1. Concept of Accounting:

Accounting is a discipline of collecting, summarizing, analyzing and reporting monetary terms of information about business. It is the language of business in the form of financial statements. It must be communicated or understood by the concerned parties relating to business. Accountant must follow some fundamental and universally accepted principals, concepts and assumptions like GAAP to make it communicable. A basic assumption of accounting on which structure of accounting is built is known as concept of accounting and they are as under:

Accounting concepts and conventions

In drawing up accounting statements, whether they are external "financial accounts" or internally-focused "management accounts", a clear objective has to be that the accounts fairly reflect the true "substance" of the business and the results of its operation.

The theory of accounting has, therefore, developed the concept of a ***"true and fair view"***. The true and fair view is applied in ensuring and assessing whether accounts do indeed portray accurately the business' activities.

To support the application of the "true and fair view", accounting has adopted certain concepts and conventions which help to ensure that accounting information is presented accurately and consistently.

Accounting Conventions

The most commonly encountered convention is the **"historical cost convention"**. This requires transactions to be recorded at the price ruling at the time, and for assets to be valued at their original cost.

Under the "historical cost convention", therefore, no account is taken of changing prices in the economy.

The other conventions you will encounter in a set of accounts can be summarized as follows:

Monetary measurement	Accountants do not account for items unless they can be quantified in monetary terms. Items that are not accounted for (unless someone is prepared to pay something for them) include things like workforce skill, morale, market leadership, brand recognition, quality of management etc.
Separate Entity	This convention seeks to ensure that private transactions and matters relating to the owners of a business are segregated from transactions that relate to the business.

Realization	With this convention, accounts recognize 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 recognize 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.
Materiality	An important convention. As we can see from the application of accounting standards and accounting policies, the preparation of accounts involves a high degree of judgment. Where decisions are required about the appropriateness of a particular accounting judgment, the "materiality" convention suggests that this should only be an issue if the judgment is "significant" or "material" to a user of the accounts. The concept of "materiality" is an important issue for auditors of financial accounts.

Accounting Concepts

Four important accounting concepts underpin the preparation of any set of accounts:

Going Concern	Accountants assume, unless there is evidence to the contrary, that a company is not going broke. This has important implications for the valuation of assets and liabilities.
Consistency	Transactions and valuation methods are treated the same way from year to year, or period to period. Users of accounts can, therefore, make more meaningful comparisons of financial performance from year to year. Where accounting policies are changed, companies are required to disclose this fact and explain the impact of any change.
Prudence	Profits are not recognized until a sale has been completed. In addition, a cautious view is taken for future problems and costs of the business (they are "provided for" in the accounts" as soon as there is a reasonable chance that such costs will be incurred in the future.
Matching (or "Accruals")	Income should be properly "matched" with the expenses of a given accounting period.

2. <u>Users of Accounting Information and Their Needs</u>:

Users	**Needs**
A. Internal Users	
Managers	To facilitate ***planning and controlling***

	functions (Production Cost, Expenditure, to find out budgeted amount and actual amount and the like)
B. External Users	
Stock Holders and Potential Stock Holders	Whether to ***buy, sell or hold stock*** or not? (Depends on performance of a Company in stock market, profit and dividends)
Bond holders, Bankers and other Creditors	Whether to provide loan or not? (Depends on company ***ability to pay loan and interest*** in time)
Government Agencies (IRS and SEC)	To collect Tax To set rules through which financial statement should be presented
Suppliers	To know the ***credit worthiness*** of the company before selling goods on credit
Financial Analyst, Financial Intermediaries, Stock Brokers	To **Advice their clients** in order to take investment decision i.e. whether to buy, sell or hold the stock?

3. OBJECTIVE OF FINANCIAL STATEMENTS:

There are numerous purposes of financial statements. The different objectives of financial statements can be explained under the following heads:

Cash flow statements:

The purpose of this financial statement is to keep an account of the different activities of the Council. It also provides information on the mode of generation of funds required for repayment. The cash flow statement also helps to analyses the amount of cash that would be required in order to meet the operating costs.

