Chapter 15: The Role of Accountants and Accounting Information

Chapter Overview

Every organization relies on accounting information and financial statements in order to gauge business activity over periods of time. Accounting information can be thought of as a measuring stick of an organization's performance in specific periods of time.

This chapter unfolds with a discussion of the role of accountants and an explanation of the types of accountants in the U.S. business system—public accountants, private accountants, management accountants, and forensic accountants. In addition, the chapter discusses the accounting equation as well as the three basic financial statements, showing how they reflect the activity and financial condition of a business. It also looks at the key standards and principles for reporting financial statements and describes how computing financial ratios can help users get more information from financial statements to determine the financial strengths of a business. Finally, the chapter ends with a discussion of the role of ethics in accounting—a subject that has received much press in recent years.

Learning Objectives

15-1. Explain the role of accountants and distinguish among the kinds of work done by public accountants, private accountants, management accountants, and forensic accountants.

15-2. Describe the purpose of the International Accounting Standards Board and explain why it exists.

15-3. Explain how the accounting equation is used.

15-4. Describe the three basic financial statements and show how they reflect the activity and financial condition of a business.

15-5. Explain the key standards and principles for reporting financial statements.

15-6. Describe how computing financial ratios can help users get more information from financial statements to determine the financial strengths of a business.

15-7. Discuss the role of ethics in accounting.

CHAPTER OUTLINE

Learning Objective 15-1

Explain the role of accountants and distinguish among the kinds of work done by public accountants, private accountants, management accountants, and forensic accountants.

What is Accounting, and Who Uses Accounting Information?

Accounting is a comprehensive system for collecting, analyzing, and communicating financial information that is used to prepare financial statements and management reports. **Bookkeeping** is just one phase of accounting—the recording of transactions. Because businesses engage in thousands of transactions, ensuring consistent, dependable financial information is mandatory. This is the job of the **accounting information system (AIS)**—an organized procedure for identifying, measuring, recording, and retaining financial information so that it can be used in accounting statements and management reports. **Users of accounting information include business managers, employees and unions, investors and creditors, tax authorities, and government regulatory agencies (read slides).**

The **controller** manages a firm's accounting activities. As chief accounting officer, the controller ensures that the AIS provides the reports and statements needed for planning, controlling, decision making, and other management activities.

A. Financial versus Managerial Accounting

1. **Financial Accounting.** A firm's financial accounting system is concerned with external information users—the firm's external stakeholders: consumer groups, unions, stockholders, suppliers, creditors, and government agencies. It prepares reports such as income statements and balance sheets that focus on the activities of the company as a whole rather than on individual departments or divisions.

2. **Managerial Accounting.** Managerial (management) accounting serves internal users. Managers at all levels need information to make departmental decisions, monitor projects, and plan future activities. Other employees also need accounting information. Engineers must know certain costs, for example, before making product or operations improvements, purchasing agents use information on materials costs to negotiate terms with suppliers, and to set performance goals, and salespeople need past sales data for each geographic region and for each of its products.

B. Certified Public Accountants (CPAs)

Certified public accountants (CPAs) offer accounting services to the public, whether a business or individual client. They are independent from the clients they serve. They are licensed by a state after passing an exam prepared by the American Institute of Certified Public Accountants (AICPA).

1. **The "Big Four" Public Accounting Firms.** The "Big Four" public accounting firms, Deloitte Touche Tohmatsu (United States), Ernst & Young (United Kingdom), PricewaterhouseCoopers, PwC (United Kingdom), and KPMG (Netherlands) account for one-half of the total revenue generated by accounting firms active in the United States.

2. **CPA Services.** Most CPA firms provide auditing services, tax services, and management services.

a. **Auditing.** An **audit** examines a company's AIS to determine whether financial reports reliably represent its operations; an audit must follow **generally accepted accounting principles (GAAP),** which are the guidelines governing the content and form of financial reports.

b. **Tax Services.** Tax services include assistance not only with tax-return preparation, but also with tax planning.

c. **Management Advisory Services.** Management advisory services range from personal financial planning to planning corporate mergers.

3. **Noncertified Public Accountants.** This category includes accountants who do not take the CPA exam, who are preparing for it, or who are waiting for state certification.

4. **The CPA Vision Project.** The CPA Vision Project is a profession-wide program that was established to assess the future of accounting; a prime reason for the project is the decline in the number of people who have entered the profession in recent years. The CPA Vision Project identifies core competencies for accounting that will be necessary for the future CPA.

C. Private Accountants and Management Accountants

Private accountants are hired as salaried employees of a firm who perform day-to-day activities. Management accountants provide services to support managers in various activities. Many hold the **certified management accountant (CMA)** designation.

D. Forensic Accountants

Forensic accounting is the use of accounting for legal purposes. Forensic accountants may be called on by law enforcement agencies, insurance companies, or law firms for investigative accounting and litigation support in crimes against companies, crimes by companies, and civil disagreements.

1. **Investigative Accounting.** Investigative accounting involves the investigation of a trail of financial transactions behind a suspected crime.

2. **Litigation Support.** Forensic accountants assist in the application of accounting evidence for judicial proceedings by preparing and preserving evidence for these proceedings, testifying as expert witnesses, and in determining economic damages in any case before the court.

a. **Certified Fraud Examiners.** The Certified Fraud Examiner (CFE) designation is administered by the Association of Certified Fraud Examiners; the CFE's activities focus specifically on fraud-related issues, including fraud prevention and deterrence, financial transactions, fraud investigation, and legal elements of fraud.

