Chapter 1

Introduction to Financial Accounting

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LEARNING OBJECTIVES

At the end of this chapter, learners should be able to:

- *Define accounting.*
- *Explain the objectives of financial accounting/reporting.*
- *Explain regulatory framework for financial reporting.*
- *Appreciate why human resource managers should care about accounting.*

Keywords: Financial accounting; accounting concepts; accounting principles; contemporary issues; legislations

> You have to understand accounting and you have to understand the nuances of accounting. It's the language of business and it's an imperfect language, but unless you are willing to put in the effort to learn accounting – how to read and interpret financial statements – you really shouldn't select stocks yourself – Warren Buffett

Introduction

Accounting has a dual meaning. The first and indeed more commonly held notion of accounting is that it is about listing and counting things that organisations or society consider important. This view underpins the more common definitions of accounting such as that by the American Accounting Association which states that 'Accounting refers to the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information'. However, this view of accounting is narrow in the sense that it focusses on economic information and so ignores accountabilities for things which are not measurable in monetary terms such as social and environmental impact.

The second sense in which accounting is used is broader in that accounting is seen as being about the rendering of an account about the stewardship of resources. Here, accounts take the form of telling stories about the important things that are the subject of listing or counting with the objective of discharging an obligation to answer for the use of resources and for which reward or punishment could result. Thus, here, accounting is linked with the idea of accountability.

However, we conceive of accounting, what is evident is that it plays an important role in organisations and society. It is the single most important and universally accepted means of collecting, analysing and communicating information on the financial and economic activities and performance of individuals, organisations and governments.

Types of Accounting

While there are several types of accounting, within organisations, three main forms of accounting exist – financial accounting, management accounting and tax accounting.

Financial accounting/reporting: This type of accounting is concerned with the systematically recording transactions of the business and using these records to prepare external financial reports such as the income statement and statement of financial position. Financial accounting requires a thorough understanding of the regulatory framework under which these external financial reports are prepared such as Generally Accepted Accounting Principles or International Financial Reporting Standards.

Management accounting: While management accounting uses much of the same records as financial accounting, its focus is internal, that is, on the production of internal reports to aid managers in operational and strategic decision-making. It encompasses areas of accounting such as cost accounting, budgeting, forecasting and investment appraisals.

Tax accounting: Tax accounting also draws on the same information used in financial accounting. However, the focus of tax accounting is on the compliance with the tax laws and regulations in the preparation and filing of tax returns. It is also concerned with tax planning to reduce an organisation's tax burden. Tax accounting requires a thorough understanding of tax laws and regulations.

Objectives of Financial Accounting

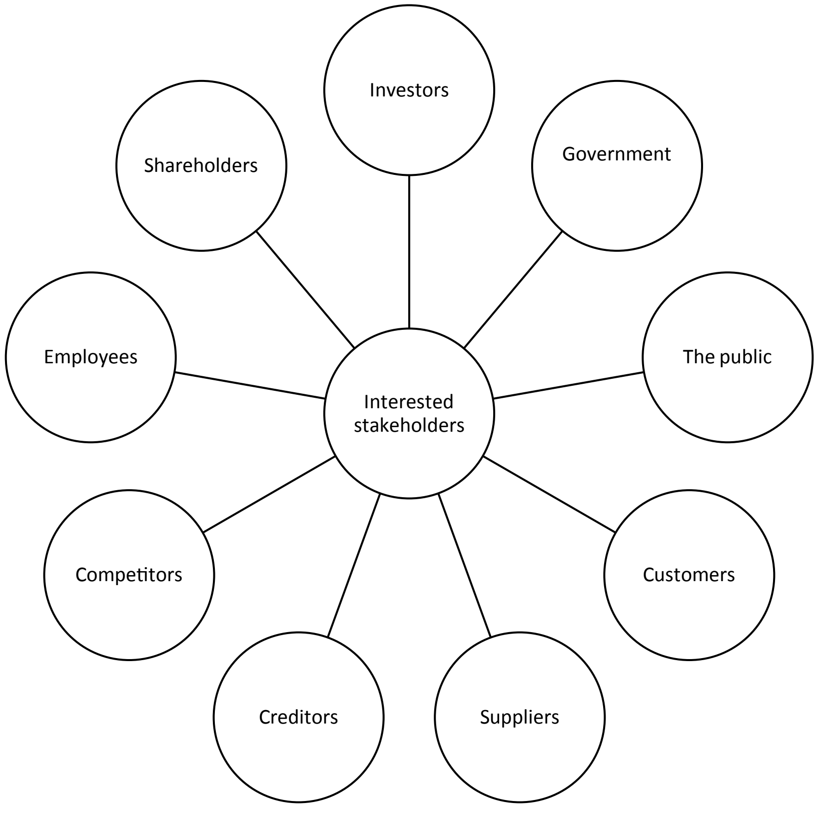
The International Accounting Standards Board (IASB) in its 2018 *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) states that the objective of financial reporting is: 'To provide financial information that is useful to users in making decisions relating to providing resources to the entity'. In order to make decisions about providing resources to organisations, users will usually seek information about an organisation's assets and liabilities and the changes to these as well as information on how efficient and effective an organisation's management is in using its economic resources. This information will enable users to assess an organisation's prospects for future net cash inflows as well as management's stewardship of an organisation's resources.

