Introduction to Accounting and Business

Chapter 1

Introduction to Accounting and Business

Learning Objective 1 → Describe the nature of a business, the role of accounting, and ethics in business.

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.

  ![Diagram](image)

- 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.

Type of Business:

- **Service Business** → Provide services rather than products to customers.
- **Merchandising Business** → Sell products they purchase from other business to customers.
- **Manufacturing Business** → Change basic input into products that are sold to customers.

The Role of Accounting in Business

There is more than definition

**Accounting** is the art of recording, summarizing, classifying and reporting financial transactions and other events of an enterprise.

**Accounting** can be defined as an information system that provides reports to users about the economic activities and condition of a business.
The process by which accounting provides information to users:

1. Identify Users
2. Assess Users’ Information’s Needs
3. Design Accounting System
4. Record Economic Data
5. Prepare Accounting Reports
Users of accounting can be divided into two groups:

- Internal Users
- External Users
Form of Business Entity

Agential Accounting → The area of accounting that provides internal users with information.

Financial Accounting → The area of accounting that provides external users with information.

→ 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.

Learning Objective 2 → Summarize the development of accounting principles and relate them to practice.

Generally Accepted Accounting Principles

➢ Financial accountants follow generally accepted accounting principles (GAAP) in preparing reports.
➢ Within the U.S., the Financial Accounting Standards Board (FASB) has the primary responsibility for developing accounting principles.
➢ Many countries (including Saudi Arabia) adopted the International Financial Reporting Standards (IFRS) that are issued by the International Accounting Standards Boards (IASB).
➢ Within Saudi Arabia, the Saudi Organisation for Certified Public Accountant (SOCPA) has the primary responsibility for developing accounting principles.
➢ These reports allow investors and other users to compare one company to another.
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<table>
<thead>
<tr>
<th>Entity Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proprietorship</td>
<td>Is owned by one individual (Small Businesses)</td>
</tr>
<tr>
<td>Partnership</td>
<td>Is owned by two or more individuals</td>
</tr>
<tr>
<td>Corporation</td>
<td>Is owned by shareholders or stockholders (Large Firms)</td>
</tr>
</tbody>
</table>

**Some of Accounting Concepts GAAP**

<table>
<thead>
<tr>
<th>Business Entity Concept</th>
<th>The activities of a business are recorded separately from the activities of its owners, creditors, or other.</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Cost Concept</td>
<td>Amounts are initially recorded in the accounting records at their cost or purchase price.</td>
</tr>
<tr>
<td>The Objectivity Concept</td>
<td>Requires that the amounts recorded in the accounting records be based on objective evidence.</td>
</tr>
<tr>
<td>The Unit Of Measure Concept</td>
<td>Requires that economic data be recorded in dollars or riyals.</td>
</tr>
<tr>
<td>The Accounting Period Concept</td>
<td>Requires that revenues and expenses be reported in the proper period.</td>
</tr>
<tr>
<td>The Revenue Recognition Concept</td>
<td>Supporting the reporting of revenues when they are earned regardless of when cash is received.</td>
</tr>
<tr>
<td>The Matching Concept</td>
<td>Supporting reporting revenues and related expenses in the same period.</td>
</tr>
</tbody>
</table>

**Learning Objective 3** → State the accounting equation and define each element of the equation.

**The Accounting Equation**

- 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 the owners are called **owner's equity**.
- The equation **Assets = Liabilities + Owner's Equity** is called the **accounting equation**.
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\[ \textbf{Assets} = \textbf{Liabilities} + \textbf{Owner's Equity} \]

\[ \textbf{Assets} = \textbf{Liabilities} + \textbf{Capital} - \textbf{Drawings} + \textbf{Revenues} - \textbf{Expenses} \]

\[ \textbf{Drawings} + \textbf{Expenses} + \textbf{Assets} = \textbf{Liabilities} + \textbf{Capital} + \textbf{Revenues} \]

\[ \text{Debit Accounts} \]

If ↑ Debit, and if ↓ Credit

\[ \text{Credit Accounts} \]

If ↑ Credit, and if ↓ Debit

**Elements of Accounting Equation:**

* All business transactions can be stated in terms of changes in the elements of the accounting equation.

**ASSETS → Resources owned by the business**

Type off Assets

**Fixed Assets →** Land, Buildings, Furniture, Cars, Machinery and Equipment.

**Current Assets →** Cash, Marketable Securities, Accounts Receivable, Notes receivables, Merchandise Inventory, Supplies, Prepaid Expenses, and Accrued Revenues.

**Intangible Assets →** Goodwill, Copy Right, Patent, Trade Mark.

**LIABILITIES → The rights of creditors**

Type of Liabilities

**Long-Term Liabilities →** Bonds and Long-Term Loans.

**Short-Term Liabilities →** Accounts Payable, Notes Payable, Short-Term Loans, Accrued Expenses, and Unearned Revenues.

**OWNER’S EQUITY → the rights of the owners**

Capital and Net Income (Revenues - Expenses)
Learning Objective 4 → Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.

Business Transaction → is an economic event or condition that directly changes an entity’s financial condition or its results of operations.

