We learned:

- What Accounting is:
  - the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions
- The Accounting Function:
  - Internal usage: Management Accounting (We will focus on Cost Accounting part)
  - External usage: Stewardship Accounting (We will focus on Financial Accounting part)
- Types of Businesses
  - Sole Proprietorship
  - Partnership
  - Corporation

We learned:

- Financial Position and the Accounting Equation

Financial Position

Economic resources that belong to a company and the claims (*equities*) against those resources at a point in time

Accounting Equation

$$\boxed{\text{Assets} = \text{Liabilities} + \text{Owner's Equity}}$$

- Business Transactions:
  - are economic events that affect the financial position of a business entity
- How to show the effects of these business transactions on Accounting Equation

Business Transactions

Defined as the economic events that affect the financial position of a business entity. To measure a business transaction, accountants must decide:

1. when the transaction occurred (recognition issue)
   - whenever the ownership passes to the firm
   - whenever revenue is earned
   - whenever a cost is incurred
2. what value to place on the transaction (valuation issue)
   - original cost (the exchange price) associated with transaction at the time of recognition.
   - The practice of recording transactions at cost is called cost principle and used due to its verifiability.
3. how the transaction should be categorized (classification issue)
   - assigning all transactions to appropriate categories and finally to accounts.

In the measurement of business transactions

- vast amount of data are gathered
- data should be recorded and stored appropriately to facilitate easy retrieval and easy usage
- preparing the accounting equation for each transaction is time consuming and can cause information losses
- Therefore, account is used as the basic storage unit for accounting data, to accumulate similar transactions

Accounts

- Accounting systems have separate accounts
  - for each Asset and for each Liability
  - for each Components of Owner's Equity (also Revenues and Expenses)

Each account is kept on a separate page and book that contains all these accounts is called General Ledger or simply Ledger. A unique number is assigned to each account for easy reference.

Assets Accounts

- Cash
- Notes Receivable
  - Written promissory note for a fixed date
- Accounts Receivable
  - Oral or implied promises
- Prepaid Expenses
  - Pay for goods and services in advance
  - Asset until used or expired
  - Supplies, Prepaid Insurance, Prepaid Rent, Prepaid Taxes
- Land
- Buildings
  - Subject to wear-tear (depreciation)
- Equipment

Liabilities Accounts

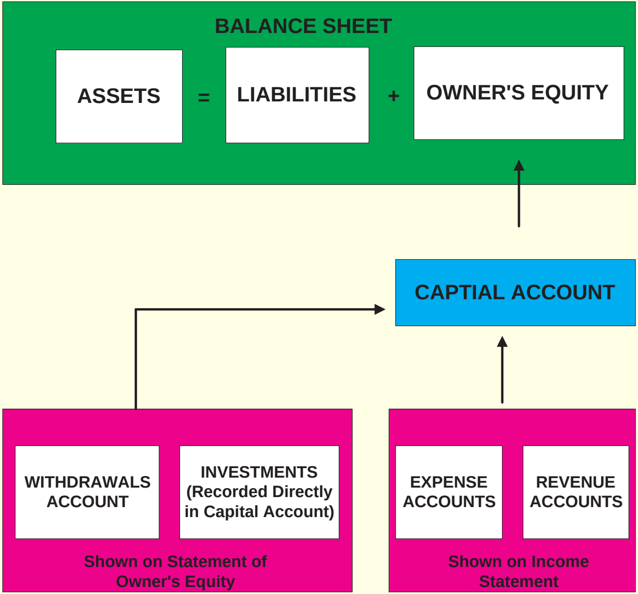
Another term is debt.

- Notes Payable
  - Opposite of Notes Receivable
- Accounts Payable
  - Opposite of Accounts Receivable
- Wages Payable
- Taxes Payable
- Rent Payable
- Interest Payable
- Accounts opposite of Prepaid Expenses (customers pay in advance)
  - Unearned Fees
  - Customer Deposits
  - Advances from Customers
  - Unearned Revenues

Owner's Equity Accounts

- Capital Account
  - investments by the owners are recorded here
  - not a revenue by law
- Withdrawals Account
  - withdrawals by the owners are recorded in this account
  - not an expense by law
- Revenue and Expense Accounts
  - Temporary accounts used to calculate net income
  - closed out at the end of the period with the net difference transferred to capital account
  - One account for each to facilitate easy understanding of revenue and expense sources

Let's see the relationships of Owner's Equity Accounts.



