Chapter 1

General Introduction to Accounting

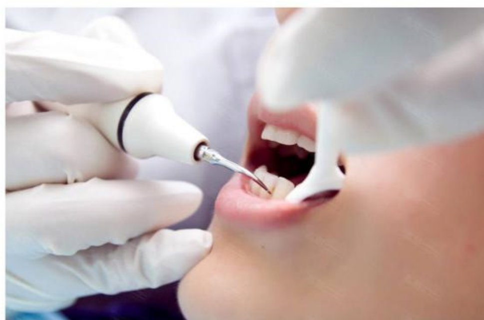
Learning Objectives:

By the end of this chapter, the learners are supposed to:

- gain some knowledge about accounting assumptions and accounting principles
- have a good command of accounting elements and accounting equation
- adhere to ethics in accounting practice
- be familiar with the terms and useful expressions in this chapter

Pre-class Task

John Cruse invested $50,000 in cash to open a dental clinic. He hired three employees. On the first day, the clinic purchased $15,000 dental equipment from the supplier on credit. This equipment provided teeth bleach service for a customer and received $500 in cash.



Could you point out the accounting elements involved in the above information?

Which belong to assets? Which belong to liabilities? Which belong to owner's equity?

Introductory Remarks

Accounting is often described as an information system of classifying, recording, measuring, summarizing, interpreting and reporting the economic activities with monetary unit as its main criterion. It is often regarded as "the language of business".

One of the most important functions of accounting is to accumulate and report financial information to its interested users including managers, stockholders, banks and other creditors, government agencies, investment advisors and general public.

Another important function of accounting system is to supply useful information for those making economic decisions, which involves planning, control and evaluation. Accounting "links" decision makers with economic activities and with the results of their decisions. It also serves other purposes: to produce operating documents, to protect the company's assets, to provide data for a company tax returns, and even provide the basis for reimbursement of costs by clients or customers.

There are several types of accounting in practice. The most common are financial accounting and management accounting. But with the growth of organizations, changes in technology, government regulation and the globalization of economy during the twentieth century, other types of accounting have sprung up such as cost accounting, budgetary accounting, tax accounting, social accounting, environment accounting, not-for-profit accounting, international accounting, etc.

Section 1　Accounting Assumptions and Accounting Principles

In order to guide accountants to make financial statements which are more reliable, understandable and comparable, we need a well-defined body of accounting assumptions and

principles. Financial accounting depends on certain standards or guides which have been proved useful in recording and reporting economic data. These standards are called Generally Accepted Accounting Principles(GAAP), which include principles as to how accountants should treat the relevant financial data and conventions as to how they should deal with specific issues that may arise.

1.1.1 Accounting Assumptions

Accounting has established group of assumptions, which are the basis of financial accounting. There are four fundamental accounting assumptions in the course of recording business transactions:

- **Economic Entity Assumption**

In this assumption, the activities of an entity are kept separate and distinct from the activities of its owner and all other economic entities. This assumption helps clearly distinguish those assets that belong to the company and those that belong to individuals. In other words, a company is a "fictional" being, the business and the owner of the business are two separate legal and economic entities. Each entity should account and report its own financial activities.

- **Going-concern Assumption**

In this assumption, the company is assumed to continue in operation long enough as a going-concern, that is, it expects to continue operating indefinitely and expects to realize its assets at the recorded amounts and to pay off its liabilities in the normal course of business.

This assumption enables accountants to make estimates on asset lives and how transactions will be amortized over time. It will affect depreciation figures and the way in which the accountant values income and expenses that have been accrued but not yet realized, such as when a company has sold goods but not yet received payment.

- **Monetary Unit Assumption**

In this assumption, only transaction data expressed in money can be included in the accounting records and the unit of measure remains relatively stable over time in terms of purchasing power. All financial transactions are in a single monetary unit or currency. Financial statements must be reported in the national monetary unit (i.e., U.S. dollars for U.S. companies). Take a Chinese company for example, if its subsidiary is in the USA, the financial data should be calculated in $ in the US. When it reports its financial statements to its parent company, it has to change its results into RMB ¥.

As a matter of fact, this assumption excludes the effects of inflation or deflation on the economy in which the company operates.

● **Periodicity Assumption**

The environment where accounting operates requires that economic activities of a business should be divided into relatively short periods, for example, financial statements are prepared monthly, quarterly or yearly. The most common accounting period is the fiscal year, the fiscal year may coincide with the calendar year but does not have to.

