

## **Lecture 2: Financial Accounting**

### **Learning Objectives**

1. To define the financial accounting and the main qualitative characteristics of accounting information.
2. To identify the main financial statements and the users of financial accounting information.
3. To understand the regulatory systems of accounting.

**Financial accounting** is a process through which managers report financial information about an economic entity to external users. The financial accounts highlight:

- The way in which company funds have been invested.
- The return made on those investments.
- New funds invested in the business by the shareholders, and funds paid back out to the shareholders as dividends.

### **The Main Qualitative Characteristics of Accounting Information**

The qualitative characteristics are a set of attributes which together make the information in financial statements useful to users. Illustration 2.1 summarizes the main characteristics of accounting information.

#### **Illustration 4.1:** The Main Qualitative Characteristics of Accounting Information

| <b>Characteristic</b>    | <b>Comment</b>                                                                                                                                                             |
|--------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Relevance</b>         | The information should be relevant to the needs of the users, so that it helps them to evaluate the financial performance of the business and to draw conclusions from it. |
| <b>Reliability</b>       | The information should be of a standard that can be relied upon by external users, so that it is free from error and can be depended upon by users in their decisions.     |
| <b>Comparability</b>     | Accounts should be comparable with those of other similar enterprises, and form one period to the next.                                                                    |
| <b>Understandability</b> | The information should be in a form which is understandable to user groups.                                                                                                |
| <b>Completeness</b>      | Accounting statements should show all aspects of the business.                                                                                                             |
| <b>Lack of bias</b>      | Accounting statements should not be biased towards the needs of one user; they should be objective.                                                                        |
| <b>Timeliness</b>        | Accounting statements should be published as soon as possible after the year end.                                                                                          |

**Source:** *Professional examinations, part 1, paper 1.1, Preparing financial statements*, Berkshire : FTC Foulks Lynch, 2005, ISBN 1-84390-584-1

## **Financial Statements**

The financial accounting process produces the following financial statements:

*The Balance Sheet (The Statement of Financial Position)* is a statement of assets and liabilities at a point in time. It shows the financial position of the enterprise.

*The Income Statement* summarizes incomes and expenditure over a period of time. It measures financial performance over a period of time.

*The Statement of Shareholders' Equity* describes the changes in the shareholders' equity items from one year to the next.

*The Statement of Cash Flows* summarizes the increases (inflows) and decreases (outflows) in cash over a period of time.

## **The Users of Financial Statements**

Financial statements serve a wide variety of users who have different interests. The main user groups are the following:

- **Management** – managers need detailed information for planning and decision-making.
- **Shareholders** – current or potential shareholders need financial information for investment decisions. They are interested in their potential profits and the security of their investment.
- **Employees** – employees and their representatives need to know if their employer can offer secure employment and possible pay-rises.
- **Lenders** – banks and suppliers need financial information to safeguard loans they have made or intend to make.
- **Government Agencies** – governments need financial information to monitor the economy and to collect tax.
- **The Public** – there are many other user groups and interest groups (e.g. members of a local community where the company operates, environmental pressure groups).

## **Regulatory Systems of Accounting in the World**

Although most countries have their own accounting standards, two primary financial reporting systems currently exist in the world – International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (US GAAP).

### **International Financial Reporting Standards**

IFRS are established by the *International Accounting Standards Board* (IASB). The IASB is the successor to the *International Accounting Standard Committee* (IASC), which was formed to develop worldwide accounting practices. The IASC's pronouncements are known as *International Accounting Standards* (IAS). These standards were revised and updated by

IASB. The IASB representing well over 100 countries, has issued a number of international reporting standards recognized as acceptable reporting by many of the major stock exchanges in the world (e.g. London, Paris, Frankfurt, Tokyo).

Since 2005, all public companies in the EU have been required to report using IFRS and IAS.

**U.S. Generally Accepted Accounting Principles**

In the U.S. financial accounting standards represent the official statements of the *Financial Accounting Standards Board* (FASB) and its predecessor bodies as well as the official statements from the *Securities and Exchange Commission* (SEC). The complete set of financial accounting standards currently in force comprise US GAAP.

**Lecture 2 - Questions and exercises**

**Q 2-1:** Define the financial accounting.

**Q 2-2:** Who are the main categories of users of financial statements?

**Q 2-3:** Describe the main financial statements.

**Q 2-4:** Consider the characteristics of useful information.

**Q 2-5:** Describe two primary worldwide financial reporting systems.

**E 2-1: Financial statements**

Account balances of ABC at the end of January 2011 are as follows (in alphabetical order):

|                      |        |
|----------------------|--------|
| Accounts payable     | 4,674  |
| Account receivable   | \$ 890 |
| Cash                 | 5,357  |
| Capital at 1 January | 16,000 |
| Closing inventory    | 6,100  |
| Discount allowed     | 138    |
| Discount received    | 5      |
| Equipment            | 15,500 |
| Inventory            | 8,210  |
| Loan                 | 9,000  |
| Opening inventory    | 5,400  |
| Profit for the month | 283    |
| Purchases            | 900    |
| Purchases returns    | 140    |
| Sales returns        | 330    |
| Sales revenue        | 806    |

***Required:***

- a) Prepare an income statement for the month of January 2011.
- b) Prepare a balance sheet as at 31 January 2011.

**The main sources:**

PRATT, J. *Financial accounting: in an economic context*. 7th edition, Hoboken: John Wiley & Sons, 2009, ISBN 978-0-470-23398-6

*Professional examinations, part 1, paper 1.1, Preparing financial statements*, Berkshire : FTC Foulks Lynch, 2005, ISBN 1-84390-584-1

**The supplementary sources:**

CAREY, M., KNOWLES, C. *Accounting: A Smart Approach*. 1st edition, New York: Oxford University Press, 2011, ISBN 978-0-19-958741-4

BOCKHOLDT, J. L. *Accounting Information Systems: transaction processing and controls*. 5th edition, Boston: McGraw Hill Education 1999, ISBN 0-07-116098-1

HUSSEY, R. *Fundamentals of International Financial Accounting And Reporting*. 1st edition, Singapore: World Scientific Publishing Co. Inc., 2010, ISBN 978-981-4280-23-5