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Introduction to Accounting Concepts and the Environment of Accounting

Learning Objectives

By the end of this chapter, you should be able to:

- Define accounting.
- Identify users of accounting information.
- List the qualitative objectives of financial information.
- List the basic underlying assumptions of financial statement preparation.

THE OBJECTIVE OF ACCOUNTING

Some years ago, accounting was defined by the American Institute of Certified Public Accountants as follows:

> Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.[1]

In this statement, accounting is referred to as an art; however, it should be understood that accounting is practiced within a body of concepts, practices, and principles that have been developed by the profession. Accounting doctrine has evolved in response to the needs of the users of financial information. The generally accepted accounting principles used today are the result of an evolutionary process--one that can be expected to continue in the future.

[1] "Accounting Terminology Bulletins, No. 1, Review and Resume," *Accounting Research and Terminology Bulletins--Final Edition* (New York: American Institute of Certified Public Accountants, 1961), par. 9. (Note: Although some of the material in the pronouncements cited here and elsewhere in this course have been superceded by subsequent AICPA and FASB publications, this and other definitions and concepts in these older pronouncements have remained an important part of the generally accepted accounting principles used in current financial reporting.)

The accounting profession views the basic objective of accounting as providing useful financial information to aid in making business decisions. The following quotation gives another description of the purpose of accounting and the kind of activity it entails:

> Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions--in making reasoned choices among alternative courses of action.[2]

USERS OF ACCOUNTING INFORMATION

The business community generally divides the users of accounting information into two broad groups--external and internal users. *External users* are those groups or individuals who are not directly involved in the operations of the business but who have an interest in the results of operations and the financial position of the business entity. External users include stockholders, creditors, potential owners, prospective creditors, labor union representatives, and governmental agency employees. *Internal users* of financial information include all levels of managers within a business organization who are responsible for planning, organizing, directing, and controlling operations.

Two related but distinct branches of accounting have developed to meet the different needs of the various users of a firm's financial reports. *Financial accounting systems* are designed primarily to provide financial statements to external users for investment, lending, and other decisions. *Managerial accounting systems* are designed primarily to supplement the financial accounting information and to assist managers in making operating decisions. This course is concerned with financial accounting and will emphasize the needs of external users.

The financial statements that have been developed to meet the needs of external users are called *general-purpose statements.* General-purpose statements include balance sheets, which disclose a firm's financial position; income statements, which summarize the results of operations; retained earning statements, which show changes in a corporation's retained earnings; and statements of change in financial position.

THE PROFESSION OF ACCOUNTING

Accountants are employed in three main areas: public accounting, private accounting, and governmental accounting.

Public Accounting

Public accounting firms offer professional services to the financial community for a fee. The main service offered by public accountants is auditing. The purpose of an audit is to lend credibility to a company's financial state-

[2] "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," *Statements of the Accounting Principles Board, No. 4* (New York: American Institute of Certified Public Accountants, 1970), par. 40.

ments. In performing an audit, the public accountant examines a firm's financial statements and the underlying business records from which the statements were prepared to determine that the statements present fairly the company's financial position and operating results and were prepared in accordance with generally accepted accounting principles. The audit services provided by public accountants are often referred to as "the attest function."

In addition to auditing, public accountants often offer management advisory services to clients. These services include designing, installing, and improving a firm's general accounting system, and giving advice in financial planning, budgeting, forecasting, inventory control, and related matters. Public accountants also provide tax services to clients. These include not only the preparation and filing of tax returns but also advice as to how to structure financial transactions so as to minimize taxes.

Private Accounting

When an accountant is employed by a particular business entity, the accountant is said to be engaged in private accounting. Private accountants work in a number of specialized areas, including general accounting, managerial accounting, cost accounting, budgeting, and internal auditing.

General accounting has to do primarily with recording transactions and preparing financial and other reports for managers, owners, creditors, and governmental agencies. *Managerial accounting* provides information to management for use in planning, organizing, directing, and controlling operations. The management accounting system can generate reports that can be used for long-term strategic planning, pricing, performance evaluation, and capital asset investment analysis. Management accounting information makes it possible for managers to manage effectively and efficiently. Both cost accounting and budgeting are activities that come under the umbrella of managerial accounting. *Cost accounting* is concerned with collecting, determining, and controlling costs, particularly the costs of producing a given product or service. The objective of *budgeting* is to provide management with a plan for future operations and, after the plan has been adopted, to provide periodic reports comparing actual performance with the plan. Finally, most large business organizations have an *internal auditing staff*, which reviews the operations of each department or branch to ensure that company policies and procedures are being carried out by the managers.

