

## Chapter 1

# Seeing the Big Picture of Financial Accounting

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### *In This Chapter*

- ▶ Figuring out why financial accounting matters
  - ▶ Meeting the financial accounting stakeholders
  - ▶ Introducing key financial accounting characteristics
  - ▶ Accepting ethical responsibilities
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**I** assume that you have a very good reason for purchasing this book; most people don't buy a title like *Financial Accounting For Dummies* on a whim in the bookstore. Most likely, you're taking your first financial accounting class and want to be sure you pass it, but perhaps you're a business owner wanting to get a better handle on financial statement preparation. Whatever your motivation, this chapter is your jumping board into the pool of financial accounting.

I explain what financial accounting is and why it's so important to many different individuals and businesses. I spell out the various users of financial accounting data and explain why they need that data. Finally, I briefly introduce four all-important characteristics of financial accounting: relevance, reliability, comparability, and consistency. Whether you're a financial accounting student or a business owner, you need to understand these crucial financial accounting terms from the very beginning.

## *Knowing the Purposes of Financial Accounting*

Broadly speaking, *accounting* is the process of organizing facts and figures and relaying the result of that organization to any interested customers of the information. This process doesn't just relate to numbers spit out by a computer software program; it pertains to any type of reconciliation.

Here's an example from my own life of accounting that doesn't involve numbers or money: A teenager slinks in after curfew, and his parent asks for a complete accounting of why he is late. When the teenager tells the facts, you have information (his car broke down in an area with no cell coverage), the individual producing the information (our mischievous teen), and the interested customer, also known as the user of the information (the worried parent).

The subject of this book, financial accounting, is a subset of accounting. *Financial accounting* involves the process of preparing financial statements for a business. (Not sure what financial statements are? No worries — you find an overview of them in the next section.) Here are the key pieces of the financial accounting process:

- ✔ **Information:** Any accounting transactions taking place within the business during the accounting period. This includes generating revenue from the sales of company goods or services, paying business-related expenses, buying company assets, and incurring debt to run the company.
- ✔ **Business entity:** The company incurring the accounting transactions.
- ✔ **Users:** The persons or businesses that need to see the accounting transactions organized into financial statements to make educated decisions of their own. (More about these users in the “Getting to Know Financial Accounting Users” section of this chapter.)

## *Preparing financial statements*

If you're taking a financial accounting class, your entire course is centered on the proper preparation of financial statements: the income sheet, balance sheet, and statement of cash flows. Financial accountants can't just stick accounting transaction data on the statements wherever they feel like. Many, many rules exist that dictate how financial accountants must organize the information on the statements; these rules are called *generally accepted accounting principles* (GAAP), and I discuss them in Chapter 4. The rules pertain to both how the financial accountant shows the accounting transactions and on which financial statements the information relating to the transactions appears.

Curious about the purpose of each financial statement? (I know the mystery is eating at you!) Here's the scoop on each:

- ✔ **Income statement:** This financial statement shows the results of business operations consisting of revenue, expenses, gains, and losses. The end product is net income or net loss. I talk about the income statement again in Chapter 3, and then I cover it from soup to nuts in Chapter 10.



For now (because I know the excitement is too much for you!), here are the basic facts on the four different income statement components:

- *Revenue*: Gross receipts earned by the company selling its goods or services.
- *Expenses*: The costs to the company to earn the revenue.
- *Gains*: Income from non-operating-related transactions, such as selling a company asset.
- *Losses*: The flip side of gains, such as losing money when selling the company car.

A lot of non-accountants call the income statement a *statement of profit or loss* or simply a *P&L*. These terms are fine to use because they address the spirit of the statement.

- ✓ **Balance sheet**: This statement has three sections: assets, liabilities, and equity. Standing on their own, these sections contain valuable information about a company. However, a user has to see all three interacting together on the balance sheet to form an opinion approaching reliability about the company.

Part III of this book is all about the balance sheet, but for now here are the basics about each balance sheet component:

- *Assets*: Resources owned by a company, such as cash, equipment, and buildings.
- *Liabilities*: Debt the business incurs for operating and expansion purposes.
- *Equity*: The amount of ownership left in the business after deducting total liabilities from total assets.

- ✓ **Statement of cash flows**: This statement contains certain components of both the income statement and the balance sheet. The purpose of the statement of cash flows is to show cash sources and uses during a specific period of time — in other words, how a company brings in cash and for what costs the cash goes back out the door.

