

## Accounting Basics

### Concepts, Principles & Basics

#### Entity Concept

- An organization stands apart from other organizations as a separate economic unit

#### Going Concern Concept

- Entity will continue to operate long enough to recover cost of its assets

#### Time Period Concept

- Report information at regular intervals

#### Reliability Principle

- Accounting records must be based on the most reliable (verifiable by an independent observer) data available

#### Cost Principle

- Assets/services acquired are recorded at actual, historical cost

#### Revenue Principle

- Establishes when to record revenue, usually when earned
- Revenue is earned when the business has completed rendering services to the customer
- Amount to record is equal to cash value of services or goods

#### Matching Principle

- Expenses matched against revenues in same accounting period

#### The Accounting Period

- Usually one year ending December 31
- Fiscal year ends on any other date of the year

#### Cash Basis Accounting

- Impact of events not recognized until cash is paid or received

#### Accrual Basis Accounting

- Impact of events recognized as they occur
- Transactions are recorded even when cash not received or paid
- Required by GAAP

#### Stable Monetary Unit

- Basis for ignoring inflation

### The Accounting Equation

$$\text{ASSETS} = \text{LIABILITIES} + \text{OWNERS' EQUITY}$$

#### Assets

Economic resources expected to benefit company in future

- Cash: Money, certificates of deposit, and checks
- Accounts Receivable: Oral or implied promise, usually arise from sales made to customers, no promissory note exists
- Notes Receivable: Promissory notes
- Inventory: Merchandise the entity holds or manufactures to sell
- Land: Property the business owns and uses in operations
- Building: Cost of an office, warehouse, garage, etc.
- Equipment, furniture, & fixtures: Accounts that record the cost of office equipment and store equipment

#### Liabilities

Economic obligations, debts

- Accounts Payable: Oral or implied promise to pay debts which arise from credit purchases
- Notes Payable: Amounts the company must pay as a result of signing a promissory note for goods or services.
- Taxes payable: Wages payable, Salary payable

#### Owners' Equity:

Claims held by owners, divided into two main categories

- Contributed or Paid in Capital (Amounts invested in corporation by owners)
- Retained Earnings (Income earned from operations)
  - Expenses: Decreases in retained earnings resulting from operations
  - Revenues: Increases in retained earnings resulting from operations
  - Dividends: Distributions of assets to shareholders decreases retained earnings

### Balance Sheet Accounts

Assets		Liabilities & Owners' Equity	
Debit	Credit	Debit	Credit
Increases	Decreases	Decreases	Increases

### Income Statement Accounts

Revenue		Expenses	
Debit	Credit	Debit	Credit
Decreases	Increases	Increases	Decreases

### Financial Statements

#### Formal Reports of an Entity

##### Balance Sheet

- Assets balanced with the sum of liabilities and owners' equity
- As of a specific date
- Also called **Statement of Financial Position**

##### Retained Earnings Statement

- Summary of changes in retained earnings during specific period;
- Begins with retained earnings balance at beginning of period;
  - Add net income or subtract net loss;
  - Deduct dividends;
  - End with new retained earnings balance.

##### Income Statement

- Summary of revenues and expenses of an entity
- For a specified period of time (fiscal accounting period, month, quarter, year)
- Reports net income or net loss for the period
- Also called **Statement of Earnings** or **Statement of Operations**

##### Statement of Cash Flows

- Reports cash flows from Operating, Investing and Financing activities

### The Accounting Cycle

**Procedures:** Process which produces financial statements

Steps in the cycle

- Open ledger accounts;
- Journalize transactions;
- Post to the ledger;
- Calculate unadjusted balances;
- Develop trial balance on a work sheet;
- Journalize and post adjusting entries;
  - Match revenues and expenses to period earned and incurred
  - Correct measurement of period's income
  - Bring related asset and liability accounts up-to-date
- Prepare financial statements;
- Journalize and post closing entries;
- Prepare post closing trial balance.

