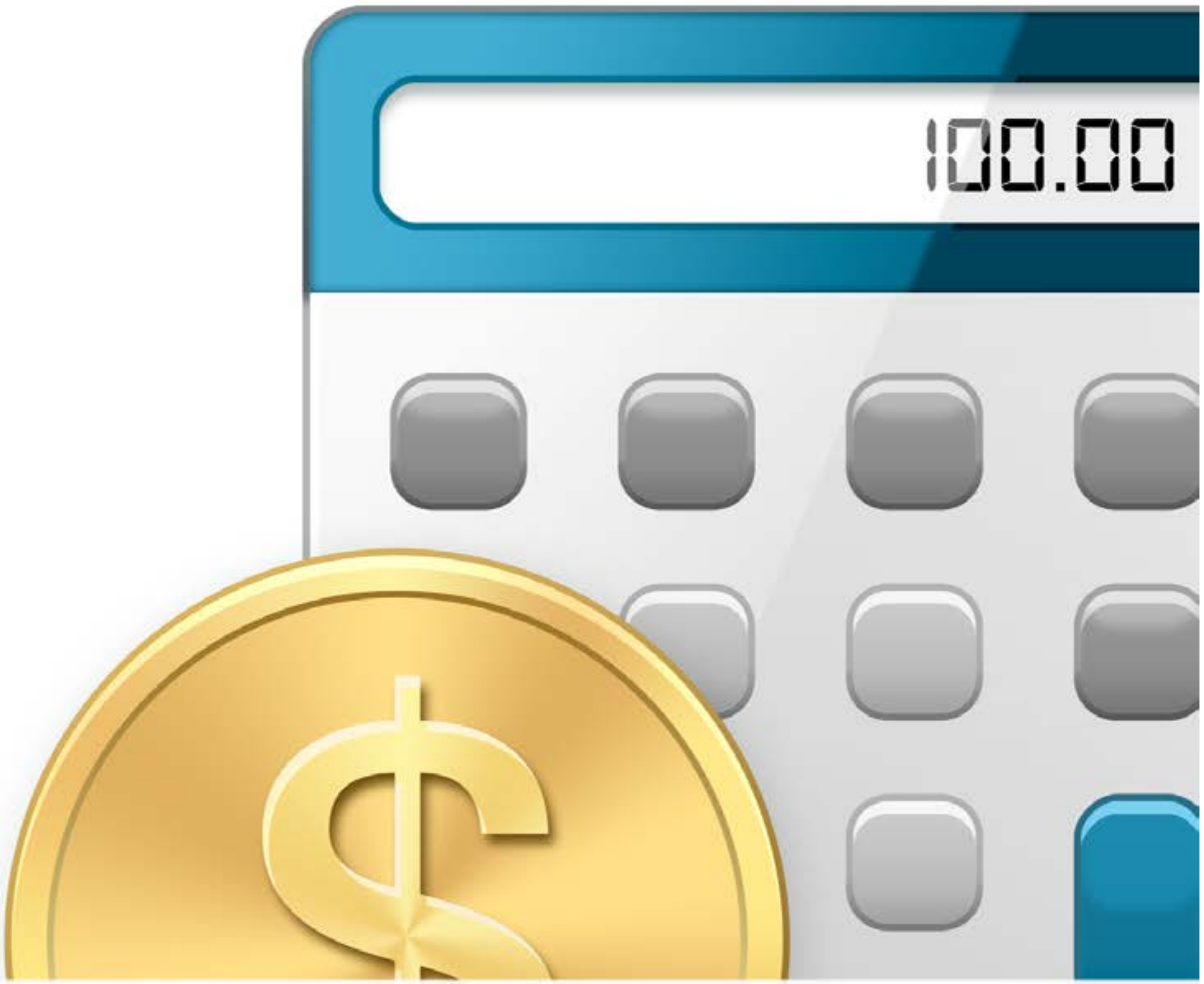
Boundless

Accounting



BOUNDLESS

Accounting

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Accounting

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Chapter 1

Introduction to Accounting

https://www.boundless.com/accounting/introduction-to-accounting/

Section 1

What is Accounting

Defining Accounting

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https://www.boundless.com/accounting/introduction-to-accounting/what-is-accounting/

Defining Accounting

Accountancy is the process of communicating financial information about a business entity to users such as shareholders and managers.

