

## Chapter 1

# Seeing the Big Picture of Financial Accounting and International Accounting

### *In This Chapter*

- ▶ Knowing why financial accounting matters
- ▶ Meeting the stakeholders
- ▶ Introducing key financial accounting characteristics
- ▶ Getting to know IFRSs
- ▶ Accepting ethical responsibilities

**I** assume that you have a very good reason for buying this book; most people don't randomly buy a title like *Financial Accounting For Dummies*. The chances are you're embarking on your first accountancy course and want to be sure you do well in it, but it might be the case that you're a business owner wanting to get a better grip on the way your financial statements are prepared or to improve your bookkeeping. Whatever your reasons, this chapter is your key to the car to start the journey on the road of financial accounting.

I explain what financial accounting is and why it's so important to many different individuals and businesses. I identify the various users of financial information and explain why they need that info. Finally, I briefly introduce four all-important characteristics of financial information: relevance, reliability, comparability and understandability. Whether you're a financial accounting student or a business owner, you need to understand these crucial financial accounting terms from the very beginning as they underpin everything to do with financial statements right from the word 'go'. For those of you reporting under IFRSs, these principles are also relevant but are split between fundamental qualitative characteristics and enhancing qualitative characteristics; I offer a run through of these for you too.

## Knowing the Objective of Financial Accounting

Broadly speaking, *accounting* is the process of organising facts and figures and communicating the results of that organisation to any parties interested in that information. This process doesn't just relate to numbers churned out by a computer software program; it pertains to any type of reconciliation.

Here's an example that a parent could possibly relate to that doesn't involve numbers or money: a teenager sneaks in after a curfew set by his parents, and his parents ask for a complete account of why he's late. When the teenager tells them the facts, we have information (his car broke down in an area with no mobile phone signal), the individual producing the information (the mischievous teenager) and the interested party, also known as the user of the information (the worried parents).

The subject of this book, financial accounting, is a subset of accountancy. *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 jigsaw:

- ✓ **Information:** Any accounting transactions taking place within the business during the accounting period. These include generating revenue from the sales of company goods or rendering of 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 organised into financial statements to make informed decisions of their own. (You can find more about these users in the 'Getting to Know the Users of Financial Statements' section of this chapter.)

## Preparing financial statements

If you're starting an accountancy course, your entire course could well centre on the proper preparation of financial statements: the income statement (profit and loss account), balance sheet (statement of financial position) cash flow statement (statement of cash flows) and statement of changes in equity. Financial accountants can't just stick accounting transaction information in the financial statements wherever they feel like. Many, many rules exist that dictate how financial accountants must organise the information in the financial statements; these rules are called *generally accepted accounting practice* (GAAP), and I discuss them in Chapter 4. The rules pertain to both how the

financial accountant shows the accounting transactions and in which financial statements the information relating to the transactions appears.

Curious about the purpose of each financial statement? Here's a run through of each one:

✓ **Income statement:** This financial statement shows the results of business operations consisting of revenue, expenses, gains and losses. The end product is net profit or net loss. I talk about the income statement again in Chapter 3, and then I cover it from start to finish in Chapter 10. For now, here are the basic facts on the four different income statement components:

- *Revenue:* Sales earned by the company selling its goods or services.
- *Expenses:* The costs to the company to earn its 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 a company car.

A lot of accountants call the income statement a *statement of profit or loss*, especially when they're working to international standards (International Financial Reporting Standards), or simply a *P&L* (as it's commonly known in the UK). 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 a reasonably reliable opinion of 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.



- ✔ **Statement of changes in equity:** This statement shows any movements in the equity accounts of the statement of financial position (balance sheet) – namely: share capital, share premium, revaluation reserve account and retained earnings. So if a company issues additional share capital, the additional capital it has issued during the accounting period will be shown within the statement of changes in equity.

## *Showing historic performance*

The information reflected in 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 informed 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 profit for the 12-month period ending 31 March 2013. This means any accounting transactions taking place prior to or after this 12-month window do not show up in the report.
- ✔ The statement of cash flows is also finite in nature, showing cash ins and outs only for the reporting period.
- ✔ The statement of financial position only shows a 'snapshot' of the state of a company's affairs *as at* the close of play on the last working day of the accounting period.

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 analysing each company's historic performance.

## *Providing results for the annual accounts*

After all the rigmarole of preparing the financial statements, *publicly traded companies* (those whose shares are bought and sold in the open market) employ independent professionally-qualified accountants 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 and if you're a student accountant, you probably won't be expected to prepare a full annual report for your course but may need to know what goes in one. I provide a more expansive look at annual reports in Chapter 16.

## Getting to Know the Users of Financial Statements

Well, who are these inquisitive financial statement users I've been referring to so far in this chapter? If you've ever purchased some shares in a company or invested money in a retirement plan, you are one of these 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 shares or bonds.
- ✓ Individuals or businesses thinking about extending credit terms to the company. Examples of creditors include banks, finance companies and the suppliers from which a company purchases its stock (sometimes called *inventory*) or office supplies.
- ✓ Governmental agencies, such as HM Revenue and Customs, which will want to make sure the company is paying the right amount of corporation tax on its profits.

