Chapter 1: Introduction to Accounting

Topics:

- Definition of Accounting
- Users of Accounting Information
- Branches of Accounting
- Accounting concepts and principles
- Accounting equation

Definition of Accounting:

- Accounting is an information system that measures business activities, processes that information into reports, and communicates the results to decision makers. For this reasons, it is called the "language of business".
- Personal planning, educational expenses, loans, car payments, and income taxes all use the information system we call accounting.
- Accounting is an information system that tells us how well a business is performing in terms of profits and losses and where it stands in financial terms.

"Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are in part at least, of a financial character, and interpreting the result thereof."

American Institute of Certified Public Accountants (AICPA)

"Accounting is the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information."

American Accounting Association (AAA)

"Accounting is a service activity. Its function is to provide qualitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions."

Accounting Principle Board (APB)

So Accounting is-

- the art of recording, classifying, and summarizing financial transactions and events;
- a service activity;
- the process of communicating economic & qualitative information to permit informed judgments and decisions by users of the information.

History and Development of Accounting

The name that looms largest in early accounting history is **Luca Pacioli**, who in **1494** first described the system of double-entry bookkeeping used by Venetian merchants in his "Summa de Arithmetica, Geometria, Proportioni et Proportionalita." Of course, businesses and governments had been recording business information long before the Venetians. But it was Pacioli who was the first to describe the system of debits and credits in journals and ledgers that is still the basis of today's accounting systems.

The industrial revolution spurred the need for more advanced cost accounting systems, and the development of corporations created large groups who were not part of a firm's management but had a vested interest in the company's results—namely, shareowners and bondholders who provided external financing. The rising public status of accountants helped to transform accounting into a profession, first in the United Kingdom and then in the United States. In 1887, thirty-one accountants joined together to create the American Association of Public Accountants. The first standardized test for accountants was given a decade later, and the first CPAs were licensed in 1896.

Users of Accounting Information:

In general, Users of accounting information fall into three categories.

1. Internal managers, who use the information for short term planning and controlling routine operations;
2. Internal managers, who use the information for making nonroutine decisions (for example, investing in equipment, pricing products and services, choosing which products to emphasize or de-emphasize) and formulating overall policies and long range plans.
3. External parties, such as-
    - Investors
    - Lenders
    - Suppliers and other trade creditors
    - Customers
    - Government and their agencies
    - Taxing authorities
    - Public
    - Nonprofit organizations

Branches of Accounting:

1. Financial accounting: financial accounting focuses on the information needs for external user of an entity.

2. Management accounting: Management accounting is primarily concerned with the information used for internal management decisions making within the entity.

Accounting concepts and principles:

Accounting Concepts

Assumptions	Principles	Constrains
1.Economic entity 2.Going concern 3.Monetary unit 4.Periodicity	1.Historical cost 2.Revenue recognition 3.Matching 4.Full discloser	1.Cost benefit 2.Materiality 3.Industry practice 4.Conservatism

Assumptions:

1. Economic entity: The assumption that the activity of a business enterprise can be kept separate and distinct from its owner and any other business unit.
2. Going concern: The assumption that the business enterprise will have a long life.
3. Monetary unit: The assumption that money is the common denominator by which economic activity is conducted, and that the monetary unit provides an appropriate basis for measurement and analysis.
4. Periodicity: The assumption that the economic activities of an enterprise can be divided into artificial time periods.

Principles:

1. Historical cost: Existing GAAP requires that most assets and liabilities be accounted for and reported on the basis of acquisition price.
2. Revenue recognition: Revenue is generally recognized when realized or realizable and when earned.
3. Matching: Expenses are recognized when the work (service) or the product actually makes its contribution to revenue.
4. Full discloser: Accountants follow the general practice of providing information that is of sufficient importance to influence the judgment and decisions of an informed user.

Constraints:

1. Cost benefit: The cost of using the information must be weighted against the benefits that can be derived from using the information.

2. Materiality: Materiality provides a threshold or cutoff point that involved is one of relative size and importance. An item is material if its inclusion or omission could influence or change the economic decisions of users taken on the basis of financial statements. So, sound and acceptable standards have to be followed in comparing the materiality of an amount.

3. Industry practice: Follow the general practices in the firm’s industry, which sometimes requires departure from basic theory.

4. Conservatism: When in doubt, choose the solution that will be least likely to overstate net assets and net income.

Accounting Organizations:

American Institute of Certified Public Accountants (AICPA)
Financial Accounting Standard Board (FASB)
Securities and Exchange Commission (SEC)
Institute of Chartered Accountants Bangladesh (ICAB)
Institute of Cost and Management Accounting Bangladesh (ICMAB)

Types of Business Organization:

1. **Proprietorship:** A proprietorship is a separate organization with a single owner. Most often the owner is also the manager. From an accounting view point, each proprietorship firm is an individual entity that is separate and distinct from the proprietor.

2. **Partnership:** A Partnership is a special form of organization that joins two or more individuals together as co-owners. From an accounting view point, each partnership firm is an individual entity that is separate from the personal activities of each partner.
3. **Corporations:** Corporations are organizations created by individual state laws. The owners are identified as stockholders. Individuals form a corporation by applying to the state for approval of company's articles of incorporation. When approved, the corporation becomes a legal entity, an artificial person that conducts its business completely apart from its owners.

Accounting Equation:
The most basic tool of the accountant is the accounting equation. This equation represents the assets of the business and the claims to those assets. This relationship of assets, liabilities, and owner's equity can be expressed as an equation follows:

Assets = Liabilities + Owner's Equity

Assets are the economic resources of a business that are expected to be of benefit in the future.

- Cash
- Land
- Building
- Equipment
- Machine
- Furniture
- Office Supplies
- Accounts Receivable
- Notes Receivable
- Prepaid Expense

Liabilities are 'outsider claims', which are economic obligations-debts-payable to outsiders. These outside parties are called creditors.

- Accounts Payable
- Notes Payable

Owner's equity or capital is 'insider claims' held by owners of the business. Owner's equity is measured by subtracting liabilities from assets.

- Capital
- Revenue
- Expenses
- Withdraw

Assets must be equal to the sum of liabilities and owner's equity. The accounting equation applies to all economic entities regardless of size, nature of business, or form of business organization.

- Increase in owner's equity—by owner's investments and revenue.
- Decrease in owner's equity—by owner's withdrawals and expenses.