FINANCIAL ACCOUNTING

WHAT IS FINANCIAL ACCOUNTING?

- Accounting is a tree while Financial Accounting one of its branch
- Accounting often referred as the language of business

- **Accounting -** a process of identifying, recording, summarizing, and reporting economic information to decision makers in the form of financial statements.
- **Financial Accounting -** focuses on the specific needs of decision makers external to the organization, such as stockholders, suppliers, banks, and government agencies.

- Accounting Helps to know the financial position of the business enterprise as on the last date of the accounting period

BRANCHES OR DIVISIONS OF ACCOUNTING

- Financial Accounting
- Management Accounting
- Cost Accounting
- Human Resource Accounting
- Social Accounting
- Government Accounting
- Green Accounting

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

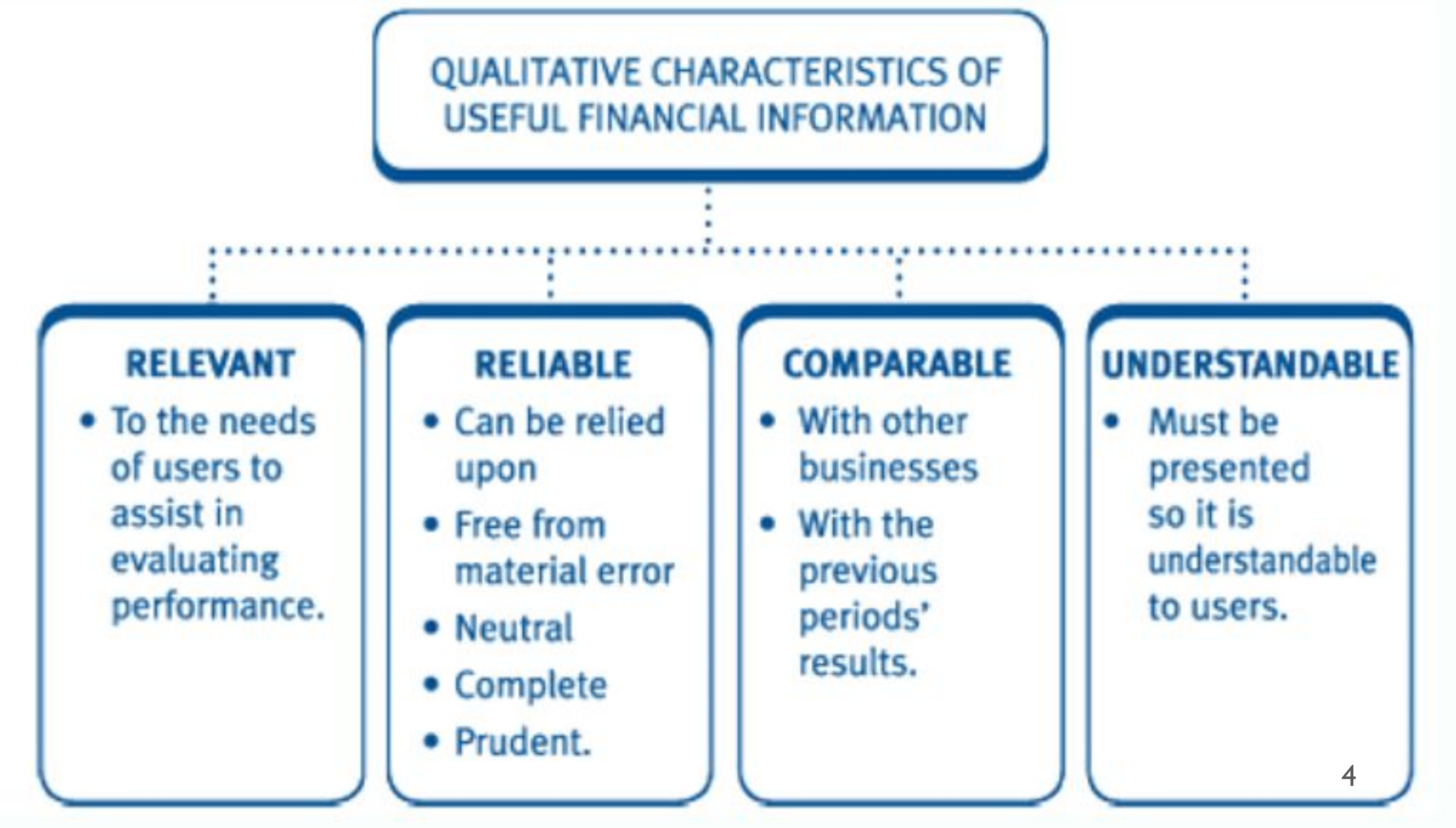
- The Institute of Chartered Accountants of India in its Framework for the Preparation of Financial Statements (Issued in July 2000) provides four principal qualitative characteristics:

1. **UNDERSTANDABILITY**
2. **RELEVANCE**
3. **RELIABILITY**
4. **COMPARABILITY**

– Horizontal (within Industry),

- Diagonal (Across Industries),

- Over the time



FUNCTIONS OF FINANCIAL ACCOUNTING

- Maintaining systematic records – Not Haphazard
- Communicating the financial results
- Meeting legal needs
- Protecting business assets
- Accounting assists the management in the task of planning , control and coordination of business activities
- Stewardship or Trusteeship
- Fixing Responsibility

ADVANTAGES OF ACCOUNTING

1. Maintenance of records rather than memory
2. Preparation of financial statements
3. Comparison of results
4. Assistance to management
5. As legal evidence
6. Helps in taxation matters
7. Ascertainment of value of the business
8. Raising loans
9. Control over assets

LIMITATIONS OF ACCOUNTING

- No recording of non-monetory transactions
- No information about the present value of the business
- Use of estimates or personal judgement
- Window dressing
- Not the sole test of managerial efficiency
- Disclosure of only material items
- Historical Information only

ACCOUNTING CONCEPTS AND CONVENTIONS

- <u>Accounting Concepts</u>
- •Business entity
- •Money Measurement
- • Accrual concept
- • Going Concern
- •Accounting Period/ Periodicity
- •Cost Concept
- •Matching Concept
- •Realization

1. **Accounting Concepts**
   - Accounting concepts include the assumptions and conditions on which the science of accounting is based.
   - These are also known as accounting standards.

2. **Accounting Conventions**

   Accounting conventions include the customs and traditions that assists the accountants in preparing accounting statements.

- Accounting Conventions

ACCOUNTING CONCEPTS

- Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared.
- Concepts are those basic assumptions and conditions which form the basis upon which the accountancy has been laid.

- **Business Entity**

- •The business and its owner(s) are two separate existence entity
- •Any private and personal incomes and expenses of the owner(s) should not be treated as the incomes and expenses of the business

- **Money Measurement**

- •All transactions of the business are recorded in terms of money
- •It provides a common unit of measurement

- **Going Concern**

- •The business will continue in operational existence for the foreseeable future
- •Financial statements should be prepared on a going concern basis unless management either intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so

- **Accounting Period Concept**

- This concept is a result the assumption of Going Concern Concept. According to going concern concept, business will continue for a long time, it will be very difficult to measure the income and analyse of financial position of the business after a very long period and would not be helpful in taking corrective action when it is actually required.
- This concept divides the life of business into periodic intervals which are known as Accounting Period. This period is normally of twelve months starting on 1st April and ends on 31st March of next calendar year. At the end of each accounting period final accounts including Income Statements and Balance Sheet are prepared to find out the profit and loss for the accounting period and financial position at the end of the period.

- **Cost Concept**
- Assets should be shown on the balance sheet at the cost of purchase instead of current value
- **Matching Concept**
- Income determination or measurement of income is a matter of matching the revenues earned during the accounting period with the expenses that were incurred in the process of earning these revenues.

- **Realization Concept**

- •Revenues should be recognized when the major economic activities have been completed
- •With this convention, accounts recognise transactions (and any profits arising from them) at the point of sale or transfer of legal ownership - rather than just when cash actually changes hands.
- For example, a company that makes a sale to a customer can recognise that sale when the transaction is legal - at the point of contract. The actual payment due from the customer may not arise until several weeks (or months) later - if the customer has been granted some credit terms.

- **Accruals Concept**

- •Revenues are recognized when they are earned, but not when cash is received
- •Expenses are recognized as they are incurred, but not when cash is paid
- •The net income for the period is determined by subtracting expenses incurred from revenues earned

ACCOUNTING CONVENTIONS

- Accounting conventions are guidelines used to help companies determine how to record business transactions not yet fully covered by accounting standards.
- They are generally accepted by accounting bodies but are not legally binding.
- If an oversight organization sets forth a guideline that addresses the same topic as the accounting convention, the accounting convention is no longer applicable.
- There are four widely recognized accounting conventions: conservatism, consistency, full disclosure, and materiality.