KEY POINTS

- Accounting is thousands of years old; the earliest accounting records, which date back more than 7,000 years, were found in Mesopotamia (Assyrians).
- Luca Pacioli's "Summa de Arithmetica, Geometria, Proportioni et Proportionalità" represents the first known printed treatise on bookkeeping; and it is widely believed to be the forerunner of modern bookkeeping practice.
- Double-entry bookkeeping is defined as any bookkeeping system in which there was a debit and credit entry for each transaction.

Introduction

Accountancy is the process of communicating financial information about a business entity to users such as shareholders and managers. The communication is generally in the form of financial statements that show in money terms the economic resources under the control of management; the art lies in selecting the information that is relevant to the user. The principles of accountancy are applied to business entities in three divisions of practical art: accounting, bookkeeping, and auditing.

Accounting Defined

The American Institute of Certified Public Accountants (AICPA) defines accountancy as "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 financial character, and interpreting the results thereof."

History

The earliest accounting records were found amongst the ruins of ancient Babylon, Assyria and Sumeria, which date back more than 7,000 years. The people of that time relied on primitive accounting methods to record the growth of crops and herds. Because there is a natural season to farming and herding, it is easy to count and determine if a surplus had been gained after the crops had been harvested or the young animals weaned (*Figure 1.1*).

When medieval Europe moved to a monetary economy in the 13th century, sedentary merchants depended on bookkeeping to oversee multiple simultaneous transactions financed by bank loans. One important breakthrough took place around that time: the introduction of double-entry bookkeeping, which is defined as any

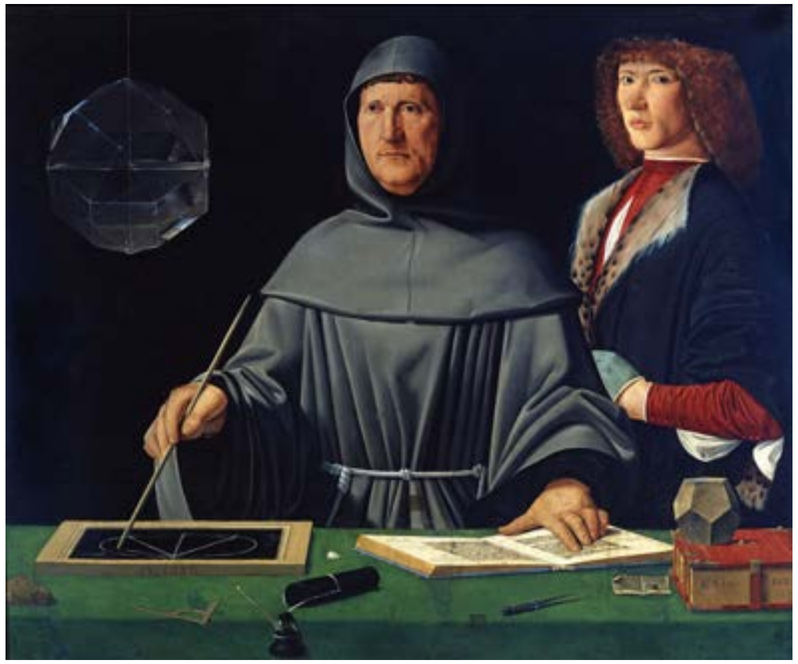


Figure 1.1 Father of Double-Entry Accounting

Portrait of Luca Pacioli, attributed to Jacopo de' Barbari, 1495 (Museo di Capodimonte).