The Double-Entry System

- backbone of accounting evolved in Renaissance
- based on principle of duality
- every economic event has two aspects that balance each other
  - effort and reward
  - sacrifice and benefit
  - source and use
- each transaction must be recorded with at least one debit and one credit
- total dollar amount of debits and the total amount of credits equal each other
- therefore, whole system is always in balance

T Accounts

Very useful to understand how the double-entry system works. They are the basic representations of the accounts and have three parts:

1. Title
2. A left side which is called the debit side
3. A right side which is called the credit side.

Title of Account	
Debit	Credit

- An entry made on the left side of the account is a debit
- An entry made on the right side of the account is a credit
- Debit and credit are simply accountant's word for left and right. NO ANY OTHER MEANINGS!

To illustrate the usage of T accounts, let's consider the cash account of the Luxury Homes Realty. The transactions that involves:

- the receipt of cash are recorded by entering on left (debit)
- payment of cash are recorded by entering on right (credit)

Tabular Summary

Cash
50,000
-35,000
1,500
-200
1,000
-1,000
-400
-600
15,300

Account Form

Cash			
(1)	50,000	(2)	35,000
(5)	1,500	(4)	200
(7)	1,000	(8)	1,000
		(9)	400
		(10)	600
	52,500		37,200
Bal.	15,300		

The difference in the debit and credit footings is called the balance or account balance. If the balance is a debit it is written on the left side of the T-account and if it is credit on the right side.

According to the rules of double-entry bookkeeping

For every transaction:

1. at least one account is debited and at least one account is credited
2. the total amount of debits must equal total of credits

Consider the Accounting Equation

Assets = Liabilities + Owner's Equity

1. if a debit increases assets, then a credit must be used to increase the liabilities or the owner's equity
2. if a credit decreases the assets, then a debit should decrease the liabilities or owner's equity

Assets		=	Liabilities		+	Owner's Equity	
Debit for Increase	Credit for Decrease		Debit for Decrease	Credit for Increase		Debit for Decrease	Credit for Increase

RULES:

1. Increases in assets are debited to asset accounts; decreases in assets are credited to the assets accounts.
2. Increases in liabilities and owner's equities are credited to liabilities and owner's equities accounts; decreases in liabilities and owner's equities are debited to the liabilities and owner's equities accounts.

Assets		=	Liabilities		+	Owner's Equity	
Debit for Increase	Credit for Decrease		Debit for Decrease	Credit for Increase		Debit for Decrease	Credit for Increase

Historical Background

- Accounts decide to enter increases in assets to the left side (debit) of accounts, since assets are on the left side of the accounting equation
- Accounts decide to enter increases in liabilities and owner's equity to the right side (credit) of accounts, since liabilities and owner's equity are on the right side of the accounting equation

The application of those rules to the owner's equity is a bit confusing since its components; revenues, expenses,withdrawals and investments have different effects.

- Revenues increase owner's equity
- Expenses decrease owner's equity
- Withdrawals decrease owner's equity
- Investment increase owner's equity

The following relationship is useful to visualize that relationship:

Owner's Equity

Decreases (debits)	Increases (credits)

Expenses

Increases (debit)	Decreases (credit)

Withdrawals

Increases (debit)	Decreases (credit)

Revenues

Decreases (debit)	Increases (credit)

Capital

Decreases (debit)	Increases (credit)

OR SIMPLY

Assets Expenses Withdrawals	
Debit for Increase	Credit for Decrease

Liabilities Revenues Capital	
Debit for Decrease	Credit for Increase

January 1: John Miller invests $10,000 to start his own advertising agency.

Cash	
Jan.1 10,000	

John Miller, Capital	
	Jan.1 10,000

Rules

Increase in assets are debited to the asset account, increase in owner's equity is credited to the owner's equity account.

January 2: John Miller rents an office, pays 2 months rent, $800 in advance.

Cash

Jan.1	10,000	Jan.2	800

Prepaid Rent

Jan.2	800		

Rules

Increase in assets are debited to the asset account, decrease in assets is credited to the asset accounts.

January 4: Purchase art equipment, $4,200, with cash.

