tactical and strategic decisions are often made. However, much more is expected of accountants today. The view of accountants being pure "number crunchers" or gatherers of information is fading.

Today accountants are becoming increasingly involved in the operational and strategy formulation side of business. They now advise and consult with owners and managers on productivity, profitability and other business issues. In short, an accountant is now expected to become an integral part of the organisation. To do this, he will need to understand the nature of organisations, their structure and their operations.

This unit is the foundation of your knowledge: if you can build a solid base, everything you "construct" will have to be consistent and will last over time. By the end of working through this unit, you should be able to understand the meaning and objectives of financial accounting, the various types of business entities, the various users of financial statements, and various types of accounting.

1.2 OVERVIEW OF 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.

Work opportunities for a financial accountant can be found in both the public and private sectors. A financial accountant's duties may differ from those of a general accountant, who works for himself or herself rather than directly for a company or organization.

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.

Financial accounting results in the determination of net income at the bottom of the income statement. Assets, liabilities and equity accounts are reported on the balance sheet. The balance sheet utilizes financial accounting to report ownership of the company's future economic benefits.

1.2.1 Meaning of Financial Accounting

The New York state society of CPAs defines financial accounting as recording and reporting financial transactions, including the origination of the transaction, its recognition, processing and summarisation in the financial statements.

From the start of a business, various transactions and events will start to take place. All transactions should have as their base certain source documents such as invoices or receipts, from which we record information in the accounting books and then summarise this information in the financial statements.

The accountant will be responsible for accounting for business transactions and reporting them to external users. The accounting will therefore consist of the following:

1. Identifying and recording the transactions that take place during the year
2. Analysing them and
3. Summarising and reporting them in the financial statements.

Recording

Recording refers to writing the transactions in words and figures so that reliable information regarding the position of the business can be made available at any point in time. The books where this information is recorded are known as the books of original entry.

The transactions are recorded in the books of accounts on the basis of documents such as:

- Invoices
- Receipts
- Vouchers
- Bank statements etc.

Analysing

From the books of original entry, the transactions are analysed and posted to the ledgers. The ledger book contains separate categories such as purchases account, sales accounts, cash account, expenses account, etc. Every transaction has two effects. As each transaction will have a double effect, two ledger accounts will be affected when a transaction is posted.

Summarising

Millions of transactions could occur during a year. Once they are categorised, we need to be able to summarise them in a structured manner to understand an entity's financial position at the end of a period and its performance during the period.

The final products of accounting are the business financial statements. The two main financial statements that summarise all the transactions and events of a business during a period are the:

- Profit and loss account
- Balance sheet

The profit and loss account is a statement that reflects all the items of income and expenses incurred by a business during a certain period. The bottom line of the profit and loss account is the profit/loss generated by the business during that period.

The balance sheet is a statement reflecting everything that the entity owns (its assets such as fixed assets, trade receivables and cash) and everything it owes (its liabilities to the owners and third parties such as loan and trade payables) as at a certain point in time.

1.2.2 Objectives of Financial Accounting

- The primary objective of accounting is to systematically record the financial information of a business and provide that information to various stakeholders to enable them to make necessary decisions.
- Accounting enables finding profit or loss made by the business in a particular period.
- Accounting enables ascertaining the financial position of a business, such as its assets and its liabilities.
- Accounting helps to ensure statutory compliance and tax filing.
- Accounting aids in evaluating the performance of the business over a particular period and helps make decisions like an investment of funds, expansion of business, closing down a branch etc., to improve performance. Thus, it helps in decision-making.
- Accounting also helps in predicting future trends based on past records.
- Properly maintained accounts are required for getting loans and advances from banks and financial statements.

1.3 TYPES OF ACCOUNTING

Accounting can be divided into three types as financial accounting, management accounting and cost accounting.

Financial Accounting

Financial accounting is collecting, classifying, recording and summarising the financial transactions for the purpose of presenting the financial results of an organisation for the given period.

Management Accounting

Management accounting primarily focuses on accumulating and providing information to the management of the entity to ensure effective fulfillment of their functions of planning, organizing, directing and controlling the business. The objective of management accounting is to assist the internal users with the necessary information in order to enable them to make business decisions.

Cost Accounting

Cost accounting deals with involves collecting, recording and analysing data relating to costs of aproduct or a process or a project with the objective of controlling those costs. There are various types ofcosts such as fixed cost, variable cost, opportunity cost, direct cost and indirect costs.

1.4 USERS OF FINANCIAL STATEMENTS

The financial statements provide a deep insight into the financial health of a company which is the basis of making various types of decisions. There are many internal as well as external users of financial statements as follows:

Owners/Shareholders and Potential Investors

The primary users of an organisation's financial statements are its owners/shareholders. In fact, the financial statements are specifically addressed to this very group. This is because owners/shareholders have provided the capital that makes it possible for an organisation to begin its operations. Therefore it is their capital that is at risk if the company goes bankrupt. Naturally, they will want as much information and detail as possible in order to determine if their investment is not only still safe but also growing.

