**FINANCIAL ACCOUNTING**

**Nature, scope and purposes of financial accounting**

**Financial Accounting**

This is mainly a method of reporting the results and financial position of a business. Unlike Management Accounting, Financial Accounting is not primarily concerned with providing information towards the more efficient running of the business but its principal function is to satisfy the information needs of persons not involved in the running of the business. This does not however mean that management is not interested in financial reports, as it is one of the users of these reports. They provide historical information.

**Management Accounting**

Management Accounting is mainly concerned with providing information to be used by management in the efficient and effective operation of the business. This is necessary as the information need of management go far beyond those of other users. Managers have the responsibility of planning and controlling the resources of the business. They therefore need much more detailed information. They also need to plan for the future (e.g budgets, which are meant to predict future revenue and expenditure).

The distinction between financial accounting and management accounting should therefore be clearly understood. Management Accounting which is also known as cost accounting is a management information system which analyses data to provide information as a basis for managerial action. And this information must be in a form most helpful to management.

**The accountant in society;**

We have seen various accountants in our society. These perform various functions of accounting such as Financial Accounting, Management accounting and auditing.

Auditing is an independent examination of a company’s financial report by an independent reviewer so as to give an independent view point of the truth and fairness of the reported information about the affairs of the company.

The purpose of financial audits is that they exist to add credibility to the implied assertion by an organization's management that its financial statements fairly represent the organization's position and performance to the firm's stakeholders (interested parties).

**Users of accounting information and their requirements**

There are various groups of people who need information about the activities of a business and these have various information requirements:

**Managers:** These are charged with the duty of directing the day to day activities of the business and to be able to perform this duty efficiently and effectively, they need information about a company’s present position and how it is expected to be in future.

**Shareholders:** These are the owners of the company and are interested in knowing how well the directors are performing their management duties. They want to know if the company is profitable and how much excess capital if any they can afford to withdraw for personal use.

**Trade contacts:** Theseincludesuppliers and customers. Suppliers want to know about a company’s ability to pay its debts if goods are supplied on credit.

Customers are interested in knowing about the continuity of the company so as to see if it’s a secure source of supplies.

**Providers of finance:** These might include a bank which allows the company to operate an overdraft, or provides longer-term finance by granting a loan. The bank wants to ensure that the company is able to keep up interest payments, and eventually to repay the amounts advanced.

**Taxation Authorities:** Tax authorities want to know about business profits in order to assess the tax payable by the company, including sales taxes.

**Employees:** Employees should have a right to information about the company’s financial situation, because their future careers and the size of their wages and salaries depend on it.

**Financial analysts and advisers:** These need information for their clients or audience. For example, stockbrokers need information to advice investors; credit agencies want information to advise potential suppliers of goods to the company; and journalists need information for their reading public.

**The public:** The may be interested in the operations of the company because a company may make a substantial contribution to a local economy by providing employment and using local suppliers. Another important factor is the effect of an entity on the environment, for example as regards pollution.

**Principles and Conventions, underlying the accounting model**

**Fundamental qualitative characteristics**

Relevance and Reliability through faithful representation are the fundamental qualitative characteristics of useful financial information.

**Relevance**

The information provided in financial statements must be relevant to the decision-making needs of users. Information has the quality of **relevance** when it is **capable of influencing the economic decisions** of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

Financial information is capable of making a difference in user’s decisions if it is material. **Materiality** is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity’s financial report. To be relevant, financial information must also be presented on a **timely** basis.

**Reliability**

General purpose financial reports represent economic phenomena in words and numbers, to be useful, financial information must not only be relevant, it must also be reliable. And to be reliable, financial statements should give **a faithful, true and fair representation** of the state of affairs of the business. This fundamental characteristic seeks to maximise the underlying characteristics of **verifiability**, **completeness**, **neutrality** (free for bias), **freedom from error** and **substance over form** presentation**.**

Financial statements are not **neutral** if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome. Financial statements should also be **complete** to be reliable as an omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

**Substance over form**

Transactions and other events and conditions should be accounted for and presented in accordance with their substance and not merely their legal form. This enhances the reliability of financial statements. A common example here is that of a finance lease say for P, P & E. In its legal sense, the property belongs to the lessor (owner) but in actual facts the property will be in use by the lessee (user) for all of its economic life and so should be according to substance over form assumption recorded by the user as if it were their own asset in the balance sheet.

