# ACCT-111 Principles of Accounting

Luka Trikha

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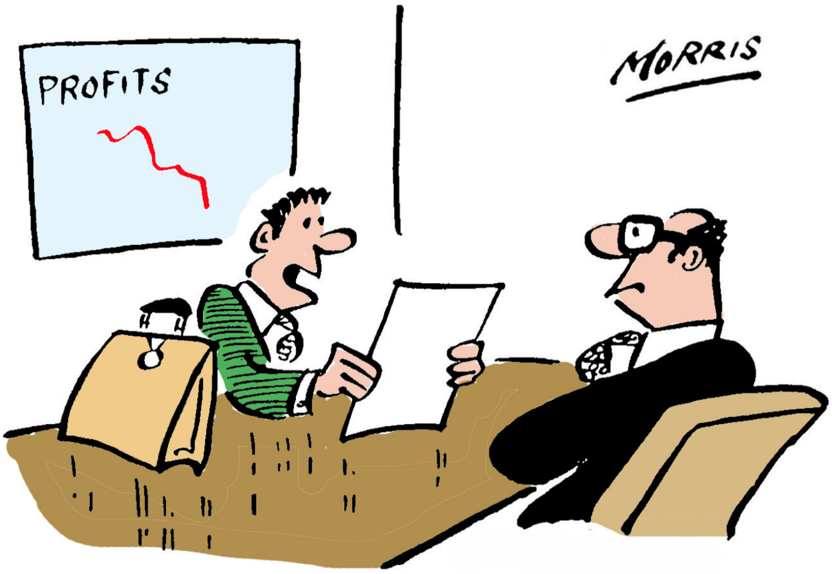


"The short-term solution is money and the long-term solution more money."

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# 1 Accounting and the Business Environment

## 1.1 Why is Accounting Important?

**Accounting** is the information system that measures business activities, processes the information into reports, and communicates the results to decision makers.

Accounting can be divided into two major fields, *financial accounting* and *managerial accounting.*

**Financial accounting** provides information for external decision makers such as outside investors, lenders, customers, and the federal government.

**Managerial accounting** focuses on information for internal decision makers, such as the company's managers and employees. Other definitions to note:

- **Creditor** are a person or business to whom a business owes money.
- **Certified public accountant (CPA)** are professional accountants who serve the general public.
- **Certified management accountants (CMA)** are professionals who work for a single company.

## 1.2 What are the Organizations and Rules that Govern Accounting?

There are different private and federal organizations which dictate accounting standards in the united states.

The **Financial Accounting Standards Board (FASB)** is a privately funded organization that oversees the creation and governance of accounting standards in the United States.

The **Securities and Exchange Commission(SEC)** is a U.S. Government agency that oversees the U.S. Financial markets, as well as oversees organizations that set standards (like FASB).

The guidelines for accounting information are called the **Generally Accepted Accounting Principles (GAAP**. It was created and governed by the FASB. GAAP rests on a conceptual framework that identifies the objectives, characteristics, elements, and implementation of financial statements and creates the acceptable accounting practices. The goal of the GAAP is to provide **faithful representation** of data. Faithful representation is information that is complete, neutral and free from material error.

Time to look at different types of economic entities. Below is a chart that goes into depth the various different business organizations that can be found.

| | Sole Proprietorship | Partnership | Corporation | Limited-Liability Company (LLC) |
|---|---|---|---|---|
| **Definition** | A business with a single owner | A business with two or more owners and not organized as a corporation | A business organized under state law that is a separate legal entity | A company in which each member is only liable for his or her own actions |
| **Number of owners** | One (called the *proprietor*) | Two or more (called *partners*) | One or more (called *stockholders*) | One or more (called *members* or *partners*) |
| **Life of the organization** | Terminates at owner's choice or death | Terminates at a partner's choice or death | Indefinite | Indefinite |
| **Personal liability of the owner(s) for the business's debts** | The owner is personally liable. | The partners are personally liable. | Stockholders are not personally liable. | Members are not personally liable. |
| **Taxation** | Not separate taxable entities. The owner pays tax on the proprietorship's earnings. | Partnership is not taxed. Instead partners pay tax on their share of the earnings. | Separate taxable entity. Corporation pays tax. | LLC is not taxed. Instead members pay tax on their share of earnings. |
| **Type of business** | Small businesses | Professional organizations of physicians, attorneys, and accountants | From small business to large multinational businesses | An alternative to the partnership |

Figure 1: Table of four different business organizations and the characteristics of each organization

When starting to note the costs you are spending/receiving, it is important to use the **cost principle**. The cost principle states that any acquired assets and services should be recorded at their actual host (or *historical cost*, aka the price *actually* paid or transaction on a receipt. We do this because it is a reliable measurement when looking back at transactions.

