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| **Characteristics of Accounting** |

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| Net profit reported in the income statement is one of the key measurements of a company. It tells the reader how much income the company has made after the expenses they had to pay.  The formula for net profit is:  **Revenues – Expenses = Net Profit**  We may have several different types of expenses which will be listed out by category. The income statement like other financial statements will need to follow GAAP in order to be considered accurate. International Financial Reporting Standards, or IFRS, are used by international companies and are less detailed than GAAP.  **Characteristics of Accounting Information**  In order for accounting information to be useful, it must be relevant, reliable, comparable, and consistent. It should be useful for evaluating and predicting the future.   * Primary Qualities are Relevance and Reliability * Predictive Value (Relevance) * Feedback Value (Relevance) * Timeliness (Relevance) * Verifiability (Reliability) * Representational Faithfulness (Reliability) * Neutrality (Reliability) * Secondary Qualities are Comparability and Consistency   **Assumptions Underlying Financial Reporting**  There are some assumptions that we expect are in place. Here is a list of the assumptions and their basic definitions:   * **Separate-entity assumption**: We expect that the business is separate from the owners and that funds are co-mingled. * **Monetary-unit assumption**: We expect that the numbers will be measured in dollars and be measurable. * **Time-period assumption**: We expect that we can divide the transactions into meaningful time periods. * **Going-concern assumption**: We expect that the company will continue to stay in business in the future.   **Principles Underlying Financial Statements**  There are also principles that guide the way that we report financial items and here is a list and basic definitions:   * **Historical-cost principle**: we record transactions at the cost we paid for it and do not change the value as time passes. * **Revenue-recognition principle**: we record revenue when we earn it, not necessarily when cash is received. * **Matching principle**: we match expenses in the same period where their applicable revenue was earned. * **Full-disclosure principle**: all important events are fully disclosed in the financial statements. * **Materiality and conservatism**: constraints that limit or control GAAP. |
| **Elements of the Financial Statements** |

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| * A complete set of financial statements includes—income statement, balance sheet, statement of cash flows, and notes to the financial statements. * There are many different elements that we will use in preparation of the financial statements.   The list is as follows:   * Assets * Liabilities * Equity * Investments by owners * Distributions to owners * Comprehensive income * Revenues * Expenses * Gains * Losses   An understanding of the accounting equation is one of the most important areas to grasp at this point since future weeks will continue to build on this understanding. To understand the equation itself, you first need to understand the different categories and what goes into them:  **Assets** are resources controlled by a business. These are items that are of value to the business. Examples include: cash, accounts receivable, inventory, supplies, prepaid expenses, buildings, land, equipment, vehicles, patents, copyrights, goodwill, and others.  **Liabilities** are claims by a creditor or other party on the company’s resources. Basically this is the debt of the company and includes any items that they might owe for. Examples include: accounts payable, notes payable, wages payable, interest payable, taxes payable, bonds payable, and others.  **Owners' Equity** are contributions to the business made by owners as well as any profits that have been kept inside of the company. Examples include: capital stock and retained earnings which are the most common accounts. **Revenues** and **Expenses** are accounts that are closed into retained earnings after the fiscal year, and so also indirectly affect the owners’ equity account.  **Accounting Equation**  Accounting is built on the foundation that everything must balance and equal out to show that we have recognized events correctly. The accounting equation is the foundation that accounting is built on:  **Assets = Liabilities + Owners’ Equity**  What this means is that if we have an increase on one side of this equation then we need to either have a decrease on the same side or an increase on the other side to keep this in balance.  You will see assets categorized into current and noncurrent assets; liabilities will be current and noncurrent liabilities. Equity will include contributed capital and retained earnings. This enables companies to prepare a classified balance sheet showing subtotals in each category. |
| **The Accounting Cycle** |