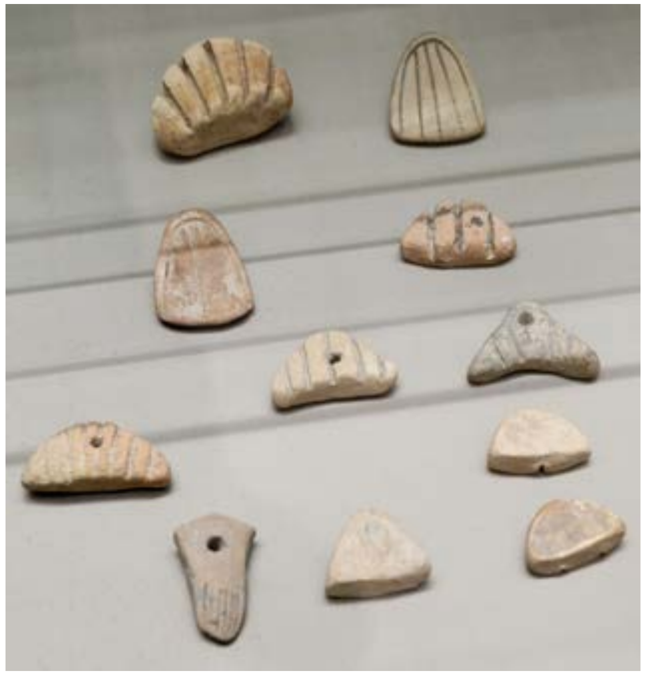
bookkeeping system in which there was a debit and credit entry for each transaction, or for which the majority of transactions were intended to be of this form. The historical origin of the use of the words 'debit' and 'credit' in accounting goes back to the days of single-entry bookkeeping in which the chief objective was to keep track of amounts owed by customers (debtors) and amounts owed to creditors. Thus, 'Debit,' from the Latin word debere means 'he owes' and 'Credit', from the Latin word credere, means 'he trusts'.

The earliest extant evidence of full double-entry bookkeeping is the Farolfi **ledger** of 1299-1300. Giovanno Farolfi & Company were a firm of Florentine merchants whose head office was in Nîmes, and who also acted as moneylenders to the Archbishop of Arles, their most important customer. The oldest discovered record of a complete double-entry system is the Messari (Italian: "Treasurer's") accounts of the city of Genoa in 1340. The Messari accounts contain debits and credits journalized in a bilateral form, and contain balances carried forward from the preceding year. Therefore, they enjoy general recognition as a double-entry system.

Luca Pacioli's "Summa de Arithmetica, Geometria, Proportioni et Proportionalità" (early Italian: "Review of Arithmetic, Geometry, Ratio and Proportion") was first printed and published in Venice in 1494. It included a 27-page treatise on bookkeeping, "Particularis de Computis et Scripturis" (Latin: "Details of Calculation and Recording"). It was written primarily for, and sold mainly to, merchants who used the book as a reference text, as a source of pleasure from the mathematical puzzles it contained, and to aid the education of their sons. It represents the first known printed treatise on bookkeeping; and it is widely believed to be the forerunner of modern bookkeeping practice (*Figure 1.2*).

In "Summa Arithmetica," Pacioli introduced symbols for plus and minus for the first time in a printed book, symbols that became standard notation in Italian Renaissance mathematics. "Summa Arithmetica" was also the first known book printed in Italy to contain algebra. Although Luca Pacioli did not invent double-entry **bookkeeping**, his 27-page treatise on bookkeeping contained the first known published work on that topic, and is said to have laid the foundation for double-entry bookkeeping as it is practiced today. Even though Pacioli's treatise exhibits almost no originality, it is generally considered as an important work, mainly because it enjoyed a wide circulation, was written in the vernacular Italian language, and was a printed book.

Figure 1.2 Token Accounting in Mesopotamia



The invention of a form of bookkeeping using clay tokens represented a huge cognitive leap for mankind.

