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Objective A

So What?

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Last winter, Tucker and Ian started a lawn-mowing and snow-shoveling service. Although they did well initially, business slowed down when summer arrived. Many past clients (who had hired them to clear snow off their driveways) chose to mow their own yards. Luckily, though, a few residents wanted the boys to mow their lawns instead of doing the work themselves.

To mow these yards, Tucker and Ian needed gasoline for their mowers. Just as they had done many times before, they opened the jar to get their money for the gas. Unfortunately, they only found two dollars inside! Why? Because they had simply put money in when they earned it and taken money out when they needed it—to print advertisements, purchase gasoline, and pay themselves—without keeping track of how much money they actually had. As a result, they weren't able to mow anyone's grass. Soon after, they went out of business. What important business function had the boys overlooked? Accounting. Wise business owners know that accounting is a "must" for high profits—and business success!

Objectives

A Describe the importance of accounting to an organization.

B Explain basic accounting activities.

Watch the Bottom Line

What is accounting? Accounting, which is both a basic business function and a career choice, is the process of keeping financial records. Most of us practice some form of accounting in our daily lives, even if we don't think of it as accounting. We keep records of our personal funds and our debts so that we know how much money we have and how much we owe.

Suppose for a moment that it's your birthday, and your Uncle Pete gives you a check for $20. If you deposit it in your savings account, write the amount in your savings book, and calculate the new total, you are doing personal accounting. If you are saving for an automobile, knowing how much is in your savings account helps you determine how much more you need to save before you can purchase the car of your dreams.

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Accounting isn't just for businesses. Most individuals also practice some form of accounting in their daily lives.

Businesses use accounting to keep track of the value of the things they own, the accounts owed to them, and the amounts that they owe to others. Without accurate financial records, businesses would not know if customers were paying their bills and cash was coming into the business. They would not know how much money they had to buy supplies or pay employees. If they didn't keep track of their money, they would have the same problem you would have if you didn't keep track of your money. One day you might need cash to buy a concert ticket, but there is no money in your account.

Objective

Keep Control

It's easy to see why accounting is so important. Businesses cannot be successful and make good financial decisions unless they maintain control of their money. That's the overall purpose of accounting—to control finances by keeping accurate financial information. But, how do businesses use that accounting information to maintain financial control? There are two main ways:

- **By tracking the business's performance**
  Keeping accurate accounting records shows the business how it is doing. A business reviews this information to find out if it is earning a profit, what its sales revenues are, the amount of operating expenses, the cost of goods sold, return on investments, and the company's net worth or total value. Then, businesses use this information to determine if they are meeting their goals, to obtain loans, to calculate taxes, and to identify sales trends. Based on this information, businesses can make changes to stay in good financial shape.

- **By planning for the future**
  Businesses are always looking ahead. As a result, they need accurate accounting records to plan for the future. Most businesses want to grow, expand, increase sales, and earn higher profits. To do this, they use accounting information to estimate income and expenses in the future based on income and expenses for previous years. Keeping good records will help a business allocate specific amounts to expand its market, increase its staff, enlarge its product mix, or increase its promotional efforts.

Businesses use accounting to track their performance, plan for the future, and, ultimately, to maintain financial control.

Use the Data

Accounting information is valuable to people and groups both inside and outside the business. However, the type of accounting information that they use is different, and their reasons for studying financial information varies, as well.

Inside the business, managers are the primary users of accounting information. It should be no surprise, then, to learn that the type of accounting that involves reporting financial data to internal users is called **managerial accounting**. Managers use managerial accounting information—often in the form of custom-designed financial reports—to control day-to-day operations and to make financial decisions and plans that affect the business. For example, managers use managerial accounting information to decide if there is enough money available to develop more advertising, give pay raises, or hire more employees. The managers decide how to spend the business's money based on managerial accounting information.