Management

Management will use the financial statements of the organisation as a kind of "report card" on their decisions/activities throughout the year. This is because the statements reflect how profitable (or unprofitable) these decisions or activities have ultimately been for the organisation.

Providers of Finance e.g. Banks or Other Financial Institutions

Creditors such as banks and other financial institutions typically provide the funding an organisation needs to carry on its operations and/or expand its business. The information they will seek from the organisation's financial statements include:

- How profitable the organisation has been.
- Whether the company will continue to operate in the coming years or is it likely that it will go out of business.
- Whether operations of the organisation have generated sufficient cash flow to satisfy their loan repayments going forward.
- The value of the assets the organisation may have pledged as security/collateral.

Traderelations

Trade relations represent the suppliers and customers of an organisation. Suppliers or vendors of an organisation will be interested in its financial statements. They will use these statements to determine the financial condition and performance of the business in order to find out whether the organisation will be able to pay for the goods/services it orders from them.

Employees

Employees of an organisation are interested in the financial condition and performance of an organisation because that is the source of their salaries. Also, organisations that are performing poorly or are in a weak financial position are unlikely to offer much scope for promotions, career development, etc. Employees can see the prospects from the financial statements.

Government

Financial statements of organisations serve as a data source for the government when it is compiling national economic statistics such as the country's GDP (Gross Domestic Product). This helps the government in making different policy decisions.

Tax Authorities

Tax authorities use financial statements to determine tax amounts. Income shown by the profit and loss account is used as the starting point for calculating taxable income. Revenue and purchase figures are used to determine GST liability.

1.5 TYPES OF BUSINESS ENTITIES

Normally, on the basis of the objectives, organisations can be divided into two parts:

1. Commercial (profit-oriented) organisations and
2. Not-for-profit organisations.

Commercial Organisations

A commercial organisation is any entity that has been created for the purpose of generating profits. There are three main types of commercial organisations as follows:

- The sole trader: A sole trader is a 'one-man-band' for example a hairdresser, a plumber, an accountant and a lawyer. The entire business is owned and controlled by a single person. The ownerand the operator of the organisation are the same people. Although other persons may be employed, ultimately, all responsibility and decision-making authority rests with this one individual. The owner's liability is unlimited for all debts of the business as he alone is responsible.
- Partnerships: When two or more individuals pool their resources and join forces, a partnership is formed. A partnership is a mutual agreement between two or more individuals involving the division of authority and profits among partners. Common examples of partnerships are law firms or accounting firms.
- Companies: A company is a business entity registered under the Companies Act, 2013. The owners buy shares in the entity and this money is used by the entity to carry out its activities. The owners are known as shareholders.

Unlike the situation with sole traders and partnerships, there is a division between the personal assets of the owners and their investment in the company. The company is a separate legal entity from the owners.

Entities may be incorporated as private limited companies or public limited companies.

- Private Limited Companies: An entity formed as a private limited company is usually held by a small group of people.

  The liability of the owners of a private limited company is limited to their investment in the company.

- Public Limited Companies: Public limited companies also have the protection of limited liability. However, unlike private limited companies, ownership of the organisation is open to the public.

  Public limited companies are listed on a Stock Exchange therefore, they can have thousands of shareholders and they are generally medium to large entities.

Not-For-Profit Organisations

In direct contrast to commercial organisations, not-for-profit organisations are started and run for the purpose of providing benefits. These benefits may be provided on an individual level or to society as a whole.

These organisations generally do not earn a profit but aim to provide or deliver a service. Not-for-profit organisations derive their revenue from three sources:

- their revenue generating activities;
- government funding and
- donations (from both individuals and organisations).

Not-for-profit organisations vary greatly in terms of both size and type. Examples include trade unions, hospitals and universities. All of these organisations have been created and are run for providing a beneficial service.

Public Sector

Public sector organisations are organisations that are owned by society. They also do not operate for a profit. They are set up and run by governments to provide goods or services to the people of the society.

Although these organisations charge their customers, their main aim is to efficiently provide the products/services the society needs.

Public sector organisations are financed by governments and their own revenue-generating activities.

Examples include the post office, electricity and water boards as well as public transportation such as the bus and railway systems.

Non-Governmental Organisations

Non-governmental Organisations (NGOs) are any organisations that work towards a social, cultural, economic, or educational cause.

They are usually started and run to provide a good or service that the government is not providing or to better the interests of citizens. NGOs cover a wide spectrum of aims ranging from education to the environment.

