Introduction

This book is designed to provide introductory concepts in Financial Accounting. Accounting can be defined as "*the process of identifying, measuring and communicating economic information to permit informed judgments and business decisions by users of the information*"[1] and "*The provision of Information to managers and owners so that they can make business decisions.*"[2]. Indeed, in the business field, the success or failure of a company is measured in financial terms, and is recorded and reported using accounting information. Specifically, according to the purpose of the accounting reports, we can define two main categories of "accounting":

– Financial accounting;
– Management accounting.

Financial accounting is suited to provide general purpose information about the business to external users such as shareholders, banks, creditors, government, suppliers, customers, financial advisors, financial press, financial analysts, etc.

To understand the role of financial accounting, consider a large corporation such as Google (Alphabet Inc.). The owners of business organisations can be referred to as shareholders, and Google has several thousand shareholders. Of course, each shareholder cannot participate and is not involved directly in the activity of Google; moreover, because Google needs to maintain trade secrets, its shareholders are not permitted to access such information. Because of this, shareholders delegate most of their decision making power to the board of directors and managers of the corporation. However, shareholders require information to evaluate the performance of the business

[1] AMERICAN ACCOUNTING ASSOCIATION, *Committee to Prepare a Statement of Basic Accounting: A statement of basic accounting theory*, American Accounting Association, Evanston, IL, 1966.

[2] WARREN C.S., REEVE J.M. e DUCHAC J., *Accounting*, 15th, Cengage Learning, Boston, MA, 2017, p. 25.

and to make decision about retaining their investment or not in the company. Therefore, financial accounting provides some of the information according to such decision making processes; furthermore, potential shareholders who are considering investing into the business may also use this information.

Creditors (i.e. banks, bond holders, suppliers, etc.) are another stakeholders' category that can use financial accounting information to know about the probability of seeing back the money they have lent to the company. Financial accounting will usually provide at least some of the information needed by these "external" decision makers.

Therefore, common questions that financial accounting users ask themselves are:

– Should I invest money in this business?
– Will the business be able to repay money lent to it?
– What are the business's earning prospects?
– Is the business financially sound?
– How much income tax has been paid?

Given the typology of external users that can get useful information from the financial accounting activity, we can see financial accounting as a kind of service activity that can be useful for companies and corporations, partnerships, clubs, associations, the Government and families.

On the other hand, **Management Accounting** (also known as Managerial Accounting) provides information primarily to support internal management's decision making [3].

Managers have to deal with a great amount of decisions which may include for example, whether to purchase new machinery, how much to spend on advertising, research and development, whether to lease or buy equipment and facilities, whether to manufacture or buy component parts for inventory production, or whether to sell a certain product. Therefore, common questions, that management accounting procedures are designed to answer are:

– How much profit is being earned?
– What products should be produced?
– What resources are available?
– What is the most efficient production process?
– What is the cost to reduce carbon emissions?

[3] HORNGREN C.T., *Management accounting: this century and beyond*, in *Management Accounting Research*, Vol. 6, 1995, pp. 281-286.

– What will be the effect of increasing or decreasing selling prices?
– How much profit is owing to outsiders?
– Will cash be available to pay debts as they fall due?
– What are benefits of owning vs leasing?

Management accounting information is usually more detailed and more tailor-made than financial accounting information. Furthermore, management accounting procedures are proprietary because the information is not disclosed to external parties outside of the company.

Although separating between financial and management accounting can be convenient for teaching purposes, practically, the distinction is somewhat blurred. For example, financial accounting provides information about the performance of a company to external users but because this information is essentially a performance's report on management, indeed managers are interested in and influenced by the process of preparing such type of information.

The aim of this book is to provide an introduction to financial accounting procedures with the purpose of understanding the basis of preparation of financial statements. Specifically, the focus will be devoted to the following areas:

- Post/journalize transactions;
- Prepare Trial balance;
- Make Adjustments & Closing;
- Preparation of Financial statements.

Theoretical discussions are supported by case studies, examples and as well excerpts from real companies' annual reports. Financial statements' preparation is discussed according to a common international perspective.

Although this book is the outcome of the authors' collaborative joint-work, Chapters 1 and 2 can be mainly referenced to Simone D. Scagnelli, Chapters 3 and 5 to Melchior Gromis di Trana and Chapter 4 to Francesco Venuti. The objective of this collective work is to support students, faculty, and practitioners in understanding, learning and practising the basics of financial accounting.

