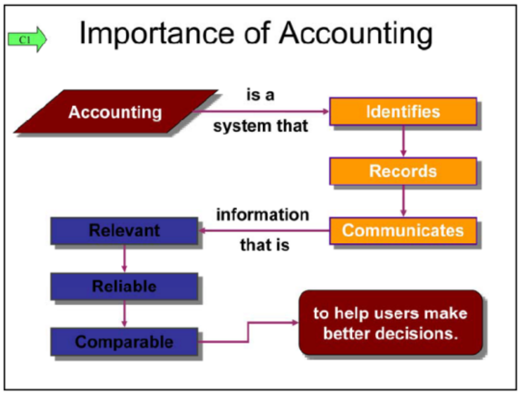
CHAPTER 1: INTRODUCING FINANCIAL ACCOUNTING

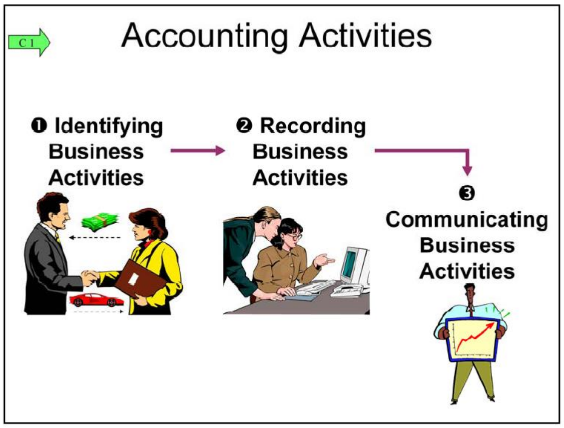
I. IMPORTANCE OF ACCOUNTING



- **Accounting** is the *language of business* and is called this because all organizations set up an accounting information system to communicate data to help people make better decisions.

- **Accounting** is a system that→Indentifies→Records→Communicates relevant, reliable, and comparable information about an organization's business activities.

- **Identifying** means selecting transactions and events relevant to an organization.



- Example: sale of iPods by Apple, receipt of ticket money by TicketMaster.

- **Recording** means keeping a chronological log of transactions and events measured in dollars and classified and summarized in a useful format.

- **Communicating** means preparing accounting reports such as financial statements, and analyzing and interpreting these reports.

- **Management Accounting** provides information for decision-making activities of management WITHIN the business.

- **Financial Accounting** is concerned with providing useful information to those parties OUTSIDE of the business.

- Financial accountants are concerned with the preparation of Financial Statements, which are distributed to outside parties in an annual report.

- Most common experience with accounting is through: credit approvals, checking accounts, tax forms, and payroll.

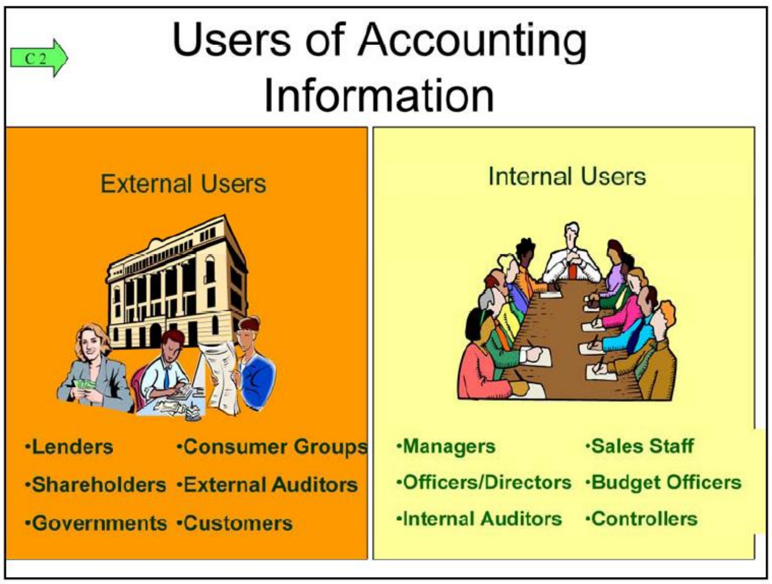
- These common experiences are limited and tend to focus on the recordkeeping parts of accounting.

- **Recordkeeping/Bookkeeping**—is recording of transactions and events, either manually or electronically of an organization's day-to-day activities. Recordkeeping is only ONE part of accounting.

- **Accounting**—is the process of analyzing and drawing conclusions from this information.