#### Five categories of adjusting entries

- Prepaid expenses: Expire or are used up in next period
- Accrued expenses: Expenses incurred but not yet paid
- Depreciation: Systematically spreads cost of assets over periods
- Accrued revenue: Revenue earned, but cash not yet received
- Unearned revenue: Revenue not earned by business but cash already received

#### The adjusting process

- Purpose is to measure income correctly when using the Accrual method
- Each entry affects one income statement account (revenue or expense)
- Each entry also affects one balance sheet account (asset or liability)

### Transactions

- A transaction is any event that affects financial position and is recorded.
- All transactions have two sides of the accounting equation – a debit and a credit

Transactions are recorded in "T Accounts", with debits on left side of "T", and credits on the right side of the "T".



## Assets

### Current Assets

- **Cash:** First item on the Balance Sheet
- **Cash Short and Over**
  - Difference between actual cash receipts and recorded total
  - If sales revenue exceeds cash receipts DEBIT Cash Short and Over (Misc. Expense)
  - If cash receipts exceed sales revenue CREDIT Cash Short and Over (Other Revenue)
- **Petty Cash**
  - Small amount of cash on hand to pay for minor expenses 2. Designate custodian
  - Keep specific amount in fund
  - All fund disbursements are supported by petty cash ticket
  - Replenish fund through normal cash disbursement procedures

### Accounts Receivable and Notes Receivable

#### Receivables - Claims against businesses and individuals

- **Accounts Receivable:** Amounts that customers owe
  - Sometimes called Trade Receivables
  - Considered Current assets
- **Notes Receivable:** Promise in writing by debtor
  - If due in one year - Current Asset
  - If due in more than one year - Long Term Asset

#### Uncollectible Accounts (Bad Debts)

- **Allowance Method (based on Accounts Receivable)**
  - Allowance for Accounts - contra asset account related to AIR
  - AIR - Allowance for Uncollectible Accounts = Net Realizable Value of AIR
  - Writing off accounts-entry has no effect on net income; no expense is incurred
    - DEBIT- Allowance for Uncollectible Accounts
    - CREDIT- Accounts Receivable
- **Direct Write-Off Method:** Written off when determined uncollectible
  - DEBIT- Uncollectible Account Expense
  - CREDIT- Accounts Receivable

#### Notes Receivable

- More formal than accounts receivable
- Promissory note (written promise to pay)
  - DEBIT - Note Receivable-Name
  - CREDIT - Cash or AIR
  - When collected
    - DEBIT - Cash:
    - CREDIT - Notes Receivable & Interest Revenue

### Long-Lived Assets and Related Expenses

#### Assets with future economic benefits

- Plant Assets: tangible, land, buildings, equipment
- Intangible Assets: benefit from rights, patents, copyrights, trademarks, goodwill
- Cost of Assets
  - Purchase price
  - Brokerage commissions
  - Survey fees
  - Legal fees
  - Back property taxes
  - Sales and other taxes
  - Transportation charges and insurance while in transit
  - Installation cost
- Group or Basket Purchase: Allocate cost by relative fair market value

### Inventory Systems

#### Periodic

- Inventory entries made only at the end of the period.
- Must calculate Cost of Goods Sold (COGS)
  - On the Balance Sheet, show ending inventory
  - On the Income Statement, show calculation of COGS
- Detailed inventory accounts are not kept up-to-date

#### Perpetual

- Continuous record of inventory on hand is maintained and calculated daily
- Physical count only to check on perpetual records

### Inventory

#### Costing Methods

- **Specific Unit**
  - Used when inventory can be individually identified - i.e. autos, jewels, real estate
  - Cost of inventory is specific cost of particular unit
- **Weighted-average** - flow of cost over periods
  - Ending inventory is based on average cost of inventory during the period
  - Average cost = Cost of goods available for sale/number of units available
  - Ending inv. and COGS = number of units x weighted average cost per unit
- **First In, First Out (FIFO)**
  - First cost into inventory are the first costs that flow out of inventory
  - Ending inventory based on most recent cost (most recent purchases)
  - Unit COGS may be different than unit cost for ending inventory
  - If inventory costs are increasing, FIFO ending inventory is high (most recent cost)
- **Last In, First Out (LIFO)**
  - Last cost in inventory is the first out
  - Ending inventory is composed of the oldest cost
  - If inventory cost is increasing, LIFO ending inventory is low (oldest cost)
  - Income Tax Advantage: Yields lower net income when prices are rising.

