# Chapter 1

**General knowledge of Accounting**

**Topic:** General knowledge of Accounting

Concept: To introduce students the overview and general idea about accounting : what accounting is, formation and operation of business entity, fields of accounting, accounting profession or accounting career paths, users and uses of accounting information and professional ethics.

##### Objectives

1. Students will be introduced to the purpose, definition, and function of accounting.
2. Students will be introduced to the business organization forms and types of operation.
3. Students will learn about the opportunity in accounting and related fields of accounting and variety of professional services or accounting career paths.
4. Students will learn about who are the users of accounting information and why they find accounting information useful.
5. Students will learn about why ethics are crucial to accounting.
   1. **What Is Accounting?**

Accounting is a body of principles and conventions as well as an established general process for capturing financial information related to an entity's resources and their use in meeting the entity's goals. Accounting is a service function that provides information of value to all operating units and to other service functions.

##### 1.1.1 Purposes and importance of Accounting

Accounting is an information and measurement system that identifies, records, and communicates relevant, reliable, and comparable information about an organization‘s business activities.

The purposes of accounting are as follows:

* + 1. To prepare financial reports those provide information about an entities‘ performance, financial position, operation to external users.
    2. To provide the relevant accounting information that is needed for sound economic decision making for both internal and external decision making.

The purpose of public accounting is to provide the comment for the financial statement of the business firm that already review and audit in order to certifies the correctness of the application of rules and generally accepted accounting principles

##### Definition of Accounting

There are many organizations and regulators who involved with Accounting Professions had defined the meaning of Accountings as follows:

* + - 1. From the committee of Terminology of American Institute of Certified Public Accountants, Accounting Terminology Bulletin No. 1, *Review and Resume* (New York: American Institute of Certified Public Accountants, 1953), paragraph 9. Originally defined accounting as follows:

###### “Accounting is the art of recording, classifying, summarizing, in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof.”

* + - 1. APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statement of Business Enterprises* (New York: American Institute of Certified Public Accountants, 1970), paragraph 40 defined accounting as follows:

###### “Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, in making reasoned choices among course of action.”(2)

* + - 1. Retrieved from [*www.theaccountspayablenetwork.com/html/m*](http://www.theaccountspayablenetwork.com/html/m) defined accounting as follows:

###### “The overall process of identifying, measuring, recording, interpreting, and

***communicating the results of economic activity; tracking business income and expenses and using these numbers to answer specific questions about the financial and tax status of the business.”***

* + - 1. Retrieved from [*www.finet.com.hk/accounting/a.htm*](http://www.finet.com.hk/accounting/a.htm) defined accounting as

###### “A service activity designed to accumulate, measure, and communicate financial information about economic entities for decision-making purposes.”

* + - 1. Retrieved from *tiefighter.et.tudelft.nl/~arthur/aaa/aaa* defined accounting as

###### “The act of collecting information on resource usage for the purpose of capacity and trend analysis, cost allocation, auditing and billing. Accounting management requires that resource consumption be measured, rated, assigned, and communicated between appropriate parties. Typical information that is gathered in accounting is the identity of the user, the nature of the service delivered, when the service began, and when it ended.”

* + - 1. Retrieved from [*www.ncbuy.com/credit/glossary.html*](http://www.ncbuy.com/credit/glossary.html) defined accounting as

###### “The process of systematically recording, classifying, verifying and summarizing business transactions, and presenting this information in periodic, interpretative financial statements and reports.”

* + - 1. Retrieved from [*www.gov.nt.ca/FMBS/documents/FAMWeb/glos.*](http://www.gov.nt.ca/FMBS/documents/FAMWeb/glos) defined accounting

as

###### “The systematic recording, presentation and interpretation of the financial facts of an enterprise in such a manner as to permit effective management and provide the required information.”

* + - 1. Retrieved from [*www.angelfire.com/anime3/internet/networ*](http://www.angelfire.com/anime3/internet/networ)*.* defined accounting as

###### “ In information technology, accounting is the process of keeping track of a user's activity while accessing a network's resources, including the amount of time spent in the network, the services accessed while there and the amount of data transferred during the session. Accounting data is used for trend analysis, capacity planning, billing, auditing and cost allocation”.

* + - 1. Retrieved from [*www.bookkeeperlist.com/definitionsa.shtm*](http://www.bookkeeperlist.com/definitionsa.shtm)*.* defined accounting as

###### “The process of gathering and preparing of financial information about a business or other organization in a form that provides accurate and useful records and enables decisions to be made”.

* + - 1. Retrieved from *wps.pearsoned.co.uk/wps/media/objects/10...* defined accounting as

###### “ A discipline dealing with the provision of information for interested parties about an entity’s financial performance, its assets and its liabilities.”

* + - 1. Retrieved from [www.rivernetwork.org/library/Accounting-](http://www.rivernetwork.org/library/Accounting-) defined accounting as

###### “The systematic record keeping and reporting of an organization’s performance in monetary terms. Accounting provides a summary of the economic results of organizational decisions for internal use and transmits them to external stakeholders such as volunteers, donors, funders, creditors and regulatory agencies.”

* + - 1. Retrieved from [*http://www.answers.com/topic/accounting?cat=biz-fin*](http://www.answers.com/topic/accounting?cat=biz-fin) defined accounting as

###### “Accounting is a field of specialization critical to the functioning of all types of organizations. Accounting often is referred to as "the language of business" because of its role in maintaining and processing all relevant financial information that an entity requires for its managing and reporting purposes.”

* + 1. **Functions of Accounting**

From the definition of Accounting, there are four main functions of accounting consist of recording, classifying, summarizing and interpreting.

##### Recording

All business transactions have to be recorded in the books of original entry in their chronological order. The number and type of books to be used in any business will depend upon the size of the firm and the nature of its operations and upon whether transactions of a particular kind occur often enough to justify having a book of original entry in which to record them. The book of original entry is called **Journal**. The process of recording business transactions in Journal is called **Journalizing.**

Recording business activities require keeping a chronological order of transactions and events measure in monetary term. **Recordkeeping** or **bookkeeping** is the recording of transactions and events, either manually or electronically by using computer software package. This is a part of accounting. Technology is a key part of modern business and plays a major role in accounting. Technology reduce time, effort, and cost of recordkeeping while improving clerical accuracy. Some small enterprises continue to perform various tasks manually.

##### Classifying

When business transactions are recorded, each transaction must be transferred or posted to the appropriated accounts, that is, assets, liabilities, capital, revenue and expenses, which are called ―ledgers‖. The process of transfer business transactions from journal to each account in ledger is called **Posting.**

##### Summarizing

In summarizing the recorded business transactions have to be presented in the form of financial statements: income statement, balance sheet, statement of change in owners‘ equity, and statement of cash flows which are useful to the owners, management, creditors, investors, suppliers, government agencies, employees, and all interested parties.

##### Interpreting

Financial statements are used to determine facts concerning business operations and the financial condition of the business, is known as interpreting. The statement users must make their own interpretation of the financial result of the firm and form their own conclusion.

##### Bookkeeping and Accounting/ Bookkeeper and Accountant

Bookkeeping is the actual recording of the business transactions, without any analysis of the information. The accounting clerks who keep record business transactions is called bookkeeper. Bookkeeper must be accurate and skilful in the routine technique of keeping records.

Accounting included bookkeeping but in broader and more analytical and interpretational subject. The persons who perform accounting duties is called accountant. Accountant must understand and be able to direct all works of the bookkeeper. Accountant evaluated and analyzed the information, making sense out of the number.

### Formation and operation of business entity

##### Basic forms of profit making business organization

The forms of business ownership are vary depend on the legal systems of various countries. The four common forms are **sole proprietorship**, **partnership**, **corporation** and **cooperative.**

##### Sole proprietorship [or Sole traders](http://en.wikipedia.org/wiki/Sole_trader)

A **sole proprietorship** is a separate organization with a single owner. Most often the owner is also the manager. Therefore sole proprietorships tend to be small retail establishments and individual professional businesses such as those of dentists, physicians, and attorneys. From a accounting viewpoint, each sole proprietorship is and individual entity that is separate and distinct from the proprietor. The owner of the business has total and unlimited personal [liability](http://en.wikipedia.org/wiki/Liability) of the debts incurred by the business.

##### Partnership

A **partnership** is a special form of organization that joins two or more individuals together as co-owners. Many retail establishments, as well as dentists, physician, attorneys, and accountants, conduct their activities as partnership. Indeed, partnerships can sometimes be gigantic. For instance, the largest independent accounting firms have more than two thousand

partners. Again, form an accounting viewpoint. Each partnership is an individual entity that is separate from the personal activities of each partner. Each partner has total and unlimited personal liability of the debts incurred by the partnership. There are three typical classifications of partnerships: [general partnerships](http://en.wikipedia.org/wiki/General_partnership), [limited partnerships](http://en.wikipedia.org/wiki/Limited_partnership), and [limited liability partnerships](http://en.wikipedia.org/wiki/Limited_liability_partnership).

##### Corporation

**Corporations** are organizations created under the corporate law of each country. Individuals form a corporation by applying to the government for approval of the company‘s articles of incorporation, which include information on shares of ownership. Most large corporations are **publicly owned** in that shares in the ownership are sold to the public, they are called Public Company Limited ([PLC](http://en.wikipedia.org/wiki/Public_limited_company)). The owners of the corporation are then identified as shareholders or stockholders. Large publicly owned corporations can have thousands of shareholders. Some corporations are **privately owned** by families, small groups of shareholders and is overseen by a [board of directors,](http://en.wikipedia.org/wiki/Board_of_directors) which hires the business's managerial staff, they are called Private Company ([Ltd).](http://en.wikipedia.org/wiki/Ltd) A business [corporation](http://en.wikipedia.org/wiki/Corporation) is a for-profit, [limited liability](http://en.wikipedia.org/wiki/Limited_liability) entity that has a separate [legal personality](http://en.wikipedia.org/wiki/Legal_personality) from its members.

##### Cooperative

**Cooperative** are often referred to as a "co-op business" or "co-op", a [cooperative](http://en.wikipedia.org/wiki/Cooperative) is a for- profit, limited liability entity that differs from a corporation in that it has members, as opposed to shareholders, who share decision-making authority. Cooperatives are typically classified as either [consumer cooperatives](http://en.wikipedia.org/wiki/Consumer_cooperative) or [worker cooperatives.](http://en.wikipedia.org/wiki/Worker_cooperative) Cooperatives are fundamental to the ideology of [economic democracy.](http://en.wikipedia.org/wiki/Economic_democracy)

##### Types of Business Operation

Businesses are classified in many ways. Three common types of business operation are service, merchandising and manufacturing firms. Some type of business operation are mixed for both service and manufacturing, they are called manufactu[ring service businesses](http://en.wikipedia.org/wiki/Service_Sector), such as Hotel, and Hospital.

One of the most common focuses on the primary profit-generating activities of a business are [manufacturers,](http://en.wikipedia.org/wiki/Manufacturer) [service businesses](http://en.wikipedia.org/wiki/Service_Sector), [retailers](http://en.wikipedia.org/wiki/Retail) and [distributors](http://en.wikipedia.org/wiki/Distribution_%28business%29), [agriculture](http://en.wikipedia.org/wiki/Agriculture) and [mining](http://en.wikipedia.org/wiki/Mining) businesse, [financial](http://en.wikipedia.org/wiki/Financial) businesses, information businesses, [utilities](http://en.wikipedia.org/wiki/Utilities), [real estate](http://en.wikipedia.org/wiki/Real_estate) businesses, and [transportation](http://en.wikipedia.org/wiki/Transport) businesses.

[***Manufacturers***](http://en.wikipedia.org/wiki/Manufacturer) produce [products](http://en.wikipedia.org/wiki/Product_%28business%29), from [raw materials](http://en.wikipedia.org/wiki/Raw_material) or component parts, which they then sell to make profit. Manufacturers produce or make physical [goods](http://en.wikipedia.org/wiki/Goods) such as cars, garment, furniture, computer, and electric products, etc.

[***Service businesses***](http://en.wikipedia.org/wiki/Service_Sector) offer intangible goods or services and typically generate a profit by charging for labor or other services provided to government, and other businesses or [consumers.](http://en.wikipedia.org/wiki/Consumers) The service businesses such as accounting and law office, consulting firm, entertainment, airline, transportation service, etc.

[***Retailers***](http://en.wikipedia.org/wiki/Retail) ***and*** [***Distributors***](http://en.wikipedia.org/wiki/Distribution_%28business%29) act as middle-men in getting goods produced by manufacturers to the intended consumer, generating a profit as a result of providing sales or distribution services. Most consumer-oriented stores and catalogue companies are distributors or retailers.

[***Agriculture***](http://en.wikipedia.org/wiki/Agriculture) ***and*** [***mining***](http://en.wikipedia.org/wiki/Mining) ***businesses*** are concerned with the production of raw material, such as plants or minerals.

[***Financial***](http://en.wikipedia.org/wiki/Financial) ***businesses*** include banks and other companies that generate profit through investment and management of [capital](http://en.wikipedia.org/wiki/Capital).

***Information businesses*** generate profits primarily from the resale of intellectual property and include movie studios, publishers and packaged software companies.

[***Utilities***](http://en.wikipedia.org/wiki/Utilities) produce public services, such as heat, electricity, or sewage treatment, and are usually government chartered.

[***Real estate***](http://en.wikipedia.org/wiki/Real_estate) ***businesses*** generate profit from the selling, renting, and development of properties, homes, and buildings.

[***Transportation***](http://en.wikipedia.org/wiki/Transport) ***businesses*** deliver goods and individuals from location to location, generating a profit on the transportation costs

##### Business Activities

###### Three major activities of business entities.

There are three major types of business activities: operating, investing, and financing. Each of these requires planning. Planning involves defining an organization‘s ideas, goals, and actions.

***Operating activities*** involve using resources to research, develop, purchase, produce, distribute, and market products and services. Sales and revenues are the inflow of assets from selling products and services. Costs and expenses are the outflow of assets to support operating activities. Strategic management is the process of determining the right mix of operating activities for the type of organization, its plans, and its market.

***Investing activities*** are the acquiring and disposing of resources or properties (assets) that an organization uses to acquire and sell its products or services. Assets are funded by an organization‘s financing. Business entities differ on the amount and makeup of assets. Some require land and factories to operate. Others need only an office. Determining the amount and type of assets for operations is called asset management.

***Financing activities*** provide the means business entities use to pay for recourses such as land, building, and equipment to carry out plans. Business entities are careful in acquiring and managing financing activities because they can determine success or failure. The two sources of financing are owner and non-owner. Owner financing refers to resources contributed by the owner by along with any income the owner leaves in organization. Non-owner (or creditor and lender) financing refers to resources contributed by creditors (lenders). Financial Management is the task of planning how to obtain these resources and set the right mix between owner and creditor financing.

Invested amounts are referred to as assets. Financing is made up of creditor and owner financing which hold claims on assets. Creditors‘ claims are called liabilities, and the owner‘s claim is called owner‘s equity. This basic equality is called the accounting equation or accounting model and can be written as: ***Assets = Liabilities + Owners’ Equity*.**

### Fields of Accounting

From The Handbook of Accounting (Fifth Edition, New York: American Institute of Certified Public Accountants, 1970), paragraph 9 identifies the **fields of accounting** as follows:

Financial Accounting

Cost and Managerial Accounting Tax determination and planning

Public Accounting /or Independent audits Data processing and information systems National income accounting

* + 1. **Financial accounting** is the field of [accountancy](http://en.wikipedia.org/wiki/Accountancy) concerned with the process of summarizing financial data taken from an organization's accounting records and preparation of [financial statements](http://en.wikipedia.org/wiki/Financial_statements) for decision makers, such as [stockholders](http://en.wikipedia.org/wiki/Shareholder), [suppliers](http://en.wikipedia.org/wiki/Vendor_(supply_chain)), [banks](http://en.wikipedia.org/wiki/Bank), employees, [government agencies,](http://en.wikipedia.org/wiki/Government_agencies) owners, and other stakeholders. Financial accountancy is governed by both local and international accounting standards. Therefore, financial accounting serves following purposes: (1) producing general purpose financial statements, (2) provision of information used by management of a business entity for decision making, planning and performance evaluation, and (3) for meeting regulatory requirements

##### Managerial and Cost Accounting

Management accounting is concerned with providing management with information and analysis to facilitate the planning, directing, motivating, controlling and performance evaluation. In management accounting, accountants provide information for use by people within the organization rather than for use by people outside the organization. Management uses this information for making decision concerning the internal workings of organization. In order for managements to make the best decision to solve problems or questions, the management accounting must provide quantitative information to the managers that are timely and relevant.

The important function of Managerial accounting is to provide cost information I a meaningful way so that managers can make decision intelligently.

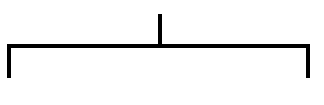
In managerial accounting, the term cost is used in many different ways. The reason is that there are many types of costs, and these costs are classified differently according to the immediate needs of management. Each different use of cost data demands a different classification and decision of costs.

Accountants have a major role in providing information for making economic and financial decisions. Rational decisions are usually based on analyses and comparisons of estimates, which in turn, are based on accounting and other data that project future results from alternative courses of action.

### Figure 1.1

**Comparison of Financial Accounting and Managerial Accounting**

##### Accounting



* + - * Recording
      * Estimating
      * Organizing

Financial and Operational Data

##### Financial Accounting

* Reports to those outside the organization.

Owners Lenders

Tax authorities Regulators

* Emphasis is on summaries of financial consequences of past activities.
* Objectivity and verifiability of data are emphasized.
* Precision is required.
* Only summarized data fir the entire organization are prepared.
* Must follow GAAP\*.
* Mandatory for external reports.

##### Managerial Accounting

* Reports to those inside the organization.

Planning

Directing and Motivating Controlling

Performance evaluation

* Emphasis is on decision affecting the future.
* Relevance is emphasized.
* Timeliness is required.
* Detailed segment reports about departments, products, customers, and employees are prepared.
* Need not follow GAAP\*.
* Not mandatory.

**\*GAAP- Generally Accepted Accounting Principle**

**Source: Managerial Accounting, Garrison, Noreen and Brewer. p 7**

##### Tax determination and planning

Tax determination is based on the tax code or taxation law or revenue code of each country. Considering the [tax](http://www.investorwords.com/4879/tax.html) [implications](http://www.investorwords.com/2381/implication.html) of [individual](http://www.businessdictionary.com/definition/individual.html) or [business](http://www.investorwords.com/623/business.html) [decisions](http://www.businessdictionary.com/definition/decision.html) throughout the year, usually with the [goal](http://www.investorwords.com/2187/goal.html) of minimizing the [tax liability](http://www.businessdictionary.com/definition/tax-liability.html).

Tax planning are devising [strategies](http://financial-dictionary.thefreedictionary.com/Strategy) throughout the year in order to minimize [tax liability,](http://financial-dictionary.thefreedictionary.com/Tax%2Bliability) for example, by choosing a tax filing status that is most beneficial to the taxpayer.

##### Public Accounting/ or Independent audits

At the core of the profession of accounting is the certified public accountant (CPA) who has passed the national CPA examination, been licensed in at least one state or territory, and engages in the practice of public accounting or auditing in a public accounting or CPA firm. The CPA firm provides some combination of two or more of four types of services: accounting, auditing, income tax planning and reporting, and management advising/consulting. Analysis of

trends indicates that the demand for auditing services has peaked and that most of the growth experienced by public accounting firms is in the consulting area

##### Data processing and information systems /or Accounting information systems

An organization's accounting system provides information that (1) helps managers make decisions about assembling resources, controlling, and organizing financing and operating activities; and (2) aids other users (employees, investors, creditors, and others—usually called stakeholders) in making investment, credit, and other decisions.

The accounting system must also provide internal controls to ensure that (1) laws and enterprise policies are properly implemented; (2) accounting records are accurate; (3) enterprise assets are used effectively (e.g., that [idle](http://www.answers.com/topic/idle) cash balances are being invested to earn returns); and

(4) steps be taken to reduce chances of losing assets or incurring liabilities from [fraudulent](http://www.answers.com/topic/fraudulent) or similar activities, such as the carelessness or [dishonesty](http://www.answers.com/topic/dishonesty) of employees, customers, or suppliers. Many of these controls are simple (e.g., the pre-numbering of documents and accounting for all numbers); others require division of duties among employees to separate record keeping and custodial tasks in order to reduce opportunities for [falsification](http://www.answers.com/topic/falsification) of records and thefts or [misappropriation](http://www.answers.com/topic/misapplication-misappropriation-of-property) of assets.

An enterprise's system of internal controls usually includes an internal auditing function and personnel to ensure that prescribed data handling and asset/liability protection procedures are being followed. The ***internal*** [***auditor***](http://www.answers.com/topic/auditor) uses a variety of approaches, including observation of current activities, examination of past transactions, and simulation—often using sample or fictitious transactions—to test the accuracy and reliability of the system.

##### National income accounting

If the entity is a state or local governmental unit, it is subject to the reporting standards and requirements of the Government Accounting Standards Board. If the entity is private and not a profit-seeking unit, it is subject to various reporting and other regulations, including those of the Internal Revenue Service, which approves its tax status and with which it must file reports.

### Accounting Profession/or Accounting career paths

##### What is the profession of accounting?

Accounting career paths, specializations, or sub professions for CPAs who join profit- seeking enterprises include being controllers, chief financial officers, or internal auditors. Other career paths include being controllers or chief financial officers in not-for-profit or government organizations and teaching in colleges and universities. Students should note that non-CPAs also could enter these sub professions and that certificates, but not licenses, could be earned by passing examinations in several areas, including internal auditing, management accounting, and bank auditing.

Accounting Profession can be classified by the major employers of accountants include public accounting firms, industrial firms, government, not for profit organizations and forensic accounting.

##### Public Accounting

The work done by public accountants varies significantly depending on whether the employer is a local, regional, or international CPA firms. Small local firms concentrate on the bookkeeping, accounting, tax return, and financial planning needs of individuals and small businesses. These firms need generalists who can adequately serve in a variety of capacities,. The somewhat larger, regional firms offer a broad rage of professional services but concentrate on the performance of audits, corporate tax returns, and management advisory services. They often hire experienced financial and industry specialists to serve particular client needs. In addition to recruiting well qualified recent graduates.

The large, international CPA firms also perform auditing, tax and consulting services. Their principal clients are large domestic and international corporations.

