FINANCIAL ACCOUNTING

UNIT-1

PART-I

Accounting information system (AIS) is an arrangement that an organization or an entity adopts to collect, manage, process, retrieve, and report its financial data so that it can be used by accountants, consultants, business analysts, managers, auditors, regulators, tax agencies, and other financial officers.

What is Accounting Information System (AIS)?

It is a structured system where all the information of an organization (business entity or non-profit organization) is collected, stored, and managed in the form of data which is thereafter processed to prepare financial records of importance.

Functions of the Accounting Information System

The three basic functions of an accounting information system are to collect and process data, to report for the management, and to maintain accuracy and security. They are detailed below.

- **Collection and Processing:** The collection phase in an accounting information system is that the accountants or bookkeepers collect and record the data from cash purchases, cash sales, amount receivables, and payables and process them among other transactions. If it a computerized system, the software program processes all the debits and credits into a complete information management database.
- **Reports for Management:** After collection of data, the Accounts personnel gives reports to the higher officials responsible for making decisions, such as sales and marketing managers, production managers, financial managers and all department heads in an organization. The information thus generated from the accounting information system supports the management to analyze the current operations and economic condition and make decisions, plan, and set goals for the future.
- **Accuracy and Security:** The third main function of the accounting information system is to make sure that the company maintains accurate data securely. The management decides that such data access is limited to authorized persons only.

Explain the Role of Accounting Information System in an Organization

1. **Detailed Requirements Analysis:** In this, all end-users of the accounting information system are examined by questions, to make sure that the system is fully understood, including the complete documentation collected.

2. **System Design:** After the detailed analysis, a new system is formed. The system is so designed that it incorporates relevant internal controls to provide the management with the necessary information to make important decisions for the organizations.
3. **Documentation:** While the system is being made, it is ensured that data is well documented. The detailed documentation provides the users with accurate instructions regarding the new system. Documentation plays an important role and is used for testing and training before rolling out the system.
4. **Testing:** The processes are tested before launching the system. The documentation collected ensures the processes are well documented and procedures are followed. This phase is considered a “trial and error” stage. At this stage, some system modifications can be done. Ensure that all processes are tested.
5. **Training:** All the staff is provided training to implement the changes as per the AIS software. Also, at this stage staff can give better input to improve the system. Since they are only going to use it.
6. **Data Conversion:** In this stage, the existing data is transferred to the new system. Before converting the data, it should be well tested and verified. And also, it is always advisable to have a data back up at the time when it is needed to restart.
7. **Rolling Out the New System:** The entire company must know the date of the launch of the new system. And this will be the ideal time for the organizations to switch over from one platform to the other.
8. **Tools:** The company should ensure that all possible online resources are made available to the staff involved in using the new Account information system. The company should define the responsibilities of each and every employee involved in this system.
9. **Support:** It should be ensured that the management and its end-users have on-going support available at all times. Since the upper management depends on the AIS to meet the success goals of the organization, system upgrades should be kept monitored at all costs.

