cHAPTER 1

Accounting in business

|  |
| --- |
| Chapter Outline |
| 1. **Importance of Accounting**—we live in the information age in which information, and its reliability, impacts the financial well-being of us all. |
| *Accounting* is an information and measurement system that identifies, records, and communicates an organization’s business activities. |
| 1. Users of Accounting Information –accounting is called the language of business because it communicates data the helps users make better decisions. People using accounting information are divided into two groups: |
| 1. External Users—those *not* directly involved with running the company. They have limited access to the company’s accounting information. Examples: shareholders (investors), lenders, external auditors, nonmanagerial and nonexecutive employees, labor unions, regulators, voters, legislators, government officials, customers, suppliers, etc. |
| 1. Financial Accounting—area of accounting aimed at serving external users by providing them with *general-purpose financial statements*. |
| 2. Internal Users—those directly involved in managing and operating an organization. Internal users include research and development, purchasing, human resource, production, distribution, marketing, and service managers. |
| 1. Managerial Accounting—area of accounting that serves the decision-making needs of internal users. 2. Internal Reports—are designed for the special needs of internal users. |
| B. Opportunities in Accounting—four broad areas of opportunities are financial, managerial, taxation, and accounting-related. |
| 1. Private accounting, which are employees working for businesses, offers the most opportunities.  2. Public accounting offers the next largest number of opportunities. Opportunities include auditing and taxation.  3. Government (and not-for-profit) agencies, including business regulation and investigation of law violations, also offer opportunities.  4. Accounting specialists include certified public accountants, CPAs. Certifications include certified management accounting, CMA, and certified internal auditors, CIA. Specialists include certified bookkeeper, CB, certified payroll professional, CPP, certified fraud examiner, CFE, and certified forensic accountant, CrFA.  5. Artificial Intelligence (AI) in Accounting – repetitive tasks such as entering invoice and transaction data could be done by AI software. AI systems analyze reports and graphics.  6. Data Analytics and Visualization in Accounting – among the top skills sought by employers. Data analytics is a process of analyzing data to identify meaningful relations and trends. Data visualization is a graphical presentation of data to help people understand its significance. They help individuals make informed business decisions. |
| **II.** **Fundamentals of Accounting** |
| A. Ethics—A Key concept—Ethics are beliefs that separate right from wrong.  1. Fraud Triangle: Ethics under Attack—model that asserts three factors must exist for a person to commit fraud: opportunity, pressure, and rationalization.   1. Internal Controls—procedures to protect assets, ensure reliable accounting, promote efficiency, and uphold company policies. |

|  |
| --- |
| B.Generally Accepted Accounting Principles (GAAP)—concepts and rules that govern financial accounting. The purpose of GAAP is to make information in accounting statements relevant, reliable, and comparable. |
| 1. The Financial Accounting Standards Board (FASB) is given the task of setting GAAP from the Securities and Exchange Commission (SEC). The SEC oversees proper use of GAAP. |
| 2. International Standards—The International Accounting Standards Board (IASB) issues standards (International Financial Reporting Standards, or IFRS) that identify preferred accounting practices in the global economy. IFRS are similar but sometimes different from U.S. GAAP. |
| 1. Conceptual Framework—FASB Conceptual Framework consists of: |
| 1. Objectives—to provide information useful to investors, creditors, and others. 2. Qualitative Characteristics—to require information that has relevance and faithful representation. 3. Elements—to define items in financial statements. 4. Recognition and Measurement—to set criteria that an item must meet for it to be recognized as an element; and how to measure that element. |
| 1. Principles, Assumptions and Constraint—two types are *general principles* (assumptions, concepts, and guidelines for preparing financial statements; stem from long-used accounting practices) and *specific principles* (detailed rules used in reporting transactions and events).    * 1. Accounting Principles—General principles consist of four general principles:         1. *Measurement principle (cost principle)*—accounting information is based on actual costs incurred in business transactions. Cost is measured on a cash or equal-to-cash basis. Information based on cost is considered objective. *Objectivity* means information is supported by independent, unbiased evidence.         2. *Revenue recognition principle*—revenue is recognized (recorded) (1) when goods or services are provided to customers and (2) at the amount expected to be received from the customer.         3. *Expense recognition principle (matching principle)*—a company record expenses it incurred to generate revenues it reported.         4. *Full disclosure principle*—a company records the details behind financial statements that would impact users’ decisions; often in footnotes to the statements. |

b. Accounting Assumptions -

i. *Going-concern assumption*—accounting information presumes that the business will continue operating instead of being closed or sold.