Income Statement: This type of financial statement keeps an account of the net surplus or deficits. The net surplus or deficit is calculated by considering all the activities in the last financial year. By having a detailed account of the past, one can forecast or assess the future performance of the company.

Balance Sheet: The balance sheet basically gives an idea of the financing structure of the company. With the help of this one can predict the funds that would be utilized in the future. It would further reflect the capacity of the firm to raise additional capital.

Financial Statement of Accounting Policies: So that financial reports serve their desired objectives the users should be keeping the following aspects in mind:

1. the system of measurement that constitutes the basis of preparing the financial reports.

2. The accounting policies that underlie a particular item in the financial report should be clearly understood. This is more important in cases where there are alternatives to use a particular item in the financial report.

3. Any change in the accounting policy should be known to the users of the financial reports.

Notes to the Financial Statements: The note to the financial statement gives an in depth understanding of the financial performance of the company.

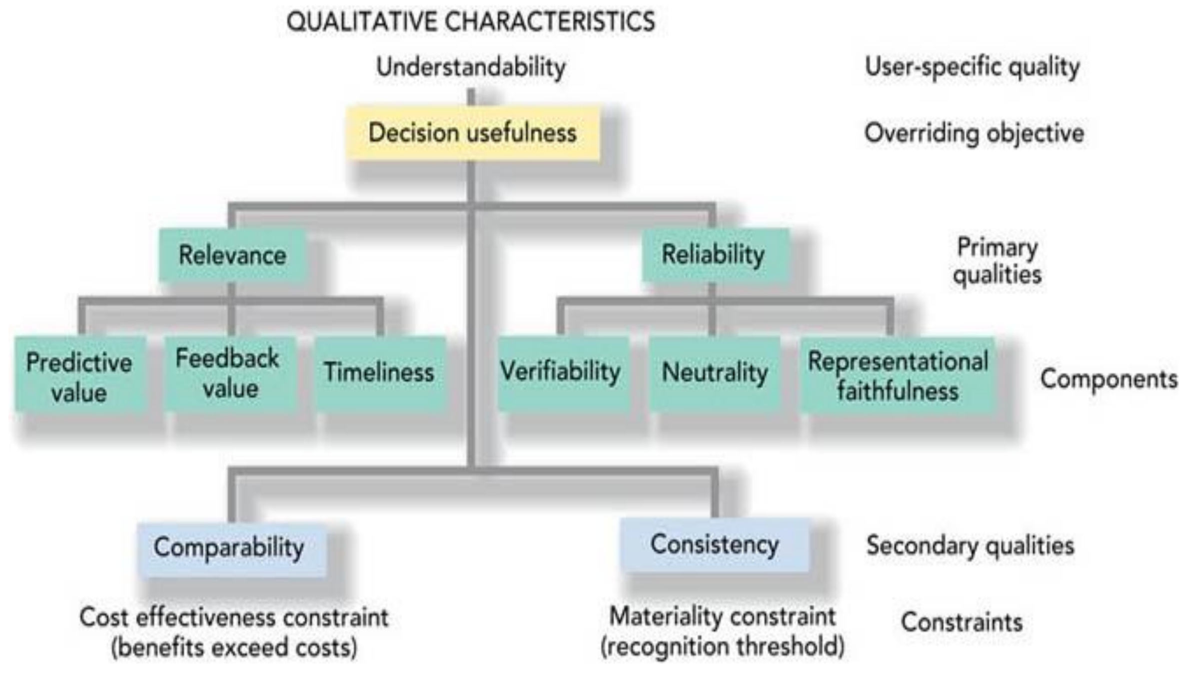
The purpose of a financial statement is to enable a business to establish the result of its operations over a period of time and to determine its worth at a specific date. Financial statements are often prepared by business people to assist them in evaluating their financial condition. Sometimes it is necessary to provide specific financial statements at the request of a banker or supplier. Tax returns require a financial statement when a business is involved. In-house monthly financial statements can be in any form that is convenient or acceptable to management. When financial statements are provided to outside parties, however, they are required to be in a standard format and follow specific rules of preparation.

