

What is Accounting?

Definition 1 (Inst. Certified Pub. Accountants):

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 results thereof.

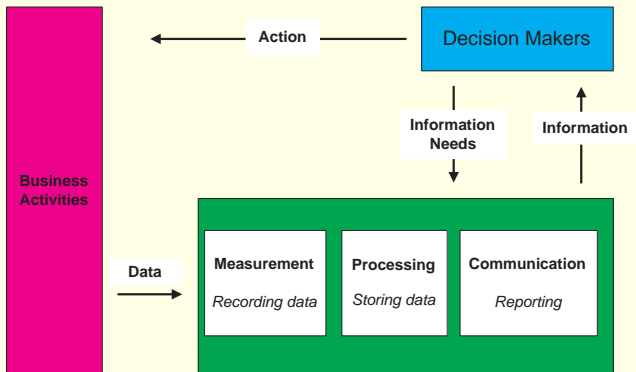
Definition 2 (A broader perspective): Accounting

is the process of identifying, measuring, and communicating economic information to **permit informed judgements and decisions** by users of the information.

Definition 3: wrt. Quantitative information

Accounting is a service activity. Its function is to provide **quantitative information**, primarily financial in nature about economic entities that is intended to be useful in making economic decisions, in making resolved choices among

Therefore, accounting is a link between business activities and decision makers.



What is the Difference between Accounting and Bookkeeping?

Bookkeeping

- Mundane function of
 - Collecting
 - Recording
 - Reporting operating & financial info of firm
- Vital but
- Clerical of **accounting**

Accounting

- Includes design of information systems that meets user's needs
- Its main goals are:
 - Analysis of data
 - Interpretation of data
 - Using these for problem solving

The Parties that Use the Accounting?

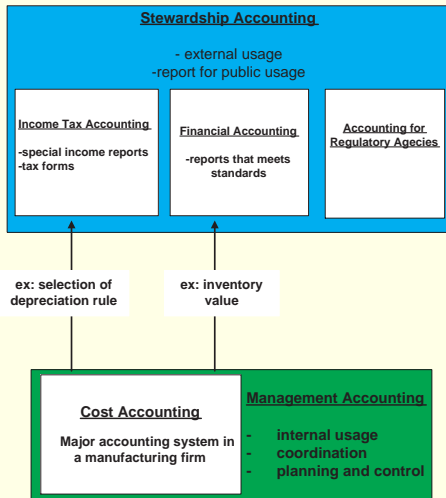
1-Internal usage: *Management Accounting*

- Creating reports for
 - controlling costs
 - measuring performance
 - planning the future
- The data and reports must be
 - accurate
 - timely
 - objective and flexible
- Cost controlling function is known as *Cost Accounting*.

2-External usage: *Stewardship Accounting*

- Measure and report information about how the business performed
 - regular
 - accurate
 - verifiable
 - standardized
- Users of these reports are
 - investors
 - creditors
 - shareholders
 - government regulatory agencies

Accounting Function



Three types of business

1 Sole Proprietorship

- owned by a single person
- Legally, the proprietorship is the same as the individual
- individual receives all profit or losses

2 Partnership

- owned by more than one person
- Legally, the Partnership is again the same as the individuals
- receive all profit or losses

3 Corporation

- separate from its owners (stockholders)
- ownership divided into transferable shares of stock
- owners do not control the operations directly
- the stockholders enjoy limited liability

From Accounting Perspective - Economic Entity Assumption

Activities of organization kept separate from the activities of owners

Financial Position - What the company owns and owes

Economic resources that belong to a company and the claims (*equities*) against those resources at a point in time

A company can be viewed as

Economic resources = Equities

Two types of equities, creditor's and owner's equity

Economic resources = creditor's equity + owner's equity

In accounting terminology, economic resources are called *Assets*, creditor's equity is called *Liabilities*.

Accounting Equation

Assets = Liabilities + Owner's Equity

This equation tells us that the assets owned by the company are subject to the rights of debt holders and owners.

Assets

Economic resources owned by a business that are expected to benefit future operations.

- converted to cash within one year are *current*
 - Cash
 - Accounts Receivable (money owed to the business)
 - Supplies
 - Inventory
- having a life exceeding one year are *noncurrent*.
 - Land
 - Equipment
 - Buildings
 - Machinery

Liabilities

Obligations in form of **money** to be paid or **services** to be rendered by the company to the outsiders

- payable within one year are *current*
 - Notes Payable
 - Account Payable and
 - Taxes payable
- payable in more than a year are *noncurrent*.
 - Bonds Payable

Owner's Equity

The residual interest in the assets of an entity that remains after deducting its liabilities or the equity interest of the owner(s).

