

Financial Accounting

Module 1: The Role of Accounting



Module Learning Outcomes

Explain the role of accounting in business

1.1: Define accounting and explain its history

1.2: Identify the ways we use accounting

1.3: State the accounting equation

1.4: Explain the effect of transactions on the accounting equation

1.5: Identify challenges in accounting

Accounting Defined

Learning Outcomes: Accounting Defined

1.1: Define accounting and explain its history

1.1.1: Define accounting

1.1.2: Describe the evolution of accounting

1.1.3: Explain the importance of accounting

What Is Accounting?

- The American Accounting Association defines accounting as:
the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by the users of the information.
- Accounting vs. Bookkeeping
- Bookkeeping is a mechanical process that records the routine economic activities of a business.
- Accounting includes bookkeeping but goes well beyond it in scope: for example, accountants also analyze and interpret financial information and prepare financial documents.

The Evolution of Accounting

- The earliest known accounting records were created over 7,000 years ago.
- In 1494 Luca Bartolomeo de Pacioli wrote: "Summa de Arithmetica, Geometria, Proportioni et Proportionalita," which became the teaching text for bookkeeping and accounting for the next several hundred years.
- It was the expansion of the railroad that transformed the practice of accounting: to get goods and people to their destinations, you need a common set of standards.
- The profession of accounting was recognized in 1896 with a law stating the title of a Certified Public Accountant (CPA) required passing a test and three years of experience.

Why Accounting Matters

- Accounting allows you to answer key business questions, such as:
 - How is my business doing right now?
 - Is it making money?
 - How did we do last year?
 - How much money is in the bank right now?



Accounting Information

Learning Outcomes: Accounting Information

1.2: Identify the ways we use accounting

1.2.1: Identify users of accounting information

1.2.2: Compare and contrast financial and managerial accounting

1.2.3: Describe the unique way the government uses accounting information

Users of Accounting Information

- Internal Users
 - Owners
 - Managers
- External Users
 - Prospective and current board members or investors
 - Creditors and lenders
 - Employees and their unions
 - Customers
 - General public
- Government



Financial vs Managerial Accounting

- Financial accounting information appears in financial statements that are intended primarily for external users, like stockholders and creditors.
- Managerial accounting is the accounting that provides managers and owners (internal users) with financial information that they need in order to make operational and strategic decisions.



Other Areas of Accounting

- **Non-Profit Accounting:** Non-profit entities, as the name implies, exist for purposes other than making a profit. Instead of business owners, a state incorporates a non-profit to benefit the public, and so the major stakeholders are the public, or in the case of some clubs, the members.
- **Forensic Accounting:** Forensic accounting involves investigating and reporting on financial crimes, fraud, and harmful business practices. Forensic accountants may be called upon to testify in court, and the work product of a forensic accountant may be admitted as evidence.
- **Tax Accounting:** Government agencies that track and use taxes are interested in the financial story of a business. They want to know whether the business is paying taxes according to current tax laws.

Government Reporting

- Today, taxes based on income or sales and payroll taxes make up the vast majority of federal and state revenues.
- Federal tax law begins with the Internal Revenue Code (IRC)
- State income tax laws are often different from the federal laws, so the financial accountants for a business may have to keep several sets of records:
 - managerial accounting for internal users
 - financial accounting for external users
 - tax accounting for governmental reporting



The Basic Accounting Equation

Learning Outcomes: The Basic Accounting Equation

1.3: State the accounting equation

1.3.1: Explain the basic accounting question

1.3.2: Define assets

1.3.3: Define liabilities

1.3.4: Define owners' equity

The Accounting Equation

One of the cornerstones of financial accounting is the accounting equation, which in its simplest form, looks like this:

$$\text{assets} = \text{liabilities} + \text{owner's equity}$$

or

$$A = L + OE$$

This equation has to always stay in balance.



Assets

- In financial accounting, an asset must meet two criteria:
 - The company must own or control it.
 - It must be expected to generate future benefit for that company.
- Assets fall into two general subcategories
 - **Current assets** are expected to convert into cash within a relatively short period of time (usually one year).
 - **Noncurrent assets** produce revenue over a long period of time by being used to produce inventory, but they won't be converted to cash any time soon.



Liabilities

- Liability is the accounting term for debt.
- Like assets, liabilities are categorized as current and noncurrent.
- There are a wide variety of items that can be liabilities, and many accounts are unique to a specific company.
- **Current liabilities** are items that must be paid soon.
- **Noncurrent liabilities** are more long-term debts.



Owner's Equity

- Owner's equity can be further broken down into four components:
 - **Capital contributed.** This represents the dollar value of resources put into the company by the owner. Often, this is cash, but it could also be assets like machinery or accounts receivable. In any case, these are personal assets that are used to fund the business.
 - **Withdrawals.** This is the dollar value of resources (usually cash) taken out of the company by the owner for personal use.
 - **Revenues.** This is the income a business takes in. We'll further define and discuss revenues on this page.
 - **Expenses.** This is what the business spends. We'll further define and discuss expenses on this page.
- Note: $\text{revenue} - \text{expense} = \text{profit}$

Practice Question 1

Sanjay started a new company this year called SanTec. The first thing he did was contribute \$50,000 of his savings and \$5,000 of computer equipment to the company. After a year of operation, SanTec earned \$35,000 in revenue and incurred \$5,500 in expenses. Sanjay needed to pay off his leased car and needed to withdraw some of the funds from the company to do it. What is the maximum cash amount from which Sanjay could withdraw from the company?

