



So What?

Show Me the Money

Who needs to understand balance sheets, accounting formulas, and complicated equations? Just hire an accountant, you say. Let someone else worry about the math.

Well, for one thing, many small businesses cannot afford to hire an accountant. In fact, accounting is often the job of the business owner. And, it's a very important job. Just consider the thousands of businesses that fail every year. At least one out of every ten has closed its doors. Many of them went out of business because of poor financial management. They failed because they weren't paying attention to the books. Then, one day there was too much debt and not enough income.

Keeping track of the money is the key to success. It doesn't matter if the business is a one-person concession stand selling T-shirts during high school football games, or a multi-million dollar corporation. If the business doesn't know where its money is, the business is doomed to fail.

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Watch

the Bottom Line



Do you have a savings account you started with birthday money or money from part-time jobs? Bet you know exactly how much money is in that account.

When you put money in or take money out, you write down the amount in your savings book to keep track of your money. You are keeping records so you will know how much money you have to spend. Did you know that you are doing accounting? You are doing the same type of accounting that businesses do, except on a much smaller scale.



So, what exactly is accounting? Accounting is one of the basic business activities. It is the process of keeping financial records. Without accurate financial records, businesses would not know if customers were paying their bills and cash was coming in to the business. They would not know how much money they had to buy supplies or pay employees. If they didn't keep track of their money, they would have the same problem you would have if you didn't keep track of your money. One day you might need cash to buy a concert ticket, but there is no money in your account.



Objectives:

- 1** Describe the importance of accounting to an organization.
- 2** Explain basic accounting activities.





The Government. Different governmental agencies review a business's accounting records for different reasons. Those agencies that collect taxes might audit the business's records to determine if the business is correctly calculating and paying taxes. Other agencies might review the records to obtain information about industry trends in order to make economic forecasts. Still other agencies might use the records to find out if the business is complying with various regulations.



Summary

Accounting is a business activity that involves keeping financial records. The purpose of accounting is to control finances. Businesses use accounting to keep track of their performance, what they own, and what they owe. They also use accounting to plan for the future. Several groups use a business's accounting information. These include the business's managers as well as investors, creditors, and the government.



1. What is accounting?
2. Why is accounting important to businesses?
3. Explain each of the following ways that accounting information is used to maintain financial control:
 - a. Tracking the business's performance
 - b. Planning for the future
4. Explain how each of the following groups makes use of a business's accounting information:
 - a. Managers
 - b. Investors
 - c. Creditors
 - d. The government

The Gray Zone

Everyone pays taxes—from the student working part-time for minimum wage to giant corporations earning millions of dollars each year. Many individuals and businesses use the services of an accountant to prepare their tax returns.

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Accountants must receive the information they are given by their clients such as total income, deductions, etc. Accountants assume their clients are being honest. However, what if they are not?

What should accountants do if they think clients are not revealing all of their income, or are taking too many deductions? For example, perhaps one client is a restaurant server who earns significant income from tips. Maybe another client is a supermarket manager who is claiming a large contribution to a charitable organization.

The accountant is certain that the server has earned more in tips than is being reported. And, the accountant thinks the charitable contribution is exaggerated based on the manager's income. Should the accountant explain these concerns to the clients? Should the accountant refuse to prepare their tax returns? If you were the accountant, what would you do?

Income statement. This is the other important financial summary that is sometimes called the profit-and-loss statement. This statement shows how much money the business has made or has lost. Income statements may be simple or more complex depending on the type of business. For example, a small service business merely subtracts its operating expenses from its sales revenue to determine net income. However, a business that buys goods for resale uses a more complicated process. It first subtracts cost of goods from net sales to determine gross profit. Then, it subtracts total expenses from gross profit to determine net profit or loss.

The income statement explains a business's financial situation for a specific period of time, usually one year. Naturally, all businesses want the income statement to show a profit. Operating an effective accounting system and accurately tracking all financial transactions are often the best ways to make this happen.

Summary

An accounting system is the process used in handling the business's financial information. To be effective, the system should be easy to use, process data quickly, be expandable and affordable, and protect the business. There are two types of basic accounting methods—the cash accounting method and the accrual method. The steps in the accounting process involve recording, organizing, and summarizing the information. Then, the information is reported on the balance sheet and income statement.



1. What is an accounting system?
2. Explain the five characteristics that are common to all effective accounting systems.
3. Explain the difference between the cash accounting method and the accrual accounting method.
4. Describe the following steps in the accounting process:
 - a. Record transactions
 - b. Organize the information
 - c. Summarize the information
5. What is the purpose of a balance sheet?
6. Define the following terms:
 - a. Assets
 - b. Liabilities
 - c. Owner's equity
7. What is the basic accounting equation?
8. What is the purpose of the income statement?

Make It Pay!

Businesses use accounting systems to track their financial transactions, especially expenses. You can use an accounting system to do the same. Just like a business, you need to know where your money is going. Your system can be very simple but still help you track your spending. At the end of a month or two, you might be very surprised at the results.

Try this simple procedure. Write down the amount you spend each day and what you buy. Keep track of small expenses, like 50¢ for a candy bar or the \$1.00 for a bag of chips. That's 50¢ a day for a bag of chips. That's \$3.50 a week for a year, it amounts to \$182.

Using an accounting system can help you decide how to best spend your money. Do you really want to blow \$182 on chips, or would you rather save and buy an MP3 player? Of course, the decision is yours. However, how would you even know you have the option if you have no idea what you are spending?

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