The accounting period assumption is needed to allow a company's financial health to be tracked over time in a way that allows fair comparisons.

1.1.2 Accounting Principles

The basic principles followed by accountants in recording business transactions can be mainly divided into 6 categories, and they are basically related to how assets, liabilities, owner's equity, revenues, expenses and profit are recognized, measured and reported.

● **Historical Cost Principle**

This principle requires us to record most of our assets and liabilities on the basis of acquisition price or original costs with no adjustments for increases in market value. It is regarded as the easiest measurement method without the need for constant appraisal and revaluation.

● **Revenue Recognition Principle**

The principle describes that expenses should be recognized in the same period as that the related revenues are recognized. Revenue is measured as the market value of the resources received or the product or service given. It is the basis for accrual accounting, which requires us to record revenue when the goods have been sold or the service has been provided.

● **Matching Principle**

One of the main objectives of accounting is to determine the periodic income by matching proper costs against revenues. The matching principle states that when you are recognizing revenue, you should match related expenses with the revenue. It is a sort of "check" for accountants to be sure that the books they are balancing or the accounts they are managing are accurate.

● **Disclosure Principle**

This accounting principle requires us to report all related financial information about our business in an understandable form. This information is presented in the main body of our financial statements, in the footnotes of our financial statements, or as supplementary information.

● **Objectivity Principle**

The objectivity principle requires financial data are expected to be objective and verifiable. In other words, accountants, accounting systems and accounting reports should rely on subjectivity as little as possible. An accountant should always use objective data (even if it's bad) rather than subjective data (even if the subjective data is arguably better). Only in this way can users rely on its accuracy while making investment and credit decisions.

● **Consistency Principle**

According to the consistency principle, although businesses can choose among different policies, they have to be consistent, which means using the same methods from one accounting period to the next, unless there is a good reason to change a policy, and accounting information of enterprises must be comparable and convenient to be analyzed. Any accounting activities against the consistency principle should be fully disclosed in the financial statements.

Section 2 Accounting Elements and Accounting Equation

1.2.1 Accounting Elements

Accounting elements consist of assets, liabilities, owner's equity, revenues, expenses and profit. These elements make up the basis for financial reports such as balance sheets, ledgers, and other means which accountants use to maintain financial records for businesses, corporations and individuals.

● **Assets**

Assets are economic resources owned or controlled by a specific entity as a result of past transactions or events and must be able to bring economic benefits. Assets can be classified into current assets and non-current assets. Current assets can be converted into cash or consumed within one year or one operating cycle such as cash, bank deposits, office supplies and accounts receivable, while non-current assets can not.

● **Liabilities**

Liabilities are debts of a business arising from past transactions or events. Liabilities will lead to future decrease of economic benefits and can be paid off by transferring assets, providing services, or borrowing new liabilities. Liabilities are usually divided into current liabilities and long-term liabilities. Current liabilities are those amounts which are repayable within a period of less than 12 months or within an accounting cycle such as accounts payable, tax payable, etc., while long-term

liabilities are debts payable over a long period such as bonds payable and long-term payable.

● **Owner's Equity**

Owner's equity, also known as the net assets of a business, refers to the economic benefit of owners in the assets of the enterprise, it is equal to assets minus liabilities. Owner's equity depends on the results of the operations of a business. If a business is profitable, owner's equity is increased, on the contrary, if a business is not profitable, owner's equity will be decreased.

● **Revenues**

Revenues refer to the gross inflows of economic benefits resulting from selling goods, providing services, transferring assets or other everyday activities. Revenues may cause the increase in assets, decrease in liabilities, or both.

● **Expenses**

Expenses are the decrease in owner's equity of economic benefits arising from the course of ordinary business activities. They are the cost of doing business and are the opposite of revenues. Expenses can be divided into cost of production and period expenses. In amount, the expenses equal the value of goods or services used up in gaining revenues. The more the expenses, the more the owner's equity is decreased.

● **Profit**

Profit which is often called net income is the operating result of an enterprise over a specific accounting period, it is the balance of all revenues after deducting the related expenses. It reflects the business' accomplishments in its efforts to operate during a certain period. By Chinese accounting standards, profit is classified into "income from main operations" and "income from other operations", but in international accounting it is not classified like this. If revenues exceed expenses, the result is called net income or profit, if expenses exceed revenues, the difference is called net loss. Revenue is a "gross" concept, while profit is a "net"concept.