How does a student prepare for the accounting profession? Persons considering entering the accounting profession should begin by doing some self-analysis to determine whether they enjoy mathematical, problem-or puzzle-solving, or other analytical activities; by taking some [aptitude tests](http://www.answers.com/topic/aptitude-test); or by talking with accounting teachers or practitioners about their work.

In Thailand anyone interested in becoming an accounting professional should expect to enter a rigorous four-year education program to earn bachelor‘s degree in of Accountancy or bachelor of Business Administration majoring in accounting and earn 3 years auditing experience in order to qualify to enter the profession and to sit for the CPA examination. To build a base for rising to the top of the profession, students should select courses that help them learn how to think and to define and solve problems. The courses should help them to develop analytical (logical, mathematical, statistical), communication (oral, reading, writing), computer, and [interpersonal](http://www.answers.com/topic/interpersonal) skills. The early part of the program should emphasize arts and sciences courses in these skill- development areas.

##### Opportunities for Accountants

In the accompanying diagram, the long arrows indicate how accountants often move from public accounting firms to positions in business or government. Obviously, these movements can occur at any level or in any direction.

##### Figure 1.2 Opportunities for Accountants

**Public Accounting Firm Business Corporation Or**

**Government Agency**

Partner

Chief Executive Officer Major Operating Executive

Manager

Controller or Treasurer or Chief Financial Officer

Senior

Accountant Senior

Accountant

Staff Accountant

Staff Accountant

##### Industrial Accounting/ Private Accounting

More accountants are employed in industry than in public accounting because of the vast number of manufacturing, merchandising, and service firms of all sizes. In additional to using the services of public accounting firms, these firms employ cost and management accountants, as well as financial accountants. Many accountants in industry start working in this environment right out of school; others get their start in public account as auditors but move to industry after getting at least a couple of years of experience.

##### Government and Not-for-Profit Account

Opportunities for accounting professionals in the government and not-for-profit sectors of the economy are constantly increasing.

##### Forensic Accounting.

Forensic Accounting use accounting, auditing, and investigating skills to conduct investigations into theft and fraud. The job of forensic accountants is to catch the perpetrators of theft and fraud in the business entities, investigate suspected fraudulent irregularities such as financial statement manipulation, misrepresentation, intentional omission from financial statement of events and transactions, falsification, intentional exploitation of loopholes in accounting standard and the misappropriation or defalcation of assets, tracing money laundering and identities-theft activities as well as tax evasion. Insurance companies employ forensic

accountants to detect insurance frauds such as arson. Law offices hire forensic accountants to identify marital assets in divorces.

##### Table 1.1 Summaries of Accounting Professions and Accounting Careers

|  |  |  |
| --- | --- | --- |
| **Accounting Professions** | **Accounting Careers** | **Services provide** |
| **Public Accounting** | Certified Public Accountant (CPA) | Auditing, Corporate tax returns, and management advisory services. |
| **Industrial Accounting/ Private Accounting** | Financial Accountant Cost and Management  Accountants, Controllers,  Chief financial officers, Internal auditors | Bookkeeping, Accounting, tax return, Income tax planning and reporting and financial planning |
| **Government and Not-for Profit Account** | Controllers ,chief financial officers ,Teacher, Lecturer | Bookkeeping, Accounting, Teaching |
| **Forensic Accounting.** | Forensic Accountant | Catch the perpetrators of theft and fraud in the business entities and tracing money laundering |

**Opportunities in Accounting Careers**

Accounting has four board areas of opportunities: financial, managerial, taxation, and accounting-related.

**Figure 1.3** Opportunities in accounting

### Opportunities in accounting

**Financial Managerial Taxation Accounting-related**

* Preparation
* Analysis
* Auditing
* Regulatory
* Consulting
* Planning
* Criminal investigation
* General accounting
* Cost accounting
* Budgeting
* Internal auditing
* Consulting
* Controller
* Treasurer
* Strategy
* Preparation
* Planning
* Regulatory
* Investigations
* Consulting
* Enforcement
* Legal services
* Estate plans
* Lenders
* Consultants
* Analysts
* Traders
* Directors
* Underwriters
* Planners
* Appraisers
* FBI investigators
* Market researchers
* Systems designers
* Merger services
* Business valuation
* Forensic accounting
* Litigation support
* Entrepreneurs

Source: Principles of financial accounting, 19th edition, John J. Wild Ken W. Shaw Barbara Chiappetta, p.6

### Accounting Professional Ethics

Importance of ethics

The goal of accounting is to provide useful information for decisions, it must be trusted. Trust requires ethics in accounting. Ethics are beliefs that distinguish right from wrong.Identifying the ethical path is sometimes difficult. The preferred path is course of action that avoid casting doubt on one‘s decisions.

Ethical guidelines for decision making are threefold:

1. Identify ethical concerns using personal ethics,
2. Analyze options considering all good and bad consequences, and
3. Make ethical decisions after weighing all consequences.

Ethics and social responsibility yield good behavior, and they often result in higher income and a better working environment.

The nature of the work carried out by accountants and auditors requires a high level of ethics. Shareholders, potential shareholders, and other users of the financial statements rely heavily on the yearly financial statements of a company as they can use this information to make an informed decision about investment. They rely on the opinion of the accountants who prepared the statements, as well as the auditors that verified it, to present a true and fair view of the company. Knowledge of ethics can help accountants and auditors to overcome ethical dilemmas, allowing for the right choice that, although it may not benefit the company, will benefit the public who relies on the accountant and auditor's reporting.

### Users and Uses of accounting information

Users of accounting information are both external and internal users. External users of accounting include lenders, shareholders, directors, customers, suppliers, regulators, lawyers, brokers, and the press. Internal users of accounting include managers, officers, and other internal decision makers involved with strategic and operating decisions. Internal users (managers) include those from research and development, purchasing, human resources, production, distribution, marketing and servicing.

From Figure 1.4 it shows the suppliers or providers and the external users of financial information.

##### Figure 1.4 Financial Information Suppliers Groups and External User Groups

PROVIDERS OF FINANCIAL INFORMATION

* Profit-oriented companies
* Not-for-profit entities (e.g., government entities, charitable organizations, schools)
* Households

EXTERNAL USER GROUPS

* Investors
* Creditors (banks, bondholders, other lenders)
* Employees
* Labor unions
* Customers
* Suppliers
* Government regulatory agencies

(e.g., Internal Revenue Service, Securities and Exchange Commission)

* Financial intermediaries (e.g., financial analysts,

stockbrokers, mutual fund managers, credit-rating organizations)

From Table 1.2, it shows who are the users of accounting information and why they find accounting information useful.

##### Table 1.2 Users and the useful of accounting information.

|  |  |
| --- | --- |
| **User/Decision maker** | **Decision/Informed Judgment Made** |
| ***Management team / Managers*** | Accounting information help in performing its functions of planning, directing, and controlling, management makes many decisions and informed judgments. For example, when considering the expansion of a product line, planning involves identifying and measuring costs and benefits; directing involves communicating the strategies selected; and controlling involves identifying, measuring, and communication the results of the product line expansion during and after its implementation. |
| ***Owners, directors*** | Accounting information help in evaluating the performance of the organization, oversee their interests in the organization, determining operating, compensation, and other policies |
| ***Investors/shareholders*** | Accounting information helps in making decision about increase or reduces their investment. Shareholders assess whether to buy, sell, or hold their shares. Investors use accounting information to help assess the amounts, timing, and uncertainty of future cash returns on their investment |
| ***Creditors/Lenders/Suppliers*** | Accounting information help in determining how much merchandise to ship to a customer before receiving payment, creditors assess the probability of collection and the risks of late (or non-)payment and make many decision such as considering the extend credit, how much, how long, grant a loan, which lending terms to specify. They need accounting information to measure the risk and return of loans. |
| ***Employees and labor unions*** | To judge the fairness of wages and assess future employment opportunities. When planning for retirement, employees assess the company‘s ability to offer long-term job prospects and an attractive retirement benefits package. |

|  |  |
| --- | --- |
| ***Income tax authorities*** | Accounting information help in measuring taxable income properly. |
| ***SEC*** (Securities and Exchanges Commission) | Accounting information helps in making decision about the financial statements of a publicly held corporation conform to requirements of securities laws, compliance with SEC regulations, |
| ***Accounting researchers, security analysts, security broker, credit rating organizations, and mutual fund manager.*** | Analysis and evaluate of enterprises, capital markets, and/or investors analyses and evaluations of enterprises, capital markets, and/or investors .Analysts determine whether financial statement issued to investors fully disclose all required information. |
| ***Union, governmental, regulatory*** | Evaluating the organization that is conforming with applicable contracts, rules, laws, and public policies and/or whether changes are needed; |
| ***Potential owners, employees, and customers*** | Evaluating their current and future commitments to the organization |

**Questions and Exercise**

Answer the following questions.

Q1-1 Explain the purpose and importance of accounting in the information era/age. Q1-2 What is the definition of accounting?

Q1-3 What are the main four functions of accounting?

Q1-4 What are the differences between accounting and bookkeeping?

Q1-5 Who are the users of accounting information and why do they find accounting information useful?

Q1-6 Identify opportunities in accounting and related fields.

Q1-7 Identify and describe the three principal formats of profit making business organization.

Q1-8 Identify and describe the three major activities of business. Q1-9 Why ethics are crucial in accounting?

Q1-10 Technology is increasingly used to process accounting data. Why must we study and understand accounting?

**Exercise** Matching Definitions with Terms

Match each definition with is related term by entering the appropriate letter A, or B, or C…. in the space provided.

|  |  |  |
| --- | --- | --- |
| **Answer** |  | **Term** |
| **C** | 1 | Journalizing |
| **D** | 2 | Merchandising firm |
| **G** | 3 | Posting |
| **E** | 4 | Sole Proprietorship |
| **I** | 5 | Partnership |
| **H** | 6 | Corporation |
| **B** | 7 | Service firm |
| **F** | 8 | Manufacturing firm |
| **A** | 9 | Financial Accounting |
| **J** | 10 | Managerial Accounting |

1. A field of [accounting](http://en.wikipedia.org/wiki/Accountancy) concerned with the process of summarizing financial data taken from an organization's accounting records and preparation of [financial statements](http://en.wikipedia.org/wiki/Financial_statements)
2. A type of business firm that provide service to customers
3. The process of recording business transactions in the book of original entries
4. A type of business firm that purchase goods or merchandise and resell to customers
5. Business organization form with one owner
6. A type of business firm that produce goods or merchandise and sell to customers
7. The process of transfer business transactions from journal to each account in ledger
8. Business organization form with seven or more owners
9. Business organization form with two or more owners
10. A field of [accounting](http://en.wikipedia.org/wiki/Accountancy) concerned with providing information and analysis to facilitate the planning, directing, motivating, controlling and performance evaluation

# Chapter 2

**FINACIAL ACCOUNTING-**

***ACCOUNTING CONCEPTUAL FRAMEWORK AND FUNDAMENTAL ACCOUNTING MODEL***

**Topic:** Financial Accounting- Accounting conceptual framework and fundamental accounting model.

**Concept:** To introduce students to understand basic concepts of financial accounting and analyze business transactions on accounting equation

##### Objectives

1. Students will learn about meaning of GAAP.
2. Students will be introduced to Accounting Concepts and Principles according to IASB Framework for preparation and presentation of financial statements.
3. Students will learn about the fundamental accounting model, basic accounting equation and meaning of Assets, Liabilities and Owners‘ Equity.
4. Students will learn about meaning of business transactions and events.
5. Students will analyze the effects of business transactions on accounting equation.
6. Students will learn about financial statements of business enterprises.

# Financial Accounting

The purpose of accounting is to provide the information that is needed for sound economic decision making. The main purpose of financial accounting is to prepare financial reports that provide information about a firm's performance to external parties such as investors, creditors, and tax authorities. Financial accounting is performed according to Generally Accepted Accounting Principles (GAAP) guidelines. These principles are "generally accepted" because an authoritative body has set them or the accounting profession widely accepts them as appropriate.

### 2.1 Financial Accounting Standards

Financial accounting practice is governed by concepts, standard and rules known as generally accepted accounting principle (GAAP). Accounting standards are needed for preparing and presenting the financial statements that will fairly and consistently describe financial performance. Without standards, users of financial statements would need to learn the accounting rules of each company, and comparisons between companies would be difficult.

### Categories of accounting principles

Accounting principles consist of two main categories (a) *general* and (b) *specific*

principles.

**General principles** are the basic assumptions, concepts, and guidelines for preparing financial statements. They stem from long-used accounting practices.

**Specific principles** are detailed rules used in reporting on business transactions and events. They usually arise from the rulings of authoritative and regulatory groups such as the Financial Accounting Standards Board or the Securities and Exchange Commission.

**Generally Accepted Accounting Principles (GAAP)** is the standard framework of guidelines for [financial accounting.](http://en.wikipedia.org/wiki/Financial_accounting) It includes the standards, conventions, and rules accountants follow in recording and summarizing transactions, and in the preparation of statements. Third- parties who must rely on such information have a right to be assured that the data are free from bias and inconsistency, whether deliberate or not. For this reason, financial accounting relies on certain standards or guides.

###### National GAAP

Every country has its own standard accounting practice version of GAAP with standards set by a national governing body, which is called Financial Accounting Standard Board (FASB).

###### International GAAP

Many countries use or are converging on the [International Financial Reporting Standards](http://en.wikipedia.org/wiki/International_Financial_Reporting_Standards) (IFRS), established and maintained by the [International Accounting Standards Board](http://en.wikipedia.org/wiki/International_Accounting_Standards_Board) (IASB)

**International Financial Reporting Standards (IFRS)** are standards and interpretations adopted by the board of [International Financial Reporting Standards Committee](http://en.wikipedia.org/wiki/International_Accounting_Standards_Board) (IFRSC).

Many of the standards forming part of IFRS are known by the older name of **International Accounting Standards** (IAS). IAS was issued between 1973 and 2001 by the board of the [International Accounting Standards Committee](http://en.wikipedia.org/wiki/International_Accounting_Standards_Committee) (IASC). In April 2001 the IASB adopted all IAS and continued their development, calling the new standards IFRS.

Standards and Interpretations adopted by IASB which comprise

* 1. International Financial Reporting Standards
  2. International Accounting Standards, and
  3. Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

### Accounting Conceptual Framework

Since GAAP is found on the basic accounting principles and guidelines based on accounting conceptual framework. Financial accounting relies on the [following basic accounting](http://www.quickmba.com/accounting/fin/concepts/) [concepts](http://www.quickmba.com/accounting/fin/concepts/) or conceptual framework:

* + - **Assumptions**: Separate economic entity assumption, going-concern assumption, stable monetary unit assumption, and fixed time period assumption.
    - **Principles**: Historical cost principle, matching principle, revenue recognition principle, and full disclosure principle.
    - **Modifying conventions** / or **Constraints**: Materiality, cost-benefit, conservatism convention, and industry practices convention.

##### Table 2.1 Accounting Concepts

|  |  |
| --- | --- |
| **Basic Accounting Concepts** | **What It Means in Relationship to a Financial Statement** |
| **1. Separate Economic Entity Assumption** | Financial records must be separately maintained for each economic entity. Economic entities include businesses, governments, school districts, churches, and other social organizations. Business records must not include the personal assets or liabilities of the owners. |
| **2 Going Concern Assumption** | Financial statements are prepared under the assumption that the  company will remain in business indefinitely or is going to be  operating for the foreseeable future. Therefore, assets do not need  to be sold at fire-sale values, and debt does not need to be paid  off before maturity. This principle results in the classification of  assets and liabilities as short-term (current) and long-term.  If the company's financial situation is such that the accountant believes the company will *not* be able to continue on, the accountant is required to disclose this assessment. |
| **3.Stable Monetary Unit Assumption** | An economic entity's accounting records include only quantifiable transactions. Accounting must be recorded using a stable currency  e.g. the U.S. dollar, Thai Baht |
| **4. Fixed Time Period Assumption** | Most businesses exist for long periods of time, Therefore information prepared and reported periodically (quarterly, annually, etc.).Once the time period has been established, accountants use GAAP to record and report that accounting period's transactions. It is *imperative* that the time interval (or period of time) be shown in the heading of each income statement, statement of stockholders'  equity, and statement of cash flows. |

|  |  |
| --- | --- |
| **4. Historical Cost Principle** | **A**ssets are reported and presented at their original cost and no adjustment is made for changes in market value. One never writes  up the cost of an asset. Accountants are very conservative in this sense. Sometimes costs are written down, for example, for some short-term investments and marketable securities, but costs never are written up.  Because of this accounting principle asset amounts are *not* adjusted upward for inflation. In fact, as a general rule, asset amounts are not adjusted to reflect *any* type of increase in value. Hence, an asset amount does not reflect the amount of money a company would receive if it were to sell the asset at today's market value. |
| **5. Matching Principle** | This accounting principle requires companies to use the accrual basis of accounting The matching principle requires that expenses be matched with revenues. For example, sales commissions expense should be reported in the period when the sales were made (and not reported in the period when the commissions were paid). |

**Table 2.1 Accounting Concepts (Con.)**

|  |  |
| --- | --- |
| **Basic Accounting Concepts** | **What It Means in Relationship to a Financial Statement** |
| **6. Revenue Recognition Principle** | Revenue is earned and recognized upon product delivery or service completion, without regard to the timing of cash flow. GAAP requires the use of accrual basis accounting rather than cash basis accounting Revenue is realized (reported on the books as earned) when everything that is necessary to earn the revenue has been completed. |
| **7. Full Disclosure Principle** | Financial statements normally provide information about a  company's past performance. However, pending lawsuits,  incomplete transactions, or other conditions may have imminent  and significant effects on the company's financial status. The full  disclosure principle requires that financial statements include  disclosure of information that is important to an investor or  lender using the financial statements. The information should be  disclosed within the statement or in the notes to the statement to  convey this information and to describe the accounting policies  the company uses to record and report business transactions. |
| **9. Materiality** | A modifying convention that relaxes certain GAAP requirements if  the impact is not large enough to influence decisions. Users of the  information should not be overburdened with information overload.  Because of this basic accounting principle or guideline, an  accountant might be allowed to violate another accounting principle  if an amount is insignificant. Professional judgment is needed to  decide whether an amount is insignificant or immaterial. Because of  materiality, financial statements usually show amounts rounded to  the nearest dollar, to the nearest thousand, or to the nearest million  dollars depending on the size of the company. |
| **10. Conservatism/ Prudence** | **Principle of conservatism/Prudence** requires that the less  optimistic estimate be chosen when there is a choice of equally  acceptable accounting methods, the firm should use the one that is  least likely to overstate income or assets. If a situation arises where  there are two acceptable alternatives for reporting an item,  conservatism directs the accountant to choose the alternative that  will result in less net income and/or less asset amount. Accountants  are expected to be unbiased and objective. |
| **11 Cost-Benefit** | A modifying convention that relaxes GAAP requirements if the  expected cost of reporting something exceeds the benefits of  reporting it. |
| **12 Industry Practices** | Accepted industry practices should be followed even if they differ  from GAAP. |

Summary of Accounting Conceptual Framework structure base on IASB

**RECOGNITION AND MEASUREMENT**

##### Third level:

**T**

**UNDERLYING ASSUMPTION**

* Accrual basis
* Going concern

**RECOGNITION OF ELEMENTS**

* Probability of future Economic benefit
* Reliability of measurement
* Recognition of assets Liabilities, income and expenses

**MEASUREMEN OF ELEMENTS**

**CONCEPTS** of

* capital maintenance
* determination of profit

The ‗how‘-

Implementation

**QUALITATIVE CHARACTERSTICS**

**Understandability Relevance**

* + Materiality

**Reliability**

* + Faithful representation
  + Substance over form
  + Neutrality
  + Prudence
  + Completeness **Comparability Constraints**
  + Timeliness
  + benefits and costs
  + Balance between qualitative

characteristics

**True and fair view**

**ELEMENTS**

**of financial statements**

**Financial position**

* Assets
* Liabilities
* Equity

**Performance**

* Income
* Expenses

**Capital maintenance**

* adjustments

**Second level:** Bridge between objectives and implementation

**OBJECTIVES of financial reporting**

* + Purpose
  + Scope
  + Users and their Information needs

##### First level:

The ‗why‘-

goals and purposes of financial reporting

**FIGURE 2.1**: Summary of Accounting Conceptual Framework structure base on IASB

**Summary of Accounting Conceptual Framework structure base on US GAAP**

**RECOGNITION AND MEASUREMENT**

**ASSUMPTINS**

1. Economic entity
2. Going concern
3. Monetary unit
4. Periodicity

**PEICIPLES**

1. Historical cost
2. Revenue
3. Matching
4. Full disclosure

**CONTRAINTS**

1. Cost-benefit
2. Materiality
3. Industry practice
4. Conservatism

**Third level:** The ‗how‘- implementation

**QUALITATIVE CHARACTERSTICS**

**ELEMENTS**

* 1. Primary qualities
     1. Relevance (1)Predictive value (2)Feedback value (3)Timeliness
     2. Reliability (1)Verifiability

(2)Representational

Faithfulness (3)Neutrality

* 1. Secondary qualities
     1. Comparability
     2. Consistency

1. Assets
2. Liabilities
3. Equity
4. Investment by owners
5. Distribution to owners
6. Comprehensive income
7. Revenues
8. Expenses
9. Gains
10. Losses

**Second level:** Bridge between Levels 1 and 3

**OBJECTIVES**

Provide information:

* 1. Useful in investment and credit decisions
  2. Useful in assessing

future cash flows 3.About enterprise resources, claims to resources, and

changes in them

##### First level:

The ‗why‘-

goals and purposes of financial reporting

### FIGURE 2.2: Summary of Accounting Conceptual Framework structure base on US GAAP

Overview of financial reporting systems

|  |  |  |  |
| --- | --- | --- | --- |
|  | International | United States | Thai |
| GAAP framework | IFRS s (including IASs and  IFRIC interpretation) | US GAAP | Thai equivalents of IFRSs  (including TASs and TASC interpretation |
| Standards board | IASB | FASB | TASB |
| Conceptual  framework | IASB Framework for the  preparation and presentation of Financial Statements | There are six Statements of  Financial Accounting Concepts (SFAC1-SFAC6) | TAS Framework for the  Preparation and Presentation of Financial Statement (essentially the TASB Framework and TAS35) |
| Relationship to  GAAP | Basis for the use of judgment  in resolving issues not specifically covered in standards | Not directly included in the  GAAP hierarchy US GAAP rely on ‘black letter’ Standards and guidance | Basis of the use of  judgment, but also clarifies that concepts are not mandatory requirements |
| Terminology | Prudence | Conservatism | Prudence |
| Assumptions | Identifies accrual basis and  going concern as the underlying assumption | Identifies monetary unit and  economic entity assumptions as underlying assumptions | Follows IASB Framework |
| Elements | Distinction between income and expenses from all sources | Distinction between gains and revenues ,and losses and expenses | Follows IASB Framework |
| Characteristics | Principal characteristics are  understandability, relevance, reliability and comparability | Distinction between primary  (relevance and reliability) and secondary qualitative factors (comparability) | Follows IASB Framework |
| Recognition and  measurement | Capital maintenance concept ;  income recognized when change in balance sheet element | Focus on historical cost  measurement including revenue recognition and matching expenses to revenues | Follows IASB Framework |
| Commonalities | The frameworks cover objectives, assumption, qualitative characteristics, elements of financial  statements and constraints. They have similar objectives of decision usefulness. Many similarities in the assumptions, characteristics and elements used. | | |

These concepts can be related to the basic model of the flow of data from transactions to financial statements shown in Figure 2.4

### Accounting entity

**Assets = Liabilities + Owners’ equity**

(accounting equation)

### Going concern

(Continuity)

Transactions

|  |  |  |
| --- | --- | --- |
| Procedures for sorting, classifying, and presenting (bookkeeping)  Selection of alternative methods of reflecting the effect of certain transactions (accounting) | | |
|  |  |  |
|  |
|  |
|  |

|  |  |  |
| --- | --- | --- |
| **Financial statements** | | |
|  |  |  |
|  |
|  |
|  |

Unit of measurement Cost principle Objectivity

Accounting period

Consistency Full disclosure Materiality Conservation

Matching principle

Revenue recognition Accrual concept

##### FIGURE 2.3 : Basic model of the flow of data from business transactions to financial statement

* 1. **Characteristics of Accounting Information**

To use and interpret financial reports effectively, they are generated by professional accountants, the information to be **relevant, reliable, verifiable, understandable, and comparable .**

According to the qualitative characteristics of accounting information that mention on the Second level of fundamental concepts (as shown in Figure 2.4).To be useful, financial information must be relevant, reliable, and prepared in a consistent manner. **Relevant information helps** a decision maker understand a company's past performance, present condition, and future outlook so that informed decisions can be made in a timely manner. Of course, the information needs of individual users may differ, requiring that the information be presented in different formats. Internal users often need more detailed information than external users, who may need to know only the company's value or its ability to repay loans. **Reliable information** is neutral, representational of faithfulness, complete, adhere the economic substance rather than legal form, and prudence. **Comparability information** is prepared by using the same methods each accounting period, which allows meaningful comparisons to be made between different accounting periods and between the financial statements of different companies that use the same methods. **Understandability** is the quality of information that permits reasonably informed users to perceive its significance. The **understandability information** is useful and there is a connection (link) between these users and the decisions they make.