Outside the business, the three main groups that use accounting information are investors, creditors, and the government. These external users utilize **financial accounting** information (usually presented in financial statements) in a number of ways. Let's examine each external group separately because they all use accounting information differently.

Investors. These are the people who have invested their money in a business, the stockholders. They use a business's financial accounting information to find out if the business will pay them a good return on their investment. Stockholders are interested in a business's profit information because it indicates if the business will be able to pay dividends.

Most large businesses publish their accounting information annually for stockholders and potential investors to review.

Investors also check out a business's financial accounting information before deciding to buy stock. They usually read annual reports or other financial reports to decide if a business is successful and growing. Most investors are looking for profitable businesses that have a bright future.

Creditors. Creditors are the individuals or businesses to whom a business owes money, or from whom it wants to borrow money. Therefore, creditors examine a business's financial accounting records to make decisions about extending credit. For example, if a business applies for a bank loan, the bank studies the business's financial accounting information to determine its financial status. The bank grants or denies the loan based on this information. If the business is profitable and will continue to be profitable, the bank will probably agree to the loan.

The government. Different governmental agencies review a business's accounting records for different reasons. Those agencies that collect taxes might audit the business's records to determine if the business is correctly calculating and paying taxes. Other agencies might review the records to obtain information about industry trends and to make economic forecasts. Still other agencies might use the records to find out if the business is complying with various regulations.

Summary

Accounting is a business activity that involves keeping financial records. The purpose of accounting is to control finances. Businesses use accounting to keep track of their performance, what they own, and what they owe. They also use accounting to plan for the future. Several groups use a business's accounting information. These include the business's managers, who use managerial accounting information, as well as investors, creditors, and the government, who all utilize financial accounting information designed for users outside the business.

1. What is accounting?
2. Why is accounting important to businesses?
3. Explain each of the following ways that accounting information is used to maintain financial control:
    a. Tracking the business's performance
    b. Planning for the future
4. Explain how each of the following groups makes use of a business's accounting information:
    a. Managers
    b. Investors
    c. Creditors
    d. The government

The Gray Zone

Jeffrey works as an accountant for Ride-go, a multi-million dollar toy company with a less than stellar past. Three years ago, Ride-go's chief executive officer (CEO) was charged and convicted for improperly using millions of dollars of the toy giant's money—money which ultimately belonged to the company's investors. Most famously, he spent two million dollars for a Roman-themed birthday party for his wife.

Unfortunately, history seems to have repeated itself. The crooked CEO's replacement held the company's most recent board meeting in the Bahamas at a luxury resort. Based on the paperwork that Jeffrey has in front of him, the five-day "meeting," which included a tattoo artist, mermaids, and fire dancers, cost $350,000. Given this information and past experience, should Jeffrey approve payment for the trip? (After all, the board did in fact hold its meeting while in the Bahamas.) Or, should Jeffrey refuse to use company funds to pay for what was obviously a party?

It's All in the System

John Foxx/Stockbyte/Thinkstock

Just as a person's medical records can be used to determine the state of his/her health, a business's accounting records show the financial health of the business.

A business's accounting records show its financial health—whether the business's health is stable, improving, or declining. To provide a meaningful reading on its health status, a business must make sure that everyone involved with the records follows the same methods or procedures. In effect, a business sets up an accounting system, a consistently applied process for handling its financial information. This enables records' users to understand and accurately interpret the numbers.

Would you expect doctors to diagnose a patient's health problems using outdated, inaccurate information? I hope not. Businesses, too, cannot determine their financial situation if the accounting systems are based on old, inaccurate information. To be useful and meaningful, accounting systems' information must be accurate and up to date.

Not surprisingly, the best accounting system meets a business's specific needs and requirements. Since businesses differ, accounting systems also vary. The system that works for a small gift shop, for example, probably won't work for a billion-dollar corporation. However, any accounting system should fulfill certain requirements.

- **Be easy to use**

  The system should be easy to use, regardless of whether a store owner records the information by hand or a large accounting department enters the information on computers. If it is hard to use, people might make mistakes or not be able to keep the information current.

