

1.1: Making Good Financial Decisions about an Organization

Learning Objectives

At the end of this section, students should be able to meet the following objectives:

1. Define “financial accounting.”
2. Understand the connection between financial accounting and the communication of information.
3. Explain the importance of learning to understand financial accounting.
4. List decisions that an individual might make about an organization.
5. Differentiate between financial accounting and managerial accounting.
6. Provide reasons for individuals to be interested in the financial accounting information supplied by their employers.

Question: This textbook professes to be an introduction to financial accounting. A logical place to begin such an exploration is to ask the obvious question: What is financial accounting?

Answer: In simplest terms, **financial accounting** is the communication of information about a business or other type of organization (such as a charity or government) so that individuals can assess its financial health and prospects. Probably no single word is more relevant to **financial accounting** than “information.” Whether it is gathering financial information about a specific organization, putting that information into a structure designed to enhance communication, or working to understand the information being conveyed, **financial accounting** is intertwined with information.

In today’s world, information is king. Financial accounting provides the rules and structure for the conveyance of financial information about businesses (and other organizations). At any point in time, some businesses are poised to prosper while others teeter on the verge of failure. Many people are seriously interested in evaluating the degree of success achieved by a particular organization as well as its prospects for the future. They seek information needed for evaluation. Financial accounting provides information that these individuals need and want.

Organization → Reports information based on the principles of financial accounting → Individuals assess financial health

Question: Every semester, most college students are enrolled in several courses as well as participate in numerous outside activities. All of these compete for the hours in each person’s day. Why should a student invest valuable time to learn the principles of financial accounting? Why should anyone be concerned with the information communicated about an organization? More concisely, what makes financial accounting important?

Answer: Many possible benefits can be gained from acquiring a strong knowledge of financial accounting and the means by which information is communicated about an organization. In this book, justification for the serious study that is required to master the subject matter is simple and straightforward: obtaining a working knowledge of financial accounting and its underlying principles enables a person to understand the information conveyed about an organization so that **better** decisions can be made.

Around the world, millions of individuals make critical judgments each day about the businesses and other organizations they encounter. Developing the ability to analyze financial information and then using that knowledge to arrive at sound decisions can be critically important. Whether an organization is as gigantic as Wal-Mart or as tiny as a local convenience store, a person could have many, varied reasons for making an assessment. As just a single example, a recent college graduate looking at full-time employment opportunities might want to determine the probability that Company A will have a brighter economic future than Company B. Although such forecasts can never be correct 100 percent of the time, knowledge of financial accounting and the information being communicated greatly increases the likelihood of success. As Kofi Annan, former secretary-general of the United Nations, has said, “Knowledge is power. Information is liberating¹.”

Thus, the ultimate purpose of this book is to provide students with a rich understanding of the rules and nuances of financial accounting so they can evaluate available information and then make good choices about those organizations. In the world of business, most successful individuals have developed this skill and are able to use it to achieve their investing and career objectives.

Question: Knowledge of financial accounting assists individuals in making informed decisions about businesses and other organizations. What kinds of evaluations are typically made? For example, assume that a former student—one who recently graduated from college—has been assigned the task of analyzing financial data provided by Company C. What real-life decisions could a person be facing where an understanding of financial accounting is beneficial?

Answer: The number of possible judgments that an individual might need to make about a business or other organization is close to unlimited. However, many decisions deal with current financial health and the prospects for future success. In making assessments of available data, a working knowledge of financial accounting is invaluable. The more in-depth the understanding is of those principles, the more likely the person will be able to use the available information to arrive at the best possible choice. Common examples include the following:

- The college graduate might be employed by a bank to work in its corporate lending department. Company C is a local business that has applied to the bank for a large loan. The graduate has been asked by bank management to prepare an assessment of Company C to determine if it is likely to be financially healthy in the future so that it will be able to repay the money when due along with interest. A correct decision to lend the money eventually earns the bank profit because Company C (the debtor) will be required to pay an extra amount (known as interest) on the money borrowed. Conversely, an incorrect analysis of the information could lead to a substantial loss if the loan is granted and Company C is unable to fulfill its obligation. Bank officials must weigh the potential for profit against the risk of loss. That is a daily challenge in virtually all businesses. The former student's career with the bank might depend on the ability to analyze financial accounting data and then make appropriate choices about the actions to be taken. Should a loan be made to this company?
- The college graduate might hold a job as a credit analyst for a manufacturing company that sells its products to retail stores. Company C is a relatively new retailer that wants to buy goods (inventory) for its stores on credit from this manufacturer. The former student must judge whether it is wise to permit Company C to buy goods now but wait until later to remit the money. If payments are received on a timely basis, the manufacturer will have found a new customer for its merchandise. Profits will likely increase. Unfortunately, another possibility also exists. Company C could make expensive purchases but then be unable to make payment, creating significant losses for the manufacturer. Should credit be extended to this company?
- The college graduate might be employed by an investment firm that provides financial advice to its clients. The firm is presently considering whether to recommend acquisition of the ownership shares of Company C as a good investment strategy. The former student has been assigned to gather and evaluate relevant financial information as a basis for this decision. If Company C is poised to become stronger and more profitable, its ownership shares will likely rise in value over time, earning money for the firm's clients. Conversely, if the prospects for Company C appear to be less bright, the value of these shares might be expected to drop (possibly precipitously) so that the investment firm should avoid suggesting the purchase of an ownership interest in Company C. Should shares of this company be recommended for acquisition?

