

# Chapter 1 — Introduction to Accounting

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**Watch the full video lecture on YouTube:** [youtube.com/@optionflowtracker](https://youtube.com/@optionflowtracker) — these notes follow the video section by section, with the same examples and the same numbers, so you can read along or revise after watching.

## 1 · What is a business?

A business is a machine: you feed it **inputs** (materials, labor) and it turns them into **outputs** — goods or services people want. A farmer feeds in seeds, water and work; out comes corn that customers pay for. Every business on Earth, from a lemonade stand to an airline, is this same machine.

Why build the machine? To earn a **profit**:

**PROFIT = REVENUES – EXPENSES** — revenues are amounts received from customers for goods sold or services performed; expenses are amounts paid for the inputs (salaries, rent, materials, interest).

Businesses come in three flavors: **service** (sell help — Uber, an accounting firm), **merchandising** (sell other people's stuff — Costco, Amazon), and **manufacturing** (make their own — Tesla, Apple, Toyota).

## 2 · What is accounting?

Accounting is an information system that provides reports to users about the economic activities and condition of a business. Baby version: accounting is the business's **diary** — it writes down everything that happens with money so anyone can read the story later. That's why it's called **the language of business**.

Accounting does exactly three things — remember **I · R · C**:

Activity	What it means
Identify	spot the economic events relevant to the business (sales, rent, wages, purchases)
Record	keep a careful, chronological history of those events
Communicate	produce the financial statements, then analyze and interpret them

**Bookkeeping vs. accounting:** bookkeeping usually involves only the recording step. Accounting is the whole package — identifying what matters, recording it, and communicating it. A bookkeeper writes the diary; an accountant writes it, reads it, and explains what the story means.

**Who reads the diary?** Internal users (managers, employees) use managerial accounting. External users (investors, creditors, customers, unions, the SEC and IRS) rely on financial accounting.

## 3 · GAAP — the rulebook, and its 4 ground rules

Imagine a soccer game where every team plays by its own rules — chaos. So accounting has one rulebook: **generally accepted accounting principles (GAAP)**, developed in the U.S. by the FASB with the SEC overseeing public markets. Internationally, the IASB develops IFRS, and the two systems are converging to make any two companies on Earth comparable.

Ground rule	Definition	Physical anchor
Economic entity	the business's activities are kept separate and distinct from its owners and from every other entity	ownership is evidenced
Cost concept	assets are initially recorded at their cost, the actual purchase price	receipts provide: a real receipt, not an opinion
Monetary unit	record only transaction data that can be expressed in money terms	customer's smile is priceless — and unrecorded
Fair value	some assets/liabilities are reported at the exit price instead of the historical cost	used only when the market price is easy to find (e.g.,

## 4 - Forms of business

Form	Owners	Key traits
Proprietorship	one individual	easy and cheap to organize; ~70% of U.S. entities; resources limited to the owner's
Partnership	two or more	~10%; profits taxed directly to partners as personal income
Corporation	shareholders	~20%; separate legal, taxable entity; stock; limited liability; unlimited life
LLC (most popular)	members	limited liability from the corporation + tax pass-through from the partnership

Your legal structure decides two things: **who is liable**, and **who gets taxed**.

## 5 · THE accounting equation

**ASSETS = LIABILITIES + OWNER'S EQUITY** — always, after every single transaction.

Assets are what the business owns. Liabilities are what it owes — the creditors' claims. Owner's equity is the owner's claim on what's left (the **residual claim**: if the business is liquidated, creditors are paid first). If a business has \$100 of assets and owes \$60, the owner's slice is \$40.

Equity isn't frozen — four forces move it. That gives the **expanded equation**:

**A = L + Owner's Capital – Owner's Drawings + Revenues – Expenses**

Investments by the owner and revenues push equity **up**; drawings and expenses push it **down**. Two forces up, two forces down.

## 6 · Transaction analysis — ABC's 13 transactions, with the WHY

What gets recorded? Only events that change assets, liabilities, or equity. External transactions happen with outside parties; internal ones (like using up supplies) get recorded later through adjusting entries.

