

Part 1: Introduction to accounting

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1-What Is Accounting?

Accounting is process of three activities: **identification**, **recording**, and **communicating** the economic events of an organization to interested users .

Accounting basic activities :

Identification

Selecting events that are considered evidence of economic activity(transaction) relevant to a particular organization.

Recording:

To provide a permanent, classified and summarized history of the financial activities of the organization

Communicating

Through the preparation of accounting reports and interpret the reported information to the users.

THE ACCOUNTING PROCESS



2- Distinguishing Between Bookkeeping And Accounting:

Bookkeeping is just one part of the accounting process.

Many individuals mistakenly consider bookkeeping and accounting to be one and the same.

Bookkeeping usually involves only the recording of economic events and is therefore just one part of the accounting process

Basic Functions of An Accounting System:

- 1-** Interpret and **record** the effects of business transactions.
- 2.** **Classify** the effects of similar transaction
- 3.** **Summarize** and **communicate** the information contained in the system to decision makers.

4-Accounting as an information system

The accounting system consists of the personnel, procedures, devices, and records used by an organization to develop and communicate accounting information to decision makers.

Viewing accounting as an information system focuses attentions on the information that provided by accounting to the users to support their financial decisions making.

A vital element **in communicating economic events** is the **accountant's ability** to :

- **analyze** the reported information(use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships.
- **interpret.** (explaining the uses, meaning, and limitations of reported data.)

2.WHO USES ACCOUNTING INFORMATION?

There are two broad groups of users of financial information: **internal** and **external users** .

1-Internal users (management):

Management at all levels uses accounting information in planning, controlling, and evaluating business operations.

managers need detailed information on a timely basis to plan, organize, and run the business.

Management accounting provides internal reports to help managers make decisions about their companies.

2- External users are individuals and organizations outside a company who want financial information about the company.

External users have either a present or potential direct or indirect financial interests.

The **two most common types** of external users are **investors** and **creditors** who provide the money to finance the company.

Investors (owners) and **creditors(suppliers and bankers)** have **direct financial interests**.

Investors (owners) use accounting information to make decisions to buy, hold, or sell ownership shares of a company.

Investors want to know how much income they can expect to earn on an investment. This requires accounting data.

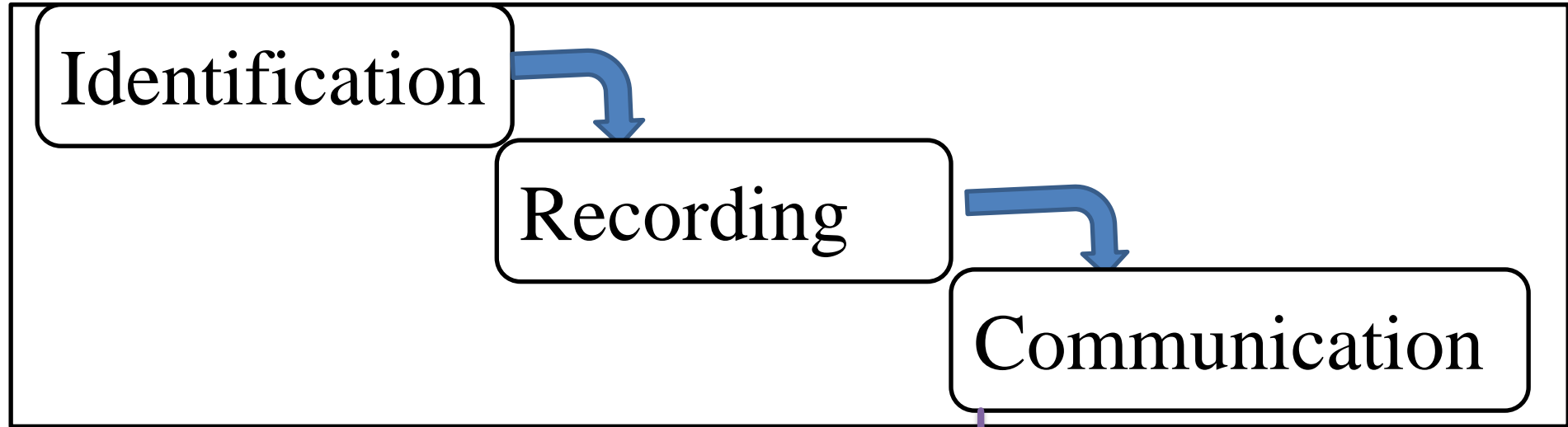
Creditors (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money .