|  |  |  |
| --- | --- | --- |
| ii. *Monetary unit assumption*—transactions and events are expressed in monetary, or money, units. Generally, this is the currency of the country in which it operates, but today some companies express reports in more than one monetary unit. | | |
| iii. *Time period assumption*—the life of the company can be divided into time periods, such as months and years, and useful reports can be prepared for those periods. | | |
| iv. *Business entity assumption*—a business is accounted for separately from other business entities and its owner. Necessary for good decisions. | | |
| c. Exhibit 1.8: Types and Attributes of Businesses   1. *Sole proprietorship* is a business owned by one person that has unlimited liability. It is not a separate legal entity. The owner has unlimited liability and is, therefore, personally liable for the business debts. 2. *Partnership* is a business owned by two or more people, called partners, who aresubject to unlimited liability. The business is not subject to an income tax, but the owners are responsible for personal income tax on their individual share of the net income of entity. 3. *Limited Liability Company (LLC)* is a business owned by one or more members. It offers limited liability to the members who are not personally liable for the debts of the LLC, and is a separate entity with the same rights and responsibilities as a person. | | |
| iv. *Corporation* is a business that is a separate legal entity whose owners are called shareholders or stockholders. These owners have limited liability. The entity is responsible for a business income tax, and the owners are responsible for personal income tax on profits that are distributed to them in the form of dividends. | |
| d. Accounting Constraints -there are basic constraints on financial reporting. | | |
| 1. The *cost-benefit* constraint says that information disclosed by the entity must have benefits to the user that are greater than the costs of providing it. 2. The *materiality* constraint is the ability of information to influence decisions. 3. *Conservatism* and *industry practices* are sometimes referred to as constraints as well. | | |
| **III. Business Transactions and Accounting** | | |
| A. Accounting Equation (Assets = Liabilities + Equity)—elements of the equation include: | | |
| 1. Assets—resources a company owns or controls that are expected to carry future benefits. Examples: cash, accounts receivable, supplies, equipment, and land).  2. Liabilities—creditors’ claims on assets. These claims reflect obligations to transfer assets or provide products or services to others. Examples: wages payable, accounts payable, notes payable, and taxes payable.  3. Equity—owner’s claim on assets; assets minus liabilities. Also called *net assets* or *residual equity.* Increases in equity result from owner investments and revenues. Decreases results from dividends and expenses. Equity consists of:   1. Common stock —owner investments are inflows of cash and other net assets from shareholders in exchange for stock which increase equity. 2. Revenues —increase equity from sales of products and services to customers. Revenues increase equity (via net income) and result from a company’s earnings activities. 3. Dividends—outflows of cash and other assets to shareholders which decrease equity. 4. Expenses—cost of assets or services used to earn revenues Expenses decrease equity. | | |
| 1. Expanded Accounting Equation:   Assets = Liabilities + Common stock – Dividends + Revenues – Expenses. Net income occurs when revenues exceed expenses. Net income increases equity. A net loss occurs when expenses exceed revenues, which decreases equity. | | |
| 1. Transaction Analysis—each transaction and event always leaves the equation in balance. (Assets = Liabilities + Equity) | | |
| 1. Investment by owner:   ASSET = LIABILITIES + EQUITY  **+ Cash + Common stock**  Increase on both sides of equation keeps equation in balance.   1. Purchase supplies for cash:   ASSET = LIABILITIES + EQUITY **+ Supplies**  **− Cash** Increase and decrease on one side of the equation keeps equation in balance.   1. Purchase equipment for cash:   ASSET = LIABILITIES + EQUITY **+ Equipment**  **– Cash** Increase and decrease on one side of the equation keeps equation in balance.   1. Purchase supplies on credit:   ASSET = LIABILITIES + EQUITY **+ Supplies + Accounts Payable**  Increase on both sides of equation keeps equation in balance.   1. Provide services for cash:  ASSET = LIABILITIES + EQUITY **+ Cash + Revenue Earned**   Increase on both sides of equation keeps equation in balance. | | |