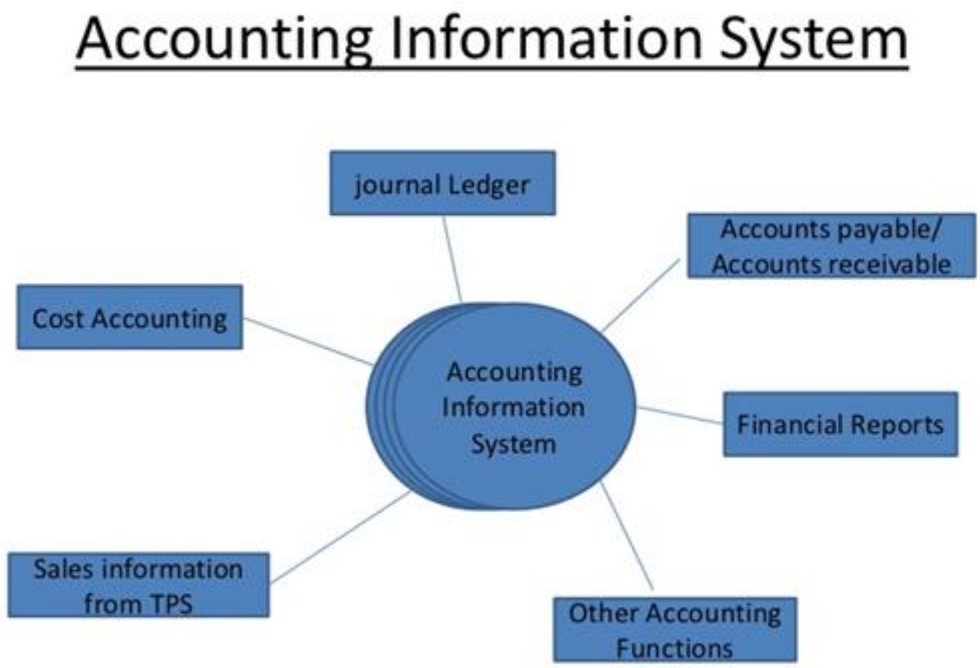
AIS and Related Disciplines

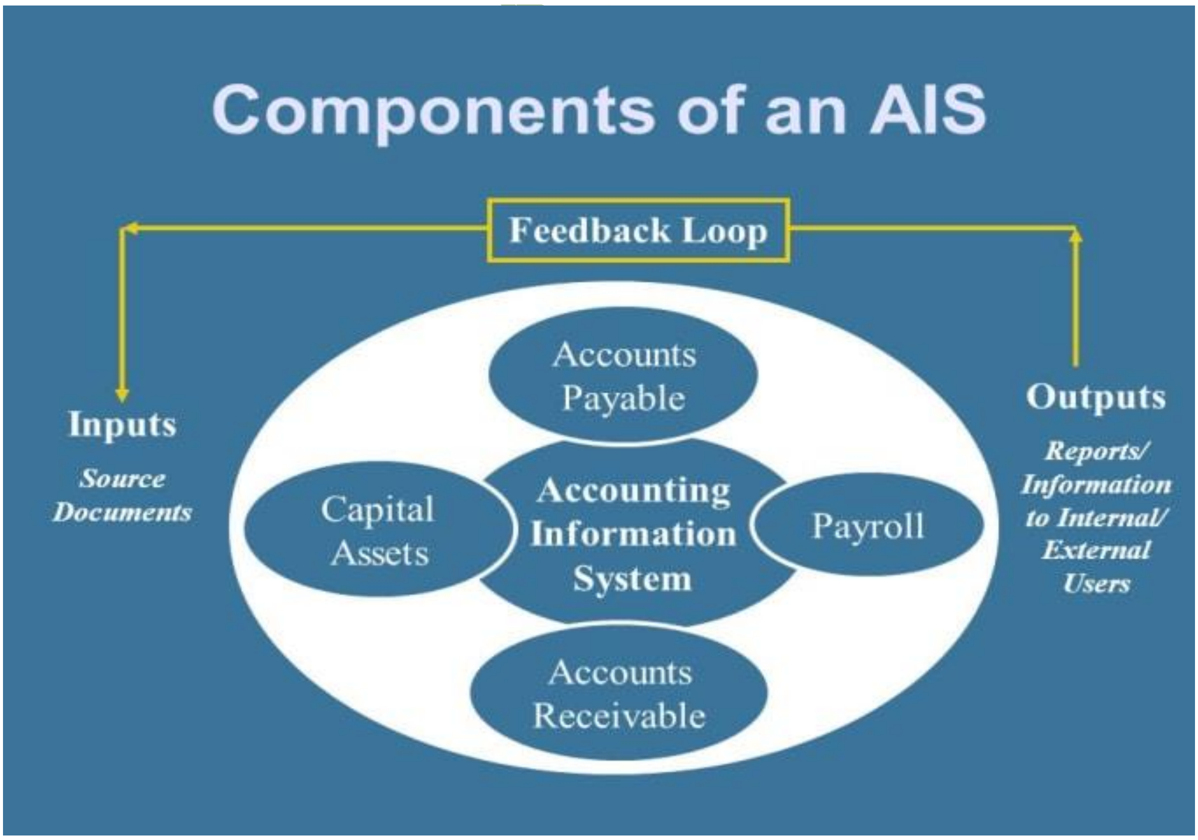
1) Managerial Information Provision: It covers systematic collecting, storing and analysing the data for the purpose of generating useful managerial information for taking efficient decisions, entity control and making the personnel accountable.