Taxing authorities, regulatory agencies, labor unions, customers, and economic planners are examples of **indirect financial interests users**.

Taxing authorities want to know whether the company complies with tax laws.

Financial accounting provides economic and financial information for investors, creditors, and other external users.

The Accounting Process



Internal Users
management

external Users

Direct Interest :Investors & Creditors

Indirect Interest .Ex :Labor unions

Since there are *external users* and *internal users* of accounting information, we can therefore classify accounting into **two** branches:
Financial accounting and Management accounting

Financial accounting

provides information for people **outside** the firm

This information **must meet standards** of relevance and reliability.

External users such :
investors, bankers,
government agencies, and
the public.

Management accounting

generates **inside** information for the managers of the companies.

This information **doesn't have to meet** external standards of reliability because only company employees use these data

internal users : company managers and employees.

3. BRANCHES OF ACCOUNTING STUDIES:

The famous branches (types) of accounting are the Financial Accounting and the Management Accounting.

However, as a result of economic, industrial, and technological developments, different specialized fields in accounting have emerged which include cost accounting, auditing, tax accounting, government accounting, and accounting information systems (AIS).

4. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP):

The accounting profession has developed Principles that are generally accepted and universally practiced.

This common set of principles termed "Generally Accepted Accounting Principles" (GAAP). These principles indicate how to report economic events.

some terms such as standards, objectives, concepts, rules, and assumptions are sometimes use to describe GAAP

GAAP include the basic objectives, concepts, and rules of preparing and presenting financial statements.

There is no comprehensive list for these generally accepted accounting principles **because** they emerge continuously as a result of the shortcoming of existing rules and the demand by outsiders, who use accounting information.

5. Some ACCOUNTING PRINCIPLES AND ASSUMPTIONS:

First Measurement Principles

GAAP generally uses one of two measurement principles:

- the historical cost principle or
- the fair value principle.

Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation

Relevance means that financial information can make a difference in a decision.

Faithful representation means that the numbers and descriptions match what really existed or happened—they are factual.

The Historical Cost Principle:

One important accounting principle is the cost principle. The **cost principle** states that assets and services should be recorded at their actual *historical cost*. This is true not only at the time the asset is purchased, but also over the time the asset is held.

For example, if a company purchases **land** for **L.E50, 000**, the company initially reports it in its accounting records at L.E50, 000. But what does the company do if, by **the end of the next year**, the **land has increased** in value to **L.E60,000**.

Under the cost principle it continues to report the **land at L.E50, 000**.

If the business has purchased land 10 Years ago for L.E 50,000. Assume that the market value of the land this year was L.E500,000. The land shown in accounting records:

A- L.E 500,000 B- L.E 450,000. **C- L.E 50,000.** D- None of the ¹⁷above.

Fair Value Principle:

The **fair value principle** states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability).

Fair value information may be more useful than historical cost for certain types of assets and liabilities

For example, certain investment securities are reported at fair value

Second: Assumptions

Assumptions provide a foundation for the accounting process. The basic concepts/assumptions are like the pillars on which the structure of accounting is based.

The Economic Entity assumption

The Going-Concern Assumption

The Stable-Monetary-Unit Assumption

The Entity assumption:

The most basic accounting concept is the **entity**, which is any organization that stands apart as a separate economic unit. Sharp boundaries are drawn around each entity so as not to confuse its affairs with those of others.

An economic entity can be any organization or unit in society.

The economic entity assumption requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

The Going-Concern «continuity Assumption

The **going-concern concept** assumes that the entity will remain in operation long enough to use existing assets—land, buildings, supplies—for their intended purpose. Also known as ‘continuity assumption’.

The Stable-Monetary-Unit Assumption

The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in money terms.

This assumption enables accounting to quantify (measure) economic events.

Objectivity:

only business transactions that actually did **occur** should be recorded.

Every accounting transaction is to be supported by an objective evidence which can be checked.

Because of the **objectivity** principle, accountants use **cost rather than current market values**.

