

## **QUESTION : WHAT PURPOSES ARE SERVED BY FINANCIAL ACCOUNTING?**

Accounting is a very ancient art and has also been described as the 'language of business'. The essential purpose of accounting is to communicate to interested users the economic measurements and quantitative information of a business enterprise which will act as a basis for performance assessment, decision making and control. This is done through the process of identifying, summarizing, analyzing, measuring, recording, reporting and interpreting business transactions.

So, who are the suppliers of the accounting information? In the private sector of the economy, they are the sole traders, partnerships, clubs and societies, and the limited companies. In the public sector of the economy, they include local authorities, nationalized industries, state colleges and the health service. These ones will provide information in the form of accounting statements or final accounts which consist of a Profit and Loss account, and a Balance Sheet. The Cash Flow Statement is also sometimes a required accounting statement in annual reports.

In general, the financial statements are prepared in a summarized form because too much detail is of little interest to the users and it is likely to obscure the important trends. In addition, a too detailed information might be used by competitors to find out the company's strengths and weaknesses.

There are two kinds of users of these financial statements. They are the internal users and the external users. The internal users are more concerned about the management of the business and will require management accounting. As for the external users, they will require financial accounting which will be discussed in greater detail in this essay.

The purpose of financial accounting varies among the external users. There are a number of external user groups. Each group, although they have a common interest in the company's accounts, they use the information provided as a basis for a quite different decisions. They all read the same published reports of the business but they will gather the information they need to make evaluations and decisions. Therefore, the financial statements should follow certain principles, clearly reflect the information and cater for the needs of each users.

Existing shareholders have already invested some of their time and money in the business and so, expect some returns, usually in the form of dividends. Thus, they would like to know how is the financial situation of the business. Knowing so, helps them to decide whether to retain their present investment, increase it or sell.

Potential shareholders are interested in the present and future activities of the business because they can either boost the revenue of the business or reduce it and thus the amount of predicted dividends they will get. They can also use the information in the financial statements to compare the company's past earnings, earnings per share, likelihood of future growth, dividends and profits with other companies in the same industry. If the financial statements of that business gives a favourable view, it could encourage new investors. If not, it will discourage them.

The providers of loan and finance will usually need to look into the company's financial statements before they extend the company any credit. The accounting information helps them to decide whether to make an initial advance, and to monitor the company's progress and ability to pay

back at the end of the loan period. The company's liquidity position and its creditworthiness is also considered. They observe the company's sales, profit, potential sales and so on. The banks, before allowing loans to the company, also need these statements.

The suppliers are also concern about the liquidity and solubility of the business. They have to decide whether to supply or continue supplying the goods on credit or not to the businesses involved. This can be derived and calculated from the financial statements by using the current and acid test ratio. The ratios will show whether the business has sufficient assets to cover the liabilities and how quickly its current assets can be converted into cash for the payment of the current liabilities.

The next group is the employee group. Employees need the financial information to help them to assess employment prospects and also for the purpose of collective bargaining. From the financial statements, they can find out if the workers have paid fairly and whether there are any funds set aside for improving the working conditions of the workers.

Governments, particularly the tax authorities, commerce and industry departments are also users of accounting statements. The tax authorities will check the financial reports of the business because they are concern about the evading of taxes by the businesses even though rules and regulations had been laid down. The departments of commerce and industry also have to make sure that the business is not dealing with any illegal activities. Therefore, all businesses are required to disclose all relevant information in their published financial reports. However, some businesses are shrew and will not reveal everything of their operation or reveal something totally different too. So, their reports cannot be truly relied upon by the authorities doing the checking of the businesses.

Then, we have the adviser group, there are the financial analysts, journalists, statisticians, researchers, trade unions, stockbrokers and credit-rating agencies who might also require to look into the financial statements of the company.

The public too, are sometimes interested in the activities of business. For example, there are environmentalists who are particularly concern about how the business functions, whether its activities are affecting the nature of the earth. Pollution of all kinds which result from the activities is not shown in the financial accounts of the business but it is a social cost to the public. Thus, sometimes the government is asked to take action against them if they are polluting the environment.

Different users require different information from the financial statements even though they may share a common interest in the accounts of the business. Therefore, financial accounting serves different purposes for different users. On the whole, the financial statements set out should be relevant, condensed, useful, timely, reliable, giving a true and fair view of the business.

References : Introduction to accounting by J.R. Edwards and H.J. Mellett.

Introduction to financial accounting by Christopher Nobes (third edition).