- In a Sole Proprietorship, only one Capital Account (owner's).
- In a Partnership, a Capital Account for each owner.
- In a Corporation, capital represents the *Stockholder's Equity*
 - Capital Stock issued
 - Retained Earnings-Accumulated earnings minus dividends
- Four types of transactions affect owner's equity
 - 1 **Owner's investments** increases owner's equity
 - 2 **Owner's withdrawals** decreases owner's equity
 - 3 **Revenues** increases owner's equity
 - 4 **Expenses** decreases owner's equity

Shares of Stock

Authorized Shares

- 1 Issued Shares
 - Treasury Stock owned by company
 - Outstanding Shares
 - Dividends based on them
 - Common Stock has voting rights
 - Preferred Stock has priority in dividend distribution
- 2 Unissued Shares

Business Transactions

are economic events that affect the financial position of a business entity. These transactions are the raw material of accounting reports. It can be:

- 1 An Exchange of Value between two or more parties
 - A purchase
 - A sale
 - A collection
 - A loan
- 2 A Nonexchange Transaction
 - Accumulation of Interest
 - Physical wear and tear on machinery and equipment
 - Losses from flood, fire, theft

Double-Entry Accounting

- It maintains the equivalence of assets and equities
- Every business transaction has dual effect
 - Debit
 - Credit
- A business transaction affects either:
 - Both sides of the equation by the same amount
 - One side of the equation only, by both increasing and decreasing it by identical amounts, netting to zero

Now Let's Analyze the Effects of some Business Transactions on Accounting Equation

Transaction 1: Aras starts a business by depositing \$50,000 in a bank in the name of Luxury Homes Realty.

Owner's Investments

Assets	=	Owner's Equity	
Cash		Aras, Capital	Type of OE Transaction
\$50,000		\$50,000	Owner's investment

Accounts

- The labels “Cash”, “Aras, Capital” are accounts
- Accounts are used by accountants to accumulate amounts produced from like transactions

Transaction 2: After starting his business, Aras finds a good location for his office, and purchases with cash a lot for \$10,000 and a small building on the that lot for \$25,000.

Purchase of Assets with Cash

Assets			=	Owner's Equity	
Cash	Land	Building		Aras, Capital	Type of OE Transaction
bal. \$50,000				\$50,000	Owner's investment
-\$35,000	+\$10,000	+\$25,000			
bal. \$15,000	\$10,000	\$25,000		\$50,000	
<u> </u>	<u> </u>	<u> </u>		<u> </u>	

Transaction 3: Aras buys office supplies for \$500 on credit. This transaction will increase both sides of the accounting equation.

Buying on Credit

On agreement to pay for the asset or service later.

Purchase of Assets by Incurring a Liability

Assets				=	Liabilities	+	Owner's Equity	
Cash	Supplies	Land	Building		Accounts Payable		Aras, Capital	Type of OE Transaction
bal. \$15,000		\$10,000	\$25,000				\$50,000	
	+\$500				+\$500			
<u>bal. \$15,000</u>	<u>\$500</u>	<u>\$10,000</u>	<u>\$25,000</u>		<u>\$500</u>		<u>\$50,000</u>	

Transaction 4: Let us see how the balance equation changes when Aras pays \$200 of the \$500 owned for the supplies he has purchased before.

Payment of a Liability

Assets				=	Liabilities	+	Owner's Equity	
Cash	Supplies	Land	Building		Accounts Payable		Aras, Capital	Type of OE Transaction
bal. \$15,000	\$500	\$10,000	\$25,000		\$500		\$50,000	
\$-200					\$-200			
bal. \$14,800	\$500	\$10,000	\$25,000		\$300		\$50,000	

Transaction 5: Let's assume that Luxury Homes Realty sells a house and gets \$1,500 commissions in cash.

Cash Revenue

Assets				=	Liabilities	+	Owner's Equity	
Cash	Supplies	Land	Building		Accounts Payable		Aras, Capital	Transaction
bal. \$14,800	\$500	\$10,000	\$25,000		\$300		\$50,000	
\$+1,500							+1,500	Commission
bal. \$16,300	\$500	\$10,000	\$25,000		\$300		\$51,500	

Timing of Recording the Revenues

Revenues can be received immediately as cash, and sometimes the clients/customers agree to pay the revenue at a later time. In either case, the revenue is recorded when it is earned.

Transaction 6: Now, let see how the transaction of \$2,000 of an earned commission that will be paid later will affect the equation.