Costs are definite , factual, and can be verified

Estimated market values are not factual therefore, they are not objective (subjective).

Types of Business Organizations:

There are three main types of business organizations:

- 1- Sole proprietorship.
- 2- Partnership.
- 3- Corporation

Sole proprietorship:

- A business owned by one person.
- The owner is often the manager/operator of the business .
- only a limited amount of money (capital) is necessary to start the business .
- the owner receives any profits, suffers any losses, and is personally liable for all debts of the business.
- there is no legal distinction between the business as an economic unit & the owner.

Partnership:

A business owned by two or more persons associated as partners is a partnership.

a partnership is similar to a proprietorship except that more than one owner is involved.

Corporation:

A business organized as a separate legal entity under state corporation law and having ownership divided into transferable shares of stock is called a corporation.

The holders of the shares called shareholders (stockholders).

stockholders enjoy limited liability, they are not personally liable for the debts of the corporate entity.

Stockholders may transfer all or part of their shares to other investors at any time.

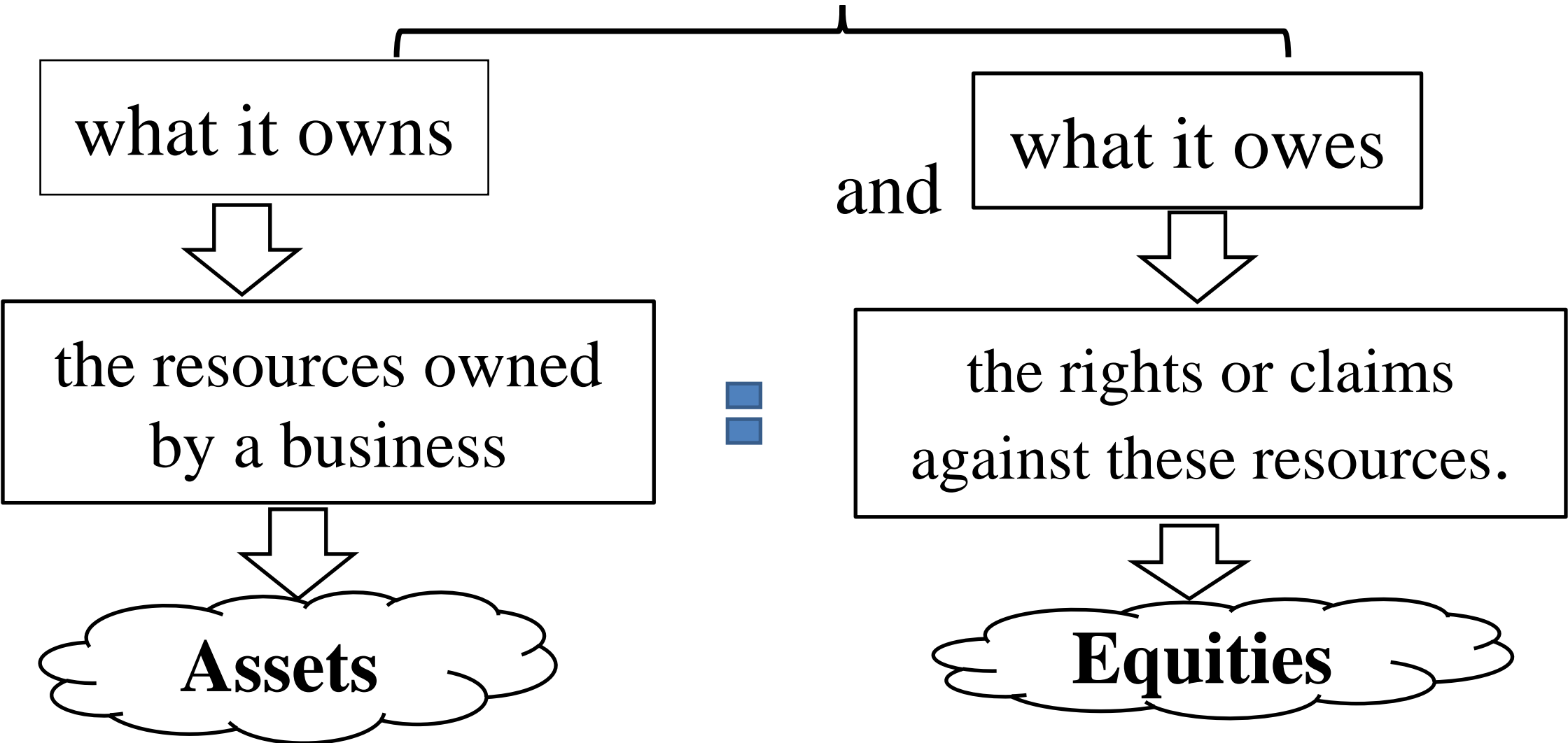
6.Determining The Financial Position Of A Business:

In order to evaluate the performance of a business entity, an accountant must be able to calculate the building blocks of the performance indicators..

Those building blocks are included in what is called the Accounting Equation

Basic Accounting Equation

The two basic elements of a business are



Equities

may be further subdivided into two categories:

claims of creditors

claims of owners.

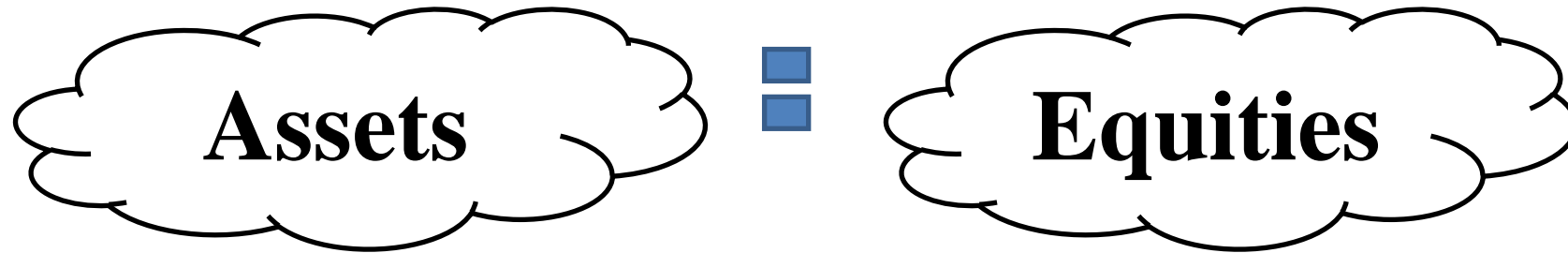
are called

liabilities.

are called

owner's equity.

Accounting Equation:



The basic accounting equation.

Assets must equal the sum of liabilities and owner's equity

The Basic Accounting Equation

$$\text{Assets} = \text{Liabilities} + \text{Owner's equity}$$

creditors claims (**Liabilities**) are paid before ownership claims if a business is liquidated, so liabilities are shown before owner's equity in the basic accounting equation .

The accounting equation applies to all economic entities regardless of size, nature of business, or form of business organization.

7.COMPONENTS OF THE ACCOUNTING EQUATION:

- **Assets:** assets are resources a business owns.

The business uses its assets in carrying out such activities as production and sales.

The common characteristic possessed by all assets is the **capacity to provide future services or benefits**

In a business, that service potential or future economic benefit eventually results in cash inflows (receipts). Assets may be:

Tangible assets :

physical assets like land, buildings,
equipment inventory(merchandise) ,
cash.....

- Intangible assets:

legal claims or rights ex: goodwill
and trademarks

Assets are valued and recorded according to their **historical costs**.

- **Liabilities:**

Businesses of all sizes usually borrow money and purchase merchandise on credit.

Liabilities are claims against assets—that is, existing debts and obligations.

Ex: accounts payable

- **Owner's Equity:** It is equal to total assets minus total liabilities.

To find out what belongs to owners, we subtract the creditors' claims (the liabilities) from assets.

The remainder is the owner's claim on the assets—the owner's equity.

Since the claims of creditors must be paid **before** ownership claims, owner's equity is often referred to as **residual equity**.

• The claims of creditors take precedence over ownership claims

Capital: The initial investment by owner

Revenues: Are result from business operations .

Revenues result in an increase in an asset

they may arise from different sources :

providing services sale products rent of property

Revenues: take various names(sales , fees, interests..) depending on nature of business.

