Week One

What is accounting? The purpose of accounting is to provide information that will help you make correct financial decisions. Your accountant's job is to give you the information you need to run your business or your client's business as efficiently as possible while maximizing profits and keeping costs low.

Accounting plays a role in business of all sizes. Your kid's orange juice stand, a one-person business, a partnership, a corporation, a non-profit organization, and a multinational corporation all use the same basic accounting principles.

Accounting is legislated. It affects your own taxes and the share of profits you would receive from a corporation. Even the president plays a role in how accounting affects you. The list goes on and on.

Accounting is the language of business. It is the process of recording, classifying, and summarizing economic events through certain documents or financial statements. Like any other language, accounting has its own terms and rules. To understand how to interpret and use the information accounting provides, you as a tax preparer, must first understand this language. Understanding the basic concepts of accounting is essential to success in the tax preparation business. Some types of information provided by accountants are:

- Information prepared exclusively by people within a company (managers, employees, or owners) for their own use. Ex. Daily cashier report.
- Financial information required by various government agencies such as the IRS, Security Exchange Commission (SEC), and Federal Trade Commission (FTC).
- General information about a company provided to people outside the firm such as investors, creditors, and labor unions.
- Information prepared for banks, financial institutions and others.

Bookkeepers. Bookkeeping procedures and bookkeepers' records keep track of the business transactions that are later used to generate financial statements. Example: A daily sales report is summarized at the end of the month to provide the total sales of the company.

Most bookkeeping procedures have been systematized and in many cases can be handled by computer programs like QuickBooks or PeachTree. Bookkeeping is a very important part of the accounting process, but it's just the beginning. There is currently no certification required to become a bookkeeper in the United States.

Accounting is the process of preparing and analyzing financial statements based on daily or periodic transactions recorded through the bookkeeping process. Accountants are usually professionals who have completed at least a bachelor's degree in accounting, and often have passed a professional examination, like the Certified Public Accountant Examination, the Certified Management Accountant Examination, or the Certified Fraud Auditor Examination.

Accounting goes beyond bookkeeping and the recording of economic data, to include the summarizing and reporting of this information, in a way that is meant to drive decision making within a business.

Who uses Accounting information? In the world of business, accounting plays an important role to aid in making critical decisions. The more complex the decision, the more detailed the information must be. Individuals and companies need different kinds of information to make their business decisions.

Let's start with you as a tax preparer. Why would you be interested in accounting? Accounting knowledge can help you with investing in the stock market, applying for a home loan, evaluating a potential job, balancing a checkbook, reading a W-2 form, preparing a tax return, refinancing your home and starting a savings plan, among other things. Areas in which managers use accounting information include:

- Marketing (Which line of goods should the company emphasize?)
- Production (Should the company produce its goods in the United States or open a new plant in Mexico?)
- Research and Development (How much money should be set aside for new products development?)
- Sales (Should the company expand the advertising budget and take money away from some other part of the marketing budget?)

Without the proper accounting information these types of decisions would be very difficult, if not impossible to make. Areas in which bankers use accounting information include:

- Granting loans to individuals and companies
- Investing a client's money
- Setting interest rates
- Meeting federal regulations for protecting your money

As you can see, government agencies such as the Internal Revenue Service (IRS), the Security Exchange Commission (SEC), the Federal Trade Commission (FTC), and the Bureau of Alcohol, Tobacco, and Firearms (ATF) base their regulation enforcement and compliance on the accounting information they receive.

Financial Statements. Accountants supply information to people both inside and outside the company by using formal reports that are called financial statements.

The financial statements are usually issued at least once a year. In many companies they are issued quarterly or more often when necessary. A set of rules called General Accounting Principles govern the preparation of the financial statements. General Accepted Accounting Principles has been defined as a set of objectives, conventions, and principles to govern the preparation and presentation of financial statements. These rules can be found in volumes of documents issued by the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), the Internal Revenue Service (IRS), the Securities and Exchange Commission (SEC), and other regulatory bodies. To understand and interpret the financial statements is a challenge, but it can be mastered through practice and study.