THE AUTHORS

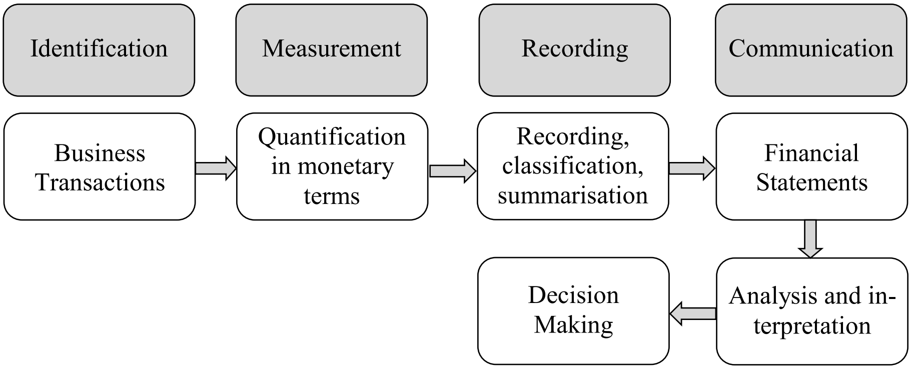
1.
The accounting system

The main goal of accounting is to measure, record and classify every transaction related to the business activity in order to provide useful information to interested stakeholders. This requires a systematic approach, regardless of whether the recordings are done by hand or by using computers; this approach is what we call the "accounting process" and can be defined by the following steps:

1. identify the business transactions;
2. measure these transactions in monetary terms;
3. record, classify and summarize the data in the accounting books;
4. communicate the information in accounting reports called "financial statements";
5. interpret and analyse the information provided in the reports in order to support one's decision-making process.

A summary of this process is presented in Exhibit 1.

Exhibit 1 – The Accounting Process


Identification
Measurement
Recording
Communication
Business Transactions
Quantification in monetary terms
Recording, classification, summarisation
Financial Statements
Analysis and interpretation
Decision Making

Specifically, this chapter clarifies the accounting process by answering the following questions:

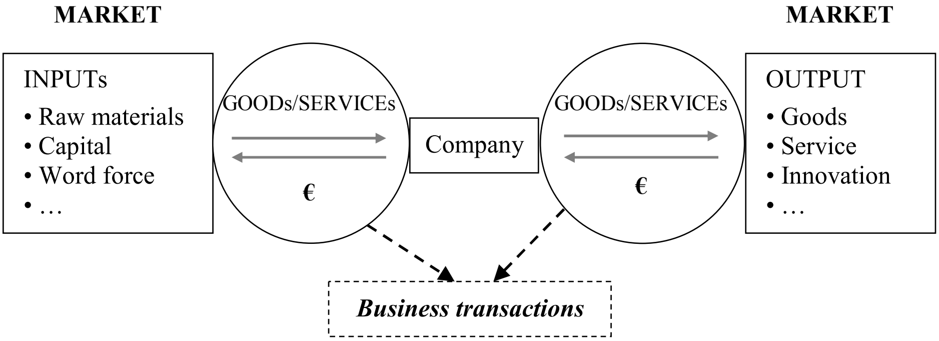
– what to account for?
– how to account for it?
– where to account for it?
– when to account for it?

Generally speaking, recording and classifying business transactions in a systematic way according to the double-entry method is called "**bookkeeping**". Accounting is a broader term than bookkeeping and encompasses bookkeeping procedures. Accounting sets the rules and the principles that have to be used, the procedures that have to be followed in bookkeeping. Bookkeeping is the day-by-day recording and classification of the transactions according to the methods and the principles determined by accounting. The designing of the whole system, the presentation of the financial statements, its analysis and interpretation are all functions of accounting.

1. What to account for?

As stated previously, the role of accounting is to systematically record and track business transactions in order to provide information which will be used in the preparation of financial statements (composed by documents such as the balance sheet, the income statement, the statement of cash flow and the notes). Accounting information is expressed and, consequently, recorded in monetary terms. However, there is not a need to account everything that happens in the business activity of a company. Therefore, to understand which business' transaction should be accounted let us examine the Inputs/Outputs diagram that depicts the relationships between a business entity (i.e. a company) and its environment/market.

Exhibit 2 – The company and the market's exchanges



In the previous exhibit, the relationships between the company and its markets' input/outputs show what we can call "business transactions" or "market exchanges". These transactions involve an exchange of what the company gives and what the company receives from the markets in its business activity. In order to purchase (receive) production elements from the market, a company needs to give (pay) money; on the other hand, a company also needs to collect money in order to sell (give) goods and services to the market[1].

Let us take an example about our personal life; in order to take notes during the lectures you need stationary, so you go to your local retailer to purchase a pencil which price is 1,00 Euro. You look into your wallet and with your right hand you take out a 1,00 Euro coin and give it to the retailer, with your left hand you take the pencil. Clearly, an exchange takes place, because if you want the goods you must pay, and specifically, you pay right away.