SECOND LEVEL – FUNDAMENTAL CONCEPTS

##### QUALITATIVE CHARACTERSTICS OF ACCOUNTING INFORMATION

Understandability Relevance Reliability Comparability

Materiality

Faithful Representation

Substance Neutrality over Form

Prudence Completenes

Constraints on relevance and reliable information

Timeliness Balance between benefits and costs

Balance between qualitative characteristics

True and fair view/fair presentation

**FIGURE 2.**4 Hierarchy of Accounting qualities based on IASB Framework

* 1. **Financial Reporting and Financial Statements**

##### Information spectrum

According to the information spectrum that mention on the FASB Statement of Financial Accounting Concepts No.5 (as shown in Figure2.2). Financial Reports are included financial statements; notes to financial statements ; supplement information; others means of financial report such as auditor‘s report, audit committee‘s report, MD&A report ; and other information such as analyst‘s report, economic statistics. Therefore Financial Statements is a part of Financial Report

##### Figure 2.5 Information spectrums

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| All Information Useful for Investment, Credit and Other Stakeholders | | | | |
| Financial Reporting | | | |  |
| Area Directly Affected by Existing Financial Accounting Standards | | |  |  |
| Basic Financial Statements | |  |  |  |
| Scope of  Recognition and measurement Concept Statement | Notes to  Financial Statements (and parenthetical disclosure) | Supplementary  Information | Others  Means of Financial Reporting | Other  Information |
| **Financial Statements**   1. Statement of Financial Position 2. Statements of   Earning and Comprehensive Income   1. Statement of Cash Flows 2. Statement of change in Owners | Examples:  1. Accounting Policies 2.Contingencs   1. Inventory costing Methods 2. Number of share authorized, issued, and   outstanding   1. Alternative measures   (market values of  items carried at historical cost) | Examples:   1. Changing Prices and Economic Disclosures 2. Monetary Reserved   Information | Examples:  1.Managemet Discussion and Analysis   1. Letters to Stockholders 2. Auditor‘s   report   1. Audit Committee‘s report | 1. Discussion   of competition and order backlog in SEC   1. Analysts' Reports 2. Economic   Statistics 4.News/  Articles about  Company |

Adapt from

Source: FASB Statement of Financial Accounting Concepts No.5, Recognition and M easurement in Financial Statement of Business Enterprises (December, 1984)

##### Financial Reporting Objectives

The objectives of financial reporting, as specified in the Financial Accounting standards Board (FASB) *Statement of Financial Accounting Concepts No. 1*, are as follows:

Financial reports provide information that

* + - 1. is useful to existing and potential investors and creditors and other users in making rational investment, credit, and similar decisions;
      2. helps existing and potential investors and creditors and other users to assess the amounts, timing, and uncertainty of prospective net cash inflows to the enterprise;
      3. identifies the economic resources of an enterprise, the claims to those resources, and the effects that transactions, events, and circum stances have on those resources.

### Business Transactions

Business activities can be described in terms of transaction and events. External transactions are exchange of value between two entities, which yield changes in accounting equation. Internal transactions are exchanges within an entity and affect the accounting equation

such as use of supplies, depreciation of plants and equipments. Events refer to happenings that affect an entity accounting equation and can be reliably measured. They include business events such as changes in market value of certain assets and liabilities, and natural events such as floods and fires that destroy assets and create losses. They are not include oral agreement or signing contracts such as signing contract for produce products or render services, which donot impact the accounting equation.

Business transaction means a business event which can be measured in monetary term and will affect the element of accounting equation. Therefore, the three characteristics of a business transaction are:

1. It is a business event or situation or circumstance occurs during operating the business,
2. It can be measure in terms of money and
3. It will affect the elements of accounting equation those are assets, liabilities and owner‘s equities.

### Cash Basis VS. Accrual Basis

##### Cash Basis Accounting

Cash Basis Accounting is the accounting method that revenues are recognized only when the company receives cash or cash equivalent, and expenses are recognized only when the company pays with cash or cash equivalent. Many small businesses utilize a cash basis, meaning that neither revenue nor expenses are recognized until the cash associated with them actually is received or paid.

When transactions are recorded on a cash basis, they affect a business entity's books only once a completed exchange of value has occurred; therefore, cash basis accounting is less accurate than accrual accounting in the short term.

##### Accrual Basis Accounting

**Basis Accounting is** the accounting method that recognizes revenue and expenses when they are earned and incurred, not necessarily when the cash is received or paid. Most of the businesses use the accrual method. It is the accounting method that measures the performance and position of a business entity by recognizing economic events regardless of when cash transactions occur. **Accrual basis accounting,** which adheres to the revenue recognition, matching, and cost principles capture the financial aspects of each economic event in the accounting period in which it occurs, regardless of when the cash changes hands. This method allows the current

cash inflows/outflows to be combined with future expected cash inflows/outflows to give a more accurate picture of a business entity‘s current financial condition.

Accrual accounting is considered to be the standard accounting practice for most business entity, with the exception of very small operations. This method provides a more accurate picture of the company's current condition, but its relative complexity makes it more expensive to implement. This is the opposite of cash accounting, which recognizes transactions only when there is an exchange of cash.

The need for accrual method arose out of the increasing complexity of business transactions and a desire for more accurate financial information. Selling on credit and projects that provide revenue streams over a long period of time affect the business entity 's financial condition at the point of the transaction. Therefore, it makes sense that such events should also be reflected on the financial statements during the same reporting period that these transactions occur.

### Fundamental Accounting Model

##### Double Entry Accounting

Financial Accounting is based on [double-entry bookkeeping](http://www.quickmba.com/accounting/fin/double-entry/) procedures in which each transaction is recorded in opposite columns of the accounts affected by the exchange. Double entry accounting is a significant improvement over simple and more error-prone [single-entry](http://www.quickmba.com/accounting/fin/single-entry/) [bookkeeping](http://www.quickmba.com/accounting/fin/single-entry/) systems.

##### Fundamental Accounting Model or Accounting Equation

The balance sheet is based on the following fundamental [**accounting equation**](http://www.quickmba.com/accounting/fin/equation/) :

|  |  |  |
| --- | --- | --- |
| **Assets** | **=** | **Equities** |
| *Resources* |  | *Claims on the Resources* |

**Assets** simply mean the resources or property owned or controlled by a business.

**Assets means the probable future economics benefit obtained or controlled by a particular entity as a result from the past transactions**.(Source : Statement of Financial Accounting Concepts No. 6 ―Elements of Financial Statement.‖ Pars.25)

**Equities** simply mean the rights or claims on the resources or assets. Equities are subdivided into two types: equity of creditors is called **liability** and equity of owner is call **owner’s equity** or **capital**

|  |  |  |
| --- | --- | --- |
| **Equities** | **=** | Equity of creditors +Equity of owners |
|  | = | **Liabilities** + **Owners’ Equity** |

* + Investors who buy ownership in the business
  + Creditors who extend loans to the business

Investors and creditors who contribute assets to a business have legal claims on those assets. Since the total assets of the business are equal to the sum of the assets contributed by investors and the assets contributed by creditors, the following relationship holds and is referred to as the **accounting equation**:

|  |  |  |  |
| --- | --- | --- | --- |
| **Assets** | **=** | **Liabilities + Owners' Equity** | |
| *Resources* |  | *Rights of Creditors to claims on the Resources* | *Rights of Owners to claims on the Resources* |

Assets are classified as tangible or intangible. **Tangible assets** are generally divided into three major categories: current assets (including cash, marketable securities, accounts receivable, inventory, and prepaid expenses); property, plant, and

equipment; and long-term investments. **Intangible assets** lack physical substance, but they may, nevertheless, provide substantial value to the company that owns them. Examples of intangible assets include patents, copyrights, trademarks, and franchise licenses

**Liabilities means probable sacrifice of economics benefits in the future or debts or obligations to be paid or settled in the future by transfer of assets or provide services to others entity as a result from past transactions.** (Source: Statement of Financial Accounting Concepts No. 6 ―Elements of Financial Statement.‖ Pars.35)

Liabilities are generally classified as short-term (current) if they are due in one year or less. Long-term liabilities are not due for at least one year.

Owner's equity means the residual interest in the assets of an entity that remains after deducting its liabilities. (Source: Statement of Financial Accounting Concepts No. 6 ―Elements of Financial Statement.‖ Pars.49)

**Owner's equity** represents the amount owed to the owner or owners by the business entity. Algebraically, owners‘ equity for sole proprietorship is called capital; for partnership is called partners‘ equity; for corporation is called stockholders‘ equity.

Sole Proprietorship

Assets- Liabilities = Owner‘s equity Partnership

Assets- Liabilities = Partners‘ equity Corporation

Assets- Liabilities = Stockholders‘ equity

In a sole proprietorship or partnership, owner's equity equals the total net investment in the business plus the net income or less loss and less owners‘ drawing generated during the business's life. **Net investment** equals the sum of all investment in the business by the owner or owners minus withdrawals made by the owner or owners. The owner's investment is recorded in the owner's capital account, and any withdrawals are recorded in a separate owner's drawing account. **Revenues** are inflows of money or other assets received from customers in exchange for goods or services. **Expenses** are the costs incurred to generate those revenues.

Components of Owner‘s Equity In a Sole Proprietorship

Owner‘s Investments

**-**

Owner‘s Drawings

**+** Revenues **-**

Expenses

Net Investments

**±** Net Income or Loss

Capital investments and revenues increase owner's equity, while expenses and owner withdrawals (drawings) decrease owner's equity. In a partnership, there are separate capital and drawing accounts for each partner.

**Stockholders’ equity**. In a corporation, ownership is represented by shares of stock, so the owners' equity. is called **stockholders’ equity** or **shareholders' equity**. Corporations use several types of accounts to record stockholders' equity activities: preferred stock, common stock, paid-in capital (these are often referred to as contributed capital), and retained earnings. **Contributed capital** accounts record the total amount invested by stockholders in the corporation. If a corporation issues more than one class of stock, separate accounts are maintained for each class. **Retained earnings** equal net income or loss over the life of the business less any amounts given back to stockholders in the form of dividends. Dividends affect stockholders' equity in the same way that owner withdrawals affect owner's equity in sole proprietorships and partnerships.

Components of Stockholders‘ Equity

in a Corporation with Two Classes of Stock

Preferred Stock

Common Stock

**+**

Additional Paid-in Capital

Revenues

- Expense

**-**

= Net Income

Dividends

Contributed Capital

**+**

**+** Retained Earnings

Most of business accounting systems utilize the double entry method. Under double entry, the transaction is recorded in two accounts.

##### The Accounting Equation – analyzing business transactions

Once a business transaction occurs, a sequence of activities begins to identify and analyze the transaction.

Initially, owner equity is affected by capital contributions. Once business operations , there will be income (revenues minus expenses, and gains minus losses) and perhaps additional capital investments and withdrawals or dividends. At the end of a reporting period, these items will impact the owners' equity as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Assets** | **=** | **Liabilities** | **+** | **Owners' Equity** |
|  |  |  | + | Revenues |
|  |  |  | - | Expenses |
|  |  |  | + | Gains |
|  |  |  | - | Losses |
|  |  |  | + | Investments |
|  |  |  | - | Withdrawals |

These additional items under owners' equity are tracked in temporary accounts until the end of the accounting period, at which time they are closed to owners' equity.

When a transaction occurs, the total assets of the business may change, but the equation will remain in balance. The accounting equation serves as the basis for the balance sheet, as illustrated in the following example.

##### Analyzing Transactions

The first step in the accounting process is to analyze every transaction (economic event) that affects the business. The accounting equation (Assets = Liabilities + Owner's Equity) must remain in balance after every transaction is recorded, so accountants must analyze each transaction to determine how it affects owner's equity and the different types of assets and liabilities before recording the transaction.

##### The Accounting Equation - A Practical Example

To better understand the accounting equation, consider the following example. Mr. Anan set up a taxi service firm under the name **Anan Taxi** on September 1, 20XX. He contributed his 4 personal cars value Baht 1,000,000 to be used as taxi and withdraw personal cash from personal bank to open Anan Taxi Bank account for Baht 500,000. He rented land and building for using as parking lot of taxi and office at a rental rate of Baht10,000 per month which is paid at the beginning of each month. The following transactions occurred during September the first month of operation.

|  |  |
| --- | --- |
| Sept 1 | Anan contributed 4 used cars Baht 1,000,000 and cash Baht 500,000 to start the  business. **Cash + Taxi+ Anan Capital+** |
| Sept 1 | Purchased 6 new taxis for Baht 500,000 each from Toyota Motor Company, 10% down payment are made for Baht 300,000 and signed a promissory note for the balance of Baht 2,700,000. **500,000 x 6taxis= 3,000,000 x 10% =300,000**  **Taxis + Cash- Note Payable +** |
| Sept 1 | Paid first month rent for land and building Baht 10,000. **Cash- Capital-** |
| Sept 2 | Hired 10 chauffeurs to drive 10 taxis at the monthly salary of Baht 10,000 each. Payments are made on the 25th of each month. **NO EFFECT** |
| Sept 2 | Agreed with gasoline station‘s owner to buy gasoline on account for 10 taxi  everyday, but payment for current month gasoline used are made monthly on the tenth of following month. **NO EFFECT** |
| Sept 3 | Agreed with Mrs. Malee to send and pick up her sons from home to school and  from school back home 20 days a month at the taxi fares rate per month Baht 4,000. Payments for current month taxi fares will be paid on the fifth of following month. **NO EFFECT** |
| Sept 15 | Total cash received from passenger for taxi fares for the first half of the month was  Baht 180,000. **Cash+ Capital+** |
| Sept 20 | Paid repair and maintenance expense for taxi Baht 5,000. **Cash - Capital-** |
| Sept 25 | Paid salaries to all chauffeurs Baht 100,000. **Cash- Capital-** |
| Sept 29 | Paid current month electricity bill, water bill and telephone bill of the office total  Baht 4,500. **Cash- Capital-** |
| Sept 30 | Total cash received from passengers for taxi fares for the second half of the month  was Baht 220,000. **Cash+ Capital+** |
| Sept 30 | Billed to Mrs.Malee Baht 4,000 for taxi service rendered for September, receipt will  be on October 5. **A/R+ Capital+** |
| Sept 30 | Received a bill from gasoline station Baht 150,000 for total gasoline used up in  September, payment will be on October 10. **A/P+ Capital-** |
| Sept 30 | Anan withdrew Baht 6,000 cash for personal use and used taxi service of his own business to send his youngest daughter to school during September Baht 2,000.  **Cash -6,000 Capital -6,000** **Capital -2,000 Capital+2,000** |
| Sept 30 | Paid Baht 50,000 cash to Toyota Motor Company for settling a partial of Notes Payable for Baht 40,000 and interest expense for September Baht 10,000.  **Cash- 50,000 N/P-40,000 Capital-10,000** |

These transactions affect the accounting equation as shown below.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Assets** | | | | | **=** | **Liabilities + Owner's Equity** | | | | | | |
|  | **Cash** | **+** | **Accounts Receivable** | **+** | **Taxi/**  Automobile | **=** | **Accounts Payable** | **+** | **Notes Payable** | **+** | **Anan, Capital** |  | **(Remarks)** |
| Sep 1 | +500,000 |  |  |  | +1,000,000 | = |  |  |  |  | +1,500,000 |  |  |
| Sep 1 | -300,000 |  |  |  | +3,000,000 | = |  |  | +2,700,000 |  |  |  |  |
| Sep 1 | -10,000 |  |  |  |  | = |  |  |  |  | -10,000 |  | Rent Expense |
| Sep 2 |  |  |  |  |  |  |  |  |  |  |  |  | No Effect |
| Sep 2 |  |  |  |  |  | = |  |  |  |  |  |  | No Effect |
| Sep 3 |  |  |  |  |  | = |  |  |  |  |  |  | No Effect |
| Sep 15 | +180,000 |  |  |  |  | = |  |  |  |  | +180,000 |  | Fares Revenue |
| Sep 20 | -5,000 |  |  |  |  | = |  |  |  |  | -5,000 |  | Repair Expense |
| Sep 25 | -100,000 |  |  |  |  | = |  |  |  |  | -100,000 |  | Salary Expense |
| Sep 29 | -4,500 |  |  |  |  | = |  |  |  |  | -4,500 |  | Utilities Expense |
| Sep 30 | +220,000 |  |  |  |  | = |  |  |  |  | +220,000 |  | Fares Revenue |
| Sep 30 |  |  | +4,000 |  |  | = |  |  |  |  | +4,000 |  | Fares Revenue |
| Sep 30 |  |  |  |  |  | = | +150,000 |  |  |  | -150,000 |  | Gasoline Expense |
| Sep 30 | -6,000 |  |  |  |  | = |  |  |  |  | -8,000  +2,000 |  | Anan Drawing Fares Revenue |
| Sep 30 | -50,000 |  |  |  |  | = |  |  | -40,000 |  | -10,000 |  | Interest Expense |
| Balance | 424,500 |  | 4,000 |  | 4,000,000 | = | 150,000 |  | 2,660,000 |  | 1,618,500 |  | |
|  | **Total Assets 4,428,500** | | | | | = | **Total Equities 4,428,500** | | | | | | |

Note that for each date in the above example, the sum of entries under the "Assets" heading is equal to the sum of entries under the "Liabilities + Owner's Equity" heading. In most of these cases, the transaction affected both sides of the accounting equation. However, note that the September 2 and 3 agreements have no affect to accounting equation. September 2 the firm hired 10 chauffeurs to driver 10 taxis, the service still are not given to the firm and cash is not paid to anyone and on September 3 agreed with gasoline station‘s owner to buy gasoline on account, the gasoline is not received and any liability is not incurred, therefore they are not transactions, they are only agreements.

The operations for the first month ended on September 30,20x8 are summarized all the revenue and operating expenses which are presented on Income Statement as follows:

##### Anan Taxi Income Statement

**For the month ended September 30, 20XX**

in Baht

##### Revenue

Fares Revenue 406,000

##### Operating Expenses

|  |  |  |
| --- | --- | --- |
| Salary Expense | 100,000 |  |
| Gasoline Expense | 150,000 |
| Rent Expense | 10,000 |
| Utilities Expense | 4,500 |
| Repair Expense | 5,000 |
| Interest Expense | 10,000 |
| Total Operating Expenses |  | 279,500 |
| **Net Income** |  | 126,500 |

Revenues – Expenses = Net Income /Loss

The changes in Anan‘s equity in the month of September are presented on the Capital Statement or Statement of Change in Owner‘s Equity as follows:

##### Anan Taxi

**Capital Statement/ Statement of Change in Owner’s Equity For the month ended September 30, 20XX**

|  |  |  |
| --- | --- | --- |
|  | | in Baht |
| Anan Capital, September 1, 20XX |  | 0 |
| **Add:** Additional Investment | 1,500,000 |  |
| Net Income | 126,500 | 1,626,500 |
| **Sub Total** |  | **1,626,500** |
| **Less:** Anan Drawing |  | 8,000 |
| Anan Capital, September 30, 20XX |  | **1,618,500** |

At the end of September, the net income (revenues minus expenses) is closed to capital and the balance sheet for the business would appear as follows:

**ACCOUNT FORM BALANCE SHEET:**

Anan Taxi

Statement of Financial Position

September 30, 20XX

in Baht

|  |  |  |
| --- | --- | --- |
| **Assets** |  | **Liabilities & Owner's Equity** |

|  |  |  |  |
| --- | --- | --- | --- |
| Cash | 424,500 | Accounts Payable | 150,000 |
| Accounts Receivable | 4,000 | Notes Payable | 2,660,000 |
| Automobile | 4,000,000 | Total Liabilities | 2,810,000 |
|  |  | Anan, Capital | 1,618,500 |

Total Assets **4,428,500** Total Liabilities& Owners‘Equity **4,428,500**

**Report form is shown below: FOR EXAM( ON A SPECIFIC DATE)**

Anan Taxi

Statement of Financial Position

September 30, 20XX

ASSETS

**Current Assets:**

Cash 424,500

Accounts Receivable 4,000

Total Current Assets 428,500

**Non-Current Assets:**

Automobile 4,000,000

Total Assets $4,428,500

LIABILITIES AND OWNERS’ EQUITY

**Liabilities:**

Accounts Payable 150,000

Notes Payable 2,660,000

Total Liabilities 2,810,000

**Owners’ Equity:**

Anan, Capital 1,618,500

Total Liabilities and Owners’ Equity $4,428,500

##### Anan Taxi Statement of Cash Flows

**For the month ended September 30, 20XX**

in Baht

##### Cash Flows from operating activities

|  |  |  |
| --- | --- | --- |
| Cash received from passenger/customers | 400,000 |  |
| Cash paid for salary, rent, repair, utility expenses |  |  |
| (100,000+10,000+5,000+4,500) | (119,500) |  |
| Cash paid for interest expense | ( 10,000) |  |
| **Net cash provided by operating activities** |  | **270,500** |

**Cash Flows from investing activities**

Purchased taxi (300,000)

##### Net cash used by investing activities (300,000) Cash Flows from financing activities

|  |  |  |
| --- | --- | --- |
| Investment by owner | 500,000 |  |
| Withdrawal by owner | (6,000) |
| Repayment of Mortgage Notes Payable | (40,000) |
| **Net cash provided by financial activities** |  | **454,000** |
| **Net increase in cash** |  | **424,500** |
| **Cash Balance, September 1, 20XX** |  | **0** |
| **Cash Balance, September 30, 20XX** |  | **424,500** |

**Question, Exercises and Problems**

Answer the following questions.

