

Chapter 6: Accounting Procedures Part I

Overview

This chapter introduces students to accounting with an explanation of its purpose, general rules, and the steps in the accounting cycle. There are a number of practice problems embedded in the chapter; please advise students to complete them. It may also be necessary to review them in class.

Lecture Notes

A. Basic Accounting Procedures and Concepts

1. Accounting Process

Accounting is the process of recording, measuring, summarizing, analyzing, and interpreting financial information and communicating it for decision-making purposes.

- a. An **Accounting Entity** is any business, individual, or not-for-profit organization whose financial information is separate from any other.
- b. Accountants are concerned with these **Types of Business Entities**.
 1. A sole proprietorship is owned by one individual; it is a separate accounting entity from the individual, but not a separate legal entity.
 2. A partnership has two or more owners that operate together and share the profits/losses as agreed. It is a separate accounting entity, but not separate legally.
 3. A corporation is a separate legal entity created by law; it has the same legal rights as individuals. A charter must be obtained from the state where it is formed and then shares of stock are issued in exchange for assets. These shareholders/stockholders are the owners.
- c. **Financial Information Is Recorded** when the transaction takes place.
 1. A common monetary unit is used for recording; this is known as the money management or monetary unit principle.
 2. Historical cost is used to determine the value of assets; that means the original cost is the basis.
 3. The stable dollar concept assumes that a dollar today is worth the same amount as the dollar used to buy the asset in the past.
- d. **Financial Information is Classified** relative to the areas that are affected.
- e. **Financial Information is Summarized** into reports to make it more useful in decision making.
- f. Accounting information is **Used by Different Groups of People**.
 1. Internal users include managers in the organization.
 2. External users are separate from the organization; specific and general reports may be generated for this group.

2. Reporting Accounting Information

- a. **External Reports** that serve general purposes are known as financial statements; they include the balance sheet, income statement, statement of retained earnings, and statement of cash flows.
 - 1. Generally Accepted Accounting Principles (GAAP) are set by the Financial Accounting Standards Board. The rules are necessary because the information is provided to external users.
 - 2. Audits are performed by CPAs to judge the fairness of reports; the independent review determines if the GAAP have been followed.
 - b. **Internal Reports** are used by managers and do not have to follow generally accepted accounting principles
3. Basic Concepts and Principles used in accounting include the following:
- a. **Going Concern** states that the accountant assumes that the entity will continue operations indefinitely
 - b. **Relevance** means the accounting information must make a difference in the decisions made using it.
 - c. **Periodicity** divides the life of an accounting entity into time intervals for reporting purposes. An accounting period consisting of 12 consecutive months is called a fiscal year; it may or may not follow the calendar.
 - d. **Estimation** is used to determine amounts for the financial reports because the life of an entity is divided into arbitrary time intervals.
 - e. **Consistency** requires that the same accounting or reporting method be used from one period to another. If a change must be made, it must also be disclosed in the financial statements.
 - f. **Conservatism** requires that the valuation method for an asset that is least likely to overstate the income or financial position be used.
 - g. **Full Disclosure** requires that all information relevant to decision makers be disclosed through financial statements.
 - h. **Materiality** refers to the relative importance of an item or event to the decisions that users will be making.

B. Summarizing Financial Data

- 1. Accounts are used to collect and summarize data; they can also be called ledger accounts.
 - a. **Recording Information in Accounts** can be done in different formats.
 - 1. Computerized systems store data on magnetic tape or disks.
 - 2. Manual systems use a three-column account format.
 - b. **T-Accounts** are used as teaching tools; they resemble a capital T.
 - c. **Recording Debits** (left side) **and Credits** (right side) add and subtract from an account's balance.
 - d. **Recording Entries** summarize transactions.
 - e. **Calculating Account Balances** means taking the difference between debits and credits; the balance is recorded on the side with the larger balance.

- f. The **Ledger** is a record of accounts.
2. Classification of Permanent Accounts
- a. **Assets** are economic resources from which the owner can expect to benefit.
 - 1. Increases are debits, decreases are credits, and the normal account balance is on the debit side.
 - 2. Assets are recorded at cost because that can be verified.
 - b. 1. **Liabilities** are obligations or debts that are owed to others.
 - 2. Increases are credits, decreases are debits, and the normal account balance is on the credit side.
 - c. **Owner's Equity** represents the resources invested by the owners; however, the liabilities must come first and the owners get what is left.
 - 1. In a sole proprietorship, the owner's equity is recorded in the owner's capital account.
 - 2. In a partnership, each owner has his or her own capital account.
 - 3. In a corporation, owner's equity is divided into contributed capital and earnings of the company.
 - 4. Increases in owners' equity may come from investments made by owners or retained earnings of the business.
 - 5. Decreases in owners' equity may come from distribution of cash or assets to owners or losses incurred through business operations.
 - 6. Increases to owners' equity are recorded as credits, decreases are debits, and the normal account balance is on the credit side.
 - d. Balance sheet accounts are also called permanent accounts because they remain on the company's books permanently.
3. The Accounting Equation: $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$
- a. **Equality** must always be represented between assets and associated rights/claims.
 - b. **Source of Assets** is another way to look at liabilities; all of the resources used to obtain assets are provided through creditors' holdings or owners' investments.
 - c. **Continual Changes in Composition** of assets, liabilities, and capital are normal; however, the equality of the basic equation must always be maintained.
 - d. **Residual Aspect of Owner's Equity** allows the equation to be rewritten as $\text{Assets} - \text{Liabilities} = \text{Owner's Equity}$.
 - e. **Double-Entry Accounting** states that debits must equal credits for every entry that is recorded.
4. Classification of Temporary Accounts
- a. 1. **Revenues** are earnings based on business operations.

