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I. Importance of Accounting

Accounting is an information and measurement system that identifies, records and communicates relevant, reliable, and comparable information about an organization's business activities. **Recordkeeping**, or **bookkeeping**, which includes just one function of accounting, is the recording of transactions and events, either manually or electronically. Technology is a key part of modern business and has changed the way we store, process, and summarize large masses of data. Technology has allowed accounting to expand to include consulting, planning and other financial services.

A. **Users of Accounting Information**

Accounting is the *language of business* because all organizations set up an accounting information system to communicate data to help people make better decisions.

1. **External information users** are not directly involved in running the organization; they include shareholders, lenders, directors, customers, suppliers, regulators, lawyers, brokers, and the press. External users have limited access to an organization's information but they must receive information that is relevant, reliable and comparable. **Financial accounting** is the area of accounting aimed at serving external users by providing them with *general-purpose financial statements*.
2. **Internal information users** are those directly involved in managing and operating an organization. They use the information to help improve the efficiency and effectiveness of an organization. **Managerial accounting** is the area of accounting that serves the decision-making needs of internal users. Internal users and the information they require include:
   a. Research and development managers need data on current and projected costs and revenues to decide whether to pursue or continue research and development projects.
   b. Purchasing managers need data on quality and quantity of merchandise and materials purchases.
   c. Human resource managers need data on current payroll costs, employee benefits, performance and compensation.
   d. Production managers need data on costs and quality of production processes.
   e. Distribution managers need data on quantity and delivery schedules.
   f. Marketing managers need data on sales and costs to effectively target consumers and set prices.

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g. Servicing managers need data on warranties and maintenance information to provide a valuable product to its customers.

3. Both internal and external users rely on internal controls to monitor and control company activities. **Internal controls** are procedures designed to protect company property, ensure reliable reports, promote efficiency, and encourage adherence to company policies.

B. **Opportunities in Accounting**

1. The four broad areas of opportunities in accounting include financial accounting, managerial accounting, taxation, and accounting-related careers.
2. The majority of accounting opportunities are in *private accounting* as employees working for businesses. *Public accounting* providing services such as auditing and tax advice to businesses, offers the next largest number of opportunities while still other opportunities exist in government (and not-for-profit) agencies, including business regulation and investigation of law violations.
3. The professional standing of accounting specialists are denoted by a certificate such as certified public accountant (CPA), certified management accountant (CMA), certified internal auditor (CIA), certified bookkeeper (CB), certified payroll professional (CPP), personal financial specialist (PFS), certified fraud examiner (CFE) and certified forensic accountant (CrFA).

II. Fundamentals of Accounting

A. **Ethics – A Key Concept**
Ethics are beliefs that distinguish right from wrong; they are accepted standards of good and bad behavior.

1. Ethical behavior is important in all successful organizations. Users must be able to trust accounting information. Good ethics are good business.
2. The AICPA and IMA have set up ethical codes of conduct.

B. **Generally Accepted Accounting Principles**
Financial accounting is governed by rules known as **generally accepted accounting principles, GAAP.** GAAP aims to make accounting information <u>relevant</u>, <u>reliable</u> and <u>comparable</u>. The Securities and Exchange Commission (SEC) has legal authority to set GAAP.

1. **Setting Accounting Principles**

a. The SEC has delegated the task of setting GAAP to **The Financial Accounting Standards Board** (FASB), a private group that sets both broad and specific principles.

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C. **International Standards.** The **International Accounting Standards Board** (IASB) issues *International Financial Reporting Standards* (IFRS) that identify preferred accounting practices. The FASB and IASB are pursuing a convergence process aimed to achieve a single-set of accounting standards for global use. Currently, there are two sets of accepted accounting principles in the U.S.: U.S. GAAP for U.S. SEC registrants and IFRS for non-U.S. SEC registrants.

D. **Conceptual Framework and Convergence.** The FASB and IASB are attempting to converge the conceptual framework. The framework consists of:

Objectives – providing useful information to investors, creditors, and others.
Qualitative Characteristics – requires that information be relevant, reliable, and comparable.
Elements – defines items that financial statements can contain.
Recognition and Measurement – sets criteria that an item must meet for it to be recognized as an element, and how to measure that element.