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| A company’s accounting system is kept in the general ledger. A general ledger is a record of each account and the transactions that affected the balance during the year.  We have specific steps of handling accounting transactions in order to get them to the ledger. The journal is the location where we store each individual transaction. The journal is recorded in chronological order and we will end up transferring out the transactions to their individual ledger account. This transfer process is referred to as posting which is the posting from the journal into the individual accounts. This is much like a personal checkbook in that you keep a record of your deposits and payments chronologically but in order to know how much you spent in a specific area, you would need to transfer those amounts out into individual account ledgers.  Here is the list of the complete accounting cycle which we will discuss next:   * Record transactions in the journal * Post the journal entries to the general ledger * Prepare an unadjusted trial balance * Prepare adjusting entries and post them to the general ledger * Prepare an adjusted trial balance * Prepare the financial statements * Close the temporary accounts * Prepare a post-closing trial balance   Now, let’s begin a discussion on the different steps:  **Accounting Cycle #1 (Record transactions in the journal):**  In the journal, we use debits and credits to represent actual entries to the individual accounts. We use the term debit to show that we entered something on the left side of the account (T account). We use the term credit to represent a right-side entry.  For asset and expense accounts, a debit entry means that we increased it. A credit entry to either of these categories means that we decreased it. Liabilities, stockholders’ equity, accounts, and revenue accounts are the opposite, and a debit means that we decreased the account and a credit means that we increased the account.  Debits must always = Credits. This system allows us to make sure everything stays in balance.  **Journalize the Transaction**  A journal entry is a record of the transaction in terms of debits and credits. Here are some rules of journal entries:   * There is always at least 1 debit and 1 credit * Debits are on the left and credits are on the right * Debits (amount) = Credits (amount)   As previously mentioned, assets and expenses are increased with a debit and decreased with a credit. Liabilities and owners’ equity are increased with a credit and decreased with a debit. Students often struggle when they first are learning journal entries in trying to remember how to treat everything. Here is a helpful hint that will help you learn how to handle the cash account which is very often involved in the transaction.  **Helpful Hint:**  First, clear your mind of any banking terms you are familiar with such as debit card. Accounting terms were in place before banking terms and unfortunately, ever since the invention of debit cards, students have been confused. Once your mind is cleared, proceed to the next paragraph.  When we get money, we “D” deposit it. “D” in deposit is like “D” in debit |
| **Debits and Credits** |

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| When we spend money, we write a “C” check. “C” in check is like “C” in credit. So, when you review a transaction involving cash, if we got some, you would think of this hint and remember that we deposit cash and that must be a debit to cash. If we are paying out money, you would associate this with writing a check and credit the account. If you have a good understanding of ½ of the transaction, it will be easier to remember if you debit or credit the other account.  All other assets are handled like cash. When we get some, we debit them, when we get rid of some, we credit the account. Liabilities and stockholders’ equity are on the opposite side as the assets so they are handled the opposite way. |
| **Journal Entries** |

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| Let’s walk through each journal entry that needs to be prepared:   |  |  |  |  | | --- | --- | --- | --- | | **Transaction Number** | **Account Name** | **Debit Amount** | **Credit Amount** | | 1 | Cash Common Stock (We have more cash now which is an asset, so we debit that, and we also have more contributed capital, so that is a credit.) | $20,000 | $20,000 | | 2 | Equipment Cash (We have more equipment which is an asset, and so we need to debit that, and less cash which is also an asset, so we need to credit that account.) | $5,000 | $5,000 | | 3 | Cash Sales (We have more cash now which is an asset, so we debit that, and we also received that cash due to sales, so we need to increase that revenue account as well which is a credit for an increase.) | $35,000 | $35,000 | | 4 | Cash Notes Payable (We have more cash now which is an asset, so we debit that, and also more liability now since we borrowed this, so our liabilities will need to be increased with a credit.) | $9,000 | $9,000 | | 5 | Rent Expense Cash (We spend money on rent, so we have more expense now which is a debit and less cash now which is an asset, so that is a credit.) | $2,000 | $2,000 | | 6 | Wages Expense Cash (We spend money on wages, so we have more expense now which is a debit, and less cash now which is an asset, so that is a credit.) | $10,000 | $10,000 | | 7 | Utilities Expense Cash (We spend money on utilities, so we have more expense now which is a debit, and less cash now which is an asset, so that is a credit.) | $3,000 | $3,000 | | 8 | Notes Payable Cash (We have paid off some of our liability, so now we owe less debt and have to debit the liability to reduce it, and also less cash which is an asset, so we have to credit that to show a decrease.) | $4,000 | $4,000 | | 9 | Accounts Receivable Sales (We have sold some of our services and we now have more owed to us which is a receivable and resource, so it is an asset which we debit to show an increase. We also received this receivable through sales, so we have an increase in sales also, which is shown as a credit.) | $10,000 | $10,000 | |
| **Posting Journal Entries to the General Ledger** |