The Basic Financial Statements. The basic financial statements include:

- The Balance Sheet
- The Income Statement (As an individual tax preparer, you should focus on this statement).
- The Statement of Cash Flows, and
- The Statement of Retained Earnings.

As a tax preparer, you will be dealing with these documents and should be prepared to ask your clients questions in order to adequately treat the transactions affecting your client's tax preparation.

In certain circumstances, as an individual tax preparer you will be interested in all of them except the Statement of Cash Flows. As we discuss the statements that are involved in the preparation of a tax return, you will see that they are not as scary as you might have thought. Many of the concepts will already be familiar to you.

Ricky's Orange Juice Business Example

Let's now do an exercise where we can prepare the basic financial statements (Balance Sheet, Income Statement and Cash Flow Statement). Assume that you are a kid, Ricky. You have an orange juice stand business and are ready to go.

Now that your place of business is ready, you need a product - and that takes money! You run to your bedroom and shake out all the quarters and nickels and dimes from your piggy bank. It adds up to $5 dollars!

Now that you're in business, how are you going to keep track of the $5 dollars? You need some paper and a pencil, for sure. You need some way to keep a record of what money goes in and out of your business. This record keeping is what accounting is all about. You decide to create a scorecard for your business. Your scorecard allows you to keep track of things happening in your business. To better understand how money flows in and out of a business, though, we need a scorecard that shows two things: WHAT WE HAVE and WHO OWNS IT. Which means we need to draw a line down the middle of the scorecard. On the left side you'll track things and stuff you have and use in your business. On the right side you'll track who owns that stuff. So, your scorecard looks like this:

WHAT WE HAVE	WHO OWNS IT

The left side represents WHAT WE HAVE. The right side of our scorecard represents WHO OWNS IT.

Now that we have a proper scorecard, let's back up a moment. You start the business with some cash, specifically $5 dollars. Who has it? You're right - you do! And, no doubt about it. You worked hard for those $5 bucks!

It's yours and nobody else's.

Which means that it goes on the left side of the scorecard, as $5 in Cash. But it also goes on the right side since you own the $5. But what will you call this $5?

The whole idea is to invest the $5 bucks in your orange juice stand. Right? So, what should we call the money that you originally shook from the piggy bank to invest in the orange juice stand?

How about "ORIGINAL INVESTMENT"?

Who owns the Original investment? You, as the owner, do. So it goes on the right side of our scorecard. Let's write in what's happened so far. Enter the $5 dollars in Cash on the left side and enter the five dollars in Original Investment on the right side. Next, enter the totals on the last line of each side.

WHAT WE HAVE		WHO OWNS IT	
Cash	$	Original Investment	$
Total	$	Total	$

Notice anything about the two sides? They're equal. The left side equals the right side. This is one of the BIG accounting rules.

You now know an important rule about this financial scorecard. The left side will always, ALWAYS equal the right side! Repeat this rule, please. Tape it to your forehead. Put it under your pillow at night, so you will remember it in your sleep: THE LEFT SIDE ALWAYS EQUALS THE RIGHT SIDE. If not, something is wrong in the process and needs to be investigated.

So far, so good. You can close your eyes and see the customers lining up around the block to sample your great tasting orange juice ... until you realize that starting an orange juice stand will cost more than the original investment of $5 dollars because you have to buy stuff to make your orange juice.

Who is most kids' personal banker? Right, Mom and Dad.

So you go to one of them (you know which one is more likely to say yes) and Mom forks over $10 .You're halfway out the door when Mom calls, "Hey Ricky, that $10 isn't a gift! It's a loan!"

This is all part of teaching you something about the real world. Okay, you still have the money, even after Mom makes you sign a piece of paper that says "IOU" at the top.

Still, the $10 dollars is yours to use, so you can add it to your Cash under "What We Have".

But you also owe it to Mom. So, since you don't, in fact, "own" the $10, we need to create a new category on the right side (Who Owns It) of the scorecard. You have, in fact, just signed a "note" that is "payable" to your mom. Businesses have a name for an IOU. It's called Notes Payable. Go ahead and record these transactions.

