PRINCIPLES OF ACCOUNTING

CHAPTER 1

INTRODUCTION TO ACCOUNTING AND BUSINESS

Understanding Business Activities, Accounting Information and Financial Statements

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Opening Case — How Does a Free Service Make Money?

A company may provide a service to millions of users without charging them directly. For example, with Google: users search free of charge, while advertisers pay.

1	2	3	4	5
Who are its customers?	Where does revenue come from?	What resources does it control?	How much profit does it earn?	How can owners evaluate success?

KEY MESSAGE Accounting provides the information that helps answer each of these questions.

Why Study Accounting?

- How businesses operate
- How profit is measured
- How assets are financed
- How financial decisions affect a business
- How businesses communicate financial information
- How managers, owners and creditors evaluate performance

KEY MESSAGE Accounting matters not only to accountants, but to managers, entrepreneurs, investors and employees.

Learning Objectives

By the end of this chapter, students will be able to:

LO1	Describe the nature of business, accounting and ethics.
LO2	Explain the development and application of accounting principles.
LO3	State the accounting equation and define its elements.
LO4	Analyze business transactions using the accounting equation.
LO5	Prepare and explain the financial statements of a proprietorship.

Chapter Roadmap

Business & Accounting

- Nature of business
- Types of businesses
- Role of accounting
- Users of accounting information
- Ethics in business and accounting

Principles & Careers

- Accounting career opportunities
- Generally accepted accounting principles
- Business entity concept
- Cost, objectivity and unit-of-measure concepts

Equation & Statements

- Accounting equation
- Business transactions
- Financial statements
- Financial-statement relationships
- Financial analysis

SECTION 1

Nature of Business and Accounting

What a business is, what it seeks to achieve, and why accounting matters

What Is a Business?

A business is an organization in which resources are acquired, combined, processed and used to provide goods or services to customers.

Acquired	Combined	Processed	Used to serve customers

The Business Model

INPUTS ▶ BUSINESS PROCESSES ▶ OUTPUTS

KEY MESSAGE Resources become value only after the business processes them into goods or services.

Business Inputs and Outputs

INPUTS

- Labour
- Materials
- Equipment
- Technology
- Finance
- Information

PROCESSES

- Production
- Marketing
- Distribution
- Administration
- Customer service

OUTPUTS

- Goods
- Services
- Customer value
- Revenue

The Objective of a Business

PROFIT = REVENUE – EXPENSES

REVENUE

- Amounts earned from providing goods or services
- Measured when the service is delivered or the good is sold

EXPENSES

- Resources used up in order to earn revenue
- Includes wages, rent, supplies and utilities

PROFIT

- The excess of revenue over expenses
- The primary objective of most businesses

The objective of most businesses is to earn a profit — the difference between amounts received from customers and amounts paid for the inputs used.

Profit versus Loss

NET INCOME (PROFIT)

Revenue > Expenses

NET LOSS

Expenses > Revenue

Worked Example

Revenue	Expenses	Net income
ETB 500,000	**ETB 420,000**	**ETB 80,000**

KEY MESSAGE ETB 500,000 – ETB 420,000 = ETB 80,000 net income for the period.

Application beyond Profit-Oriented Businesses

Accounting concepts also apply to organizations that do not seek profit:

- NGOs
- Hospitals
- Universities
- Religious organizations
- Charities
- Government agencies
- Professional associations

These entities still need information about:

- **Resources**
- **Obligations**
- **Revenue**
- **Expenses**
- **Cash**
- **Financial sustainability**

KEY MESSAGE Not-for-profit entities measure stewardship of resources rather than profit.

SECTION 2

Types of Businesses

Service, merchandising and manufacturing organizations

Three Types of Businesses

Businesses operated for profit are commonly classified into three types, according to what they provide to customers.

1

SERVICE

Provides services rather than physical products

2

MERCHANDISING

Buys products from others and resells them

3

MANUFACTURING

Converts inputs into finished products

KEY MESSAGE A single company may combine more than one of these business types.