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| As you approach the concept of journal entries, remember that practice will help so take advantage of your reading examples and also these examples. The more you do these, the higher your understanding levels will reach.  **Accounting Cycle #2 (Post the journal entries to the general ledger):**  As noted above, the general ledger is a set of individual accounts. We can use t-accounts to simplify the general ledger group and will follow the same rules of the left side being the debit and right side being the credit.  So, if we had $20,000 that we received from an investor and our transaction was a debit to cash for $20,000 and a credit to common stock for $20,000, we would record this in the cash and common stock accounts as follows: (These are T accounts—Left side is debit and right side is credit.)   |  |  |  |  |  | | --- | --- | --- | --- | --- | | Cash | |  | Common Stock | | | $20,000 |  |  |  | $20,000 | |  |  |  |  |  |   Every cash transaction we then have will either be a debit or credit to this account and likewise with other accounts. So, if we borrow $10,000 from the bank in a long-term note, we will debit the cash account for $10,000 which will now give us a balance of $30,000 if that was all we had for the period. We would also have a new account for the notes payable we would enter the $10,000 into. Once all transactions have been entered into the t-accounts, we need to total each one.  If there are debits and credits into the account, we take the difference between the two side totals and then the final total will be the side of the higher number so if we have $100,000 in debits to cash and $45,000 in credits to cash, the balance will be $55,000 ($100,000 - $45,000) and that will be on the debit side since that is the bigger number.  The side that we enter to when we have an increase is what we consider the normal balance. So, if we normally show an increase to the debit side on all asset accounts, we will consider the normal balance to be a debit for all asset accounts so we can expect the balance to be a debit. We normally show an increase as a credit to any liability accounts, so we expect liability accounts to have a normal balance of a credit. Here is a summary of normal balances:  Normal Balances: (These balances are normally posted in the trial balance.)  Assets: Debit Liabilities: Credit Stockholders’ Equity: Credit Revenues: Credit Expenses: Debit There will be exceptions related to contra accounts such as dividends, which is an equity account but reduces the balance like expenses do. |
| **Preparing an Unadjusted Trial Balance** |

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| **Accounting Cycle #3 (Prepare an unadjusted trial balance):**  Once we have all of the balances in each individual ledger account, we are ready to prepare an unadjusted trial balance. This is a report showing all debit and credit balances and each account and is used to verify that the debits equal the credits and also to give us a chance to review any accounts that might need to be adjusted. Here is a sample unadjusted trial balance:  Account                                                               Debit                    Credit  Cash                                                                $100 Accounts Receivable                                         $300 Inventory                                                           $900 Common Stock                                                 $800 Accounts Payable                                                                            $  200 Sales                                                                                              $3,000 Rent Expense                                                    $400 Office Supplies Expense                                     $700 TOTALS                                                          $3,200                      $3,200  If the totals do not balance, you will need to go back and review each journal entry to make sure that it balances and then check your transfer from the journal to the ledger to make sure you put the amounts in the correct column. Finally, if you still can’t locate this, re-add up each individual ledger account to double check your balances there.  **Accounting Cycle #4 (Prepare adjusting entries and post them to the general ledger):**  Under the accrual method, there will be items that need to be adjusted at the end of the period in order to bring certain accounts to their correct balances. We have briefly mentioned a couple of examples of this in the revenue and expense section related to the unearned revenue account and prepaid expense account. Here is an overall summary of the different categories of adjusting entries:   1. **Deferred (prepaid) Expenses**: We have paid for an expense in advance of using it such as rent expense or insurance expense or supplies. These need to be booked as an asset initially and at the end of the year, as part of the adjusting entries, you need to review the balance and adjust it for any usage that has happened.   Example:  Original Entry: Prepaid $1,000 for 1 month rent:  Debit Prepaid Rent                          $1,000 Credit Cash                                    $1,000  Adjusting Entry: When used up  Debit Rent Expense                       $1,000 Credit Prepaid Rent                        $1,000 |
| **Preparing Adjusting Entries** |

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| 1. **Accrued Revenues**: These are revenues that we have earned but not yet billed for. We need to look for year-end transactions that might not have made it to the books and increase our accounts receivable account and decrease our revenue account.   Example: no entry has been done:  Adjusting Entry: Provided services to a client that we haven’t billed for yet for $2,000.  Debit Accounts Receivable          $2,000 Credit Revenue                                                $2,000   1. **Accrued Expenses**: These are expenses that we have incurred but have not recognized them as an entry yet. We need to review for these transactions and make sure to recognize an expense and corresponding liability in the correct period. Accrued wages would be an example of this.   Example: no entry has been done:  Adjusting Entry: Owed wages at the end of the year for $3,000 that will be paid next month.  Debit Wages Expense                    $3,000 Credit Wages Payable                    $3,000   1. **Depreciation Expense**: This is the deduction of a portion of the cost of a fixed asset over its useful life. When we buy an asset, all of its cost goes onto the balance sheet as a fixed asset and as time passes, we move a portion of that onto the income statement through depreciation based on the depreciation method chosen.   Example: no entry has been done:  Adjusting Entry: Calculated depreciation on fixed assets of $5,000  Debit Depreciation Expense        $5,000 Credit Accumulated Depreciation             $5,000  All adjusting entries involve at least 1 income statement account and 1 balance sheet account and never involve cash. |
| **Preparing Adjusting Entries Example** |

