CHAPTER 1
ACCOUNTING IN BUSINESS

Chapter Outline | Notes

I. **Importance of Accounting**—we live in the information age, where information, and its reliability, impacts the financial well-being of us all.

A. Accounting Activities
Accounting is an information and measurement system that identifies, records and communicates relevant, reliable, and comparable information about an organizations business activities.

B. Users of Accounting Information

1. External Information Users—those not directly involved with running the company. Examples: shareholders (investors), lenders, customers, suppliers, regulators, lawyers, brokers, the press etc.

a. Financial Accounting—area of accounting aimed at serving external users by providing them with *general-purpose financial statements*.

b. General-Purpose Financial Statement—statements that have broad range of purposes which external users rely on.

2. Internal Information Users—those directly involved in managing and operating an organization.

a. Managerial Accounting—is the area of accounting that serves the decision-making needs of internal users.

b. Internal Reports—not subject to same rules as external reports. They are designed with special needs of internal users in mind.

3. Internal Controls—procedures set up to protect company property and equipment, ensure reliable accounting reports, promote efficiency, and encourage adherence to company policies.

II. Fundamentals of Accounting—accounting is guided by principles, standards, concepts, and assumptions.

A. Ethics—a key concept. Ethics are beliefs that distinguish right from wrong.

B. Generally Accepted Accounting Principles (GAAP)—concepts and rules that govern financial accounting. Purpose of GAAP is to make information in accounting statements relevant, reliable and comparable.

Chapter Outline

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1. Setting Accounting Principles
   a. In U.S. major rule-setting bodies are the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB).
   b. The International Accounting Standards Board (IASB) issues standards that identifies preferred accounting practices in the global economy and hopes to create harmony among accounting practices in different countries.
2. Principles and Assumptions of Accounting—two types are *general* (basic assumptions, concepts and guidelines for preparing financial statements; stem from long used accounting practices) and *specific* (detailed rules used in reporting transactions; from rulings of authoritative bodies). The four principles discussed in this chapter are:
   a. *Cost principle*—financial statements are based on actual costs incurred in business transactions. Cost is measured on a cash or equal-to-cash basis. This principle emphasizes reliability and verifiability, and information based on cost considered objective. *Objectivity* means information is supported by unbiased evidence: more than someone's opinion.
   b. *Revenue recognition principle*—revenue is recognized (recorded) when earned. Proceeds need not be in cash. Revenue is measured by cash received plus the cash value of other items received.
   c. *Matching principle*—a company must record expenses incurred to generate revenues it reported.
   d. *Full disclosure principle*—requires reporting the details behind the financial statements that would impacts users' decisions.

   The four assumptions discussed in this chapter are:
   a. *Going-concern assumption*—accounting information reflects the assumption that the business will continue operating instead of being closed or sold.
   b. *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.
   c. *Time period assumption*—the life of the company can be divided into time periods, such as months and years, and that useful reports can be prepared for those periods.

d. *Business entity assumption*—a business is accounted for separate from other business entities and separate from its owner.

III. Transactions Analysis and the Accounting Equation

A. Accounting equation (Assets = Liabilities + Equity)—elements of the equation include:

1. Assets—resources owned or controlled by a company that are expected to yield future benefit. (i.e. cash, supplies, equipment and land)
2. Liabilities—creditors' claims on assets. These claims reflect obligations to transfer assets or provide products or services to others.
3. Equity—owner's claim on assets. Also called *net assets* or *residual equity.*

B. Changes in Equity—result from investments, revenues, withdrawals, expenses.

1. Investments—assets an owner puts into the company results in an increase in equity. Recorded under the title *Owner, Capital*.
2. Revenues—gross increases in equity resulting from a company's earning activities.
3. Owner's withdrawals—assets an owner takes from the company for personal use (results in decrease in equity).
4. Expenses—cost of assets or services used to earn revenues (results in decrease in equity).

C. Expanded Accounting Equation:

Assets = Liabilities + Owner's Capital – Owner's Withdrawal + Revenues – Expenses

D. Transaction Analysis—each transaction and event always leaves the equation in balance. (Assets = Liabilities + Equity)

1. Investment by owner =
   +Asset (Cash) = + Owner's Equity (Owner's Name, Capital)
   reason: investment
   Increase on both sides of equation keeps equation in balance
2. Purchase supplies for cash =
   +Asset (Supplies) = – Asset (Cash)
   Increase and decrease on one side of the equation keeps the equation in balance.
3. Purchase equipment for cash =
   + Asset (Equipment) = – Asset (Cash)
   Increase and decrease on one side of the equation keeps the equation in balance.
4. Purchase supplies on credit =
   + Asset (Supplies) = + Liability (Account Payable)
   Increase on both sides of equation keeps equation in balance.
5. Provide services for cash =
   + Asset (Cash) = + Owner's Equity (reason: revenue earned)
   Increase on both sides of equation keeps equation in balance.

6. Payment of expense in cash (salaries, rent etc.) =
   – Asset (Cash) = – Owner's Equity (reason: expense incurred)
   Decrease on both sides of equation keeps equation in balance.
7. Provided services and facilities for credit =
   + Asset (Accts Receivable) = + O E (reason: revenue earned)
   Increase on both sides of equation keeps equation in balance.
8. Receipt of cash from account receivable =
   + Asset (Cash) = – Asset (Accounts Receivable)
   Increase and decrease on one side of the equation keeps the equation in balance.
9. Payment of accounts payable =
   –Asset (Cash) = – Liability (Accounts Payable)
   Decrease on both sides of equation keeps equation in balance.
10. Withdrawal of cash by owner =
    –Asset (Cash) = – Equity (reason: owner's withdrawal)
    Decrease on both sides of equation keeps equation in balance.(note: since withdrawals are not expenses they are not used in computing net income.)

IV. Financial Statements

The four financial statements and their purposes are:

1. *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.)
2. *Statement of Owner's Equity*—explains changes in equity from net income (or loss) and from owner investment and withdrawals over a period of time.
3. *Balance Sheet*—describes a company's financial position (types and amounts of assets, liabilities, and equity) at a point in time.
4. *Statement of Cash Flows*—identifies cash inflows (receipts) and cash outflows (payments) over a period of time.

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.

VI. **Business Activities and the Accounting Equation—Appendix 1B**

A. The accounting equation is derived from business activities.

B. Three major business activities are:

1. Financing activities—activities that provide the means organizations use to pay for resources such as land, buildings, and equipment to carry out plans. Two types of financing are:
    a. Owner financing—refers to resources contributed by owner including income left in the organization.
    b. Nonowner (or creditor) financing—refers to resources contributed by creditors (lenders).
2. Investing activities—are the acquiring and disposing of resources (assets) that an organization uses to acquire and sell its products or services.
3. Operating activities—involve using resources to research, develop, purchase, produce, distribute, and market products and services.

C Investing (assets) is balanced by Financing (liabilities and equity). Operating activities is the results of investing and financing.