Chapter 1

Introducing Accounting and Financial Statements

- What Is Accounting?
- Who Uses Accounting Information?
- Financial Statements
- How Different Business Entities Present Accounting Information

What Is Accounting?

The purpose of accounting is to provide information that will help you make correct financial decisions. The accountant's job is to provide the information needed to run a business as efficiently as possible while maximizing profits and keeping costs low.

Quick Tip

Finding an Accountant: Hiring a professional and ethical accountant to aid in your business operations can be critical to the success of your company. Meet with a few accountants before making a final choice so that you know your options and can select one whose experience and work style will be best suited to your needs and the needs of your business. Local chapters of your state societies of CPAs offer referral services that can help with this.

Accounting plays a role in businesses of all sizes. Your kids' lemonade stand, a one- person business, and a multinational corporation all use the same basic accounting principles. Accounting is legislated; it affects your taxes; even the president plays a role in how accounting affects you.

Accounting is the language of business. It is the process of recording, classifying, and summarizing economic events through certain documents or financial statements. Like any other language, accounting has its own terms and rules. To understand how to interpret and use the information accounting provides, you must first understand this language. Understanding the basic concepts of accounting is essential to success in business.

Different types of information furnished by accountants are shown in figure 1.1 on the next page.

Figure 1.1: **TYPES OF INFORMATION PROVIDED BY ACCOUNTANTS**

- Information prepared exclusively by people within a company (managers, employees, or owners) for their own use.
- Financial information required by various government agencies such as the Internal Revenue Service (IRS), Securities and Exchange Commission (SEC), and the Federal Trade Commission (FTC).
- General information about companies provided to people outside the firm such as investors, creditors, and labor unions.

Accounting and Bookkeeping

Bookkeeping procedures and bookkeepers record and keep track of the business transactions that are later used to generate financial statements. Most bookkeeping procedures have been systematized and, in many cases, can be handled by computer programs. Bookkeeping is a very important part of the accounting process, but it is just the beginning. There is currently no certification required to become a bookkeeper in the United States.

Accounting is the process of preparing and analyzing financial statements based on the transactions recorded through the bookkeeping process. Accountants are usually professionals who have completed at least a bachelor's degree in accounting, and often have passed a professional examination, like the Certified Public Accountant Examination, the Certified Management Accountant Examination, or the Certified Fraud Auditor Examination.

Accounting goes beyond bookkeeping and the recording of economic information to include the summarizing and reporting of this information in a way that is meant to drive decision making within a business.

Who Uses Accounting Information?

In the world of business, accounting plays an important role to aid in making critical decisions. The more complex the decision, the more detailed the information must be. Individuals and companies need different kinds of information to make their business decisions

Let's start with you as an individual. Why would you be interested in accounting? Accounting knowledge can help you with investing in the stock market, applying for a home loan, evaluating a potential job, balancing a checkbook, and starting a personal savings plan, among other things.

Managers within a business also use accounting information daily to make decisions, although most of these managers are not accountants. Some of the decisions they might make for which they will use accounting information are illustrated in figure 1.2.

Figure 1.2: **AREAS IN WHICH MANAGERS USE ACCOUNTING INFORMATION**

- Marketing (Which line of goods should the company emphasize?)
- Production (Should the company produce its goods in the United States or open a new plant in Mexico?)
- Research and Development (How much money should be set aside for new product development?)
- Sales (Should the company expand the advertising budget and take money away from some other part of the marketing budget?)

Without the proper accounting information, these types of decisions would be very difficult, if not impossible, to make.

Bankers continually use accounting information. They are in the business of taking care of your money and making money with your money, so they absolutely must make good decisions. Accounting is fundamental to their decision-making process. Figure 1.3 looks at some of the decisions bankers make using accounting information.

Figure 1.3: **AREAS IN WHICH BANKERS USE ACCOUNTING INFORMATION**

- Granting loans to individuals and companies
- Investing clients' money
- Setting interest rates
- Meeting federal regulations for protecting your money

Government agencies such as the Internal Revenue Service (IRS), the Securities and Exchange Commission (SEC), the Federal Trade Commission (FTC), and the Bureau of Alcohol, Tobacco, and Firearms (ATF) base their regulation enforcement and compliance on the accounting information they receive.

Accountability in Accounting

A business's financial statements can also be of great interest to other members of the local or national community. Labor groups might be interested in what impact management's financial decisions have on their unions and other employees. Local communities have an interest in how a business's financial decisions (for example, layoffs or plant closings) will impact their citizens.

As the economy becomes more complex, so do the transactions within a business and the process of reporting them to various users and making them understandable become more complex as well. A solid knowledge of accounting is helpful to individuals, managers, and business owners who are making their decisions based on the information accounting documents provide.

Financial Statements

Accountants supply information to people both inside and outside the firm by issuing formal reports that are called financial statements.

The financial statements are usually issued at least once a year. In many cases they are issued quarterly or more often where necessary. A set of rules, called Generally Accepted Accounting Principles (GAAP), govern the preparation of the financial statements. Generally Accepted Accounting Principles has been defined as a set of objectives, conventions, and principles to govern the preparation and presentation of financial statements. These rules can be found in volumes of documents issued by the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), the Internal Revenue Service (IRS), the Securities and Exchange Commission (SEC), and other regulatory bodies. In chapter 2 we look at some of the overriding principles of accounting as they apply to all businesses and individuals.

The Basic Financial Statements

The basic financial statements include the Balance Sheet, the Income Statement, the Statement of Cash Flows, and the Statement of Retained Earnings. We will look at these in depth in the following chapters and see how they all interact with each other. As we discuss these financial statements, you will see they are not as scary as you might think they are. Many of the concepts will already be familiar to you.

