

THE ABCs OF Accounting

Lesson 1: Getting Started with Accounting

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Lesson Objectives

- After studying this lesson, you will be able to:
 - ▲ Explain what accounting is
 - ▲ Explain why accounting is important
 - ▲ Explain the different business entities
 - ▲ Explain how to work with journals and ledgers
 - ▲ Explain the benefits of computerized accounting over manual accounting systems

What Is Accounting?

- The systematic, quantitative recording of activities
- The language of business
- How we keep track of activities in a business
- How we evaluate a potential purchase

Why is accounting important?

- Helps business owner make decisions about the business
- Helps business owner pay the right amount of taxes
- Helps banks value businesses
- Without accounting, a business person would have no idea who owed him what, who he owed...

History

- Sumerians (Mesopotamia) more than 5,000 years ago used clay tokens to keep track of agricultural and manufactured goods.
- The tally stick in the Middle Ages was used to keep tally of livestock, agricultural products, money, and even the lunar cycle. The tally marks were notched on a stick and the stick split in half. The tax collector would hold both stick halves to see if they were altered at tax time.



Luca Pacioli

- Franciscan monk who wrote about accounting in 1494
- He argued that a successful merchant needed only three things:
 - ▲ Enough cash or credit
 - ▲ An accounting system that told the merchant how he was doing
 - ▲ A good bookkeeper to operate the system

Business Entities

- What is a business entity?
 - ▲ Business or organization whose primary purpose is to make a profit for the owners
- Four major business entities:
 1. Sole proprietorship
 2. Partnership
 3. Corporation
 4. Limited Liability Company

Sole Proprietorship

- One individual owns all the property used in the operation of the business enterprise
- This individual is responsible for *all* the debts
- This individual is entitled to receive *all* the profits
- The business ends with the death of the owner or the owner's wish to discontinue the business

What are some examples of sole proprietorship businesses?

Partnership

- A business owned by more than one individual
 - ▲ Examples: accounting firms, law firms, medical practices, dental practices
- Partnership agreement signed up front spells out:
 - ▲ The amount each partner will contribute
 - ▲ The percentage ownership of each partner
 - ▲ The share of profits for each partner
 - ▲ The duties and responsibilities of each partner



Corporation

- A business entity that is separate from the owners
- It has a legal right to own property
- It has a legal right to do business in its own name
- Corporation must get permission from a state to operate
- This is called a *charter*
- Ownership is represented by shares of stock

Advantages of a Corporation

- The indefinite life of the corporation
- The shareholders are not personally liable for the debts or taxes of the corporation
- If the corporation cannot meet its obligations, the most a shareholder can lose is the value of her investment

Characteristics of Business Entities

Characteristic	Sole Proprietorship	Partnership	Corporation
Ownership	One owner	Two or more	One or more
Business life	Life ends when the owner dies, is unable to carry on the day-to-day operations, or decides to close the firm	Ends with the death of a partner, withdrawal of a partner, or when the partners decide to end the business	Can live forever; ends only when the corporation goes bankrupt or its stockholders vote to liquidate
Responsibility for debts	Owner is responsible when the company cannot pay	Partners are responsible individually and jointly	Stockholders are not responsible; they can lose only their investment



Limited Liability Company

- Recognized first in 1977 by Wyoming
- Recognized in 1997 by Hawaii, the final state
- Offers the business the limited liability of a corporation, but the business is treated as a partnership for tax purposes (only one tax on the business)
- The entity of choice for many small and family-owned businesses



Advantages and Disadvantages

- Owners are called members and protected from liability for acts and debts of the LLC
- LLCs are enduring entities
- The earnings are subject to self-employment tax
- In order to be treated as an LLC, must have at least two members



Most states allow single-member LLCs, but you may not elect partnership classification for federal tax purposes.



Different Types of Corporations

Characteristic	LLC	C Corporation	S Corporation
Ownership	Unlimited number of “members”	Unlimited number of shareholders; no limit on stock classes	Up to 100 shareholders; only one class of stock allowed
Personal liability	Generally, none	Generally, none	Generally, none
Tax Treatment	Entity is not taxed (unless it chooses to be); profits and losses are passed on to members	Taxed on its earnings; shareholders are taxed on dividends or distributions	Profits and losses are passed through to the shareholders
Capital contributions	Money and services are contributed to receive an interest in profits and losses	Shareholders purchase stock, common or preferred	Shareholders purchase the one type of stock allowed

Journals and Ledgers

- The journal is a chronological record of all business transactions
- Often called “the book of original entry”
- The business must have an account form for each account, each customer, and every vendor
- These forms are put in a book called a ledger
- Each transaction affects two accounts and must be recorded correctly (lots of paperwork)



Compare two systems

■ Manual System

- ▲ For each invoice, you must write the name and address again
- ▲ To see what customers owe you, look at each customer's ledger account form and total them

■ Accounting Software

- ▲ Enter a customer's name only once
- ▲ Each invoice recalls the information
- ▲ Create a receivables report with the push of a button

What if you have 450 customers?



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Summary

- Documents from Venice over 500 years ago talk about accounting in pretty much the same way we do now. What is the advantage to a debit or credit? What if my customer does not pay me?
- Cavemen started with sticks, the Sumerians used clay tablets, we use computers.
- Business owners need information about their business to make good decisions.
- Accounting can be very exciting.



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