Examples include Amnesty International, Greenpeace and the Red Cross. Amnesty International campaigns for human rights across the globe. Greenpeace activities are all geared towards protecting and preserving the natural environment. The Red Cross's mission is to provide relief to victims of wars and internal conflicts.

Cooperative Societies

Cooperative societies are autonomous associations of persons united voluntarily to meet a common economic, social and/or cultural objective, through a jointly-owned and controlled enterprise.

In short, it is an organisation that is owned and managed jointly by those who use its facilities and services. A cooperative's purpose is to provide services on a non-profit basis to the shareholders or members who control it.

An example of a cooperative (in certain countries) is apartment buildings. A cooperative would own the building and the land it is on. Individual apartment owners would be granted shares in the cooperative based upon the size/value of their apartments.

The cooperative would also be responsible for the maintenance of the building with financing from members' monthly dues.

1.6 Users of financial statements (Internal and External)

Financial statements serve as critical tools for communication and decision-making for both internal and external users. Here's an overview of the primary users of financial statements and their interests:

External Users:

1. **Investors and Shareholders:**

- *Interest:* Investors and shareholders are concerned with the profitability and financial health of the company. They use financial statements to assess the company's performance, make investment decisions, and evaluate the potential for returns.

2. **Creditors and Lenders:**

- *Interest:* Creditors, such as banks and bondholders, are interested in the company's ability to meet its financial obligations. They analyze financial statements to assess creditworthiness and determine the risk of lending money to the business.

3. **Customers:**

- *Interest:* Customers may be interested in a company's financial stability and profitability as it can affect the long-term availability and quality of products or services.

4. **Suppliers:**

- *Interest:* Suppliers want to ensure the financial stability of their customers to reduce the risk of nonpayment. Financial statements help them assess the creditworthiness of the businesses they supply.

5. **Government Agencies:**

- *Interest:* Regulatory authorities and tax agencies use financial statements to ensure compliance with accounting standards and tax regulations. They may also use the information for tax assessment purposes.

6. **Analysts and Financial Advisors:**

- *Interest:* Financial analysts use financial statements to conduct in-depth analyses of a company's performance. Their insights are valuable for investors and stakeholders looking for expert opinions on investment decisions.

Internal Users:

1. **Management:**

- *Interest:* Management uses financial statements for strategic planning, decision-making, and performance evaluation. Key financial metrics and trends help in assessing the effectiveness of business strategies and making informed decisions.

2. **Employees:**

- *Interest:* Employees may be interested in a company's financial health as it can impact job security, potential for salary increases, and the availability of employee benefits. Financial statements provide insights into the company's stability.

3. **Board of Directors:**

- *Interest:* The board of directors monitors the overall financial performance of the company to ensure it aligns with the company's goals and objectives. They use financial statements to make informed decisions and provide guidance to management.

4. **Internal Auditors:**

- *Interest:* Internal auditors assess the accuracy and reliability of financial statements, ensuring compliance with internal policies and procedures. They play a crucial role in maintaining internal controls and risk management.

5. **Employees' Unions:**

- *Interest:* Unions may use financial statements to assess a company's financial health during contract negotiations. The financial stability of the company can impact negotiations related to wages and benefits.

Conclusion 1.7 CONCLUSION

- An accountant's main function has always been to provide owners / managers of an organisation with accurate and timely financial information.
- This information serves as the foundation from which tactical and strategic decisions are often made. However, much more is expected of accountants today.
- The view of accountants being pure "number crunchers" or gatherers of information is fading.
- 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.
- Work opportunities for a financial accountant can be found in both the public and private sectors.
- A financial accountant's duties may differ from those of a general accountant, who works for himself or herself rather than directly for a company or organization.
- 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, businessesare 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.
- Financial accounting results in the determination of net income at the bottom of the income statement.
- Assets, liabilities and equity accounts are reported on the balance sheet.
- The balance sheet utilizes financial accounting to report ownership of the company's future economic benefits.
- Accounting can be divided into three types as financial accounting, management accounting and cost accounting.
- The primary users of an organisation's financial statements are its owners/shareholders.
- In fact, the financial statements are specifically addressed to this very group. This is because owners/shareholders have provided the capital that makes it possible for an organisation to begin its operations.
- Therefore, it is their capital that is at risk if the company goes bankrupt. Naturally, they will want as much information and detail as possible in order to determine if their investment is not only still safe but also growing.