2) Accounting and Administrative Organisation: The focus is to generate and provide information for the purpose of smooth running of the accounting process and thereby assisting in the administrative operations.

3) Internal Control: The judgement and activities of others are controlled so as to bring uniformity in the organisation and for controlling the deviations.

4) Information Systems: An information system is defined as the set of allied components that work in random for collecting, storing and retrieving the information so that efficient planning, control, coordination, communication and decision-making can be carried out.





Components of AIS

1) General Ledger System: This aids the firm to leverage the processing speed of the General Ledger, streamlining the accounting process and further reducing the period-end closing cycle. The financial statements comprising of the Balance Sheet and the Profit & Loss A/c are generated and the past and the new occurring accounts are duly managed.

2) Asset Management: As the name itself suggests, this module is useful for tracking the assets, depreciating the same and also to arrange for a maintenance schedule of the assets. The purpose is to get maximum benefits from the assets and also to maximise gain from the indirect benefits arising out of tax saving. Under this, complete record of the long-term assets of the organisation is maintained.

3) Order-entry System: Under this, complete range of data relating to a transaction is stored, like customer details, billing info, etc.

4) Inventory Control System: This module is responsible for handling all the issues related to the inventory. It includes the inventory received, cost of the inventory, any normal as well as abnormal loss and the balance inventory.

5) Payroll System: It stores and captures the entire data relating to salary and wages of the employees in the organisation such as basic pay, overtime, bonus, taxes, deductions relating to provident fund and insurance and net outlay.

6) Cash Management: This can be termed as one of the most important modules presently. It involves forecasting the cash inflow and the outflow at respective time periods and arranging the shortfalls and investing the surplus. It is also concerned with taking adequate measure for fraud prevention and avoidance.

How Accounting Information System is Used?

AIS is used to store data that is related to the business. Important data like revenue, purchases, employee, customer, tax, etc are stored in AIS. All the storage requires a database to perform. There are computer languages that are used to input data in the database and also to generate output as and when required. After all the inputs, the main challenge is security. So several measures are taken for cyber-security in order to protect sensitive data.

Advantages and Disadvantages of AIS

Some of the advantages and disadvantages are given below:

Advantages

Below are the advantages mentioned:

- All the important data of a business can be found in a single centralized location which helps several stakeholders to check vital information as and when required
- Accounting principles are pre-installed which helps account professionals to read data in a globally accepted form

- The output generated helps in preparation of Financial Statements that is required for disclosure and also for tax calculation
- The origination of each entry can be tracked with specific dates which is stored for future reference. This helps in internal as well as external audit

Disadvantages

Below are the disadvantages mentioned:

- The main concern of AIS is security. As all the vital information is updated online, so it is really important that the security of the data is kept intact. There are several scenarios where AIS has been hacked and information stolen.
- As the information that is stored is in computer language, so someone who is trained in computer language can perform the task.
- If there is an issue with the software, then the whole data can get corrupted. This is a severe threat as no manual records are kept as a backup.

Conclusion

Accounting Information System is a modernized form of record keeping that merges hardware and software in order to provide an error free form of record keeping and processing. Almost all the business use AIS. The main concern of AIS is security. One should keep the security factor in mind before choosing an effective AIS.

What is Financial Accounting?

Accounting in general deals with identifying business activities, like sales to customers, recording these activities, like journalizing, and communicating these activities with people outside the organization with financial statements.

Financial accounting, however, is a subsection of the general field of accounting that focuses on gathering and compiling data in order to present it to external users in a usable form. So what does that mean? Basically, financial accounting's main purpose is to provide useful, financial information to people or groups outside of companies often called external users.

Who Uses Financial Accounting?

Unlike company management or internal users, external users of financial information are not directly involved in running the business or organization. They are outsiders to the business and only have limited information about companies' operations, financial position, and well-being. In other words, external users need financial information about companies in order to support their financial decisions.

The ultimate goal of financial accounting is to compile business transactions and other input documents like invoices and sales receipts in the form of general purpose financial statements that can be understood by external users.

The key concept here is that external users must be able to understand and use this financial information when they are making decisions about the company. If the information can't be used, it is worthless. That is why the FASB has created a series of accounting principles and concepts to make sure financial statements are comparable and understandable.

Users of accounting are both internal and external to the organization.

Internal Users of Accounting

Internal users are the primary users of accounting.