- **Process data quickly**

  Businesses often need up-to-date financial information on short notice, such as to apply for a loan. Therefore, the system should be able to process the data quickly so financial statements can be available at any time.

> If a business suddenly needs a short-term loan, it will need an up-to-date financial statement immediately to present to the creditor.

- **Be expandable**

  Since most businesses plan to grow, the accounting system should be able to grow with them. Today, most systems are computerized. When selecting a system, businesses should buy one that can be enlarged as needed to handle additional information.

- **Be affordable to operate**

  Some systems are less expensive to operate than others. Businesses should select one that meets their needs, but not one that's more costly than necessary. For example, a small business owner might need only a simple accounting software program. In that case, spending money to hire an accountant would be unnecessary.

- **Protect the business**

  Theft and fraud are always concerns in business. However, an effective system will make it difficult for anyone to enter false information or change accounting information to steal a business's funds. Also, the system should warn the business of potential problems. For example, the system should make it easy for the business to see that it has too much capital invested in inventory.

Objective B

Follow the Steps

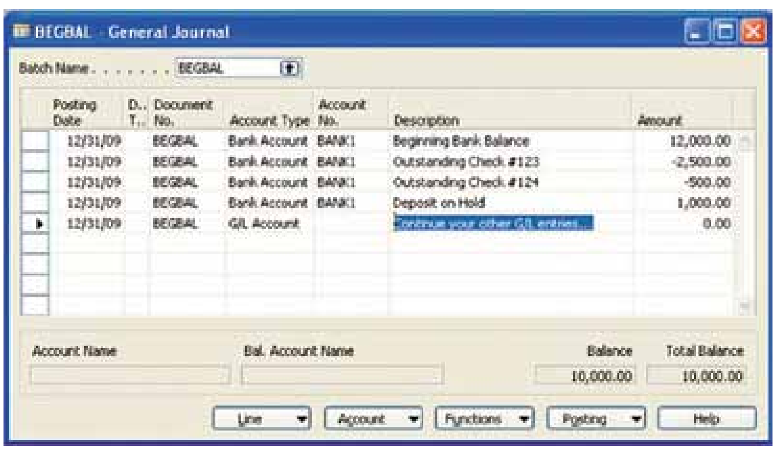
Businesses typically complete a series of several steps—a process called the **accounting cycle**—to maintain their financial records effectively. The steps of the accounting cycle must be completed in a certain order. However, a business can perform each step in the way that is best for it. The major steps of the accounting cycle include:

- **Analyzing financial transactions.** The accounting process begins with the collection of source documents—checks, receipts, invoices, purchase orders, etc.—for the business's financial transactions, which can include sales, purchases, or returns. After collecting this documentation, the business analyzes each transaction, determines the transaction amount, and identifies the accounts that the transaction affects.

- **Journalizing transactions.** The next step in the cycle involves recording each transaction in the appropriate journal. A journal is a special book or computer program in which transactions are recorded in the order that they occur. Today, most businesses use specialized accounting computer programs to enter, store, and analyze financial information. However, some smaller businesses still journalize transactions by hand. Regardless, businesses often use sales journals to record daily receipts and disbursement journals to record daily expenditures.


Stockbyte/Stockbyte/Thinkstock

Checks, receipts, invoices, and purchase orders are examples of source documents that are reviewed during the first step of the accounting cycle.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Batch Name . . . . BEGBAL

Posting Date	D.. T..	Document No.	Account Type	Account No.	Description	Amount
12/31/09		BEGBAL	Bank Account	BANK1	Beginning Bank Balance	12,000.00
12/31/09		BEGBAL	Bank Account	BANK1	Outstanding Check #123	-2,500.00
12/31/09		BEGBAL	Bank Account	BANK1	Outstanding Check #124	-500.00
12/31/09		BEGBAL	Bank Account	BANK1	Deposit on Hold	1,000.00
12/31/09		BEGBAL	G/L Account		Continue your other G/L entries...	0.00

Account Name · Bal. Account Name · Balance 10,000.00 · Total Balance 10,000.00

Line · Account · Functions · Posting · Help

Businesses use journals to record financial transactions in the order in which they occur.

