

CHAPTER TWO

Basic Accounting and Financial Statement

Overview of Accounting

Debits and Credits

Goal of Accounting

Main Functions of Money

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An Overview of Accounting

Accounting

The process of recording financial transactions.

Accounting provides the framework that allows each and every economic transaction to be expressed in a systematic way.

Accounting enables people to record transactions and measure assets, liabilities, and capital.

- $\text{Assets} = \text{Liabilities} + \text{Capital}$

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An Overview of Accounting

An understanding of accounting is required to understand the economy and the way the banking system operates.

Accounting is based on a system called double-entry bookkeeping.

- Double-entry bookkeeping:
 - A system of accounting where every entry requires a corresponding and opposite entry.
 - Double entries are referred to as debits and credits.

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Balance Sheet transactions are described by credits and debits.

- Debits are recorded on the left side of each entry and can be described as funds that are coming into a household, firm, or organization.
- Credits are recorded on the right side of each entry, and can be described as outgoing funds, obligations, or equity.

Transactions must be in balance.

The total debits must be equal to the total credits.

Generic Manufacturing Company

If Generic sells a product for \$100 in a cash transaction, the correct entry is the following:

	Debits	Credits
Cash (asset account)	\$100	
Sales (revenue account)		\$100

If Generic pays cash wages of \$50, the correct entry is the following:

	Debits	Credits
Wages (expense account)	\$50	
Cash (asset account)		\$50

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Two primary rules of accounting:

1. Accounts must be in balance
2. Every single transaction must generate at least one debit and one credit

Accounts are categorized as debit and credit accounts.

- Debit accounts include assets and expenses
- Credit accounts include liabilities, revenue, and capital

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T-accounts

An informal table used by accountants to visualize transactions.

T-accounts are formalized with journal entries in double-entry bookkeeping.

- T-accounts easily maintain activity for each account and are used to help visualize the entries.

	Cash (Asset)	Wages (Expense)	Sales (Revenue)
Entry #1	\$100		\$100
Entry #2		\$50	\$50

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Ultimate Goal of Accounting

The ultimate goal of accounting is to produce a set of financial statements that include income statements and balance sheets.

Financial statements provide a picture of the company's overall financial position at the end of the reporting period.

- **Income Statement:** reports the revenues and expenses for a firm over a given period of time.
- **Balance Sheet:** reports a company's assets, liabilities, and equity for a specific point in time.

Private sector businesses → focuses on reporting financial activity and, often, disclosing financial position for purposes of budgetary planning or shareholder reporting.

Governmental entity → no profit motive. Reporting focuses on disclosing performance from the perspective of the fiscal responsibility.

ABC Company

Income Statement

	Debits	Credits
REVENUE:		
Sales:		\$100,000
EXPENSES:		
Wages:	\$50,000	
Material:	\$20,000	
Overhead:	\$10,000	
PROFIT:		\$20,000

Balance Sheet

	Debits	Credits
ASSETS:		
Cash:	\$20,000	
LIABILITIES & CAPITAL:		
Liabilities:		\$0
Capital (Retained Earnings / Profits):		\$20,000

USA Bank

Income Statement

	Expenses (Debits)	Revenue (Credits)
INCOME:		
Interest Income:		\$200,000
EXPENSES:		
Salaries (wages): (paid to employees)	\$50,000	
Interest: (paid to depositors)	\$50,000	
Other Overhead:	\$50,000	
TOTAL EXPENSES:	\$150,000	
PROFIT (Credit) or LOSS (Debit):		\$50,000

Balance Sheet

	Debits	Credits
ASSETS:		
Loans to Borrowers:	\$1,000,000	
Government Bonds:	\$1,000,000	
LIABILITIES & CAPITAL:		
Deposits from Customers:		\$1,800,000
Capital		\$200,000
TOTALS:	\$2,000,000	\$2,000,000

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Money

Money is valuable because it is accepted as a means of payment.

Historically, we have seen two types of money:

1. Commodity Money: money with intrinsic value
2. Fiat Money: paper money without intrinsic value

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Main Functions of Money

Money fulfills three main functions:

1. Money must act as a medium of exchange.
2. Money acts as a store of value.
3. Money must act as a unit of account that enables us to compare different prices.