Accounting Fundamentals Lesson 2

2.0 Processing Accounting Information

Lesson 2 discusses how companies record the transactions that take place and eventually become part of the financial statements.

A transaction is any event that has a financial impact on the business and can be measured reliably.

Transactions provide objective information about the financial impact on a company, and it has two sides:

- Giving something
- Receiving something in return

Both sides of the transaction must be recorded.

2.1 Account Categories and Examples

Assets - economic resources that provide a future benefit for a business.

Examples of assets include:
- Cash
- Accounts receivable
- Notes receivable
- Inventory
- Prepaid expenses
- Land
- Buildings
- Equipment
- Furniture
- Fixtures

Liabilities - debts of the business.

Common types include:

Accounts payable
Notes payable
Accrued liabilities

Stockholders' equity - The owners' claims to the assets of a corporation

Accounting is based on a **double-entry system**, whereby each transaction affects at least two accounts.

Journal – utilized by accountants to record transactions in the company's books.

Three steps must be taken in order to journalize a transaction:
1. Each affected account must be specified,
2. A determination must be made regarding the increase/decrease of each account,
3. The transaction is recorded in the journal.

These journal entries are then copied to the ledger in a process called posting. After all entries are posted, a balance in each account can be determined.

Journalizing Example:

Account and Explanation	Debit	Credit
Cash	50,000	
Common Stock		50,000

T-account - An account represented by the letter "T"

The vertical line divides the "T" into a left side and a right side. The left side is called the **debit** side, and the right side is called the **credit** side.

ACCOUNT TITLE

Debit	Credit

T-Account Example:

Office Furniture	
4/19 250	

Accounts Payable	
	4/19 250

Posting Example:

Account and Explanation	Debit	Credit
Cash	50,000	
Common Stock		50,000
Issued Common Stock		

Cash	
50,000	

Common Stock	
	50,000

Increases in assets are recorded on the debit side of the account, while decreases to assets are recorded on the credit side.

Liabilities and stockholders' equity are increased with credits, and they are decreased with debits.

Revenues - increases in stockholders' equity that result from delivering goods or services to customers.

Expenses - decreases in stockholders' equity due to the cost of operating the business.

Dividends and expenses are equity accounts that are increased with a debit. Revenues are equity accounts that are increased with a credit.

Trial balance - lists all accounts with their balances and shows whether total debits equal total credits. The trial balance is shown with assets listed first, followed by liabilities and stockholders' equity.

A trial balance may be prepared at any time, but typically the preparation occurs at the end of the period. The trial balance assists in the preparation of the financial statements – income statement, statement of retained earnings, and balance sheet.

The ledger - used to analyze the activity of a company's transactions. Additionally, a trial balance can be used to correct any accounting errors that may have occurred during the period.

Organizations use a chart of accounts to list all of their accounts and the corresponding account numbers. Each account will have a normal balance.

Account Type	Normal Balance	Increase	Decrease
Asset	Debit	Debit	Credit
Liability	Credit	Credit	Debit
Stockholders' Equity	Credit	Credit	Debit
Revenue	Credit	Credit	Debit
Expense	Debit	Debit	Credit
Common Stock	Credit	Credit	Debit
Retained Earnings	Credit	Credit	Debit
Dividends	Debit	Debit	Credit

When a company receives cash (asset), the Cash account is debited.

When the company pays cash (asset), the Cash account is credited.

2.2 The Accounting Process

The same basic process that bookkeepers and accountants used to perform by hand are present in today's accounting software. Here are the steps in the accounting cycle:

(1) Identify the transaction from source documents, like purchase orders, loan agreements, invoices, etc.

(2) Record the transaction as a journal entry

(3) Post the entry in the individual accounts in ledgers. Accounts are been represented T-accounts, with debits on the left and credits on the right.

(4) At the end of the reporting period (usually the end of the month), create a preliminary trial balance of all the accounts by (a) netting all the debits and credits in each account to calculate their balances and (b) totaling all the left-side (i.e, debit) balances and right-side (i.e., credit) balances. The two columns should be equal.

(5) Make additional adjusting entries that are not generated through specific source documents. For example, depreciation expense is periodically recorded for items like equipment to account for the use of the asset and the loss of its value over time.

(6) Create an adjusted trial balance of the accounts. Once again, the left-side and right-side entries - i.e. debits and credits - must total to the same amount.

(7) Combine the sums in the various accounts and present them in financial statements created for both internal and external use.

(8) Close the books for the current month by recording the necessary reversing entries to start fresh in the new period (usually the next month).

Nearly all companies create end-of-year financial reports, and a new set of books is begun each year. Depending on the nature of the company and its size, financial reports can be prepared at much more frequent (even daily) intervals. The SEC requires public companies to file financial reports on both a quarterly and yearly basis.

SEC - Securities and Exchange Commission. A government agency that enforces and regulates federal laws on the securities industry and the nation's stock and options exchanges.