Nature of Business and Accounting

- A **business** is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers.
- The objective of most businesses is to earn a **profit**.
  - Profit is the difference between the amounts received from customers for goods or services and the amounts paid for the inputs used to provide the goods or services.

Role of Accounting in Business

- **Accounting** can be defined as an information system that provides reports to users about the economic activities and condition of a business.

Managerial Accounting

- The area of accounting that provides internal users, such as managers and employees, with information is called **managerial accounting**, or **management accounting**.
- The objective of managerial accounting is to provide relevant and timely information for managers' and employees' decision-making needs.
- Managerial accountants employed by a business are employed in **private accounting**.

Financial Accounting

- The area of accounting that provides external users, such as investors, creditors, customers, and the government, with information is called **financial accounting**.
- The objective of financial accounting is to provide relevant and timely information for the decision-making needs of users outside of the business.
- **General-purpose financial statements** are one type of financial accounting report that is distributed to external users.

Role of Ethics in Accounting and Business

(slide 1 of 2)

- The objective of accounting is to provide relevant, timely information for user decision making.
- Accountants must behave in an ethical manner so that the information they provide users will be trustworthy and, thus, useful for decision making.
- Managers and employees must also behave in an ethical manner in managing and operating a business.
- **Ethics** are moral principles that guide the conduct of individuals.

Role of Ethics in Accounting and Business
(slide 2 of 2)

- As a result of accounting and business frauds, Congress passed laws to monitor the behavior of accounting and business, such as the **Sarbanes-Oxley Act (SOX)**.
  - SOX established a new oversight body for the accounting profession called the **Public Company Accounting Oversight Board (PCAOB)**.
  - In addition, SOX established standards for independence, corporate responsibility, and disclosure.

Opportunities for Accountants

- Accountants employed by a business are employed in private accounting.
- Accountants and their staff who provide services on a fee basis are said to be employed in **public accounting**.
  - In public accounting, an accountant may practice as an individual or as a member of a public accounting firm.
  - Public accountants who have met a state's education, experience, and examination requirements may become **Certified Public Accountants (CPAs)**.

Generally Accepted Accounting Principles (GAAP)

(slide 1 of 2)

- Financial information in the United States is based on **generally accepted accounting principles (GAAP)**.
- GAAP is a collection of *accounting standards*, *principles*, and *assumptions* that define how financial information will be reported.
  - **Accounting standards** are the rules that determine the accounting for individual business transactions.
  - **Accounting principles** and **assumptions** provide the framework upon which accounting standards are constructed.

Generally Accepted Accounting Principles (GAAP)

(slide 2 of 2)

- Within the United States, the **Financial Accounting Standards Board (FASB)** has the primary responsibility for developing accounting principles.
- The **Securities and Exchange Commission (SEC)**, an agency of the U.S. government, has authority over the accounting and financial disclosures for companies whose shares of ownership (stock) are traded and sold to the public.
- Outside the United States, most countries use accounting standards and principles adopted by the **International Accounting Standards Board (IASB).**

Characteristics of Financial Information

- To be useful, financial reports must possess two important characteristics: *relevance* and *faithful representation*.
  - **Relevant** information has the potential to impact decision making.
  - **Faithful representation** means that the information accurately reflects an entity's economic activity or condition.

Assumptions

(slide 1 of 5)

- Financial accounting and generally accepted accounting principles are based upon the following assumptions:
  - Monetary unit
  - Time period
  - Business entity
  - Going concern

Assumptions
(slide 2 of 5)

- The **monetary unit assumption** requires that financial reports be expressed in a single money unit, or currency.
  - This provides a common measurement of the effects of economic events and transactions on an entity.
  - The monetary unit used is normally determined by the country in which the company operates.

Assumptions
(slide 3 of 5)

- The **time period assumption** allows a company to report its economic activities on a regular basis for a specific period of time.
  - In doing so, financial condition and changes in financial condition are reported periodically on a consistent basis.

Assumptions
(slide 4 of 5)

- The **business entity assumption** limits the economic data in financial reports to that directly related to the activities of the business.
  - In other words, the business is viewed as an entity separate from its owners, creditors, or other businesses.

Assumptions
(slide 5 of 5)

- The **going concern assumption** requires that financial reports be prepared assuming that the entity will continue operating into the future.

Principles
(slide 1 of 5)

- The following four principles are an integral part of financial accounting:
  - Measurement
  - Historical cost
  - Revenue recognition
  - Expense recognition

Principles
(slide 2 of 5)

- The **measurement principle** determines the amount that will be recorded and reported.
  - The measurement principle requires that amounts be *objective* and verifiable.
    - An amount is objective if it is based upon independent, unbiased evidence.
    - An amount is *verifiable* if it can be confirmed by a third party.
  - Transactions between two independent parties, called **arm's-length transactions**, provide amounts that are objective and verifiable.