## *Showing historic performance*

The information reflected on the financial statements allows its users to evaluate whether they want to become financially involved with the company. But the financial statement users cannot make educated decisions based solely on one set of financial statements. Here's why:

- ✓ The income statement is finite in what it reflects. For example, it may report net income for the 12-month period ending December 31, 2012. This means any accounting transactions taking place prior to or after this 12-month window do not show up on the report.
- ✓ The statement of cash flows is also finite in nature, showing cash ins and outs only for the reporting period.

While the balance sheet shows results from the first day the company opens to the date on the balance sheet, it doesn't provide a complete picture of the company's operations. All three financial statements are needed to paint that picture.



Savvy financial statement users know that they need to compare several years' worth of financial statements to get a true sense of business performance. Users employ tools such as ratios and measurements involving financial statement data (a topic I cover in Chapter 14) to evaluate the relative merit of one company over another by analyzing each company's historic performance.

## *Providing results for the annual report*

After all the hoopla of preparing the financial statements, *publicly traded companies* (those whose stock and bonds are bought and sold in the open market) employ independent certified public accountants (CPAs) to audit the financial statements for their inclusion in reports to the shareholders. The main thrust of a company's annual report is not only to provide financial reporting but also to promote the company and satisfy any regulatory requirements.

The preparation of an annual report is a fairly detailed subject that your financial accounting professor will review only briefly in class. Your financial accounting textbook probably contains an annual report for an actual company, which you'll use to complete homework assignments. I provide a more expansive look at annual reports in Chapter 16.

## *Getting to Know Financial Accounting Users*

Well, who are these inquisitive financial statement users I've been referring to so far in this chapter? If you've ever purchased stock or invested money

in a retirement plan, you number among the users. In this section, I explain why certain groups of people and businesses need access to reliable financial statements.

## *Identifying the most likely users*

Financial statement users fall into three categories:

- ✓ Existing or potential investors in the company's stocks or bonds.
- ✓ Individuals or businesses thinking about extending credit terms to the company. Examples of creditors include banks, automobile financing companies, and the vendors from which a company purchases its inventory or office supplies.
- ✓ Governmental agencies, such as the U.S. Securities and Exchange Commission (SEC), which want to make sure the company is fairly presenting its financial position. (I discuss the history and role of the SEC in Chapter 4.)

And what other governmental agency is particularly interested in whether a company employs any hocus pocus when preparing its financial statements? The Internal Revenue Service, of course, because financial statements are the starting point for reporting taxable income.

## *Recognizing their needs*



All three categories of financial statement users share a common need: They require assurance that the information they are looking at is both materially correct and useful. *Materially correct* means the financial statements don't contain any serious or substantial misstatements. In order to be useful, the information has to be understandable to anyone not privy to the day-to-day activities of the company.

Investors and creditors, though sitting at different ends of the table, have something else in common: They are looking for a financial return in exchange for allowing the business to use their cash. Governmental agencies, on the other hand, don't have a profit motive for reviewing the financial statements; they just want to make sure the company is abiding by all tax codes, regulations, or generally accepted accounting principles.

## *Providing information for decision-making*



The onus is on financial accountants to make sure a company's financial statements are materially correct. Important life decisions may hang in the balance based on an individual investing in one stock versus another. Don't believe me? Talk to any individual close to retirement age who lost his or her whole nest egg in the Enron debacle.

Two of the three groups of financial statement users are making decisions based on those statements: investors and creditors.

Creditors look to the financial statements to make sure a potential debtor has the cash flow and potential future earnings to pay back both principal and interest according to the terms of the loan.

Investors fall into two groups:

- ✔ **Those looking for growth:** These investors want the value of a stock to increase over time. Here's an example of growth at work: You do some research about a little-known company that is poised to introduce a hot new computer product into the market. You have \$1,000 sitting in a checking account that bears no interest. You believe, based on your research, that if you purchase some stock in this company now, you'll be able to sell the stock for \$2,000 shortly after the company releases the computer product.
- ✔ **Those looking for income:** These investors are satisfied with a steady stock that weathers ebbs and flows in the market. The stock neither increases nor decreases in value per share by an enormous amount, but it pays a consistent, reasonable dividend. (Keep in mind that reasonableness varies for each person and his or her investment income goals.)

Remember that there are two ways to make money: the active way (you work to earn money) and the passive way (you invest money to make more money). Passive is better, no? The wise use of investing allows individuals to make housing choices, educate their children, and provide for their retirement. And wise investment decisions can be made only when potential investors have materially correct financial statements for the businesses in which they're considering investing.

