



## **Financial Accounting**

Introduction The purpose of accounting is to provide the information that is needed for sound economic decision making. The main purpose of financial accounting is to prepare financial reports that provide information about a firm's performance to external parties such as investors, creditors, and tax authorities. Managerial accounting contrasts with financial accounting in that managerial accounting is for internal decision making and does not have to follow any rules issued by standard-setting bodies. Financial accounting, on the other hand, is performed according to Generally Accepted Accounting Principles (GAAP) guidelines.

### **CPA's**

The primary accounting professional association in the U.S. is the American Institute of Certified Public Accountants (AICPA). The AICPA prepares the Uniform CPA Examination, which must be completed in order to become a certified public accountant. To be eligible to become a CPA, one needs an undergraduate degree in any major with 150 credit hours of course work. Of these 150 credit hours, a minimum of 36 credit hours must be in accounting. Only about 10% of those taking the CPA exam pass it the first time.

### **Accounting Standards**

In order that financial statements report financial performance fairly and consistently, they are prepared according to widely accepted accounting standards. These standards are referred to as Generally Accepted Accounting Principles, or simply GAAP. Generally Accepted Accounting Principles are those that have "substantial authoritative support".

### **Accrual vs. Cash Method**

Many small businesses utilize an accounting system that recognizes revenue and expenses on a cash basis, meaning that neither revenue nor expenses are recognized until the cash associated with them actually is received. Most larger businesses, however, use the accrual method.

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Under the accrual method, revenues and expenses are recorded according to when they are earned and incurred, not necessarily when the cash is received or paid. For example, under the accrual method revenue is recognized when customers are invoiced, regardless of when payment is received. Similarly, an expense is recognized when the bill is received, not when payment is made.

Under accrual accounting, even though employees may be paid in the next accounting period for work performed near the end of the present accounting period, the expense still is recorded in the current period since the current period is when the expense was incurred.

### Underlying Assumptions, Principles, and Conventions

Financial accounting relies on the following underlying concepts:

- Assumptions: Separate entity assumption, going-concern assumption, stable monetary unit assumption, fixed time period assumption.
- Principles: Historical cost principle, matching principle, revenue recognition principle, full disclosure principle.
- Modifying conventions: Materiality, cost-benefit, conservatism convention, industry practices convention.

Financial Statements Businesses have two primary objectives:

- Earn a profit
- Remain solvent

Solvency represents the ability of the business to pay its bills and service its debt. The four financial statements are reports that allow interested parties to evaluate the profitability and solvency of a business. These reports include the following financial statements:

- Balance Sheet
- Income Statement
- Statement of Owner's Equity
- Statement of Cash Flows

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These four financial statements are the final product of the accountant's analysis of the transactions of a business. A large amount of effort goes into the preparation of the financial statements. The process begins with bookkeeping, which is just one step in the accounting process. Bookkeeping is the actual recording of the company's transactions, without any analysis of the information. Accountants evaluate and analyze the information, making sense out of the numbers.

For the reports to be useful, they must be:

- Understandable
- Timely
- Relevant

Fair and Objective (free from bias)

Double Entry Accounting Financial accounting is based on double-entry bookkeeping procedures in which each transaction is recorded in opposite columns of the accounts affected by the exchange. Double entry accounting is a significant improvement over simple and more error-prone single-entry bookkeeping systems.

Fundamental Accounting Model The balance sheet is based on the following fundamental accounting equation :

$$\mathbf{Assets = Liabilities + Equity}$$

This model has been used since the 18th century. It essentially states that a business owes all of its assets to either creditors or owners, where the assets of a business are its resources, and the creditors and owners are the sources of those resources.

### **Transactions**

To record transactions, one must:

- Identify an event that affects the entity financially.

- Measure the event in monetary terms.
- Determine which accounts the transaction affects.
- Determine whether the transaction increases or decreases the balances in those accounts.
- Record the transaction in the ledgers.

Most larger business accounting systems utilize the double entry method. Under double entry, instead of recording a transaction in only a single account, the transaction is recorded in two accounts.

## **The Accounting Process**

Once a business transaction occurs, a sequence of activities begins to identify and analyze the transaction, make the journal entries, etc. Because this process repeats over transactions and accounting periods, it is referred to as the accounting cycle.