In the appendix you can see examples of these financial statements from the Coca-Cola Company.

The Balance Sheet is the statement that presents the Assets of the company (those items owned by the company) and the Liabilities (those items owed to others by the company)The Income Statement shows all of the Revenues of the company less the Expenses, to arrive at the "bottom line," the Net Income.

The Statement of Cash Flows shows how much cash we started the period with, what additions and subtractions were made during the period, and how much cash we have left over at the end of the period.

The Statement of Retained Earnings shows how the balance in Retained Earnings has changed during the period of time (year, quarter, month) for which the financial statements are being prepared. Normally there are only two types of events that will cause the beginning balance to change:

Alert!

Seeing the Bigger Picture: None of these financial statements alone can tell the whole story about a company. We need to know how to read, understand, and analyze these statements as a package in order to make any kinds of decisions about the company. In addition to the financial statements, you must understand the industry you are operating in and the general economy.

1) the company makes a profit, which causes an increase in Retained Earnings (or the company suffers a loss, which would cause a decrease) and
2) the owners of the company withdraw money, which causes the beginning balance to decrease (or invest more money, which will cause it to increase).

Financial statements vary in form depending upon the type of business in which they are used. In general there are three forms of business operating in the United States: proprietorships, partnerships, and corporations.

How Different Business Entities Present Accounting Information

Proprietorships are businesses with a single owner like you and me. These types of businesses tend to be small retail businesses started by entrepreneurs. The accounting for these proprietorships includes only the records of the business—not the personal financial records of the proprietor of the business.

Partnerships are Very similar to proprietorships, except that instead of one owner, there are two or More owners In general most of these businesses are small to medium-sized. However, there are some exceptions, such as large national or even international accounting

Alert!

Don’t Mix and Match: The financial records of an individual owner of a business should never be combined with those of the business. They are two separate entities and need to be ac-counted for separately. Taking money from one of these entities (the business) for the other (the owner) must be accounted for by both entities.

or law firms that may have thousands of partners. As with the proprietorships, accounting treats these organizations' records as separate and distinct from those of the individual partners.

Finally there are corporations. These are businesses that are owned by one or more stockholders. These owners may or may not have a managerial interest in the company. Many of these stockholders are simply private citizens who have money invested in the company by way of stocks that they have purchased.

In a corporation a person becomes an owner by buying shares in the company and thus becomes a stockholder. The stockholders may or may not have a vote in the company's long-term planning, depending on the type of stock they have purchased. However, simply by being stockholders (owners), they do not have decision-making authority in the day-to-day operations. These investors (or stockholders) are not much different than the bankers that loan money to a proprietorship or a partnership. These bankers have a financial interest in the business, but no daily managerial decision- making power. As is the case with the stockholders who have invested money into the corporation, in general they have a no managerial interest in the business. As with the other two types of business organizations discussed here, the accounting records of the corporation are maintained separately from those of the individual stockholders or owners.

The accounting records of a proprietorship are less complex than those of a corporation in that there is a simple capital structure and only one owner. In the case of a corporation, there are stockholders who buy a piece of the ownership of a company by buying stock. As we will discuss later, because of this stock ownership, the financial statements become more complex. Some of the basic differences between these three types of businesses are shown in figure 1.4.

Figure 1.4: **DIFFERENCES IN THE THREE TYPES OF BUSINESSES**

Business Type	Proprietorship	Partnership	Corporation
Number of Owners	One	Two or more	One or more
Accounting Records	Maintained separately from owner's records	Maintained separately from owner's records	Maintained separately from owner's records
Owner Has Managerial Responsibilities	Yes	Usually not	Usually not

In this chapter you have learned what accounting is, why you and other people in business need to understand accounting, what businesses use accounting for, and what the basic financial statements used in these businesses are. In chapter 2 you will learn about principles accountants use in the United States and worldwide on a regular basis.

GLOSSARY

Accounting: The process of recording, classifying, and summarizing economic events through the preparation of financial statements such as the Balance Sheet, the Income Statement, and the Statement of Cash Flows.

American Institute of Certified Public Accountants (AICPA): The professional organization of CPAs in the United States. The AICPA is charged with preparation of the CPA Examination, the establishment and enforcement of the code of professional ethics, and working with the Financial Accounting Standards Board in the proclamation of accounting standards.

Corporations: Businesses that are given the right to exist by an individual state in the United States. With this right to exist, the corporation is then allowed to sell stock. Those buying this stock become owners of the corporation. Corporations can be set up as for profit or not for profit, and make that decision when applying for their charter with the state.

Financial Accounting Standards Board (FASB): Sets the accounting standards to be followed for the preparation of financial statements. All rulings from the FASB are considered to be GAAP.

Financial Statements: Reports prepared by companies on the financial status of their business; examples are Balance Sheets, Income Statements, Statement of Cash Flow, and Statement of Retained Earnings.

Generally Accepted Accounting Principles (GAAP): The rules that govern the preparation of financial statements. These rules are developed by the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the Securities and Exchange Commission, and other government agencies.

Internal Revenue Service (IRS): The government agency charged with the collection of federal taxes in the United States. There are different accounting rules for the preparation of taxes in the United States than for the presentation of financial statements.

Partnerships: A business entity with two or more owners. The accounting for partnerships is similar to that of proprietorships.

Proprietorships, Sole Proprietorships: Businesses with one single owner. Even though there is only one owner, the records of the owner's personal financial affairs are kept separate from those of the accounting records of the business. Separate tax returns are prepared for the business and for the individual.