Past

Early accounts served mainly to assist the memory of the businessperson, and the audience for the account was the proprietor or record keeper alone. Cruder forms of accounting were inadequate for the problems created by a business entity involving multiple investors, so double-entry bookkeeping first emerged in northern Italy in the 14th century, where trading ventures began to require more capital than a single individual was able to invest. The development of joint stock companies created wider audiences for accounts, as investors without firsthand knowledge of their operations relied on accounts to provide the requisite information. This development resulted in a split of accounting systems for internal (i.e., management accounting) and external (i.e., financial accounting) purposes, and subsequently also in accounting and disclosure regulations, following a growing need for independent attestation of external accounts by auditors.

Present

Today, accounting is called "the language of business" because it is the vehicle for reporting financial information about a business entity to many different groups of people. Accounting that concentrates on reporting to people inside the business entity is called management accounting and is used to provide information to employees, managers, owner-managers, and auditors. Management accounting is concerned primarily with providing a basis for making management or operating decisions. Accounting that provides information to people outside the business entity is called financial accounting and provides information to both current and potential shareholders, creditors such as banks or vendors, financial analysts, economists, and government agencies. Because these users have different needs, the presentation of financial accounts is very structured and subject to many more rules than management accounting. The body of rules that governs financial accounting in a given jurisdiction is called Generally

Accepted Accounting Principles, or GAAP. Other rules include International Financial Reporting Standards (IFRS), U.S. GAAP, Canadian GAAP, and the GAAP in other specific countries.

Inputs to Accounting

Inputs into accounting include journal entries, the bookkeeping process, and the general ledger.

KEY POINTS

- In accounting, a journal entry is a logging of transactions into accounting journal items.
- The extraction of account balances is called a trial balance.
- The purpose of the trial balance is, at a preliminary stage of the financial statement preparation process, to ensure the equality of the total debits and credits.

Journal Entries

In accounting, a **journal entry** is a logging of transactions into accounting journal items. The **journal** entry can consist of several items, each of which is either a debit or a credit. The total of the debits must equal the total of the credits or the journal entry is said to be "unbalanced." Journal entries can record unique items or recurring items such as depreciation or bond amortization. Some data commonly included in journal entries are: journal entry number; batch number; type (recurring vs. nonrecurring); amount of money, name, auto-reversing; date; accounting period; and description.

The balance sheet is a statement showing net worth on a particular date (*Figure 1.3*). Journal entries are used to record injections and ejections to such net worth. After recording the transactions through journal entries the revised balance sheet can be prepared.Journal entries are an easier means for perpetrating financial statement fraud than adjusting the subledgers. The former requires only a management override, while the latter requires collusion with other departments. False journal entries figured prominently in the frauds at WorldCom, Cendant, and Xerox.

Bookkeeping

In accounting, the two bookkeeping methods are the single-entry and double-entry bookkeeping systems. For modern day purposes, it is most important to know the double-entry bookkeeping system.

The 'basic accounting equation' is the foundation for the double-entry bookkeeping system. For each transaction, the total debits equal the total credits.

Bookkeeping is the recording of financial transactions. Transactions include sales, purchases, income, receipts and payments by an individual or organization. Bookkeeping is usually performed by a **bookkeeper**. Many individuals mistakenly consider bookkeeping and accounting to be the same thing. This confusion is understandable because the accounting process includes the bookkeeping function, but is just one part of the accounting process.

The accountant creates reports from the recorded financial transactions recorded by the bookkeeper and files forms with government agencies. There are some common methods of bookkeeping such as the single-entry bookkeeping system and the double-entry bookkeeping system. However, while these systems may be seen as "real" bookkeeping, any process that involves the recording of financial transactions is a bookkeeping process. A bookkeeper (or book-keeper), also known as an

Figure 1.3 The Balance Sheet

XYZ Company
Balance Sheet
As at 30 June 2010

Current Assets		
Cash at bank	30,000	
Inventory	250,000	
Debtors	75,000	
Total current assets		355,000
Non - Current Assets		
Buildings	550,000	
Plant & equipment	250,000	
Vehicles	120,000	
Total non-current assets		920,000
Total Assets		**1,275,000**
Current Liabilities		
Credit cards	15,000	
Creditors	110,000	
Tax Payable	25,000	
Total current liabilities		150,000
Non-current Liabilities		
Long term loans		700,000
Total Liabilities		**850,000**
Owners Equity		
Capital	100,000	
Retained earnings	250,000	
Current earnings	75,000	
Total Owners Equity		**425,000**

accounting clerk or accounting technician, is a person who records the day-to-day financial transactions of an organization.