1.8 GLOSSARY

- Accounting: Accounting is the process of recording and reporting financial transactions, including the origination of the transaction, its recognition, processing and summarisation in the financial statements.
- Recording: Recording refers to writing the transactions in words and figures so that reliable information regarding the position of the business can be made available at any point in time.
- Financial accounting: Financial accounting is collecting, classifying, recording and summarising the financial transactions for the purpose of presenting the financial results of an organisation for the given period.
- Cost accounting: Cost accounting deals with involves collecting, recording, and analysing data relating to costs of a product or a process or a project with the objective of controlling those costs
- Partnership: A partnership is a mutual agreement between two or more individuals involving the division of authority and profits among partners.
- Public sector Organisations: Public sector organisations are organisations that are owned by society.
- Non-governmental Organisations (NGOs): NGOs are organisations that work towards a social, cultural, economic or educational cause.
- Cooperative societies: Cooperative societies are autonomous associations of persons united voluntarily to meet a common economic, social and/or cultural objective, through a jointly-owned and controlled enterprise.

1.9 CASE STUDY: BUSINESS RISK

Case objective

This case study highlights the way of study by which a Ana and Jay can reduce their business risk.

'Say it with a Card, is a studio run by two friends Ana and Jay. The studio is famous for handmade birthday cards, anniversary cards and seasonal greeting cards on the occasions of Diwali, Christmas and New Year made by budding artists from Maharashtra. Pankaj Variety Stores (PVS) is a large retail store having 12 branches in various cities of Maharashtra. PVS wants to order a very large quantity of Diwali cards for its stores with payment to be made three months after delivery.

Having never dealt with PVS before, Ana and Jay are nervous about sending out such a large order, as they are unsure as to whether they will be paid after three months. Ana and Jay believe they have only two options: to ask for payment up-front (and risk losing the order) or to go ahead with the order and hope for the best.

However, their accountant suggests a third option. They should review the published financial statements of PVS to ascertain its past financial performance and condition. These statements will indicate PVS's liquidity (i.e. ability to pay its debts). If the statements reflect that PVS is in a strong financial position, then accepting the order becomes a much more calculated business risk.

Questions

1. Is ‘Say it with a Card’ an internal user or an external user of financial statement?

   (Hint: ‘Say it with a Card’ is an external user.)

2. What constitutes financial statements?

   (Hint: Financial statements primarily constitute a statement of profit or loss account and balance sheet.)

3. Is it possible that ‘Say it with a Card’ is registered as an NGO?

   (Hint: No, ‘Say it with a Card’ cannot be an NGO as it is a commercial organisation.)

4. ‘Say it with a Card’ is most likely to be what type of organisation?

   (Hint: ‘Say it with a Card’ is more likely to be a partnership firm or a private limited company. Since two people are managing the company, it cannot be a sole trader. Also, since it is closely held, it is unlikely to be a public company.)

5. Can ‘Say it with a Card’ view management accounts of PVS to evaluate their financial position?

   (Hint: ‘Say it with a Card’ cannot view PVS’s management accounts as management accounts are available only to internal users. The external users only have access to financial statements based on financial accounting.)

1.10 SELF-ASSESSMENT QUESTIONS

A. Essay Type Questions

1. Describe the three main branches of accounting.
2. What type of information do the financial institutions normally seek from an entity’s financial statements?
3. Explain what is commercial organisation.

Answers for Self- Assessment questions

A. Hints for Essay Type Questions

1. The three main branches of accounting are financial accounting, management accounting, and cost accounting.

   Financial accounting is collecting, classifying, recording, and summarising the financial transactions to present the financial results of an organisation for the given period. Financial accounting reflects on the past performance of the entity and uses historical data to generate financial statements for the use of internal as well as external users.

   Management accounting accumulates and provides information to the management of the entity to assist them with the necessary information to enable them to make business decisions. Management accounting usually involves budgeting and forecasting, financial analysis, cost analysis, etc.

Cost accounting involves collecting, recording and analysing data relating to costs of a product or a process or a project to control those costs. Cost accounting uses various techniques such as budgeting, activity-based costing, and variance analysis to evaluate cost data. This analysis helps the management to improve efficiencies and save costs. Refer to section types of accounting

2. The information that the financial institutions normally seek from the organisation's financial statements include:

    - How profitable the organisation has been.
    - Whether the company will continue to operate in the coming years or is it likely that it will go out of business.
    - Whether operations of the organisation have generated sufficient cash flow to satisfy their loan repayments going forward.
    - The value of the assets the organisation may have pledged as security/collateral.

    Refer to section Types of Business Entities

3. A commercial organisation is any entity that has been created for the purpose of generating profits. This is the only criterion that needs to be satisfied for an organisation to be deemed a commercial organisation. The primary goal of commercial organisations is to maximise profits. The type of activity or work that the organisation does is of no relevance. The same rule applies in regards to the size of the organisation. A small one-man consulting firm and the multiband empire of Reliance Industries are both commercial organisations. Refer to section Users of Financial Statements.

Post Unit

- https://idronline.org/the-laws-that-govern-indias-nonprofits/

1.12 TOPICS FOR DISCUSSION FORUMS

- Discuss the need and importance of public sector organisations.
- Discuss how the doctrine of a separate legal entity protects the interest of the business.

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