Businesses typically use one of two accounting methods to record transactions in their journals: the cash accounting method or the accrual accounting method. The difference between the two methods is the time at which the business records transactions. Let's take a closer look at each one.

Cash accounting method. Businesses using the cash accounting method record income and expenditures at the time the money changes hands. This means that the business enters the amount of a transaction into one of its journals on the day the money is received from a customer or paid out to a creditor. For example, a business sells a product to a customer and agrees to send the customer an invoice. The business doesn't record the income until the customer pays the bill. The same goes for the business when it buys supplies from a vendor on credit. The business records the expense when it pays the vendor rather than when it places the order.

The cash accounting method is easy to use and popular with small businesses. A lot of businesses that do not offer credit use this system because it tracks the actual amount of cash that the business has on hand. For example, a business that accepts only cash or personal checks would use this system because it receives the money from customers at the time of purchase. Maybe this business also offers cash-on-delivery (COD) service that allows customers to order a product and pay for it when the item is delivered. Then, the business records the transaction on the day of delivery rather than the day the customer ordered the item. The business doesn't record the sale until it actually receives payment from the customer.

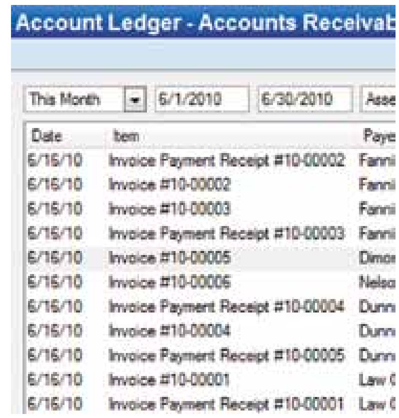
Accrual method. Businesses using the accrual accounting method journalize income and expenditures at the time they occur even if no money changes hands at that time. This means that the business enters the amount of a transaction into the appropriate journal when a customer makes a credit purchase, or when the business orders goods from a supplier.

MANY ACCOUNTING PROGRAMS COMBINE THE PROCESS OF JOURNALIZING AND POSTING TRANSACTIONS, MEANING THAT ONLY ONE ENTRY—NOT TWO—IS REQUIRED.

No money changes hands at the time, but the business's records indicate the transaction as either income or an expense. For example, a business sells an item on credit and sends the customer an invoice. The business records the amount of the sale that it will receive sometime in the future.

This method is often used by large businesses and by businesses that offer credit. Think Target and Wal-Mart! Since these businesses generally buy and sell on a credit basis, the accrual method allows them to track sales and expenses instead of the amount of cash received or paid out. For example, a business sells $20,000 worth of goods on credit in March and will receive payment in April. The accounting records for March show sales of $20,000, even though the business does not have the money.

- **Posting to ledgers.** The information that has been recorded in the journal must be sorted and posted to the correct ledger, which is an accounting record for a specific department or area of the business. In a large business, for example, all of the sales recorded in the sales journal need to be classified by department. The total sales for each department would then be posted, or transferred, to that department's ledger. By reviewing the business's ledger(s), managers and business owners can get a better feel for the firm's overall financial situation.



After journalizing transactions, businesses sort and post these transactions to the proper ledger.

- **Balancing the books.** After posting journal entries to the business's ledger(s), a trial balance is prepared. A trial balance is a listing of the business's different accounts and their current balances, found in the different ledgers. The trial balance is done to check the accuracy of journal and ledger entries.