2. **Increases** are credits, decreases are debits, and the normal balance is credit.
- b. 1. **Expenses** are costs of goods and services used as a result of earning revenue.
2. **Increases** are debits, decreases are credits, and the normal balance is debit.
- c. **Net Income = Revenue–Expenses**
 1. Net income is reported periodically (when it is earned).
 2. Accrual concept matches revenue with its associated expenses; they are reported when they are accrued rather than when they are paid.
 3. The matching principle states that expenses incurred in earning revenues should be matched with that revenue to calculate the net income.
 4. Increases to owner's equity come from reporting a net income; decreases come from a net loss.
 5. Revenue and expense accounts are closed to income summary.
- d. **Investment by Owners**
 1. The investment is not revenue; it is recorded as assets and increases owners' equity.
 2. If a corporation sells shares of stock, the cash is not revenue. It is recorded as an increase to cash and an increase to capital stock.
- e. **Withdrawals and Dividends**
 1. Withdrawals of assets from a business are not expenses; they decrease owners' equity and the asset.
 2. Dividends represent a distribution of assets to stockholders; that is not an expense.
5. The Accounting Cycle includes all procedures performed during each accounting period.
 - a. **Analyze and Record** transactions while preparing the source document.
 - b. **Post journal Entries** to ledger accounts, both the debits and credits.
 - c. **Prepare a Trial Balance** to check debits/credits.
 1. The trial balance proves the equality of debits and credits; however, it does not ensure there are no errors in the previous steps.
 2. A trial balance can be prepared at any time.
 - d. **Complete Worksheet** to make the end-of-period processes easier, like adjusting entries, closing entries, and financial statements.
 1. Complete each set of columns on the worksheet.
 2. Make the end-of-period adjustments.
 3. Journalize and post the entries.
 - e. **Prepare Financial Statements** using the worksheet information.

- f. **Prepare a Post-closing Trial Balance** is the final step in the accounting cycle; it includes only the permanent accounts.
- g. **The Next Accounting Cycle Begins** on the first day of the next accounting period.

C. Preparing Journal Entries

1. Recording accounting transactions

- a. **Journalizing** is done chronologically; it is the first recording of each transaction.
 - 1. A source document provides information for recording journal entries; examples include checks, sales invoices, purchase orders, and receipts.
 - 2. A general journal most common type of journal; if a business uses just one type, then it is general.
- b. **Posting** is a process that transfers journal entries to the ledger.
 - 1. Post debit entry first; the journal page number is recorded in the reference column.
 - 2. The ledger account number is the reference recorded in the journal.
 - 3. The same procedure is followed for the credit side of the journal entry.
- c. *Review the typical accounting transactions that are analyzed in this section to reinforce the concepts that have been presented so far.*
- d. *Review the typical accounting transactions, including revenue and expenses, to reinforce the concepts that have been presented so far.*

2. Adjusting Entries are necessary to bring accounts up to date that have incorrect balances at the end of the accounting period. *Review the sample entries throughout this section.*

- a. **Estimates** are one reason for adjusting entries.
 - 1. Depreciation expense is adjusted to properly reflect the asset's value and depreciation expense for the accounting period.
 - 2. Allowance for uncollectible accounts is adjusted to correspond with the current accounting period.
- b. **Prepaid/Unearned Accounts** are another area where adjusting entries are recorded.
 - 1. Expenses that are originally recorded as assets are adjusted for the current accounting period. Some expenses that are adjusted include insurance expense and supplies expense. Adjustments are also made for expenses that are originally recorded as expenses like supplies and insurance.
 - 2. Revenues that are originally recorded as liabilities represent deferred revenue; the adjustment updates the account for the revenue that has been received, like rent revenue. The revenue may also have been first recorded as revenue, and an adjusting entry would update that.
- c. Accruals

1. Accrued expenses are adjusted to display the expenses that have actually been incurred, like salaries and interest.
 2. Accrued revenues are also updated for the revenue earned in the current period; interest is a good example.
 3. Interest revenue is earned with the passage of time on most notes receivable held by a company, but interest revenue is not normally recorded until it is received.
 4. The **Worksheet** is used to show the unadjusted trial balance, adjustments, adjusted trial balance, income statement, and balance sheet information. *Other adjustments are shown in examples.*
3. Closing Entries are recorded to close the temporary accounts at the end of each accounting period to prepare for the next. They are done in the following order:
- a. Close revenue and gain accounts to income summary.
 - b. Close expense and loss accounts to income summary.
 - c. Close the income summary account.
 - d. Close withdrawal and dividend accounts.
 - e. Journalize and post closing entries.

Prepare the post-closing trial balance and everything is ready for the next accounting period.

