Introduction to Business Administration Lesson 8

8. Accounting

Accounting is the language of business.

Accounting - the recording, measurement, and interpretation of financial information essential in making business decisions.

It provides information that feeds into many different areas of a business.

Decisions cannot be made without financial information, which is what accountants provide.

Accounting is used to communicate financial information internally and externally.

Accountants – professionals responsible for ethics (integrity and transparency) in the reporting of financial information.

8.1 Fields of Accounting

Two primary fields of accounting:

- Management Accounting
- Financial Accounting

Management Accounting – Provides information to decision makers INSIDE the organization to help operate the business.

Information in management accountant can be tailored to the needs of the individual managers in order to provide relevant, accurate, timely information to aid in making decisions.

Financial Accounting – furnishes information to individuals and groups inside/outside the organization to assess the company financial performance.

Two primary types of accountants:

Public Accountant – Independent professional who provides accounting services to individuals and companies

Private Accountant – Accountant employed by a corporation or organization and works from within.

Private accountants enter corporations yearly to perform audits.

- Firm Certifies that GAAP standards have been followed
- Submit audited financial statements to a company's lenders
- Prepare tax filings

8.2 Users of Accounting Information

Accounting is the language of business because it is needed and used by many individuals in different areas such as:

- Owners and Managers
- Government Agencies
- Investors and Creditors
- Other users (Employees)

Managers use accounting information to:

- Plan and Set Goals
- Organize
- Lead and Motivate
- Control
- Marketing – analyze effectiveness of advertising and promotional campaigns.

Governmental Agencies use accounting information to:

- Confirm tax liabilities
- Confirm payroll
- Deductions
- Approve new issues of stocks and bonds

Creditors use accounting information to:

- Evaluate credit risks

Other users such as Stockholders, Investors, Employees use accounting information to:

- Evaluate investments and be involved in and up to date with the company

8.3 Generally Accepted Accounting Principles

Also known as GAAP

GAAP – accounting rules used to prepare, present, and report financial statements for companies.

Not a law, more of a standard that is closely followed

SEC – security and exchange commission requires that publicly traded companies follow it.

Full disclosure principle – requires that all information relevant to financial statement users have to be disclosed.

In other words, all financial records and transactions have to be available for viewing.

8.4 Types and Functions of Financial Statements

Four Types of statements:

- Income Statements
- Balance Sheet
- Statement of Retained Earnings
- Statement of Cash Flows

Income Statements – Shows revenue/expenses and shows if a profit, loss, or break even occurred.

- Revenue
- Expenses
- Cost of goods sold or COGS

- Operating Expenses
- Gross Profit
- Net Income/Net Loss

Balance Sheet – Indicates assets/liabilities and amount invested in company.

It tells what you have and where it came from

Think of a balance sheet as a snapshot because it is about a specific point in time.

- Assets – Business Resources
- Liabilities – Debts owned to outside entities
- Owners' Equity – Amount invested by owners.
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Statement of Retained Earnings – Provides the stockholders equity, which is the equity of the owners.

Statement of Cash Flow – Shows how much cash is in or out of the company

- Cash Flow From Operating Activities
- Cash Flow from investing activities
- Cash Flow from financing activities

8.5 Creative Accounting and Earnings Management

Shareholders and market reaction is highly related to managers' actions.

Directors are increasingly judged on profit and growth and have large bonuses at stake.

Companies and directors want to use reports to present the message they want investors to see and sometimes, that involves creative accounting.

Creative Accounting – term used to indicate the management of earnings that follow the rules but deviate from the intentions of those rules.

The terms innovative, aggressive and cooking the books are also sometimes used.

Creative Accounting is used to:

- Hide a bad year for the company
- Force a good year
- Continue the pressure to be the best
- Give an impression of stability or sustainability
- Boost assets to avoid take-over

Creative Accounting / Earnings Management Methods:

- Artificial Transactions to manipulate balance sheet and move profits
- Timing of Genuine transactions (accelerations)

  For example, a company receives upfront payment for a four-year service contract but records the full payment as sales of only the period that the payment is received.

- Prediction/Estimation
- Big Bath (Worsening a bad year to make next years considerably better)
- Cookie Jar Reserves (delay)
- Failing to record expenses