In setting out the objectives of financial reporting, the IASB takes a limited view of the users of financial reports as an organisation's existing and potential investors, lenders and other creditors. However, we know that several other stakeholders are interested in the financial statements of organisations. Fig. 2 highlights stakeholders who could be interested in an organisation's financial statements.

Reflective Question 1. Why are these stakeholders interested in financial accounting information?

While financial accounting information is important to investors, lenders, creditors and other stakeholders highlighted earlier, it is also important to the managers of the organisation. Indeed, management decisions are influenced by how they think these decisions will ultimately be presented and interpreted by users of the financial statements. The information from the financial accounting system also underpins the planning and control activities which managers are involved in.

Fig. 2. Interested Stakeholders.



Qualitative Characteristics of Useful Information

For financial accounting information to be useful, it must possess certain characteristics. The IASB classifies these into two groups: fundamental characteristics (relevance and faithful representation) and enhancing characteristics (comparability, verifiability, timeliness and understandability).

Relevance: For information to be relevant, it must be capable of making a difference in decisions made by users. In order to make a difference to user's decisions, they must be able to use the information to either predict future outcomes (predictive value) or provide feedback about previous evaluations (confirmatory value).

Faithful representation: Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not just represent these phenomena, it must faithfully represent the substance of what it purports to represent. A faithful representation is necessary that the information presented is, as much as possible, complete, neutral and free from error.

Comparability: Decisions for which users of financial accounting information require this information usually entail a choice between alternatives, for example, investing in one or another organisation. In order to make these types of decisions, they must be able to compare an organisation's financial statements over time and compare these with the financial statements of other organisations. In order to achieve this, measurement and presentation of economic needs to be consistent over time and where it is not, explanations need to be made so the users can identify and understand similarities in and differences among items.

Verifiability: Verifiability means that different knowledgeable and independent observers (such as auditors) can agree, after that the information presented is a faithful representation of the phenomena which it purports to represent.

Timeliness: For information to be useful, it needs to be available to the users in time to be capable of influencing their decisions.

Understandability: Information should be presented in a manner that is understandable to the user. Presenting information clearly and concisely makes it more likely to be understandable.

Regulatory Framework for Financial Reporting

To ensure that financial reports are useful to the users, that is, that all the qualitative characteristics of useful information are met by the financial reports, it is important that the preparation of financial reports is regulated.

The framework that regulates the form and content of financial reports is made up of the following elements:

National law: In the United Kingdom, the Companies Act 2006 requires directors to ensure that adequate accounting records are kept and that annual accounts give a true and fair view. The Act also includes requirements relating to the form, content and preparation of the company's annual accounts.

Accounting standards: Accounting standards are rules or sets of rules which set out specific guidelines on acceptable methods for preparing and presenting financial statements. They are usually issued by national or international standard setting bodies. For several years now, there has been concerted effort to have national standards converge around the international standards.

Stock exchange requirements: The listing rules of stock exchanges usually require listed companies to make more extensive and more frequent accounting disclosures than those required by legislation.

Accounting principles – Concepts and conventions: In addition to the rules set out in laws, standards and listing requirements, there are certain principles that are commonly accepted and adhered to by practitioners in the preparation of accounts. Some of these are assumptions, conditions and ideas upon which the science of accounting is based.

We refer to these as accounting concepts. Others are customs or traditions that have evolved to guide the preparation of accounts. We refer to these as accounting conventions. Some of the accounting concepts and conventions are set out as follows:

Historical cost: This concept is based on the valuation of the assets of a company. In the historical cost concept, assets presented in the financial statement are valued at their initial cost.