## Respecting the Key Characteristics of Financial Accounting Information

Now that you understand who uses financial accounting information, I want to discuss the substantive characteristics of that information. If financial accountants don't assure that financial statement information has these characteristics, the statements aren't worth the paper on which they're printed.

The information a company provides must be relevant, reliable, comparable, and consistent. In this section, I define what each characteristic means.

### Relevance

*Relevance* is a hallmark of good evidence; it means the information directly relates to the facts you're trying to evaluate or understand. The inclusion or absence of relevant information has a definite effect on a user's decision-making process.

Relevant information has *predictive value*, which means it helps a user look into the future. By understanding and evaluating the information, the user can form an opinion as to how future company events may play out. For example, comparing financial results from prior years, which are gleaned from the financial statements, can give investors an idea as to the future value of a company's stock. If assets and revenue are decreasing while liabilities are increasing, you have a pretty good indicator that investing in this company may not be such a hot idea.

Relevant information also has *feedback value*, which means that new relevant information either confirms or rebuts the user's prior expectations. For example, you review a company's financial statements for 2012, and your analysis indicates that the company's sales should increase two-fold in the subsequent year. When you later check out the 2013 income statement, the company's gross receipts have, indeed, doubled. Woohoo! With the relevant information in hand, you see that your prediction came true.



Timeliness goes hand in hand with relevance. The best and most accurate information in the world is of no use if it's no longer applicable because so much time has elapsed that facts and circumstances have changed. Look at it this way: If you were in the market to replace your flat-screen TV, and you

found out about a killer sale at the local electronics store the day after the sale ended, this information is utterly useless to you. The same thing is true with financial information. That's why the SEC requires publicly traded companies to issue certain reports as soon as 60 days after the end of the financial period. (See Chapter 16 for more about this reporting requirement.)

## Reliability

*Reliability* means you can depend on the information to steer you in the right direction. For example, the information must be free from material misstatements (meaning it doesn't contain any serious or substantial mistakes). It also has to be reasonably free from bias, which means the information is neutral and not slanted to produce a rosier picture of how well the company is doing.

Here's an example of how a company would create biased financial statements. Say that a company has a pending lawsuit that it knows will likely damage its reputation (and, therefore, its future performance). In the financial statements, the company does not include a note that mentions the lawsuit. The company is not being neutral in this situation; it is deliberately painting a rosier picture than actually exists. (See Chapter 15 for my explanation of the purpose of financial statement notes.)

Reliable information must be verifiable and have representational faithfulness. Here's what I mean:



- ✓ A hallmark of *verifiability* is that an independent evaluation of the same information leads to the same conclusion as presented by the company. An accounting application of this concept could be an independent third party, such as an auditor, checking that the dollar amount shown on the balance sheet as *accounts receivable* (money owed to the company by customers) is indeed correct.
- ✓ *Representational faithfulness* means that if the company says it has gross receipts of \$200,000 in the first quarter of 2012, it actually has receipts of \$200,000 — not any other amount.

## Comparability

*Comparability* means the quality of the information is such that users can identify differences and similarities among companies they are evaluating — or among different financial periods for the same company. For example, users need to know what particular GAAP the different companies they are examining are using to depreciate their assets. Without this knowledge, the users cannot accurately evaluate the relative worth of one company over the other.



## Independent verification of accounts receivable

Many companies sell goods or services to customers *on account*, which means the customer promises to pay in the future. When this happens, the amount of unpaid customer invoices goes into an account called *accounts receivable*. (See Chapters 7 and 10 for detailed info about accounts receivable.) For a business carrying a sizable amount of accounts receivable, an error in this account can have a material effect on the reliability of the income statement and balance sheet.

Independent confirmation of the accounts receivable balance is done by sending requests for confirmation. *Confirmations* are form letters sent to customers listed in the accounts

receivable subsidiary ledger (a listing showing all customers with a balance owed). The letters seek to verify the facts and figures contained in the company's books. The confirmation form letter is usually brief, listing the total amount the company shows the customer owes at a certain date.

Some confirmation letters ask for a response; others ask the customer to respond only if the information on the confirmation form is incorrect. An independent party, such as the company's external certified public accountant (CPA), tallies the results of the confirmations and either verifies or refutes the amount the company asserts that its customers owe.

Consider a personal example: Think about the last time you purchased a laptop. To the novice computer buyer, the shiny black cases and colored displays all look pretty much the same. But the price of each model varies — sometimes substantially. Therefore, you have to ferret out the facts about each model to be able to compare models and decide on the best one for your needs. What do you do? You check out the manufacturer's specs for each laptop in your price range, comparing such important facts as the size of the hard drive, processing speed, and (if you want to be truly mobile) the laptop's size and weight. By doing so, you are able to look beyond outward appearance and make a purchasing decision based on comparative worth among your options.