1. **Principles and Assumptions of Accounting**
   Accounting principles (and assumptions) are both general (basic assumptions, concepts and guidelines for preparing financial statements) and specific (detailed rules used in reporting transactions). The principles, assumptions and constraints discussed in this chapter are:
   a. **Cost principle**—accounting information is based on actual costs incurred in business transactions. Cost is measured on a cash or equal-to-cash basis.
   b. **Revenue recognition principle**—provides guidance on when a company must recognize revenue; to *recognize* means to record it. Revenue is recognized when earned.
   c. **Expense Recognition** or **Matching principle**—a business records expenses incurred to generate the revenue reported.
   d. **Full disclosure principle**—requires a company to report the details behind financial statements that would impact users' decisions.
   e. **Going-concern assumption**—accounting information reflects a presumption that the business will continue operating instead of being closed or sold
   f. **Monetary unit assumption**—transactions and events are expressed in monetary, or money, units (generally the currency of the country in which the business operates).

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   g. **Time period assumption**—presumes that the life of a company can be divided into time periods and that useful reports can be prepared for those periods.
   h. **Business entity assumption**—a business is accounted for separately and distinctly from its owner(s). A business entity can take one of three legal forms:
      i. ***Sole proprietorship*** is a business owned by one person that has unlimited liability. Requires no special legal requirements. The business is not subject to an income tax but the owner is responsible for personal income tax on the net income of the entity.
      ii. ***Partnership*** is a business owned by two or more people, called partners, who are subject to unlimited liability. No special legal requirements must be met. The only

requirement is an oral or written agreement between the partners which usually outlines how profits and losses are to be shared. 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 the entity.

iii. ***Corporation*** is a business that is a separate legal entity whose owners are called shareholders or stockholders. These owners have limited liability because the business is legally responsible for its own actions and debts. 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.

i. **Accounting Constraints** – the two constraints include

Materiality constraint – only information that would influence the decisions of a reasonable person need be disclosed and

Cost-benefit constraint – only information with benefits of disclosures greater than the costs of providing it need be disclosed.

E. Sarbanes-Oxley (SOX) is an act which requires documentation and verification of internal controls. The goal of this act is to provide more transparency, accountability and truthfulness in reporting transactions. Auditors also must verify the effectiveness of internal controls.

III. Transaction Analysis and the Accounting Equation

A. **Accounting Equation**

The accounting system reflects two basic aspects of a company: what it owns and what it owes. Together, liabilities and equity are

the source of funds to acquire assets. The relation of assets, liabilities and equity is reflected in the accounting equation:

Assets = Liabilities + Owner's Equity (A = L + OE)

1. **Assets** are resources owned or controlled by a company; these resources are expected to yield future benefits.
2. **Liabilities** are creditors' claims on assets.
3. **Equity** is the owner's claim on assets; equity is also called *net assets* or *residual equity (interest)*.

A corporation's equity—often called stockholders' or shareholders' equity—has two parts: contributed capital and retained earnings:

a. **Contributed capital**, refers to the amount that stockholders invest in the company—included under the title **common stock**.

b. **Retained earnings** refer to income (revenues less expenses) that is not distributed to stockholders. The distribution of assets to stockholders is called **dividends**, which reduce retained earnings. **Revenues** increase retained earnings via net income from a company's earnings activities. **Expenses** decrease retained earnings and are the cost of assets or services used to earn revenues.

4. The above breakdown of equity yields the expanded accounting equation:
   A= L + Contributed Capital + Retained Earnings

   A = L + Common Stock – Dividends + Revenues – Expenses

5. **Net income** occurs when revenues exceed expenses. A **net loss** occurs when expenses exceed revenues, which decreases equity.