- Example: *bookkeeper* of a shoe store keeps the day-to-day records as to how many shoes are sold and what bills need to be paid; *accountant* analyzes this data to evaluate the profitability and health of the business.

A. Users of Accounting Information



1. External Information Users

- **External Users**—are NOT directly involved in running the organization.

- Examples: shareholders (investors), lenders, directors, customers, suppliers, regulators, lawyers, brokers, and the press.

- External users have limited access to an organization's information.

- External users business decisions depend on information that is reliable, relevant, and comparable.

- These financial statements are called *general-purpose financial statements.*

a. Lenders (creditors)

- Loan money or other resources to an organization.

- They look for information to help them assess whether an organization is likely to repay its loans with interest.

- Examples: banks, savings and loans, co-ops, and mortgage and finance companies.

b. Shareholders (investors)

- Owners of a corporation.

- Use accounting reports in deciding whether to buy, hold, or sell stock.

c. Board of Directors

- oversees stockholders interests in an organization.

d. External (Independent) Auditors

- Examine financial statements to verify that they are prepared according to generally accepted accounting principles (GAAP).

e. Employees and Labor Unions

- Use financial statements to judge the fairness of wages, assess job prospects, and bargain for better wages.

f. Regulators

- Often have legal authority over certain activities of organizations.

- IRS who requires organizations to file accounting reports in computing taxes.

- Utility boards use accounting information to set utility rates.

g. Voters, Legislators, and Government Officials

- Use accounting information to monitor and evaluate government receipts and expenses.

h. Contributors

- Use accounting information to evaluate the use and impact of their donations.

i. Suppliers

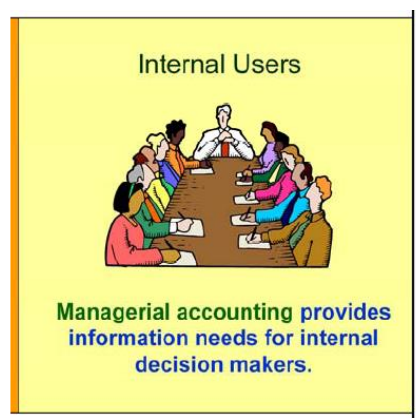
- Use accounting information to judge the soundness of a customer before making sales on credit.

j. Customers

- Use financial reports to assess the staying power of potential suppliers.

2. Internal Information Users

- **Internal Users—**are those directly involved in managing and operating an organization.



- **Managerial Accounting—**area of accounting that serves the needs of internal users.

- **Internal Controls—**are procedures set up to protect company property and equipment, ensure reliable accounting reports, promote efficiency, and encourage adherence to company policies.

- <u>Examples</u>: good records, physical controls (locks, passwords, guards), and independent reviews

a. Research and Development Managers

- ♦ Need information about projected costs and revenues of any proposed changes in products and services.

b. Purchasing Managers

- ♦ Need to know what, when, and how much to purchase.

c. Human Resource Managers

- ♦ Need information about employees' payroll, benefits, performance, and compensation.

d. Production Managers

- ♦ Depend on information to monitor costs and ensure quality.

e. **Distribution Managers**

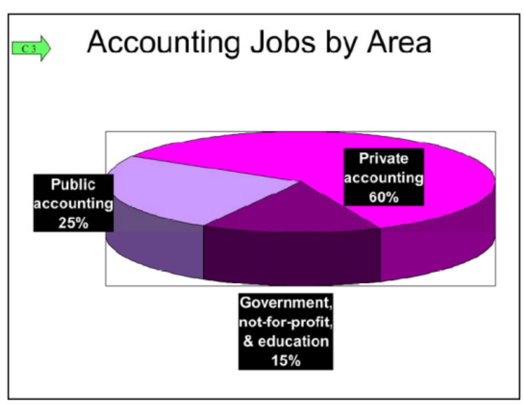
- ♦ Need reports for timely, accurate, and efficient delivery of products and services.

f. Marketing Managers

- ♦ Use reports about sales and costs to target consumers, set prices, and monitor consumer needs, tastes, and price concerns.

g. Service Managers

- ♦ Require information on the costs and benefits of looking after products and services.



