**Accounting – 1:4**

Financial Accounting Assumptions and Principles/

The Accounting Cycle

1. GAAP.
2. Accountants prepare financial statements and accounting records in accordance with what are known as **generally accepted accounting principles,** commonly abbreviated as **GAAP**.
3. GAAP is derived from the FASB, the EITF, the AICPA Ac- SEC and ASB, SEC FRRs (formerly ASRs) and SABs, the AICPA CAP, the APB, and even the IRS.
4. FASB- Financial Accounting Standards Board
5. AICPA- American Institute of Certified Public Accountants
6. SEC- Securities and Exchange Commission
7. Cash vs. Accrual Accounting
8. Cash accounting recognizes the impact of events when cash is paid or received
9. Accrual accounting recognizes the impact of events as they occur.
10. Transactions are recorded even when cash is not received or paid
11. Conforms with generally accepted accounting principles (GAAP)
12. The Primary objectives of financial reporting are as follows:

To provide information

1. useful in investment and credit decisions
2. useful in assessing future cash flows
3. about enterprise resources, claims to these resources, and changes in them.
4. Relevance and reliability are two primary qualitative characteristic of useful accounting information.
5. **Relevant** information has a bearing on a decision and is capable of making a difference in the decision.
6. **Reliable** information can be depended upon to represent the conditions and events that it is intended to represent.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Basic Assumptions** |  | **Principles** |  | **Constraints** |
|  |  |  |  |  |
| **1. Economic entity** |  | **1. Historical Cost** |  | **1. Cost Benefit** |
| **2. Going concern** |  | **2. Revenue Recognition** |  | **2. Materiality** |
| **3. Monetary Unit** |  | **3. Matching** |  | **3. Industry practices** |
| **4. Periodicity** |  | **4. Full Disclosure** |  | **4. Conservatism** |

1. Economic entity assumption.
2. A business is a business and is identifiable and distinct from some other business.
3. Going concern assumption.

a. If you’re in business today you’ll be in business tomorrow and able to carry out your

1. Monetary unit assumption.
2. We record transactions in current dollars (see Historical Cost) and record only those financial statement elements that can be expressed in dollar values.
3. Periodicity assumption.
4. We break a business’ activities up over time to have a better idea of its performance.
5. The typical unit is a fiscal year that is divided into four quarters.
6. Historical Cost principle.
7. We record purchased assets at the price we paid for them plus any costs to get them set up and working.
8. This prevents fluctuates that would occur if we were constantly re-recording their values at current fair market values.
9. Revenue Recognition principle.
10. Revenue is generally recognized when (1) realized or realizable, and (2) earned.
11. Revenues are **realized** when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash.
12. Revenues are **realizable** when related assets received or held are readily convertible to known amounts of cash or claims to cash.
13. Readily convertible assets have (1) interchangeable (fungible) units and (2) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.
14. Revenues are **earned** when services are rendered or goods are disposed of or exchanged.
15. Matching principle.
16. The idea here is to match the revenue we record with the expenses we incur to generate that revenue. Matching refers to pairing these elements in the same time periods. The matching principle dictates that expenses be recognized when they make their contribution to revenues.
17. The Accounting cycle

These are the steps followed in analyzing accounting transactions and in preparing the financial statements.

