INTRODUCTION TO ACCOUNTING

Accounting has been defined in many ways. Probably each one of us has an implicit definition of what accounting is in our minds that is based on our experiences to date. For our present purposes we may define it as:

(a) an information system that
(b) collects data about organizations and
(c) reports to people.

Immediately flowing from this definition are a number of questions that need answering.

1. Who are these people who want information?
2. How do they use this information?
3. Which information do they want, i.e., what data should be collected?
4. What does the information system look like? Answering these questions and adding flesh to the definition will absorb the entire course. We can, however, begin to provide some answers now.

1) Users: We shall for the most part deal with for-profit organizations, specifically the large publicly owned, limited liability corporations. The people who are interested in information about such corporations include

(a) the IRS: What was income for tax purposes?
(b) creditors: Is the company solvent? Can it meet its debts?
(c) present owners: What dividends can be expected?
(d) future owners: Should they invest by buying shares?
(e) present managers: Is the company being run efficiently?
(f) future managers: Is the company ripe for a takeover bid?

Two things should be noted. One is that the users fall into two broad groups – the internal users and the external users. The second is that accounting information has no single use -- a report designed for a bank manager may not satisfy an owner and vice-versa.

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1 The term financial accounting usually refers to reporting for external users while the terms managerial or cost accounting refer to reporting for internal users.

2 In particular, many corporations keep separate records for the IRS – not with an intent to deceive but simply because the IRS wants different information from shareholders.
2) **Decisions:** Each of these users presumably uses accounting data. To use data implicitly means to use it in a decision. In other words, a creditor does not simply ask “Is a company solvent?,” but “Should we lend it money?” Put another way every user of accounting information is involved in decisions and requires information to make these decisions.

This enables us first to distinguish between data and information. Data is a set of symbols, e.g. AOQR16y2. Information is data which is of value in making a decision. The value of the information is the amount the decision maker is prepared to pay for it in making the decision. Consider, by way of example, Idaho farmers. Weather forecasts for Argentina may be data to them. On the other hand, weather forecasts for Idaho might be information. If they know what weather to expect they can presumably make more money by planting a more suitable crop than they would without the forecast. Rationally they should be willing to turn over at least some of their expected extra profits for this information. The amount they might be willing to pay is the value of the information.

Several important concepts emerge from this. Data remains data regardless of its objectivity, reliability, accuracy, etc., etc. Data becomes information only when it has value, i.e. when it can be used in a decision. You should therefore always think of accounting in terms of what decision this information will be used for – if any.

Secondly, accounting information is a free good for most external users, who quite rationally then want as much of it as they can get. It is after all free! On the other hand, managers of firms perceive that production of information has a real cost. Rationally, therefore, they try to limit its production. The result is an inevitable conflict. One result is a heavy government and regulatory influence on the production of information. Most of accounting in fact revolves around laws and regulations that force the production of information. The organizations that are involved in regulating accounting are the SEC, the AICPA, the FASB, the CASE, the AAA, the NAA, the FEI, Congress itself, and until recently the APB. You should know broadly who each of these are.

Thirdly, if one wants to evaluate what information should be produced, one should do a cost-benefit analysis. The problem here is that different users have different benefits. For example, the public at large might want to know the details of oil companies' oil reserves. This might make them less competitive and result in lower profits and hence dividends to existing shareholders. One group in society, therefore, benefits at the cost of another. Clearly what results is a political problem. It is in fact important to remember at all times the political dimension in accounting.

3) **Accounting Information:** There is much disagreement at the detailed level on what accounting data should be collected and reported. However, at the broad level there is general agreement that users want to know.
(a) What is the value of the company?
(b) What income did it earn?
(c) How much cash and liquid assets does it have?
(d) What obligations has it incurred?
(e) Where did it get its funds, e.g., by borrowing or from profits?
(f) How did it use its funds, e.g., to pay dividends, invest in new plant?

All this raises a number of new questions, e.g.

(a) What is value?
(b) What is income?
(c) What are assets? What are liquid assets?
(d) What are liabilities or obligations?
(e) What are funds?

These and many other items will have to be defined very carefully later. For the moment we can continue to attach our common sense notions to them.

4) **The Accounting System:** Over the years, a fairly standard set of reports has evolved that might be called the accounting information system. These are

(a) a balance sheet that broadly speaking reflects the value of a company at a point in time, its assets and its liabilities, and its basic solvency.

(b) an income statement that reports income earned.

(c) a cash flow statement that reports the source and use of funds.

Each of these will be discussed in depth during the course. These appear four times a year — four quarterly reports and one annual report. The annual report is accompanied by an auditors’ statement to the effect that the company has produced information in accordance with GAAP. You have an annual report which you should now study.

**Summary:** Accounting is information that goes to a variety of users. These users presumably find it of value in making decisions. The question at all times is what use might this particular piece of data have for a potential user.