1.2.2 Accounting Equation

The relationship between the assets, liabilities, and owner's equity of a business can be illustrated in a simple mathematical formula known as the accounting equation:

Assets = Liabilities + Owner's Equity

● **Expanding the Accounting Equation**

Profit is the balance of all revenues after deducting the related expenses. Therefore, the

quantitative relation among the revenues, expenses, and profit can be expressed as follows:

Profit = Revenues − Expenses

The balance of profit distribution after tax is accumulated in retained earnings account, and the retained earnings account belongs to owner's equity item. So, the two equation above can be consolidated as below:

Assets = Liabilities + Owner's Equity + (Revenues − Expenses)

Or: Assets = Liabilities + Owner's Equity + Profit

Revenues, expenses, and profit are temporary accounts, so they will be closed at the end of the accounting period. In the accounting equation, they belong to owner's equity. The equation above will be restored as basic accounting equation:

Assets = Liabilities + Owner's Equity

● **The Effects of Economic Transaction on the Accounting Equation**

The basic accounting equation, also called the balance sheet equation, is the foundation for the double-entry bookkeeping system. For each transaction, the total debits equal the total credits. In a corporation, capital represents the stockholder's equity. Since every business transaction affects at least two of a company's accounts, the accounting equation will always be "in balance", meaning the left side should always equal the right side. Thus, the accounting formula essentially shows that what the firm owns (its assets) is purchased by either what it owes (its liabilities) or by what its owners invest (its shareholder's equity or capital). Every time a transaction occurs, the elements of the equation change, but the basic equality remains.

Example

Transaction 1: *Suppose a company owns assets of $28,000, borrows $15,000 from a creditor, and invests by the owner $13,000, thus the entry made in the accounting equation should be:*

Assets	=	*Liabilities*	+	*Owner's Equity*
$28,000	=	*$15,000*	+	*$13,000*

Transaction 2: *If the company paid $500 bank deposit to purchase a computer. The entry made in the accounting equation should be:*

Assets	=	*Liabilities*	+	*Owner's Equity*
$28,000	=	*$15,000*	+	*$13,000*
+$500 −$500		______		______
$28,000	=	*$15,000*	+	*$13,000*

Transaction 3: *Suppose the company purchased $300 office supplies on credit. The entry*

made in the accounting equation should be:

Assets	=	Liabilities	+	Owner's Equity
$28,000	=	$15,000	+	$13,000
+$300		+$300		
$28,300	=	$15,300	+	$13,000

Transaction 4: *The company paid $800 for telephone fees.*

Assets	=	Liabilities	+	Owner's Equity
$28,300	=	$15,300	+	$13,000
−$800				−$800
$27,500	=	$15,300	+	$12,200

Transaction 5: *The company received $4,000 for providing professional services.*

Assets	=	Liabilities	+	Owner's Equity
$27,500	=	$15,300	+	$12,200
+$4,000				+$4,000
$31,500	=	$15,300	+	$16,200

Total Assets	=	Total Liabilities	+	Total Owner's Equity
$31,500	=	$15,300	+	$16,200

Section 3 Ethics in Accounting

Integrity and objectivity are two key elements of ethical behavior for a professional accountant. Integrity means being honest and forthright in dealing and communicating with others. Objectivity means impartiality and freedom from any conflict of interest. Other elements of ethical behavior include independence, competence and acceptance of an obligation to serve the best interests of the employer, the client and public.

Focuses on enforcing accounting laws vary from country to country. In Germany, accounting legislation is governed by "tax law"; in Sweden, by "accounting law"; and in the United Kingdom, by the "company law". In addition, countries have their own organizations which regulate accounting. For example, the United States has its Financial Accounting Standards Board (FASB).

Knowledge of ethics can help accountants and auditors to overcome ethical dilemmas, allowing for the right choice that, although it may not benefit the company, will benefit the public who relies on the accountant/auditor's reporting.

