Introduction to Business Accounting

Chapter 2 - Introduction to Accounting and Business

WORKBOOK

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Defining a Business

A business is an organization where resources (labor or materials) are utilized to provide goods or services to customers. The objective of most businesses is to earn a profit.

Profit is the difference between the price a customer is willing to pay for the sale of goods or service and the expenses incurred by the business to produce and deliver the goods or service.

A Not-for-profit business is typically a charitable organization that does not earn a profit but rather uses funds raised to perform a service or distribute goods or funds to those in need.

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Types of Businesses

There are basically three types of businesses:

Service – this type of business provides a service, such as bookkeeper or plumber.

Merchandising (retail) – this type of business is where we go to purchase products we need. Examples include a pharmacy, book store, online store.

Manufacturing – this type of business produces items to be sold to the merchandising business for resale. Examples are autos, toys, clothing, and just about anything else we purchase.

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Role of Accounting

Accounting is the systematic and comprehensive recording of financial transactions pertaining to a business. It is also the process of summarizing, analyzing and reporting these transactions.

[Company Name] **Income Statement**

For the Years Ending [Dec 31, 2008 and Dec 31, 2007]

Revenue	**2008**	**2007**
Sales revenue	110,000	95,000
(Less sales returns and allowances)		
Service revenue	70,000	62,000
Interest revenue		
Other revenue		
Total Revenues	**180,000**	**157,000**
Expenses		
Advertising	1,000	1,000
Bad debt		
Commissions		
Cost of goods sold	65,000	63,000
Depreciation		
Employee benefits		
Furniture and equipment		8,000
Insurance		
Interest expense	4,200	5,200
Maintenance and repairs		
Office supplies		
Payroll taxes		
Rent		
Research and development		
Salaries and wages	55,000	55,000
Software		
Travel		
Utilities		
Web hosting and domains		
Other	17,460	
Total Expenses	**142,660**	**132,200**
Net Income Before Taxes	37,340	24,800
Income tax expense	14,936	9,920
Income from Continuing Operations	**22,404**	**14,880**
Below-the-Line Items		
Income from discontinued operations		
Effect of accounting changes		
Extraordinary items		
Net Income	**22,404**	**14,880**

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Role of Accounting

An effective accounting system must:

- Identify the users
- Determine the users' information needs
- Be designed to meet the identified needs
- Accurately record business activities and events
- Prepare informative reports for the user

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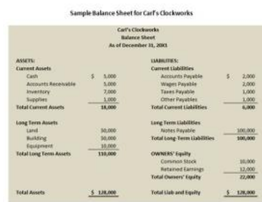
Introduction – Role of Accounting

The objective of Financial Accounting is to provide timely information for making business and investment decisions

Managerial Accounting – this area of accounting provides company officials with information – private accounting

Financial Accounting – this area of accounting provides information to individuals that are external to the company


Sample Balance Sheet for Carl's Clockworks

Carl's Clockworks
Balance Sheet
As of December 31, 20X1

ASSETS:		**LIABILITIES:**	
Current Assets		**Current Liabilities**	
Cash	$ 5,000	Accounts Payable	$ 2,000
Accounts Receivable	5,000	Wages Payable	2,000
Inventory	7,000	Taxes Payable	1,000
Supplies	1,000	Other Payables	1,000
Total Current Assets	**18,000**	**Total Current Liabilities**	**6,000**
Long Term Assets		**Long Term Liabilities**	
Land	50,000	Notes Payable	100,000
Building	50,000	**Total Long-Term Liabilities**	**100,000**
Equipment	10,000		
Total Long Term Assets	**110,000**	**OWNERS' Equity**	
		Common Stock	10,000
		Retained Earnings	12,000
		Total Owners' Equity	**22,000**
Total Assets	**$ 128,000**	**Total Liab and Equity**	**$ 128,000**

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Ethics in Accounting

Ethics are the moral principles that guide the conduct of individuals.

Why do you think it is critical that bookkeepers have integrity and behave in an ethical manner at all times?

Write down your answer.

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Ethics in Accounting

It is critical that bookkeepers have integrity and behave in an ethical manner at all times for several reasons.

1. The information they provide will be used to make critical business decisions.
2. They have the ability to change the outcome of business results.
3. They often have access to sensitive information.

Example 1: A client or supervisor asks you to record a transaction in manner that is not correct but benefits the profitability of the company and perhaps their bonus.

Example 2: A public accountant finds evidence of false revenue and destroys the evidence for their client. Public accountants such as Arthur Anderson can be prosecuted and dissolve when employees are unethical.

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Ethics in Accounting

An approach to handling an ethical issue:

Step 1: Identify issue using your own personal ethical standards of honesty and fairness.

Step 2: Identify the consequences of a possible decision and its effect on others.

Step 3: Consider your obligations to those affected by the decision.

Step 4: Make a final decision that is ethical and fair.

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Generally Accepted Accounting Principles (GAAP)

These principles are the rules by which all accountants must live by. They guide how and when we record the transactions of a business.

We will review 5 principles that are important to a Bookkeeper:

- The Business Entity Principle
- The Matching Principle
- The Cost Principle
- The Objectivity Principle
- The Unit of Measure Concept

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The Business Entity Principle

Business Entity Principle states that the activities of a business are recorded separately from the activities of its owners, creditors, or other businesses.

Under the business entity concept, the business entity is considered to be distinct from its owners for the purpose of accounting.

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Business Entity Principle

Common forms of business entities:

Sole Proprietorship is owned by an individual. About 70% of the businesses in the United States are sole proprietorships.

Partnership is similar to a Sole Proprietorship but it is owned by two or more individuals and does not need to be split equally. Partnerships represent 10% of the businesses in the United States.

Corporations are organized under state and federal statutes and are legally recognized as a separate taxable entity. Ownership is divided into shares called stock. While corporations represent 20% of the businesses in the United States, they generate 90% of all business revenue.

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The Matching Principle

The matching principle requires that revenues and any related expenses be recognized in the same period or in other words matched.

Without it, you will have large fluctuations in your financial performance and your financial reports won't make sense!

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Other Principles

The Revenue Recognition Principle states that all revenue must be recorded in the period in which it is earned. (ie. Service provided or goods delivered)

The Cost Principle requires that all transactions are initially recorded in the records at their cost or purchase price.

The Objectivity Principle requires that objective evidence be present to support the transaction.

The Unit of Measure Principle requires that economic data be recorded in dollars.

Questions

and

Answers

Review Questions:

1. True or False: The Cost Principle states that assets should be recorded at cost and adjusted when the market value changes.
    A. True
    B. False

2. Which of the following statements about Partnerships is true?
    A. They have several owners
    B. The business must be split equally
    C. They make up 90% of all businesses
    D. All of the above

3. An effective accounting system does NOT:
    A. Meet the user needs
    B. Record transactions at cost plus a profit
    C. Accurately record business activities and events
    D. Prepare informative reports for the user

4. True or False: Financial accountants provide information for managers to make good decisions.
    A. True
    B. False

5. True or False: The Matching Principle states that expenses must be recorded when paid.
    A. True
    B. False

Answer Key:

1. B
   False. The Cost Principle states that assets should be recorded at cost and kept at cost.

2. A
   Partnerships can have two or more owners. They can be split any way the owners agree on and make up only a small percentage of businesses.

3. B
   An effective accounting system must meet the needs of the users, be accurate, and provide informative reports.

4. B
   False. Financial accountants provide information for external reporting.

5. B
   False. The Matching Principle states that expenses must be recorded when incurred.