B. **Transaction Analysis**

Business activities can be described in terms of transactions and events. **External transactions** are exchanges of value between two entities, which yield changes in the accounting equation. **Internal transactions** are exchanges within an entity; they can also affect the accounting equation. **Events** refer to those happenings that affect an entity's accounting equation and can be reliably measured. The next section uses the accounting equation to analyze eleven selected transactions and events. Transactions leave the accounting equation in balance; assets always equal the sum of liabilities and equity.

Transaction 1: Investment by Owner
+ Assets (Cash) = + Equity (Common Stock)
After this transaction, cash (an asset) and stockholders' equity equal the amount invested. The source of the increase in equity is the owner's investment (stock issuance), which is included in Common Stock.

Transaction 2: Purchase supplies for cash
+Assets (Supplies) = – Assets (Cash)
This transaction changes the form of assets from cash to supplies; the decrease in cash is exactly equal to the increase in supplies.

Transaction 3: Purchase Equipment for Cash

+ Assets (Equipment) = – Assets (Cash)
Like Transaction 2, this transaction is an exchange of one asset, cash, for another asset, equipment; the equipment is an asset because of its expected future benefits.

Transaction 4: Purchase Supplies on Credit
+Assets (Supplies) = + Liability (Account Payable)
The supplies are acquired in exchange for a promise to pay for them later; the liability created is referred to as *accounts payable*.

Transaction 5: Provide Services for Cash
+ Assets (Cash) = + Equity (Revenues)
The company earns revenues by providing services to its clients; the increase in equity is included in revenues because the cash received from clients is earned by providing services.

Transactions 6 and 7: Payment of Expenses in Cash
- Assets (Cash) = – Equity (Expenses)
These two transactions involve the payment of cash for this month's rent and employee salary; the costs of both rent and salary are expenses, as opposed to assets, because their benefits are used in the current month (they have no further benefits after the current month). Both transactions decrease equity which is included in the column titled Expenses.

Transaction 8: Provide Services and Facilities for Credit
+ Assets (Accts Receivable) = + Equity (Revenues)
The company earns revenues by providing services to its clients; the clients are billed for the services. This transaction results in an asset, called *accounts receivable*, which is the amount owed by this client, and also yields an increase in equity reflected in the column titled Revenues.

Transaction 9: Receipt of Cash from Accounts Receivable
+ Assets (Cash) = – Assets (Accounts Receivable)
The client pays the company the amount that it was billed for the services provided in Transaction 8. This transaction does not change the total amount of assets and does not affect liabilities or equity; it converts the receivable (an asset) to cash (an asset). It does not create new revenue. The revenue was recognized in Transaction 8.

Transaction 10: Payment of accounts payable
– Assets (Cash) = – Liability (Accounts Payable)
The company made a partial payment to the vendor for the supplies acquired in Transaction 4. This transaction decreases cash and decreases its liability to the vendor. Equity does not change; this event does not create an expense. The expense will be recorded in the future when the company derives the benefits from these supplies by using them.

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Transaction 11: Payment of cash dividend
– Assets (Cash) = – Equity (Dividends)
The company declared and paid a dividend to its owner. Dividends (decreases in equity) are not reported as expenses because they are not part of the company's earnings process, and they are not used in computing net income.

IV. Financial Statements

A *Income Statement*
Reports on operating revenue and expense activities *over a period of time*. Net income (or loss) is computed as sales less all costs and expenses. Revenues are reported first followed by expenses. Expenses reflect the costs to generate the revenue reported.

B. *Statement of Retained Earnings*
Reports changes in retained earnings of the business over a period of time. Changes result from net income, which increases retained earnings. A net loss and dividends decrease retained earnings. Ending retained earnings is reported on the balance sheet.

C. *Balance Sheet*
Reports a listing of amounts for assets, liabilities, and equity *at a point in time*.

D. *Statement of Cash Flows*
Reports on cash flows for operating, investing, and financing activities over a period of time.

V. Global View

A. Basic Principles - both U.S. GAAP and IFRS include broad and similar guidance for financial accounting. However, neither system specifies particular account names nor the detail required.

B. Transactions Analysis - both U.S. GAAP and IFRS apply transaction analysis identically as shown in this chapter. Some variations exist in revenue and expense recognition and other principles.

