eAnnexure 2: Financial Accounting

Financial accounting is the branch of accounting intended for users outside the organization (external accountability). Although nowadays enterprises publish a broad range of reports to the public, such as environmental, corporate, and social responsibility reports, financial reporting is still extremely important and is mandatory.

Financial accounting refers to mandatory financial reports that companies are required to prepare and publish according to international and national rules. These reports include:

- Annual reports, which are the main documents published yearly. The timeline is the *accounting year*, with a duration of 12 months but starting in different months throughout the world (January, March, June, and so forth).
- Interim reports, including quarterly and half-year reports.

Because it is the most complete document, in this annex, we analyze the annual report with reference to international financial reporting standards (IFRS).[1] According to IFRS, there are four compulsory financial statements:

- A *balance sheet*, which describes the condition of resources (assets) and rights over these resources (equity and liabilities) at the end of the accounting year.
- An *income statement*, which summarizes revenues and costs incurred during the year.
- A *cash flow statement* presenting cash flows during the year.
- A *statement of changes in equity*, which details variations that occurred in equity throughout the year.

In addition to these financial statements, which are expressed in accounting terms, enterprises must include *notes to the financial statements*, which explain the rules followed and choices made in preparing the financial statements.

This chapter will provide the basics for understanding and reading these documents.

A2.1 OVERVIEW AND PRINCIPLES

The four aforementioned financial statements follow two different accounting methods: accrual principle and cash accounting.

According to the accrual principle, the effects of transactions and other events are recognized when they occur (and not as cash—or its equivalent—is received or paid), and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. For example, take a single transaction for

[1] IFRS is an international standard for financial accounting enacted by the International Accounting Standards Board (IASB); although other standards exist at the national level (e.g., US GAAP), there have been efforts in standard convergence toward and alignment with IFRS. Going into detail about national accounting differences is beyond the scope of this annex.