Special Terms and Useful Expressions

criterion 标准
stockholder 股东
advisor 顾问
creditor 债权人，债主；[会] 贷方
evaluation 评价，评估
reimbursement 报销，补偿
globalization 全球化
spring up 涌现
budgetary accounting 预算会计
convention 会议，惯例，规矩
transaction 交易
economic entity assumption 经济实体假设
fictional 虚构的
distinguish 区分
individual 个人
distinction 区别
going-concern assumption 持续经营假设
indefinitely 无限期地
liability 负债
amortize 分期偿还（债务）
depreciation 折旧
accrue 增加，获得，（利息等）自然增值
subsidiary 子公司，附带的
periodicity assumption 会计分期假设
acquisition price 购置价格
revenue recognition principle 收入实现原则
accrual accounting 权责发生制会计
disclosure 揭露，披露
objectivity 客观性
verifiable 能证实的
consistency 一致性
owner's equity 所有者权益
ledger 分类账，账簿
current assets 流动资产
fixed assets 固定资产
intangible assets 无形资产
note payable 应付票据
formula 公式
equation 方程式，等式
ethic 伦理，（复数）行为准则
attach importance to 重视
integrity 完整性
impartiality 公平，公正，不偏袒
competence 胜任，能力
legislation 立法
auditor 审计师
Financial Accounting Standards Board (FASB) 财务会计标准委员会

Exercises

1. Translations.

(1) 固定资产
(2) 长期债务
(3) 财务报表
(4) 一致性原则
(5) 持续经营假设
(6) 故意地
(7) attach importance to
(8) gross profit
(9) owner's equity
(10) budgetary accounting
(11) parent company
(12) accounting equation

2. Fill in the blanks according to what you have learned in this chapter.

(1) Accounting elements consist of assets, ________, owner's equity, ________, expenses and __________.

(2) Assets are ______________owned by a company.

(3) Assets are usually divided into ______________ and non-current assets.

(4) The basic accounting equation is: Assets = _____________ + ______________.

(5) At all times the accounting equation must be __________.

(6) ____________ assumption assume that the business will continue in operation for quite a long time.

(7) ____________ is the net assets of a business.

(8) _____________are debts of a business arising from past transactions or events, such as accounts payable, tax payable and salaries payable, etc.

3. Choose the correct answer.

(1) Which is the most common accounting period? (　　)

A. a day　　B. a week　　C. a month　　D. a year

(2) Which of the following belongs to assets? (　　)

A. Raw material　　B. Accounts payable

C. Rent expense　　D. Unearned revenue

(3) Which of the following belongs to non-current assets? (　　)

A. Factory　　B. Cash

C. Bank deposit　　D. Inventory

(4) Which of the following belongs to liabilities? (　　)

A. Accounts receivable　　B. Notes receivable

C. Short-term loan　　D. Paid-in capital

(5) Which of the following belongs to non-current liabilities? ( )

A. Unearned revenue B. Long-term loan

C. Accounts payable D. Short-term loan

(6) Current assets are the economic resources that can be converted into cash or consumed ( ).

A. within one year B. in one operating cycle

C. over one year or one operating cycle D. within one year or one operating cycle

(7) The basic accounting equation is ( ).

A. Assets = Liabilities + Revenues

B. Assets = Liabilities + Owner's Equity + (Revenues − Expenses)

C. Assets = Liabilities + Owner's Equity

D. Assets = Liabilities + Owner's Equity + Profit

(8) In ( ), the activities of an entity are kept separate and distinct from the activities of its owner and all other economic entities.

A. Economic entity assumption B. Going concern assumption

C. Monetary unit assumption D. Periodicity assumption

(9) A company has Assets of $100,000 and Liabilities of $20,000. The Owner's Equity of the company would be ( ).

A. $100,000 B. $20,000 C. $800,000 D. $120,000

(10) A company purchased supplies of $1,000 on credit. The effects of transaction on the Accounting Equation is ( ).

A.

Assets		=	Liabilities	+	Owner's Equity
Supplies	Cash				
+$1,000	−$1,000				

B.

Assets	=	Liabilities	+	Owner's Equity
Supplies		Accounts Payable		
+$1,000		+$1,000		

C.

Assets	=	Liabilities	+	Owner's Equity
Supplies				Revenue
+$1,000				+$1,000

D.

Assets	=	Liabilities	+	Owner's Equity
Cash				Expense
−$1,000				−$1,000

4. Analysis of economic transactions.

Assume the following transactions took place during January, 2014, for James Co.

(1) The owner invested $10,000 cash in the business.

(2) James Co. purchased office supplies for cash, $500.

(3) Paid office rent for January, $800.

(4) Bought office furniture $2,000, not paid.

(5) Paid $2,500 on accounts payable.

(6) Borrowed $3,000 from the local bank.

Use the accounting equation to analysis the transactions and put the data into the following Exhibit 1-1.

Exhibit 1-1

Transactions	Assets		Liabilities		Owner's Equity	
	Increase	Decrease	Decrease	Increase	Decrease	Increase
1						
2						
3						
4						
5						
6						
Totals						