**Chapter 1 – Introduction to Accounting Basics**

Even if you are not planning on being an accountant, you will need to be proficient in understanding accounting. It is the basis of most business and is called the language of business. Most of the jobs for graduating seniors go to accountants. So even if your heart is in another discipline, consider accounting as a way to get your foot in the door of a company.

**Accounting consists of three basic activities.**

1. Identify – What should be recorded in the accounting books of a company?
2. Record – How do we record transactions for a business? Recording encompasses keeping a systematic and chronological diary of the events that have been identified as those that should be recorded in the accounting system. Recording encompasses bookkeeping but accounting is more than bookkeeping.
3. Communicate – How to communicate the results of the business operations? Businesses publish their results in Financial Statements. Financial Statements consist of and are prepared in the following order.
   1. Income Statement
   2. Statement of Owners’ Equity or Shareholder’s Equity (In this course, we will learn about the Statement of Owners’ Equity – which is a statement for a sole proprietor. The Statement of Shareholders’ Equity is related to a corporation).
   3. Balance Sheet
   4. Statement of Cash Flows

For this course, we will focus on the I/S, SOE, and B/S.

**Users of Accounting Information**

The users of the information from the accounting system include both internal users and external users.

Internal users are the managers and owners of the company. They need accounting information to properly plan, organize and run the business. Managers include personnel from various divisions in the company including marketing, production, finance, and accounting as well as the company officers. General ledger accountants (accounting department) provide this information as well as managerial accountants. General ledger accountants interact with internal and external parties. Managerial accountants are accountants who support only internal users of information and aid in decision making.

External users include investors and creditors as well as taxing authorities and regulatory agencies. These users only have access to the published financial statements. Investors or owners use the information to determine levels of investment in the company and to assess the financial health of the company. Creditors or lenders (vendors and bankers) use accounting information to determine whether to extend credit or lend money.

**Does everyone have to use the same rules when preparing Financial Statements?**

The profession of accounting has developed rules over a long period of time to make certain there is a cohesive framework for accounting. These are Generally Accepted Accounting Principles (GAAP) that provide standards on recording economic events. We will be learning more about GAAP this semester than complicated math formulas. Accounting is more about following a framework and GAAP than it is about math. It is similar to learning a language.

If a company publishes financial statements in accordance with GAAP, then they will be following the rules we will learn. All public companies (companies listed on a stock exchange and sold to the public) must follow GAAP. All lenders require GAAP statements; therefore most companies follow GAAP. The Financial Accounting Standards Board (FASB) sets the standards for GAAP.

Public companies are regulated by the Securities and Exchange Commission (SEC) and are strictly required to follow GAAP.

Outside of the US, the standards are called International Financial Reporting Standards (IFRS) and are set by the International Accounting Standards Board (IASB). FASB and IASB are seeking to converge in the future.

**GAAP – Measurement Principles**

GAAP will either follow the historical cost principle or the fair value principle. Which one is used depends upon relevance and faithful representation. In this context, relevant information is information that is meaningful to a decision maker. Faithful representation means the accounting information and descriptions are factual. FASB uses these principles to guide them in making pronouncements on accounting treatment for a particular subject.

Historical Cost Principle – A transaction (accounting event) is recorded at cost even if the value of the item increases over time. Land purchased at $50,000 in 1970 will be carried on the books of a company in 2015 at $50,000 even if the land is now worth $6,000,000. (All items will be recorded at historical cost in this class). The cost principle is considered to be objective and verifiable because the value of transaction can be traced to a third party document.

Fair Value Principle – Current market prices instead of historical cost have been deemed by FASB to be more relevant for certain types of assets a company owns and liabilities it owes. (We will not use this principle this semester).

**Other GAAP Principles**

Revenue recognition principle – A company records revenue when earned not when paid. Companies (such as the New Orleans Saints) receive money before services are performed. Also, companies can earn revenue and wait for payment when a credit card is used or a customer will be billed.

Expense recognition principle – A company must recognize the expenses associated with earning revenue even if the expense are not yet paid for.

Full disclosure principle – A company must report all details in the financial statements that would affect a user’s decision either in the financial statements or in the accompanying notes.

**GAAP – Assumptions**

These assumptions are part of the foundation of GAAP. They are:

1. The monetary unit assumption—US companies record information expressed in dollars.
2. The going concern assumption—unless otherwise stated, the entity is considered to be a viable, continuing business.
3. The economic identity assumption–companies record only the information related to the company on the books of the company and should not commingle information from the owners or other companies. Each company should be separate from other companies and the activities of the owner should not be included in the books of the company.
4. The time period assumption—a company is assumed to have the ability to record transactions as of a specific date for financial reporting purposes

**GAAP – Specific Principles**

Each account has its own accounting treatment; and as we learn about them, we will learn about the specific GAAP principles associated with each.

**There are three basic company formats.**

Sole proprietor – owned by one person. It doesn’t take much money to form a sole proprietorship. The owners gets all of the profits, suffers all of the losses and are personally liable for all debts of the company. We will focus on a sole proprietorship this semester.

Partnerships – owned by two or more persons. Usually, there will be a partnership agreement guiding the accounting allocations among partners. Each partner has unlimited liability for the debts of the partnership and again, the partners must keep their assets and expenses separate from the partnership. Most common form for lawyers, doctors, accountants, and architects.

Corporations – owned by stockholders. Liability is limited to the amount invested in the stock. Stockholders can sell shares at any time. Enjoys unlimited life. Treated as a separate legal entity by the law. Stockholders elect the board of directors who, in turn, hire the executive staff who, in turn, hire mid-level managers and employees.

Most companies are sole proprietors and partnerships but most of the wealth is held by corporations.

**The Basic Accounting Equation**

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| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Accounting Equation** | | | | | | | | |
|  |  |  |  |  |  |  |  |  |
| Assets |  | is equal to |  | Liabilities |  | and |  | Owner's Equity |
| What you have |  |  |  | What you owe |  |  |  | What you own |

**Assets** represent resources a company has that will provide **future services or benefits**, i.e. usually more than a month or so. If a company pays for its insurance every six months, it has an asset. If a company pays for its insurance every month, it has incurred an expense. They are many different types of assets, such as cash, accounts receivable, supplies, equipment, etc. There are various GAAP rules associated with the accounting treatment for each.

**Liabilities** represent what a company owes to its creditors. The obligations can be short term such as accounts payable or salaries payable or long-term such as a lease or a loan. When you owe money to another party (vendor) on a short-term basis for the purchase of supplies, it is called “accounts payable.” When someone owes you money (customer) on a short-term basis it is an asset called “accounts receivable.”

All of those to whom a company owes money are its creditors. These come first in the accounting equation, because they must be paid first before the owners can receive anything when a company is liquidated.

**Owner’s Equity** represents accumulation of owner wealth. There are different types of owner’s equity accounts. Investments represent infusions of cash or property to the company—increases owner’s equity. Income from operations also increases owner’s equity. Withdrawals by the owner decrease owner’s equity as do expenses from operations.

**Expanded Accounting Equation and Financial Statements** There are four financial statements and they are prepared in a specific order.

1. **Income Statement** – Statement of **income** and **expenses** from company operations yielding either net income or a net loss
2. Statement of Owner’s Equity – New owner **investments (capital)** and **net income** from the income statement minus **withdrawals** from the owner, yielding the ending balance of owner’s equity.
3. Balance Sheet – Listing of **Assets** and **Liabilities** and the **ending balance of Owner’s Equity**
4. Statement of Cash Flows – How cash was obtained and spent (We will look at this financial statement last in this course).

**Expanded Accounting Equation and Financial Statements**