- **Convention of Full Disclosure**

- •Financial statements should be prepared to reflect a true and fair view of the financial position and performance of the enterprise
- •All material and relevant information must be disclosed in the financial statements

- **Convention of Materiality**

- •Immaterial amounts may be aggregated with the amounts of a similar nature or function and need not be presented separately
- •Materiality depends on the size and nature of the item

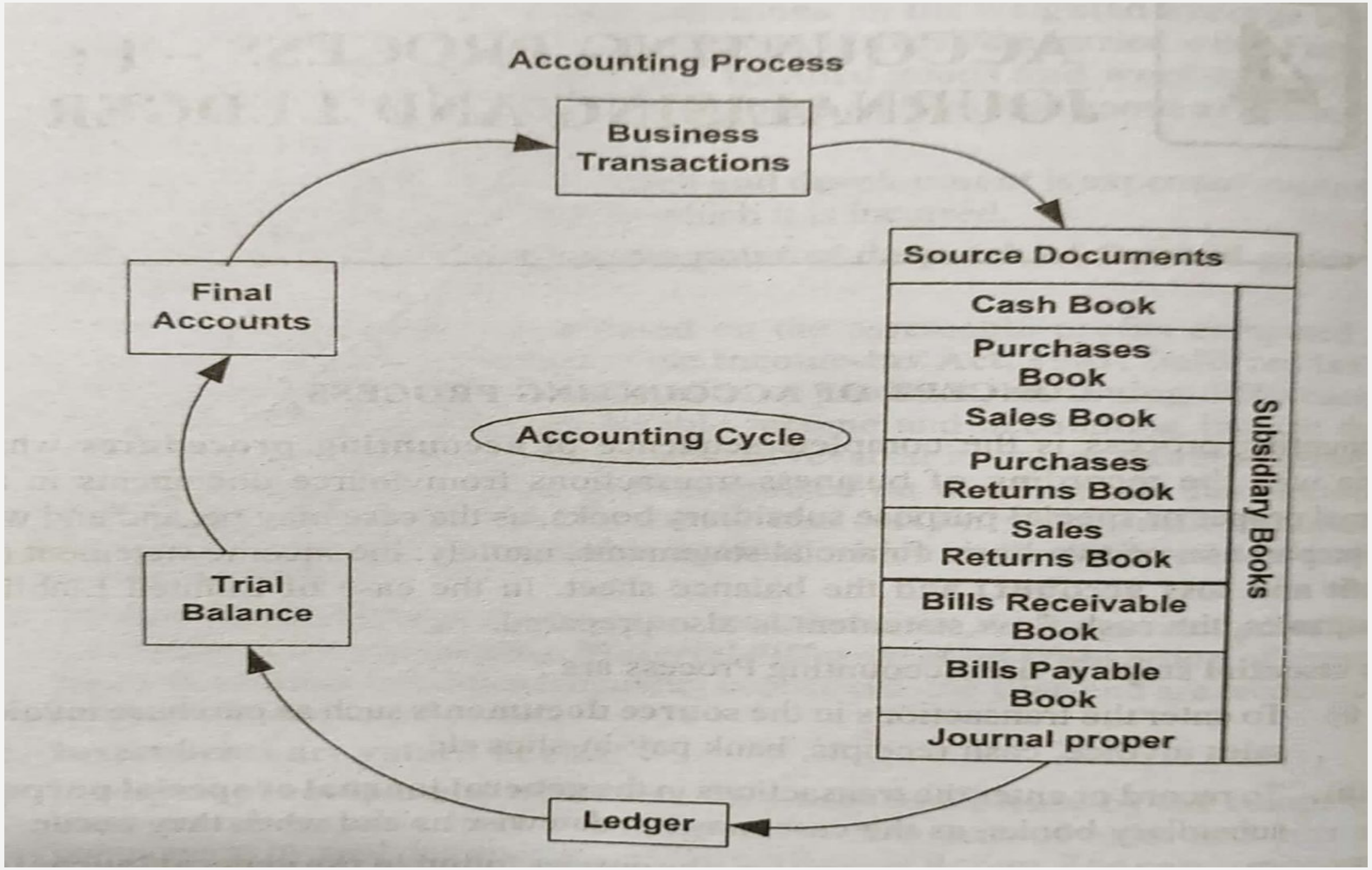
- **Convention of Prudence/Conservatism**