  The first four steps of the accounting cycle—analyzing financial transactions, journalizing transactions, posting to ledgers, and balancing the books—are all aspects of **bookkeeping**. Bookkeeping must be carried out on a daily basis, and much of it is now done on computers. While the basic responsibility of bookkeepers is to make an accurate record of each business transaction, accountants are responsible for preparing financial statements and closing the books.

- **Preparing financial statements.** Accounting information by itself is not very useful. Businesses need to summarize the information and put it in a form that can be easily read and understood. In fact, there are certain rules, called accounting standards, which accountants must follow when preparing financial statements. In years past, the most widely used accounting standards in the United States were the Generally Accepted Accounting Principles (GAAP). However, there is currently a push in the U.S. accounting community to transition to the International Financial Reporting Standards (IFRS), a global set of accounting standards that is popular internationally. As a result of accounting standards, the format used to prepare and present financial data is consistent from company to company—making comparisons of the financial conditions at multiple organizations possible. Three of the most important financial statements are the balance sheet, the income statement, and the cash flow statement.

  Balance sheet. The balance sheet captures the business's financial condition at a particular moment—somewhat like a photograph captures just one second of time. Although this means that the balance sheet is accurate for only that time, it is still important to prepare this report. Businesses need to know how they are doing on a regular basis, and preparing a balance sheet is the best way to do that.

"The books" is a term that means a business's accounting records. The term dates back hundreds of years to the days when accounting information was recorded by hand in an actual book. These records were referred to as the business's books.

The balance sheet presents three important categories of financial information: assets, liabilities, and owner's equity. Assets are anything of value that the business owns, such as cash in the bank, buildings, and equipment. Liabilities, on the other hand, are debts that the business owes. Finally, owner's equity is the amount the owner has invested in the business, plus or minus profits and losses. These three categories are the components of the basic accounting equation: Assets – Liabilities = Owner's Equity. The balance sheet gets its name from the fact that the sides of the equation must balance each other.

Income statement. The income statement, sometimes called the profit-and-loss statement, shows how much money the business has made or lost during a specific period of time, usually one year. For a large merchandising business, this figure is determined by first subtracting cost of goods from net sales to determine gross profit. Then, total expenses are subtracted from gross profit to determine net profit or loss. A small service business, on the other hand, is likely to determine net income by merely subtracting operating expenses from sales revenue.

Cash flow statement. A cash flow statement is a financial summary estimating when, where, and how much money will flow into and out of a business during a specific period of time. Managers need to know when money will flow in and out of the business so that they can prepare for any periods of time when the business will be low on cash. By preparing a cash flow statement, the business can also identify different sources of cash and determine which of these sources are more or less likely to make payments to the business as promised. Lastly—but most importantly—the cash flow statement indicates how much cash is expected to flow into the business in the given time period. If the business knows that there will be a cash shortage during a certain month or quarter of the year, for instance, it can plan ahead to generate more income and/or reduce expenses.

- **Closing the books.** The final step of the accounting cycle involves closing any temporary accounts and transferring the temporary account balances to permanent accounts such as owner's equity. After closing the books, the accounting-cycle process starts over again.

Make It Pay!

Consider for a minute your school-based enterprise's or career and technical student organization's accounting system. Who is responsible for keeping its books? Do the individuals responsible for accounting activities follow a specific process? What is that process? Who uses this financial data? How could the accounting system be improved?

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Summary

An accounting system is the process used in handling the business's financial information. To be effective, the system should be easy to use, process data quickly, be expandable and affordable, and protect the business. The steps in the accounting cycle involve analyzing financial transactions, journalizing transactions, posting to ledgers, balancing the books, preparing financial statements, and closing the books.

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1. What is an accounting system?
2. Explain the five characteristics that are common to all effective accounting systems.
3. What are the steps of the accounting cycle?
4. Explain the difference between the cash accounting method and the accrual accounting method.
5. What is the purpose of accounting standards?
6. What is the purpose of each of the following financial statements:
   a. Balance sheet
   b. Income statement
   c. Cash flow statement