- A. \$50,000
- B. \$35,000
- C. \$79,500
- D. \$29,500

Accounting in Business

Learning Outcomes: Accounting in Business

- 1.4: Explain the effect of transactions on the accounting equation
 - 1.4.1: Explain the effect of various transactions on the accounting equation
 - 1.4.2: Differentiate among service, manufacturing, and merchandising businesses
 - 1.4.3: Differentiate among common financial statements

Transactions and the Accounting Equation

- One of the key aspects of the process is keeping “running totals” of things.
- Examples of items a business might keep track of include the following:
 - the amount of cash the business currently has
 - what a company has paid for utilities for the month
 - the amount of money it owes
 - a company's income for the entire year
 - the total cost of all the equipment it has purchased
- It's important that businesses keep these running totals up to date so they are readily available when they need the information.

Types of Business Activities

- There are three forms of business organizations:
 - **Service companies** perform services for a fee. This group includes accounting firms, law firms, and dry cleaning establishments.
 - **Merchandising companies** purchase goods that are ready for sale and then sell them to customers. Merchandising companies include auto dealerships, clothing stores, and supermarkets.
 - **Manufacturing companies** buy materials, convert them into products, and then sell the products to other companies or the final consumers. Manufacturing companies include steel mills, auto manufacturers, and clothing manufacturers.



Financial Statements

- There are four basic financial statements and they are prepared in the following order:
 - Income Statement
 - Statement of Owner's Equity
 - Balance Sheet
 - Statement of Cash Flows

Challenges in Accounting

Learning Outcomes: Challenges in Accounting

1.5: Identify challenges in accounting

1.5.1: Describe the role of ethics in accounting

1.5.2: Identify significant events in the history of accounting

1.5.3: Identify the organizations that govern accounting

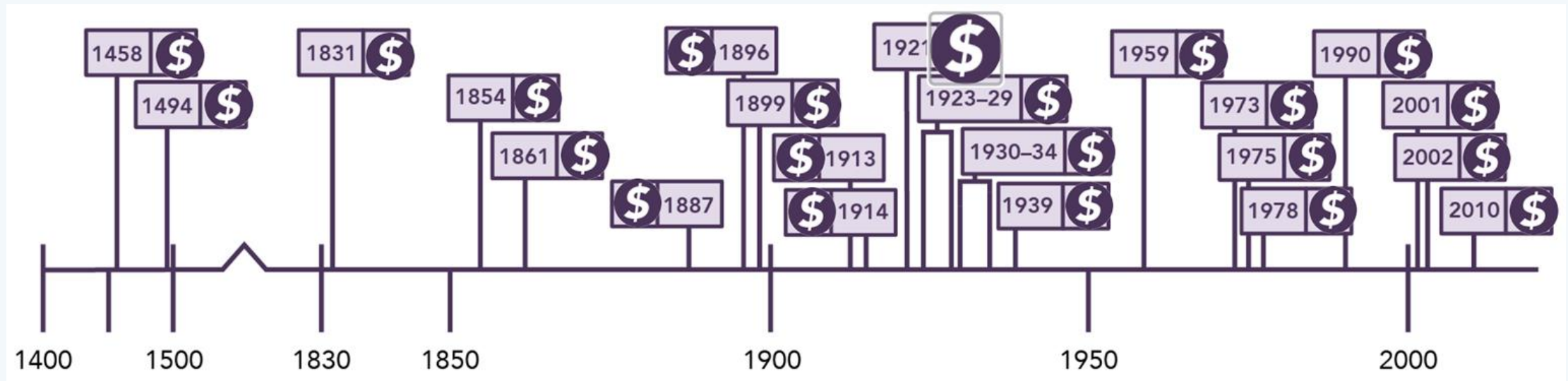
Ethics in Accounting

- An accountant's career is heavily reliant on their clients' trust in them.
- Several accounting organizations have codes of ethics governing the behavior of their members.
- AICPA'S Code of Professional Conduct:
 - Responsibilities principle.
 - The public interest principle.
 - Integrity principle.
 - Objectivity and independence principle.
 - Due care principle.
 - Scope and nature of services principle.



Significant Events in Accounting

Over the past five hundred plus years, accounting has seen its share of ups and downs.



Regulations in Accounting

- **SEC (Securities and Exchange Commission):** has the legal authority to provide oversight and regulation of the accounting profession
- **FASB (Financial Accounting Standards Board):** the organization officially recognized by the SEC as the governing body for the accounting profession
- **IRC (Internal Revenue Code):** the rules and regulations accountants must adhere to
- **IASB (International Accounting Standards Board):** the standard-setting body for International Financial Reporting Standards



Practice Question 2

Which of the following institutions sets the standards for international standards for financial reporting?

- A. IASB
- B. FASB
- C. IFA
- D. SEC

Quick Review

- What is the definition of accounting?
- Describe the evolution of accounting.
- Why is accounting important?
- Who uses financial accounting information?
- What are the differences between financial and managerial accounting?
- Describe the unique way the government uses accounting information.
- What is the basic accounting question?
- What is the definition of assets in accounting?
- Define what liabilities are in accounting.

More Quick Review

- What does owner's equity mean in accounting?
- What is the effect of various transactions on the accounting equation?
- Differentiate between service, manufacturing, and merchandising businesses.
- What are the differences between the common financial statements?
- How do ethics play a role in accounting?
- What are significant historic events in the long history of accounting?
- Which organizations govern and set rules and principles for accounting?