But what happens if you forgot to bring your wallet with you? Let us assume you have known the retailer for many years and, therefore, you take the pencil with your left hand and consequently you say "Tomorrow I will pay and bring you 1 Euro"; from this moment on, you owe money to the retailer, that is what we call "account payable", in other words, it reminds you that you are committed to giving money to someone.

This example can be transferred to the business activity, where companies and other organisations buy and sell "on credit", which means they do not pay right away for what they purchase, but agree to pay in the future the supplier and, on the other hand, they don't collect right away the amounts

[1] When goods/services are exchanged for other goods/services and not for money, a historical process called a "barter" system takes place.

related to what they have sold but agree with the client to collect it later.

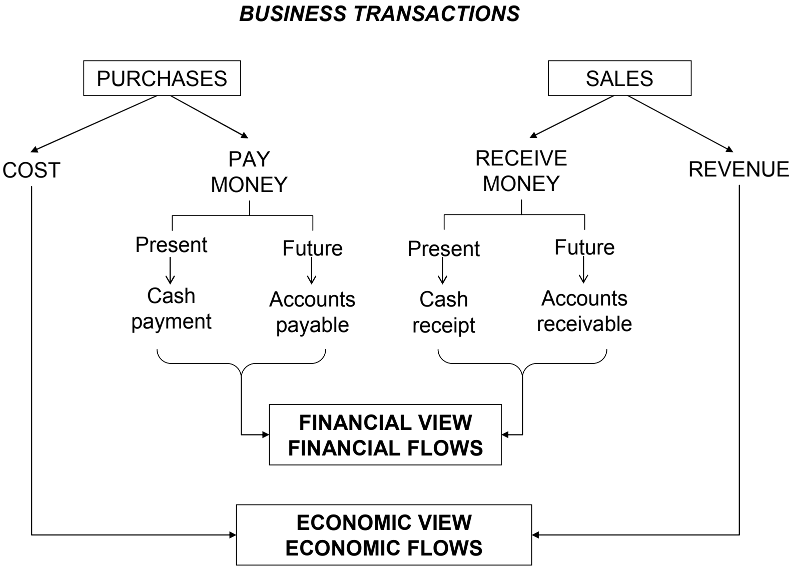
When a company makes a purchase and does not pay right away the supplier but agrees to pay the amount in the future (before or on a certain date), an *account payable* arises. When a company sells something and its customer does not pay straight away, the company owns the right to collect the amount in the future (before or on a certain date), an *account receivable* arises.

To summarise:

– *accounts payable* are money due to suppliers;
– *accounts receivable* are money customers owe to the company.

According to such credit perspective, we can start structuring of the main flows involved in basic market exchanges/transactions, please see the following Exhibit.

Exhibit 3 – Typical business transaction flows


BUSINESS TRANSACTIONS
PURCHASES
SALES
COST
PAY MONEY
RECEIVE MONEY
REVENUE
Present
Future
Present
Future
Cash payment
Accounts payable
Cash receipt
Accounts receivable
FINANCIAL VIEW
FINANCIAL FLOWS
ECONOMIC VIEW
ECONOMIC FLOWS

In the previous Exhibit you can see that if we focus on the term of payment of the exchange, we are dealing with the *financial view* of the transaction, if we focus on the goods/services exchanged (purchased or sold) we are dealing with the *economic (or income) view* of the transaction. The financial view is related to the financial flows interesting the company business while the economic view is related to the income flows. The accounting system must measure and record the information related to these two different views.

In general, business transactions involve at least one financial flow (cash flow, change in accounts receivable or accounts payable, debts, etc.). Specifically, in order to account for transactions during the activity we need to identify and measure the amounts involved within the financial flows – namely, the exchange of money – as well as the amounts related to the flows that affect the income – namely exchange of good, services and other economic resources.

Business transactions that do not involve financial flows (i.e. moving goods from inventory stock to the production process within the same company) shall not be accounted under this accounting perspective.

Hence, the following business events can be related to business transactions that shall be recorded by the accounting system:

- purchases/sales of goods and services;
- payments/receipts of cash;
- payment of salaries;
- purchase of assets;
- financing operations;
- tax payments;
- etc. …

2. How to account for? The double entry method

Almost every company in the World adopts a specific methodology to account for such business transactions, a process called "double entry method". This method has a long history and its roots date back to the Assyrians and Babylonians empires; however, the first "modern" book which documented the double-entry method was written in 1494 by an Italian monk called Luca Pacioli.

The name "double entry" relates to the fact that each transaction is analysed under at least two different perspectives and, consequently, is entered at least twice, recognizing both the "giving" and "receiving" aspects of the exchange according to the different types of views and flows that can be identified and measured. In other words, the double-entry method recognizes the two-fold character of every single transaction, in other words, the two different views we have discussed in the previous section.