Service Businesses

Service businesses provide services rather than physical products.

Examples

Banks	Airlines
Hotels	Consulting firms
Hospitals	Transport companies
Law firms	Training institutions

MAIN SOURCE OF REVENUE

Fees earned

Revenue is recognised from providing services to clients — there is no inventory of goods to sell.

KEY MESSAGE No inventory is held; the product delivered to the customer is the service itself.

Merchandising Businesses

Merchandising businesses purchase products from other businesses and resell them to customers.

Supermarkets	Pharmacies	Clothing stores
Electronics retailers	Bookstores	Fuel stations

Operating Cycle

PURCHASE MERCHANDISE ▶ STORE MERCHANDISE ▶ SELL MERCHANDISE

KEY MESSAGE Profit arises from the difference between selling price and the cost of the merchandise sold.

Manufacturing Businesses

Manufacturing businesses transform raw materials and other inputs into finished products.

Garment factories	Food-processing plants	Furniture manufacturers
Cement factories	Beverage producers	Pharmaceutical manufacturers

Manufacturing Flow

RAW MATERIALS ▶ PRODUCTION ▶ FINISHED GOODS ▶ SALES

KEY MESSAGE Value is created by converting inputs into products customers are willing to buy.

Classification Exercise

Classify each organization by business type:

Organization	Classification
Commercial bank	Service
Supermarket	Merchandising
Cement factory	Manufacturing
Consulting firm	Service
Pharmacy	Merchandising
Furniture factory	Manufacturing

DISCUSSION

Can a single company conduct more than one type of business?

Consider a manufacturer that also runs its own retail outlets and offers after-sales servicing.

KEY MESSAGE Classification depends on the dominant activity through which the business earns revenue.

SECTION 3

The Role of Accounting

Accounting as an information system and the users it serves

What Is Accounting?

Accounting is an information system that provides reports to users about the economic activities and condition of a business.

Accounting reports on the business's:

- **Economic activities**
- **Financial performance**
- **Financial position**
- **Financial condition**

KEY MESSAGE Accounting is the language through which financial information about a business is communicated.

The Accounting Information Process

Accounting converts business activities into information that users can act upon.

STEP 1	STEP 2	STEP 3	STEP 4	STEP 5
Identify users	**Assess needs**	**Design the system**	**Record economic data**	**Prepare reports**
Determine who relies on the information	Establish what those users must know	Build records and reports to meet the needs	Capture the effects of transactions	Communicate results to users

KEY MESSAGE The process begins and ends with the user — information has value only if it is used.

Users of Accounting Information

INTERNAL USERS

Individuals who manage the business day to day.

- Managers
- Employees
- Department heads
- Supervisors
- Business owners

EXTERNAL USERS

Parties outside the business with a financial interest.

- Investors
- Creditors
- Customers
- Government
- Regulators
- Suppliers

KEY MESSAGE The type of user determines the type of accounting information prepared.

Managerial Accounting

Managerial accounting provides information to internal users of the business.

IT SUPPORTS

- Planning
- Decision-making
- Budgeting
- Cost control
- Performance evaluation
- Operational improvement

IT MAY INCLUDE CONFIDENTIAL DATA ON

- Customers
- Prices
- Costs
- Expansion plans
- Internal performance

KEY MESSAGE Managerial reports are prepared to meet specific internal needs, not a fixed external format.

Financial Accounting

Financial accounting provides information to external users through general-purpose financial statements.

External reports help users decide:

- Whether to invest
- Whether to lend money
- Whether the business can pay its obligations
- Whether the business is profitable
- Whether management uses resources effectively

KEY MESSAGE General-purpose statements are designed to satisfy a broad range of external users at once.

SECTION 4

Ethics and Accounting Careers

Why trustworthy information matters, and where accountants work

The Role of Ethics

Ethics are moral principles that guide the conduct of individuals.

