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Financial Accounting For Dummies®

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Introduction

Accountancy is known as the language of business because it communicates financial and economic facts about a business to all sorts of interested parties – both *internal* (employees of the company) and *external* (people not employed by the company in question). External users include investors, creditors, banks and regulatory agencies such as HM Revenue and Customs and the stock markets.

Focusing on the external users of accounting information, this book is about financial accounting. *Financial* accounting serves the needs of external users by providing them with understandable, materially correct financial statements. Three financial statements exist: the income statement (often termed the *profit and loss account* in the UK and also known internationally as the *statement of comprehensive income* or *statement of profit or loss*), balance sheet (known internationally as the *statement of financial position*) and the cash flow statement (known internationally as the *statement of cash flows*). This book is a step-by-step guide on how to prepare all three.

You also find out the purposes of the financial statements:

- ✔ To report on the financial position of the company – what types of assets the company owns and what types of liabilities it owes.
- ✔ To show how well the company performs over a period of time, which is referred to as an *accounting period*. You measure performance by seeing whether the company made or lost money during the accounting period.

A lot of people considering starting out in the world of accountancy are often afraid they won't do well in their accountancy studies because they haven't done well in maths. Forget about the maths – that's why you have a computer and a calculator! Financial accounting is less about adding and subtracting and more about using logic-based skills. Added to the mix is the importance of gaining a working understanding of the standards set in place by authoritative accountancy bodies.

The reason I've written this book is to breathe some life into the subject of financial accounting and make it more understandable to students, trainee accountants and those seeking a career change into the world of accountancy.

About This Book

This book, like all *For Dummies* books, is written so that each chapter stands on its own. I always assume that whatever chapter you're reading is the first one you've tackled in the book. Therefore, you can understand the concepts I explain in each chapter regardless of whether it's your first chapter or your last.

However, certain terms and concepts are relevant to more than one subject in this book. To avoid writing the same explanations over and over, whenever I refer to a financial accounting term, method or other type of fact that I fully explain in another chapter, I give you a brief overview and direct you to the chapter where you can get more information. For example, I may suggest that you 'flick to Chapter 13' (which, by the way, discusses the statement of cash flows).

Also, in this book I break financial accounting down to its lowest common denominator. I avoid using jargon that only accountants with several years' experience already under their belts will understand. Please keep in mind that the list of financial accounting topics and methods I present in this book isn't exhaustive. I simply can't cover every possible transaction and event related to preparing financial accounting data and statements. This book is meant to give a basic introduction to the world of financial accounting in a down-to-earth, easy-to-understand and light-hearted manner.

Conventions Used in This Book

Following are some conventions I use that you need to bear in mind while reading this book:

- ✔ I introduce new terms in *italic* with an explanation immediately following. For example, *liquidity* refers to a company's ability or lack thereof to meet current financial obligations. To put it even more simply, does the company have enough cash to pay its bills?
- ✔ Many accounting terms have acronyms (which you'll soon be bandying about with your fellow novice accountants after you gain some familiarity or experience with the topic). The first time I introduce an acronym in a chapter, I spell it out and place the acronym in brackets. For example, I may discuss the Association of Chartered Certified Accountants (ACCA).
- ✔ I use **bold** text to highlight key words in bulleted lists.
- ✔ All web addresses are in monospace typeface so that they're set apart from the rest of the text.

What You're Not to Read

It would be great if you read every word of this book, but I realise that people lead busy lives and sometimes just want to get the specific information they need. So if you're short on time, you can safely skip the following without jeopardising your understanding of the subject at large:

- ✔ **Material marked with a Technical Stuff icon:** These paragraphs contain extra financial accounting information that, while useful, isn't critical to your understanding of the topic at hand.
- ✔ **Sidebars:** These grey-shaded boxes contain asides that I think you'll find interesting but that, again, aren't vital to understanding the fundamental concepts of a certain accountancy topic.

Foolish Assumptions

I assume you don't have more than a basic understanding of accountancy, and I'm guessing you're one of the following people:

- ✔ A financial accounting student who just isn't getting it by reading (and rereading) the relevant textbook.
- ✔ A non-accountancy student currently enrolled in either business or another course who's considering changing direction to go down the accountancy route.
- ✔ A business owner (particularly someone operating a small business with a relatively small/modest turnover) who wants to attempt preparing her own financial statements or just wants to have a better understanding about the financial statements prepared by the in-house or external accountant.
- ✔ A brand-new accountant working in financial accounting who needs a plain-English refresher of accountancy concepts.