Governmental Accounting

The procedures and purposes of governmental accounting differ from those in the private sector. Governmental accountants are responsible for the accumulation of data to enable elected and appointed officials to provide governmental services as authorized by municipal, state, and federal legislative bodies. Governmental accounting systems are designed to show that the activities of the agencies were conducted within the applicable laws and regulations and to report fairly the results of the operations. Also, accountants provide specialized skills at federal and state regulatory agencies and governmental taxation divisions.

ORGANIZATIONS CONCERNED WITH THE DEVELOPMENT OF ACCOUNTING PRINCIPLES

In the first quarter of the twentieth century, the formation of large corporations and the introduction of federal and state income tax laws made necessary the development of a body of accounting doctrine to enable absentee owners, creditors, and governmental agencies to assess the financial position and the results of operations of business organizations. The American Institute of Certified Public Accountants (AICPA), which was formed in 1887 as the American Institute of Accountants, is the professional organization of practicing certified public accountants in the United States.

Until 1973 the AICPA, through various committees, issued a number of bulletins, statements, and opinions that established guidelines for reporting the financial activity of business organizations. The most significant statements issued include several Accounting Research Bulletins; four Accounting Terminology Bulletins; and, from 1958 to 1973, thirty-one Accounting Principles Board Opinions. During the 1960s and early 1970s, many vocal and influential business leaders and governmental officials expressed concern that the professional accountants represented too narrow a group to develop principles and standards that affect the entire business community. As a result of this widespread public concern, a study was made; and in 1973 the Financial Accounting Standards Board (FASB) was organized to replace the AICPA's Accounting Principles Board as the organization responsible for establishing and improving financial accounting standards and reporting practices.

The FASB is completely independent of the AICPA. The board consists of seven members and includes public accountants as well as other members of the business community, including financial analysts and business executives. The FASB issues statements of financial accounting standards and interpretations of ones; the interpretations provide explanations and clarifications of previously issued pronouncements, including those of the FASB's predecessors. Since its organization in 1973, the FASB has issued over 30 standards and interpretations, and it has a large number of important topics under consideration.

Two other organizations concerned with the development of accounting theory and practice include the American Accounting Association (AAA.) and the Securities and Exchange Commission (SEC). The membership of the AAA consists primarily of accounting educators. The AAA serves as a forum from which members can discuss issues dealing with basic accounting theory. The Securities and Exchange Commission was created by an act of Congress in 1934. Its primary role is to regulate the issuance and trading of securities by corporations to the general public. The SEC has contributed to the development of accounting doctrine by issuing rules and regulations relating to the financial reports filed by publicly held corporations. The issuance of Accounting Series Releases (ASRs) by the SEC provides opinions on accounting principles that contribute to the development of uniform standards and practices in financial reporting.

FORMS OF BUSINESS ORGANIZATION

Businesses are organized in one of three ways--single proprietorships, partnerships, and corporations. A business owned by one person is called a *single proprietorship*. If a business is owned by two or more people who consider themselves co-owners, the business is organized as a *partnership.* A *corporation* is a form of business incorporated under state law. The owners are called *stockholders* because their ownership is represented by shares of stock issued by the corporation.

The legal characteristics of proprietorships, partnerships, and corporations differ substantially. Each form has advantages and disadvantages. The accounting issues relative to the three forms of business organization are described and discussed in subsequent chapters of this course.

In addition to business organizations, there are other kinds of entities, such as governmental units, trusts, and not-for-profit organizations, that also need accounting systems and financial reporting. The accounting issues relative to these forms of organization, however, are beyond the scope of this course.

KINDS OF BUSINESS ACTIVITIES

Business organizations engage in three kinds of activities--service, merchandising or trading, and manufacturing. To make full use of the information contained in a given set of financial statements, a reader must be aware of the kind or kinds of business activity being reported on by a business entity.

Service enterprises perform services for customers or clients, and earn commissions or fees. Examples of service businesses include public accountants, lawyers, laundries, transportation companies, real estate brokers, repair shops, and theaters.

