

lesson 1

What is accounting

The purpose of accounting is to provide information that will help you make correct financial decisions. The accountant's job is to provide the information needed to run a business as efficiently as possible while maximizing profits and keeping costs low.

Accounting plays a role in businesses of all sizes. Your kid's lemonade stand, a one-person business, and a multinational corporation all use the same basic accounting principles. Accounting is legislated; it affects your taxes; even the president plays a role in how accounting affects you.

Accounting is the language of business. It is the process of recording, classifying, and summarizing economic events through certain documents or financial statements. Like any other language, accounting has its own terms and rules. To understand how to interpret and use the information accounting provides, you must first understand this language. Understanding the basic concepts of accounting is essential to success in business.

Accounting and bookkeeping

Bookkeeping procedures and bookkeepers record and keep track of the business transactions that are later used to generate financial statements based on the transactions recorded through the bookkeeping process. Accountants are usually professionals who have completed at least a bachelor's degree in accounting, and often have passed a professional examination.

Accounting goes beyond bookkeeping and the recording of economic information to include the summarizing and reporting of this information in a way that is meant to drive decision making within a business.

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Who uses Accounting information?

In the world of business, accounting plays an important role to aid in making critical decisions. The more complex the decision, the more detailed the information must be. Individuals and companies need different kinds of information to make their business decisions.

Let's start with you as an individual. Why would you be interested in accounting? Accounting knowledge can help you with investing in the stock market, applying for a home loan, evaluating a potential job, balancing a checkbook, and starting a personal savings plan, among other things.

Managers within a business also use accounting information daily to make decisions, although most of these managers are not accountants.

Without the proper accounting information these types of decisions would be very difficult, if not impossible, to make.

Bankers continually use accounting information. They are in the business of taking care of your money and making money with your money, so they absolutely must make good decisions. Accounting is fundamental to their decision-making process.

Accountability in accounting

A business's financial statements can also be of great interest to other members of the local or national community. Labor groups might be interested in what impact management's financial decisions have on their unions and other employees. Local communities have an interest in how a business's financial decisions (for example, layoffs or plant closings) will impact their citizens.

As the economy becomes more complex, so do the transactions within a business and the process of reporting them to various users and making them understandable become more complex as well. A solid knowledge of accounting is helpful to individuals, managers, and business owners who are making their decisions based on the information accounting documents provide.

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The first step in the accounting process is to analyze every transaction (economic event) that affects the business. The accounting equation ($\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$) must remain in balance after every transaction is recorded, so accountants must analyze each transaction to determine how it affects owner's equity and the different types of assets and liabilities before recording the transaction.

Double-Entry Bookkeeping:

Accountants use double-entry bookkeeping system to keep the accounting equation in balance and to double-check the numerical accuracy of transaction entries. Under this system, each transaction is recorded using at least two accounts. An account is a record of all transactions involving particular item.

Under the double-entry bookkeeping system, the full value of each transaction is recorded on the debit side of one or two more accounts. Therefore, the combined debit balance of all accounts always equals the combined credit balance of all accounts.

Chart of accounts:

Companies maintain separate accounts for each type of asset (cash accounts receivable, inventory, etc.), each type of liability (accounts payable, wages payable, notes payable, etc.), owner investments (usually referred to as the owner's capital account in a sole proprietorship) owner drawings (withdrawals made by the owner), each type of revenue (sales revenue, service revenue, etc.), and each type of expenses (rent expense, wages expense, etc.). All accounts taken together make up the *general ledger*. For organizational purposes, each account in the general ledger is assigned a number, and companies maintain a *chart of accounts*, which lists the accounts and account numbers.

Account numbers vary significantly from one company to the next, depending on the company's size and complexity. A sole proprietorship may have few accounts, but a multinational corporation may have thousands of accounts and use ten- or even twenty-digit numbers to track accounts by

location, department, project code, and other categories. Most companies numerically separate asset, liability, owner's equity, revenue, and expense accounts. A typical small business might use the numbers 100-199 for asset accounts, 200-299 for liability accounts, 300-399 for owner's equity accounts, 400-499 for revenue accounts, and 500-599 for expense accounts.

Journal Entries

Business activities (transactions) are initially recorded on source documents such as invoices or checks. The first step in the accounting process is to *analyze* each transaction and identify what effect it has on the accounts. After making this determination, an accountant enters the transactions in chronological order into a journal, a process called *journalizing the transactions*. Although many companies use specialized journals for certain transactions, all businesses use a general journal. The journal's page number appears near the upper right corner. Many general journals have five columns: Date, Account Title and Description, Posting Reference, Debit and Credit.

Posting and General Ledger

To determine account balances, the amounts in the *journal entries* need to be placed in the general ledger. Transcribing the amounts from journal entries into the *general ledger* is called *posting*. From a procedural standpoint, transactions, events, and so on, are never initially entered into the general ledger. General journal entries are always prepared first and are then posted to the general ledger.