A bookkeeper is usually responsible for writing the "daybooks." The daybooks consist of purchases, sales, receipts, and payments. The bookkeeper is responsible for ensuring all transactions are recorded in the correct day book, suppliers ledger, customer ledger, and general ledger. The bookkeeper brings the books to the trial balance stage. An accountant may prepare the income statement and balance sheet using the trial balance and ledgers prepared by the bookkeeper.

The General Ledger

General Ledger is the final repository of the accounting records and data. In modern accounting softwares or ERP, the general ledger works as a central repository for accounting data transferred from all sub-ledgers or modules like accounts payable, accounts receivable, cash management, fixed assets, purchasing, and projects. General ledger is the backbone of any accounting system which holds financial and non-financial data for an organization. The statement of financial position and the statement of income and comprehensive income are both derived from the general ledger.

Each account in the general ledger consists of one or more pages. The general ledger is where posting to the accounts occurs. Posting is the process of recording amounts as credits, (right side), and amounts as debits, (left side), in the pages of the general ledger. Additional columns to the right hold a running activity total (similar to a checkbook). The listing of the account names is called the chart of accounts. The extraction of account balances is called a trial balance. The purpose of the trial balance is, at a preliminary stage of the financial statement preparation process, to ensure the equality of the total debits and credits.

The general ledger should include the date, description, and balance or total amount for each account. It is usually divided into at least seven main categories. These categories generally include assets, liabilities, owner's equity, revenue, expenses, gains, and losses. The main categories of the general ledger may be further subdivided into subledgers to include additional details of such accounts as cash, accounts receivable, accounts payable, etc.

Outputs of Accounting

Accounting outputs are financial statements that detail the financial activities of a business, person, or other entity.

KEY POINTS

- The balance sheet, reports on a company's assets, liabilities, and ownership equity at a given point in time.
- The income statement is also referred to as profit and loss statement, or a "P&L." This statement reports on a company's income, expenses, and profits over a period of time.
- A statement of changes in shareholder's equity explains the changes of the company's equity throughout the reporting period.

Financial Statements

A financial statement, or financial report, is a formal record of the financial activities of a business, person, or other entity. For a business enterprise, relevant financial information presented in a structured manner is called a financial statement. Statements typically include four basic financial statements accompanied by a management discussion and analysis. These statements are as follows:

Balance Sheet

This statement reports on a company's assets, liabilities, and ownership equity at a given point in time.

Income Statement

This statement, also referred to as profit and loss statement (or a "P&L"), reports on a company's income, expenses, and profits over a period of time. A profit and loss statement provides information on the operation of the enterprise. These statements include sale and various expenses incurred during the processing state (*Figure 1.4*).

Statement of Cash Flows

This statement reports on a company's cash flow activities—particularly its operating, investing, and financing activities. For large corporations, these statements are often complex and may include extensive notes, an explanation of financial policies, and management analysis. The notes typically provide detail for items on the balance sheet, income statement, and cash flow statement. Notes to financial statements are considered an integral part of the financial statements.

