



Financial Accounting

Financial accounting uses a universally accepted set of accounting principles, called **Generally Accepted Accounting Principles (GAAP)**, to record a company's financial information for tax authorities. Financial accountants also provide this information to company shareholders and creditors, such as vendors and banks, who may be lending goods and money to the company. This type of accounting is unlike managerial accounting, as managerial accounting is performed within the company and does not have to adhere to standard accounting principles.

The heart of financial accounting is financial statements. These statements follow the GAAP to produce a consistent record of financial transactions. Financial statements especially demonstrate whether a company is turning a profit and remaining solvent (able to pay off its bills and outstanding debt). Each financial accounting statement bases itself on either cash accounting or accrual accounting. Cash accounting means that a business's revenue and expenses become valid only after the business receives the cash relating to them. Many small businesses use the cash accounting method to prepare their financial statements.

Larger businesses and corporations, on the other hand, operate more on credit than cash. They therefore use the accrual method for their financial statements. When using this method, accountants record revenue and expenses as soon as they have been transacted. In other words, revenue becomes valid as soon as a client purchases a good or service from a business. It does not use cash as a prerequisite to recording **financial transactions**.

There are four types of financial statements that shed light on a business's profit-making and solvency. First of all, there is the balance sheet, which marks assets and liabilities. Assets include items of value to a company, including tangible assets such as cash, stocks, bonds, real estate, and tools; likewise, there are intangible assets such as patents, trademarks, copyrights, and other documents of ownership. Conversely, liabilities refer to debt and other entities that require the transfer of assets to satisfy them. They include both current liabilities such as wages, taxes, and other accounts, and long-term liabilities such as bonds, leases, pensions, and product warranties.

Besides assets and liabilities, the balance sheet also displays owner's equity. Owner's equity shows the real value of a company because it subtracts liabilities from assets. It gives instant insight into whether a company is generating enough revenue to survive. This deduction of liabilities from assets

to equal owner's equity is known to accountants as the accounting equation.

Besides balance sheets and statements of owner's equity, accountants also prepare income statements, statements of retained earnings, and statements of cash flows. The income statement, or a Profit and Loss Statement (P & L), records a business's profit and loss in a given span of time. Its purpose is to show **company managers** whether a company made or lost more money in that given time. The income statement differs from the balance sheet in that it tracks income during a set period of time, while the balance sheet represents a single date, such as the final date of the financial year.

Moreover, the statement of retained earnings shows a company's net income after earnings belonging to shareholders have been meted out. If a company has lost revenue after this process, the statement becomes the statement of retained losses. This statement is often added to the balance sheet to show shareholders' equity, or the remaining assets belonging to shareholders after liabilities have been deducted.

The final type of financial statement is the statement of cash flows. Rather than displaying earned or lost revenue, this statement simply records a company's financial transactions in a given span of time. It basically shows the money flowing out of a company (cash outflow), and money coming into it (cash inflow), along with their origins and destinations. Mainly, it displays the business's operating, financing, and investing activities. Accountants use the statement of cash flows to evaluate a company's ability to wisely invest and distribute its money.

In preparing these financial statements, accountants use double-entry bookkeeping procedures. This double-entry process reflects that every financial transaction has two actors. Therefore, accountants record each transaction in two accounts, debit and credit. For each debit (an asset for



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the company), there is an equal amount of credit (a loss of money on the client's part). Double-entry book-keeping reflects both where the money goes into and where it comes from. That is, money is never gained or lost, but transferred from one account to another. This type of bookkeeping has greatly helped to reduce data-entry errors, as it informs accountants of the exact origins of the transacted money and its destination.

Accountants do financial accounting on a quarterly basis to keep relevant parties up to date on a business's financial status. Without these regular financial accounting reports, many businesses would fail to acquire outside financing and would most likely collapse.

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