Accounting information must be:

Honest	**Trustworthy**	**Complete**	**Neutral**	**Fair**	**Reliable**

Without ethical conduct, users cannot confidently rely on accounting reports — and information that cannot be relied upon has no value.

KEY MESSAGE Trust is the foundation on which all accounting information rests.

Causes of Unethical Conduct

The textbook identifies two major causes of unethical accounting conduct.

FAILURE OF INDIVIDUAL CHARACTER

- Individuals justify small violations under pressure
- Deadlines, targets and personal gain erode judgement
- Small compromises grow into serious misstatement

CULTURE OF GREED AND INDIFFERENCE

- Senior management tolerates dishonesty
- Results are valued above how they are achieved
- Employees follow the example set at the top

Unethical accounting can lead to:

- Bankruptcy
- Loss of investment
- Fines
- Dismissal
- Lawsuits
- Criminal prosecution

Guidelines for Ethical Conduct

The chapter presents a four-step guideline for resolving an ethical issue.

1

Identify the ethical issue

Use standards of honesty and fairness to recognise the problem.

2

Identify the consequences

Consider the short-term and long-term effects on others.

3

Consider obligations

Weigh your duties to all affected stakeholders.

4

Make the decision

Choose the course of action that is fair and ethical.

KEY MESSAGE Working through the four steps in order turns an ethical dilemma into a defensible decision.

Accounting Career Opportunities

PRIVATE ACCOUNTING

- Bookkeeper
- Payroll accountant
- General accountant
- Budget analyst
- Cost accountant
- Internal auditor
- Information-systems auditor

PUBLIC ACCOUNTING

- External auditor
- Tax accountant
- Accounting consultant
- Advisory professional

OTHER AREAS

- Government accounting
- NGO accounting
- Forensic accounting
- Financial analysis
- Academia

SECTION 5

Accounting Principles

Generally accepted principles and the concepts that underpin them

Generally Accepted Accounting Principles

Generally accepted accounting principles provide the common rules used in preparing financial reports.

Common principles help users:

- Compare businesses
- Understand reported amounts
- Evaluate performance
- Assess financial position
- Rely on consistent practices

Without common principles, each business could report the same transaction differently, making comparison impossible.

KEY MESSAGE Comparability is the reason accounting principles must be generally accepted.

The Business Entity Concept

The business entity concept requires the activities of the business to be recorded separately from the activities of other parties.

Kept separate from the business:

- Owners
- Creditors
- Other businesses
- Related organizations

EXAMPLE

The owner's personal home and personal bank account are NOT recorded as business assets.

The business is treated as an entity separate from its owner and from all other parties.

KEY MESSAGE Defining the entity is the first step — it determines what belongs in the accounting records.

Forms of Business Organization

PROPRIETORSHIP

- One owner
- Easy to establish
- Used by small businesses
- Resources may be limited

PARTNERSHIP

- Two or more owners
- Combines skills and resources
- Profits and risks are shared

CORPORATION

- Separate legal entity
- Ownership divided into shares
- Can raise significant capital

LIMITED LIABILITY CO.

- Combines partnership and corporate features
- Provides legal-liability advantages

Cost, Objectivity and Unit of Measure

COST CONCEPT

- Assets are initially recorded at their purchase cost
- The amount actually agreed and paid is used

OBJECTIVITY CONCEPT

- Recorded amounts must be supported by reliable evidence
- Estimates and opinions are not sufficient

UNIT-OF-MEASURE CONCEPT

- Economic data are recorded in a common monetary unit
- This allows amounts to be added and compared

Illustration: land is recorded at its agreed purchase price — not at the seller's asking price, a tax assessment or a later market offer.

SECTION 6

The Accounting Equation

Assets, liabilities and owner's equity

The Accounting Equation

The accounting equation is the foundation of the entire accounting system.

ASSETS = LIABILITIES + OWNER'S EQUITY

ASSETS	LIABILITIES	OWNER'S EQUITY
What the business controls	Claims of creditors	Claim of the owner

KEY MESSAGE Total resources always equal the total claims against those resources.