As of this writing, U.S. GAAP are different from accounting principles used by businesses in other countries. Therefore, comparing financial statements of a foreign-based company and a U.S.-based company is difficult.

## Consistency

*Consistency* means the company uses the same accounting treatment for the same type of accounting transactions — both within a certain financial period and among various financial periods. Doing so allows the user to know that the financial accountant is not doing the accounting equivalent of comparing a dog to a cat. Both are animals, both are furry, but as any pet owner knows, you have a basic lack of consistency between the two.

## Seeing how depreciation affects the bottom line

*Depreciation* is the process of systematically reclassifying the cost of an asset from the balance sheet to the income statement over its useful life — a topic I discuss at length in Chapter 12. A few different methods of depreciation are allowed by GAAP, so unless you know which method the company is using, you can't effectively compare one company to another.

Consider an example. For the same asset, here is the amount of depreciation a company can take for the asset's first year of use depending on which commonly used depreciation method it employs:

- ✓ Straight-line depreciation: \$54,000
- ✓ Double-declining balance depreciation: \$120,000

The difference between the two methods is a whopping \$66,000 (\$120,000 – \$54,000)! Now imagine depreciating equipment that costs in the millions of dollars; the effect on the company's bottom line net income of choosing one depreciation method versus another would be even more astonishing.

Luckily for the financial statement users, to aid in comparability, the depreciation method in use by a company must be disclosed in the notes to the financial statements. For much more info about depreciation, jump to Chapter 12. For the scoop on what financial statement notes are, head to Chapter 15.



Keep in mind that a company *is* allowed to switch accounting methods if it has a valid business purpose for the switch; the company isn't stuck using only one method throughout its existence. An example of a good reason for a switch in methods is if using a different accounting method presents a more accurate financial picture. But a change in methods can't be done willy-nilly whenever the business feels like it. I provide the whole scoop on changes in accounting treatment in Chapter 20. Also, the company has to disclose this change in its footnotes to the financial statements; see Chapter 15.

Consistency is crucial when it comes to depreciation. If the company lacks consistency—for example, it uses different depreciation methods when accounting for the same asset in different years—you cannot create truly useful financial statements.

## Accepting Financial Accounting Constraints

While preparing financial statements, accountants realize that time is money and there is a limit to the amount of cost that should be incurred for any reporting benefit. The agencies that set the standards for accounting practices (which I introduce in Chapter 4) always perform a cost/benefit analysis before finalizing any reporting requirements. Associated with this financial accounting constraint is the concept of materiality.

## Cost/benefit lost in the woods

Years ago, the bookkeeper at one of my client companies spent five hours tracking down the reason why the company bank reconciliation was off by \$2.00 to make sure the bank hadn't made a mistake. (Preparing a *bank reconciliation* means you take the balance in the bank account per the bank as of a certain date, add in any deposits that got to the bank too late to hit the statement, and subtract any checks the

company has written that have not yet cleared.) Yikes!

Now, was this an effective and efficient use of that bookkeeper's time and salary expense? No, of course not. Let's say she was paid \$10 per hour. It cost the company \$50 for her to confirm that the operating account bank balance was indeed off by \$2, and it wasn't just an inadvertent mistake on the part of the bank.



*Materiality* is the importance you place on an area of financial reporting based upon its overall significance. What is material for one business may not be material for another. You have to consider the size of the company, the size of the financial statement transaction, the particular circumstances in which the transaction occurred, and any other factors that can help you judge whether the issue is truly significant to the financial statement users.

For example, an expense totaling \$10,000 would be material if the total expense amount is \$50,000 but would likely be immaterial if the total expense was \$500,000. But the nature of the transaction may make the difference material even if the comparative size is immaterial. For example, \$10,000 that is deliberately — not accidentally — excluded from income may be material even if the amount is a small percentage of overall income. That's because the deliberate exclusion may be an attempt by the owner of the company to avoid paying taxes on the income.



*Conservatism* is very important in financial accounting. It means that when in doubt, the financial accountant should choose the financial accounting treatment that will cause the least effect on revenue or expenses.

## Considering Your Ethical Responsibilities

Every professional — and, frankly, every individual — should operate using a code of conduct. This means you should always attempt to act in an ethical manner and do the right thing, regardless of whether doing the right thing is the best choice for you personally.