Q2-1 What is GAAP?

Q2-2 What is business transaction? Q2-3 What is accounting equation? Q2-4 What is the meaning of assets?

Q2-5 What is the meaning of liabilities?

**Exercise 2-1** Multiple Choice. For each of the following questions, circle the best response.

|  |  |  |
| --- | --- | --- |
| 1. | Which of the following is not a correct expression of the accounting equation? | |
|  | a. | Assets – Liabilities = Owners‘ equity |
|  | b. | Net assets = Liabilities + Owners‘ equity |
|  | c. | Assets = Liabilities + Owners‘ equity |
|  | d. | Net assets = Owners‘ equity |
| 2. | Partnerships, as contrasted with corporations, can be characterized as being  relatively. | |
|  | a. | Easier to form, less risky to be an owner of , and easier to raise large amounts  of capital for. |
|  | b. | Easier to form, more risky to be an owner of, and harder to raise large amounts  of capital for. |
|  | c. | Harder to form, less risky to be an owner of, and easier to raise large amounts  of capital for. |
|  | d. | None of the above is accurate. |
| 3. | Which of the following accounts is *not* an asset? | |
|  | a. | Cash. |
|  | b. | Inventory |
|  | c. | Accounts Payable. |
|  | d. | Equipment |
| 4. | Which of the following financial statement descriptions is inaccurate? | |
|  | a. | Balance Sheet-shows the organization‘s financial position for a period of  time. |
|  | b. | Income Statement-shows what the organization‘s earnings were for a  period time. |
|  | c. | Statement of Cash Flows-shows what the organization‘s receipts and  disbursements were for a period of time. |
|  | d. | Statement of Owners‘ Equity-shows the investments by and distributions to  owners for a period of time. |
| 5. | If total assets were $21,000 and total liabilities were $12,000 at the beginning of the  year, and if net income for the year was $5,000, what is total owners‘ equity at the end of the year? | |
|  | a. | $4,000 |
|  | b. | $5,000 |
|  | c. | $9,000 |
|  | d. | $14,000 ( 21,000 -12,000 = 9,000 +5,000 = 14,000) |
| 6. | At the beginning of the year, owners‘ equity totaled $119,000. During the year, net  income was $35,000 and dividends of $29,000 were declared and paid. Owners‘ equity at the end of the year was | |
|  | a. | $113,000. |
|  | b. | $125,000 (119,000 +35,000 – 29,000) |
|  | c. | $148,000 |
|  | d. | $154,000 |

|  |  |  |
| --- | --- | --- |
| 7. | The principle stating that all expenses incurred while earning revenues should be  identified with the revenues when they are earned and reported for the same time period is the | |
|  | a. | Cost principle |
|  | b. | Timing principle |
|  | c. | Revenue principle |
|  | d. | Matching principle. |
| 8. | Which of these is *not* a limitation of financial statements? | |
|  | a. | Qualitative data are not reflected in financial statements. |
|  | b. | Market values of assets are not generally reported. |
|  | c. | Estimates are commonly used and are sometimes inaccurate. |
|  | d. | It may be difficult to compare firms in the same industry because they often  use different accounting methods. |

**Exercise 2-2** Determining Financial Statement Effects of Several Transactions

For each of the following transactions of Betty Co. for the month of January 20X1, indicate the accounts, amounts, and direction of the effects on the accounting equation. A sample is provided

1. (Example) Borrowed $20,000 from a local bank
2. Loaned $500 to an employee who signed a note.
3. Received investment of $24,000 cash by organizers and distributed stock of them.
4. Purchased $ 15,000 of equipment, paying $ 6,000 cash and the rest on account or on credit due in one month.
5. Declared and paid $ 200 in dividends to stockholders.
6. Purchased $15,000 of land; paid $4,000 in cash and signed a mortgage note for the balance.
7. Issue Common Stock to new stockholders $ 5,000 for cash.
8. Paid to creditor on account (from transaction d).
9. Collected cash from employee for the amount loaned. (from transaction b)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Assets** | **=** |  |  |  |
| **Liabilities** | **+** | **Owner’s Equity** |
| a. Example | Cash + 20,000 |  |  |  |  |
| Note Payable +20,000 |  |  |
| b |  |  |  |  |  |
|  |  |  |
| c |  |  |  |  |  |
|  |  |  |
| d |  |  |  |  |  |
|  |  |  |
| e |  |  |  |  |  |
|  |  |  |
| f. |  |  |  |  |  |
|  |  |  |
| g. |  |  |  |  |  |
|  |  |  |
| h. |  |  |  |  |  |
|  |  |  |
| i. |  |  |  |  |  |
|  |  |  |

**Exercise 2-3** Matching Definitions of Accounting Assumption, Principle, and Constraint with Terms

Listed below are several terms and phrases associated with basic assumptions, underlying principles, and constraints. Pair each items from List A (by letter) with the items from List B that is most appropriately associated with it.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **List A** |  | **List B** |
| 1. | Matching principle (d) | a. | The enterprise is separate from its  owners and other entities. |
| 2. | Periodicity (g) | b. | A common denominator is the dollar. |
| 3. | Historical cost principle (e) | c. | The entity will continue indefinitely. |
| 4. | Materiality (i) | d. | Record expenses in the period the related  revenue is recognized. |
| 5. | Revenue recognition  Principle (h) | e. | Information is based on actual original  costs incurred in transactions. |
| 6. | Going concern assumption© | f. | All information that could affect decision  should be reported |
| 7. | Monetary unit assumption(b) | g. | The life of an enterprise can be divided  into artificial time periods. |
| 8. | Economic entity assumption(a) | h. | Revenue is recorded only when the  earnings process is complete. |
| 9. | Full-disclosure principle (f) | i. | Concerns the relative size of an item and  its effect on decisions. |
| 10. | General accounting principle(j) | J | Derived from long-used and generally  accepted accounting practices. |

**Exercise 2-4**. Matching Definitions with Terms and Concepts

**Matching** Following is a list of the key terms and concepts introduced in the chapter, along with a list of corresponding definitions. Match the appropriate letter for the key term or concepts to each definition provided (items 1-10). Note that not all key terms and concepts will be used.

|  |  |  |  |
| --- | --- | --- | --- |
| **Item** | **Terms and Concepts** | **Item** | **Terms and Concepts** |
| **A** | Accounting | **N** | Cash flows |
| **B** | Entity | **O** | Controller |
| **C** | Financial accounting | **P** | Independence |
| D | Bookkeeping | **Q** | Generally accepted accounting principles |
| **E** | Certified Public Accountant | **R** | Internal auditing |
| **F** | Managerial accounting | **S** | Securities and Exchange Commission |
| **G** | Cost accounting | **T** | Financial Accounting Foundation |
| **H** | Certified Management Accountant | **U** | Financial Accounting Standards board |
| **I** | Auditing | **V** | Statements of Financial accounting Standards |
| **J** | Public accounting | **W** | Cost Accounting Standards Board |
| **K** | Certified Internal Auditing | **X** | Government Accounting Standards |
| **L** | Generally accepted auditing | **Y** | Accrual accounting |
| **M** | Integrity | **Z** | Objectivity |

|  |  |
| --- | --- |
| Answer | Definitions. |
| 1. | The process of identifying, measuring, and communicating economic information  about an organization for the purpose of making decisions or informed judgments |
| 2. | Accounting that recognizes revenues and expenses as they occur, even though cash  receipts from revenues and cash disbursements related to expenses may occur before or after the event that revenue or expense recognition. |
| 3. | The process of examining the financial statements of an entity by an independent  third party with the objective of expressing an opinion about the fairness of the presentation of the entity‘s financial position, results of operations, changes in financial position, and cash flows. |
| 4. | Procedures that are used to keep track of an entity‘s financial transactions and to  accumulate the results of its operations. |
| 5. | Pronouncements of the Financial Accounting Standards Board (FASB) that  constitute generally accepted accounting principles. |
| 6. | Accounting that is concerned with the use of economic and financial information to  plan and control the activities of an entity and to support the management decision- making process. |
| 7. | An organization, individual, or group of organizations or individuals for which  accounting services are performed. |
| 8. | A unit of the federal government that is responsible for establishing regulations and  ensuring that full disclosure is made to investors about large companies and their securities traded in interstate commerce. |
| 9. | Pronouncements of the Financial Accounting Statement Board and its predecessors  that constitute appropriate accounting for various business transactions (principles used for reporting financial position and results of operations to investors and creditors). |
| 10. | The personal characteristics of honesty, including being forthright in dealings and  communications with others. |

##### Exercise 2-5

Diamond Consulting began a professional practice on June 1 and plans to prepare financial statements at the end of each month. During June the first month of operation, Diamond ( owner) completed these transactions:

* 1. Owner invested $70,000 cash in the business firm along with equipment that had a

$20,000 market value.

* 1. The company paid $2,000 cash for rent of office space for the month.
  2. The business firm purchased $25,000 of additional equipment on credit (payment due within 30 days).
  3. The business firm completed work for a client and immediately collected the $3,000 cash earned.
  4. The business firm completed work for a client and sent a bill for $9,500 to be received within 30 days.
  5. The business firm purchased additional equipment for $5,000 cash.
  6. The business firm paid an assistant $3,500 cash as wages for the month.
  7. The business firm collected $6,500 cash as a partial payment for the amount owed by the client in transaction e.
  8. The business firm paid $25,000 cash to settle the liability created in transaction c.
  9. Owner withdrew $1,500 cash from the business firm for personal use.

Required

Create a table in accounting equation form, using the following headings for columns: Cash; Accounts Receivable; Equipment; Accounts Payable; R. Diamond, Capital; R. Diamond, Withdrawals; Revenues; and Expenses. Then use additions and subtractions to show the effects of the transactions on individual items of the accounting equation. Show new balances after each transaction.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Cash** | **Accounts**  **+ Receivable +** | | | **Equip-**  **ment** | **Accounts** | | | **R. Diamond,**  **Capital** | **R. Diamond,** | | | | | |
| **a** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **b** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Bal** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **c** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Bal** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **d** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Bal** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **e** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Bal** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **f** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Bal** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **g** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Bal** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **h** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Bal** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **i** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Bal** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **j** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **Bal** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

##### Problem 2-1

**Transaction analysis.** Kanikar Monruedee and family own and operate Monruedee‘s Furniture Emporium, Inc. The balance sheet totals for assets, liabilities, and owners‘ equity at August 1, 20X9, are as indicated. Described here are several transactions entered into by the company throughout the month of August.

##### Required

1. Indicate the amount and effect (+or-) of each transaction on total assets, total liabilities and owners‘ equity, and then compute the new totals for each category.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Transactions** | **Assets** | **= Liabilities** | **+Owners’ Equity** |
| August 1,  20X9 | Beginning Balance | $700,000 | $550,000 | $150,000 |
| August 3 | borrowed $24,000 in cash from the  bank | +24,000 | +24,000 |  |
|  | New Balance | $724,000 | $574,000 | $150,000 |
| August 7 | bought merchandise inventory  valued at $38,000 on account |  |  |  |
|  | New Balance |  |  |  |
| August10 | paid $14,000 cash for operating  expenses |  |  |  |
|  | New Balance |  |  |  |
| August14 | received $100,000 in cash from  sales of merchandise that had cost  $66,000 |  |  |  |
|  | New Balance |  |  |  |
| August17 | paid $28,000 owed on account  payable |  |  |  |
|  | New Balance |  |  |  |
| August21 | collected $34,000 of account  receivable |  |  |  |
|  | New Balance |  |  |  |
| August24 | repaid $20,000 to the bank plus  $400 interest |  |  |  |
|  | New Balance |  |  |  |
| August29 | paid cash dividend of $10,000 |  |  |  |
| August31 | New Balance |  |  |  |

1. What was the amount of net income (or loss) during August? How much were total revenues and total expenses during August?

|  |
| --- |
|  |
|  |
|  |
|  |
|  |
|  |

1. What were the net changes during the month of August in total assets, total liabilities, and total owners‘ equity?

|  |
| --- |
|  |
|  |
|  |

|  |
| --- |
|  |
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1. Explain to Monruedee which transactions caused the net change in owners‘ equity during August.

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1. Explain why dividend payments are not an expense, but interest is an expense

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##### Problem 2-2

Mario Joe decides to open a laundry and dry- cleaning service near the university campus that will be named ***“MJ Laundry & Dry- cleaning Services*”.**

Transactions:

* 1. Mario Joe invests $20,000 cash to start a laundry and dry-cleaning business on July 1, 2009.
  2. Hired two employees with starting salaries of $500 each.
  3. Purchased laundry equipment for $8,000, paying $5,000 in cash and signed a 90 day note for remainder.
  4. Purchased laundry supplies for $1,600 cash.
  5. Received a bill from AU Press for $300 for advertising in the campus newspaper.
  6. Cash receipts from customers for laundry and dry -cleaning services amounted to $4,000.
  7. Paid salaries of $1,000 to employees.
  8. Billed the AU Varsity Football Team $2,500 for laundry and dry- cleaning services.
  9. Paid $300 to AU Press for advertising that was previously billed in Transaction 5.
  10. Mario Joe withdrew $900 for personal use.
  11. Incurred utility expenses for the month on account, $500.

###### Instructions:

* + 1. Analyze the following transactions for the month of July in terms of their effect on the

basic accounting equation. Record each transaction by increasing (+) or decreasing (–) the dollar amount of each item affected. Identify the cause of changes in Capital account.

* + 1. From the results of the analysis, prepare the Income Statement of MJ Laundry & Dry cleaning Services for the month ended July 31, 2009, and
    2. Balance Sheet at July 31, 2009.

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| **Trans- actions** | **ASSETS** | | | **= LIABILITIES** | | | **+ OWNERS’EQUITIES** | | |
| Cash | Accounts  Receivable | Supplies | Equipment | Notes  Payable | Accounts  Payable | | Mario Joe,  Capital | Accounts affecting  Capital |
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| **Balance**  **JULY31** |  |  |  |  |  |  | |  |  |

##### Income Statement

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**Balance Sheet/ Statement of Financial Position**

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**Problem 2-3**

―Apisith Consulting Service‖, a sole proprietorship, had the following transactions during the month of November, 2020

* + - 1. Mr. Apisith, the owner of the business, withdrew $120,000 from his personal account and deposited $ 100,000 under the name of ―Apisith Consulting Service.
      2. Purchased office equipment $ 15,000, paid cash $ 5,000 and signed a 45-day promissory note for the balance.
      3. Purchased office supplies on account $ 1,000.
      4. Sent a bill to a customer for $ 8,000.
      5. Paid $ 500 for the purchase made on **c**.
      6. Purchased and paid a 1-year insurance policy $ 2,400.
      7. Consulting Fees earned on this date totaled $ 12,000, received cash $ 2,000 and the remaining balance is on account.
      8. Received a check of $ 5,000 from the customer as a partial payment in transaction d.
         1. Mr. Apisith took office supplies $ 200 from the business for family use.

1. Received a bill $ 400 for delivery expense for the month (will be paid within 10 days)
2. Paid the following expenses for the month:

|  |  |
| --- | --- |
| Office salary | $ 1,500 |
| Water and electricity | $ 1,000 |
| Rent | $ 1,200 |

##### REQUIRED :

1. Analyze the above transactions into the accounting equation form given below.

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **ASSETS** | | |  |  | **= LIABILITY + CAPITAL** | | | |
|  | Cash | Acts  Receiv. | Supplies | Prepaid  Insurance | Equip. | Accounts  Payable | Notes  Payable | Apisith,  Capital | REMARKS |
| a. |  |  |  |  |  |  |  |  |  |
| b. |  |  |  |  |  |  |  |  |  |
| c. |  |  |  |  |  |  |  |  |  |
| d. |  |  |  |  |  |  |  |  |  |
| e. |  |  |  |  |  |  |  |  |  |
| f. |  |  |  |  |  |  |  |  |  |
| g. |  |  |  |  |  |  |  |  |  |
| h. |  |  |  |  |  |  |  |  |  |
| i. |  |  |  |  |  |  |  |  |  |
| j. |  |  |  |  |  |  |  |  |  |
| k |  |  |  |  |  |  |  |  |  |
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| Nov 30  Bal. |  |  |  |  |  |  |  |  |  |

1. From the end result of the tabular; prepare Income Statement and Balance Sheet in the proper from.

##### Apisith Consulting Service.

**Income Statement**

**For the Month ended November, 20X6**

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**Apisith Consulting Service**

**Balance Sheet**

**As of November, 20X6**

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**Problem 2-4**

P.S. FRESHY operates a sole proprietorship known as Freshy Dry Cleaners. The actual work of dry cleaning is done by other company at wholesale rates. The assets and the liabilities of his business on May 1 of the current year are as follows: Cash $ 1,800 ; Accounts Receivable $ 550 ; Supplies $ 110 ; Equipment $ 4,300 ; Accounts Payable $ 1,020. Business transactions during the month of May are summarized below:

1. Paid rent for the month $240.
2. Purchased supplies on account $65.
3. Received cash from cash customers for dry cleaning sale $ 2,500
4. Paid creditors on account $ 920.
5. Charged customers for dry cleaning sales on account $ 820.
6. Received monthly invoice for dry cleaning expense for the month of May (to be paid on June 10) $ 1,320.
7. Paid the following: Wages Expense, $330, Truck Expense $ 85 : Utilities Expense $ 50 and Miscellaneous expense $ 80.
8. Purchased an item of Equipment on account $ 180.
9. Received cash from customers on account $ 780.
10. Paid personal expenses by checks drawn on the business $ 340 and withdrew $ 100 in cash for personal use.

##### REQUIRED :

1. Analyzed the above transactions into the accounting equation form given below.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **ASSETS = LIABILITY + CAPITAL** | | | | | | |
|  | Cash | Accts  Receivable | Supplies | Equipment | Accounts  Payable | FRESHY  Capital | REMARKS |
| May 1  Bal. |  |  |  |  |  |  |  |
| a. |  |  |  |  |  |  |  |
| b. |  |  |  |  |  |  |  |
| c. |  |  |  |  |  |  |  |
| d. |  |  |  |  |  |  |  |
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| h. |  |  |  |  |  |  |  |
| i. |  |  |  |  |  |  |  |
| j. |  |  |  |  |  |  |  |
| May31  Bal. |  |  |  |  |  |  |  |

1. From the result of the tabular; prepare Income Statement and Balance Sheet in the proper from.

##### Freshy Dry Cleaners.

**Income Statement**

**For the Month ended May31, 2020**

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**Freshy Dry Cleaners.**

**Balance Sheet/ Statement of Financial Position As of May31, 2020**

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**Problem 2-5**

Golden George started The George Cleaning Service, a new business that began operations on May 1. The George Cleaning Service completed the following transactions during its first month of operations.

May 1 G. George invested $43,000 cash in the company

1 The service firm rented a furnished office and paid $2,200 cash for May‘s rent.

3 The service firm purchased $1,940 of office equipment on credit.

5 The service firm paid $750 cash for this month‘s cleaning services.

8 The service firm provided consulting services for a client and immediately collected $5,800 cash.

12 The service firm provided $2,800 of consulting services for client on credit.

15 The service firm paid $850 cash for an assistant‘s salary for the first half of this month.

20 The service firm received $2,800 cash payment for the services provided on May

12.

22.

22 The service firm provided $4,000 of consulting services on credit.

1. The service firm received $4,000 cash payment for the services provided on May
2. The service firm paid $1,940 cash for the office equipment purchased on May 3.
3. The service firm purchased $85 of advertising in this month‘s (May) local paper on credit; cash payment is due June 1.
4. The service firm paid $850 cash for an assistant‘s salary for the second half of this month.

30 The service firm paid $400 cash for this month‘s telephone bill.

1. The service firm paid $260 cash for this month‘s utilities.
2. G. George withdrew $2,000 cash from the company for personal use.

##### Required

* 1. Arrange the following asset, liability, and equity titles in a table like Exhibit 1.9: Cash,

Accounts Receivable; Office Equipment; Accounts Payable; G. George, Capital; G. George, Withdrawals; Revenues; and Expenses.

* 1. Show effects of the transactions on the accounts of the accounting equation by recording increases and decreases in the appropriate columns. Do not determine new account balances after each transaction. Determine the final total for each account and verify that the equation is in balance.
  2. Prepare an income statement for May, a statement of owner‘s equity for May, a May 31 balance sheet, and a statement of cash flows for May.

##### Problem 2-1

Diamond Consulting began a professional practice on June 1 and plans to prepare financial statements at the end of each month. During June the first month of operation, Diamond (owner) completed these transactions:

1. Owner invested $70,000 cash in the business firm along with equipment that had a

$20,000 market value.

1. The company paid $2,000 cash for rent of office space for the month.
2. The business firm purchased $25,000 of additional equipment on credit (payment due within 30 days).
3. The business firm completed work for a client and immediately collected the $3,000 cash earned.

