CHAPTER 1

Introduction to Accounting

What Is Accounting?

Accounting is the language of business. It is a standard set of rules for measuring a firm's financial performance. Assessing a company's financial performance is important for many groups, including:

- The firm's officers (managers and employees)
- Investors (current and potential shareholders)
- Lenders (banks)
- General public

Standard financial statements serve as a yardstick of communicating financial performance to the general public.

For example, monthly sales volumes released by McDonald's Corp. provide both its managers and the general public with an opportunity to assess the company's financial performance across major geographic segments.

Why Is Accounting Important?

Making Corporate Decisions

Suppose a telecom company is looking to acquire a regional company to boost its presence in that region. There are several potential targets that fit the bill. How does this company determine which of these targets, if any, would make a good acquisition candidate?

Making Investment Decisions

A mutual fund is looking to invest in several diverse technology companies—Microsoft, Oracle, and Intel. How does this mutual fund determine in which of these targets it should make an investment?

Accounting Facilitates Corporate and Investment Decisions

A major part of corporate and investment decisions relies on analyzing all of the companies' financial information in the above-mentioned cases. Accounting, the standard language by which such financial information can be assessed and compared, is fundamental to making these decisions.

Who Uses Accounting?

Accounting is used by a variety of organizations, from the federal government to nonprofit organizations to small businesses to corporations (Exhibit 1.1). We will be discussing accounting rules as they pertain to publicly traded companies.

U.S. Accounting Regulations

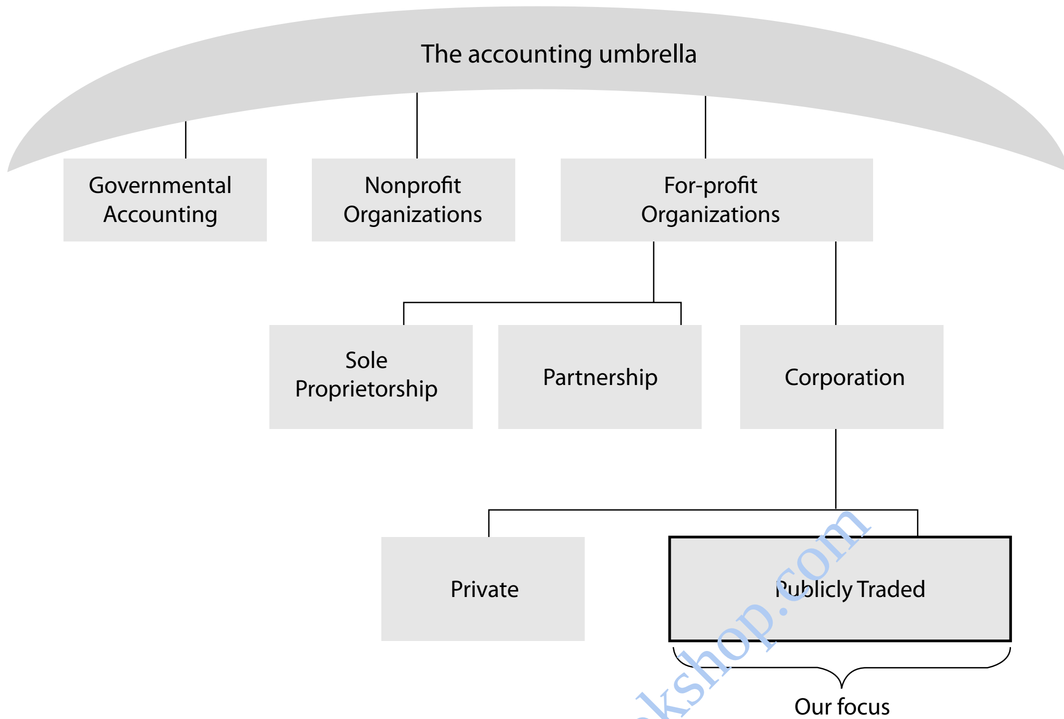
Accounting attempts to standardize financial information, and like any language, follows rules and regulations. What are these accounting rules, how are they established, and by whom?

Generally Accepted Accounting Principles

In the United States, a governmental agency called the Securities and Exchange Commission (SEC) authorizes the Financial Accounting Standards Board (FASB) to determine U.S. accounting rules.