Elements of the Accounting Equation

ASSETS

Resources owned or controlled by the business.

- Cash
- Supplies
- Land
- Buildings
- Equipment
- Receivables

LIABILITIES

Amounts owed to creditors.

- Accounts payable
- Loans payable
- Salaries payable

OWNER'S EQUITY

The owner's claim on assets after liabilities are deducted.

- Owner's investments
- Net income retained
- Reduced by withdrawals and losses

Solving the Accounting Equation

Given

Assets	**ETB 800,000**
Liabilities	**ETB 350,000**

OWNER'S EQUITY

800,000 – 350,000 = ETB 450,000

Rearranged Equations

Assets = Liabilities + Owner's Equity

Owner's Equity = Assets – Liabilities

Liabilities = Assets – Owner's Equity

KEY MESSAGE Any one element can be found when the other two are known — the equation always holds.

SECTION 7

Business Transactions

How economic events change the accounting equation

What Is a Business Transaction?

A business transaction is an economic event that directly changes the financial condition of the business.

What it changes

Assets	**Liabilities**
Owner's equity	**Revenue**
Expenses	**Financial condition**

Examples of transactions

- Owner investment
- Purchase of land
- Purchase of supplies on account
- Earning service revenue
- Paying expenses
- Paying creditors
- Owner withdrawal

KEY MESSAGE Every business transaction can be expressed as a change in the accounting equation.

Transaction Analysis

Transaction	Assets	Liabilities	Owner's Equity
Owner invests cash	Increase	No effect	Increase
Buy land for cash	One rises, one falls	No effect	No effect
Buy supplies on account	Increase	Increase	No effect
Earn cash revenue	Increase	No effect	Increase
Pay operating expense	Decrease	No effect	Decrease
Pay creditor	Decrease	Decrease	No effect
Owner withdraws cash	Decrease	No effect	Decrease

KEY MESSAGE Paying a creditor reduces a liability, whereas paying an expense reduces owner's equity.

SECTION 8

Financial Statements

Reporting performance, position and cash flows

The Four Main Financial Statements

1 INCOME STATEMENT

- Reports revenue and expenses
- Shows net income or net loss
- Covers a period of time

2 STATEMENT OF OWNER'S EQUITY

- Reports changes in owner's capital
- Investments and withdrawals
- Covers a period of time

3 BALANCE SHEET

- Reports assets and liabilities
- Reports owner's equity
- Prepared at a specific date

4 STATEMENT OF CASH FLOWS

- Reports cash receipts
- Reports cash payments
- Covers a period of time

Three statements cover a period of time; the balance sheet reports the position at a single date.

Financial-Statement Relationships

The statements are prepared in sequence, each feeding the next.

INCOME STATEMENT	Determines net income or net loss for the period.
STATEMENT OF OWNER'S EQUITY	Adds net income and investments; deducts withdrawals.
BALANCE SHEET	Reports closing capital with assets and liabilities.
STATEMENT OF CASH FLOWS	Explains the change in cash during the period.

Chapter Summary

BUSINESS

- Businesses transform inputs into goods and services
- Most businesses seek to earn a profit
- Service, merchandising or manufacturing

ACCOUNTING & ETHICS

- Accounting informs internal and external users
- Ethical conduct makes information trustworthy
- Principles promote consistency and comparability

EQUATION

- The entity is separate from its owner
- Assets = Liabilities + Owner's Equity
- Every transaction keeps the equation balanced

STATEMENTS

- Communicate performance
- Communicate financial position
- Communicate cash flows

KEY MESSAGE Accounting identifies, measures, records and communicates the financial effects of business activities so users can make informed decisions.

A strong understanding of accounting begins with understanding the business itself — how it acquires resources, creates value, earns revenue, incurs expenses and communicates its financial results to users.

THANK YOU

Questions and Discussion

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