A typical account includes date, explanation, and reference columns to the left of the debit column and a balance column to the right of the credit column. The reference column identifies the journal page containing the transaction. The balance column shows the account's balance after every transaction.

The Trial Balance

After posting all transactions from an accounting period, accountants prepare a trial balance to verify that the total of all accounts with debit balances equals the total of all accounts with credit balances. The trial balance lists every open general ledger account by account number and provides separate debit and credit columns for entering account balances.

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Financial statements

Accountants supply information to people both inside and outside the firm by issuing formal reports that are called financial statements.

The financial statements are usually issued at least once a year. In many cases they are issued quarterly or more often where necessary. A set of rules, called Generally Accepted Accounting Principles (GAAP), govern the preparation and presentation of financial statements.

The Basic Financial Statements

The basic financial statements include the Balance Sheet, the Income Statement, The statement of Cash Flows, and the Statement of Retained Earnings. As we discuss these financial statements, you

will see they are not as scary as you might think they are. Many of the concepts will already be familiar to you.

How Different Business Entities Present Accounting Information

Proprietorships are businesses with a single owner like you and me. These types of businesses tend to be small retail businesses started by entrepreneurs. The accounting for these proprietorships includes only the records of the business_ not the personal financial records of the proprietor of the business.

Partnerships are very similar to proprietorships, except that instead of one owner, there are two or more owners. In general most of these businesses are small to medium-sized. However, there are some exceptions, such as large national or even international accounting or law firms that may have thousands of partners. As with the proprietorships, accounting treats these organizations' records as separate and distinct from those of the individual partners.

Finally there are corporations. These are businesses that are owned by one or more stockholders. These owners may or may not have a managerial interest in the company. Many of these stockholders are simply private citizens who have money invested in the company by way of stocks that they have purchased.

In a corporation a person becomes an owner by buying shares in the company and thus becomes a stockholder. The stockholders may or may not have a vote in the company's long-term planning, depending on the type of stock they have purchased.

However, simply by being stockholders (owners), they do not have decision-making authority in the day-to-day operations. These investors (or stockholders) are not much different than the bankers that loan money to a proprietorship or a partnership. These bankers have a financial interest in the business, but no daily managerial decision-making power.

The Accounting Records

As is the case with the stockholders who have invested money into the corporation, in general they have a no managerial interest in the business. As with the other two types of business organizations discussed here, the accounting records of the corporation are maintained separately from those of the individual stockholders or owners.

The accounting records of a proprietorship are less complex than those of a corporation in that there is a simple capital structure and only one owner. In the case of a corporation, there are stockholders who buy a piece of the ownership of a company by buying stock. As we will discuss later, because of this stock ownership, the financial statements become more complex.

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It is important that you understand the concepts of Generally Accepted Accounting Principles (GAAP), which form the basis of accounting and are part of the language of accounting and business. Third parties who invest in provide loans to any company must know that they can rely on the financial information provided.

Generally Accepted Accounting Principles (GAAP)

Generally Accepted Accounting Principles begin with the three basic assumptions made about each business. First, it is assumed that the business is separate from its owners or other businesses. Second, it is assumed that the business will be in operation indefinitely. Only when liquidation of a business is certain does this assumption no longer apply. Third, it is assumed a business's accounting records include only quantifiable transactions. Certain economic events that affect a company, such as hiring a new employee or introducing a new product, cannot be quantified in monetary units and, therefore, do not appear in a company's accounting records.

Financial statements must present relevant, reliable, understandable, sufficient, and practicably obtainable information in order to be useful.

Relevant Information

Relevant information is that information which helps financial statement users estimate the value of a firm and/or evaluate how well the firm is being managed. The financial statements must be stated in terms of a monetary unit, since money is our standard means of determining the value of a company.

Reliable Information

Reliable information is a key in accounting. Sufficient and objective evidence should be available to indicate that the information presented is valid. In addition, the information must not be biased in favor of one statement user or one group of users to the detriment of other statement users.

Verifiable Information

The need for verifiable information does not preclude the use of estimates and approximation. If you were to eliminate all estimates from accounting, the resulting statements would not be useful primarily because the statement would not provide sufficient information.

Understandable Information

To be understandable the financial information must be comparable. Any item on the Balance Sheet that an accountant labels as an Asset or Liability, users of the financial statements should also call Assets and Liabilities. Statement users must compare financial statements of various firms with one another, and they must compare statements of an individual firm with prior years' statements of that same firm in order to make valid decisions.

Quantifiable Information

Information is easier to understand and use if it is quantified. Most information that accountants and users of financial information use is represented by numbers. The information that is presented in the financial statements is presented in a numerical form; however, where that is impossible, the information (if it is relevant, reliable, understandable, and practicably obtainable) will be presented in narrative form, usually in a footnote to the statements.

Obtainable Information

Furthermore, to be useful, the information must be reasonably easy to obtain. This fits into the concept of cost vs. benefit. The information must be worth more than what it will cost to obtain it and must be secured on a timely basis. Financial statements must be prepared at least once a year (in many cases, quarterly or monthly).