E The business firm completed work for a client and sent a bill for $9,500 to be received within 30 days.

F The business firm purchased additional equipment for $5,000 cash.

G The business firm paid an assistant $3,500 cash as wages for the month.

H The business firm collected $6,500 cash as a partial payment for the amount owed by the client in transaction e.

1. The business firm paid $25,000 cash to settle the liability created in transaction c.
2. Owner withdrew $1,500 cash from the business firm for personal use.

Required

Create a table in accounting equation form, using the following headings for columns: Cash; Accounts Receivable; Equipment; Accounts Payable; R. Diamond, Capital; R. Diamond, Withdrawals; Revenues; and Expenses. Then use additions and subtractions to show the effects of the transactions on individual items of the accounting equation. Show new balances after each transaction.

# Chapter 3 UNDERSTANDING FINANCIAL STATEMENTS

**Topic:** Understanding Financial Statements

**Concept:** To introduce students the preparation and presentation of financial statements

##### Objectives

1. Students will be introduced to the financial statements for each type of Business Organization formats and business operation

Income statement

Balance Sheet/ Statement of Financial Position Statement of change in owners‘ equity Statement of cash flows

1. Students will the learn about the formats and elements for each financial statements.

**3** [**Financial statements**](http://www.quickmba.com/accounting/fin/statements/)

Businesses entities report information in the form of financial statements issued on a periodic basis. International Accounting Standard (IAS) No1 and Thai Accounting Standard (TAS) no 35 require the following the four [financial statements](http://www.quickmba.com/accounting/fin/statements/) and notes to financial statements:

* Income Statement - revenues minus expenses for a given time period ending at a specified date.
* Statement of Change in Owner's Equity- investment by owner, distribution to owner and income or less from operation.
* Balance Sheet - Statement of Financial Position at a given point in time.
* Statement of Cash Flows - summarizes sources and uses of cash; indicates whether enough cash is available to carry on routine operations.
* Notes to the Financial Statements- additional information provided in a company's financial statements. It reports the details and additional information that are left out of the main reporting documents, such as the balance sheet and income statement. This is done mainly for the sake of clarity because these notes can be quite long, and if they were included, they would cloud the data reported in the financial statements.

The four elements that are always to be displayed in the heading of the statements.

1. The entity name whose financial statement is being presented
2. The title of the statement
3. The date of the statement or the period of time which the statement is being presented
4. Monetary unit of measurement

**3.1 Income statement or Profit and Loss statement.** The income statement presents the results of the entity's operations during a period of time, such as one year. The simplest equation to describe income is:

Net Income or Net Loss = Revenue - Expenses

It lists revenues and expenses and calculates the company's net income or net loss for a period of time. **Net income** means total revenues are greater than total expenses. **Net loss** means total expenses are greater than total revenues.

An [**income statement**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-I.html#income%20statement) covers a period of time (or time interval), such as a year, quarter, month, or four weeks. It is imperative to indicate the period of time in the heading of the income statement such as "For the Nine Months Ended September 30, 2020". (This means for the period of January 1 through September 30, 2020.) If prepared under the [**accrual basis of accounting**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-A.html#accrual%20basis%20of%20accounting), an income statement will show how profitable a company was during the stated time interval.

##### Structure

**Heading identifies four significant items related to** Income Statement**:**

1. **Name of the entity,** Mary's Design Service
2. **Title of the statement,** Income Statement
3. **Accounting period of the statement,** For the Nine Months Ending September 30, 2020
4. **Unit of measure** (in thousand of dollars)

##### Mary's Design Service Income Statement

**For Nine Months Ending September 30, 2020**

(in thousand of dollars)

|  |  |  |  |
| --- | --- | --- | --- |
| **Revenues and Gains** | | |  |
|  | [Revenues](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-R.html#revenues) | $ 10,000 |  |
|  | [Gain on Sale of Land](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-G.html#gain%20on%20sale%20of%20land) | 5,000 |  |
|  | Total Revenues and Gains | | $ **15,000** |
| **Expenses and Losses** | | |  |
|  | Operating Expenses | 8,000 |  |
|  | [Loss on Sale of Computer](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-L.html#loss%20on%20sale%20of%20computer) | 350 |  |
|  | Total Expenses and Losses | | **8,350** |
| **Net Income** | | | **$ 6,650** |

**Revenues** are the fees that were earned during the period of time shown in the heading. Recognizing revenues when they are earned instead of when the cash is actually received follows the [revenue recognition principle](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-R.html#revenue%20recognition%20principle) and the [matching principle](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-M.html#matching%20principle). (The matching principle is what steers accountants toward using the accrual basis of accounting rather than the cash basis. Small business owners should discuss these two methods with their tax advisors.)

**Gains** are a net amount related to transactions that are not considered part of the company's main operations. For example, Mary's Design Service is in the business of designing, not in the land development business. If the company should sell some land for $30,000 (land that is shown in the company's accounting records at $25,000) Mary's Design Service will report a [Gain on Sale of Land](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-G.html#gain%20on%20sale%20of%20land) of $5,000. The $30,000 selling price will *not* be reported as part of the company's revenues.

**Expenses** are costs used up by the company in performing its main operations. The matching principle requires that expenses be reported on the income statement when the related sales are made or when the costs are used up (rather than in the period when they are paid).

**Losses** are a net amount related to transactions that are not considered part of the company's main operating activities. For example, let's say a retail clothing company owns an old computer that is carried on its accounting records at $650. If the company sells that computer for

$300, the company *receives* an asset (cash of $300) but it must also remove $650 of asset amounts from its accounting records. The result is a [Loss on Sale of Computer](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-L.html#loss%20on%20sale%20of%20computer) of $350. The $300 selling price will *not* be included in the company's sales or revenues

Major components of the income statement. IAS 1 stipulates that, at the minimum the income statement must include line items that present the following items (if they are pertinent to the entity‘s operations for the period in question):

* 1. Revenue
  2. Finance costs
  3. Share of profits and losses of associates and joint ventures accounted for by the equity method
  4. Tax expense
  5. Discontinued operations
  6. Profit or loss
  7. Minority interest
  8. Net profit attributable to equity holders in the parent

Business entities typically show their regular trading operations first and the present any items to which they wish to direct users‘ attention.

1. Sales or other operating revenues are charges to customer for the goods and/or services provided to them during the period. This section of the income statement should include information about discounts, allowances, and returns, to determine net sales or net revenues.
2. Cost of goods sold is the cost of the inventory items sold during the period. Cost of goods sold insures only in the case of a merchandising firm and manufacturing firm, not for service firm.
3. Operating expenses are primary recurring costs associated with central operations, other than cost of goods sold, which are incurred to generate sales. Operating expenses are normally classified into the following two categories:

Distribution costs (or selling expenses) General and administrative expenses

Distribution costs are those expenses related directly to the company‘s effort to generate sales (e.g., sales salaries, commissions, advertising, delivery expenses, depreciation of store furniture and equipment, and store supplies). General and administrative expenses are expenses related to the general administration of the company‘s operations (e.g.‘ officers and office salaries, office supplies, depreciation of office furniture and fixtures, telephone, postage, accounting and legal services, and business licenses and fees).

1. Other revenues and expenses are incidental revenues and expenses not related to the central operations of the company (e.g., rental income from letting parts of premises not needed for company operations).
2. Separate disclosure items are items that are of such size, nature, or incidence that their disclosure becomes important in order to explain the performance of the enterprise for the period. Examples of items that , if material, would require such disclosure are as follows:
   1. Write-down of inventories to net realizable value, or of property, plant, and equipment to recoverable amounts, and subsequent reversals of such write-downs
   2. Costs of restructuring the activities of an enterprise and any subsequent reversals of such provisions.
   3. Costs of litigation settlements
   4. Other reversals of provisions.
3. Income tax expense. The total of taxes payable and deferred taxation adjustments for the period covered by the income statement.

### Statement of owner's equity / Statement of change in owner’s equity/ or Capital statement.

The statement of owner's equity is prepared after the income statement. It shows the beginning and ending owner's equity balances and the items affecting owner's equity during the period. These items include investments, the net income or loss from the income statement, and withdrawals. Because the specific revenue and expense categories that determine net income or loss appear on the income statement, the statement of owner's equity shows only the total net income or loss. Balances enclosed by parentheses are subtracted from unenclosed balances.

##### Structure

Equity**:**

**Heading identifies four significant items related to** Statement of Change in Owner's

1. **Name of the entity,** Mary's Design Service
2. **Title of the statement,** Statement of Change in Owner's Equity /Retained Earning Statement
3. **Accounting period of the statement,** For the Nine Months Ending September 30, 2020
4. **Unit of measure** (in thousand of dollars)

EXAMPLE

**Statement of Owners' Equity** (Statement of Retained Earnings)

Statement of Owners' Equity or Statement of Change in Owners' Equity explains the change in owners‘ equity or capital during the accounting period. If the business organization formats are sole proprietorship and partnership, capital of each owner will increase from additional investment and sharing income and it will decrease from personal drawing and sharing loss. If the business organization format is corporation, the equity statement explains the changes

in retained earnings, it will increase from net income and will decrease from net loss and dividend. Retained earnings appear on the balance sheet as a part of Stockholders‘ Equity. The Statement of Retained Earnings therefore uses information from the Income Statement and provides information to the Balance Sheet.

The following equation describes the equity statement for a sole proprietorship: Ending Equity = Beginning Equity + Investments + Net Income (-Loss)- Withdrawals

For a corporation, substitute "Dividends Paid" for "Withdrawals".

Ending Retained Earning = Beginning R/E + Net Income (-Net Loss) - Dividend

##### Mary's Design Service Statement of Owners' Equity

**For Nine Months Ending September 30, 2020**

(in thousand of dollars)

|  |  |  |
| --- | --- | --- |
| [Mary Smith Capital](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-M.html#mary%20smith%2C%20capital), January1, 2020 |  | 2,600 |
| Add: Additional Investment | 1,000 | |
| Net Income | 6,650 | 7,650 |
| Sub Total |  | 10,250 |
| Less: Mary Smith, Drawing |  | (200) |
| [Mary Smith Capital](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-M.html#mary%20smith%2C%20capital), September 30, 2020 |  | 10,050 |

* 1. **Balance sheet / or Statement of Financial Position:**

The balance sheet reports the resources and the rights to claims to the resources of the entity. It is useful when evaluating the financial position of the business entities at specific date. The balance sheet shows the balance, at a particular time, o f each asset, each liability, and owner's equity. It proves that the **accounting equation** (Assets = Liabilities + Owner's Equity) is in balance. The ending balance on the statement of owner's equity is used to report owner's equity on the balance sheet.

Because of th[e economic entity assumption](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-E.html#economic%20entity%20assumption), only the assets, liabilities, and owner's equity specifically identified with Mary's Design Service are shown—the personal assets of the owner, Mary Smith, are not included on the company's balance sheet.

##### Structure

**Heading identifies four significant items related to Balance Sheet:**

1. **Name of the entity,** Mary's Design Service
2. **Title of the statement,** Balance Sheet
3. **Specific date of the statement,** At September 30, 2020
4. **Unit of measure** (in thousand of dollars)

##### Mary's Design Service

**Balance Sheet / Statement of Financial Position At September 30, 2020**

(in thousand of dollars)

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Assets** |  | | | **Liabilities** |  | | |
| [Cash](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-C.html#cash) | $ 300 | | | [Notes Payable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-N.html#notes%20payable) | $ 1,000 | | |
| [Accounts Receivable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-A.html#accounts%20receivable) | 1,000 | | | [Accounts Payable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-A.html#accounts%20payable) | 325 | | |
| [Supplies](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-S.html#supplies) | 160 | | | [Wages Payable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-W.html#wages%20payable) | 75 | | |
| [Prepaid Insurance](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-P.html#prepaid%20insurance) | 90 | | | [Unearned Revenues](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-U.html#unearned%20revenue) | 100 | | |
| [Land](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-L.html#land) | 10,000 | | | Total Liabilities | 1,500 | | |
|  |  | | | **Owner's Equity** |  | | |
|  |  | | | [Mary Smith , Capital](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-M.html#mary%20smith%2C%20capital) | 10,050 | | |
| Total Assets |  | $11,550 |  | Total Liabilities & Owner's  Equity |  | $11,550 |  |
|  | | |  | | |

The assets listed on the balance sheet have a cost that can be measured and each amount shown is the original cost of each asset. For example, let's assume that a tract of land was purchased in 1996 for $10,000. Mary's Design Service still owns the land, and the land is now appraised a[t $250,000. The cost principle](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-C.html#cost%20principle) requires that the land be shown in the asset account [Land](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-L.html#land) at its original cost of $10,000 rather than at the recently appraised amount of $250,000.

If Mary's Design Service were to purchase a second piece of land, the [monetary unit](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-M.html#monetary%20unit%20assumption) [assumption](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-M.html#monetary%20unit%20assumption) dictates that the purchase price of the land bought today would simply be added to the purchase price of the land bought in 1996, and the sum of the two purchase prices would be reported as the total cost of land.

The [Supplies](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-S.html#supplies) account shows the cost of supplies (if material in amount) that were obtained by Mary's Design Service but have not yet been used. As the supplies are consumed, their cost will be moved to the [Supplies Expense](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-S.html#supplies%20expense) account on the income statement. This complies with the [matching principle](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-M.html#matching%20principle) which requires expenses to be matched either with revenues or with the time period when they are used. The cost of the unused supplies remains on the balance sheet in the asset account Supplies.

The [Prepaid Insurance](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-P.html#prepaid%20insurance) account represents the cost of insurance that has not yet expired. As the insurance expires, the expired cost is moved to [Insurance Expense](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-I.html#insurance%20expense) on the income statement as required by the [matching principle](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-M.html#matching%20principle). The cost of the insurance that has not yet expired remains on Mary's Design Service's balance sheet (is "deferred" to the balance sheet) in the asset account Prepaid Insurance. Deferring insurance expense to the balance sheet is possible because of another basic accounting principle, the [going concern assumption](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-G.html#going%20concern%20assumption).

The [cost principle](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-C.html#cost%20principle) and [monetary unit assumption](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-M.html#monetary%20unit%20assumption) prevent some very valuable assets from ever appearing on a company's balance sheet. For example, companies that sell consumer products with high profile brand names, trade names, trademarks, and logos are not reported on their balance sheets because they were not purchased. Similarly, a company might have an excellent reputation and a very skilled management team, but because these were not purchased for a specific cost and we cannot objectively measure them in dollars, they are not reported as assets on the balance sheet. If a company actually purchases the trademark of another company

for a significant cost, the amount paid for the trademark will be reported as an asset on the balance sheet of the company that bought the trademark.

* + 1. **Assets**—Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

The following three characteristics must be present for an item to qualify as an asset:

* 1. The asset must provide probable future economic benefit that enables it to provide future net cash inflows.
  2. The entity is able to receive the benefit and restrict other entities‘ access to that benefit.
  3. The event that provides the entity with the right to the benefit has occurred.

##### Classification of Assets

Assets can be classed as current assets and non current assets. Current assets include cash, accounts receivable, marketable securities, notes receivable, inventory, and prepaid assets such as prepaid insurance. Non current assets are long life assets which acquired for use in operation and its benefits more than one year. They are Property, Plant, and Equipment or Fixed assets, Long-term investment and Intangible assets.

Assets, liabilities, and stockholders‘ equity are separated in the statement of financial position or Balance Sheet. IAS 1 says that companies should make a distinction between current and non-current assets and liabilities, except when a presentation based on liquidity provides information that is more reliable or relevant.

**Current Assets**. An asset should be classified as a current asset when it satisfies any one of the following:

* + 1. It is expected to be realized in, or is held for sale or consumption in, the normal course of the enterprise‘s operating cycle;
    2. It is held primarily for trading purposes;
    3. It is expected to be realized within twelve months of the statement of financial position date;
    4. It is cash or a cash equivalent asset that is not restricted in its use. Management intention takes priority over liquidity potential

The following items would be classified as current assets:

1. Inventories are assets held, either for sale in the ordinary course of business or in the process of production for such sale, or in the form of materials or supplies to be consumed in the production process or in the rendering of services .
2. Receivables include accounts and notes receivable, receivables from affiliate companies, and officer and employee receivables. The term accounts receivable represents amounts due from customers arising from transactions in the ordinary course of business.
3. Prepaid expenses are assets created by the prepayment of cash or incurrence of a liability.

They expire and become expenses with the passage of time, use, or events (e.g., prepaid rent, prepaid insurance and deferred taxes).

1. Trading investments are those that are acquired principally for the purpose of generating a profit from short-term fluctuations in price or dealer‘s margin
2. Cash and cash equivalents include cash on hand, consisting of coins, currency, and un- deposited checks; money orders and drafts; and deposits in banks. Anything accepted by a bank for deposit would be considered cash.

**Non-current assets**. IAS 1 uses the term ―non-current‖ to include tangible, intangible, operating, and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions, as long as the meaning is clear.

Held-to-maturity investments are financial assets with fixed or determinable payments and fixed maturity that the enterprise has a positive intent and ability to hold to maturity.

Investment property. This denotes property being held to earn rentals, or for capital appreciation, or both, rather than for use in production or supply of goods or services, or for administrative purpose or for sale in the ordinary course of business

Property, plant, and equipment. Tangible assets that are held by an enterprise for use in the production or supply of goods or services, or for rental to others, or for administrative purposes and which are expected to be used during more than one period. Include are such items as land, buildings, machinery and equipment, furniture and fixtures, motor vehicles and equipment.

* + 1. **Liabilities**---Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

The following three characteristics must be present for an item to qualify as a liability:

1. A liability requires that the entity settle a present obligation by the probable future transfer of an asset on demand when a specified event occurs or at a particular date.
2. The obligation cannot be avoided.
3. The event that obligates the entity has occurred.

Liabilities represent the portion of a firm's assets that are owed to creditors.

##### Classification of Liabilities

The liabilities are normally displayed in the statement of financial position in the order of payment due dates.

**Current liabilities / short-term liabilities**. According to IAS 1, a liability should be classified as a current liability when

* 1. It is expected to be settled in the normal course of business within the enterprise‘s operating cycle;
  2. It is due to be settled within twelve months of the date of the statement of financial position;
  3. It is held primarily for the purpose of being traded; or
  4. The entity does not have an unconditional right to defer settlement beyond twelve months.

All other liabilities should be classified as non-current / long-term liabilities. Obligations that are due on demand or are callable at any time by the lender are classified as current regardless of the present intent of the entity for the lender concerning early demand for repayment. Current liabilities also include.

1. Obligations arising from the acquisition of goods and services entering in to the entity‘s normal operating cycle (e.g.‘ accounts payable, short-term notes payable, wages payable, taxes payable, and other miscellaneous payables).
2. Collections of money in advance for the future delivery of goods or performance of services, such as rent received in advance and unearned subscription revenues.
3. Other obligations maturing within the current operating cycle, such as the current maturity of bonds and long-term notes.

**Non-current liabilities**. Obligations that are not expected to be liquidated within the current operating cycle, including

##### Owners’ Equity.

**Owners’ Equity**—the residual interest in the assets that remains after deducting its liabilities. Owners‘ Equity is referred to as owner‘s equity in a sole proprietorship or a partnership, and stockholders‘ equity or shareholders‘ equity in a corporation. The equity owners of a business are residual claimants, having a right to what remains only after the creditors have been paid. For a sole proprietorship or a partnership, the equity would be listed as the owner or owners‘ names followed by the word ―capital‖. For example:

|  |  |
| --- | --- |
| **Type of Business Organization formats** | **Capital Accounts Name** |
| Sole Proprietorship | Mr. John Doe, Capital |
| Partnership | Ms Marry Marr, Capital Mr. Joseph Smith, Capital |
| Corporation | Common Stock /Capital Stock Preferred Stock  Retained Earnings |

##### Shareholders’ Equity

Shareholders‘ equity represents the interest or capital of shareholders. It shows the cumulative net results of past transactions and other events affecting the entity since its inception. There are two classes of stocks; Common stock and Preferred stock that corporation normally issue to stockholders.

Retained Earnings. This represents the accumulated earnings since the inception of the enterprise, less any earnings distributed to owners in the form of dividends.

### Statement of cash flows.

The statement of cash flows tracks the movement of cash during a specific accounting period. It provides the sources of cash, uses of cash and change in cash balance. It assigns all cash exchanges to one of three categories—operating, investing, or financing—to calculate the net change in cash and then reconciles the accounting period's beginning and ending cash balances. The information used to construct the cash flow statement comes from the beginning and ending balance sheets for the period and from the income statement for the period. As its name implies, the statement of cash flows includes items that af fect cash. Although not part of the statement's main body, significant non-cash items must also be disclosed. In the statement of cash flows, cash is defined as cash and cash equivalent: cash is cash on hand and demand deposits with banks or other financial institutions, and cash equivalents is included short-term highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Treasury bills, commercial paper, and money market funds are all examples of cash equivalents.

There are two methods for computing cash flows from operating activity: direct and indirect methods

Direct method. A method that derives the net cash provided by or used in operating activities from major components of operating cash receipts and payments.

Indirect (reconciliation) method. A method that derives the net cash provided by or used in operating activities by adjusting net income (loss) for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing activities.

**Operating activities**. The transactions not classified as financing or investing activities generally involving producing and delivering goods or providing services.

Cash inflows and outflows transactions from operating activities are as follows: Cash inflows - Receipts from sale of goods or services

* + - Sale of loans, debt, or equity instruments carried in trading portfolio
    - Returns on loans (interest)
    - Returns on equity securities (dividends) Cash outflows
    - Payments to suppliers for goods and other services
    - Payments to or on behalf of employees
    - Payments of taxes
    - Payments of interest
    - Purchase of loans, debt, or equity instruments carried in trading portfolio

**Investing activities**. The acquisition and disposal of long-term assets and other investments. Cash inflows and outflows transactions from investing activities are as follows:

Cash inflows

* + - Principal collections from loans and sales of other entities‘ debt instruments
    - Sale of equity instruments of other enterprises and from returns of investment in those instruments
    - Sale of plant and equipments Cash outflows
    - Loans made and acquisition of other entities‘ debt instruments
    - Purchase of equity instruments\* of other enterprises Purchase of plant and equipment

**Financing activities.** The transactions that cause changes in the size and composition of an enterprise‘s capital and borrowings. Cash inflows and outflows transactions from investing activities are as follows:

Cash inflows

* + - Proceeds from issuing share capital
    - Proceeds from issuing debt (short-term or long-term)

Not-for-profits‘ donor-restricted cash that is limited to long-term purposes Cash outflows

* + - Payment of dividends
    - Repurchase of company‘s shares
    - Repayment of debt principal, including capital lease obligation

### The Notes to Financial Statements

Another basic accounting principle, the [**full disclosure principle**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-F.html#full%20disclosure%20principle), requires that a company's financial statements include disclosure notes. These notes include information that helps readers of the financial statements make investment and credit decisions. The notes to the financial statements are considered to be an integral part of the financial statements.