1. **Transaction occurs**- this takes place in the normal flow of business
2. **Prepare journal entry**- this is where the accountant first makes a record of transactions. In the journal entries transactions are recorded as single events.
3. **Post to the general ledger**- when transactions are posted to the general ledger they are “split” into their respective accounts (often shown as t- accounts). Ledger entries include the transaction date and references to the journal page from which the entry was posted.
4. **Prepare a trial balance**- at the end of the accounting period the balance in each ledger account is determined and reported in the trial balance. The trial balance has two purposes; 1) to act as a check on the equality of the debits and credits, and 2) to act as a starting point for the preparation of the financial statements.
5. **Journalize and post adjusting entries**- many of the accounts in the trial balance are outdated and incorrect and must be adjusted before preparing the financial statements. Correcting and updating these accounts is done via adjusting journal entries and posting adjustments to the general ledger.
6. **Prepare a worksheet (optional)** - After adjusting entries have been made a second or adjusted trial balance is prepared. To help in the above mentioned process accountants often opt to use a worksheet to keep things organized.
7. **Prepare the financial statements** – the final statements are now prepared directly from the worksheet by transferring the accounts and their balances onto the appropriate financial statements.
8. **Journalize and post closing entries** – we use closing entries to record the affect of expense, revenue, and drawing transactions on the capital account. Revenue and expense accounts are “poured” into the income summary account which is then netted and closed into the capital account. Drawings are then closed directly into the capital account.
9. **Prepare a post-closing trial balance** – we prepare this tool to make sure that no mistakes were made in the entries we’ve made since preparing the first trial balance. This trial balance will be smaller than the original once since all the expense, revenue, and merchandise-related accounts that appeared on the first trail balance have been closed.
10. **Journalize and post reversing entries (optional)** – these entries reverse certain adjustment entries and are done on the first day of the new accounting period. The optional entries include adjustments for accrued revenue, accrued expenses, expiration and use of prepaid items initially debited to expense accounts, and adjustments for unearned revenue initially credited to a revenue account.

**Accounting – 2:**

The Accounting Equation, Account Types

**THE ACCOUNTING EQUATION**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Left (Debits)** | = | **Right (Credits)** | + | **Right (Credits)** |
| **ASSETS** |  | **LIABILITIES** |  | **Owner's Equity** |
|  | = |  | + |  |
| **(Debit +)** |  | **(Credits +)** |  | **(Credits +)** |
| **(Credit -)** |  | **(Debits -)** |  | **(Debits -)** |

1. Debit & Credit
   1. Debit just means **left** NOT increase or decrease. Depending on the account a debit may increase or decrease an account.
   2. Credit just means **right** NOT increase or decrease. Depending on the account a credit may increase or decrease an account.
2. The “normal or natural balance”.
   1. The normal balance is the balance we’d naturally expect an account to have.
   2. The side of the accounting equation an account is on ‘usually’ determines it normal balance.
3. For example, Assets are on the left of the accounting equation and assets have a normal debit balance.

**Accounting – 3:**

The Classified Balance Sheet

Sections of a Classified Balance Sheet

* 1. In a **classified balance sheet** companies often group similar assets and similar liabilities together as they have similar economic characteristics. At a high level, the balance sheet format follows the accounting equation.
  2. The groupings help users to determine (1) whether the company has enough assets to pay its debts and (2) the claims of short-and long-term creditors on the company’s total assets.

A **classified balance sheet** generally contains the following standard classifications in the following order. It is important that you **know the format of this classified B/S.**

* **Current Assets**
  + Assets that are expected to be converted to cash or used in the business within a short period of time, < 1 year.
  + Examples of current assets include: cash, marketable securities, receivables, inventories and prepaid expenses. On the balance sheet, current assets are listed in order of liquidity.
* **Non-current Assets**
  + **Long-Term Investments**
    - Assets that can be converted into cash, but whose conversion occurs

> 1 year

* + - Assets not intended for use as part of the business’ normal operations.
    - Examples are investments of stocks and bonds of other corporations.
  + **Property, Plant, and Equipment**
    - Assets with relatively long useful lives.
    - Physical assets used in the business.
    - Examples include land, buildings, machinery, delivery equipment, and furniture and fixtures.
  + **Intangible Assets**
    - Non current assets which have no physical substance.
    - Examples are patents, copyrights, and trademarks or trade names.
* **Current Liabilities**
  + - Obligations that are supposed to be paid within the coming year. < 1 year
    - Common examples are accounts payable, wages payable, bank loans payable, interest payable, taxes payable, and current maturities of long-term bank loans payable, interest payable, and current maturities of long-term obligations.
* **Non-current Liabilities**
  + **Long-Term Liabilities**
    - Obligations expected to be paid after one year. > 1 year
    - Liabilities in this category include bonds payable, mortgages payable, long-term notes payable, lease liabilities, and obligations under employee pension plans.
* **Stockholders’ (Owners’) Equity**
  + **Paid in (contributed) capital –** investments in the business by stockholders.
  + **Retained earnings –** earnings retained for use in the business.