Noting historical costs is also good for **going concern assumption**, which is the assumption that a business will remain in operation long enough to use existing resources for their intended purposes.

The costs we keep track of are in dollar units, since that is the medium of exchange in the U.S. Even though inflation can decrease the value of the dollar, accountants assume the dollar's purchasing power is stable, and that is the essence of **monetary unit assumption**. Monetary unit assumption requires items on a financial statement be in units of monetary value.

So far, these principals are the ones that follow U.S. GAAP and are traded on the U.S stock exchange. But if a company deals with international partners, then they will publish financial statements using the **International Financial Reporting Standards (IFRS)**, which are published by the **International Accounting Standards Board (IASB)**. IFRS is a set of global accounting standards that are used by more than 166 nations/jurisdictions and are usually less specific compared to U.S. GAAP. Another difference is that IFRS allows periodic revaluation of certain assets and liabilities to restate financial statements to market value rather than keeping the financial statements at historical cost.

There can be different ethical concerns when dealing with business and what they wish to disclose to the public/investors. This is why the SEC requires publicly help companies to have their financial statements audited by independent accountants. An audit is an examination of a company's financial statements and records. It is then up to the independent accountant to issue an opinion that states whether or not the financial statements give a fair picture of the company's financial situation.

There have been two major outcomes form scandalous accounting actions. The **Sarbanes-Oxley Act (SOX)** requires management to review internal control and take responsibility for the accuracy and completeness of their financial reports. The SOX also created the **Public Company Accounting Oversight Board (PCAOB)** to monitor the work of independent accountants who audit public companies.

## 1.3 What is the Accounting Equation?

The **accounting equation** measures the resources of the business (what the business owns or has control of) and the claims to those resources ( what the business owes to creditors and to the owners). The equation is $Assets = Liabilities + Equity$. Since this is an *equation*, both sides need to be equal to each other, that is, the total amount in *assets* must equal the total amount of $liabilities + equity$. This is also called "balancing the books."

An **asset** are economical resources that are expected to benefit the business in the future and something the business owns or has control of. A few examples of what an asset is are:

- cash
- merchandise inventory
- furniture
- land
- equipment

A **liability** are debts that are owed to creditors. They are something the business owes and represent the creditors' claim on the business's assets. Most of the times, liabilities have the word *payable* in their titles. Examples of liabilities are:

- accounts payable
- notes payable
- salaries payable
- a creditor who has loaned money to a business has a claim to some of the business's assets until the business pays the debt.

**Equity** is the owner's claim to the assets of the business. This is also called *owner's equity*. Equity represents the amount of assets that are left over after the company has paid its liabilities. It is the company's net

When an owner of a business contributes to a business (cash, equipment, etc.), this is called **owner's capital**. This can also be called common stock. When a business makes earnings from delivering goods or services to customers, this is called **revenue**. Some examples of revenue are:

- sales revenue
- service revenue
- rent revenue

Again, these are ways that equity increases for the business.

Equity can also decrease when an owner makes a withdrawal or the business has expenses it needs to pay.

**Owner's *withdrawals*** or ***drawings*** are payments of equity (usually in cash) to the owner. Owner withdrawals are the opposite of owner contribution. Owner withdrawals are *not* expenses. Owner's drawings can also be known as dividends.

**Expenses** are the costs of selling goods or services. Some examples of expenses are:

- rent expense
- salaries expense
- advertising expense
- utilities expense

While looking at this as a whole, we can calculate a **net income** or a **net loss**. A net income is when the difference between revenue and expenses is positive ($revenue - expenses = +$), while net loss is when the difference between revenue and expenses are negative ($revenue - expenses = -$).

As a reminder, assets are what a company has, liabilities are what a company owes, and equity is the net worth of the company.

## 1.4 How do you Analyze a Transaction?

A transaction is any event that affects the financial position of the business *and* can be measured with faithful representation (trustworthy exchange between goods and services, expenses, etc.) Accountants do not note any type of financial anomaly that appear (financial booms, recession, inflation, etc.), accountants only note down what is of monetary value and can be measured reliably. Furthermore, they will only account for the true cost of the transaction, ignoring *potential* value and only focusing on what goods and services are worth at the time the transaction occurred.

When looking at transactions with a business, you must always look in the eyes of the business, not the owner or customer.

There can be two different types of assets/liabilities you can see when looking at a transaction, **accounts payable** and **accounts receivable**.

Accounts payable is a short-term *liability* that will be paid in the future. This is when a business obtains an asset but does not pay right away, instead, the business promises to pay in the future (like credit).