Here are ABC's 13 transactions — don't just read WHAT moved, understand WHY:

1	Owner invests \$20,000 cash	Cash +20,000 · Capital +20,000	money entered the business's pocket; it isn't a gift — it's the owner's claim (separate entities)
2	Buys equipment \$12,000 cash	Equip +12,000 · Cash –12,000	a SWAP: one asset traded for another; total assets unchanged
3	Buys \$6,000 supplies: \$2,000 cash, rest on account	Supplies +6,000 · Cash –2,000 · A/P +4,000	you own the whole pile on delivery; the unpaid 4,000 is a promise to pay — a liability
4	Performs services, \$4,000 cash	Cash +4,000 · Revenue +4,000	NOT a swap — you gave up effort, not an asset; the business genuinely grew
5	Performs services ON ACCOUNT, \$2,000	A/R +2,000 · Revenue +2,000	revenue is earned when the work is DONE, not on payday; the customer's IOU is an asset
6	Borrows \$800 on a note payable	Cash +800 · N/P +800	money with a string attached — it must go back, so it can never be revenue
7	Buys \$3,000 equipment on account	Equip +3,000 · A/P +3,000	asset arrives, promise to pay is born — no cash touched
8	Pays office rent \$2,500	Cash –2,500 · Rent exp +2,500	you got nothing you can KEEP — the space is consumed. That's what makes it an expense
9	Collects the \$2,000 billed in #5	Cash +2,000 · A/R –2,000	the IOU vanishes; swap of paper promise for cash. NO new revenue — counting it again = counting the same work twice
10	Owner withdraws \$1,000	Cash –1,000 · Drawings +1,000	business pocket → owner's personal pocket. Not a business cost, so NOT an expense — a direct cut to equity
11	Pays bills: salaries 500 · utilities 300 · ads 100	Cash –900 · Expenses +900	services already consumed to run the month, nothing left to own

	Transaction	Effect	Explanation
12	\$400 ad bill arrives, pays later	A/P +400 · Ad exp +400	the ad already RAN — recognition doesn't wait for cash
13	Pays the \$3,000 owed from #7	Cash -3,000 · A/P -3,000	settling old business, not creating a new cost — equity feels nothing

After all 13: total assets \$26,400 = liabilities \$5,200 + equity \$21,200 — perfectly balanced. **The golden rule:** the equation must balance after every transaction, and at least TWO accounts are always affected (double-entry — chapter 2's subject).

## 7 - The four financial statements — strict order

Four reports, always prepared in the same order because each hands a number to the next, like runners passing a baton:

#	Statement	Covers	Components	Hands off
1	Income statement	a period	Revenues – Expenses = NET INCOME	net income →
2	Owner's equity statement	a period	Beg. capital + Investments + NI – Drawings = <b>ENDING CAPITAL</b>	<b>ENDING CAPITAL</b> →
3	Balance sheet	a DATE (snapshot)	Assets = Liabilities + Owner's Equity	cash balance →
4	Statement of cash flows	a period	cash in – cash out (where the cash went)	—

ABC's numbers from the video: service revenue \$90,000; expenses \$29,000 (salaries 15,000 + rent 10,000 + utilities 4,000); **net income \$61,000**. Owner's equity statement: beginning capital \$0 (a brand-new business — before January 1st there was no company, nothing to own; an older business would start from last year's ending capital) + investments \$20,000 + net income \$61,000 – drawings \$1,000 = **ending capital \$80,000**. The balance sheet then reports A = L + OE at December 31 with that \$80,000 — the equation printed on paper.

Two warnings the exam loves: investments by the owner are NOT revenue, and withdrawals are NOT a business expense — the income statement excludes both.

Calendar year = Jan 1 to Dec 31. Fiscal year = begins the first day of any month, ends twelve months later.

## 8 - Chapter cheat sheet

#	Lock it in
1	Business = inputs → outputs → PROFIT (revenues – expenses)
2	Accounting = identify + record + communicate — the language of business
3	GAAP: entity apart · record at cost · measure in \$ · fair value only when easy
4	A = L + OE — always, after every single transaction
5	Expanded: A = L + Capital – Drawings + Revenues – Expenses
6	Every transaction touches at least TWO accounts (double-entry)
7	4 statements, strict order: income → equity → balance sheet → cash flows

**Next:** practice with the FREE Chapter 1 exercises (with full solutions) — and Chapter 2 answers the question this chapter created: nobody scribbles on an equation 500 times a day, so what did a 500-year-old Italian monk invent? See you there.