### Financial Statements

The underlying purpose of accounting is to provide financial information about an economic entity to persons to assist them in making commercial as well as economic decisions.

The specific objectives of financial statements and reports that are the end product of accounting process are to provide information about:

1. ***Financial position*** i.e. it assets, liabilities and capital. This information is presented in a financial statement known as a **Statement of financial position*.***
2. ***Financial performance***i.e. income and expenses, including gains and losses. This information is presented in a financial statement known as an ***Income statement.***

#### ACCOUNTING PRINCIPLES

Accounting Standards are methods of approaches to preparing accounts which have been chosen and established by the bodies overseeing the accounting profession. They are essentially working rules established to guide accounting practice.

***The going concern concept:***implies that the business will continue in operational existence for the foreseeable future, and that there is no intention to put the company into liquidation or to make drastic cutbacks to the scale of operations.

Financial statements should be prepared under the going concern basis unless the entity is being (or is going to be) liquidated or if it has ceased (or is about to cease) trading. The directors of a company must also disclose any significant doubts about the company’s future if and when they arise. The main significance of the going concern concept is that the assets of the business should not be valued at their ‘break-up’ value, which is the amount that they would sell for it they were sold off piecemeal and the business were thus broken up.

***The accrualsprinciple (or matching concept):***States that revenue and costs must be recognized as they are earned or incurred, not as money is received or paid. They must be matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate.

***The Prudence principle***The prudence concept states that where alternative procedures, or alternative valuations, are possible, the one selected should be the one that gives the most cautious presentation of the business’s financial position or results.

Therefore, revenue and profits are not anticipated but are recognized by inclusion in the profit and loss account only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty: provision is made for all liabilities (expenses and losses) whether the amount of these is known with certainty or is best estimate in the light of the information available.

Assets and profits should not be overstated, but a balance must be achieved to prevent the material overstatement of liabilities or losses.

***Consistency principlet:***The consistency concept states that in preparing accounts consistency should be observed in two respects. Similar items within a single set of accounts should be given similar accounting treatment.

The same treatment should be applied from one period to another in accounting for similar items. This enables valid comparisons to be made from one period to the next.

***Business entity principle****:* The concept is that accountants regard a business as a separate entity, distinct from its owners or managers. The concept applies whether the business is a limited company (and so recognized in law as a separate entity) or a sole proprietorship or partnership (in which case the business is not separately recognized by the law.

***Money measurement principle****:* The money measurement concept states that accounts will only deal with those items to which a monetary value can be attributed.

For example, in the statement of financial position of a business, monetary values can be attributed to such assets as machinery (e.g. the original cost of the machinery; or the amount it would cost to replace the machinery) and stocks of goods (e.g. the original cost of goods, or, theoretically, the price at which the goods are likely to be sold).

The monetary measurement concept introduces limitations to the subject matter of accounts. A business may have intangible assets such as the flair of a good manager or the loyalty of its workforce. These may be important enough to give it a clear superiority over an otherwise identical business, but because they cannot be evaluated in monetary terms they do not appear anywhere in the accounts.

***Materialityprinciplet****:* An item is considered material if it’s omission or misstatement will affect the decision making process of the users. Materiality depends on the nature and size of the item. Only items material in amount or in their nature will affect the true and fair view given by a set of accounts.

An error that is too trivial to affect anyone’s understanding of the accounts is referred to as immaterial. In preparing accounts it is important to assess what is material and what is not, so that time and money are not wasted in the pursuit of excessive detail.

***Historical cost principle****:* It’s a basic principle of accounting (some writers include it in the list of fundamental accounting concepts) is that resources are normally stated in accounts at historical cost, i.e. at the amount that the business paid to acquire them. An important advantage of this procedure is that the objectivity of accounts is maximized: there is usually objective, documentary evidence to prove the amount paid to purchase an asset or pay an expense. Historical cost means transactions are recorded at the cost when they occurred.

***Realization Principle****:* Revenue and profits are recognized when realized. The concept states that revenue and profits are not anticipated but are recognized by inclusion in the income statement only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty

#### QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

These are the attributes that make the information provided in financial statements useful to users. They include:

1. ***Understandability***

Financial statements should be readily understandable by users not only in terms of simplicity but should avoid misleading them.