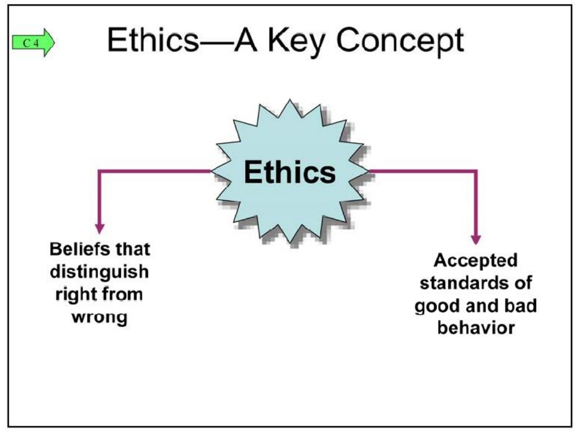
B. Opportunities in Accounting

- ♦ We are influenced by accounting when we earn money, pay taxes, invest savings, budget earnings, and plan for the future.

- There are accounting jobs in private accounting, public accounting, and government (and non-for-profit) agencies.
- Majority of the jobs are in private accounting, followed by public accounting.
- Accounting specialists are highly regarded.
- People with accounting knowledge are always in demand as they can help with financial analysis, strategic planning, e-commerce, product feasibility analysis, information technology, and financial management.
- Demand for accounting specialists is boosting salaries, and can vary because of location, company size, professional designation, experience, etc.
- <u>Accountants can possibly have great benefit packages that can include</u>: flexible work schedules, telecommuting options, career path alternatives, casual work environments, extended vacation time, and child and elder care.
- <u>Examples of Accounting Specialists</u>: Certified public accountant (CPA), certified bookkeeper (CB), certifi

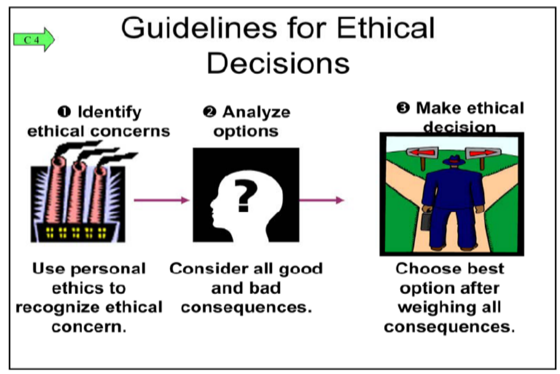
ed payroll professional (CPP),personal financial specialist (PFS), certified fraud examiner (CFE), certified forensic accountant (CrFA)

II. FUNDAMENTALS OF ACCOUNTING

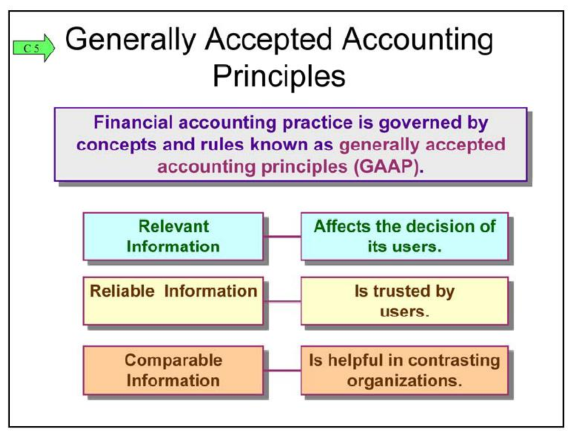


A. Ethics—A Key Concept

- **Ethics—**are beliefs that distinguish right from wrong; they are accepted standards of good and bad behavior.
- Goal of accounting is to provide useful information for decisions.
- So there must be ethics in accounting.
- Old saying: **"Good ethics are good business"**
- Providers of accounting information often face ethical choices as they prepare financial reports.
- For example, these choices can affect the price a buyer pays and the wages paid to workers



B. Generally Accepted Accounting Principles (GAAP)



- **GAAP—**are rules that specify acceptable accounting practices.
- GAAP aims to make information in financial statements relevant, reliable, and comparable.

1. Setting Accounting Principles

- Two main groups establish GAAP in the US:

a. Financial Accounting Standards Board (FASB)

- Private group that sets both broad and specific principles.

b. Securities and Exchange Commission (SEC)

- Government group that establishes reporting requirements for companies that issue stock to the public.

- **International Accounting Standards Board (IASB)—**issues International Financial Reporting Standards (IFRS) that identify preferred accounting practices, for example, when companies wish to raise money from lenders and investors in different countries.

