

Introduction to Accounting: Lecture Notes

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1 Definition of Accounting

Accounting is the formal collection, aggregation, analysis, and reporting of financial and non-financial data about a company to various end users.

- **Mandated Reporting:** Public companies are required to release data periodically (typically quarterly and annually).
- **End Users:** Data is provided to both internal parties (managers) and external parties (investors, creditors).

2 The Three Types of Accounting

The field of accounting is broadly categorized into three distinct branches based on the target audience and purpose:

Type	Primary Audience	Purpose & Characteristics
Financial	External (Investors, Banks)	Assess performance, health, and credit risk.
Managerial	Internal (Management)	Decision making: pricing, product mix, and budgeting.
Tax	Tax Authorities (IRS)	Compliance and estimation of tax liabilities.

Table 1: Comparison of Accounting Branches

2.1 Financial Accounting

- **Primary Purpose:** To inform outsiders (equity investors, investment banks) for valuation and credit risk assessment.
- **Secondary Purpose:** To monitor managers and ensure responsible use of company resources.
- **Compliance:** Reports must follow specific rules and are audited by external parties for accuracy.

2.2 Managerial Accounting

- **Purpose:** Capacity planning, determining production volumes, and evaluating product profitability.
- **Format:** No fixed formats; reports are not audited.

3 Accrual Accounting

3.1 Meaning of Accrual Basis of Accounting

Under the **accrual basis of accounting**: A key element of financial accounting is the concept of **Accruals**. Financial statements are prepared on an accrual basis rather than a cash basis.

- Income is recognized when it is earned, irrespective of when cash is received.
- Expenses are recognized when they are incurred, irrespective of when cash is paid.

Thus, transactions are recorded at the time when the economic activity occurs, not when cash flows take place.

3.2 Meaning of Cash Basis of Accounting

Under the **cash basis of accounting**:

- Income is recorded only when cash is actually received.

- Expenses are recorded only when cash is actually paid.

This method ignores outstanding receivables, payables, and other non-cash adjustments.

3.3 Why Accrual Basis is Preferred for Financial Statements

3.3.1 True and Fair View

Accrual accounting follows the matching principle, whereby expenses are matched with the revenues earned during the same accounting period. This results in a true and fair view of financial performance.

3.3.2 Correct Measurement of Profit

Cash receipts and payments may relate to different accounting periods. Accrual accounting ensures that only the income and expenses pertaining to the current period are considered.

3.3.3 Better Assessment of Financial Position

Assets such as receivables and liabilities such as outstanding expenses are recognized, providing a realistic picture of the financial position of the entity.

3.3.4 Comparability and Consistency

Financial statements prepared on an accrual basis are comparable across different periods and entities, facilitating better decision-making by users.

3.4 Key Principles

Transactions are recognized when the *economic event* occurs, not necessarily when cash changes hands.

1. **Revenue Recognition:** Revenue is reported when earned (delivery of product/service), measurable, and collection is reasonably certain.
2. **Matching Principle:** Expenses related to revenues must be recognized in the same period as the revenue itself.

3.5 The Fundamental Difference

The distinction between earnings and cash flow is often summarized by the adage:

$$\text{Cash Flow} = \text{Fact} \quad \longleftrightarrow \quad \text{Earnings} = \text{Opinion}$$

3.6 Pros and Cons of Accrual Accounting

- **Advantages:** Provides timelier, decision-relevant information by reflecting economic reality.
- **Disadvantages:** Relies on managerial judgment and estimates, making it potentially less reliable than raw cash flow data.

3.7 Summary of Financial Statements

Accrual accounting directly results in the creation of two primary statements:

- **Income Statement:** Also known as the Profit and Loss (P&L) statement.
- **Balance Sheet:** Reflects the net financial position of the company.

4 Introduction to the Balance Sheet

The **Balance Sheet** captures the financial position of a company as of a *particular date* (e.g., the end of a quarter or the end of a fiscal year). It acts as a snapshot in time, showing what a company owns and what it owes.

