

What is Accounting?

Quite simply, accounting is a language: a language that provides information about the financial position of an organization. When you study accounting you are essentially learning this specialized language. By learning this language you can communicate and understand the financial operations of any and all types of organizations. This is because the information required by most organizations is very similar and can be broken down into three main categories:

Operating Information:

This is the information that is needed on a day-to-day basis in order for the organization to conduct its business. Employees need to get paid, sales need to be tracked, the amounts owed to other organizations or individuals need to be tracked, the amount of money the organization has needs to be monitored, the amounts that customers owe the organization need to be checked, any inventory needs to be accounted for: the list goes on and on. Operating information is what constitutes the greatest amount of accounting information and it provides the basis for the other two types of accounting information.

Financial Accounting Information

This is the information that is used by managers, shareholders, banks, creditors, the government, the public, etc... to make decisions involving the organization and its operations. Shareholders want information about what their investment is worth and whether they should buy or sell shares, bankers and other creditors want to know whether the organization has an ability to pay back money lent, managers want to know how the company is doing compared to other companies. This type of information would be very difficult to extract if every company used a different system for recording their financial position. Financial accounting information is subject to a set of ground rules that dictate how the information is reported and this ensures uniformity.

Managerial Accounting Information

In order for the managers of a company to make the best decisions for a company they need to have specific information prepared. They use this information for three main management functions: planning, implementation and control. Financial information is used to set budgets, analyze different options on a cost basis, modify plans as the need arises, and control and monitor the work that is being done.

As you can see, **accounting** is a multifaceted system involving different people with different needs and after analyzing the various uses and applications of accounting information the American Accounting Association has come up with this definition: **“the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.”**

In order to facilitate the informed use of this financial information, accounting has come to be based on specified rules or conventions called **“principles.”** These principles provide general laws or rules that are used to guide accounting activity and are called

Generally Accepted Accounting Principles, or GAAP for short. These principles are established by the Financial Accounting Standards Board (FASB) which is a nongovernmental agency funded by the accounting profession and contributions from business organizations. While there is no legal obligation for companies to adhere to GAAP, there are strong practical reasons to do so. From auditing to reporting earnings to the US Securities Exchange Commission to applying for a loan, there are very compelling reasons for organizations to conform to the generally accepted standard.

What Is The End Result Of All This Accounting Information?

We've talked about the reason for maintaining accounting information and the end result of all of this recording is the preparation of financial statements. These statements let people see, at a glance, the financial position of an organization. These statements provide summaries of the operating information and are used extensively by people within and external to the company. The statements fall into one of two categories:

Status/Stock – these statements show the financial status of an organization at one specified instant in time. Stock reports = a snapshot.

Flow Report – these statements show the flow of financial information over a period of time. Flow reports = motion picture

GAAP requires the preparation of three different statements:

Balance Sheet

A Balance Sheet is a status report that shows information about the organization's resources at one given time. Examples of information found on a balance sheet are how much cash is in the bank, what is owed to creditors, and the value of the company's assets.

Income Statement

An Income Statement (also called a Statement of Earnings, Statement of Operations, or a Profit and Loss Statement) is a report that shows the flow of revenues (amounts earned from business activity) and expenses (amounts paid in the course of operations) over a given period of time, typically a month, quarter, or year.

Statement of Cash Flow

As the name suggests, this is also a flow statement that details the movement of cash through the organization over a specified period.

The whole purpose of accounting is to provide information that is useful and relevant for interested parties when making decisions regarding the company and its operations. In order to do that effectively, a specific language and subsequent rules have been developed for users of the information. By learning accounting you learn these rules and can then communicate financial information with others in a comprehensible and comparable manner.