On long train journey south, Rajesh, a fresh engineering graduate from UP, is speculating what to do with the property he has inherited from his uncle who died a month ago. He gets into a conversation with Farouk who is in perfumery business for the last two years in Mysore. He learns from him that agarbhattis are doing very well in Mysore and provides him a lot of details. Rajesh is excited, decides to try the same. They exchange business cards and Farouk even offers to be a partner in the business. Rajesh considers using the industrial shed owned by his uncle and produce exotic aroma sticks for international market immediately. He hopes to achieve a Rs 5.00 crore turnover in two years.

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Risk and Return

When it comes to financial matters, we all know what risk is -- the possibility of losing your hard-earned cash. And most of us understand that a return is what you make on an investment. What many people don't understand, though, is the relationship between the two.  
  
Trade-offs  
  
The relationship between risk and return is often represented by a trade-off. In general, the more risk you take on, the greater your possible return. Think of lottery tickets, for example. They involve a very high risk (of losing your money) and the possibility of an extremely high reward (the giant check with lots of zeroes). Or penny stocks: They're also very risky and yet seem full of amazing potential.  
  
At the other end of the spectrum are options such as a savings account at your bank, or buying government bonds. They're quite low-risk, but you're not going to make a mint on them, either -- at least not these days, with interest rates so low.  
  
Your personal risk tolerance can affect how much risk you take on, but sometimes a lack of information can get in the way and influence you, too.  
  
Getting the Facts  
  
Let's review the examples above.  
  
Ironically, lotteries are presented as low-risk, high-return propositions. But they're really more like very high-risk, very low-return ones. Sure, all you have to do is shell out a few bucks for a ticket that *might* pay you a multimillion-dollar jackpot. But you're really much, much, much more likely to just lose all of the cost of the ticket. With the Powerball lottery, the [odds of winning the jackpot](http://www.dailyfinance.com/2013/03/20/powerball-drawing-lottery-facts-personal-finance/) are 1 in 175,223,510. Flip that around and you'll see that your odds of losing are 175,223,509 in 175,223,510 -- or, about 99.9999994 percent. And while you might win a lesser prize, overall, in the long run of buying tickets, you'll likely collect only [about 60 cents or so for every dollar you spend](http://www.dailyfinance.com/2012/03/27/who-are-the-nations-biggest-suckers-lottery-players/).  
  
Penny stocks, those trading for less than $5 or so per share, seem much more sensible than lottery tickets because they're tied to companies that are described as likely to grow in value. There's also excitement due to their low price: Being able to buy, say, 1,000 shares for just a few hundred dollars can make you feel rich. But penny stocks are often (though not always) tied to companies that have not proven themselves. Instead of track records of sales and profits, they tend to mainly offer the *chance* of riches, as they drill for oil or aim to cure cancer. They're also easily manipulated since there are relatively few shares of each issue. Thus, you stand a decent chance of doing worse investing in penny stocks than even with lottery tickets!  
  
Less Risk, Lower Return

According to Bankrate.com, the average money market account has recently been yielding about 0.5 percent, and you can collect as much as 1.2 percent on a two-year CD. That might sound slightly good, but when you factor in inflation, which tends to average close to 3 percent annually, you'll see that you're actually [losing purchasing power](http://www.dailyfinance.com/2013/01/10/best-interest-rates-borrowing-saving-credit-cards/) over time with such investments. So, while you know at the end of the CD term you'll have made 1.2 percent on your investment, you also must recognize that with the the apparently low-risk investment comes the apparently high risk that you won't keep up with inflation.  
  
In your Life  
  
Risk and return play a part in our nonfinancial lives, as well. Think of that lovely person you'd like to date, for example. Asking him or her out involves the risk of being turned down or embarrassed. But the possible return is significant, too, if you end up in a meaningful relationship.  
  
The principle even applies at restaurants. Take a chance on a menu item you've never tried and can't pronounce instead of your safe and boring usual order. It's riskier, but you might discover a new favorite.  
  
Find Balance  
  
When it comes to your money and the financial decisions you make, the more informed you are, the more rationally you'll be able to assess risk and return.  
  
In many cases, you'll want to aim for the middle of the spectrum, taking on a moderate level of risk in exchange for a moderate return. You can do that by spreading your money around -- for example, including a mix of stocks and bonds in your portfolio. It's via [smart asset allocation](http://www.dailyfinance.com/2012/10/31/how-strategic-asset-allocation-can-make-you-a-bett/) that you'll make sure not to overexpose yourself to risk while getting the best reward possible.  
  
Learning about some simple economic concepts can make you a better financial thinker and decision maker.  
  
On what seems like the more sensible side of the spectrum are bank accounts and government bonds. Are they low-risk? Absolutely. But their returns are low, too.

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. Financial accounting provides data that these individuals need and want.

organization → reports information based on the principles of financial accounting → individual assesses 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 decisions 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 talent 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. 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 outlet 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.

Exercise

Link to multiple-choice question for practice purposes: <http://www.quia.com/quiz/2092614.html>

*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 advertisements to alert the public about a new product be carried on the Internet or on television?*

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 accountingThe communication of financial information within an organization so internal decisions can be made in an appropriate manner2.. 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 Motorola or Starbucks) as a whole. Thus, questions such as the following all fall within the discussion of financial accounting:

* Do we loan money to Company C?
* Do we sell on credit to Company C?
* Do we recommend that our clients buy the ownership shares of Company C?

They relate to evaluating the financial health and prospects of Company C 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.

Exercise

Link to multiple-choice question for practice purposes: <http://www.quia.com/quiz/2092571.html>

*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>.

2Tax 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.

http://open.lib.umn.edu/financialaccounting/chapter/17-1-the-structure-of-a-statement-of-cash-flows/