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| Next, let’s look at the second adjusting entry. We have wages that have not been recognized. Think about what the journal entry would look like and see below to confirm that you are correct.  So, here is what the complete solution looks like along with the ending balances in each column which are calculated:   |  |  |  |  | | --- | --- | --- | --- | |  | Assets | Liabilities | Equity (Retained Earnings) | | Year end amounts before correction | $163,000 | $22,000 | $141,000 | | Adjusting Entry A: |  |  |  | | Decrease Prepaid Insurance | ($1,000) |  |  | | Increase Insurance Expense |  |  | ($1,000) | | Adjusting Entry B: |  |  |  | | Increase Wages Payable |  | $500 |  | | Increase Wages Expense |  |  | ($500) | | Year end corrected amounts | $162,000 | $22,500 | $139,500 | |
| **Preparing the Adjusted Trial Balance and Financial Statements** |

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| **Accounting Cycle #5 (Prepare the adjusted trial balance.):**  This is the same process as step #3 in that you prepare another trial balance but this time, you will have the new balances after the adjusting entries have been done. Again, you will want to make sure that the debits and credits balance and that all accounts look reasonable.  **Accounting Cycle #6 (Prepare the financial statements.):**  Using the adjusted trial balance, you are now ready to prepare the financial statements. Here are the 4 financial statements that need to be prepared and the order:   1. The first financial statement you will need to prepare is the income statement which will have all revenues and expenses on this statement. 2. The statement of changes in shareholder’s equity statement is next. You will need the net income from the income statement in order to calculate the total shareholder’s equity so this statement can’t be prepared until the income statement is done. 3. The balance sheet is next and will list out all assets, liabilities, and shareholder’s equity balances. The shareholder’s equity balance will come from the statement of changes in the shareholder’s equity statement so the balance sheet can’t be prepared before that statement is done. 4. The final statement is the statement of cash flows and this will be a record of all transactions related to cash. We will need to get the cash balance and some account changes from the balance sheet in order to prepare a statement of cash flows.   **Accounting Cycle #7 (Close the temporary accounts.):**  Once you have prepared the adjusting entries and financial statements following that, you are ready to close out the period to get ready for the new period. All revenue and expense accounts should be closed out to retained earnings so that they can have a $0 opening balance for the new period since the income statement just looks at a specific period of time. The dividends account should also be closed when there is a balance. |
| **Closing Process Example** |

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| The closing process includes 2 different journal entries. The first entry is the closing of the revenue account into retained earnings. Since the revenue account normally has a credit balance, we will need to debit that account for the balance to create a $0 balance and offset it against retained earnings so the journal entry will look like this:  Debit revenue accounts                                               $X Credit retained earnings                                               $X  The second entry is the closing of the expense accounts into retained earnings. Since the expense accounts normally have a debit balance, we will need to credit these accounts for the balance to create a $0 balance and offset it against retained earnings so the journal entry will look something like this:  Debit retained earnings                                        $X Credit cost of goods sold                                     $X Credit expense account #1                                  $X Credit expense account #2                                  $X Credit expense account #3, and so on                  $X |
| **The Final Step in the Accounting Cycle** |

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| **Accounting Cycle #8 (Prepare a post-closing trial balance.):**  Preparing the post-closing trial balance allows for a check of the accounts still in the general ledger to make sure no temporary accounts remain, and that the accounting equation is still in balance. This is another trial balance but now will have the latest balances after the closing of the accounts.  Now that we have looked at the different examples under the accrual basis, you should have gained a better understanding of the different time periods that we recognize revenues and expenses in, because there can be a big difference if it is not done correctly on the financial statements. We have now been through the complete accounting cycle so you can see what happens from the beginning steps throughout the period to the closing process.  As you have seen, there are many transactions that involve the cash account which makes internal controls especially important in this area. The company will analyze the risks associated with cash and collections and put controls to minimize risk. Cash is a temptation for theft due to the nature of its use. Therefore, as a company we need to work to have a strong safeguarding of cash and other controls put into place such as bank reconciliations.  **Bank Reconciliation**  A bank reconciliation is a comparison between the records of the bank and the records in the books and adjusting for any discrepancies. Due to the timing of transactions and other things that we might not know about in our books, the bank statement balance and the book balance will most likely not match. We need to prepare a bank reconciliation making adjustments to each applicable side. It is a critical part of controlling cash. Here is a template that is often used to prepare this:   |  |  |  |  | | --- | --- | --- | --- | | **Bank Statement** | | **General Ledger (Book)** | | | Ending balance per bank statement | $X | Ending balance per books | $X | | + Deposits in transit | + $X | + Bank collections | + $X | | - Outstanding checks | - $X | + Interest earned | + $X | | +/- Bank errors | +/- $X | - Bank service charge | - $X | |  |  | - NSF checks | - $X | |  |  | + / - Book errors | +/- $X | |  |  |  |  | | Ending balance per bank statement | $X | Ending balance per books | $X | |