History of accounting analysis flashcard

A person’s daily activities consist of making decisions, from personal, political, economic, or social nature. Often people rely on relevant information to make a decision.

One pertinent information people deal with everyday is economic information. Economic activity ranges from producing, trading, buying and using up goods. Thus it is important to process economic information accurately. This is where accounting comes in. Accounting is a systematic process involving two sub processes: measuring and reporting, specifically measuring and reporting pertinent financial information needed to make a decision on a specific economic activity (Salmonson, Hermanson and Edwards 1).

Financial information must comply with a certain standard, called generally accepted accounting principles or GAAP. GAAP will be discussed in details in the succeeding paragraphs. There are four types of financial decision: financing, resource allocation, production or marketing (4). A financing decision involves knowing the capital amount needed and finding if this capital will be obtained from the owner or the creditor; resource allocation decision is deciding how to divide the total capital, how it will be invested; production decision is made to identify production details such as what product will be produced and how it will be produced; and lastly, marketing decision is establishing prices and advertising budgets (4). Moreover, accounting is also an information design created to provide important financial information by means of a financial statement (2). Accountants are people who have specialized in accounting.

Accountants may seek employment in public accounting, private industry or for the non-profit sector (Salmonson, Hermanson and Edwards 5). Several historical events have influenced the development of accounting. Financial accounting history is often divided into three time periods- pre-formal era, problem solving era, and conceptual framework era (Chasteen, Flaherty and O'Connor 8). The pre-formal theory era dates back to accounting developments before 1930. Accounting in this period is sometimes called laissez-faire accounting for accountants based their decisions on their own judgments (Chasteen, Flaherty and O'Connor 10).

Moreover, Accounting is said to have started in Italy in the fourteenth century (8). An Italian monk named Luca Pacioli is often called the " father of accounting" (Murphy Smith 2002). Brother Luca, was he was known, wrote the first book on entitled " Everything about Arithmetic, Geometry and Proportions" (2002). It was a Math book but had a section on accounting which ultimately became the world's accounting textbook (2002). However, Brother Luca did not really invent accounting.

In the book, he narrated the method employed by Venice merchants (2002). According to Brother Luca, in order for a merchant to be successful, he should have these things- enough cash, an accounting system and a bookkeeper (Le Moine 2004). The foundations of his accounting system were the use of ledgers and journals and double-entry bookkeeping (2004). Debits, which means ' left" are placed on the left side while credits on the right (2004).

If the entries are accurate, the bookkeeper will do a trial balance wherein debits and credits are added separately, resulting in matching total sums (2004). Furthermore, Brother Luca included assets, liabilities, capital, income and expense accounts in his ledger (2002). At that time, double-entry bookkeeping was very basic especially since businesses were either single proprietorship or small partnerships (10). Accounting was merely for internal purposes only (10). At the start of the nineteenth century, financial accounting grew as businesses started to boom and capital requirements augmented (10).

It was also at this time that business taxation was introduced (2004). In the aftermath of the Great Depression, the accounting industry was rocked (Le Moine 2004). Companies experienced bankruptcy even after posting profits (2004). When accountants testified in court cases, it was found that their bookkeeping processes were done based on ‘ generally accepted accounting principles’ or GAAP (2004).

These were basic principles that accountants usually did, hence the term ‘ generally accepted’. There were no stone-cast rules. In other words, “ anything goes” (2004). Under GAAP, the financial requirements consist of 1. Balance sheet / statement of financial position 2. Income statement/ income or earnings 3.

Statement of retained earnings for the statement of other changes in owners’ or stockholders’ equity 4. Statement of cash flows (Chasteen, Flaherty and O’Connor 6). In 1930, the American Institute of Accountants (AIA) later renamed the American Institute of Certified Public Accountants

(AICPA) created a committee to work on the growing change in accounting issues and objectives (Le Moine 2004). The committee, called Committee of Accounting Procedure, made auditing of financial statements restricted to certified public accountants or CPAs (2004).

A federal regulatory board was established- Securities and Exchange Commission (SEC) to oversee audit reports of publicly traded companies (Chasteen, Flaherty and O'Connor 11). SEC does not do the auditing per se but depend on the reports of the registrants' CPA in accordance with GAAP (11). The committee was abolished in 1959 and was replaced with the Accounting Principles Board (APB) that same year (13). By 1973, APB was replaced with the Financial Accounting Standards Board or FASB (2004).

This change paved the way for the conceptual framework era. FASB was independent from AICPA (Le Moine 2004). It also became the standard setting accounting body in the industry. As a private, nongovernment entity, FASB became responsible for the " entire economic community" (Chasteen, Flaherty and O'Connor 15). FASB has four statements: 1.

Statement of financial accounting standards, Statements of Standards; 2. Interpretations of ARB or Accounting Regulatory Board, ARB Opinions and FASB Interpretations; 3. Technical Bulletins; and 4. Statements of Financial Accounting Concepts (15). The house of GAAP first appeared in a 1984 article from the Journal of Accountancy (Emory University 2008).

Steven Rubin likened GAAP to a floor plan of a house, saying that the basic concepts of financial reporting lies on a foundation which may also fall over if the foundation is not solid (2008). The house was " remodelled" in 1991, changing some authority levels while separating the standards between state and government entities as created by the Government Accounting Standards Board (GASB) (2008). The revised house has five floors. First Floor (Category A) represents the highest level of GAAP authority.

This consists of the “ officially established accounting principles” and statements such as the “ FASB Statements of Financial Accounting Standards, FASB Interpretations, AICPA Options and Interpretations, and AICPA Accounting Research Bulletins “(Emory 2008). Second Floor (Category B) comprises analysis of accountants and organizations on accounting matters (Emory University 2008). These include “ FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Positions” (2008). Third Floor represents statements from organizations coordinated by FASB deliberating on accounting issues in public forums. The purpose of which is to understand and create accounting principles or perhaps explain current accounting philosophy (2008). These include “ FASB Emerging Issues Task Force consensus position, and AICAP Practice Bulletins “(2008).

Fourth Floor (Category D) consists of pronouncements that are not specified in the first three floors (Emory University 2008). These include “ AICPA Accounting Interpretations, FASB Implementation Guides in Q and A format, uncleared AICPA Statements of Position and Industry Audit and Accounting Guides and recognized industry practices “(2008). Fifth Floor (Category E) covers pronouncements not discussed in the first four floors. These include “ FASB Financial Accounting Concepts, AICPA Accounting Principles Board Statements, AICPA Issues Papers, pronouncements of other professionals association or regulatory agencies, AICPA Technical Practice Aids and accounting textbooks, handbooks and articles” (Emory University 2008).

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