#### Lower of Cost or Market Rule (LCM)

- Accounting conservatism, report an asset at the lower of historical cost or its market value.
- Market value means replacement cost
- May show higher amount in parentheses

### Depreciation

#### Definition - Process of allocating asset's cost over period asset used

- **Depreciation Expense** for a period is amount of asset's cost that is used up
- **Accumulated Depreciation:** Total amount of cost that has been used up over life of asset

#### Straight-line Method

- Equal amount of depreciation each year
- Cost - Residual Value/Useful life in years
- Entry to record depreciation expense
  - DEBIT- Depreciation expense
  - CREDIT- Accumulated depreciation

#### Units of Production Method

- Amount of depreciation depends on units of output
- Cost - Salvage Value/Estimated hours

#### Double-Declining Balance

- Accelerated, larger in beginning
- DDB Rate per year = (1/Useful life in years) x 2 = %
- Only method that ignores residual value

#### Sum of Year Digits (SYD) Accelerated, larger in beginning:

- Step 1. Sum of years' digits =  $N(N+1)/2$ ,  
N=useful life in years
- Step 2. Numerator = last year of life, count backwards each year
- Step 3. Denominator = Sum of years' digits
- Step 4. Cost-Residual Value x (Step 2/Step 3)

#### MACRS Depreciation Rate Schedule

5-Year Class Depreciation		7-Year Class Depreciation	
Year	Rates	Year	Rates
1	20.00%	1	14.29%
2	32.00%	2	24.49%
3	19.20%	3	17.49%
4	11.52%	4	12.49%
5	11.52%	5	8.93%
6	<u>05.76%</u>	6	8.92%
	100.00%	7	8.93%
		8	<u>4.46%</u>
			100.00%



## Liabilities

### **Obligation to Transfer Assets or Provide Services**

**Current liabilities** are due in one year or less

- Trade Accounts Payable: Represent amounts owed to suppliers for products or services
- Short-term Notes Payable: Notes Payable due within one year
- Discounted Note Payable
- Current portion of long-term debt
- Unearned Revenue: Revenue collected in advance
- Warranty Expenses Payable

### **Contingent Liability**

- Potential liability that depends on future events which arise from past transactions
- Recorded if both Probable and Estimable

**Long-Term:** Any obligation other than current

- Bonds
  - Issued at a premium means at a price above par
  - Issued at a discount means at a price below par
  - Interest Rates
    - Contract or stated interest rate is the rate on the bond
    - Market or effective interest rate is rate investors' demand in exchange for loaning their money
  - When bonds are issued between interest dates, accrued interest must be calculated

### **Lease Liabilities**

- Operating Leases – Short term
  - DEBIT - Rent Expense
  - CREDIT – Cash
- Capital Leases – Long term, accounted for like purchase of asset
  - DEBIT – Asset account
  - CREDIT - Cash
  - CREDIT – Lease Liability (PV of future lease payments)
- Also record Depreciation Expense (over the life of the lease) and Interest Expense.

## Payroll

*Payroll is employee compensation*

### **Payroll deductions**

- Employee income tax
- Federal Insurance Contributions Act (FICA);
  - Social Security, 6.2% of first \$87,000 (2003 limit)
  - 1.45% of total wages

### **Entries**

- To record Salary Expense
  - DEBIT- Salary Expense (gross)
  - CREDIT- Employee Income Tax Payable (amounts withheld)
  - CREDIT- FICA Tax Payable (7.65%)
  - CREDIT- Employee Union Dues Payable
  - CREDIT- Salary Payable to Employees (net)
- To record employer's payroll taxes
  - DEBIT- Payroll Tax Expense
  - CREDIT- FICA Payable
  - CREDIT- State Unemployment Tax Payable
  - CREDIT- Federal Unemployment Tax Payable
- To record fringe benefits
  - DEBIT- Health Insurance Expense
  - DEBIT- Life Insurance Expense
  - DEBIT- Pension Expense
  - CREDIT- Employee Benefits Payable