**Enhancing qualitative characteristics**

Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and reliable.

**Comparability**

Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Comparability enables users to identify and understand similarities in, and differences among, items.

**Verifiability**

Verifiability helps to assure users that information represents faithfully the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

**Timeliness**

Timeliness means that information is available to decision-makers in time to be capable of influencing their decisions.

**Understandability**

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information with diligence.

Classifying, characterising and presenting information clearly and concisely make it understandable. However, the need for understandability does not allow relevant information to be omitted on the grounds that it may be too difficult for some users to understand as this would make financial reports incomplete and potentially misleading.

**Financial Accounting concepts/ Assumptions**

**Accrual Concept**

An entity shall prepare its financial statements, except for cash flow information, using the **accrual basis** of accounting. On this basis, assets are recognized when they are **receivable** rather than when they are physically received, and liabilities are recognized when they are **payable** rather than when actually paid. This is why you find payables and receivables on the balance sheet.

**Prudence**

The General rule here is do not underestimate costs/liabilities and do no overestimate incomes/asset.

The uncertainties that inevitably surround many events and circumstances are acknowledged by the disclosure of their nature and extent and by the exercise of **prudence** in the preparation of the financial statements.

Prudence is the inclusion of a **degree of caution** in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses. In short, prudence does not permit bias.

This is in line with the accounting constraint of **conservatism** were when in doubt, an accountant should choose a solution that will be least likely to overstate assets and income. The conservatism constraint should be applied only when doubt exists. An intentional understatement of assets or income is not acceptable accounting.

**Going Concern**

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

**Matching**

The matching principle requires an entity to relate expenses in the period that the related revenues are recognized. Ideally, matching is based on a **cause and effect relationship**. If no cause and effect relationship exists, an expense shall be recognized in the accounting period when a cost is incurred. Use of **accrual accounting procedures** assist the accountant in allocating revenues and expenses properly among the fiscal periods that compose the life of a business enterprise.

**Consistency**

Accounting information is consistent when an entity applies the same accounting treatment to similar events from period to period.

**Accounting Model, Recording Transactions, Reporting Results**

**The Accounting Equation**

Financial accounting is based on the accounting equation. The rule of the accounting equation is that the assets of a business will at all times equal liabilities.

ASSETS = CAPITAL

The resources possessed by the firm are known as assets. The total amount supplied by the owner is known as capital. If in fact the owner is the only one who had supplied the assets in form of capital, then the above equation would hold true.

However, someone other than the owner would normally have supplied some of the resources/assets. Liabilities are the name given to the amounts owing to these people for these assets. This then changes the equation to:

ASSETS = CAPITAL + LIABILITIES

The two sides of the equation will have the same total because we are dealing with the same thing from two different points of view. The actual assets, capital and liabilities may change, but the equality of the assets with that of capital and liabilities will always hold true.

**Nature of Assets, Liabilities and Owners Equity**

Definitions of the elements relating to financial position:

* **Asset.** An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
* **Liability.** A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
* **Equity.** Equity is the residual interest in the assets of the entity after deducting all its liabilities.

**Current Assets**

These consist of assets which are intended in the course of events to be changed into cash within one year. Current assets form the basis for trading, in that they circulate and change in the short term.

The commonest current assets are:

* + Stock of goods or inventory
  + Debtors or Trade Receivables
  + Prepayments
  + Cash at Bank
  + Cash at hand

**Fixed Assets/ Non Current Assets**

A NCA is an asset acquired for use within the business (rather than for selling to a customer), with a view to earning income or making profits from its use, either directly or indirectly. Fixed assets are used to make the business more efficient in carrying out trading operations.