Success in life—especially in business—frequently results from making appropriate decisions. Many economic choices, such as those described above, depend on the ability to understand and make use of the financial information that is produced and presented about an organization in accordance with the rules and principles underlying financial accounting.

Check Yourself

Which of the following would NOT be an example of a situation where financial information may be important in making the best possible decision?

- A. A large company in the United States is looking at purchasing stock in a small company in India as a way to help them better sell products in the growing market in India.
- B. An entrepreneur wants to purchase a franchise and open a McDonalds along a busy freeway and has applied to the bank for a loan to build the building.
- C. Sylvia inherited from her grandfather shares in IBM stock when he passed away and is wondering if she should sell the stock or hold on to it for several years.
- D. All of the above are examples of situations where financial information would be important.

The answer is D. Any kind of investment scenario whether it is to make a new investment or stick with an old is based on the prospects of making a return on that investment. Looking at past returns and measures of financial success will help project future success even though it does not guarantee it.

Question: A great number of possible decisions could be addressed in connection with an organization. Is an understanding of financial accounting relevant to all business decisions? What about the following?

- Should a business buy a building to serve as its new headquarters or rent a facility instead?
- What price should a data processing company charge customers for its services?
- Should videos to alert the public about a new product be posted on Facebook or on YouTube?

Answer: Organizational decisions such as these are extremely important for success. However, these examples are not made about the reporting organization. Rather, they are made within the organization in connection with some element of its operations.

The general term “accounting” refers to the communication of financial information for decision-making purposes. Accounting is then further subdivided into (a) financial accounting and (b) managerial accounting. Financial accounting is the subject explored in this textbook. It focuses on conveying relevant data (primarily to external parties) so that decisions can be made about an organization (such as Harley Davidson or Starbucks) as a whole. Thus, questions such as the following all fall within the discussion of financial accounting:

- Do we loan money to Harley Davidson?
- Do we sell on credit to Starbucks?
- Do we recommend that our clients buy the ownership shares of Starbucks?

They relate to evaluating the financial health and prospects of Harley or Starbucks as a whole.

Managerial accounting is the subject of other books and other courses. This second branch of accounting refers to the communication of information within an organization so that internal decisions (such as whether to buy or rent a building) can be made in an appropriate manner. Individuals studying an organization as a whole have different goals than do internal parties making operational decisions. Thus, many unique characteristics have developed in connection with each of these two branches of accounting. Financial accounting and managerial accounting have evolved independently over the decades to address the specific needs of the users being served and the decisions being made. This textbook is designed to explain those attributes that are fundamental to attaining a usable understanding of financial accounting.

It is not that one of these areas of accounting is better, more useful, or more important than the other. Financial accounting and managerial accounting have simply been created to achieve different objectives. They both do their jobs well; they just do not have the same jobs.

Thinking it over

While financial and managerial accounting have a different focus, they are very much related. For example, a Burger King franchise may be trying to decide whether or not to offer breakfast at one of its restaurants. Looking at the costs to add needed equipment and keeping the store open longer would all be the kind of information they would look at internally to make that decision. However, the decision to open for breakfast will also increase sales and maybe profits as reported to outside investors which will then influence the franchise manager’s decision. So it kind of like a circle with the information desired by outside investors influencing very much what kind of information internal managers are interested in and tracking.

Question: Financial accounting refers to the conveyance of information about an organization as a whole and is most frequently directed to assisting outside decision makers. Is there any reason for a person who is employed by a company to care about the financial accounting data reported about that organization? Why should an employee in the marketing or personnel department of Company C be interested in the financial information that it distributes?

Answer: As indicated, financial accounting is designed to portray the overall financial condition and prospects of an organization. Every employee should be quite interested in assessing that information to judge future employment prospects. A company that is doing well will possibly award larger pay raises or perhaps significant end-of-year cash bonuses. A financially healthy organization can afford to hire new employees, buy additional equipment, or pursue major new initiatives. Conversely, when a company is struggling and prospects are dim, employees might anticipate layoffs, pay cuts, or reductions in resources.

Thus, although financial accounting information is often directed to outside decision makers, employees should be vitally interested in the financial health of their own organization. No one wants to be clueless as to whether their employer is headed for prosperity or bankruptcy. In reality, employees are often the most avid readers of the financial accounting information distributed by their employers because the results can have such an immediate and direct impact on their jobs and, hence, their lives.

Key Takeaway

Financial accounting encompasses the rules and procedures to convey financial information about an organization. Individuals who attain a proper level of knowledge of financial accounting can utilize this information to make decisions based on the organization's perceived financial health and outlook. Such decisions might include assessing employment potential, lending money, granting credit, and buying or selling ownership shares. However, financial accounting does not address issues that are purely of an internal nature, such as whether an organization should buy or lease equipment or the level of pay raises. Information to guide such internal decisions is generated according to managerial accounting rules and procedures that are introduced in other books and courses. Despite not being directed toward the inner workings of an organization, employees are interested in financial accounting because it helps them assess the future financial prospects of their employer.

¹See <http://www.deepsky.com/~madmagic/kofi.html>.

Tax accounting serves as another distinct branch of accounting. It is less focused on decision making and more on providing the information needed to comply with all government rules and regulations. Even in tax accounting, though, decision making is important as companies seek to take all possible legal actions to minimize tax payments.

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