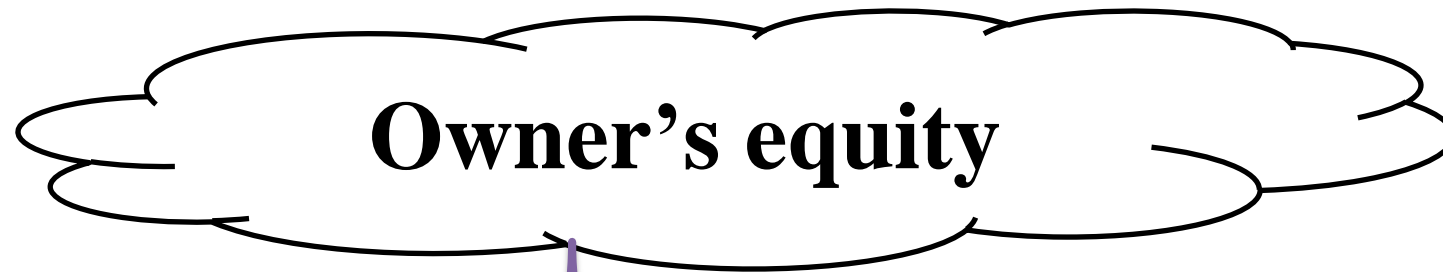
Drawings(withdrawals): Owner's withdrawals of assets

Expenses:

cost of assets consumed, or services used in process of earning revenues

Expenses take various names depending on the type of asset consumed or service used. Ex: salaries(wages), utility expense(electric , gas and water expense)

What affects the owner's equity:



Increased by
Investments By Owner(capital)
Revenues

Decreased by
Drawing
Expenses

| | |
|------------------------------|---|
| Basic Accounting Equation | Assets = Liabilities + Owner's equity |
| Expanded Accounting Equation | Assets= Liabilities + Owner's - Owner's + Revenues - Expenses capital drawings |

Net income results when revenues exceed expenses

Net loss occurs when expenses exceed revenues

8.USING THE ACCOUNTING EQUATION:

Transactions (business transactions) are a business's economic events recorded by accountants.

Transactions may be external or internal.

External transactions involve economic events between the company and some outside enterprise

For example, a company **purchases** of equipment **from a supplier**, **payment of monthly rent** to the landlord, and **sale** of products **to customers**
Internal transactions are economic events that occur entirely within one company.

Companies carry on many activities that do not represent business transactions. Ex: The use of supplies. hiring employees

Some of these activities may lead to business transactions:
Employees will earn wages, suppliers will deliver ordered merchandise.

The company must analyze each event to find out if it affects the components of the accounting equation.

If it does, the company will record the transaction

Each transaction must have a **dual effect** on the accounting equation.

For example,

if an asset is increased, there must be a corresponding

(1) decrease in another asset (2) increase in a specific liability, or
(3) increase in owner's equity. Two or more items could be affected.

For example: as one asset is increased LE 10,000, another asset could decrease LE 6,000 and a liability could increase LE 4,000.

Any change in a liability or ownership claim is subject to similar analysis.

Exercise:

The transactions appearing below are those of “ El Nasr” company during the first month of the operation of the business:

- 1- owner invested cash, L.E 100 000.
- 2-purchased equipment for L.E 30000 cash.
- 3-paid for rent L.E3000, salaries L.E2000.
- 4- owner withdrew L.E 10000 in cash

1- owner invested cash, L.E 100 000.

| | | | |
|---------|---|-------------|-----------------|
| Cash | = | liabilities | + owners equity |
| 100 000 | = | 0 | + 100000 |

2-purchased equipment for L.E 30000 cash.

| | | |
|------------------|---|---------------|
| Cash + equipment | = | owners equity |
| 100000 + 0 | = | 100000 |
| 70000 + 30000 | = | 100000 |

3-paid for rent L.E3000, salaries L.E2000

| | | |
|------------------|---|---------------|
| Cash + equipment | = | owners equity |
| 100 + | = | 100000 |
| 70000 + 30000 | = | 100000 |
| 65000 + 30000 | = | 95000 |

4- owner withdrew L.E 10000 in cash

| | | |
|------------------|---|---------------|
| Cash + equipment | = | owners equity |
| 100 000 + | = | 100000 |
| 70000 + 30000 | = | 100000 |
| 65000 + 30000 | = | 95000 |
| 55000 + 30000 | = | 85000 |