

**Objective**



So? What



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Last winter, Tucker and Ian started a lawn-mowing and snow-shoveling service. Although they did well initially, business slowed down when summer arrived. Many past clients (who had hired them to clear snow off their driveways) chose to mow their own yards. Luckily, though, a few residents wanted to hire them to mow their lawns instead of doing it themselves.

To mow lawns, Tucker and Ian needed gasoline. They had done many times before, so they didn't get their money out of their pockets. Unfortunately, they only found two dollars inside! Why? Because they had simply put money in when they earned it and taken money out when they needed it—to print advertisements, purchase gasoline, and pay themselves—without keeping track of how much money they actually had. As a result, they weren't able to mow anyone's grass. Soon after, they went out of business. What important business function had the boys overlooked? Accounting. Wise business owners know that accounting is a "must" for high profits—and business success!

**SAMPLE PAGE**

**Objectives**

- A** Describe the importance of accounting to an organization.
- B** Explain basic accounting activities.

**Watch the Bottom Line**

What is accounting? Accounting, which is both a basic business function and a career choice, is the process of keeping financial records. Most of us practice some form of accounting in our daily lives, even if we don't think of it as accounting. We keep records of our personal funds and our debts so that we know how much money we have and how much we owe.

Suppose for a moment that it's your birthday, and your Uncle Pete gives you a check for \$20. If you deposit it in your savings account, write the amount in your savings book, and calculate the new total, you are doing personal accounting. If you are saving for an automobile, knowing how much is in your savings account helps you determine how much more you need to save before you can purchase the car of your dreams.



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**A** Accounting isn't just for businesses. Most individuals also practice some form of accounting in their daily lives.

Businesses use accounting to keep track of the value of the things they own, the accounts owed to them, and the amounts that they owe to others. Without accurate financial records, businesses would not know if customers were paying their bills and cash was coming into 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.



status. The bank grants or denies the loan based on this information. If the business is profitable and will continue to be profitable, the bank will probably agree to the loan.

**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 and 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, who use managerial accounting information, as well as investors, creditors, and the government, who all utilize financial accounting information designed for users outside the business.



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

Jeffrey works as an accountant for Ride-go, a multi-million dollar toy company with a less than stellar past. Three years ago, Ride-go's chief executive officer (CEO) was fired for improperly using millions of dollars of the toy giant's money—money that belonged to the company's investors. Most famously, he spent two million dollars for a Roman-themed party.

Unfortunately, history seems to be repeating itself. Jeffrey's replacement held the company's most recent board meeting in the Bahamas. The CEO's travel arrangements, including the cost of the five-day "meeting," which included a private jet, a limousine, and fire dancers, cost \$350,000. Given this information and past experience, should Jeffrey approve payment for the trip? (After all, the board did in fact hold its meeting while in the Bahamas.) Or, should Jeffrey refuse to use company funds to pay for what was obviously a party?

**SAMPLE PAGE**

The balance sheet presents three important categories of financial information: assets, liabilities, and owner's equity. Assets are anything of value that the business owns, such as cash in the bank, buildings, and equipment. Liabilities, on the other hand, are debts that the business owes. Finally, owner's equity is the amount the owner has invested in the business, plus or minus profits and losses. These three categories are the components of the basic accounting equation:  $\text{Assets} - \text{Liabilities} = \text{Owner's Equity}$ . The balance sheet gets its name from the fact that the sides of the equation must balance each other.

**Income statement.** The income statement, sometimes called the profit-and-loss statement, shows how much money the business has made or lost during a specific period of time, usually one year. For a large merchandising business, this figure is determined by first subtracting cost of goods from net sales to determine gross profit. Then, total expenses are subtracted from gross profit to determine net profit or loss. A small service business, on the other hand, is likely to determine net income by merely subtracting operating expenses from sales revenue.

**Cash flow statement.** A cash flow statement is a financial summary estimating when, where, and how much money will flow into and out of a business during a specific period of time. Managers need to

know when money will flow in and out of the business so that they can prepare for any periods of time when the business will be low on cash. By preparing a cash flow statement, the business can also identify different sources of cash and determine which of these sources are more or less likely to make payments to the business as promised. Lastly—but most importantly—the cash flow statement indicates how much cash is expected to flow into the business in the given time period. If the business knows that there will be a cash shortage during a certain month or quarter of the year, for instance, it can plan ahead to generate more income and/or reduce expenses.

- **Closing the books.** The final step of the accounting cycle involves closing any temporary accounts and transferring the temporary account balances to permanent accounts such as owner's equity. After closing the books, the accounting-cycle process starts over again.

## 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. The steps in the accounting cycle involve analyzing financial transactions, journalizing transactions, posting to ledgers, balancing the books, preparing financial statements, and closing the books.



1. What is an accounting system?
2. Explain the five characteristics that are common to all effective accounting systems.
3. What are the steps of the accounting cycle?
4. Explain the difference between the cash accounting method and the accrual accounting method.
5. What is the purpose of accounting standards?
6. What is the purpose of each of the following financial statements:
  - a. Balance sheet
  - b. Income statement
  - c. Cash flow statement

## Make It Pay!

Consider for a minute... school-based enter-  
prise... student organization's  
responsible for keep-  
responsible for

**SAMPLE  
PAGE**

... what is  
that process? Who  
uses this financial  
data? How could the  
accounting system  
be improved?



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