FASB communicates these rules through the issuance of Statements of Financial Accounting Standards (SFAS). These statements make up the body of U.S. accounting

EXHIBIT 1.1 WHO USES ACCOUNTING?



rules known as the Generally Accepted Accounting Principles (GAAP). These rules have been developed to provide guidelines for financial accounting in order to ensure that businesses present their financial information on a fair, consistent, and straightforward basis. Financial statements of U.S. companies must be prepared according to U.S. GAAP.

Overview of the Securities and Exchange Commission

The SEC is a U.S. federal agency that was established by the U.S. Congress in 1934. The agency's primary mission is "to protect investors and maintain the integrity of the securities markets," which includes the establishment and maintenance of accounting principles and regulations. The SEC comprises five presidentially appointed *commissioners* heading approximately 3,100 staff employees across 4 *divisions* and 18 *offices* (Exhibit 1.2).

EXHIBIT 1.2 SEC ORGANIZATIONAL STRUCTURE

	Securities & Exchange Commission (SEC) Five Presidentially Appointed Commissioners 3,100 Staff and 18 Offices			
Divisions	Division of Corporate Finance	Division of Market Regulation	Division of Investment Management	Division of Enforcement
Major Oversight	Oversees financial reporting by corporations; monitors the activities of FASB	Establishes and maintains market rules through regulation of stock exchanges and broker-dealers	Regulates investment companies and investment advisers	Oversees securities laws violations (insider trading, securities price manipulation, etc.)

Overview of the Financial Accounting Standards Board

The SEC has historically charged the private sector with establishing and maintaining financial accounting and reporting standards. Accordingly, FASB was established in 1973 to carry out these functions on the behalf of the SEC.

FASB is composed of seven full-time members appointed for five years by the Financial Accounting Foundation (FAF), a parent organization. FASB formulates accounting standards through the issuance of Statements of Financial Accounting Standards (SFAS). These statements make up the body of accounting rules known as the Generally Accepted Accounting Principles (GAAP). While FASB is independent, with close relations with the SEC, its decisions are influenced by a variety of entities (Exhibit 1.3).

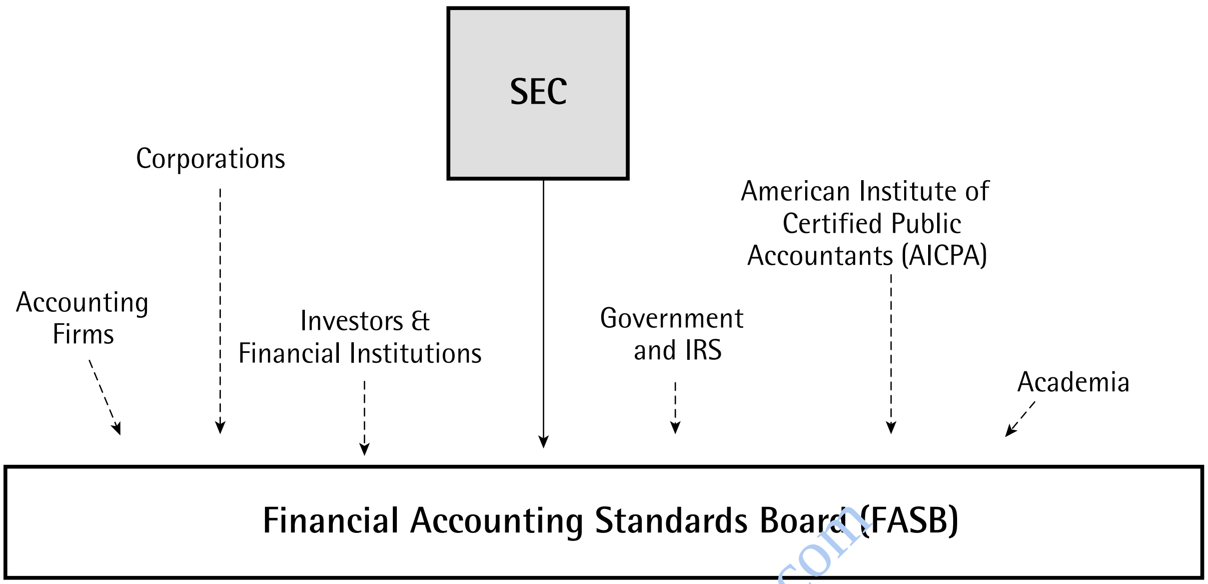
International Accounting Regulations

Up to now, we have discussed accounting regulations and the bodies that oversee them in the United States. But what about companies that must answer to the accounting regulations of other countries?