The commonest fixed assets are:

* + Land and buildings
  + Plant and machinery
  + Fixture and fittings
  + Motor vehicle
  + Office machinery

Certain assets are described as intangible. An intangible fixed asset is a fixed asset that is non-monetary in nature and without physical substance. This includes such assets as brands, development expenditure, goodwill, patents, trademarks etc.

**Current liabilities**

Current liabilities are those liabilities which are payable within a fairly short period of time ( by convention, within twelve months of the balance sheet date).

Examples of current liabilities are:

* + Loans payable within the year
  + Bank overdraft
  + Trade creditors/ trade payables (amounts owed to suppliers for goods supplied)
  + Amounts owed to creditors for other business expenses
  + Taxation payable
  + Accrued charges – these are expenses already incurred by the business but not yet paid for.

**Long-term liabilities**

This is usually a formal loan of money either from a bank or other lending institutions. Long-term liabilities are debts that not payable within the short-term and so any liability that is not current must be long-term.

Examples of long-term liabilities are:

* + Bank/other loan – loans which are not repayable for more than one year.
  + A mortgage loan, which is a loan specifically secured against a freehold property. If the business fails to repay the loan, the lender then has ‘first claim’ on the property, and is entitled to repayment from the proceeds from the enforced sale of the property.
  + Debentures or debenture loans – these are usually found in larger companies’ accounts. Debentures are securities issued by a company at a fixed rate of interest. Holders of debentures are therefore lenders of money to a company.

**The Institutional and Regulatory Framework of Accounting**

It is important to understand the rules regulating the preparation of accounts. These may differ depending on the type of business. For a limited company, these may be stricter than those of a sole trader and a partnership. The activities of a limited company including the way they prepare their accounts are closely regulated.

For unincorporated businesses, any form of accounting information is adequate if it gives the owner(s) of the business a basis for planning and control, and satisfies the requirement of external users such as Zambia Revenue Authority (ZRA).

As far as limited companies are concerned, the following are some of the factors that have shaped financial accounting:

**\* Company law**; the primary legislative document is the companies Act 1985 (amended 1989), which lays down certain requirements for the format and layout of company accounts and their content. It also includes some guidance on approaches to certain transactions, and states that companies above a certain size are required to have their accounts audited by a registered auditor. However, it is widely accepted that the Companies Act does not cover many issues in sufficient detail, and as a result there are a number of other sets of guidance available.

\* The **Accountancy Professional Bodies** e.g. The Chartered institute of Management Accountants (CIMA), The Association of Chartered Accountant (ACCA), Zambia Institute of Chartered Accountants (ZICA) and others.

\* **Accounting Standards** – these are developed at both national and International level. For example, the International Financial Reporting Standards (IFRSs) are at an international level.

An International Financial Reporting Standard (IFRS) is an [accounting standard](http://moneyterms.co.uk/accounting-standards/) set by the [International Accounting Standards Board](http://www.iasb.org/). IFRS has replaced the older term International Accounting Standard (IAS).

IFRSs are compulsory for [listed companies](http://moneyterms.co.uk/listed/) in the EU, and most national accounting standards globally are also converging on IFRSs.

IFRSs have been adopted by many other national accounting standards bodies. In the US, the Financial Accounting Standards Board is working towards converging US [GAAP](http://moneyterms.co.uk/gaap/) with IFRSs. Japanese accounting standards have been extensively revised to bring them into line with IFRSs. In the rest of the world IFRSs are either being incorporated into national standards or national standards are being gradually converged with IFRSs.

The advantages to investors are clear. IFRSs make it easier to compare the accounts of companies in different countries. They also incorporate many improvements on most current standards.

\* **Generally Accepted Accounting Practice** (GAAP).

\* The requirements of the **stock exchange**. These of course only apply to listed companies, being those companies whose shares are bought on the stock exchange.

\* **Accounting Concepts and individual Judgment**. Financial Statements are prepared on the basis of a number of fundamental accounting assumptions and conventions. Many figures in financial statements are derived from the application of judgment in putting these assumptions into practice. This can however lead to subjectivity.