A basic set of financial statements will consist of an Income Statement, which shows the profit or loss over a period of time, and a Balance Sheet, which is a summary of the Assets, Liabilities and Equity of the business at a specific date. Sometimes, a Statement of Cash Flows may be prepared, which summarizes the receipts and disbursements of cash during the period. This is often a useful tool for management and owners to see where the cash is really going.

4. Qualitative Characteristics of Accounting Information:

To satisfy the stated objectives, information should possess certain characteristics. Graph below indicates these qualitative characteristics, presented in the form of a hierarchy of their perceived importance. Notice that the main focus, as stated in the first concept statement is on *decision usefulness*—the ability to be useful in decision making. *Understandability* means that users must understand the information within the context of the decision being made. This is a user-specific quality because users will differ in their ability to comprehend any set of information. The first stated financial reporting objective of *SFAC 1* is to provide comprehensible information to those who have a reasonable understanding of business and economic activities and are willing to study the information.

Hierarchy of Desirable Characteristics of Accounting Information



To be useful, information must make a difference in the decision process.

PRIMARY QUALITATIVE CHARACTERISTICS

The primary decision-specific qualities that make accounting information useful are relevance and reliability. Both are critical. No matter how reliable, if information is not relevant to the decision at hand, it is useless. Conversely, relevant information is of little value if it cannot be relied on. Let's look closer at each of these two characteristics, including the components that make those qualities desirable. We also consider two secondary qualities—comparability and consistency.

To be useful for decision making, accounting information should be *relevant* and *reliable.*

Relevance. To make a difference in the decision process, information must possess predictive value and/or feedback value. Generally, useful information will possess both qualities. For example, if net income and its components confirm investor expectations about future cash-generating ability, then net income has feedback value for investors. This confirmation can also be useful in predicting future cash-generating ability as expectations are revised.

This predictive ability is central to the concept of "earnings quality," the ability of reported earnings (income) to predict a company's future earnings. This is a concept we revisit frequently throughout this textbook in order to explore the impact on earnings quality of various topics under discussion. Timeliness also is an important component of relevance. Information is timely when it is available to users early enough to allow its use in the decision process. The need for timely information requires that companies provide information to external users on a periodic basis. The SEC requires its registrants to submit financial statement information not only on an annual basis, but also quarterly for the first three quarters of each fiscal year.

Information is *timely* if it is available to users before a decision is made.

Reliability:

Reliability is the extent to which information is *verifiable, representational faithful,* and *neutral.* Verifiability implies a consensus among different measurers. For example, the historical cost of a piece of land to be reported in the balance sheet of a company is usually highly verifiable. The cost can be traced to an exchange transaction, the purchase of the land. However, the market value of that land is much more difficult to verify. Appraisers could differ in their assessment of market value. The term *objectivity* often is linked to verifiability. The historical cost of the land is objective but the land's market value is subjective, influenced by the measurer's past experience and prejudices. A measurement that is subjective is difficult to verify, which makes it more difficult for users to rely on.

Representational faithfulness exists when there is agreement between a measure or description and the phenomenon it purports to represent. For example, assume that the term *inventory* in a balance sheet of a retail company is understood by external users to represent items that are intended for sale in the ordinary course of business. If inventory includes, say, machines used to produce inventory, then it lacks representational faithfulness.

***Representational faithfulness* means agreement between a measure and a real-world phenomenon that the measure is supposed to represent.**

Several years ago, accountants used the term *reserve for doubtful accounts* to describe anticipated bad debts related to accounts receivable. For many, the term *reserve* means that a sum of money has been set aside for future bad debts. Because this was not the case, this term lacked representational faithfulness. The description "reserve…" now has been changed to "allowance for uncollectible accounts" or "allowance for doubtful accounts."

Reliability assumes the information being relied on is neutral with respect to parties potentially affected. In that regard, neutrality is highly related to the establishment of accounting standards. You learned earlier that changes in accounting standards can lead to adverse economic consequences to certain companies, their investors and creditors, and other interest groups.