Fortunately, there has been unprecedented convergence between the accounting standards for the United States and other countries over the last 30 years. Here is a brief recap of the history of this convergence.

In 1973, the International Accounting Standards Committee (IASC) was founded by accountancy bodies in Australia, Canada, France, Germany, Ireland, Japan,

EXHIBIT 1.3 FASB RECEIVES INPUT FROM A VARIETY OF SOURCES



Types of FASB Pronouncements	Statements of Financial Accounting Standards (SFAS)	Interpretations	Financial Accounting Concepts	Emerging Issues Task Force Statements
	SFAS are considered Generally Accepted Accounting Principles (GAAP)	Modifications or extensions of existing SFAS	Objectives and concepts underlying establishment of future SFAS	Identification of new financial transactions and establishment of "consensus" reporting practices for them

Mexico, the Netherlands, the United Kingdom, and the United States, with the goal of developing global accounting standards.

In 2001, the IASC was replaced by the International Accounting Standards Board (IASB), an independent entity based in London, in order to oversee the continued convergence of global accounting standards.

IASB comprises 14 board members appointed by the Trustees of the IASC Foundation, a parent organization. IASB has the sole responsibility of developing International Financial Reporting Standards (IFRS).

In 2005, all EU countries adopted IFRS. In addition, accounting standards for many countries outside of Europe, including Japan, are largely equivalent to IFRS.

Convergence of U.S. GAAP and IFRS

In 2002, FASB and IASB agreed to work together toward the convergence of U.S. GAAP and IFRS. Since then, there has been a convergence of these two sets of accounting standards. Nevertheless, there remain some differences. This book presumes U.S. GAAP, but will highlight the differences where they are significant.

> **IFRS Perspective**
>
> Throughout the book, accounting differences between U.S. GAAP and IFRS will be highlighted in the *IFRS Perspective* sidebar.

Summary

Accounting is a standard language of measuring financial performance by a variety of organizations. Accounting follows GAAP, which are guidelines for measuring and presenting financial information on a fair, consistent, and straightforward basis.

U.S. GAAP are developed by FASB on the behalf of the SEC, with input from a variety of interest groups. IFRS are international accounting standards and are developed by IASB. Although we have seen unprecedented convergence over the last few years between U.S. GAAP and IFRS, there remain differences, which will be highlighted throughout this book.

Exercise 1: Accounting

What is accounting?

❑ The language of business

❑ A standard set of rules for measuring a firm's financial performance

❑ An outdated system of tracking a company's finances

❑ A framework for assessing a company's financial performance

Exercise 2: Accounting

Why is accounting important?

❑ Completely prevents manipulation of financial information

❑ Serves as a standard language of recording financial performance

❑ Allows company officers, investors, and general public to assess a firm's financial performance

❑ Standardizes financial information so that it can be assessed and compared across companies

Exercise 3: Accounting

What is the focus of this crash course on accounting?

❑ U.S. federal government

❑ Individuals

❑ Publicly traded corporations

❑ Hospitals

❑ Universities

Exercise 4: Accounting Regulations

Generally Accepted Accounting Principles (GAAP) are:

- ❑ Rules and regulations governing accounting
- ❑ Developed by the SEC on behalf of FASB
- ❑ Communicated through the issuance of Statements of Financial Accounting Standards (SFAS)
- ❑ All of the above

Exercise 5: IFRS

International Financial Reporting Standards (IFRS) are:

- ❑ Rules and regulations governing international accounting
- ❑ Developed by FASB and used by all EU countries
- ❑ Converging with U.S. GAAP, but a number of differences still exist
- ❑ Converging with U.S. GAAP, with both accounting systems set to be identical by 2007

Exercise 6: FASB

From what sources does FASB receive input in making its decisions?

- ❑ Academia
- ❑ SEC
- ❑ Students
- ❑ Financial institutions
- ❑ Company employees

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