**Notes to the Financial Statements** are additional notes and information added to the end of the [financial statements](http://en.wikipedia.org/wiki/Financial_statement) to supplement the reader with more information. Notes to Financial Statements help explain the computation of specific items in the [financial statements](http://en.wikipedia.org/wiki/Financial_statements) as well as provide a more comprehensive assessment of a company's financial condition. Notes to Financial Statements can include information on [debt](http://en.wikipedia.org/wiki/Debt), [going concern,](http://en.wikipedia.org/wiki/Going_concern) [accounts](http://en.wikipedia.org/wiki/Accounts), [contingent liabilities](http://en.wikipedia.org/wiki/Contingent_liabilities), or contextual information explaining the financial numbers (e.g. to indicate a lawsuit). The information contained within the notes not only supplements financial statement information, but they clarify line-items that are part of the financial statements. For example, if a company lists a loss on fixed asset impairment in their income statement, Notes to Financial Statements could serve to corroborate the reason for the impairment by providing specific information relative to how the asset became impaired. Notes to the Financial Statements are also used to explain the method of accounting used to prepare the financial statements (all publicly traded companies are required to use [accrual basis accounting](http://en.wikipedia.org/wiki/Accrual_basis_accounting) for financial reporting purposes as mandated by the [SEC](http://en.wikipedia.org/wiki/United_States_Securities_and_Exchange_Commission)), and they provide valuations for how particular accounts have been represented. In [consolidated financial statements](http://en.wikipedia.org/wiki/Consolidated_financial_statements), all [subsidiaries](http://en.wikipedia.org/wiki/Subsidiaries) should be listed as well as the amount of ownership ([controlling interest](http://en.wikipedia.org/wiki/Controlling_interest)) that the [parent company](http://en.wikipedia.org/wiki/Parent_company) has in the subsidiary companies. Any items within the financial statements that are valuated by estimation should be part of the Notes to Financial Statements if a substantial difference exists between the amount of the estimate

previously reported and the amount of the actual results. Full disclosure of the effects of the differences between the estimate and the actual results should be in the note.

##### Summary of four basic financial statements

|  |  |  |
| --- | --- | --- |
| **Financial Statement** | **Purpose** | **Elements** |
| Balance Sheet/  Statement of Financial Position | **Reports the financial**  **position (Economic resources and sources of financing) of a business entity at a point of time.** | **ASSET=LIABILITY+**  **OWNERS’EQUITIES** |
| Income Statement/  Profit and Loss Statement | **Reports the entities’**  **primary measure of economic performance during an accounting period.** | **REVENUE-EXPENSES=**  **NET INCOME(NET LOSS)** |
| Statement of Change  in Owner's Equity Retained Earnings Statement | **Reports the way that**  **increase in owners’ equity by owners’ contribution and net income and decrease in owners’ equity by distribute to owners (drawing or dividend) and net loss** | **CAPITAL,BEGINNING+ADDITION**  **AL INVESTMENT+NET INCOME (OR-NET LOSS) –DRAWING= CAPITAL,ENDING**  **RETAINED EARNINGS, BEGINNING+NET INCOME (OR- NET LOSS) –DIVIDEND= RETAINED EARNINGS, ENDING** |
| Statement of Cash  Flows | **Reports cash inflows and**  **outflows during an accounting period by 3 differences activities : operating, investing, and financing** | **+/- CASH FLOWS FROM**  **OPERATING ACTIVITIES**  **+/- CASH FLOWS FROM INVESTING ACTIVITIES**  **+/- CASH FLOWS FROM FINANCING ACTIVITIES** |

**Questions, Exercises and Problems**

**Answer the following questions.**

1. **What are basic financial statements according to IAS#1 or TAS#35?**
2. **What are the purposes of financial statements?**
3. **What are the elements of accounts that report on balance sheet?**
4. **What are the elements of accounts that report on income statement?**
5. **What are the three activities that report on statement of Cash Flows? Exercise 3-1.** Identify **Type of Account** and **Financial statement**

The following are items taken from its recent balance sheet and income statement. Identified each in the following list of account title as an asset (A),liability (L),or stockholders‘ equity (SE) or a revenue (R) or expense(E) and which financial statement that would it appear on the balance sheet (B/S) or on the income statement (I/S).

|  |  |  |  |
| --- | --- | --- | --- |
| **Item** | **Account Title** | **Type of Account (A, L, SE, R, E)** | **Financial Statement**  **(B/S, I/S)** |
| 1 | Account Receivable |  |  |
| 2 | Accounts Payable |  |  |
| 3 | Building |  |  |
| 4 | Cash |  |  |
| 5 | Sales |  |  |
| 6 | Supply |  |  |
| 7 | Supply Expense |  |  |
| 8 | Notes Payable |  |  |
| 9 | Capital Stock |  |  |
| 10 | Retained Earnings |  |  |
| 11 | Cost of Goods Sold |  |  |
| 12 | Operating Expenses |  |  |
| 13 | Income Taxes Expense |  |  |
| 14 | Land |  |  |
| 15 | Equipment |  |  |
| 16 | Bonds Payable |  |  |
| 17 | Inventories |  |  |
| 18 | Interest Expense |  |  |
| 19 | Prepaid Rent |  |  |
| 20 | Unearned Rent |  |  |
| 21 | Prepaid Expense |  |  |
| 22 | Unearned Revenue |  |  |
| 23 | Income Tax Payable |  |  |
| 24 | Salary Expense |  |  |
| 25 | Salary Payable |  |  |

**Exercise 3-2** Identify accounts by category and financial statement

Listed here are a number of financial statement captions. Indicate in the spaces to the right of each caption the category of each item and the financial statement(s) on which the item can usually be found. Use the following abbreviations:

##### Category Financial Statement

|  |  |  |  |
| --- | --- | --- | --- |
| Asset | A | Balance sheet | B/S |
| Liability | L | Income statement | I/S |
| Owners‘ equity | OE |  |  |
| Revenue | R |  |  |
| Expense | E |  |  |
| Gain | G |  |  |
| Loss | LS |  |  |

|  |  |  |
| --- | --- | --- |
| **Account Titles** | **Category** | **Financial Statement** |
| Cash |  |  |
| Accounts payable |  |  |
| Depreciation expense |  |  |
| Net sales |  |  |
| Income tax expense |  |  |
| Short-term investments |  |  |
| Gain on sale of land |  |  |
| Retained earnings |  |  |
| Dividends payable |  |  |
| Accounts receivable |  |  |
| Short-term debt |  |  |
| Accumulated depreciation |  |  |
| Long-term debt |  |  |
| Equipment |  |  |
| Loss on sale of short-term Investments |  |  |
| Net income |  |  |
| Merchandise inventory |  |  |
| Other accrued liabilities |  |  |
| Dividends paid |  |  |
| Cost of goods sold |  |  |
| Additional paid-in capital |  |  |
| Interest income |  |  |
| Selling expenses |  |  |

**Exercise 3-3** Matching Elements with Financial Statements

Matching each element with its financial statement by entering the appropriate letter in the space provided.

|  |  |  |  |
| --- | --- | --- | --- |
| **Answer** |  | **Element** | **Financial statements** |
| ………. | 1. Expenses |  | **A.** Balance sheet |
| ……… | 2. Cash flow from investing activities | | **B.** Income statement |
| ……… | 3. Assets |  | **C.** Statement of remained earnings |
| ……… | 4. Dividends |  | **D.** Statement of cash flows |
| ……… | 5. Revenues |  |  |
| ……… | 6. Cash flow from operating activities | |  |
| ……… | 7. Liabilities |  |  |
| ……… | 8. Cash flow from financing activities | |  |

**Exercise 3-4** Matching Definitions with Terms

Match each definition with its related term by entering the appropriate letter in the space provided. There should be only one definition per term (that is, there are more definitions than terms).

|  |  |  |
| --- | --- | --- |
| **Answer** | **Term** | **Definitions** |
| ………. | 1 Expenses | **A.** Report the long life of a company in shorter periods |
| ……… | 2. Gains | **B.** Record expenses when incurred in earning revenue. |
| ……… | 3. Revenue principle | **C.** The time it takes to purchase goods or service from suppliers, sell goods or services to customers, and collect cash from customers |
| ……… | 4. Cash basis accounting | **D.** A liability account used to record cash received before revenues have been earned |
| ……… | 5. Unearned revenue | E.. Increases in assets or decreases in liabilities from peripheral transactions |
| ……… | 6. Operating cycle | **F.** Decreases in assets or decreases in liability from ongoing operations. |
| ……… | 7. Accrual basis accounting | **G**. Record revenues when earned and measurable (delivery of goods or services has occurred, there is  persuasive evidence of an arrangement for customer  payment, the price is fixed or determinable, and collection is reasonably assured) |
| ……… | 8. Prepaid expenses | **H**. Decreases in assets or increases in liabilities from peripheral transactions |
| ……… | 9 Revenues – Expenses = Net income. | **I.** Record revenues when received and expenses when paid |
| ……… | 10 Ending Retained Earnings = Beginning Retained  Earnings + Net Income – Dividends Declared | 1. The income statement equation 2. An asset account used to record cash paid before expenses have been incurred |
| **L.** The retained earnings equation. |
|  |  | **M.** Record revenues when earned and expenses when  incurred |

**Exercise 3-5** Matching Definitions with Terms

Following is a list of the key terms and concepts along with a list if corresponding definitions. Match the appropriate letter for the key term or concept will be used.

|  |  |  |  |
| --- | --- | --- | --- |
| **Item** | **Terms and Concepts** | **Item** | **Terms and Concepts** |
| **A** | Accumulated depreciation | **O** | Earnings per share of common stock |
| **B** | Balance sheet | **P** | Paid-in capital |
| **C** | Accrued liabilities | **Q** | Common stock |
| D | Current assets | **R** | Additional paid-in capital |
| **E** | Current liabilities | **S** | Retained earnings |
| **F** | Merchandise inventory | **T** | Dividends |
| **G** | Revenues | **U** | Par value |
| **H** | Expenses | **V** | Going concern concept |
| **I** | Gains | **W** | Matching concept |
| **J** | Losses | **X** | Accrual concept |
| **K** | Net sales | **Y** | Opportunity cost |
| **L** | Cost of goods sold | **Z** | Annual report |
| **M** | Gross profit | **AA** | Income statement |
| **N** | Net income | **BB** | Income tax |

|  |  |
| --- | --- |
| Answer | Definitions. |
| 1. | The difference between the total amounts invests by the owners and the par value or  stated value of the stock issued. |
| 2. | Outflows or using up of assets or incurrence of liabilities during a period from  delivering or producing goods, rendering services, or carrying out other activities that constitute the entity‘s major operations. |
| 3. | The financial statement that is a list of the entity‘s assets, liabilities, and owners‘  equity at a point in time |
| 4. | A document distributed to stockholders that contains the financial statements for the  fiscal year of the reporting firm with the report of the external auditor‘s examination of the financial statements |
| 5. | A distribution of earning to the owners of a corporation. |
| 6. | An arbitrary value assigned to a share of stock when the corporation is organized. |
| 7. | Net income available to the common stockholders divided by the average number  of shares of common stock outstanding during the period. |
| 8. | Items held by an entity for dale to potential customers in the normal course of  business. |
| 9. | Inflows of cash or increase in other assets, or settlement of liabilities during a  period from delivering or producing goods, rendering services, or other activities that constitute the entity‘s major operations. |
| 10. | Cash and those assets likely to be converted to cash or used to benefits the entity  within one year of the balance sheet date. |
| 11 | Cumulative net income that has not been distributed to the owners of a corporation  as dividends. |
| 12 | The difference between gross profit and operation expenses. Also referred to as  operating income and earning from operations |
| 13 | Increases in net assets from incidental transactions and other events affecting an  entity during a period except those that results from revenues or investments by owners. |
| 14. | A presumption that the entity will continue in existence for the indefinite future. |
| 15 | Net sales less cost of goods sold |

**Problem 3-1** Financial Statements

The following accounts and their balances are listed in alphabetical order and taken from the books of Lucky Games Enterprise which operate the service of playing games and internet at the end of the fiscal year on December 31, 20X9.

|  |  |  |  |
| --- | --- | --- | --- |
| Accounts Payable | ฿18,000 | Mortgage Notes Payable | ฿45,000 |
| Accounts Receivable | 13,500 | Notes Payable(3-month Note) | 3,000 |
| Building | 40,000 | Prepaid Insurance | 6,500 |
| Cash | 10,000 | Rent Expense | 5,000 |
| Equipment | 15,700 | Repair and Maintenance Expense | 3,000 |
| Insurance Expense | 4,000 | Salaries and Wages Expense | 20,000 |
| Interest Expense | 1,000 | Service Revenue | 70,000 |
| Interest Payable | 1,000 | Supplies Expense | 2,000 |
| Land | 11,000 | Tax Expense | 5,000 |
| Lucky, Capital | 14,000 | Tax Payable | 1,200 |
| Miscellaneous Expense | 2,000 | Utilities Expense | 15,000 |

Lucky, Capital ฿14,000, it represents Lucky‘s capital on January1,20X9 .During the year he invested ฿ 6,000 and withdrew ฿ 4,500 cash .

Required: 1 . Prepare a good form of Income Statement for the fiscal ended on December31, 20X9 .

* 1. Prepare Statement of Owner‘s equity
  2. Prepare Balance Sheet as of December31,20X9

##### ……………………………..

**Income Statement**

**…………………………………………….**

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**……………………………..**

**Statement of Owner’s equity**

**…………………………………………….**

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**………………………**

**Balance Sheet/ Statement of Financial Position**

**……………………………..**

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**Problem 3-2** Financial Statements

The Following information were taken from general ledger of Micky Laundry service on December 31,20X8,the end of fiscal year.

|  |  |  |  |
| --- | --- | --- | --- |
| Accounts Payable | $650 | Laundry Supplies | $300 |
| Accounts Receivable | 600 | Laundry Supplies Expense | 412 |
| Automobile | 15,000 | Loan Payable | 3,000 |
| Bonds Payable | 2,000 | Micky, Capital |  |
| Building | 20,000 | Micky, Drawing | 420 |
| Cash | 3,760 | Notes Payable(3-year Note) | 5,000 |
| Gasoline Expense | 235 | Notes Receivable | 1,275 |
| Income Tax Expense | 30 | Office Supplies | 380 |
| Insurance Expense | 200 | Office Supplies Expense | 890 |
| Interest Expense | 100 | Prepaid Insurance | 400 |
| Interest Payable | 25 | Property Tax Expense | 75 |
| Land | 10,000 | Tax Payable | 30 |
| Laundry Equipment | 4,700 | Utilities Expense | 1,565 |
| Laundry Service Revenue | 5,500 | Wages Expense | 1,000 |

**Required:** Prepare the following financial statements

1. Income Statement
2. Balance Sheet/ Statement of Financial Position

##### ……………………………..

**Income Statement**

**…………………………………………….**

|  |
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**Balance Sheet/ Statement of Financial Position**

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**Chapter 4**

**RECORD KEEPING AND THE ACCOUNTING PROCESS**

**Topic:** Record Keeping and the Accounting Process

**Concept:** To introduce students to formal recording keeping and the steps involved in the accounting process.

##### Objectives

1. Students will review transaction analysis
2. Students will learn about the Chart of Account
3. Students will learn about the general journal
4. Students will learn about the posting process from the general journal to the general ledger
5. Students will learn how to prepare Trial Balance
6. Students will be introduced to the concept of the entire accounting process from journalizing to preparing financial statements



### 4 ACCOUNTING PROCESS

**Steps in the Accounting Process** or **Accounting Cycle**



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| **Identify the Business Transaction/Event**  Identify the event as a transaction  and generate the source document. |
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| **Analyze the Business Transaction effect the accounting equation**  Determine the transaction amount,  which accounts are affected(asset, liability, owners‘ equity, revenue, and expense, from chart of account) and in which direction (increase or decrease). |
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| **Journal Entries**  The transaction is recorded in  the journal (book of original entry) as a debit and a credit. |
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| **Post to Ledger**  The journal entries are transferred  to the appropriate T-accounts(Two-column) or Three-column accounts in the ledger. |
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| **Trial Balance**  A trial balance is calculated  to verify that total amount of the debits balance is equal to total amount of the credits balance. |
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| **Adjusting Entries** |
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| **Adjusted Trial Balance** |
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| **Financial Statements** |
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| **Closing Entries** |
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| **Post-Closing Trial Balance** |
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**Analyzing Business Transactions** / events for identification and measurement their effects in Accounting Equation.

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| --- | --- |
|  |  |
| Reversing entries | |

##### Recording in Journals

* General journal
* Cash receipts journal
* Cash payments journal
* Purchases journal
* Sales journal

**ACCO**

Preparing **Post-closing Trial balance**

##### THE ACCOUNTING CYCLE

**Posting to Ledger** General ledger (usually monthly) Subsidiary ledgers (usually daily)

**Closing Entries** (nominal /or temporary accounts)

Computing Accounts Balance and preparing **Trial balance**

Preparing **Financial Statements**

* Statement of changes in equity
* Balance sheet
* Statement of Cash Flows

Worksheet

##### Adjusting Entries

* Accruals
* Deferrals / Prepayments
* Depreciations and Amortization

Preparing

##### Adjusted Trial Balance

The accounting process identifies business transactions and events, analyzes and records their effects, and summarizes and presents information in reports and financial statements. These reports and statements are used for making investing, lending, and other business decisions. The steps in the accounting process

1. Identify the business transaction and generate the source document.
2. Analyze each transaction and event from source documents
3. Record relevant transactions and events in a journal
4. Post journal information to ledger accounts
5. Prepare and analyze the trial balance

Business transactions and events are the starting points. Relying on source documents, the transactions and events are analyzed using the accounting equation to understand how they affect company performance and financial position. These effects are recorded in accounting records, informally referred to as the accounting books, or simply the books. Additional steps such as posting and then preparing a trail balance help summarize and classify the effects of transactions

and events. Ultimately, the accounting process provides information in useful reports or financial statements to decision makers.

### The Source Document

The ***source document*** is the original record of a transaction. The source document describes the basic facts of the transaction such as its date, purpose, and amount. During an audit, source documents are used as evidence that a particular business transaction occurred. Examples of source documents include:

* + Cash receipts
  + Credit card receipts
  + Cash register tapes
  + Cancelled checks
  + Customer invoices
  + Supplier invoices
  + Purchase orders
  + Credit memo for a customer refund
  + Time cards / employee time sheet
  + Deposit slips
  + Notes for loans
  + Payment stubs for interest

The source document is the initial input to the accounting process and serves as objective evidence of the transaction, serving as part of the audit trail should the firm need to prove that a transaction occurred. It provides the information required to analyze and classify the transaction and to create the journal entries.

To facilitate referencing, each source document should have a unique identifier, usually a number or alphanumeric code. Pre numbering of commonly-used forms helps to enforce numbering, to classify transactions, and to identify and locate missing source documents. A well- designed source document form can minimize errors and improve the efficiency of transaction recording.

The source document may be created in either paper or electronic format. For example, automated accounting systems may generate the source document electronically or allow paper source documents to be scanned and converted into electronic images. Accounting software often provides on-screen entry forms for different types of transactions to capture the data and generate the source document.

Once a transaction has been journalized, the source document should be filed and made retrievable so that transactions can be verified should the need arise at a later date.

### Chart of Accounts

A [**chart of accounts**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-C.html#chart%20of%20accounts) is a listing of all the accounts available to a company to record and sort its business transactions. A chart of accounts is generally customized by an accountant to fit the needs of the company and can be modified when necessary. For example, if a new product line is introduced or a new department is started, accounts can be added to accommodate the change.

The chart of accounts consists of two types of accounts: (1) balance sheet accounts, they are real accounts or permanent accounts, and (2) income statement accounts; they are temporary accounts or notional accounts. Account categories are generally listed in the following standardized order:

|  |  |  |
| --- | --- | --- |
| **Major Types of Accounts** | **Characteristics** | **Elements on financial**  **Statements** |
| **Assets** | **Real / Permanent**  **Accounts** | **Balance Sheet** |
| **Liabilities** |
| **Stockholders' (or) Owner's Equity /Capital** |
| **Revenues** | **Temporary /**  **Nominal Accounts** | **Income Statement** |
| **Expenses** |
| **Gains** |
| **Losses** |

The Chart of Account is list of all the accounts used by an entity to record financial transactions. A simple example Chart of Accounts of a small business firm, the accounts are grouped according to type and then numbered using the following conventions:

|  |  |
| --- | --- |
| **Type** | **Accounts Code/ Number** |
| Asset | 101-199 |
| Liability | 200-299 |
| Owners‘ Equity / Capital | 300-399 |
| Revenue | 400-499 |
| Expense | 500-599 |

The account numbers or codes are assigned by purely numeric code with 2 digits or 3 digits or more than 3 digits or assigned by alpha-numeric codes depending on the firm size and complexity of transactions. When numbering accounts it is important to leave gaps between the numbers in order to accommodate additional accounts as required.

Account numbers vary significantly from one company to the next, depending on the company's size and complexity. A sole proprietorship may have few accounts, but a multinational corporation may have thousands of accounts and use ten - or even twenty- digit numbers to track accounts by location, department, project code, and other categories. Most companies numerically separate asset, liability, owner's equity, revenue, and expense accounts. A typical small business might use the numbers 100 – 199 for asset accounts, 200–299 for liability accounts, 300–399 for owner's equity accounts, 400–499 for revenue accounts, and 500–599 for expense accounts.