Revenue to be Collected

Assets					=	Liabilities +	Owner's Equity
Cash	Accounts Receivable	Supplies	Land	Building		Accounts Payable	Aras, Capital
bal. \$16,300		\$500	\$10,000	\$25,000		\$300	\$51,500
	+2,000						+\$2,000
bal. \$16,300	\$2,000	\$500	\$10,000	\$25,000		\$300	\$53,500

Transaction 7: A few days later, Luxury Homes Realty receives \$1,000 of \$2,000 from his client

Collection of Accounts Receivable

Assets					=	Liabilities +	Owner's Equity
Cash	Accounts Receivable	Supplies	Land	Building		Accounts Payable	Aras, Capital
bal. \$16,300	\$2,000	\$500	\$10,000	\$25,000		\$300	\$53,500
\$+1,000	\$-1,000						
bal. \$17,300	\$1,000	\$500	\$10,000	\$25,000		\$300	\$53,500

Transaction 8: Assume that Aras paid in cash \$400 for wages of his aid and \$1,000 for rent of some equipments.

Expenses in Cash

		Assets			=	Liabilities +	Owner's Equity
Cash	Accounts Receivable	Supplies	Land	Building		Accounts Payable	Aras, Capital
bal. \$17,300	\$1,000	\$500	\$10,000	\$25,000		\$300	\$53,500
-\$400							\$-400
-\$1,000							\$-1,000
<u>bal. \$15,900</u>	<u>\$1,000</u>	<u>\$500</u>	<u>\$10,000</u>	<u>\$25,000</u>		<u>\$300</u>	<u>\$52,100</u>

Timing of Recording the Expenses

Expenses are recorded when they are incurred.

Transaction 9: Let's assume that a bill of \$300 for utilities incurred but not paid yet.

Expenses to be paid

Assets					=	Liabilities +	Owner's Equity
Cash	Accounts Receivable	Supplies	Land	Building		Accounts Payable	Aras, Capital
bal. \$15,900	\$1,000	\$500	\$10,000	\$25,000		\$300	\$52,100
						+\$300	-\$300
bal. \$15,900	\$1,000	\$500	\$10,000	\$25,000		\$600	\$51,800

Transaction 10: At the end of the month, Aras withdraws \$600 in cash from Luxury Homes Realty and deposits it into his personal account.

Owner's Withdrawal

Assets					=	Liabilities +	Owner's Equity
Cash	Accounts Receivable	Supplies	Land	Building		Accounts Payable	Aras, Capital
bal. \$15,900	\$1,000	\$500	\$10,000	\$25,000		\$600	\$51,800
\$-600							-600
bal. \$15,300	\$1,000	\$500	\$10,000	\$25,000		\$600	\$51,200

CAUTION!

Withdrawals are NOT expenses.

Financial statements

- 1 Reflect the activities of the company **over a period or time**
 - **Income Statement**
 - Summarizes amount of revenues earned and expenses incurred
 - Shows whether a business earned an acceptable level of income
 - **Statement of Owner's Equity**
 - Changes in the owner's capital
 - **Statement of Cash Flows**
 - Changes in cash that result from operating activities, investing activities and financing activities
- 2 Indicate the financial position **at a point in time**
 - **Balance Sheet**
 - Financial position of the firm on a certain date

Luxury Homes Realty
Income Statement
For the Month Ended December 31,2007

Revenues

Commissions Revenues	\$3,500
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Expenses

Equipment Rental Expense	\$1,000
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Wages Expense	\$400
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Utility Expense	\$300
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Total Expenses	\$1,700
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Net Income

\$1,800

Luxury Homes Realty
Statement of Owner's Equity
For the Month Ended December 31, 2007

Aras, Capital, December 1, 2007		\$0
Add: Investments by Aras	\$50,000	
Net Income for the Month	\$1,800	\$51,800
Subtotal		\$51,800
Less Withdrawals by Aras		\$600
Aras, Capital December 31, 2007		\$51,200

Luxury Homes Realty
Balance Sheet
December 31,2007

Assets		Liabilities	
Cash	\$15,300	Accounts Payable	\$600
Accounts Receivable	\$1,000		
Supplies	\$500	Owner's Equity	
Land	\$10,000	Aras, Capital	\$51,200
Building	\$25,000		
Total Assets	<u>\$51,800</u>	Total Equities	<u>\$51,800</u>

Luxury Homes Realty
Statement of Cash Flows
For the Month Ended December 31,2007

Cash Flows from Operating Activities

Net Income		\$1,800
Non Cash Expenses and Revenues Included in Income		
Increase in Accounts Receivable	\$(1000)	
Increase in Supplies	(500)	
Increase in Accounts Payable	600	(900)
Net Cash Flows from Operating Activities		\$900

Cash Flows from Investing Activities

Purchase of Land	\$(10,000)	
Purchase of Building	(25,000)	
Net Cash Flows from Investing Activities		(35,000)

Cash Flows from Financing Activities

Investments by Aras	\$50,000	
Withdrawals by Aras	(600)	
Net Cash Flows from Financing Activities		49,600

Net Increase (Decrease) in Cash

		\$15,300
Cash at Beginning of Month		0

Cash at End of Month		\$15,300
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