| 6, 7. Payment of expenses in cash (salaries, rent, etc.):  ASSET = LIABILITIES + EQUITY **− Cash − + Expense**  Decrease on both sides of equation keeps equation in balance.  8. Provided services and facilities for credit:  ASSET = LIABILITIES + EQUITY **+ Accts. Receivable + Revenue Earned**  Increase on both sides of equation keeps equation in balance.  9. Receipt of cash from accounts receivable (customers paying on their accounts):  ASSET = LIABILITIES + EQUITY  **+ Cash**  **− Accts. Receivable**  Increase and decrease on one side of the equation keeps equation in balance. | | |
| 10. Payment of accounts payable:  ASSET = LIABILITIES + EQUITY  **− Cash − Accounts Payable**  Decrease on both sides of equation keeps equation in balance. | | |
| 11. Payment of Cash Dividends:  ASSET = LIABILITIES + EQUITY  **− Cash − (+ Dividends)**  Decrease on both sides of equation keeps equation in balance. (Note: since dividends  are not expenses, they are not used in computing net income.) | | |
| |  | | --- | | **IV. Communicating with Users** | | The four financial statements and their purposes are: | | A*.* *Income Statement*—describes a company’s revenues and expenses along with the resulting net income or loss over a period of time. (Net income occurs when revenues exceed expenses. Net loss occurs when expenses exceed revenues.)  B*.* *Statement of Retained Earnings* —explains changes in retained earnings from net income (or loss), and dividends over a period of time. | | C*.* *Balance Sheet*—describes a company’s financial position (types and amounts of assets, liabilities, and equity) at a point in time.  D. *Statement of Cash Flows*—identifies cash inflows (receipts) and cash outflows (payments) over a period of time. | | Statement Preparation from Transaction Analysis—prepared in the following order using the *procedure* indicated below. | | A. Income Statement⎯information about revenues and expenses is conveniently taken from the owner's equity column. Total revenues minus total expenses equals net income or loss. Net income (or net loss) is transferred to the Statement of Retained Earnings.  B. Statement of Retained Earnings⎯reports retained earnings over the reporting period. Shows beginning retained earnings balance, dividends and net income, (or net loss) from the income statement, Ending retained earnings balance is added to Balance Sheet.   |  | | --- | | C. Balance Sheet⎯shows the financial position as of the date of the statement. Includes the balance of each asset, liability and the ending retained earnings balance. Note that the retained earnings balance is taken from the statement of retained earnings, and added to total liabilities to get total liabilities and equity. This total must agree with total assets to prove the accounting equation. Either the *account form* or the *report form* may be used to prepare the balance sheet. | | D. Statement of Cash Flows⎯the cash column must be carefully analyzed to organize and report cash flows in categories of operating, investing, and financing. The net change in cash is determined by combining the net cash flow in each of the three categories. This change is combined with the beginning cash. The resulting figure should be the ending cash that was shown on the balance sheet. | | | |

|  |  |  |
| --- | --- | --- |
| |  | | --- | | **V. Decision Analysis—Return on Assets (ROA)—**a profitability measure. Also called Return on Investment (ROI). | | A. Useful in evaluating management, analyzing and forecasting profits, and planning activities.  B. The return on assets is calculated by dividing net income for a period by average total assets. (Average total assets is determined by adding the beginning and ending assets and dividing by 2.)  C. As with all analysis tools, results should be compared to previous business results as well as competitor’s results and industry norms. | |