**Accounting – 4:**

The Income Statement

Retained Earnings & Dividends

1. The **Income Statement** (a.k.a. Statement of Earnings or Statement of Operations)
2. Is a summary of company’s revenues and expenses
3. For a specified period of time (refer to the periodicity assumptions)
4. Reports net income or net loss for that period. This is a measure of how well or poorly a company performed during the period.
5. The Income Statement consists of four building blocks
6. **Revenues** – inflows or other enhancements of assets or settlements of liabilities during a period from activities that constitute the entity’s ongoing major or central operations.
7. **Expenses** – Outflows or other using-up of assets or incurrence of liabilities during a period from activities that constitute the entity’s ongoing major or central operations.
8. **Gains** – Increases in net assets from peripheral or incidental transactions of an entity, except for those that result from investments by the owners.
9. **Losses** – Decreases in net assets from peripheral or incidental transactions, except those that result from distributions to owners.
10. The Multiple-Step Income Statement
11. Has at least three important sections:
    * 1. The operating section – relating to the primary operations of the firm
      2. The non-operating section – operations other than those primarily conducted by the firm
      3. The income tax section – calculations for income tax expense for the period
12. Has four important line items:
13. Gross profit (for a merchandising firm) = Sales Rev – sales discounts and allowances – cost of goods sold
14. Income from operations = Gross profit – operating expenses (e.g., utilities, insurance, salaries, etc.)
15. Non operating (other) revenues and gains/expenses and losses
16. Net income = Income before income taxes (income from operation net non-operating rev/exp and gains/losses) – income tax expense
17. Putting them together:
18. The operating section contains the gross profit and income from operations.
19. The non-operation section contains the Other revenues and gains and other expenses and losses
20. The income tax section contains the income before income taxes and income tax expense calculations
21. Finally the last item in net income
22. The **Statement** of **Retained Earnings** (earnings retained for use in the business) is a “moving picture” of how the retained earnings changed from the beginning of the period to the end of the period.
23. Retained Earnings and Dividends
    1. Net Income increases equity
    2. Dividends decrease equity
    3. The retained earnings account increases by the amount of net income each period and decreases by the amount of dividends.
    4. Net income is the increase in equity in one year
    5. Retained Earnings refers to the net increases over the life of the business to date
24. The elements, in order of appearance, on the statement of Retained Earnings:
    1. Beginning retained earnings balance
    2. Prior period adjustments (correction of errors in the net income of previous periods) that correct this balance
    3. Net income (loss) – which increases (decrease) this balance
    4. Declared dividend – which decreases this balance. Note: these are dividends DECLARED not necessarily paid. Declaration creates the liability; Debit: Retained Earnings, Credit: Dividends Payable
25. It is correct to report retained earnings as a separate financial statement but it can also be presented at the end of the income statement. For example;

John Henry Income Statement for

The year ending 2018 and 2019

|  |  |  |
| --- | --- | --- |
|  | **2018** | **2019** |
| Sales | $900,000 | $990,000 |
| Less Cost of Goods Sold | -250000 | -262,500 |
| **Gross Profit on Sales** | **650,000** | **727,500** |
| Less General Operating Expenses | -120,000 | -127,500 |
| Less Depreciation Expense | -30,000 | -30,000 |
| **Operating Income** | **500,000** | **570,000** |
| Other Income | 50,000 | 30,000 |
| **Earnings Before Interest and Tax** | **550,000** | **600,000** |
| Less Interest Expense | -30,000 | -30,000 |
| Less Taxes | -50,000 | -54,500 |
|  |  |  |
| **Net Earnings (Available Earnings for Dividends)** | **470,000** | **515,500** |
|  |  |  |
| Less Preferred and/or Common Dividends Paid | -70,000 | -80,000 |
| **Retained Earnings** | **400,000** | **435,500** |