2. Principles and Assumptions of Accounting

- Two types:

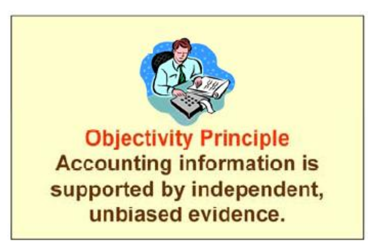
(1) **General Principles—**the basic assumptions, concepts, and guidelines for preparing financial statements.

(2) **Specific Principles—**detailed rules used in reporting business transactions and events.

a. Accounting Principles

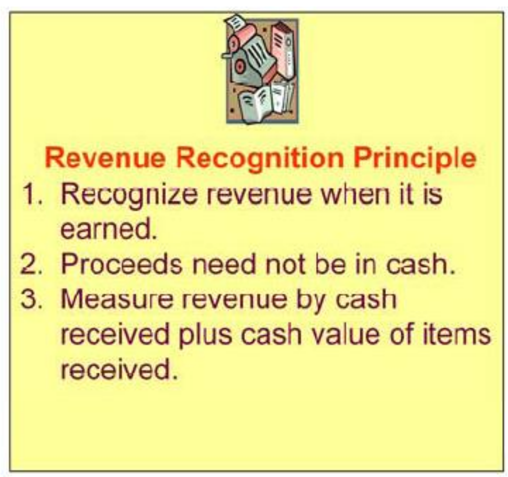
i. Cost Principle

- Means that accounting information is based on actual cost.
- Cost is measure on a cash or equal-to-cash basis.
- Cash Example: cash is given for a service, its cost is measured as the amount of cash paid.
- Equal to Cash Example: if something besides cash is exchanged (i.e. truck), cost is measured as the cash value of what is given up or received.
- It emphasizes reliability and verifiability, and information based on cost is considered objective.
- **Objectivity—**information is supported by independent, unbiased evidence; it demands more than a person's opinion.



ii. **Revenue Recognition Principle**

- **Revenue (sales)—**is the amount received from selling products and services.
- **Revenue Recognition Principle—**provides guidance on when a company must recognize revenue.
- **Recognize—**means to record it.
- If revenue is recorded too early, then a company would look more profitable than it is.
- If revenue is recorded too late, a company would look less profitable than it is.



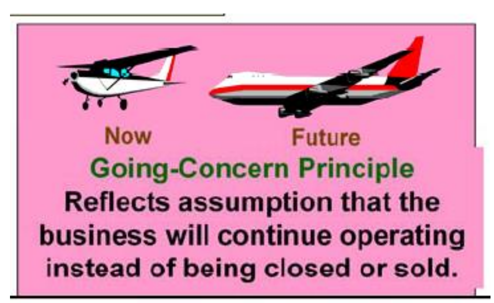
- Three important concepts:
  1. Revenue is recognized when earned.
  2. Proceeds from selling products and services need not be in cash (can be credit sale).
  3. Revenue is measured by the cash received plus the cash value of any other items received.

iii. **Matching Principle**

- A company must record its expenses incurred to generate the revenue reported.

iv. **Full Disclosure Principle**

- Requires a company to report the details behind financial statements that would impact users' decisions.



b. Accounting Assumptions

i. **Going-Concern Assumption**

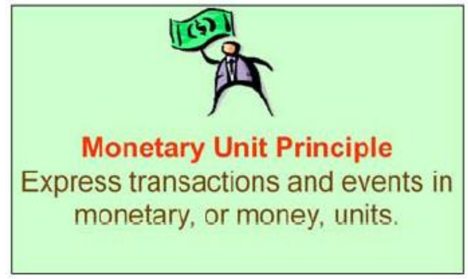
- Accounting information reflects a presumption that the business will continue operating instead of being closed or sold.

♦ Think *Energizer Bunny*, it keeps going and going.

ii. Monetary Unit Assumption

♦ We can express transactions and events in monetary, or money units.

♦ Money is the most common denominator in business.



iii. Time Period Assumption

♦ Presumes that the life of a company can be divided into time periods, such as months and years, and that useful reports can be prepared for those periods.

iv. Business Entity Assumption

♦ A business is accounted for separately from other business entities, including its owner.

♦ Separate information about each business is necessary for good decisions.

v. Conservatism

♦ By being conservative with the numbers.

C. Sarbanes-Oxley (SOX)

♦ Congress passed this act to help curb financial abuses at companies that issue their stock to the public.

♦ It requires that the public companies apply other accounting oversight and stringent internal controls.

♦ Failure to comply can lead to financial penalties, stock market delisting, and criminal prosecution of executives.

♦ Management and Auditors must verify the effectiveness of internal controls.