Learning Objective 15-3:
Explain how the accounting equation is used.

The Accounting Equation

Underlying all record-keeping procedures is the most basic tool of accounting—the **accounting equation.**

The accounting equation states that **Assets = Liabilities + Owners' Equity.**

A. Assets and Liabilities
An asset is any economic resource that is expected to benefit a firm or an individual who owns it; a liability is a debt that the firm owes to an outside organization.

B. Owners' Equity
Owners' equity refers to the amount of money that owners would receive if they sold all assets and paid all debts. Assets - Liabilities = Owners' Equity.

Learning Objective 15-4:

Describe the three basic financial statements and show how they reflect the activity and financial condition of a business.

Financial Statements
Accountants summarize the results of a firm's transactions and issue reports to help managers make informed decisions. Among the most important reports are financial statements, which fall into three broad categories—*balance sheets, income statements,* and *statements of cash flows*.

A. **Balance Sheets**
Balance sheets display a firm's financial condition at one point in time. They supply information about assets, liabilities, and owners' equity.

1. **Assets.** An *asset* is any economic resource that a company owns and from which it expects to get some future benefit.

a. **Current Assets.** Current assets include cash and assets that can be converted into cash within a year. The act of converting something into cash is called *liquidating*. Assets are normally listed in order of **liquidity**—the ease of converting them into cash. Typically, assets range from cash to marketable securities to merchandise inventory.

b. **Fixed Assets.** Fixed assets, including land, buildings, and equipment, have long-term use or value. Accountants use **depreciation** to spread the cost of an asset over the years of its useful life.

c. **Intangible Assets.** Intangible assets have monetary value in the form of expected benefits. These usually include the cost of obtaining rights or privileges, such as patents, trademarks, copyrights, and franchise fees. **Goodwill** is the amount paid for an existing business beyond the value of its other assets.

2. **Liabilities. Current liabilities** are debts that must be paid within one year. **Accounts payable** are unpaid bills to suppliers for materials as well as wages and taxes that must be paid in the coming year. **Long-term liabilities** are debts that are not due for at least a year.

3. **Owners' Equity.** Owners' equity is broken down into *paid-in capital* and *retained earnings*. **Paid-in capital** is additional money invested in the firm by its owners. **Retained earnings** are net profits kept by a firm rather than paid out as dividend payments to stockholders.

B. **Income Statements**

The income statement is sometimes called a **profit-and-loss statement** because its description of revenues and expenses results in a figure showing the firm's annual profit or loss.

Profit (or Loss) = Revenues - Expenses

1. **Revenues.** Revenues are funds that flow into a business from the sale of goods or services.

2. **Cost of Revenues (Cost of Goods Sold).** The cost of revenues section shows the costs of obtaining the revenues from other companies during the year (used for service providers). Cost of goods sold are costs of obtaining materials to make products sold during the year (used for goods producers).

a. **Gross Profit.** Gross profit is calculated by subtracting the cost of revenues from revenues obtained by selling the firm's products.

b. **Operating Expenses.** Operating expenses are resources that must flow out of a company if it is to earn revenues. Expense categories include research development, selling, administrative, and general expenses.

3. **Operating and Net Income.** Operating income compares the gross profit from operations against operation expenses. Net income (**net profit** or **net earnings**) is calculated by subtracting income taxes from operating income.

C. Statements of Cash Flows

Required of all firms whose stock is publicly traded, the statement of cash flows shows a company's yearly cash receipts and cash payments. This statement shows cash flows from operating, investing, and financing activities.

D. The Budget: An Internal Financial Statement

A budget is a detailed statement of estimated receipts and expenditures for a future period of time.

Learning Objective 15-6:

Describe how computing financial ratios can help users get more information from financial statements to determine the financial strengths of a business.

Analyzing Financial Statements

Financial statements provide data, which can reveal trends and be applied to create various *ratios*. These trends and ratios can be used to evaluate a firm's financial health, its progress, and its prospects.

A. **Solvency Ratios: Borrower's Ability to Repay Debt**

Solvency ratios provide measures of the firm's ability to meet its debt obligations. They can be used to estimate short-term and long-term risk.

1. **The Current Ratio and Short-Term Solvency.** Short-term solvency ratios measure a company's liquidity and its ability to pay immediate debts. The most commonly used of these is the current ratio, which measures a company's ability to meet current obligations out of current assets. It is calculated by dividing current assets by current liabilities. The higher the ratio, the lower the risk to investors. A 2:1 ratio is accepted as satisfactory.

2. **Long-Term Solvency.** Long-term solvency is calculated by dividing **debt**—total liabilities—by owners' equity; this ratio illustrates the extent to which a firm is financed through borrowed money. The lower the debt, the lower the risk to investors and creditors.

Leverage. Leverage refers to the ability to make otherwise unaffordable investments by borrowing funds.

B. **Profitability Ratios: Earnings Power for Owners**

Profitability ratios are used for measuring potential earnings.

Earnings per Share. This ratio is calculated by dividing net income by the number of shares outstanding; this determines the size of the dividend that a firm can pay shareholders. As the ratio goes up, stock value increases because investors know that the firm can better afford to pay dividends.

C. **Activity Ratios: How Efficiently Is the Firm Using Its Resources?**

Activity ratios reveal the efficiency with which firms have used resources; an example is when annual sales revenues can increase without an increase in operating costs. These ratios are used for evaluating management's use of assets.