Accounts receivable (*equity*) is when a company give away goods or services, and is promised revenue (cash) from the customer in the future.

## 1.5 How do you Prepare Financial Statements?

In order to determine whether a business is profitable or not, an analysis of **financial statements** are required. There are four different financial statements that need to be prepared in order to make decisions. All four documents are prepared in an ordered list as seen in figure 2.

### 1.5.1 Income statements

An income statement (also called *statement of earnings* is a summary of a business entity's revenues and expenses for a period of time (months, quarters, yearly). Income statement tells us whether the business:

- has a *net income* (total revenue is greater than total expenses)
- has a *net loss* (total expenses are greater than total revenue)

***Only*** revenues and expenses are reported on an income statement. Information on what an income statement should have is shown in figure 3

| Financial Statement | Information Provided and Purpose | How Is It Prepared? |
|---|---|---|
| Income statement | Provides information about profitability for a particular period for the company | Revenues − Expenses = Net Income or Net Loss |
| Statement of owner's equity | Shows the changes in the owner's capital account for a particular period | Owner, Capital, Beginning<br>+ Owner Contribution<br>+ Net Income or − Net Loss for the period<br>− Owner withdrawal<br>= Owner, Capital, Ending |
| Balance sheet | Provides valuable information to financial statement users about economic resources the company has (assets) as well as debts the company owes (liabilities), and allows decision makers to determine their opinion about the financial position of the company | Assets = Liabilities + Owner's Equity |
| Statement of cash flows | Reports on a business's cash receipts and cash payments for a period of time | Cash flows from operating activities<br>Cash flows from investing activities<br>Cash flows from financing activities |

Figure 2: Ordered list of how financial statement documents should be prepared

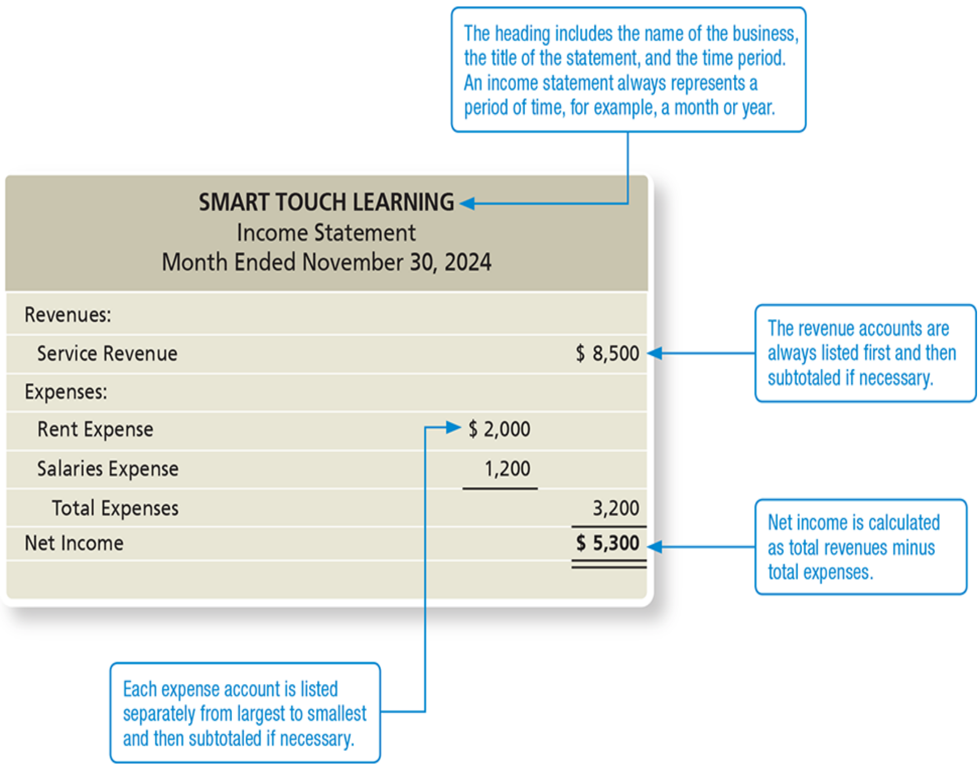



Figure 3: Similar information every income statement should have

### 1.5.2 Statement of Owner's Equity

A statement of owner's equity shows the changes in owner's capital for a business entity for a period of time (months, quarters, yearly). This document is built upon the income statement. See figure 4 a reference.