4.1 The Accounting Equation

The balance sheet derives its name from the fact that it must always balance. This relationship is expressed through the fundamental accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity} \quad (1)$$

- **Assets:** Represent how the company *uses* its resources.
- **Liabilities & Equity:** Represent *where* the company gets its resources from.

4.2 Components of the Balance Sheet

4.2.1 Assets

Assets are resources owned by the company used to generate future economic benefits (higher cash inflows or lower cash outflows).

- **Classification:**
 - **Current Assets:** Expected to be converted to cash, sold, or consumed within **one year**. (Examples: Cash, equivalents, inventory).
 - **Non-current Assets:** Expected to be realized after one year. (Examples: Property, Plant, and Equipment [PP&E], Patents, Trademarks).

4.2.2 Liabilities

Liabilities represent the company's economic obligations to outsiders.

- **Classification:**
 - **Current Liabilities:** Obligations expected to be paid within **one year**. (Examples: Accounts payable, short-term borrowing).
 - **Non-current Liabilities:** Obligations expected to be settled after one year. (Example: Long-term debt).

4.2.3 Shareholders' Equity

This represents the owners' claims on the total assets of the company.

- **Contributed Capital:** Investments made by the owners.
- **Retained Earnings:** The aggregate undistributed profits of the company over time.

4.3 Key Characteristics

- **Historical Cost:** Items are recorded at their original purchase price. They are generally **not** updated to reflect current market values.
- **Presentation:**
 - Typically, Assets are on the left (or top), while Liabilities and Equity are on the right (or bottom).

- Formats may vary internationally based on local accounting standards.
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5 Overview of Assets

Assets represent how a company uses its resources to generate future economic benefits. On the balance sheet, assets are categorized based on their liquidity and expected lifespan.

5.1 Current Assets

Current assets are resources expected to be sold, converted to cash, or consumed within **one year**.

5.1.1 Cash and Cash Equivalents

This is the most liquid category. It includes:

- Currency, coins, and petty cash.
- Checks received but not yet deposited.
- Checking/savings accounts and money market accounts.
- Short-term, highly liquid investments with maturities of **three months or less** at the time of purchase.
- *Example:* Amazon (2015) held \$15.89 billion.

5.1.2 Marketable Securities

Investments in financial securities like stocks and bonds. While easily convertible to cash, they are considered less liquid than cash equivalents.

- *Example:* Amazon (2015) held \$3.92 billion.

5.1.3 Inventories

Includes physical goods at various stages of production:

- **Raw Materials:** Unprocessed materials.
- **Work in Progress (WIP):** Partially finished goods.
- **Finished Goods:** Products ready for sale.
- *Note:* Service industries may only have supplies, while retailers like Amazon hold massive finished goods (\$10.24 billion in 2015).

5.1.4 Accounts Receivable

Money owed to the company by its clients/customers. This occurs when a company extends credit by delivering a product or service before receiving payment.

- Represents a legal obligation from the client to the company.
- *Example:* Amazon (2015) had \$6.42 billion due from customers, vendors, and sellers.

5.2 Non-Current Assets

Non-current assets are long-term investments and resources that are expected to provide value for more than one year.

5.2.1 Property, Plant, and Equipment (PP&E)

The largest component of non-current assets for most physical businesses.

- **Tangible Items:** Land, buildings, machinery, office furniture, vehicles, and fixtures.
- **Technology:** Servers, networking equipment, and internal-use software.
- *Example:* Amazon (2015) held \$21.84 billion in PP&E (including capital leases).

5.2.2 Intangible Assets

Non-physical assets that contribute to a company's future value.

- **Intellectual Property:** Patents, trademarks, and copyrights.
- **Goodwill:** The value of a company's brand recognition and reputation (Amazon 2015: \$3.76 billion).

5.3 Total Asset Summary: Case Study Amazon (2015)

The total value of assets must be funded by either liabilities or equity.

- **Total Current Assets:** \$36.47 billion
 - **Total Non-Current Assets:** \$28.97 billion
 - **Total Assets:** \$65.44 billion
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