**Accounting – 5:**

Merchandising vs. Service Operations

Analyzing Transactions

1. A service company’s primary business operation is to provide services to its customers. While there may be an occasional opportunity to provide merchandise to customers selling merchandise is NOT the primary operation.
2. Service companies record daily sales in a sales journal. Documents to record service transactions include sales invoices, daily cash register totals, daily cash sheets, and daily sales registers.
3. Accounting for service operations is fairly simple when compared to merchandising (and manufacturing) operations. Normally, for services provided on account, a debit will be made to a receivable (asset) and a credit to service revenue. If the transaction is made for cash then the debit will be to cash with an offsetting credit to service revenue.
4. Merchandising businesses generate revenue by purchasing goods (called inventory) and selling the product to customers.
5. The difference between the selling price of an item and its cost is called the gross margin or gross profit. The term **‘gross’** is used because the formula does not take into consideration the **operating** expenses of the period. Merchandising expenses are divided into two categories:
6. Operating expenses- selling and administrative expenses.
7. Cost of goods sold- the total cost of merchandise sold during the period.
8. Operating expenses are deducted from the gross profit to determine the net income.
9. Cost of goods sold is a term used to describe the relationship between inventories at the beginning and end of each accounting period and the net additions to inventory during the period.
10. Merchandisers have to deal with the purchase of inventories, expenditures to get inventories ready for sale, e.g., transportation costs, merchandise returned to suppliers and returns by customers, damaged merchandise, purchase and sales discounts, etc.
11. **Inventory Systems**- Merchandising companies have to account for inventories. There are 2 methods to record inventory transactions:
12. Perpetual method- which continuously tracks quantity on hand provides better control but is more costly to administer.
13. Periodic method- which periodically determines inventory on hand and adjusts accounts to determine cost of goods sold.

In preparation for the next section, we need a small detour into analyzing transactions

1. **Analyzing Transactions:**
2. You have to think through these transactions as if you were participating. If you can **write down in words** what is going to happen then recording it will be much easier.
3. **Ask yourself simple questions**. For example, “What am I giving up?” or “What am I getting?” or “Is there cash changing hands?”
4. Steps in analyzing transactions

1st- Identify what is being exchanged

2nd- Classify the exchanged items according to the accounting equation

3rd - Determine which item increases and which decreases

4th – Check that the equation remains in balance.

1. Example- Acquisition of Assets
2. Assets can be acquired in a number of ways including purchasing for **cash**, on **credit**, in a **services exchange**, by barter, etc…
3. The primary methods you need to be concerned with are purchases for **cash**, on **credit**, or as part of an exchange for other assets
4. **Assets have a natural Debit balance**. Therefore to increase an asset it’s debited.
5. **To offset the debit you must either credit something on the LHS of the accounting equation, e.g., cash, or credit something on the RHS, e.g., a liability.**
6. Knowing which accounts are involved will allow you to reason through the affects on balance sheet and other F/S.
7. Sample Transactions
8. Purchase an Assets

**Debit** the asset

**Credit** either Cash or A/P

1. Record an Expense

**Debit** the Expense

**Credit** either Cash or A/P

1. Record Revenue

**Debit.** Cash or A/R

**Credit \_\_\_\_\_**Revenue

1. Incur a Liability

**Debit** the Benefited Acct.- e.g., Cash

**Credit** the Liability

1. Owner takes a draw

**Debit** Drawing

**Credit** Cash

1. Issue Common Stock

**Debit** Cash

**Credit** Common Stock

1. Write out the transaction under the accounting equation to help in the analysis. For example,

Transaction:

2/29/04 Purchase 400 of office supplies on account:

Analysis:

I don’t give up cash but I do get something (supplies) so…

**A = L + O.E.**

Supplies A/P No Change

**Dr.** $400 **Cr.** $400 --

…which balances on both sides of the equation.