

IN THIS CHAPTER

- » Knowing why financial accounting matters
- » Meeting the stakeholders
- » Exploring the most important principles in financial reporting
- » Introducing key accounting characteristics
- » Understanding the limitations of financial accounting
- » Accepting ethical responsibilities

Chapter **1**

Looking at the Bigger Picture of Financial Accounting

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. However, it may 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 two all-important characteristics of financial information: fundamental qualitative characteristics

and enhancing qualitative characteristics. Whether you're a financial accounting student or a business owner, you need to understand these crucial financial accounting terms as they underpin everything to do with financial statements right from the word 'go'.

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 can possibly relate to that doesn't involve numbers or money: a teenager sneaks in after a curfew set by their parents, and their parents ask for a complete account of why they're late. When the teenager tells them the facts, we have information (their 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).



REMEMBER

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 sale of 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 third parties 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 can 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 rules and regulations 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.



REMEMBER

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

» **Income statement (or profit and loss account):** This financial statement shows the results of business operations consisting of revenue, expenses, gains and losses. The end result 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 from selling its goods or services.
- *Expenses:* The costs a company incurs in earning 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.



REMEMBER

A lot of accountants call the income statement a *profit and loss account* 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 3 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 buildings, equipment and cash.

- *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. This statement is often referred to as the *cash flow statement* in the UK.

» **Statement of changes in equity**: This statement shows any movements in the equity accounts of the balance sheet – such as 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 is presented within the statement of changes in equity.

Showing historic performance

The information reflected in the financial statements allows its users to make reasoned decisions about the business, for example, whether or not they want to invest in it. But the 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 ended 31 March 2026. This means any accounting transactions taking place prior to or after this 12-month window are not included.
- » The statement of cash flows is also finite in nature, showing cash ins and outs only for the reporting period.
- » The balance sheet 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.



REMEMBER

Savvy financial statement users are interested in trends and performance over time and 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.

Pulling information together for the annual accounts

After all the rigmarole of preparing the financial statements, many companies including *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 the annual report 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 in-depth 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 pension 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.
- » 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, that want to make sure the company is paying the right amount of corporation tax on its profits.

Understanding users' needs



REMEMBER

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



REMEMBER

The legal responsibility for ensuring a company's financial statements are materially correct rests with the directors or management. Even if the business engages the services of an external professional accountant to prepare the year-end financial statements, that legal responsibility does not pass to the accountant. However, the professional accountant is bound by strict ethical rules which require a high standard of work be carried out. I look at some of these rules in the section 'Considering Your Ethical Responsibilities', later in this chapter.

Two of the three groups of financial statement users are making decisions based on those financial statements: investors and creditors. Creditors look to the financial statements to make sure the business 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. Suppliers (another form of creditor) are looking to ensure the business is financially stable enough to pay off invoices as they fall due.

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 their investment income goals as well as attitude to risk.)

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 certain information, including materially correct financial statements for the businesses in which they're considering investing.

Introducing Concepts and Pervasive Principles



REMEMBER

These are probably the most important principles in financial reporting because they underlie the way in which financial statements are prepared. *Accounting standards* prescribe the recognition, measure, presentation and disclosure methods a business uses when drawing up its financial statements. In the UK and Ireland, accounting standards for private companies consist of the following:

- » FRS 100 Application of Financial Reporting Requirements
- » FRS 101 Reduced Disclosure Framework
- » FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland
- » FRS 103 Insurance Contracts
- » FRS 104 Interim Financial Reporting
- » FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime

Chapter 4 goes into a more detailed review of the above accounting standards. But, if you want to have a look at the accounting standards themselves, they're available at www.frc.org.uk/library/standards-codes-policy/accounting-and-reporting/uk-accounting-standards.

The Concepts and Pervasive Principles can be found in Section 2 of FRS 102 and FRS 105.



Public Limited Companies and Public Interest Entities in the UK prepare their accounts using UK-adopted IFRS Accounting Standards, which are issued by the International Accounting Standards Board (IASB) and endorsed for use in the UK by the UK Endorsement Board. The IASB has its own version of the Concepts and Pervasive Principles, which is the *Conceptual Framework for Financial Reporting* (the equivalent to the UK and Ireland Concepts and Pervasive Principles).

The Concepts and Pervasive Principles do not have the force of an accounting standard. Instead, its purpose is to assist the Financial Reporting Council (FRC), which eventually becomes the Audit, Reporting and Governance Authority to develop new or revised sections of FRS 102 and FRS 105. It also assists preparers of financial statements in applying standards and in dealing with issues that are not addressed by an accounting standard.