How This Book Is Organised

To help you find the financial accounting facts you need, this book is organised into parts that break down the subject of financial accounting into easily digestible portions that all relate to one another.

Part I: Getting Started with Financial Accounting

This part introduces you to the world of financial accounting. You receive an initiation into the purpose, constraints and responsibilities of financial accountants; various financial accounting career options; and the sorts of professional courses you need to pursue these careers. I also provide an overview of the three financial statements. For the business owner, it provides information about the education, training, certification and experience of the stranger who comes into your business asking about private accountancy-related facts.

Part II: Looking at Some Accounting Basics

In this part, I lay the foundation of the basics of financial accounting that you're likely to come across in your day-to-day working life as a financial accountant or as an accountancy student. You discover how to enter accounting transactions into a company's books through the use of journal entries. You also find out about the general ledger, which is the place where accountants record the impact of transactions taking place in a business during a particular accounting period. Finally, you find out about the two different methods of accounting, the cash-based method and the accruals-based method – though I concentrate on the accruals method because this is the one financial accountants use.

Part III: Bonding with the Balance Sheet

This section contains three chapters, each explaining a different section of the balance sheet. The three sections of the balance sheet are assets, liabilities and equity, and together they show the financial position of a company. *Assets* are resources a company owns, *liabilities* are what a company owes and *equity* is the difference between assets and liabilities, which equals the total of each owner's investment in the business.

Part IV: Investigating Income and Cash Flow

This part looks at the income statement and the statement of cash flows. The *income statement* shows a company's revenue and expenses, the end result of which shows whether a company made or lost money during the accounting period. The *statement of cash flows* shows the cash received by a company and the cash paid by a company during the accounting period. It tells users of the financial statements how well the company is managing its sources and uses of cash.

Part V: Analysing the Financial Statements

After all your hard work preparing the financial statements, in this section you find out about key measurements that users of the financial statements perform to gauge the effectiveness and efficiency of the business. I provide the complete picture on a company's *annual report*, which informs the shareholders about the company's operations for the past year. And you get an overview of corporate governance and interpretations of the explanatory notes and other information found in most companies' annual reports.

Part VI: Tackling More Advanced Financial Accounting Topics

Here, I delve into other financial accounting topics, like accounting for income taxes and leases. Knowing about these topics makes your financial accounting experience well-rounded, preparing you in case you decide to continue on your journey through the world of accountancy and, perhaps, enrolling on one of the chartered qualification courses.

Part VII: The Part of Tens

I wrap up the book by explaining ten financial statement deceptions to look out for when preparing financial statements. These include ways to inflate income by understating expenses and hiding unfavourable information from the users through use of accountancy lingo. I also provide some helpful information about industries that may deviate from generally accepted accounting practice (GAAP) while doing their bookwork and preparing their financial statements.

Icons Used in This Book

Throughout the book, you see the following icons in the left-hand margin:



Text accompanied by this icon contains useful hints that you can apply during your studies (or on the job) to make your studies (or work) a bit easier and more successful.



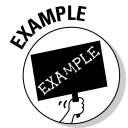
When you see this icon, get those brain cells in gear, because it sits next to information you want to commit to memory.



Looking for what not to do in the world of financial accounting? Check out paragraphs next to this icon because they alert you to what can trip you up during your studies or working in the field.



This icon includes information that enhances the topic under discussion but isn't necessary to understand the topic.



This icon shows you that a financial accounting concept is demonstrated by working through an example.

Where to Go from Here

Each chapter stands on its own, so no matter where you start, you won't feel like you've missed anything fundamental beforehand. Your motivation for purchasing this book will probably dictate which chapters you want to read first and which you'll read only if you have some spare time in the future.

If you're an accountancy student, flip to the chapter explaining a topic you're a little confused with after reading your textbook. Business owners can get a good overview of the financial accounting process by starting with Chapters 1 and 3; these two chapters explain the nuts and bolts of financial accounting and its concepts. Otherwise, check out the table of contents or index for a topic that interests you, or jump in anywhere in the book that covers the financial accounting information you're wondering about.

Part I

Getting Started with Financial Accounting

getting started
with

**Financial
Accounting**



Go to www.dummies.com/extras/financialaccounting for online bonus content.

In this part . . .

- ✓ Understand why financial accounting is so important to many different individuals and businesses.
- ✓ Come to grips with the key characteristics of financial accounting.
- ✓ Chart a career in financial accounting.
- ✓ Get a handle on the primary financial statements.
- ✓ Go to www.dummies.com/extras/financial-accounting for online bonus content, including an extra Part of Tens chapter: 'Ten Differences Between Some National Standards and IFRS'.

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.