Account payable → is liability created by a purchase on account.

Account receivable → is a claim against a customer, which is an asset.

Expenses → Assets used in this process of earning revenue.

Revenue → the Amount of money that A business earned by selling goods or services to its customers.

Examples of revenue

- Fees earned → Revenue from providing services.
- Sales → Revenue from the sale of merchandise
- Rent revenue
- Interest revenue.

Some Notes before solving the transactions

- Account payable = creditor = suppliers = purchase on account
- Account receivable = customer = client = billed on account
- Revenues in services business called Fees earned but in merchandising business called sales
- Revenues always credit account and the debit account can be cash, account receivables, or note receivables
- Expenses always debit account and the credit account is cash, account payable, or note payable
On November 1, 2011, Chris Clark begins a business that will be known as Net Solution:

**Transaction**

**A:** On November 1, 2011, Chris Clark deposited $25,000 in a bank account in the name of Net Solutions.

\[\text{Assets} \uparrow (\text{cash}) = \text{Owner equity} \uparrow (\text{capital})\]

**B:** On November 5, 2011, Net Solutions paid $20,000 for the purchase of land as a future building site.

\[\text{Assets} \downarrow (\text{cash}) = \text{Assets} \uparrow (\text{Land})\]

**C:** On November 10, 2011, Net Solutions purchased supplies for $1,350 and agreed to pay the supplier in the near future.

\[\text{Assets} \uparrow \text{(supplies)} = \text{Liabilities} \uparrow (\text{Account Payable})\]

**D:** On November 18, 2011, Net Solutions received cash of $7,500 for providing services to customers.

\[\text{Assets} \uparrow \text{(cash)} = \text{Owner equity} \uparrow (\text{Fees earned})\]

**E:** On November 30, 2011, Net Solutions paid the following expenses: wages, $2,125; rent, $800; utilities, $450; and miscellaneous, $275.

\[\text{Assets} \downarrow \text{(cash)} = \text{Owner equity} \downarrow (\text{Expenses})\]

**F:** On November 30, 2011, Net Solutions paid creditors on account, $950.

\[\text{Assets} \downarrow \text{(cash)} = \text{Liabilities} \downarrow (\text{Account payable})\]

**G:** On November 30, 2011, Chris Clark determined that the cost of supplies on hand at the end of the period was $550.

\[\text{Assets} \downarrow \text{(supplies)} = \text{Owner equity} \downarrow (\text{supp. Exp.})\]

**H:** On November 30, 2011, Chris Clark withdrew $2,000 from Net Solutions for personal use.

\[\text{Assets} \downarrow \text{(cash)} = \text{Owner equity} \downarrow (\text{Drawing})\]

**Instructions:** Indicate the effect of each transaction using the following tabular headings:
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<table>
<thead>
<tr>
<th>Transitions</th>
<th>Assets</th>
<th>= Liabilities</th>
<th>+ Owner Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>+25,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b.</td>
<td>-20,000</td>
<td>+20,000</td>
<td></td>
</tr>
<tr>
<td>c.</td>
<td>+1,350</td>
<td></td>
<td></td>
</tr>
<tr>
<td>d.</td>
<td>+7,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>e.</td>
<td>-3,650</td>
<td></td>
<td></td>
</tr>
<tr>
<td>f.</td>
<td>-950</td>
<td></td>
<td></td>
</tr>
<tr>
<td>g.</td>
<td>-800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>h.</td>
<td>-2,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\[
\begin{align*}
\text{5,900} + 550 + 20,000 & = 400 + 25,000 - 2,000 + 7,500 - 2,125 - 800 - 800 - 450 - 275 \\
\end{align*}
\]

\[
\begin{align*}
\text{26,450} & \quad \text{26,450}
\end{align*}
\]
Learning Objective 5 ➔ Describe the financial statements of a proprietorship and explain how they interrelate.

Financial Statements ➔ After transactions have been recorded and summarized, reports are prepared for users. The accounting reports providing this information are called financial statements.

<table>
<thead>
<tr>
<th>Order Prepared</th>
<th>Financial Statement</th>
<th>Description of Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Income Statement</td>
<td>A summary of the revenue and expenses for a specific period of time, such as a month or a year.</td>
</tr>
<tr>
<td>2</td>
<td>Statement of Owner's Equity</td>
<td>A summary of the changes in the owner’s equity that have occurred during a specific period of time, such as a month or a year.</td>
</tr>
<tr>
<td>3</td>
<td>Balance Sheet</td>
<td>A list of the assets, liabilities, and owner’s equity as of a specific date, usually at the close of the last day of a month or a year.</td>
</tr>
<tr>
<td>4</td>
<td>Statement of Cash flows</td>
<td>A summary of cash receipts and cash payments for a specific period of time, such as a month or a year.</td>
</tr>
</tbody>
</table>

* matching concept:
This concept is applied by matching the expenses incurred during a period with the revenue that those expenses incurred during a period with the revenue that those expenses generated.

The excess of the revenue over the expenses is called net income, net profit or earnings. If the expenses exceed the revenue, the excess is a net loss.
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