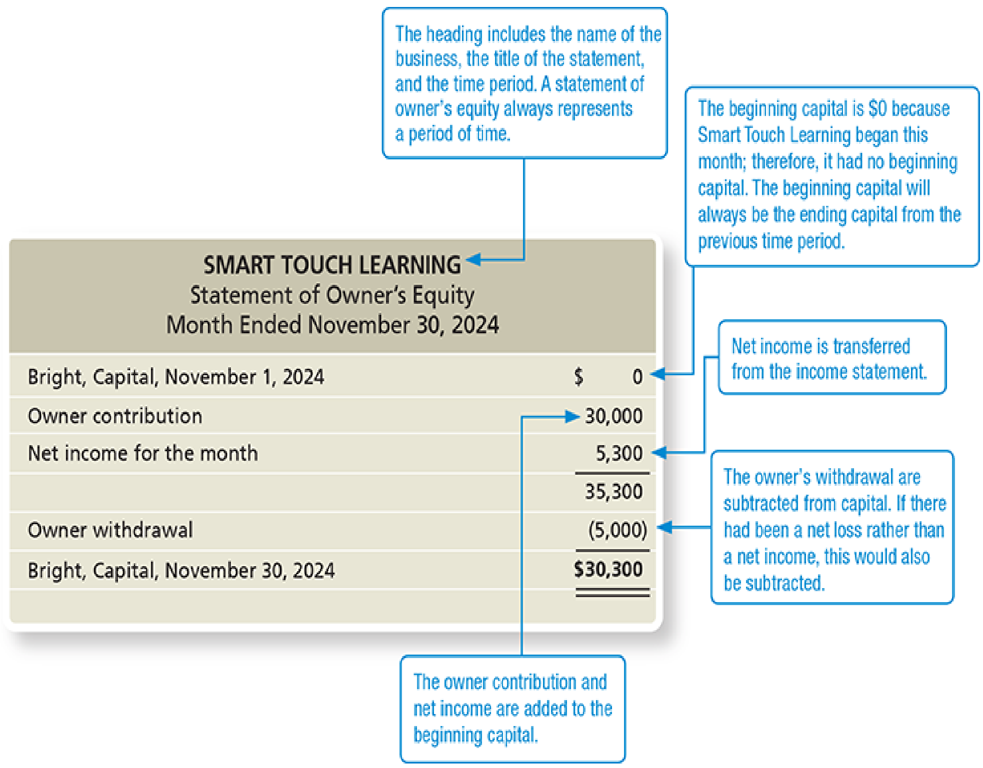



Figure 4: Similar information every owner's equity should have

### 1.5.3 Balance Sheet

Also known as the *statement of financial position*, the balance sheet lists a business entity's assets, liabilities, and owner's equity for a period of time (months, quarters, yearly). Balance sheets are seen as a snapshot of the business entity, and is used by investors or creditors to quickly assess the overall health of a business. Figure 5 shows an example of a balance statement.

### 1.5.4 Statement of Cash Flow

Statements of cash flow reports cash coming in (positive) and going out (negative). If a transaction does not involve cash (buying supplies on account),