**Payroll register:** Special payroll journal

## Owners' Equity

### Stock

- **Capital Stock** is the basis unit issued in shares
- **Outstanding Stock** is stock issued to shareholders
  - Shareholders' Rights
    - To vote
    - To receive dividends, if declared
    - To receive assets in a liquidation after liabilities are paid
    - Preemptive Right: the right to maintain your proportionate ownership percentage
- **Stockholders' Equity** contains two types of accounts
  - **Contributed Capital**
    - Capital Stock is Paid in Capital
    - Preferred Stock
      - Priority in dividends
      - Priority in distribution of assets when liquidation occurs
  - **Earned Capital**
    - Retained Earnings** – increases in equity through profitable operations
    - Entry to transfer income to the equity section of the Balance Sheet
      - If recording Profit
        - DEBIT – Income Summary
        - CREDIT – Retained Earnings
      - If recording a Net Loss
        - DEBIT –Retained Earnings
        - CREDIT – Income Summary

## Statement of Cash Flow

- Reports cash receipts and cash payments during a period
- Cash means cash and cash equivalents
- Three sections
  - **Operating Activities** - Revenues and expenses from firm's major line of business
    - **Collections from customers** = Sales Revenue (+ decrease in A/R or - increase in A/R)
    - Receipt of interest and dividends
    - **Payments to suppliers** = COGS (+increase in inv. or - decrease in inv.) and (+ decrease in Notes Payable or - increase in A/P)
    - **Payments of operating expenses** = Operating expenses other than salaries, wages and depreciation (+ increase in prepaid expenses or – decrease in prepaid expenses) and (+ decrease in accrued liabilities or - increase in accrued liabilities)
    - **Payments to employees** = Salary and wage expense (+ decrease in salary and wages payable or - increase in salary and wages payable)
    - **Payments of interest and taxes**
  - **Investing Activities**
    - Increases and decreases in cash due to dispositions or purchases of firm's assets
    - Sale of plant assets
    - Sale of investments
    - Cash received on loans receivable
    - Acquisition of plant assets
    - Acquisition of investments
    - Loans made
  - **Financing Activities**
    - Increases and decreases in cash from investors and creditors
    - Stock issuance
    - Sale and purchase of treasury stock
    - Borrowing money
    - Payments of dividends
    - Payments of principle on debts





### Types of Business Organizations

#### **Proprietorship:**

- Usually small retail businesses or individual professional businesses such as attorneys and accountants
- Single owner with personal liability

#### **Partnership:**

- More than one owner
- Each owner is a partner with personal liability

#### **Corporations:**

- Owned by stockholders with limited liability
- Dominant form of business in the United States

### Corporate Characteristics

#### **Separate legal entity**

- Formed under state law
- Granted a charter from the state
- Similar to an artificial person
- Ownership interests are divided into shares of stock

#### **Continuity of life:**

- Corporations live regardless of changes in ownership of stock

#### **No mutual agency:**

- Stockholder cannot commit the corporation to a contract, unless he does so in his capacity as an officer

#### **Limited liability:**

- The most a stockholder can lose is the amount of money he invested

#### **Separation of ownership and management:**

- The stockholders own the business and elect Board of Directors (BOD) who appoint corporate officers who manage the company

### Accounting in Business

#### **Users of accounting information**

- **Individuals:** To manage bank accounts, evaluate job prospects, make investments, and decisions
- **Businesses:** To set goals, evaluate company progress, decide which building or equipment to purchase
- **Investors and Creditors:** To decide whether to start a new venture, evaluate what income they expect on their investment, analyze a company's financial statements

#### **The accounting profession**

- Public accountants
  - Serve the general public
  - Work includes auditing, income tax planning and preparation, management consulting
  - 10% of all accountants
- Private accountants
  - Work for a single business
  - Examples are restaurants, charitable organizations, educational institutions, and government agencies

#### **Accounting organizations and designations**

- American Institute of Certified Public Accountants (AICPA)
  - The national professional organization of CPAs
  - Prepares and grades the CPA exam
  - Publishes monthly journal, the Journal of Accountancy
  - Each state has its own AICPA chapter
- Financial Accounting Standards Board (FASB)
  - Formulates Generally Accepted Accounting Principles (GAAP)
  - These principles establish accounting guidelines
- Institute of Management Accountants (IMA)
  - Formerly the National Association of Accountants (NAA)
  - Focus on the practice of management accounting

#### **Certifications**

- Certified Public Accountant (CPA)
- Certified Management Accountant (CMA)
- Certified Internal Auditor (CIA)