The function of *merchandising,* or *trading, companies* is the distribution of merchandise. Merchandising concerns, either as wholesalers or retailers, earn revenue by selling goods purchased from other companies. Merchandising firms may provide some services to their customers, but the services are generally incidental or supplemental to the major function of distribution.

Manufacturing companies are like merchandising concerns in that both earn revenue from the sale of commodities or products. However, manufacturing companies differ from merchandising concerns in that a merchandising concern buys the goods it sells in the finished state in which they are sold, while a manufacturing company buys raw materials that it manufactures into the finished products it sells. For example, a furniture store buys furniture and sells the merchandise in the same form in which it was purchased; but a furniture manufacturer buys wood, nails, screws, paint, varnish, and other supplies and works on these raw materials to manufacture salable furniture. Some of the major accounting problems and financial reporting issues relative to service, merchandising, and manufacturing entities are described and discussed later in this course.

SOME BASIC CONCEPTS AND PRINCIPLES UNDERLYING FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

In this section, we will present some essential concepts relating to financial accounting and financial statements. The discussion incudes what the objectives of financial accounting and financial statements are; what the basic features of financial accounting are; and what is meant by the term *generally accepted accounting principles.*[3] Many of the concepts and principles introduced in this chapter will be discussed more fully in later chapters.

Objectives

The basic purpose of financial accounting and financial statements is to provide financial information about individual businesses that can be used in making economic decisions. General and qualitative objectives help to fulfill this basic purpose and provide means for evaluating present and proposed accounting principles.

General objectives determine the appropriate content of financial accounting information. These objectives are to present reliable financial information about the resources and obligations of the enterprise, information on economic progress and other changes in resources and obligations, information helpful in estimating earnings potential, and other financial information needed by users, particularly owners and creditors.

Qualitative objectives refer to certain qualities or characteristics of financial information that make that information useful. Providing information that has these qualities is an objective of financial accounting. Qualitative objectives are:

- *Relevance.* Financial accounting information should relate to the economic decisions for which it is used. Relevance is the primary qualitative objective because information that does not bear on the decisions for which the information is wanted is useless, regardless of how well it satisfies other objectives.
- *Understandability*. Financial accounting information should present data that can be understood by the users of the information. It should be expressed in a form and with terminology adapted to the users' range of understanding.
- *Verifiability*. Financial accounting information should provide results that would be substantially duplicated by independent measurers using the same measurement methods.
- *Neutrality*. Financial accounting information should be directed toward the common needs of users. It should be free of presumptions about the particular assumptions and desires of specific users of the information.
- *Timeliness.* Financial accounting information should be ready early enough to be used in making the economic decisions that it relates to. Also, its

[3] The material discussed in this section has been taken from *AICPA Professional Standards, Volume* 3, Section 1022, par. 13-24; and Section 1024, par. 15-22 (New York: American Institute of Certified Public Accountants, 1977).

delivery should not cause delays in making those decisions.

- *Comparability.* Financial accounting information should present similarities and differences that arise from basic similarities and differences in the enterprise or enterprises and their transactions, not merely from differences in financial accounting treatment.
- *Completeness.* Financial accounting information should include all financial accounting data that reasonably fulfill the requirements of the other qualitative objectives.

Basic Underlying Assumptions of Financial Accounting

Financial statements are prepared under some basic underlying assumptions, which are listed below:

- The existence of an accounting entity. Economic activities of individual entities are the focus of financial accounting.
- The assumption of a going concern. Continuation of the operations of the entity is usually assumed in financial accounting (in the absence of evidence to the contrary).
- Measurement of economic resources and obligations. Financial accounting is concerned primarily with measurement of economic resources and obligations, and changes in them.
- Time periods. Financial accounting presents information about activities for relatively short time periods.
- Measurement in terms of money. Financial accounting measures in terms of money.
- Accrual. Determining periodic income and financial position depends on measurement of noncash resources and obligations.
- Exchange price. Financial accounting measurements are based primarily on exchange prices.
- Approximation. Approximations are inevitable in allocations required in financial accounting.
- Judgment. Financial accounting requires informed judgment.
- Quality of financial information. Financial accounting presents general-purpose financial information.
- Relation of financial statements. Statements of financial position and income and statements of cash flow are fundamentally related.
- The principle of substance over form. Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment.
- Materiality. Financial reporting is only concerned with significant information.

