

## Notes on the Structure of Accounting (Y1)

Chapters 2 and 3 in the Antle-Garstka text introduce the major financial statements, the *balance sheet*, *income statement* and *cash flow statement*. You may already have some feel for this, but these statements are linked to each other through the elegant and useful structure of the accounting system. In fact, it is really not possible to appreciate the significance, or make intelligent use of, these statements without a sound understanding of the accounting system. In this class we will stress the logical structure of accounting. This is your foundation and is more important for now than the technical details

The key aspect of accounting systems is its *double entry* nature. When one account is affected, so is at least one other. As we shall see, its double entry nature serves two purposes. First, it is natural to tally up what things are of benefit to the firm, and which parties have claims on those things. This idea is established in the following *Fundamental Law of Accounting*.

$$\text{Assets} = \text{Liabilities} + \text{Owner's equity}$$

I refer to this relationship as a law because it must always hold. When the firm's assets go up, someone must have a claim on them. The claim is that of either the owners (owner's equity) or debtors (liabilities). If one asset increases, then: (1) some party has an increase on his or her claim to the firm's assets, so owner's equity or a liability increases, or (2) some other asset must go down.

A second purpose served by the double entry system of accounting is it provides constraints on what can be recorded and reported. Its structure implies certain relationships among accounts whose balances appear in the financial statements. This *control* aspect of accounting makes it very appealing in the context of organizations where individuals have conflicting information and objectives. The control aspect is emphasized heavily in your managerial accounting classes (H212 and H525).

We typically teach the structure of accounting systems through the use of the debit-credit convention. This convention is a substitute for adding and subtracting numbers and actually helps us ensure we have not violated the Fundamental Law of Accounting. This debit-credit convention is emphasized in Chapter 4 in the Antle-Garstka text when you study the Statement of Cash Flows.