### Recognising their needs

All three categories of financial statement users share a common need: they require assurance that the information they're 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're 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 tax legislation, regulations or generally accepted accounting practice.

## *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 shares in one company rather than another. Don't believe me? Talk to any individual close to retirement age who lost his 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 (sometimes called *capital*) and interest according to the terms of the loan.

Investors fall into two groups:

- ✓ **Those looking for growth:** These investors want the value of their shares in a company to increase over time. Here's an example of growth at work: you do some research on a fairly unknown company that's poised to introduce a ground-breaking new computer into the market. You have £1,000 sitting in a bank account that pays no interest. You believe, based on your research, that if you purchase some shares in this company now, you'll be able to sell the shares for £2,000 shortly after the company releases the new computer.
- ✓ **Those looking for income:** These investors are satisfied with a steady share price that weathers ebbs and flows in the market. The share price 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 her investment income goals.)

Remember that two ways to make money exist: 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, maybe educate their children, and make provision 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.

## Understanding 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 make sure that financial statement information has these characteristics, the financial 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 pan 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 share price. If assets and revenue are decreasing while liabilities are increasing, that's a pretty good indicator that investing in this company may not be such a good idea.

Relevant information also has *confirmatory 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 revenue has, indeed, doubled. Woohoo! With the relevant information in hand, you see that your prediction was right.



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 shop the day after the sale ended, this information is utterly useless to you. The same thing is true with financial information.

## 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 trade debtors (or *accounts receivable* in international terms). (See Chapters 7 and 10 for detailed information about accounts receivable.) For a business carrying a sizeable 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* (referred to as

*debtors' circularisations*) are 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 letter is usually brief, listing the total that the company's records show 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. The company's external auditor then tallies the results of the confirmations and either confirms or refutes the amount the company asserts that its customers owe.

## 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 thinks will probably damage its reputation (and, therefore, its future performance). In the financial statements, the company doesn't include a disclosure note that mentions the lawsuit. The company is not being neutral in this situation; it's deliberately painting a rosier picture than is actually the case. (See Chapter 15 for my explanation of the purpose of financial statement notes.)

Reliable information must be neutral, have representational faithfulness, be free from material error, be complete and be prudent. Here's what I mean:



- ✓ A hallmark of *neutrality* is that information must be free from deliberate or systematic bias. Financial information will not be neutral if it's been selected or presented in such a way as to influence the users' decision-making process.
- ✓ *Representational faithfulness* means that if the company says it has sales of £200,000 in the first quarter of 2012, it actually has sales of £200,000 – not any other amount.

- ✔ *Free from material error and complete* means that the financial statements aren't significantly incorrect. Financial information that's been omitted (for reasons other than materiality) or contains a material error will mean the financial statements are misleading. For example, understating liabilities by £50,000 will more than likely be material in a smaller company, but understating liabilities by £5 probably won't influence the users' decision-making process because £5 will be immaterial (not significant).
- ✔ *Prudence* in UK GAAP (but not seen in the world of IFRSs) recognises that uncertainty will often surround many events and circumstances that are reported in the financial statements and uncertainty is dealt with by exercising care.

## Comparability

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

### 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 charge for the asset's first year of use depending on which commonly used depreciation method it employs:

- ✔ Straight-line depreciation: £54,000
- ✔ Reducing balance method: £120,000

The difference between the two methods is a whopping £66,000 (£120,000 – £54,000)! Now imagine depreciating equipment that costs millions of pounds; the effect on the company's bottom line net profit 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 lowdown on what financial statement notes are, head to Chapter 15.

Consider a personal example: think about the last time you purchased a laptop. To the novice computer buyer, the shiny black cases and coloured displays all look pretty much the same. But the price of each model varies – sometimes substantially. Therefore, you have to dig 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’re able to look beyond outward appearance and make a purchasing decision based on comparative worth among your options.

## *Consistency*

*Consistency* is a subset of comparability. It 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.



Keep in mind that a company *is* allowed to switch accounting methods if it has a valid reason for doing so; the company isn’t stuck with 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 a complete picture on changes in accounting policies and estimates in Chapter 20. Also, the company has to disclose such changes in its notes 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.

## *Understandability*

UK GAAP recognises that it isn’t always possible to present a piece of relevant, reliable and comparable information in a way that a user can fully understand. Now that doesn’t mean that if a piece of information is complex it can be left out – because it most certainly can’t! Something that is material and left out because users won’t be able to understand it will result in the

financial statements being misleading. Therefore, UK GAAP requires information that's relevant and reliable to be included in the financial statements and not to be excluded just because it's too difficult for some users to understand.