Generally Accepted Accounting Principles

Generally accepted accounting principles incorporate the consensus at any time as to which economic resources and obligations should be recorded as assets and liabilities; which changes in them should be recorded; when these changes should be recorded; how the recorded assets, liabilities, and changes in them should be measured; what information should be disclosed; how it should be disclosed; and which financial statements should be prepared.

Accounting principles determine the operation of the financial accounting process. These principles have developed from experience, reason, and custom; they become generally accepted by agreement (often tacit agreement) and are not formally derived from a set of postulates. Present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue. Because the principles are conventional and have been developed in relation to a specific environment and with assumptions about needed financial information, they are all subject to review, evaluation, and possible change.

AN OVERVIEW OF THE COURSE

This chapter provided an introduction to accounting principles and the role of accounting in business. Chapters Two and Three describe the purpose and content of three of the four general-purpose financial statements--the balance sheet, the income statement, and the statement of retained earnings. Chapter Four explains and illustrates the process whereby financial transactions are recorded and summarized. Chapter Five discusses the procedures used to prepare adjusting and closing entries and the sequential steps in the accounting cycle. Chapter Six examines the accounting problems merchandising and manufacturing companies have in dealing with merchandise inventory, the goods held for sale to customers. Chapter Seven discusses the nature and valuations of plant assets and the various methods of depreciating those assets. Chapter Eight describes the major kinds of obligations included in long-term liabilities and discusses the major components of the owners' equity section of the balance sheet. Chapter Nine explains the content and significance of the fourth general-purpose financial statement--the statement of cash flows. The second part of Chapter Nine provides an introduction to analyzing and interpreting financial statements.

SUMMARY

Despite the fact that the accounting principles guide accountants when recording, classifying, and summarizing the economic events of an enterprise, accounting is more of an art than a science. Although much of accounting is based on objective evidence, it also requires judgment and approximations. Accounting principles are the result of an evolutionary process that can be expected to continue just as the environment in which business operates continues to change.

Accounting is a service activity that exists to provide quantitative information to users who need to make decisions. The users of accounting information include external and internal users. External users include both prospective and current investors and creditors along with labor unions and governmental agencies. The audience for internal accounting is the managers of the firm. Managers use accounting information to plan, organize, direct, and control the organization. Both internal and external users can have confidence in relying on financial data because of the generally accepted concepts and principles that underlie the preparation of accounting data. These concepts and principles help to insure that financial reports are useful and relevant and therefore, crucial to the efficient operation of an economic system.

Review Questions

1. Accounting is a science that follows natural laws.
   ( ) True
   ( ) False

   1. False

2. The users of accounting information fall into two broad groups: _______ and _______ users.

   2. external ...internal

3. The financial statements that have been developed to meet the needs of external users are called __________ statements.

   3. general-purpose

4. The main service offered by public accountants is __________ ; two other services offered by public accountants are __________ services and __________ services.

   4. auditing... management advisory... tax

5. When an accountant is employed by a particular business entity, the accountant is said to be engaged in ________________________

   5. private accounting

6. The professional organization of practicing certified public accountants in the United States is known as the ____________________

   6. American Institute of Certified Public Accountants (AICPA)

7. The ____ is the organization responsible for the establishment and improvement of financial standards and reporting practices. — 7. Financial Accounting Standards Board (FASB)

8. Businesses are organized in one of three ways: ____________________ ____________ and ______________________________ — 8. single proprietorships...partnerships ... corporations

9. Business organizations engage in three kinds of activities: ________________________ and ______________________________ — 9. service ...merchandising or trading... manufacturing

10. Manufacturing companies are like merchandising concerns in that both ____ — 10. earn revenue from the sale of commodities or products

11. The basic purpose of financial accounting and financial statements is ____ ____ ____ — 11. to provide financial information about individual business enterprises that is useful in making economic decisions

12. The primary qualitative objective of financial accounting is __________________ — 12. relevance

13. The basic features of financial accounting are determined by the characteristics of the environment in which financial accounting operates. — 13. True

( ) True

( ) False

14. Materiality implies that ____ ____ ____ — 14. financial reporting is only concerned with significant information

15. Present generally accepted accounting principles are the result of an evolutionary process that can be expected to continue. — 15. True

( ) True

( ) False