Principles

(slide 3 of 5)

- Recording an item at its initial transaction price is called the **historical cost principle** or **cost principle**.

Principles

(slide 4 of 5)

- **Revenue** is the amount earned for selling goods or services to customers.
- The **revenue recognition principle** determines when revenue is recorded in the accounting records.
  - Normally, revenue is recorded when the services have been performed or goods are delivered to the customer.

Principles
(slide 5 of 5)

- **Expenses** are amounts used to generate revenue.
- The **expense recognition principle**, sometimes called the *matching principle*, requires expenses to be recorded in the same period as the related revenue.
  - Doing so allows the reporting of a profit or loss for the period.

The Accounting Equation
(slide 1 of 2)

- The resources owned by a business are its **assets**.
- The rights of creditors are the debts of the business and are called **liabilities**.
- The rights of owners are called **equity**.
  - Since stockholders own a corporation, equity is called **stockholders' equity**.
  - For a proprietorship, partnership, or limited liability company, equity is called **owner's equity**.

The Accounting Equation
(slide 2 of 2)

- The following equation is called the **accounting equation**:

Assets = Liabilities + Stockholders’ Equity

- Liabilities usually are shown before equity in the accounting equation because creditors have first rights to the assets.

Business Transactions and the Accounting Equation

- An economic event or condition that directly changes an entity's financial condition or its results of operations is a **business transaction**.
- All business transactions can be stated in terms of changes in the elements of the accounting equation.

Transactions

(slide 1 of 2)

- A corporation issues **common stock** to investors as proof of their ownership rights.
- The liability created by a purchase on account is called an **account payable**.
- Items such as supplies that will be used in the business in the future are called **prepaid expenses**, which are assets.
- A business earns money by selling goods or services to its customers. This amount is called **revenue**.
- Revenue from providing services is recorded as **fees earned**.

Transactions
(slide 3 of 4)

- Revenue from the sale of merchandise is recorded as **sales**.
- Other examples of revenue include rent, which is recorded as **rent revenue**, and interest, which is recorded as **interest revenue**.
- An **account receivable** is a claim against the customer, which is an asset.
- Assets used in the process of earning revenue are called **expenses**.
- **Dividends** are distributions of earnings to stockholders.

Classifications of Stockholders' Equity
(slide 1 of 2)

- Stockholders' equity is classified as:
  - Common Stock
  - Retained Earnings

Classifications of Stockholders' Equity
(slide 2 of 2)

- **Common stock** is shares of ownership distributed to investors of a corporation.
  - It represents the portion of stockholders' equity contributed by investors.
- **Retained earnings** is the stockholders' equity created from business operations through revenue and expense transactions.

Financial Statements

- After transactions have been recorded and summarized, reports are prepared for users. The accounting reports providing this information are called **financial statements**.
- The primary financial statements of a corporation are the:
  - Income statement
  - Retained earnings statement
  - Balance sheet
  - Statement of cash flows

Income Statement

- The income statement reports the revenues and expenses for a period of time, based on the revenue and expense recognition principles.
  - These principles match revenues and their related expenses so that they are reported in the same period.
- The excess of the revenue over the expenses is called **net income**, **net profit**, or **earnings**.
- If expenses exceed revenue, the excess is a **net loss**.

Retained Earnings Statement

- The retained earnings statement reports the changes in the retained earnings for a period of time.
- It is prepared *after* the income statement because the net income or net loss for the period must be reported in this statement.
- Similarly, it is prepared *before* the balance sheet, since the amount of retained earnings at the end of the period must be reported on the balance sheet.

Balance Sheet

- A balance sheet reports the amounts of assets, liabilities, and stockholders’ equity as of a specific date.
- The **report form** presents a balance sheet in a vertical form.

Statement of Cash Flows

- A statement of cash flows consists of the following three sections:
  1. operating activities
  2. investing activities
  3. financing activities

Statement of Cash Flows: Cash Flows from Operating Activities

- The cash flows from operating activities section reports a summary of cash receipts and cash payments from operations.

Statement of Cash Flows: Cash Flows from Investing Activities

- The cash flows from investing activities section reports the cash transactions for the acquisition and sale of relatively permanent assets.

Statement of Cash Flows: Cash Flows from Financing Activities

- The cash flows from financing activities section reports the cash transactions related to cash investments by stockholders, borrowings, and dividends.

Analysis for Decision Making: Ratio of Liabilities to Stockholders' Equity

- The **ratio of liabilities to stockholders' equity** is useful in analyzing the ability of a company to pay its creditors.
- The ratio of liabilities to stockholders' equity is computed as follows:

$$\text{Ratio of Liabilities to Stockholders' Equity} = \frac{\text{Total Liabilities}}{\text{Total Stockholders' Equity}}$$