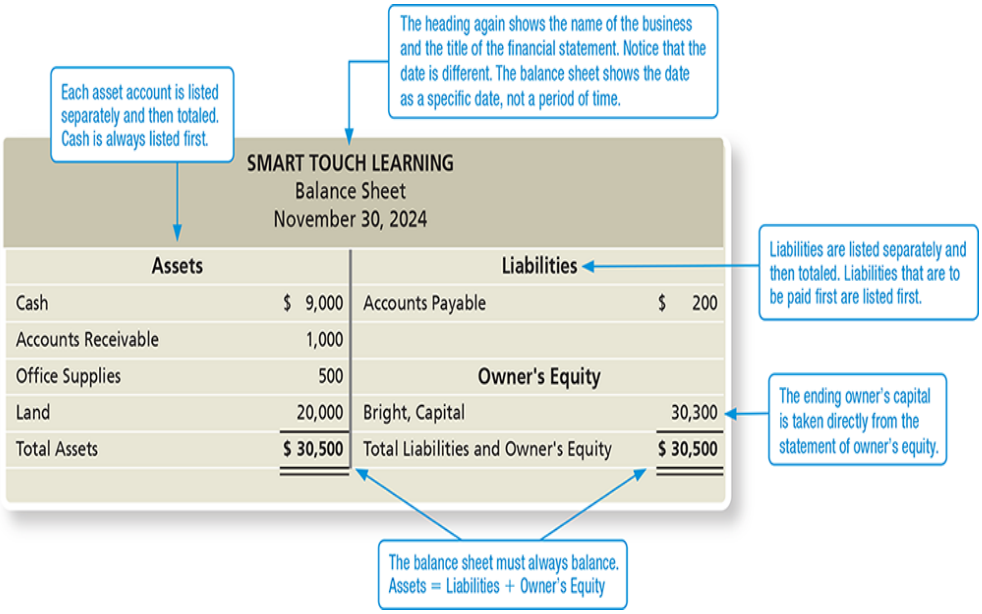



Figure 5: Similar information every balance sheet should have

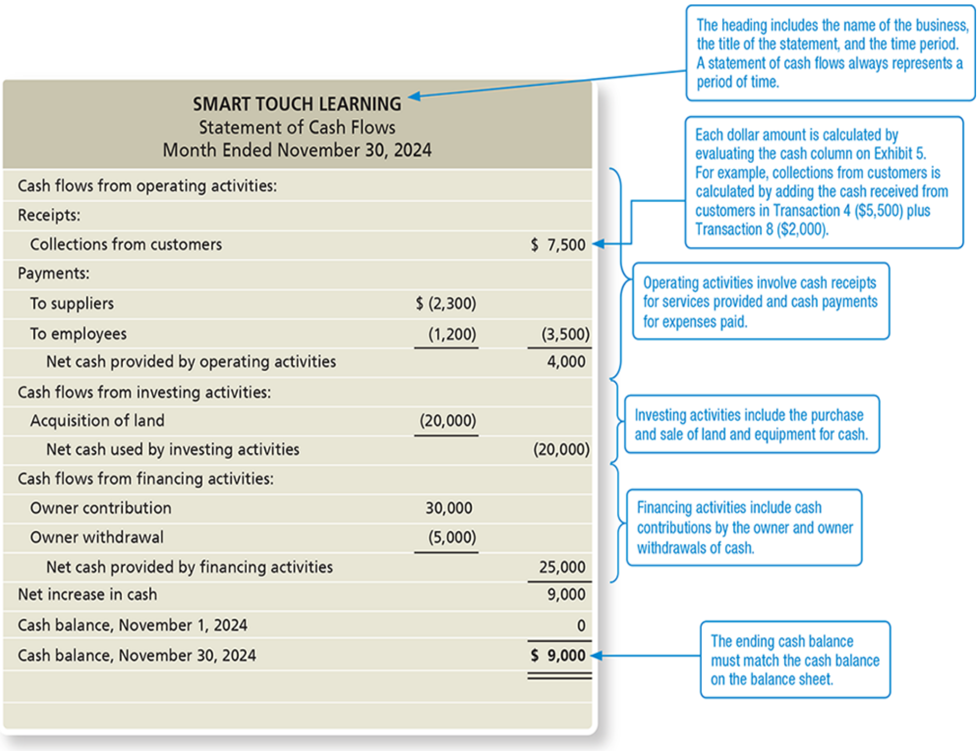
then it will not be reported in this statement. This statement is to analyze net increases or decreases during a period of time (months, quarters, yearly). Cash flow statements are divided into three sections:

- **Operating activities** involve cash payments for expenses.
- **Investing activities** involve the cash purchase and sale of land and equipment.
- **Financial activities** involve cash contributions by the owner, cash withdrawals paid to the owner, cash received from borrowing, and cash paid when loans are repaid.

Figure 6 how a cash flow statement looks like.

## 1.6 How do you use Financial Statements to Evaluate Business Performance?

When you have a financial statement, you can compute the **return on assets (ROA)** to determine how well a company is performing. ROA measures how profitably a company uses its assets. It is calculated by $Returnonassets = \frac{\text{net income}}{\text{average total assets}}$. Average total assets is calculated by adding the beginning and ending total assets for the time period and diving by two. Average total assets $= \frac{(\text{beginning total assets} + \text{ending total assets})}{2}$.



SMART TOUCH LEARNING
Statement of Cash Flows
Month Ended November 30, 2024

| | | |
|---|---|---|
| Cash flows from operating activities: | | |
| Receipts: | | |
| Collections from customers | | $ 7,500 |
| Payments: | | |
| To suppliers | $ (2,300) | |
| To employees | (1,200) | (3,500) |
| Net cash provided by operating activities | | 4,000 |
| Cash flows from investing activities: | | |
| Acquisition of land | (20,000) | |
| Net cash used by investing activities | | (20,000) |
| Cash flows from financing activities: | | |
| Owner contribution | 30,000 | |
| Owner withdrawal | (5,000) | |
| Net cash provided by financing activities | | 25,000 |
| Net increase in cash | | 9,000 |
| Cash balance, November 1, 2024 | | 0 |
| Cash balance, November 30, 2024 | | $ 9,000 |



Figure 6: Similar information every cash flow should have