Money measurement: Within this concept, accounting information are traditionally expressed in a form that is measurable in financial or monetary terms. This is very useful as it provides a common way of presenting different information.

Business entity: The business entity concept holds that there is a separation between businesses and their owners. This concept requires that only business-related transactions are recorded in a financial statement. There are two likely situations for owners of business. When an owner injects money or other forms of asset to a business, it is treated as capital. On the contrary, if money or other forms of assets are taken from the business, it is treated as a reduction in investment.

Time interval: This concept requires that financial statements are prepared regularly (annually). It is advisable for managers to request financial basis more regular for internal decision-making to allow for monitoring and controlling of business activities.

Going concern: This concept holds that the preparation of financial statement is done under the assumption of the continued existence of the business. This concept is closely associated with the historical cost concept when valuing the assets of a business.

Accrual (matching): The matching concepts make it a requirement for expenses and income to be matched to the period of occurrence. Revenues are only recognised for the accounting period that a service is performed, or goods sold. On the contrary, expenses are required to be charged to the accounting period that was used to produce the revenue.

Consistency: Here, it is fundamental that items presented in the financial statement are treated in a similar way each accounting period. The method used for treating items on the financial statement in a period should be consistent for the succeeding years. This is important so that different periods are compared using similar basis.

Prudence: This concept suggests that losses and costs are charged immediately they occur. However, when it comes to revenue, records should be made only when they are realised or when there is certainty of receipt. As a rule, profits are usually understated.

Substance over form: There is a need to ensure that financial statements show the true position of a business. For this to happen, care should be taken to record each transaction to determine their economic impact. There are situations where a transaction legal form may differ from their real term. In this case, the item should be recorded in its real substance to determine the economic impact. For example, where a machinery is bought on credit, it is not fully recognised as a property of the company until it is fully paid for.

Mini Reflective Case 1.1

1. Consider this transaction – Alpha Beta Charlie INC (a pseudonym) purchased a machinery on hire purchase contract worth £10,000. Using the substance over form concept, the company is advised to record the full value of the machinery in their financial statement in the form a legally owned asset. The full amount of the machinery should be charged separately to the supplier as a liability.

Why do you think this approach is necessary?

Materiality: The concept suggests that the accountant should attach importance to material detail and ignore insignificant or immaterial detail.

Why Should Human Resource Managers Care About Accounting?

It is human resource managers' (HRMs') interest to see that employees are engaged and motivated to achieve the goals and objectives of their organisations. The Chartered Institute for Personnel and Development (CIPD) professional map places significant importance to the development of business acumen skills (CIPD, 2020). There is also a growing demand for HRMs to demonstrate basic understanding of business issues that are related to the human resource (HR) practice (Mone & London, 2018). Some important aspects of HRM, which require accounting knowledge include the understanding of the following:

Budgeting: A budget is a financial document that sets out the monetary value of the programmes and activities of the HR department. This document helps HRMs to plan and manage HR-related cost. Most common items included in the budget for HRMs are training, recruitment, reward, performance management and staffing.

Introduction of policies and programmes: In response to the ever-changing external environment, HRMs are required to introduce new policies and programs to support the needs of an organisation. For this to happen successfully, there is need for HRMs to write the plans in the form of a proposal. The proposal helps allows for a costing of the proposed policy or programme and gives the manager a wholistic view of the proposal.

Performance management: As organisations continue to increase the scope of HRMs, knowledge of accounting becomes essential (Director, 2012). With this knowledge and skills, HRMs are able to review business reports to identify areas that are not performing well financially. For example, if the financial statement shows that there is an increase in losses due to defective production, the HRM may use this information as a business case to train the relevant department.

Significantly, most of the information that is used in budgeting and decision-making will come from the same accounting records used in preparing the financial accounts. The impacts of the decisions made will ultimately be reported in the financial statements. As such, the way in which they will be reported and the potential effect of this on stock prices will be a significant influencer of these decisions. It is therefore imperative that managers understand these.

Summary

This chapter has provided fundamental knowledge of financial accounting. The key issues discussed in the chapter include accounting, principles, concepts and legislations. The chapter also identifies critical accounting issues with contemporary relevance, especially from the perspective of HRMs' knowledge and competence of accounting.

Further Readings

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