A simple example Chart of Accounts of a business firm that assigned 3 digit numeric code are shown below

|  |  |  |  |
| --- | --- | --- | --- |
| **Asset Accounts** | | **Revenue Accounts** | |
| ***Code*** | ***Account title*** | ***Code*** | ***Account title*** |
| 101 | Cash | 410 | Sales Revenue |
| 102 | Short-term Investment | 420 | Service Revenue |
| 105 | Accounts Receivable | 430 | Interest Revenue |
| 110 | Prepaid Insurance | Expense Accounts | |
| 115 | Supplies | 501 | Cost of Goods Sold |
| 120 | Land | 510 | Salary Expense |
| 121 | Building | 511 | Advertising Expense |
| 130 | Equipment | 515 | Equipment Rental Expense |
| 135 | Truck | 520 | Insurance Expense |
| **Liability Accounts** | | 525 | Maintenance Expense |
| 200 | Bank Overdraft / Bank Loan | 526 | Utilities Expense |
| 205 | Accounts Payable | 530 | Supplies Expense |
| 210 | Taxes Payable | 535 | Rent Expense |
| **Owners’ Equity Accounts** | | 540 | Wages and Salary Expense |
| 301 | Common Stock | 545 | Miscellaneous Expense |
| 305 | Retained Earnings | 550 | Truck Expense |
| 310 | Dividend | 555 | Interest Expense |
| 360 | Income Summary | 590 | Income Tax Expense |

In some accounting software the chart of accounts may be the means to open new general ledger accounts and to control their position in the financial statements.

###### Sample Chart of Accounts for a Large Corporations

Each account in the chart of accounts is typically assigned a name and a unique number by which it can be identified. (Software for some small businesses may not require account numbers.) Account numbers are often five or more digits in length with each digit representing a division of the company, the department, the type of account, etc.

As you will see, the first digit might signify if the account is an asset, liability, etc. For example, if the first digit is a "1" it is an asset. If the first digit is a "5" it is an operating expense.

A gap between account numbers allows for adding accounts in the future. The following is a *partial* listing of a sample chart of accounts.

**Current Assets** (account numbers 10000 - 16999)

10100 Cash - Regular Checking 10200 Cash - Payroll Checking 10600 Petty Cash

12100 Accounts Receivable

12500 Allowance for Doubtful Accounts 13100 Inventory

14100 Supplies

15300 Prepaid Insurance

**Property, Plant, and Equipment** (account numbers 17000 - 18999) 17000 Land

17100 Buildings

17300 Equipment

17800 Automobile

18100 Accumulated Depreciation - Buildings 18300 Accumulated Depreciation - Equipment 18800 Accumulated Depreciation - Automobile

**Current Liabilities** (account numbers 20000 - 24999) 20010 Bank Overdraft

20100 Notes Payable - Credit Line #1 20200 Notes Payable - Credit Line #2 21000 Accounts Payable

22100 Wages Payable

23100 Interest Payable

24500 Unearned Revenues

**Long-term Liabilities** (account numbers 25000 - 26999) 25100 Mortgage Loan Payable

25600 Bonds Payable

25650 Discount on Bonds Payable

**Stockholders' Equity** (account numbers 27000 - 29999) 27100 Common Stock, Par stock

27110 Additional in excess of par-Common Stock 27500 Retained Earnings

29500 Treasury Stock

**Operating Revenues** (account numbers 30000 - 39999) 31010 Sales - Division #1, Product Line 010

31022 Sales - Division #1, Product Line 022

32015 Sales - Division #2, Product Line 015

33110 Sales - Division #3, Product Line 110

**Cost of Goods Sold** (account numbers 40000 - 49999)

41010 Cost of Goods Sold - Division #1, Product Line 010 41022 Cost of Goods Sold - Division #1, Product Line 022 42015 Cost of Goods Sold - Division #2, Product Line 015 43110 Cost of Goods Sold - Division #3, Product Line 110

**Selling Expenses** (account numbers 50000 - 50999)

50100 Sales Salaries Expense 50150 Sales Commission Expense

50160 Delivery Expense 50200 Store Supplies Expense

50600 Utilities Expense-Selling

**General and Administrative Expenses** (account numbers 59000 - 59999) 59100 Officers Salaries Expense

59150 Office Supplies Expense 59200 Insurance Expense

59300 Property Tax Expense 59600 Utilities Expense- Office

59700 Depreciation Expense-Buildings 59800 Depreciation Expense - Equipment 59900 Depreciation Expense – Automobile

**Other** (account numbers 90000 - 99999)

91800 Gain on Sale of Assets 96100 Loss on Sale of Assets

### Record Keeping

Accounting is the process of keeping track of those changes and recording and then reporting them. When a business makes a transaction, the effect of that transaction is recorded in the accounting system. According to the fundamental accounting equation, each transaction will affect at least two accounts and the balances in those accounts will change.

##### 4.3.1 Double Entry Bookkeeping

Accounting record dating back several thousand years have been found in various parts of the world. These records indicate that at all levels of development people desire information about their efforts and accomplishments. In 1494 an Italian monk, Friar Luca Pacioli, wrote a book *“Summa de Arithmetic Geometria Proportioni et Proportionalita***”**. In one of five section of his book was double entry bookkeeping which is known as ―*the method of Venice*‖. In its most simple formulation double entry is a formulation of ―Where-got, Where -give‖, a two dimensional system that permit classification within one set of classes. It calls for a dual classification along duality principle. Double-entry bookkeeping enabled business organizations to keep complete records of transactions and ultimately resulted in the ability to prepare financial statements

###### Debits and Credits

Whether bookkeeping tasks are performed manually by a bookkeeper or electronically by clerks, one thing remains the same: *every business transaction involves at least two accounts*. This is known as [**double entry**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-D.html#double%20entry) bookkeeping (or "double entry accounting"). Double entry bookkeeping requires that for each transaction, *one* (or more) account must be *debited*, and *one* (or more) account must be *credited*. Therefore, two notable characteristics of double-entry

systems are that 1) each transaction is recorded in two or more accounts, and 2) each account has two columns which are debit and credit.

###### Debits on the Left, Credits on the Right

Every account has two "sides," a right side and a left side. A [**debit**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-D.html#debit) refers to an entry on the *left* side of an account, and a [**credit**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-C.html#credit%20-%20as%20in%20debit%20and%20credit) refers to an entry on the *right* side of an account. Double entry bookkeeping requires that for every transaction, there is an entry to the left side of one (or more) account, and a corresponding entry to the right side of another account(s).

##### Debit

**Credit**

"Enter in the **left** column of"

"Enter in the **right** column of"

Note that negative amounts were portrayed as negative numbers. In practice, negative numbers are not used; in a double-entry bookkeeping system the recording of each transaction is made via [debits and credits](http://www.quickmba.com/accounting/fin/debits-credits/) in the appropriate accounts.

Two accounts always are affected by each transaction, and one of those entries must be a debit and the other must be a credit of equal amount. Actually, more than two accounts can be used if the transaction is spread among them, just as long as the sum of debits for the transaction equals the sum of credits for it.

The double entry accounting system provides a system of checks and balances. By summing up all of the debits and summing up all of the credits and comparing the two totals, one can detect and have the opportunity to correct many common types of bookkeeping errors.

###### Rules for recording Debit and Credit

The rules of recording transaction for debit and credit come from the accounting equation. Asset is in the left side of accounting equation, asset increase record debit. Liability is in right side, liability increase record credit. Owners‘ equity is on right side, owners‘ equity increase record credit. If theses account decrease they are recorded in the opposite side. Revenue increase owners‘ equity, then revenue incurs record credit. Expense decrease owners‘ equity, then expense incurs record debit

|  |  |  |  |
| --- | --- | --- | --- |
| ***Assets*** | = | | ***Liabilities + Owner's Equity*** |
| **Debit** | | **Credit** | |
| Assets + | | Liabilities + | |
| Expense + | | Owner's Equity + | |
| Drawing + / Dividend + | | Revenue + | |

Whether a debit or a credit increases or decreases an account balance depends on the type of account. Asset and expense accounts are increased on the debit side, and liability, equity, and revenue accounts are increased on the credit side. The following chart serves as a graphical reference for increasing and decreasing account balances:

Assets = Liabilities + Owner's Equity

Asset

Liability

Capital

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Debit | Credit |  | Debit | Credit |  | Debit | Credit |
| + | - |  | - | + |  | - | + |

Expense

Revenue

Debit

+

Credit

-

Debit

-

Credit

+

**A debit will *increase* these accounts:**

* + - Assets ([**Cash**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-C.html#cash), [**Accounts Receivable**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-A.html#accounts%20receivable), [**Inventory**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-I.html#inventory), [**Land**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-L.html#land), [**Equipment**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-E.html#equipment), etc.)
    - Expenses ([**Rent Expense**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-R.html#rent%20expense), [**Wages Expense**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-W.html#wages%20expense), [**Interest Expense**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-I.html#interest%20expense), etc.)
    - Losses ([**Loss on Sale of Assets**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-L.html#loss%20on%20sale%20of%20assets), [**Loss from Lawsuit**](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-L.html#loss%20from%20lawsuit), etc.)
    - Sole proprietor's Drawing account
    - Corporation Dividend account

**A debit will *decrease* these accounts:**

* + - Liabilitie[s (Notes Payable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-N.html#notes%20payable), [Accounts Payable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-A.html#accounts%20payable), [Interest Payable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-I.html#interest%20payable), etc.)
    - Owners' Equity / Partners‘ equity (……..,Capital, …..Drawing)
    - Stockholders' Equity (Capital Stock, Retained Earnings)

**A credit will *increase* these accounts:**

* + - Liabilitie[s (Notes Payable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-N.html#notes%20payable), [Accounts Payable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-A.html#accounts%20payable), [Interest Payable](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-I.html#interest%20payable), etc.)
    - Revenue[s (Sales,](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-S.html#sales) [Service Revenues](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-S.html#service%20revenues), [Fees Earned,](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-F.html#fees%20earned) [Interest Revenues](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-I.html#interest%20revenues), etc.)
    - Ga[ins (Gain on Sale of Assets](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-G.html#gain%20on%20sale%20of%20assets), Gain on Retirement of Bonds, etc.)

**A credit will *decrease* these accounts:**

* + - Asse[ts (Cash](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-C.html#cash), [Accounts Receivable,](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-A.html#accounts%20receivable) [Supplies](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-S.html#supplies), [Inventory,](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-I.html#inventory) [Land](http://www.accountingcoach.com/accounting-terms/accounting-dictionary/accounting-terms-L.html#land), etc.)

##### General Journal Entries

**The General Journal**

The General Journal is called the book of original entry and the process of recording transactions in the journal is called journalizing. The following are the steps for journalizing transactions:

1. The year is recorded at the top of the page and the month is recorded on the first line in the first column of the date section. This information is repeated for every new journal page.
2. The date of the first transaction is entered in the second column in the date section.
3. The name of the account(s) to be debited is entered in the description column and the amount of the debit is recorded in the Debit column. When more than two accounts are involved in the transaction the entry is called a compound entry.
4. The name of the account(s) to be credited is entered on the next line and indented. The amount of the credit is recorded in the Credit column.
5. An explanation of the transaction is included in the description column on the line below the credit entry.

The journal is the point of entry of business transactions into the accounting system. It is a chronological record of the transactions, showing an explanation of each transaction, the accounts affected, whether those accounts are increased or decreased, and by what amount. Because the journal is where the information from the source document first enters the accounting system, it is known as the *book of original entry*.

A general journal entry takes the following form:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| ***Date*** | | **Account Title and explanation** | **P/R** | **Debit** | **Credit** |
| *Month* | *Date* | *Name of account being debited* | a/c  code | *Amount* |  |
|  | | *Name of account being credited* | a/c  code |  | *Amount* |
|  | | short description of transaction |  |  |  |

##### Illustrate double entry bookkeeping with the following sample transactions:

Mr. Anan set up a taxi service firm under the name **Anan Taxi** on September 1, 20X8. He contributed his 4 personal cars value Baht 1,000,000 to be used as taxi and withdraw personal cash from personal bank to open Anan Taxi Bank account for Baht 500,000. He rented land and building for using as parking lot of taxi and office at a rental rate of Baht10,000 per month which is paid at the beginning of each month.

Chart of Accounts of **Anan Taxi** firm that assigned 3 digit numeric code are shown below

|  |  |  |  |
| --- | --- | --- | --- |
| **Asset Accounts** | | **Revenue Accounts** | |
| ***Code*** | ***Account title*** | ***Code*** | ***Account title*** |
| 101 | Cash | 410 | Fares Revenue |
| 102 | Accounts Receivable | Expense Accounts | |
| 120 | Automobile | 501 | Salary Expense |
| **Liability Accounts** | | 502 | Gasoline Expense |
| 201 | Accounts Payable | 503 | Office Supplies Expense |
| 205 | Notes Payable | 510 | Rent Expense |
| **Owners’ Equity Accounts** | | 511 | Utilities Expense |
| 301 | Anan, Capital | 512 | Repair Expense |
| 302 | Anan, Drawing | 520 | Interest Expense |
| 330 | Income Summary | 530 | Tax Expense |

The following transactions occurred during September the first month of operation.

|  |  |
| --- | --- |
| Sept 1 | Anan contributed 4 used cars Baht 1,000,000 and cash Baht 500,000 to start the  business. |
| Sept 1 | Purchased 6 new taxis for Baht 500,000 each from Toyota Motor Company, 10%  down payment are made for Baht 300,000 and signed a promissory note for the balance of Baht 2,700,000. |
| Sept 1 | Paid first month rent for land and building Baht 10,000. |
| Sept 2 | Hired 10 chauffeurs to driver 10 taxis at the monthly salary of Baht 10,000 each. Payments are made on the 25th of each month. |
| Sept 2 | Agreed with gasoline station‘s owner to buy gasoline on account for 10 taxi  everyday, but payment for current month gasoline used gas are made monthly on the tenth of following month. |
| Sept 3 | Agreed with Mrs. Malee to send and picked up her sons from home to school and  from school back home 20 days a month at the taxi fares rate per month Baht 4,000. Payments for current month taxi fares will be paid on the fifth of following month. |
| Sept 15 | Total cash received from passenger for taxi fares for the first half of the month  was Baht 180,000. |
| Sept 20 | Paid repair and maintenance expense for taxi Baht 5,000. |
| Sept 25 | Paid salaries to all chauffeurs Baht 100,000. |
| Sept 29 | Paid current month electricity bill, water bill and telephone bill of the office total  Baht 4,500. |
| Sept 30 | Total cash received from passenger for taxi fares for the second half of the month  was Baht 220,000. |
| Sept 30 | Billed to Mrs. Malee Baht 4,000 for taxi service render for September, receipt  will be on October 5. |
| Sept 30 | Received a bill from gasoline station Baht 150,000 for total gasoline used up in  September, payment will be on October 10. |
| Sept 30 | Anan withdraw Baht 6,000 cash for personal use and used taxi service of his own  business to send his youngest daughter to school during September Baht 2,000. |
| Sept 30 | Paid Baht 50,000 cash to Toyota Motor Company for settle a partial of Notes  Payable for Baht 40,000 and interest expense for September Baht 10,000. |

###### Analyzing Transactions

**Assets = Liabilities + Owner's Equity**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Cash + Accounts Taxi/ Accounts Notes Anan, Receivable +** Automobile **= Payable + Payable + Capital** | | | | | | | | **(Remar- ks)** |
| Sep 1  Sep 1 | +500,000  -300,000 |  | +1,000,000  +3,000,000 | =  = |  | +2,700,000 | +1,500,000 |  |
| Sep 1 | -10,000 |  |  | = |  |  | -10,000 | Rents Expense |
| Sep 2 |  |  |  | = |  |  |  | No affect |
| Sep 3 |  |  |  | = |  |  |  | No affect |
| Sep 15 | +180,000 |  |  | = |  |  | +180,000 | Fares Revenue |
| Sep 20 | -5,000 |  |  | = |  |  | -5,000 | Repair Expense |
| Sep 25 | -100,000 |  |  | = |  |  | -100,000 | Salary Expense |
| Sep 29 | -4,500 |  |  | = |  |  | -4,500 | Utilities Expense |
| Sep 30 | +220,000 |  |  | = |  |  | +220,000 | Fares Revenue |
| Sep 30 |  | +4,000 |  | = |  |  | +4,000 | Fares Revenue |
| Sep 30 |  |  |  | = | +150,000 |  | -150,000 | Gasoline Expense |
| Sep 30 | -6,000 |  |  | = |  |  | -8,000  +2,000 | Anan  Drawing Fares Revenue |
| Sep 30 | -50,000 |  |  | = |  | -40,000 | -10,000 | Interest Expense |
| Balance | 424,500 | 4,000 | 4,000,000 | = | 150,000 | 2,660,000 | 1,618,500 |  |

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Analyzing Transactions** | | | | **Double Entry Bookkeeping** | |
| **Date** | **Assets** | **Liabilities** | **Owners’ equity** | **Account Debited** | **Account Credited** |
| Sep 1 | Cash+  Automobile + |  | Anan, Capital + | **Cash Automobile** | **Anan, Capital** |
| Sep 1 | Cash -  Automobile + | Notes Payable  + |  | **Automobile** | **Cash**  **Notes Payable** |
| Sep 1 | Cash - |  | Anan, Capital-  (Rents Expense) | **Rents Expense** | **Cash** |
| Sep 15 | Cash+ |  | Anan, Capital+  (Fares Revenue) | **Cash** | **Fares Revenue** |
| Sep 20 | Cash - |  | Anan, Capital-  (Repair Expense) | **Repair Expense** | **Cash** |
| Sep 25 | Cash - |  | Anan, Capital-  (Salaries Expense) | **Salaries Expense** | **Cash** |
| Sep 29 | Cash - |  | Anan, Capital-  (Utilities Expense) | **Utilities Expense** | **Cash** |
| Sep 30 | Cash+ |  | Anan, Capital+  (Fares Revenue) | **Cash** | **Fares Revenue** |
| Sep 30 | Accounts  Receivable + |  | Anan, Capital+  (Fares Revenue) | **Accounts Receivable** | **Fares Revenue** |
| Sep 30 |  | Accounts  Payable+ | Anan, Capital-  (Gasoline Expense) | **Gasoline**  **Expense** | **Accounts Payable** |
| Sep 30 | Cash - |  | Anan,  Capital+- (Fares Revenue  ,Anan Drawing) | **Anan Drawing** | **Cash**  **Fares Revenue** |
| Sep 30 | Cash - | Notes Payable- | Anan, Capital-  (Interest Expense) | **Notes Payable Interest**  **Expense** | **Cash** |

General Journal Page 1

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Names & Explanation** | P/R | **Debit** | **Credit** |
| 20X8  Sept 1 | Cash Automobile  Anan, Capital  *Owner contributes cash and automobile to capitalize the business.* |  | 500,000  1,000,000 | 1,500,000 |
| 1 | Automobile  Cash  Notes Payable  *Purchased automobile with down payment 10% and 90% on a notes payable* |  | 3,000,000 | 30,000  2,700,000 |
| 1 | Rent Expense  Cash  *Paid first month’s shop rent* |  | 10,000 | 10,000 |
| 15 | Cash  Fares Revenue  *Received cash from Passenger* |  | 180,000 | 180,000 |
| 20 | Repair Expense  Cash  *Paid repair expense* |  | 5,000 | 5,000 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 25 | Salaries Expense  Cash  *Paid salaries expense* |  | 100,000 | 100,000 |
| 29 | Utilities Expenses  Cash  *Paid electricity, water and telephone expense* |  | 4,500 | 4,500 |
| 30 | Cash  Fares Revenue  *Received cash from Passenger* |  | 220,000 | 220,000 |
| 30 | Accounts Receivable  Fares Revenue  *Taxi fare revenue earned on account* |  | 4,000 | 4,000 |
| 30 | Gasoline Expense  Accounts Payable  *Gasoline expense incurred on account* |  | 150,000 | 150,000 |
| 30 | Anan, Drawing  Cash  Fares Revenue  *Owner withdrew cash and use service* |  | 8,000 | 6,000  2,000 |
| 30 | Notes Payable  Interest Expense Cash  *Paid to creditor to settle notes payable and interest* |  | 40,000  10,000 | 50,000 |

The first step in the accounting process is to analyze every transaction (economic event) that affects the business. The accounting equation (Assets = Liabilities + Owner's Equity) must remain in balance after every transaction is recorded, so accountants must analyze each transaction to determine how it affects owner's equity and the different types of assets and liabilities before recording the transaction.

Given the large number of transactions that companies usually have, accountants need a more sophisticated system for recording transactions than the one shown on the previous page. Accountants use the double-entry bookkeeping system to keep the accounting equation in balance and to double-check the numerical accuracy of transaction entries. Under this system, each transaction is recorded using at least two accounts. An **account** is a record of all transactions involving a particular item.

Most of the above transactions are entered as simple journal entries each debiting one account and crediting another. The entry for September 1 and September 30( last transaction) are compound journal entries, composed of two lines for the debit and one line for the credit, The transaction could have been entered as two separate simple journal entries, but the compound form is more efficient.

Companies maintain separate accounts for each type of asset (cash, accounts receivable, inventory, etc.), each type of liability (accounts payable, wages payable, notes payable, etc.), owner investments (usually referred to as the owner's capital account in a sole proprietorship), owner drawings (withdrawals made by the owner), each type of revenue (sales revenue, service revenue, etc.), and each type of expense (rent expense, wages expense, etc.). All accounts taken together make up the **general**

**ledger**. For organizational purposes, each account in the general ledger is assigned a number, and companies maintain a **chart of accounts**, which lists the accounts and account numbers.

##### General Ledger

**From Journal Entry to Ledger Posting**

Once the [source document](http://www.quickmba.com/accounting/fin/source-document/) is generated and the appropriate journal entry is made, the next step in the accounting cycle is to post the entry to the general ledger.

##### General Ledger

The General Ledger is the formalization of the t-accounts. The General Ledger consists of ledger accounts, one for each account set up in the Chart of Accounts. Debits and credits to each account are *posted* to the ledger from the journal and the balance is kept current. Posting is the process of transferring amounts from the general journal to specific general ledger

accounts. Because entries are recorded in the ledger after the journal, the general ledger is often called the book of final entry.

The posting process is as follows:

* + The date and amount of a journal transaction are posted to the appropriate ledger account.
  + The journal page number is recorded in the ledger account‘s number for posting reference (P/R) column as a cross-reference.
  + The appropriate ledger account number is recorded in the posting reference (P/R) column in the journal *after* the posting has been made.
  + The balance of the ledger account is calculated and recorded in the Balance column with a DR or CR in the appropriate column indicating what type of balance it is.
  + The description column is used to record anything noteworthy that should be immediately available to readers of the ledger.