Figure 1.4 A Sample Income Statement

XYZ Retailers

Income Statement

For the year ended 30 June 2011

REVENUE	$	$
Sales		250,000
Cost of Goods Sold		
Opening inventories (as at 1 July 2010)	40,000	
Add purchases	100,000	
Add freight-in and customs duty	10,000	
Less closing inventory (as at 30 June 2011)	60,000	
Less Cost of Goods Sold		90,000
Gross Profit		160,000
Add other operating revenue		
Rent received	3,000	
Commission received	2,000	
Total Revenue		165,000
LESS OTHER OPERATING EXPENSES		
Selling & Distribution expense		
Advertising	5,000	
Public Relations	2,000	
Website marketing	7,500	
General and Administrative expenses		
Depreciation	10,000	
Electricity	1,500	
Insurance	1,000	
Rent expense	30,000	
Wages & salaries	46,500	
Financial expenses		
Bad debts	1,500	
Total expenses		105,000
NET PROFIT (EBIT)		60,000

An example of an income statement

Statement of Shareholder's Equity

This statement explains changes in the company's equity throughout the reporting period.

Purpose of Financial Statements

The objective of financial statements is to provide information about financial position, performance, and changes. Statements are useful to a wide range of users making economic decisions. Financial statements should be understandable, relevant, reliable, and comparable. Reported assets, liabilities, equity, income, and expenses are directly related to an organization's financial position.

Financial statements are intended to be understandable by readers who have a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently.

Owners and managers require financial statements to make business decisions that affect continued operations. Statements are analyzed to provide management with a more detailed understanding of the figures. These statements are also used as part of management's annual report to the stockholders.

Employees need financial statements when making collective bargaining agreements (CBA) with the management and when discussing their compensation, promotion, and rankings.

Prospective investors hire analysts to prepare financial statements. This allows investors to assess the viability of a business

Financial institutions (banks and other lending companies) use statements to decide whether to grant a company fresh working capital or extend debt securities (such as a long-term bank loan or **debentures**).

Government entities (tax authorities) need financial statements to ascertain the propriety and accuracy of taxes and other duties declared and paid by a company.

Vendors who extend credit to a business require financial statements to assess the creditworthiness of the business.

Uses of Financial Reports

Financial reporting is used by owners, managers, employees, investors, institutions, government, and others to make important decisions about a business.

KEY POINTS

- Owners and managers require financial statements to make important business decisions that affect its continued operations.
- Employees also need these reports in making collective bargaining agreements with the management, in the case of labor unions or for individuals in discussing their compensation, promotion, and rankings.
- Although laws differ from country to country, an audit of the financial statements of a public company is usually required for investment, financing, and tax purposes.

Financial statements may be used by different stakeholders for a multitude of purposes

Owners and managers require financial statements to make important business decisions affecting its continued operations. Financial analysis is then performed on these statements, providing management with a more detailed understanding of the figures.

These statements also are used as part of management's annual report to the stockholders.

Employees need these reports in making collective bargaining agreements with the management, in the case of labor unions or for individuals in discussing their compensation, promotion, and rankings.

Prospective investors make use of financial statements to assess the viability of investing in a business. Financial analyses are used by investors and prepared by professionals (financial analysts), thus providing them with the basis for making investment decisions.

Financial institutions (banks and other lending companies) use them to decide whether to grant a company working capital or extend debt securities (such as long-term bank loans or debentures) to finance expansion and other significant expenditures.

Government entities (tax authorities) need financial statements to ascertain the propriety and accuracy of taxes and other duties declared and paid by a company.

Vendors who extend credit to a business require financial statements to assess the **creditworthiness** of the business.

Media and the general public are interested in financial statements for a variety of reasons.

Government

Government also produces financial reports to stay accountable to the public and people. The rules for recording, measurement and presentation of government financial statements may be different from those required for business and even for non-profit organizations.

Not-for-profit Organizations

The requirements for non-profit financial statements differ from those of a for profit institution and therefore, will not be discussed.

Personal

Personal financial statements may be required from persons applying for a personal loan or financial aid. Typically, a personal financial statement consists of a single form for reporting personally held assets and liabilities (debts) or personal sources of income and expenses, or both. The form to be filled out is determined by the organization supplying the loan or aid.

Audit and Legal

Although laws differ from country to country, an audit of financial statements of a public company is usually required for investment, financing, and tax purposes. These are usually performed by independent accountants or auditing firms (*Figure 1.5*). Results are