

## 6.2: Accounting in Business

### What you'll learn to do: define accounting, and explain its role as a form of business communication

How businesses express their financial health and stability is by presenting an “accounting” of all their financial transactions. In this section you will explore in depth what accounting is and the vital information it communicates about the business.

#### Learning Objectives

- Identify the users and uses of financial accounting
- Identify the users and uses of managerial accounting

### What Is Accounting?

#### Why Do we Need Financial Information?

As you learned earlier in the course, businesses have large groups of stakeholders who have a vested interest in the continued success of the enterprise. If a business, whether for-profit or nonprofit, becomes financially insolvent and can't pay its bills, it will be forced to close. Financial information enables a business to track its accounts and avoid insolvency.

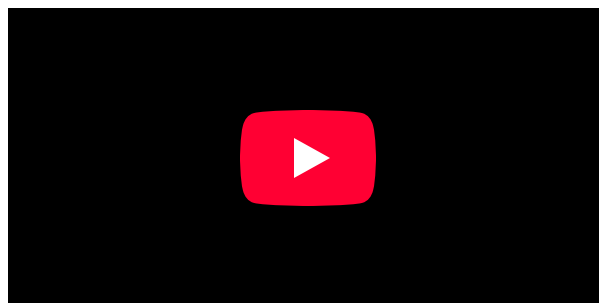
Each business needs financial information to be able to answer questions such as the following:

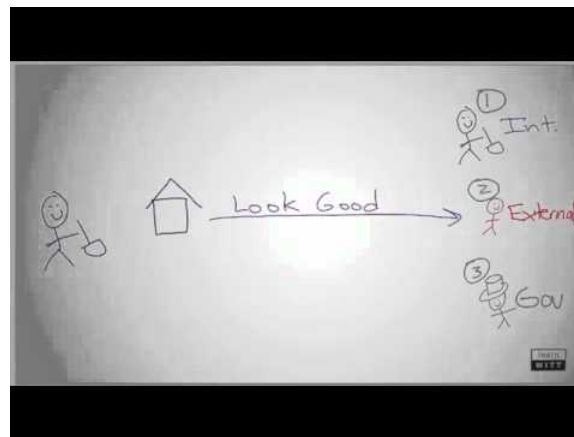
- How much cash does the business need to pay its bills and employees?
- Is the business profitable, earning more income than it pays in expenses, or is it losing money and possibly in danger of closing?
- How much of a particular product or mixture of products should the business produce and sell?
- What is the cost of making the goods or providing the service?
- What are the business's daily, monthly, and annual expenses?
- Do customers owe money to the business, and are they paying on time?
- How much money does the business owe to vendors (suppliers), banks, or other investors?



The video below gives a brief overview of many of the topics in this section. Before you review the video, consider these questions:

- What is accounting?
- What is business?
- Who are the three people that want to know the story of your business?
- What language of accounting does the government use?
- What language of accounting do investors use?
- What language of accounting do internal users employ?





## Accounting Is the Language of Business

Every business organization that has economic resources, such as money, machinery, and buildings, uses accounting information. For this reason, accounting is called the language of business. Accounting also serves as the language providing financial information about not-for-profit organizations such as governments, churches, charities, fraternities, and hospitals. However, in this module we will focus on accounting for business firms.

The accounting process provides financial data for a broad range of individuals whose objectives in studying the data vary widely. Bank officials, for example, may study a company's financial statements to evaluate the company's ability to repay a loan. Prospective investors may compare accounting data from several companies to decide which company represents the best investment. Accounting also supplies management with significant financial data useful for decision making.

### Definition of Accounting

As the video explained, accounting is "the language of business." The American Accounting Association defines **accounting** as "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by the users of the information."

This information is primarily financial—stated in money terms. Accounting, then, is a measurement and communication process used to report on the activities of profit-seeking business organizations. As a measurement and communication process for business, accounting supplies information that permits informed judgments and decisions by users of the data.

### Internal and External Users

Users of accounting information are separated into two groups, internal and external. **Internal users** are the people within a business organization who use accounting information. For example, the human resource department needs to have information about how profitable the business is in order to set salaries and benefits. Likewise, production managers need to know if the business is doing well enough to afford to replace worn-out machinery or pay overtime to production workers. **External users** are people outside the business entity that use accounting information. These external users include potential investors, the Internal Revenue Service, banks and finance companies, as well as local taxing authorities. Accounting information is valuable to both groups when it comes time to evaluate the financial consequences of various alternatives. Accountants reduce uncertainty by using professional judgment to quantify the future financial impact of taking action or delaying action. In short, although accounting information plays a significant role in reducing uncertainty within an organization, it also provides financial data for persons outside the company.

**Financial accounting** information appears in financial statements that are intended primarily for external use (although management also uses them for certain internal decisions). Stockholders and creditors are two of the outside parties who need financial accounting information. These outside parties decide on matters pertaining to the entire company, such as whether to increase or decrease their investment in a company or to extend credit to a company. Consequently, financial accounting information relates to the company as a whole, while managerial accounting focuses on the parts or segments of the company.

Because the external users of accounting information vary greatly, the way that financial information is presented must be consistent from year to year and company to company. In order to facilitate this, financial accountants adhere to set of rules called Generally Accepted Accounting Principles (GAAP). **GAAP** are a uniform set of accounting rules that allow users to compare the financial statements issued by one company to those of another company in the same industry. These principles for financial

reporting are issued by an independent non-profit agency created by the Securities Exchange Commission (SEC) called the **Financial Accounting Standards Board (FASB)**. The FASB's mission is "to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports."

**Tax accounting** information includes financial accounting information, written and presented in the tax code of the government—namely the Internal Revenue Code. Tax accounting focuses on compliance with the tax code and presenting the profit and loss story of a business to minimize its tax liability.

Accounting is more than just reporting income to taxing authorities or providing revenue and expense information to potential investors. As the language of business, accounting is used for decision-making as well.

**Managerial accounting** information is for internal use and provides special information for the managers of a company. The information managers use may range from broad, long-range planning data to detailed explanations of why actual costs varied from cost estimates. The employees of a firm who perform these managerial accounting functions are often referred to as Cost Accountants. Managerial accounting is more concerned with forward looking projections and making decisions that will affect the future of the organization, than in the historical recording and compliance aspects of the financial accountants. There are no reporting guidelines such as GAAP; therefore, managerial accounting reports will vary widely in both scope and content. Also, much of the information generated by managerial accountants is confidential and not intended to be shared outside of the organization. Managerial accounting focus on range of topics from production planning to budgets for raw materials. When a company makes a decision to purchase a component part instead of manufacture it in house, that decision is based primarily on managerial accounting information. For this reason, many managerial accountants consider themselves to be provide "accounting information for decision making."

#### *Bookkeeping vs. Accounting*

Accounting is often confused with bookkeeping. **Bookkeeping** is a mechanical process that records the routine economic activities of a business. **Accounting** includes bookkeeping, but it goes further to analyze and interpret financial information, prepare financial statements, conduct audits, design accounting systems, prepare special business and financial studies, prepare forecasts and budgets, and provide tax services.

#### *Importance of Accounting*

You probably will find that of all the business knowledge you have acquired or will learn, the study of accounting will be the most useful. Your financial and economic decisions as a student and consumer involve accounting information. When you file income tax returns, accounting information helps determine your taxes payable.

Understanding the discipline of accounting also can influence many of your future professional decisions. You cannot escape the effects of accounting information on your personal and professional life.

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