Accounting standards should be established with overall societal goals and specific objectives in mind and should try not to favor particular groups or companies.

Accounting standards should not favor any particular groups or companies nor influence behavior in any specific way.

The qualities of relevance and reliability often clash. For example, a net income forecast provided by the management of a company may possess a high degree of relevance to investors and creditors trying to predict future cash flows. However, a forecast necessarily contains subjectivity in the estimation of future events. GAAP presently do not require companies to provide forecasts of any financial variables.

A trade-off often is required between various degrees of relevance and reliability.

SECONDARY QUALITATIVE CHARACTERISTICS

Graph identifies two secondary qualitative characteristics important to decision usefulness—comparability and consistency. Comparability is the ability to help users see similarities and differences between events and conditions. We already have discussed the importance of the ability of investors and creditors to compare information across companies to make their resource allocation decisions. Closely related to comparability is the notion that consistency of accounting practices over time permits valid comparisons between different periods. The predictive and feedback value of information is enhanced if users can compare the performance of a company over time.

Accounting information should be *comparable* across different companies and over different time periods.

5. Nature of Business Activities:

1. Financing Activities:

It is the process of borrowing money to buy property. It is the process or means of acquiring capital necessary to conduct a business activity. Two of the most common forms of financing are debt financing and equity financing. In debt financing, one borrows money, usually from an institution, with the promise to return the money with interest at some point in the future. This provides capital to the borrower and a profit to the lender. In equity financing, a company sells portions of ownership to those who are interested. Unlike debt financing, equity financing usually raises capital without incurring liabilities, but the risk exists that the company will not raise enough. An alternative to both debt financing and equity financing, especially for start-ups, is using money from personal savings to pay for activities. A category in the cash flow statement that accounts for external activities such as issuing cash dividends, adding or changing loans, or issuing and selling more stock. The formula for cash flow from financing activities is as follows:

Cash Received from Issuing Stock or Debt - Cash Paid as Dividends and for Re-Acquisition of Debt/Stock

This section of the statement of cash flows measures the flow of cash between a firm and its owners and creditors. Negative numbers can mean the company is servicing debt, but it can also mean the company is making dividend payments and stock repurchases, which investors might be glad to see. In fact, process of collecting money or raising fund and fulfilling their business liability is known as financial activities. Generally, business organizations raise funds by selling bonds and stocks to the public. Payment made for share holders, stock holders, creditors, debtors, all, includes in financial activities.

2. Investing Activities:

Expenditures made for income-producing assets is known as investment. Investment is the act of placing capital into a project or business with the intent of making a profit on the initial placing of capital. An investment may involve the extension of a loan or line of credit, which entitles one to repayment with interest, or it may involve buying an ownership stake in a business, with the hope that the business will become profitable. Investing may also involve buying a particular asset with the intent to resell it later for a higher price. Many types of investing exist, and each is subject to greater or lesser regulation in the jurisdiction in which it takes place. Legally, investing requires the existence and protection of individual property rights. Investing wisely requires a combination of astuteness, knowledge of the market, and timing Generated funds from financial activities i.e. selling of bonds and stocks will be invested on the factor of production i.e. generally on productive assets such as land and building, plant and machinery, furniture and fixture, tools and equipment, free hold property, business premises, long term investment and the like.

3. **Operating Activities**:

It is the process of generating profit from selling product (goods) or services. In other word, it is the inflow and out flow of assets (cash) resulting from the sales of goods and services. It is an accounting item indicating the cash a company brings in from ongoing, regular business activities. Cash flow from operating activities does not include long-term capital or investment costs. It can be calculated as:

Cash Flow from Operating Activities = EBIT + Depreciation – Taxes

Cash flow from operating activities is reported on the cash flow statement in a company's quarterly/annual report. Income that a company receives from investment activities is reported separately, since it is not from business operations. Comparing the cash flow from operating activities with EBITDA can give insights into how a company finances short-term capital.