Welcome to the World of Accounting

Part 1

Your goals for this “welcoming” chapter are to learn about:

- The nature of financial and managerial accounting information.
- The accounting profession and accounting careers.
- The fundamental accounting equation: Assets = Liabilities + Owners’ Equity.
- How transactions impact the fundamental accounting equation.
- The four core financial statements.

1. Accounting Information

You likely have a general concept of what accountants do. They capture information about the transactions and events of a business, and summarize that activity in reports that are used by persons interested in the entity. But, you likely do not realize the complexity of accomplishing this task. It involves a talented blending of technical knowledge and measurement artistry that can only be fully appreciated via extensive study of the subject. The best analogy is to say that you probably know what a heart surgeon does, but you no doubt appreciate that considerable knowledge and skill is needed to successfully treat a patient. If you were studying to be a surgeon, you would likely begin with some basic anatomy class. In this chapter, you will begin your study of accounting by looking at the overall structure of accounting and the basic anatomy of reporting.

Be advised that a true understanding of accounting does not come easily. It only comes with determination and hard work. But, if you persevere, you will be surprised at what you discover about accounting. Knowledge of accounting is very valuable to business success. And, once you conquer the basics, accounting is actually quite an interesting subject.

1.1 Accounting Defined

It seems fitting to begin with a more formal definition of accounting: Accounting is a set of concepts and techniques that are used to measure and report financial information about an economic unit. The economic unit is generally considered to be a separate enterprise. The information is potentially reported to a variety of different types of interested parties. These include business managers, owners, creditors, governmental units, financial analysts, and even employees. In one way or another, these users of accounting information tend to be concerned about their own interests in the entity. Business managers need accounting information to make sound leadership decisions. Investors hold out hope for profits that may eventually lead to distributions from the business (e.g., "dividends").

Creditors are always concerned about the entity's ability to repay its obligations. Governmental units need information to tax and regulate. Analysts use accounting data to form their opinions on which they base their investment recommendations. Employees want to work for successful companies to further their individual careers, and they often have bonuses or options tied to enterprise performance. Accounting information about specific entities helps satisfy the needs of all these interested parties. The diversity of interested parties leads to a logical division in the discipline of accounting: financial accounting and managerial accounting. Financial accounting is concerned with external reporting of information to parties outside the firm. In contrast, managerial accounting is primarily concerned with providing information for internal management. You may have some trouble seeing why a distinction is needed; after all aren't we just reporting financial facts? Let's look closer at the distinctions.

1.2 Financial Accounting

Consider that financial accounting is targeted toward a broad base of external users, none of whom control the actual preparation of reports or have access to underlying details. Their ability to understand and have confidence in reports is directly dependent upon standardization of the principles and practices that are used to prepare the reports. Without such standardization, reports of different companies could be hard to understand and even harder to compare. As a result, there are well organized processes to bring consistency and structure to financial reporting. In the United States, a private sector group called the Financial Accounting Standards Board (FASB) is primarily responsible for developing the rules that form the foundation of financial reporting. With the increase in global trade, the International Accounting Standards Board (IASB) has been steadily gaining prominence as a global accounting rule setter.

Financial reports prepared under the generally accepted accounting principles (GAAP) promulgated by such standard setting bodies are intended to be general purpose in orientation. This means they are not prepared especially for owners, or creditors, or any other particular user group. Instead, they are intended to be equally useful for all user groups. As such, attempts are made to keep them free from bias (neutral).

1.3 Managerial Accounting

In sharp contrast to financial accounting, managerial accounting information is intended to serve the specific needs of management. Business managers are charged with business planning, controlling, and decision making. As such, they may desire specialized reports, budgets, product costing data, and other details that are generally not reported on an external basis. Further, management may dictate the parameters under which such information is to be accumulated and presented. For instance, GAAP may require that certain research costs be deducted immediately in computing a business's externally reported income; on the other hand, management may see these costs as a long-term investment and stipulate that internal decision making be based upon income numbers that exclude such costs. This is their prerogative. Hopefully, such internal reporting is being done logically and rationally, but it need not follow any particular set of guidelines.

1.4 A Quality Information System

Both financial accounting and managerial accounting depend upon a strong information system to reliably capture and summarize business transaction data. Information technology has radically reshaped this mundane part of the practice of accounting during the past 30 years. The era of the "green eye-shaded" accountant has been relegated to the annals of history. Now, accounting is more of a dynamic, decision-making discipline, rather than a bookkeeping task.

1.5 Inherent Limitations

Accounting data is not absolute or concrete. Considerable amounts of judgment and estimation are necessary to develop the specific accounting measurements that are reported during a particular month, quarter, or year (e.g., how much pension expense should be reported now for the future benefits that are being earned by employees now, but the amounts will not be known with certainty until many years to come?). About the only way around the problem of utilizing estimation in accounting is to wait until all facts are known with certainty before issuing any reports. However, by the time any information could be reported, it would be so stale as to lose its usefulness. Thus, in order to timely present information, it is considered to be far better to embrace reasonable estimations in the normal preparation of ongoing financial reports.

In addition, accounting has not yet advanced to a state of being able to value a business (or a business's assets). As such, many transactions and events are reported based upon the historical cost principle (in contrast to fair value). This principle holds that it is better to maintain accountability over certain financial statement elements at amounts that are objective and verifiable, rather than opening the door to random adjustments for value changes that may not be supportable. For example, land is initially recorded in the accounting records at its purchase price. That historical cost will not be adjusted even if the fair value is perceived as increasing. While this enhances the "reliability" of reported data, it can also pose a limitation on its "relevance."