To understand the posting process, consider a journal entry in the following format:

GENERAL JOURNAL Page 1

Date Description P/R Debit Credit 20X8

Sept 1

Cash 101 500,000

Automobile 120 1,000,000

Anan, Capital 301 1,500,000

*Owner contributes cash and automobile to capitalize the business.*

GENERAL LEDGER

Cash Account # 101

Date Description P/R Debit Credit Balance 20X8

Sept 1

Owner‘s investment J1 500,000 500,000

Automobile Account # 120 Date Description P/R Debit Credit Balance 20X8

Sept 1

Owner‘s investment J1 1,000,000 1,000,000

Anan Capital Account # 301

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Date | | Description | P/R | Debit | Credit | Balance |
| 20X8 | |  |  |  |  |  |
| Sept | 1 | Invested cash 500,000and  used automobile1,000,000 | J1 |  | 1,500,00 | 1,500,000 |

The simplest account structure is shaped like the letter *T*. The account title and account number appear above the T. Debits (abbreviated Dr.) always go on the left side of the T, and credits (abbreviated Cr.) always go on the right.

Account Title Acct.#

Debit Side Credit Side

Note that the debit portion of the journal entry is posted to the left side of its associated T-account, and the credit portion is posted to the right side of its T-account. The date helps to identify the transactions with the journal entries. Additionally, a reference number may be added to further facilitate cross-referencing

The journal entry is the first entry of a transaction in the accounting system. Before the entry is made, the following decisions must be made:

* + which accounts are affected by the transaction, and
  + which account will be debited and which will be credited.

Once entered in the journal, the transactions may be posted to the appropriate **T-accounts**

or **three-column** or **balance-column account** of the general ledger. Unlike the journal entry, the

posting to the general ledger is a purely mechanical process - the account and debit/credit decisions already have been made.

###### Account Name Acct #

Date Debit Date Credit

*mm/dd xxxx.xx*

Bal. *xxxx.xx*

##### T-account

Account Name Acct. #

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Date | Explanation/  Description | Post  Ref. | Debit | Credit | Balance |
|  |  |  |  |  |  |
|  |  |  |  |  |  |
|  |  |  |  |  |  |

##### Three-column / or Balance-column account The General Ledger

While the journal lists transactions in chronological order, its format does not facilitate the tracking of individual account balances. The **general ledger** is used for this purpose.

The general ledger is a collection of T-accounts to which debits and credits are transferred. The action of recording a debit or credit in the general ledger is referred to as **posting**.

Because the general ledger is organized by account, it allows one to view the activity and balance of any account at a glance.

Accountants record increases in asset, expense, and owner's drawing accounts on the debit side, and they record increases in liability, revenue, and owner's capital accounts on the credit side. An account's assigned **normal balance** is on the side where increases go because the increases in any account are usually greater than the decreases. Therefore, asset, expense, and owner's drawing accounts normally have debit balances. Liability, revenue, and owner's capital accounts normally have credit balances. To determine the correct entry, identify the accounts affected by a transaction, which category each account falls into, and whether the transaction increases or decreases the account's balance. You may find the following chart helpful as a reference.

Normal or Usual Balance of accounts are on the side which they incurred or increase

|  |  |
| --- | --- |
| **Normal or Usual Balance is *Debit*** | **Normal or Usual Balance is *Credit*** |
| Assets | Liabilities |
| Expense | Owner's Equity |
| Drawing / Dividend | Revenue |

##### Example of T-Account

**From Journal Entry posting to Ledger(From Journal page…..)**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Cash** | | | |  | ***Acct#***101 | |
| **Date** | **Debit** | | **Date** | | **Credit** | |
| *Sept 1* | *500,000* | | *Sept* | *1* | 300,000 | |
| *15* | 180,000 | | *1* | | 10,000 | |
| *30* | 220,000 | | *20* | | 5,000 | |
|  |  | | 25 | | 100,000 | |
|  |  | | 29 | | 4,500 | |
|  |  | | 30 | | 6,000 | |
|  |  | | 30 | | 50,000 | |
|  | Total pencil footing | 900,000 |  | | Total pencil footing | 475,500 |
| **Bal.** | **424,500** | |  | |  | |

|  |  |  |  |
| --- | --- | --- | --- |
| **Accounts Receivable *Acct#***102 | | | |
| Date | Debit | Date | Credit |
| *Sept 30* | *4,000* |  |  |
| **Bal.** | ***4,000*** |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| **Automobile *Acct#***120 | | | |
| Date | Debit | Date | Credit |
| *Sept 1* | *1,000,000* |  |  |
| *1* | *3,000,000* |  |  |
| **Bal.** | ***4,000,000*** |  |  |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Accounts Payable | | |  | ***Acct#***201 |
| Date | Debit | Date | Credit | |
|  |  | *Sept 30* | *150,000* | |
|  |  | **Bal.** | **150,000** | |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Notes Payable | | |  | ***Acct#***205 |
| Date | Debit | Date | Credit | |
| *Sept30* | *40,000* | *Sept 1* | *2,700,000* | |
|  |  | **Bal.** | **2,660,000** | |

|  |  |  |  |
| --- | --- | --- | --- |
| Anan, Capital ***Acct#***301 | | | |
| Date | Debit | Date | Credit |
|  |  | *Sept 1* | *1,500,000* |
|  |  | **Bal.** | **1,500,000** |

|  |  |  |  |
| --- | --- | --- | --- |
| Anan, Drawing ***Acct#***302 | | | |
| Date | Debit | Date | Credit |
| *Sept30* | *8,000* |  |  |
| **Bal.** | **8,000** |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| **Fares Revenue *Acct#*410** | | | |
| Date | Debit | Date | Credit |
|  |  | *Sept 15* | *180,000* |
|  |  | *30* | *220,000* |
|  |  | *30* | *4,000* |
|  |  | *30* | *2,000* |
|  |  | **Bal.** | **406,000** |

|  |  |  |  |
| --- | --- | --- | --- |
| **Salary Expense *Acct#*501** | | | |
| Date | Debit | Date | Credit |
| *Sept*25 | *100,000* |  |  |
| **Bal.** | ***100,000*** |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| **Gasoline Expense *Acct#*502** | | | |
| Date | Debit | Date | Credit |
| *Sept30* | *150,000* |  |  |
| **Bal.** | **150,000** |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| **Rent Expense *Acct#*510** | | | |
| Date | Debit | Date | Credit |
| *Sept1* | *10,000* |  |  |
| **Bal.** | **10,000** |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| **Utilities Expense *Acct#***511 | | | |
| Date | Debit | Date | Credit |
| *Sept29* | *4,500* |  |  |
| **Bal.** | **4,500** |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| Repair Expense ***Acct#***512 | | | |
| Date | Debit | Date | Credit |
| *Sept20* | *5,000* |  |  |
| **Bal.** | **5,000** |  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| Interest Expense ***Acct#***520 | | | |
| Date | Debit | Date | Credit |
| *Sept30* | *10,000* |  |  |
| **Bal.** | **10,000** |  |  |

**4.4 Trial Balance (Unadjusted Trial Balance)**

*Prepare an unadjusted trial balance:* At the end of the period, double-entry accounting requires that debits and credits recorded in the general ledger be equal. *Debit* and *credit* merely [signify](http://www.answers.com/topic/signify) position— left and right, respectively. Some accounts normally have [debit](http://www.answers.com/topic/debit) balances (e.g., assets, expenses, and drawing or dividend) and other accounts have credit balances (e.g., liabilities, owners' equity, and revenues). As transactions are recorded in the general journal and subsequently posted to the ledger, all amounts recorded on the debit side of accounts (i.e., recorded on the left side) must equal all amounts recorded on the credit side of accounts (i.e., recorded on the right side). Preparing an [unadjusted trial balance](http://www.answers.com/topic/unadjusted-trial-balance) tests the equality of debits and credits as recorded in the general ledger. If unequal amounts of debits and credits are found in this step, the reason for the [inequality](http://www.answers.com/topic/inequality) is investigated and corrected before proceeding to the next step.

Example of unadjusted Trial Balance is prepare from the balance of ledger accounts on pages 89-91

##### Anan Taxi Trial Balance

**As of September 30, 20X8**

in Baht

|  |  |  |  |
| --- | --- | --- | --- |
| **Account code** | **Account title** | **Debit** | **Credit** |
| 101 | Cash | 424,500 |  |
| 102 | Accounts Receivable | 4,000 |  |
| 120 | Automobile | 4,000,000 |  |
| 201 | Accounts Payable |  | 150,000 |
| 205 | Notes Payable |  | 2,660,000 |
| 301 | Anan, Capital |  | 1,500,000 |
| 302 | Anan, Drawing | 8,000 |  |
| 410 | Fares Revenue |  | 406,000 |
| 501 | Salary Expense | 100,000 |  |
| 502 | Gasoline Expense | 150,000 |  |
| 510 | Rent Expense | 10,000 |  |
| 511 | Utilities Expense | 4,500 |  |
| 512 | Repair Expense | 5,000 |  |
| 520 | Interest Expense | 10,000 |  |
|  |  | **4,716,000** | **4,716,000** |

# Questions, Exercises and Problems

### Answer the following questions

Q4-1 What are the steps in processing transactions? Q4-2 What are source documents and their purpose?

Q4-3 What is an account and its use in recording transactions? Q4-4 What is a ledger and how it relates with a chart of accounts?

Q4-5 What are debits and credits and how it relates with double-entry accounting?

**Exercise 4-1** Classifying Accounts and their Usual Balances/or Normal Balance

Classifying Accounts on a Balance Sheet ,indicate whether the account is classified as a current asset **(CA),** non-current asset **(NCA),** current liability **(CL),** non-current liability **(NCL),** or owners‘ equity **(OE),** and whether the account usually has a debit (**Dr)**or credit (**Cr)** balance.

The following are several of the account of Beauty Salon, a sole trader.

|  |  |  |  |
| --- | --- | --- | --- |
| Item | Account Titles | Types/Classify | Usual  Balances |
| Example | Cash | **CA** | **Dr** |
| 1 | Accounts payable |  |  |
| 2 | Accounts receivable |  |  |
| 3 | Buildings |  |  |
| 4 | Equipment |  |  |
| 5 | Miss Beauty, Capital |  |  |
| 6 | Land |  |  |
| 7 | Miss Beauty, Withdrawal |  |  |
| 8 | Income taxes payable |  |  |
| 9 | Long tern investment |  |  |
| 10 | Note Payable (due in three years) |  |  |
| 11 | Note Receivable (due in six years) |  |  |
| 12 | Retained Earnings |  |  |
| 13 | Prepaid rent |  |  |
| 14 | Supplies |  |  |
| 15 | Utilities payable |  |  |

**Exercise 4-2** Classified Balance Sheet and Their Normal Debit or Credit Balances

Exxon Mobil Corporation explores, produces, refines markets, and supplies crude oil, natural gas, and petroleum products in the United States and around the world. For each account, indicate how it normally should be categorized on a classified balance sheet. Use **CA** for current asset, **NCA** for non-current asset, **CL** for current liability, **NCL** for non-current liability, and **SE** for stockholders‘ equity. Also indicate whether the account normally has a debit (Dr) or credit (Cr) balance.

The following are accounts from a recent balance sheet of Mobil Corporation:

|  |  |  |
| --- | --- | --- |
| Account Name/Title | Balance Sheet  Classification | Debit (Dr) or  Credit(Cr) Balance |
| 1) Retained Earnings |  |  |
| 2) Note and Loans Payable(short-term) |  |  |
| 3) Materials and Supplies |  |  |
| 4) Long-Term Loan Payable |  |  |
| 5) Prepaid Taxes and Expenses |  |  |
| 6) Patents(an intangible asset) |  |  |
| 7) Income Taxes Payable |  |  |
| 8) Contributed Capital |  |  |
| 9) Property , Plant, and equipment |  |  |
| 10) Accounts Receivable (Short-term) |  |  |
| 11) Cash and Cash Equivalents |  |  |
| 12) Accounts Payable |  |  |
| 13) Investments (long-term) |  |  |
| 14) Crude Oil Products and Merchandise |  |  |

**Exercise 4-3** Identifying Account Titles The following are independent situations.

|  |  |  |  |
| --- | --- | --- | --- |
| **Item** | **Independent situations** | **Account Title** | |
|  |  | **Debit** | **Credit** |
| a. | A company purchases and receives 10 personal computers for  office use for which it signs a note promising to pay $ 25,000 within three months. |  |  |
| b. | A company purchases for $21,000 cash a new delivery truck that  has a list price of $ 24,000. |  |  |
| c. | A women‘s clothing retailer orders 30 new display stands for  $300 each for future delivery. |  |  |
| d. | A new company is formed and sells 100 shares of stock for $ 12  per share to investors. |  |  |
| e. | A manufacturing company signs a contract for the construction of  a new warehouse for $500,000 at the signing, the company writes for $500,000 to the construction company as the initial payment for the construction (receiving construction in progress).Answer from the standpoint of the manufacturing company. |  |  |
| f. | A publishing firm purchases for $ 40,000 cash the copyright (an  intangible asset) to a manuscript for an introductory accounting text. |  |  |
| g. | A manufacturing firm pays stockholders a $ 100,000 cash  dividend. |  |  |
| h. | A company purchases 100 shares of Apple Inc. common stock for  $5,000 cash |  |  |
| i. | A company purchases a piece of land for $50,000 cash. An  appraiser of the buyer valued the land at $52,500. |  |  |
| j. | A manufacturing company acquires the patent (an intangible  asset) on a new digital satellite system for television reception, paying $ 5000,000 cash and singing a $400,000 note payable due in one year |  |  |
| k. | A local business is a sole proprietorship; its owner buys a car for  $10,000 for personal use. (Answer from the company‘s point of view). |  |  |
| l. | A company borrows $1,000 from a local bank and signs a six-  month note for the loan. |  |  |
| m. | A company pays $1,500 principal on its note payable. |  |  |
| n. | A company pays $2,500 salaries to employees |  |  |

##### Exercise 4-4

Record the transaction below for Amena Law Office by recording the debit and credit entries

directly in the following T-accounts: Cash; Accounts Receivable; Office Supplies; Office Equipment; Accounts Payable; S. Amena, Capital; S. Amena, Withdrawals; Fees Earned; and Rent Expense. Use the letters beside each transaction to identify entries. Determine the ending balance of each T-account.

1. Severe Amena, owner, invested $14,000 cash in the company.

Cash 14,000

Amena, Capital 14,000

1. The law office purchased office supplies for $406 cash.

Office Supplies 406

Cash 406

1. The law office purchases $7,742 of office equipment on credit.

Office Equipment 7,742

Accounts Payable 7,742

1. The law office received $1,652 cash as fees for services provided to a customer.

Cash 1,652

Service Revenue 1,652

1. The law office paid $7,742 cash to settle the payable for the office equipment purchased in transaction c.

Accounts Payable 7,742

Cash 7,742

1. The law office billed a customer $2,968 as fees for services provided.

Accounts Receivable 2,968

Service Revenue 2,968

1. The law office paid $510 cash for the monthly rent.

Rent expense 510

Cash 510

1. The law office collected $1,246 cash as partial payment for the account receivable created in transaction f.

Cash 1,246

Accounts Receivable 1,246

1. S. Amena withdrew $1,200 cash from the company for personal use.

Amena, Withdrawal 1,200

Cash 1,200

##### Cash

**S. Amena, Capital**

**Accounts Receivable**

**S. Amena, Withdrawals**

**Office Supplies**

**Fees Earned\_ \_**

**Office Equipment**

**\_ Rent Expense**

**Accounts Payable**

**Exercise 4-5**

Following is a list of the key terms and concepts along with a list if corresponding definitions. Match the appropriate letter for the key term or concept will be used.

|  |  |  |  |
| --- | --- | --- | --- |
| **Item** | **Key Terms and Concepts** | **Item** | **Key Terms and Concepts** |
| **A** | Balance sheet equation | **K** | Account balance |
| **B** | Transactions | **L** | Debit |
| **C** | On account | **M** | Credit |
| D | Accrued (or accrual) | **N** | Entry |
| **E** | Journal | **O** | Balance |
| **F** | Post (posting) | **P** | Charge |
| **G** | Ledger | **Q** | Journal entry |
| **H** | Account | **R** | Source document |
| **I** | Chart of accounts | **S** | Adjusting journal entry |
| **J** | T-account | **T** | Closing the books |

|  |  |
| --- | --- |
| Answer | Definitions. |
| 1. | The left side of an account; an increase in asset and expense accounts or  decrease in liability, owners‘ equity, and revenue accounts. |
| 2. | Economic interchanges between entities that are accounted for and  reflected in financial statements. |
| 3. | A chronological record of transactions. |
| 4. | Assets = Liabilities + Owners‘ Equity (A = L = OE) expresses the  fundamental structure of the balance sheet and is the basis of bookkeeping procedures. |
| 5. | Used to describe a purchase or sale for which cash will be paid or received at a  later date. A ―credit‖ transaction. |
| 6. | The process of recording a transaction in the respective ledger accounts using a  journal entry as the source of information recorded. |
| 7. | Listing of all the accounts available to a company to record and sort its business  transactions. |
| 8. | The arithmetic sum of the additions and subtractions to an account through  a given date. |
| 9. | The right side of an account; a decrease in asset and expense accounts or an  increase in liability, owners‘ equity, and revenue accounts. |
| 10. | Evidence of a transaction that supports the journal entry recording the  transaction. |

##### Problem 4-1

System Company, formed in 2009, is a largest marketer and distributor of food service products, serving approximately 40,000 restaurants, hotels, schools, hospitals, and other institutions. The following summarized transactions are typical of those that occurred in a recent year

1. Borrowed $185,000 from a bank, signing a 90-day note.
2. Provided $29,335 in services to customers during the year, with $21,300 on account and the remainder received in cash.
3. Purchased Land for $ 200,000 and Building $ 530,000 in cash.
4. Purchased $23,836 inventory on account.(Merchandise Inventory account will be recorded)
5. Paid salaries to employees, $3,102 during the year.
6. Received $21,120 on account paid by customers.
7. Purchased and used fuel of $730,000 in delivery vehicles during the year (paid for in cash)
8. Mr Alexander withdrew $10,000 cash for personal use.
9. Paid $4,035 cash on accounts payable.
10. Incurred $ 61,000 in utility usage during the year; paid $53,000 in cash and owed the rest on account.

Required: Recording the above transactions in Journal.

### General Journal Page 1

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Account Title/Explanation** | **PR** | **Debit** | **Credit** |
|  |  |  |  |  |
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**Problem 4-2**

Nicole Harn opened ―Green Spa Clinic‖ on September 1, 2020. During the month, the following transactions were completed:

Sept. 1 Nicole Harn invested $10,000 cash into the business.

2 Purchased equipment for $5,000 to be paid within 30 days.

4 Purchased spa supplies for $1,400 on account.

7 Paid one-year insurance policy $600.

11 Received cash $3,000 for spa services rendered to customers.

15 Paid the salaries of the employees for the first half of the month, $800.

20 Billed customers $4,000 for the services rendered.

25 Paid 40% of the amount due for the purchase of equipment on Sept. 2 and $1,400 for the spa supplies purchased on Sept. 4.

1. Paid for the following expenses for the month: Rent - $3,000; Utilities - $800; Advertising - $200.
2. Paid employees salaries for the second half of the month $800.

30 Nicole took home spa supplies for her personal use $500.

###### Instructions:

1. Journalize the above transactions. Explanation is required.
2. Post the recorded transactions into the ledgers. Posting reference is required.
3. Prepare the trial balance as of September 30, 2009.

###### Chart of Accounts

1. Cash 41 Service Revenue
2. Accounts Receivable 51 Salaries Expense
3. Supplies 52 Utilities Expense
4. Prepaid Insurance 53 Rent Expense
5. Equipment 54 Advertising Expense

21 Accounts Payable

1. Nicole Harn, Capital
2. Nicole Harn, Withdrawal

**Journalizing**

**General Journal Page1**

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| **Date** | **Account Title/Explanation** | **PR** | **Debit** | **Credit** |
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##### General Journal Page2

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**Posting to the ledgers**

**\_Cash**

**11 Nicole Harn, Capital 31**

**Nicole Harn, Withdrawal 32**

**Accounts Receivable 12 Service Revenue 41**

**Supplies 13 Salaries Expense 51**

**Prepaid Insurance 15 Utilities Expense 52**

**Equipment 16 Rent Expense 53**

**Accounts Payable 22 Advertising Expense 54**

**Trial Balance**

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| **Account Title** | **Debit** | **Credit** |
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**Problem 4-3**

Silver Kordon opens a computer consulting business called Silk Consultants and completes the

following transactions in its first month of operations.

April 1 Kordon invests $95,000 cash along with office equipment valued at $22,800 in the company.

1. The Silk Consultant prepaid $7,200 cash for twelve months‘ rent for office space. (Hint: Debit Prepaid Rent for $7,200)
2. The Silk Consultant made credit purchases for $11,400 in office equipment and

$2,280 in office supplies. Payment is due within 10 days.

6 The Silk Consultant completed services for a client and immediately received $2,000 cash.

9 The Silk Consultant completed a $7,600 project for a client, who must pay within 30 days.

13 The silk Consultant paid $13,680 cash to settle the account payable created on April 3.

19 The Silk Consultant paid $6,000 cash for the premium on a 12-month insurance policy. (Hint: Debit prepaid insurance for $6,000)

22 The Silk Consultant received $6,080 cash as partial payment for the work completed on April 9.

25 The Silk Consultant completed work for another client for $2,640 on credit.

28 Kordon withdrew $6,200 cash from the company for personal use.

1. The Silk Consultant purchased $760 of additional office supplies on credit.
2. The Silk Consultant paid $700 cash for this month‘s utility bill.

##### Required

1. Prepare general journal entries to record these transactions (use account titles listed in part

2)

1. Open the following ledger accounts—their account number are in parentheses (use the balance column format): Cash 101; Accounts Receivable (106); Office Supplies (124); Prepaid Insurance (128): Prepaid Rent (131); Office Equipment (163); Accounts Payable (201); S. Kordon, Capital (301); S. Kordon, Withdrawals (302); Services Revenue (403); and Utilities Expense (690). Post journal entries from part 1 to the ledger accounts and enter the balance after each posting.
2. Prepare a trial balance as of April 30.

##### General Journal Page 2

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**Posting to the ledgers**

**Cash Acct. #101**

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**Accounts Receivable Acct. #106**

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**Office Supplies Acct. #124**

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**Prepaid Insurance Acct. #128**

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**Prepaid Rent Acct. #131**

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**Office Equipment Acct. #163**

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**Accounts Payable Acct. #201**

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**S. Kordon, Capital Acct. #301**

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**S. Kordon, Withdrawals Acct. #302**

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**Services Revenue Acct. #403**

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**Utilities Expense Acct. #690**

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**Trial Balance**

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