1. ***Relevance***

To be useful, information must relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them make correct judgements about an enterprise.

1. ***Reliability***

Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

1. ***Comparability***

Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and changes in financial position.

**Basic requirements of the computerised accounting system**

The basic requirements of any computerised accounting system are the followings:

l **Accounting framework**

It is the application environment of the computerised accounting system. A healthy accounting framework in terms of accounting principles,coding and grouping structure is a pre-condition for any computerisedaccounting system.

2 **Operating procedure**

A well-conceived and designed operating procedure blended withsuitable operating environment of the enterprise is necessary to workwith the computerised accounting system.Thecomputerised accounting is one of the database-oriented applications wherein the transaction data is stored in well- organized database. The user operates on such database using the required interface and also takes the required reports by suitable transformations of stored data into information.

Therefore, the fundamentals of computerised accounting include all the basic requirements of any database-oriented application in computers.

**COMPLETE FINANCIAL ACCOUNTING CYCLE**

Accounting cycle is a step-by-step process of recording, classification and summarization of economic transactions of a business. It generates useful financial information in the form of financial statements including income statement, balance sheet, cash flow statement and statement of changes in equity.

The accounting cycle is a methodical set of rules to ensure the accuracy and conformity of financial statements. Computerized accounting systems have helped to greatly reduce mathematical errors in the accounting process, but the uniform process of the accounting cycle also helps reduce mistakes.

The name given to the collective process of recording and processing the accounting events of a company. The series of steps begin when a transaction occurs and end with its inclusion in the financial statements

The time period principle requires that a business should prepare its financial statements on periodic basis. Therefore accounting cycle is followed once during each accounting period. Accounting Cycle starts from the recording of individual transactions and ends on the preparation of financial statements and closing entries.

**Major Steps in Accounting Cycle**

Following are the major steps involved in the accounting cycle. We will use a simple example problem to explain each step.

1. Analyzing and recording transactions via journal entries
2. Posting journal entries to ledger accounts
3. Preparing unadjusted trial balance
4. Preparing adjusting entries at the end of the period
5. Preparing adjusted trial balance
6. Preparing financial statements
7. Closing temporary accounts via closing entries
8. Preparing post-closing trial balance

It comprises of the steps from the initial recording of transactions to the preparation of a “set” of financial statements. These are:

1. ***Journalise (record) transactions***. Enter all transactions in the journal, thus creating a chronological record of events.
2. ***Post to ledger accounts***. Post debits and credits from the journal to the proper ledgers accounts, thus creating a record classified by accounts.
3. ***Prepare a trial balance***. Prove the equality of debits and credits in the ledger.
4. ***Make end-of-period adjustments***. Draft adjusting entries in the general journal, and post to ledger accounts.
5. ***Prepare an adjusted trial balance.*** Prove again the equality of debits and credits in the ledger. (***Note***: these are the amounts used in the preparation of financial statements).
6. ***Prepare financial statements and appropriate disclosures***. An income statement shows the results of operation for the period. A statement of owner’s equity shows changes in owner’s equity during the period. A statement of financial position shows the financial position of the business at the end of the period. Financial statements should be accompanied by notes disclosing facts necessary for the proper ***interpretation*** of those statements.
7. ***Journalise and post the closing entries***. The closing entries “zero” the revenue, expense, and drawing accounts, making them ready for recording the events of the next accounting period. These entries also bring the balance in the owner’s capital account up-to-date.
8. ***Prepare an after-closing trial balance***. The step ensures that the ledger remains in balance after posting of the closing entries.

**CHART OF ACCOUNTS**

## A chart of accounts (COA) is a financial organizational tool that provides a complete listing of every account in an accounting system.

An [account](http://searchfinancialapplications.techtarget.com/definition/account) is a unique record for each type of asset, liability, equity, revenue and expense.

The chart of accounts is a listing of all accounts used in the general ledger of an organization. The chart is used by the accounting software to aggregate information into an entity's financial statements.

