Chapter 1 — Introduction to Accounting

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1 · What is accounting?

Accounting is often called the language of business — and that is exactly what it is: a system for turning the everyday activity of a company (buying, selling, borrowing, paying) into information people can actually use. More precisely, accounting is the process of identifying, recording, and communicating the economic events of an organization to interested users.

Those three words carry the whole idea. Identifying means deciding which events are worth capturing — a sale matters; hiring a talented employee, however valuable, is not itself recorded as a transaction. Recording means keeping a systematic, dated diary of those events, measured in money. Communicating means summarizing the raw data into reports called financial statements, and helping people interpret what those reports actually mean.

Bookkeeping: The recording part of accounting only. Every bookkeeper performs accounting's middle step, but accounting also includes the analysis and interpretation that turn numbers into decisions.

For an investor or trader this is not busywork — it is the raw material of every valuation. A company's price ultimately traces back to the numbers in its financial statements, so learning to read those statements is learning to read the business itself.

2 · Who uses accounting information?

Accounting information serves two broad audiences, and the whole system is designed around them.

Internal users: The managers who run the business. They use accounting to answer operating questions: Can we afford a raise? Which product line is most profitable? Will we have enough cash next month?

External users: People outside the business who must make decisions about it without running it. The two most important are investors, who decide whether to buy, hold, or sell an ownership stake, and creditors — lenders and suppliers — who decide whether the business can repay what it owes.

Other external users include tax authorities checking that taxable income is reported correctly, regulators, labour unions, and customers. Because outsiders cannot simply walk in and ask, accounting exists to give them a fair, standardized picture from the outside.

3 · The building blocks: assets, liabilities, and equity

Everything in accounting is built from three elements. Get these straight and the rest of the course falls into place.

Assets: Resources the business owns that will provide future benefit — cash, accounts receivable (money customers owe you), supplies, equipment, and buildings.

Liabilities: Claims of creditors — what the business owes. Accounts payable (owed to suppliers), notes payable (formal written promises to repay, usually with interest), and salaries payable are all liabilities.

Owner's equity: The owner's claim on the assets after debts are subtracted — what would be left for the owner if every asset were sold and every liability paid.

A quick way to feel the difference: liabilities are the outside claim, equity is the inside claim. Both are claims against the same pool of assets.

4 · The accounting equation

These three elements are locked together in the single most important sentence in all of accounting.

The accounting equation. Assets = Liabilities + Owner's Equity. In plain English: everything the business owns was funded either by borrowing (liabilities) or by the owner (equity). Own = owe + your slice.

The equation must always balance, because every economic event has two sides. If a business borrows $10,000 in cash, assets rise by $10,000 and liabilities rise by $10,000 — both sides move together. This two-sided nature is why the system is called double-entry accounting, and it is what lets the books be checked for accuracy.

We can expand the equity piece to see exactly what moves it: Assets = Liabilities + Owner's Capital - Owner's Drawings + Revenues - Expenses. Every transaction you will ever analyze slots into that expanded equation somewhere.

5 · What changes owner's equity

Four forces push owner's equity up or down.

- Investments — cash or assets the owner puts into the business — increase equity.
- Revenues — amounts earned by delivering goods or services — increase equity. Revenue is recorded when it is earned, not necessarily when cash arrives.
- Drawings — assets the owner takes out for personal use — decrease equity, and are not an expense.
- Expenses — the costs of assets and services used up to earn revenue, such as rent, salaries, and utilities — decrease equity.

A classic exam trap lives here: owner drawings feel like an expense, but they are not. An expense helps the business earn revenue; a withdrawal simply hands value to the owner. Keep them separate — one belongs on the income statement, the other never does.

6 · Analyzing transactions

Because the equation must stay balanced, analyzing a transaction just means asking: which items changed, and does the equation still balance afterward? Walk through the first few days of a small design studio.

A worked example. 1) Owner invests $20,000 cash: Cash +20,000, Owner's Capital +20,000. 2) Buys equipment for $6,000 cash: Equipment +6,000, Cash -6,000 — one asset swapped for another, totals unchanged. 3) Buys $1,200 of supplies on account: Supplies +1,200, Accounts Payable +1,200. 4) Bills a client $3,500 for work performed: Accounts Receivable +3,500, Revenue +3,500. 5) Pays $900 rent: Cash -900, Rent Expense (equity down). After all five, assets still equal liabilities plus equity.

Three patterns repeat forever: investments and revenues raise equity, expenses and drawings lower it, and swapping one asset for another (or paying off a debt) leaves the two sides in step. Analyze transactions this way and you already understand the heart of accounting.

7 · The four financial statements

At the end of a period, all those recorded transactions are summarized into four reports — prepared in a specific order, because each feeds the next.

- Income statement — revenues minus expenses for the period, giving net income (or a net loss). It answers: did the business make money?
- Owner's equity statement — begins with beginning capital, adds investments and net income, subtracts drawings, and arrives at ending capital. It answers: how did the owner's stake change?
- Balance sheet — a snapshot at a single point in time listing assets, liabilities, and ending equity. It is simply the accounting equation, formatted.
- Statement of cash flows — where cash came from and went during the period, split into operating, investing, and financing activities.

The order matters: net income flows from the income statement into the owner's equity statement, and the ending capital flows from there into the balance sheet. Miss the order and the statements will not connect.

8 · GAAP and the ground rules

For statements to be comparable from one company to the next, everyone must play by the same rules. In the United States those rules are called GAAP — Generally Accepted Accounting Principles — developed mainly by the FASB, with oversight from the SEC.

- Economic entity assumption — the business's records stay separate from the owner's personal affairs. Business money is not your wallet.
- Monetary unit assumption — only things measurable in money are recorded, which is why a loyal customer base or great morale never appears as an asset.
- Historical cost principle — assets are recorded at what was paid for them and generally kept at that cost, not marked up to a later appraised value.
- Going concern assumption — we assume the business will keep operating into the foreseeable future, which is what justifies spreading an asset's cost over the years it is used.

These may feel abstract now, but they are the reason the numbers can be trusted — and knowing them is exactly what separates someone who can read a financial statement from someone who is only guessing.