## *Setting out qualitative characteristics under the IASB's Conceptual Framework*

Financial statements prepared to IFRS GAAP have the same characteristics as those described above, but are set out in different ways under the *Conceptual Framework for Financial Reporting* of the International Accounting Standards Board (IASB). These characteristics are split into two bits:

- ✓ **Fundamental qualitative characteristics:** Financial information is:
  - **Relevant:** The information is capable of making a difference in the decisions made by users.
  - **Faithful in its presentation:** The information is complete, neutral and free from error.
- ✓ **Enhancing qualitative characteristics:** Financial information is enhanced when it's comparable, verifiable, timely and understandable.

The *Conceptual Framework* also includes materiality as a sub-section of relevance. Don't forget that an item is *material* if its omission or misstatement may cause the user of the financial statements to arrive at the wrong conclusion.

## *Understanding the Limitations of Financial Accounting*

While preparing financial statements, accountants realise that time is money and a limit exists to the amount of cost that should be incurred for any reporting benefit. The bodies that set the standards for accountancy practices (which I introduce in Chapter 4) always perform a cost–benefit analysis before finalising any reporting requirements. Associated with this financial accounting limitation is the concept of materiality.



*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.

## Cost–benefit lost in the woods

It's not unheard of for some bookkeepers to spend hours tracking down the reason why the company bank reconciliation has a difference of £2.00 to make sure the bank hasn't made a mistake. (Preparing a *bank reconciliation* means you take the balance in the bank account per the bank as at a certain date, add in any deposits that got to the bank too late to hit the statement, and subtract any cheques the company has written that have not yet cleared.)

Now, is this an effective and efficient use of the 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 bank account balance was indeed out by £2, and it wasn't just a mistake on the part of the bank.

For example, an expense totalling £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's 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 tax 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

When you're looking into becoming a financial accountant you'll see lots of different options available (I discuss some of these options in Chapter 2). Financial accountants who are serious about their profession normally become *chartered* or *chartered certified accountants* with the various professional bodies, which means they have to take several accountancy, audit and tax exams and have a certain number of years' practical work experience under their belts in order to become fully-fledged members of a professional body such as the Institute of Chartered Accountants in England and Wales (ICAEW), the Association of Chartered Certified Accountants (ACCA) or the Chartered Institute of Management Accountants (CIMA), to name just a few.



All professionally-qualified accountants at any level have to abide by their country's code of conduct and also follow the code of conduct established by their respective professional body. The Financial Reporting Council's Accounting Council is responsible for establishing accounting and auditing standards for companies in the UK that report under UK GAAP, and professional bodies are responsible for enforcing a code of professional conduct for their members. The International Accounting Standards Board (IASB) is responsible for establishing the International Financial Reporting Standards (IFRSs). In Chapter 4, I outline the code of conduct in detail.

But what if you're a financial accountant who isn't a member of a professional body? Do you still have to worry about abiding by a code of conduct? Of course you do! Any profession lacking ethical behaviour 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're 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 practice (you have multiple clients) or for a company (you provide accountancy 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 because doing so means you risk creating the perception that your work – and the financial statements that result from your work – cannot be trusted.

## Achieving independence and objectivity

Many types of accountancy services, such as auditing, require the financial accountant to be independent in both mind 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 mind 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 in a major competitor of your client, your client may question whose best interests you have in mind while performing the services.

Financial accountants providing tax and consultancy services don't necessarily 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 practice or for a company. *Public practice* is when a financial accountant, most likely an accounting technician, chartered or chartered certified accountant, works for an accountancy firm providing services such as auditing or financial statement preparation for clients. *Working for a company* is when you do accountancy work for your own employer

rather than for a client. Obviously, you can't strive for independence when you're doing accountancy work for your own employer. So when you're working for a company, objectivity is key.

***Making sure that you're professionally competent and take due care***

To work for a client, or a company, you have to ensure that you're competent to do the work, are up-to-date with technical developments (such as accounting standard changes or changes in tax laws) and act in accordance with applicable technical and professional standards.

***Keeping information confidential***

During the course of her work, a financial accountant must ensure she keeps all information she acquires confidential and does not disclose it to third parties without express authority from either the client or a responsible individual within the company. A financial accountant must never disclose confidential information for personal advantage.

***Behaving professionally***

A financial accountant must make sure that she behaves in a professional manner at all times and does not undertake any action that discredits the accountancy profession.

## ***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, an airline pilot has a detailed checklist he must follow each and every time he gets in the cockpit, regardless of how many years of experience he has.

For financial accountants, the UK's Accounting Standards Board (now the Financial Reporting Council's Accounting Council) started work on providing the *Statement of Principles* – a structure of financial accounting concepts – back in the 1970s. The Statement of Principles covers the financial accounting topics of objectives, characteristics, elements and financial statement recognition and 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!

The International Accounting Standards Board (IASB) has an international equivalent to the UK's Statement of Principles: the *Conceptual Framework for Financial Reporting*. You can check out this document at [www.iasb.org.uk](http://www.iasb.org.uk); click on 'Standards and Interpretations' and then scroll down until you see the word 'Framework'. You may have to register to view the Conceptual Framework, but to do so is free!