Following are the 3 types of internal users and their information needs:

Owners

Owners need to assess how well their business is performing.

Financial statements provide information to owners about the **profitability** of the overall business as well as individual products and geographic segments.

Owners are also interested in knowing how risky their business is.

Accounting information helps owners in assessing the level of stability in business over the years and to what extent have changes in economic factors affected the bottom line of the business.

Such information helps owners to decide if they should invest any further in the business or if they should use their financial resources elsewhere in more promising business ventures.

Managers

Managers need accounting information to plan, monitor and make business decisions.

Managers need to allocate the financial, human and capital resources towards competing needs of the business through the budgeting process.

Preparing and monitoring budgets effectively requires reliable accounting data relating to the various activities, processes, products, services, segments and departments of the business.

Management requires accounting information to monitor the performance of business by comparison against past performance, competitor analysis, key performance indicators and industry benchmarks.

Managers rely on accounting data to form their business decisions such as investment, financing and pricing decisions.

In case of investment decisions for example, managers would require the return on investment calculation of a proposed project supported by reliable estimates of the costs and revenues.

Employees

For the employees operating in the finance department, using accounting information is usually part of their job description. This includes for example preparing and reviewing various financial reports such as financial statements.

Employees are interested in knowing how well a company is performing as it could have implications for their job security and income.

Many employees review accounting information in the annual report just to get a better understanding of the company's business.

In recent years, the increase in number of shares and share options schemes for employees particularly in start-ups has fostered a greater level of interest in accounting information by employees.

Moreover, potential employees are also interested to learn about the financial health of the organization they aspire to join in the future.

External Users of Accounting

External users are the secondary users of accounting.

Following are the 8 types of external users and their information needs:

Investors

Investors need to know how well their investment is performing. Investors primarily rely on the financial statements published by companies to assess the profitability, valuation and risk of their investment.

Investors use accounting information to determine whether an investment is a good fit for their portfolio and whether they should hold, increase or decrease their investment.

Lenders

Lenders use accounting information of borrowers to assess their credit worthiness, i.e. their ability to pay back any loan.

Lenders offer loans and other credit facilities on terms that are based on the assessment of financial health of borrowers.

Good financial health is indicated by the borrower's ability to pay its liabilities on time, high profitability, substantial securable assets and liquidity.

Poor liquidity, low profitability, lack of assets that can be secured and an inability to pay liabilities on time demonstrate poor financial health of borrowers.

On a lighter note, borrowers can only get a loan from lenders if they can prove that they don't need the money.

Suppliers

Just like lenders, suppliers need accounting information to assess the credit-worthiness of its customers before offering goods and services on credit.

Some suppliers only have a handful of customers. These customers could be very large businesses themselves. Suppliers need accounting information of its key customers to assess whether their business is in good health which is necessary for sustainable business growth.

Customers

Most consumers don't care about the financial information of its suppliers.

Industrial consumers however need accounting information about its suppliers in order to assess whether they have the required resources that are necessary for a steady supply of goods or services in the future. Continuity in supply of quality inputs is essential for any business.

Tax Authorities

Tax authorities determine whether a business declared the correct amount of tax in its tax returns.

Occasionally, tax authorities conduct audits of the tax returns filed by businesses in order to verify the information with the underlying accounting records.

Tax authorities also cross reference accounting information of suppliers and consumers in order to identify potential tax evaders.

Government

Government ensures that a company's disclosure of accounting information is in accordance with the regulations that are in place to protect the interest of various stakeholders who rely on such information in forming their decisions.

Government defines and monitors accounting thresholds such as sales revenue and net profit to determine the size of each business for the purpose of ensuring that it complies with the relevant employee, consumer and safety regulations.

Auditors

External auditors examine the financial statements and the underlying accounting record of businesses in order to form an audit opinion.

Investors and other stakeholders rely on the independent opinion of external auditors on the accuracy of financial statements.

Public

General public may also be interested in accounting information of a company. These could include journalists, analysts, academics, activists and individuals with an interest in economic developments.

Creditors

Creditors are interested in accounting information, because it enables them to determine the credit worthiness of the business. The credit terms and standards are set on the basis of the financial health of a business, so, it helps them to analyse by using the accurate information accordingly. Creditors include suppliers and lenders of finance, such as banks. Trade creditor are generally interested in the accounting information for a short period of time than lenders.