FRS 102 and FRS 105 are split into 'Sections' (for example, Section 11 of FRS 102 deals with financial instruments and Section 13 deals with inventory). If there is ever a conflict between the Concepts and Pervasive Principles and a section of FRS 102 or FRS 105, the relevant section prevails.

Included within the Concepts and Pervasive Principles are the characteristics that financial statements must contain. These are called the *qualitative characteristics* (discussed in the next section of this chapter).

Understanding the Qualitative Characteristics of Financial Statements

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. I discuss the qualitative characteristics in further detail in Chapter 6.



There are two types of qualitative characteristics the financial statements must possess:

- » Fundamental qualitative characteristics
- » Enhancing qualitative characteristics

These are considered in more detail in the next sections.

Fundamental qualitative characteristics

The two fundamental qualitative characteristics are relevance and faithful representation. This section describes 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 2026, and your analysis indicates that the company's sales can increase two-fold in the subsequent year. When you later check out the 2027 income statement, the company's revenue has, indeed, doubled. Woohoo! With the relevant information in hand, you see that your prediction was right.



TECHNICAL
STUFF

A sub-set of 'relevance' is *materiality*. Information is material if omitting, misstating or obscuring it can reasonably be expected to influence the decisions that the users make on the basis of those financial statements. Materiality is very much an entity-specific issue. What may be material in one company may not be material in another. So, an electricity bill for £200 that's been missed out of the accounts may not make a user bat an eyelid if the company has made a profit of, say, £100,000. However, a £50,000 omission or duplication is more than likely going to make them change their view of the business. Getting the materiality balance right is a fine art! I discuss materiality in a bit more detail later on in this chapter. See 'Appreciating the Limitations of Financial Accounting'.

Faithful representation

Faithful representation means that the financial statements accurately reflect the commercial reality (the substance) of the transactions and events it purports to represent.



REMEMBER

To be a faithful representation, the information must be:

- » **Complete:** Meaning that all necessary information is included and no material information is excluded.
- » **Neutral:** Meaning that the information is free from bias and has not been manipulated to achieve a desired result or outcome.
- » **Free from error:** This does not mean 'perfectly accurate' but instead means there are no significant errors or omissions and that estimates and judgements used are reasonable and based on a sound methodology.

Enhancing qualitative characteristics

The four enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability. This section looks at each of these characteristics in turn.

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 recognise revenue or depreciate their assets. Without this knowledge, the users cannot accurately evaluate the relative worth of one company over another.

Verifiability

Verifiability means that different users can reach the same conclusion – although not necessarily absolute agreement – that a particular depiction is a faithful representation. It provides assurance to the users that the information accurately depicts what it claims to represent. For example, verifying the bank balance in the accounts through reviewing a bank statement or bank reconciliation.

Timeliness

Timeliness means that the financial information is made available to the users in time to influence their decisions. Generally, information loses its relevance if its publication is delayed.

Understandability

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 results in the financial statements being misleading. Therefore, all information that's relevant and reliable must be included in the financial statements and cannot be excluded just because it's too difficult for some users to understand. The users would be expected to seek professional advice to help interpret any complex pieces of information.

Appreciating 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 can be incurred for any reporting benefit. The regulators that set accounting standards (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.



REMEMBER

Materiality is the importance you place on an area of financial reporting based upon its overall significance. 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 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.

MATERIALITY AS A COST-BENEFIT ISSUE

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 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 they were paid £30 per hour. It cost the company £150 for the bookkeeper 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.

Considering Your Ethical Responsibilities



WARNING

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 an 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.



REMEMBER

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.

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 them. Many laws protect individuals from any recourse if they uphold their integrity values and refuse to be involved in anything that can put them or their career in jeopardy.

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.



WARNING

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 professional 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.



REMEMBER

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 as an in-house bookkeeper 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. If you're a member of one of the professional bodies I mention earlier in this chapter (namely, ICAEW or ACCA) you'll have to complete a minimum amount of annual continuing professional development (CPD).

Keeping information confidential

During the course of their work, a financial accountant must ensure they keep all information they acquire confidential and do 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 they behave in a professional manner at all times and does not undertake any action that discredits the accountancy profession.



WARNING

This extends to behaviour on social media platforms. There have been cases where professionally qualified accountants have been frogmarched to the professional body's disciplinary panel for abusive comments and behaviour on social media platforms, as this is deemed as bringing the accountancy profession into disrepute. So, minding your manners in your private life does creep into how you are treated in your professional life as well.

