

## Chapter 8 Notes:

- **Accounting** is the function devised to provide decision makers with the financial information they need.
  - Recognizing, measuring, recording, and reporting
  - Composed of two elements: 1) processes used to account for the transactions 2) rules that specify when and how accounting can be executed
  - Managers try to standardize their accounting system= only way that they're useful
- Accounting Process:
  - **Effective internal control:** to protect against fraud and to capture all business transactions
  - Correct and consistent application of rules
  - Effective communication of results: give info to the decision makers with financial statements
    - Balance sheet: shows assets and debt and owner's money; owner's equity is shown
      - **Assets=Liabilities + Owner's equity**
    - Income statement: how the business has performed during a period
- Accounting Rules:
  - Managers within the business, leaders and owners, customers, regulators, and taxing authorities make up the groups of decision makers
  - Business transaction: economic event that affected the value of a business
    - Rule 1: recognize a sale only when the contract is fulfilled by all parties
  - Account: summary of the transaction of the particular type (ex: cash)
  - The complete transaction is what you GAVE and RECEIVED
    - Debts and credits to record transaction
  - **Managerial accounting:** attempting to meet the information needs of a business's managers by looking at the details of a business transaction
  - **Financial Accounting:** the accounting rules used to report to owners and lenders
    - SEC protects owners and lenders from fraud
      - SEC directs the PCAOB with oversees and approves of the rules set by the FASB
      - Generally Accepted Accounting Principles (GAAP) has an underlying principle called **conservatism**=> accountants should not *overstate* the value of an asset or *understate* the value of a liability or debt

- o Government regulators often represent the customer
- o **Cash basis:** business transaction is recognized only when it affects the business's cash (ex: used to measure personal finances)
- o **Accrual basis:** business transactions when they occur whether or not they are cash or credit.
  - Problem: makes assumptions. What if the customer is in debt?
- o **Assets:**
  - **Current asset/ short term assets/ working capital:** assets expected to be converted to cash within the next year
  - **Long term assets:** greater economic life than short term assets; land, building, equipment, and intangible assets (patents, copyrights, and trademarks)
- o **Inventory (current assets):** purchased (ex: Target because they resell products) or produced (ex: Hyundai because they make their own products to sell)
  - *Raw materials inventory:* materials needed to make the product (car parts)
  - *Work-in-process inventory:* partially finished product
  - *Finished good inventory:* self explanatory
- o **Tangible and Intangible Assets (Long term assets):**
  - Property, plant, and equipment/ fixed assets: tangible
    - Depreciate
  - Copyright, trademark, and patents: intangible
    - **Amortize:** adjustment to the value
    - Goodwill is an intangible asset that reflects the special value that some businesses have created
      - o Is NOT amortized
- o **Liabilities:**
  - Loan or a debt that needs to be paid off
  - **Current liability:** short term liability that is due to be paid off in a year or less
    - *Accounts payable* (amounts a business owes it's suppliers; formal docs), estimated liabilities called **accrued liabilities (no formal doc used)**, and short term debt from banks and other lenders
  - **Long Term Liability:** liabilities that are due to be paid in periods beyond one year
  - **Owner's Equity:** represents the money that owners have provided the businesses
    - Give money by providing money directly=receive ownership rights
      - o Owner's capital (sole proprietorship)
      - o Stock (corporation)
    - Give money by leaving the profits in the business

- Retained earnings: business's accumulated net income and losses that owners have left in business
  - Cash Dividend: when owners decide they do not want to retain earnings, businesses pay earnings to owners
- The Income Statement:
  - Reflects how a business uses assets in a given period of time to create sales and expenses
  - Sales-expenses= Net Income (Loss)
    - Sales-cost of goods sold=gross profit
    - Gross profit-operating expenses=earnings before interest and taxes
    - Earnings-interest expense=taxable income
    - Taxable income-taxes=net income
  - Sales: creates an exchange
    - Amounts exchanged must be earned!
    - You must receive money or value for the sale
  - Expenses:
    - Matching concept: accountants try to match sales and expenses incurred to generate those sales
    - Salaries, rent, depreciation, advertising, utilities
- **Statement of retained earnings:** shows how the retained earnings account has changed over a period of time
- **Cash Flow statement:** shows how the cash account (in the balance sheet) changed over time
- **Operating activities:** cash provided by or used in generating net income
  - Investing activities: cash used or provided to buy *long term assets*
  - Financing activities: cash provided or used to pay for *financing activities*
    - Repaying debt, paying cash dividends
- Managerial accounting:
  - Managers should plan future business transactions
    - Create a **budget** which is a basis for creating **standards**
    - Standards: benchmark that businesses used to see if their budgeted transactions are being achieved
  - Execute/ operate your business as well as monitor your operations
    - **Variance:** difference between actual and budgeted (standards) amounts
  - Review allows managers to improve in the future/ learning process