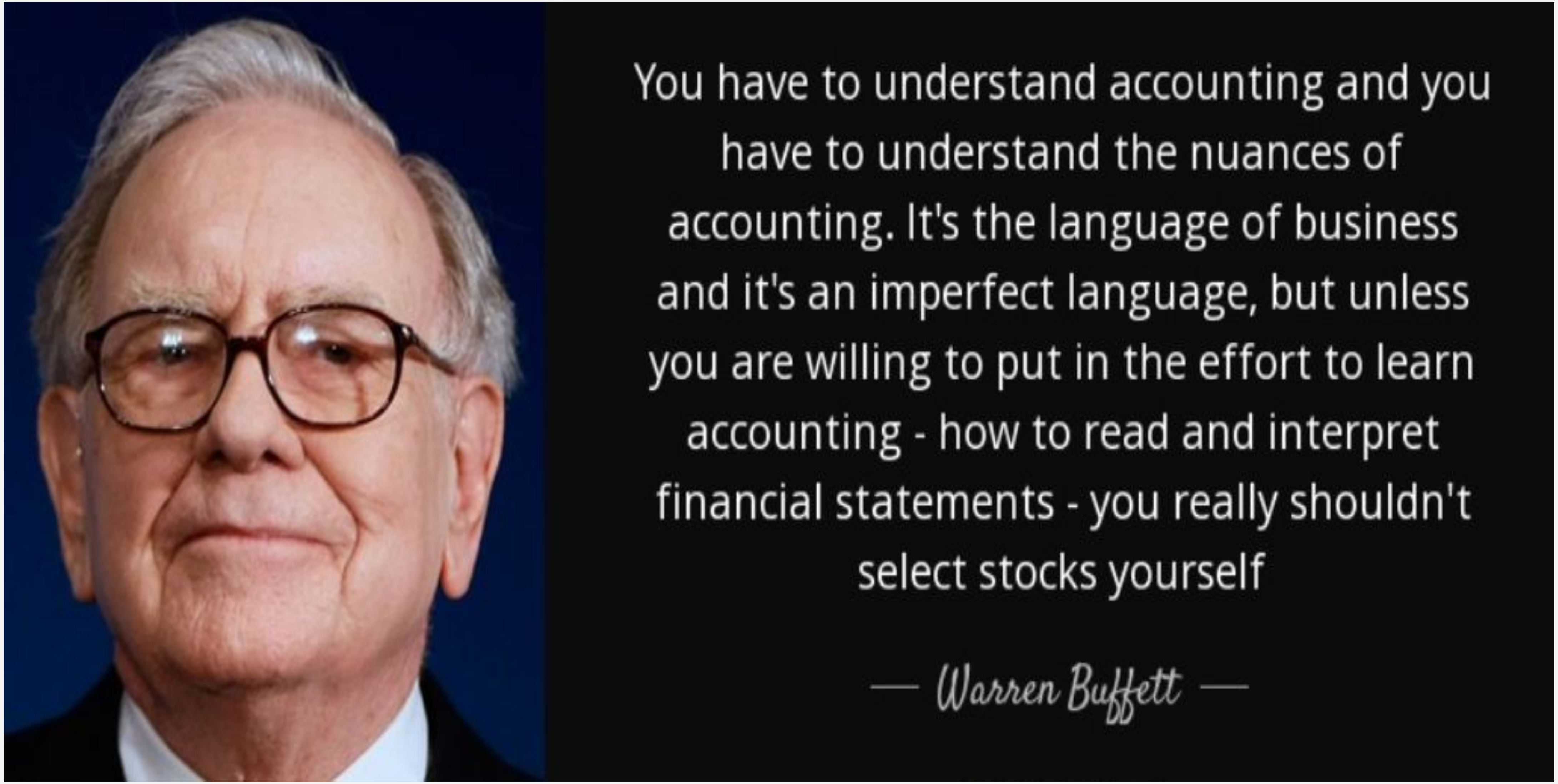
- •Revenues and profits are not anticipated. Only realized profits with reasonable certainty are recognized in the profit and loss account
- •However, provision is made for all known expenses and losses whether the amount is known for certain or just an estimation
- •This treatment minimizes the reported profits and the valuation of assets

- **Convention of Consistency**

- •Companies should choose the most suitable accounting methods and treatments, and consistently apply them in every period
- •Changes are permitted only when the new method is considered better and can reflect the true and fair view of the financial position of the company
- •The change and its effect on profits should be disclosed in the financial statements

THE ACCOUNTING PROCESS




You have to understand accounting and you have to understand the nuances of accounting. It's the language of business and it's an imperfect language, but unless you are willing to put in the effort to learn accounting - how to read and interpret financial statements - you really shouldn't select stocks yourself
— Warren Buffett —