C. Financial Statements - Both U.S. GAAP and IFRS prepare the same four basic financial statements.

VI. Decision Analysis—Return on Assets (ROA)

A. Return on assets, also called return on investment (ROI), is a profitability measure; useful in evaluating management, analyzing and forecasting profits, and planning activities.

B. It is calculated by dividing net income by average total assets.

VII. Return and Risk Analysis (Appendix 1A)

A. Net income is often linked to return. Return on assts (ROA) is stated in ratio form as income divided by assets invested.

B. **Risk** is the uncertainty about the return we will earn. All business investments involve risk, but some involve more risk than others.

C. The lower the risk of an investment, the lower is our expected return. Higher risk implies higher, but riskier, expected returns.

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D. The trade-off between risk and return is a normal part of business. We use accounting information to assess both return and risk.

VIII. Business Activities and the Accounting Equation (Appendix 1B)

There are three major types of business activities:

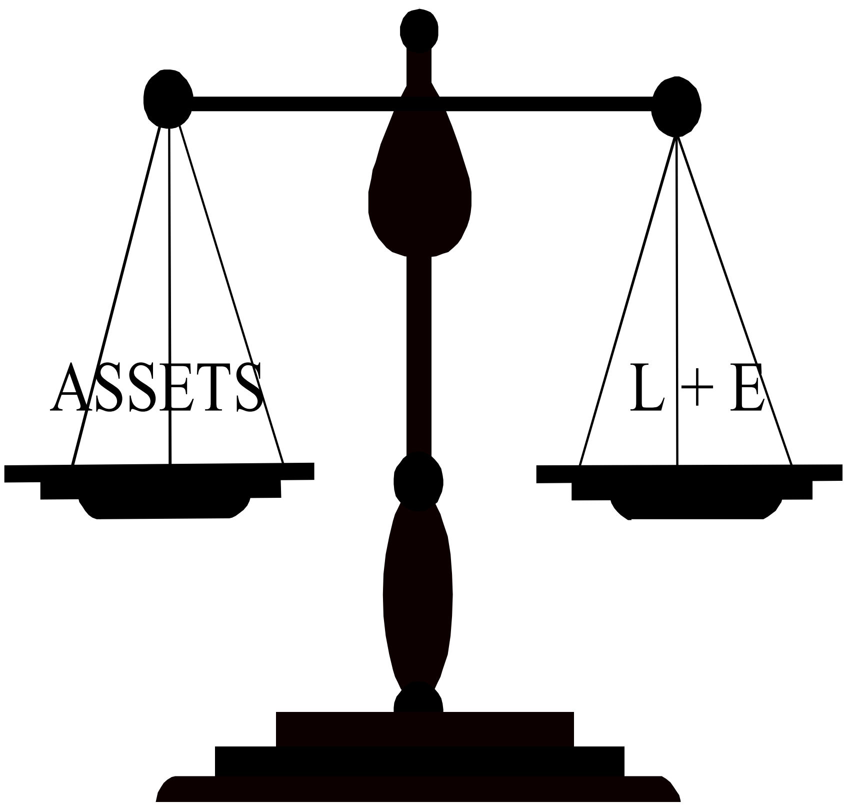
A. Financing Activities—provide the means organizations use to pay for resources such as land, buildings, and equipment to carry out plans.

B. Investing Activities—the acquiring and disposing of resources (assets) that an organization uses to acquire and sell its products or services.

C. Operating Activities—involve using resources to research, develop, purchase, produce, distribute, and market products and services.

VISUAL #1-1

WARNING: NO MATTER WHAT HAPPENS
ALWAYS KEEP THIS SCALE
IN BALANCE



Basic Accounting Equation

ASSETS = LIABILITIES + EQUITY

TRANSACTION ANALYSIS RULES

1) Every transaction affects at least two items.

2) Every transaction must result in a balanced equation.

TRANSACTION ANALYSIS POSSIBILITIES:			
A		=	L + E
(1)	+	and	+
or (2)	-	and	-
or (3)	+ and -	and	No change
or (4)	No change	and	+ and -