The chart is usually sorted in order by account number, to ease the task of locating specific accounts. The accounts are usually numeric, but can also be alphabetic or alphanumeric.

Accounts are usually listed in order of their appearance in the financial statements, starting with the balance sheet and continuing with the income statement. Thus, the chart of accounts begins with cash, proceeds through liabilities and shareholders' equity, and then continues with accounts for revenues and then expenses. Many organizations structure their chart of accounts so that expense information is separately compiled by department; thus, the sales department, engineering department, and accounting department all have the same set of expense accounts.

Typical accounts found in the chart of accounts are:

**Assets:**

* Cash
* Marketable Securities
* Accounts Receivable
* Prepaid Expenses
* Inventory
* Fixed Assets
* Accumulated Depreciation
* Other Assets

**Liabilities:**

* Accounts Payable
* Accrued Liabilities
* Taxes Payable
* Wages Payable
* Notes Payable

**Stockholders' Equity:**

* Common Stock
* Retained Earnings

**Revenue:**

* Revenue
* Sales returns and allowances (contra account)

**Expenses:**

* Cost of Goods Sold
* Advertising Expense
* Bank Fees
* Depreciation Expense
* Payroll Tax Expense
* Rent Expense
* Supplies Expense
* Utilities Expense
* Wages Expense
* Other Expenses

There are a number of ways to structure the chart of accounts.

**Chart of Accounts Best Practices**

The following points can improve the chart of accounts concept for a company:

* Consistency. It is of some importance to initially create a chart of accounts that is unlikely to change for several years, so that you can compare the results in the same account over a multi-year period. If you start with a small number of accounts and then gradually expand the number of accounts over time, it becomes increasingly difficult to obtain comparable financial information for more than the past year.
* Lock down. Do not allow subsidiaries to change the standard chart of accounts without a very good reason, since having many versions in use makes it more difficult to consolidate the results of the business.
* Size reduction. Periodically review the account list to see if any accounts contain relatively immaterial amounts. If so, and if this information is not needed for special reports, shut down these accounts and roll the stored information into a larger account. Doing this periodically keeps the number of accounts down to a manageable level.

If you acquire another company, a key task is shifting the acquiree's chart of accounts into the parent company's chart of accounts, so that you can present [consolidated](http://www.accountingtools.com/dictionary-consolidated-financ) financial results. This process is known as mapping the acquiree's information into the parent's chart of accounts.

A COA, which lists the names of the [accounts](http://www.accountingcoach.com/terms/A/account.html) that a company has identified and made available for recording transactions in its [general ledger](http://www.accountingcoach.com/terms/G/general-ledger.html), establishes the level of detail tracked in a record-keeping system. Typically, a COA contains the accounts’ names, brief descriptions and identification codes.

In practice, the COA serves as the foundation for a company’s financial record keeping system. It provides a logical structure that facilitates the addition of new accounts and deletion of old accounts.

**At Least Two Accounts for Every Transaction**

The chart of accounts lists the accounts that are available for recording transactions. In keeping with the [**double-entry system**](http://www.accountingcoach.com/terms/D/double-entry-accounting) of accounting, a **minimum of two accounts** is needed for every transaction—at least one account is debited and at least one account is credited.

When a transaction is entered into a company's accounting software, it is common for the software to prompt for only one account name—this is because the software is programmed to automatically assign one of the accounts. For example, when using accounting software to write a check, the software automatically reduces the asset account [**Cash**](http://www.accountingcoach.com/terms/C/cash) and prompts you to designate the *other* account(s) such as [**Rent Expense**](http://www.accountingcoach.com/terms/R/rent-expense), [**Advertising Expense**](http://www.accountingcoach.com/terms/A/advertising-expense), etc.

Some general rules about debiting and crediting the accounts are:

* **Expense** accounts are *debited* and have *debit balances*
* **Revenue** accounts are *credited* and have *credit balances*
* **Asset** accounts normally have *debit balances*
* To increase an **asset** account, *debit* the account
* To decrease an **asset** account, *credit* the account
* **Liability** accounts normally have *credit balances*
* To increase a **liability** account, *credit* the account
* To decrease a **liability** account, *debit* the account