In this section, I give you the nuts and bolts of the code of conduct that financial accountants must follow. Plus, you find out about the goals toward which financial accountants strive: integrity, objectivity, and independence.

## Following the accountant's code of conduct

In a financial accounting class, you learn about different licensing options available to financial accountants — a topic I discuss in Chapter 2. Financial accountants who are serious about their profession normally become *certified public accountants* (CPAs), which means they have to take a certain number of accounting and auditing classes, pass a four-part exam, and comply with any other requirements of their state's licensing board.

Working as a financial accountant doesn't require any special licensing, but a lack of licensing may limit your career options. (However, in the spirit of full disclosure, my sister-in-law never passed the CPA exam but still rose to the vice-presidency level of a large multinational corporation.)



CPAs have to abide by their state's code of conduct and also follow the code of conduct established by the American Institute of Certified Public Accountants (AICPA) — the national professional organization for all CPAs. The AICPA is responsible for establishing accounting, auditing, and attestation standards for private companies in the United States, as well as for enforcing a code of professional conduct for its members. (*Attestation* involves generating reports on subjects that are the responsibility of another person or business.) In Chapter 4, I outline that code of conduct in detail.

But what if you're a financial accountant who isn't a CPA or a member of the AICPA? Do you still have to worry about abiding by a code of conduct? Of course you do! Any profession lacking ethical behavior descends into chaos. Financial accountants must have high professional standards, a strict code of professional ethics, and a commitment to serving the public interest. They achieve these goals through their integrity, objectivity, and independence.

## Having integrity

In the world of financial accounting, *integrity* means you act according to a code or standard of values. You demonstrate integrity when you do the right thing, regardless of whether doing so is best for you personally.

Specifically, having integrity means that you serve, to the best of your ability, your employer and/or the client for whom you are preparing financial statements, keeping in mind that doing so may not be the same thing as completely agreeing with the way the employer or client wants you to prepare the financial statements. You can't be worried that your employer or client is going to be mad at you or fire you if you disagree with him.

## Maintaining objectivity

Whether you work in public accounting (you have multiple clients) or private accounting (you provide accounting services only for your employer), you must be *objective*, meaning impartial and intellectually honest:

- ✓ Being impartial means you're neutral and unbiased in all decision-making processes. You base your opinion and reporting only on the facts, not on any preconceived notions or prejudices.
- ✓ Being intellectually honest means you interpret rules and policies in a truthful and sincere manner, staying true to both their form and spirit.

If you're objective, you keep an open mind until all facts are revealed, despite what you hear from your client's managers, employees, or anyone else privy to the work you're doing.



Financial accountants must be objective, and the users of the financial statements must perceive that the accountants are objective. You never want to compromise your objectivity or else you risk creating the perception that your work — and the financial statements that result from your work — cannot be trusted.

## Achieving independence

Many types of public accounting services, such as auditing, require the financial accountant to be independent in both fact and appearance. Being *independent* while providing services means that you have no special relationship with or financial interest in the client that would cause you to disregard evidence and facts when evaluating your client.

What does it mean to be independent in both fact and appearance? The biggie is that you avoid any real or perceived conflicts of interest: You don't perform services for any client with whom you have either a personal or non-audit-related business relationship. For example, if you have a significant financial interest with a major competitor of your client, your client may question whose best interests you have in mind while performing the accounting services.

Financial accountants providing tax and consulting services do not have to be independent; however, they still have to be objective.



The concepts of independence and objectivity differ somewhat depending on whether you work in public accounting or private accounting. *Public accounting*

is when a financial accountant, most likely a CPA, works for an accounting firm providing services such as auditing or financial statement preparation for clients. *Private accounting* is when you do accounting work for your own employer rather than for a client. Obviously, you can't strive for independence when you're doing accounting work for your own employer. So in private accounting, objectivity is key.

## *Introducing the Conceptual Framework of Financial Accounting*

Every profession needs a roadmap to help the people employed in the field provide the best possible service while doing their jobs. For example, my airline pilot clients have shown me a detailed checklist they must follow each and every time they get in the cockpit, regardless of how many years of experience they have.

For financial accountants, the Financial Accounting Standards Board (FASB) started work on providing a *conceptual framework* — a structure of financial accounting concepts — back in the 1970s. These days, this conceptual framework is organized into Statements of Financial Accounting Concepts (CONs). The CONs cover the financial accounting topics of objectives, characteristics, elements, and financial statement measurement. Not sure what each of these terms means? I discuss this topic in detail in Chapter 6. For now, just remember that this financial accounting conceptual framework exists — or jump to Chapter 6 right now to read all about it!