WHAT WE HAVE		WHO OWNS IT	
Cash	$	Note Payable	$
		Original Investment	5.00
Total	$	Total	$

Talking Points

Accounting Software. Many people think that they do not need to learn accounting because the accounting software will do the work for them. Well, there are many programs on the market today that will adequately take care of your needs. However, if you do not understand the recordkeeping basics, you will not know how to tailor the program to your business or feed in the proper information. This is also applicable to any income tax preparation software.

Single and Double Entry Systems. There are two basic bookkeeping methods: (1) single entry and (2) double entry. In the past, only single entry accounting was thought to be proper for business. However, it is now generally recognized that although a single entry system will adequately serve many smaller (micro) businesses, as the business grows and becomes more complex, it will become necessary to move into a double entry accounting system in which each transaction is posted as debit to one account and credit to another. The halves of the double entry always have to be equal. Through the utilization of software, the process has been simplified for the user, because the transaction is easily entered and matched to its primary account. The software then automatically debits or credits the proper corresponding account. From now on, in the orange juice business we will use the double entry system.

IRS Point of view. So far you do not have to do anything with Uncle Sam, since this is an individual business that started this week . Uncle Sam wishes you the best of luck with your new business.

So, we have the left side which represents what you have and use. And what do you have? **Cash.**

And how much cash so far? **$15.**

Businesses have a name for the WHAT WE HAVE. Do you know it? **Assets.**

So, from now on, we'll use Assets as our heading for the left side. On the right side, who owns that cash? You own $5 and your bankers (Mom & Dad) own how much? **$10**

Since there are two owners on the right half, we will draw a horizontal line that divides the right side into two parts. The upper right side represents the people that the business owes money to ... or to whom you are LIABLE.

Are you going to have to pay back the $10 to Mom or Dad? So, are you liable to them for $10? **Yes.**

Which is why, from now on, we'll label the top part of the right side, LIABILITIES.

The lower right side represents the portion of the business you own; right now, that is your Original Investment. What do some people call the part of the business owned by the owners? Make a check mark by the answer below. (Hint: there may be more than one answer).

__Equity
__Owner's Equity
__Stockholder's Equity
__Net Worth

Did you make a check in front of all of the above? You should, because they're all the same thing. To keep it simple, we're going to call this lower right side, Owner's Equity.

So, the right side has two parts: Liabilities (what you owe others) and Owner's Equity (what's yours). Remember we said the left side always equals the right side? Well, here's the next accounting rule to remember:

Assets = Liabilities + Owner's Equity

Ricky must know this equation, he should write it down on the palm of his hand - even put it under a magnet on the fridge. Here's your scorecard again, with the proper accounting terms. Now, lets do the first journal entry:

Account	Debit (Dr)	Credit (Cr)
Cash	$10.00	
Notes Payable (Mom & Dad)		$10.00
Total	$10.00	$10.00

Description: To record the loan from Mom & Dad.

Talking Points

A Journal Entry. A journal entry *is the process where a transaction affects a minimum of two accounts and its recorded as a journal entry, often assigned a number for reference purposes. Information in the journal entry would include: the source, the date, a description of the entry, what accounts are debited and credited and for what value. If applicable, the entry may also be job costed (this means the revenue and/or expense is allocated to a specific department, job,etc).*

Now, lets see how the scorecard looks:

ASSETS		LIABILITIES	
Cash	$15	Notes Payable	$ 10
		Owner's Equity:	
		Original Investment	5
TOTAL ASSETS	$15	TOTAL LIABILITIES & OWNERS'S EQUITY	$ 15

Before moving on - does the left side still equal the right side? It should. **Always! Always! Always!**

You're doing great. And, hopefully, you're having fun. You're making discoveries, maybe seeing things clearly for the first time.

Well, now think about the balance sheet. What does it represent? Think about this. What's a good way to capture a beautiful moment? How about by taking a snapshot. What period of time does a snapshot record? Check one:

__ A moment
__ Longer than a moment