Cash

Jan.1	10,000	Jan.2	800
		Jan.4	4,200

Art Equipment

Jan.4	4,200		

Rules

Increase in assets are debited to the asset account, decrease in assets is credited to the asset accounts.

January 5: Purchases office equipment, \$3,000, pays \$1,500 in cash and agree to pay the rest of the payment \$1,500 next month.

Cash

Jan.1	10,000	Jan.2	800
		Jan.4	4,200
		Jan.5	1,500

Office Equipment

Jan.5	3,000		

Account Payable

		Jan.5	1,500

Rules

Increase in assets are debited to the asset account, decrease in assets is credited to the asset accounts, increase in liabilities are recorded as credits.

January 6: Purchases art supplies, $1,800, office supplies, $800 on credit from Taylor Company.

Office Supplies

Jan.6 800	

Art Supplies

Jan.6 1,800	

Account Payable

	Jan.5 1,500
	Jan.6 2,600

Rules

Increase in assets are debited to the asset accounts, increase in liabilities are recorded as credits.

January 8: Pays for a one-year life insurance policy, $480, with coverage effective January 1.

Cash

Jan.1	10,000	Jan.2	800
		Jan.4	4,200
		Jan.5	1,500
		Jan.8	480

Prepaid Insurance

Jan.8	480	

Rules

Increase in assets are debited to the asset account, decrease in assets is credited to the asset accounts.

January 9: Pays Taylor Company $1,000 of the amount owned.

Cash

Jan.1	10,000	Jan.2	800
		Jan.4	4,200
		Jan.5	1,500
		Jan.8	480
		Jan.9	1,000

Account Payable

Jan.9	1,000	Jan.5	1,500
		Jan.6	2,600

Rules

Decrease in assets is credited to the asset accounts, decrease in liabilities is recorded as debits.

January 10: Performs a service by placing an advertisement for an automobile dealer and collects a fee, $1,400.

Cash

Jan.1	10,000	Jan.2	800
Jan.10	1,400	Jan.4	4,200
		Jan.5	1,500
		Jan.8	480
		Jan.9	1,000

Adv. Fee Earned

		Jan.10	1,400

Rules

Increase in assets is debited to the asset accounts, increase in owner's equity is recorded as credits.

January 12: Pays the two week wage of the secretary, $600.

Cash

Jan.1	10,000	Jan.2	800
Jan.10	1,400	Jan.4	4,200
		Jan.5	1,500
		Jan.8	480
		Jan.9	1,000
		Jan.12	600

Wages Expense

Jan.12	600	

Rules

Decrease in assets is credited to the asset accounts, decrease in owner's equity is recorded as debits.

January 15: Accepts an advance fee, $1000, for artwork to be done.

Cash

Debit		Credit	
Jan.1	10,000	Jan.2	800
Jan.10	1,400	Jan.4	4,200
Jan.15	1,000	Jan.5	1,500
		Jan.8	480
		Jan.9	1,000
		Jan.12	600

Unearned Art Fees

Debit	Credit	
	Jan.15	1000

Rules

Increase in assets is debited to the asset accounts, increase in liabilities is recorded as credits.

January 19: Performs a service by placing a major advertisement for Wall Mart. The fee, $2,800 is billed now but will be collected next month.

Accounts Receivable

Debit	Credit
Jan.19 2,800	

Adv. Fee Earned

Debit	Credit
	Jan.10 1,400
	Jan.19 2,800

Rules

Increase in assets is debited to the asset accounts, increase in owner's equity is recorded as credits.

January 25: John Miller withdraws $1,400 for his personal usage.

Cash

Jan.1	10,000	Jan.2	800
Jan.10	1,400	Jan.4	4,200
Jan.15	1,000	Jan.5	1,500
		Jan.8	480
		Jan.9	1,000
		Jan.12	600
		Jan.25	1,400

John Miller, Withdrawals

Jan.25	1,400	

Rules

Decrease in assets is credited to the asset accounts, decrease in owner's equity is recorded as debits.

January 26: John Miller pays this secretary two more weeks' wages, \$600.

Cash

Jan.1	10,000	Jan.2	800
Jan.10	1,400	Jan.4	4,200
Jan.15	1,000	Jan.5	1,500
		Jan.8	480
		Jan.9	1,000
		Jan.12	600
		Jan.25	1,400
		Jan.26	600

Wages Expense

Jan.12	600		
Jan.26	600		

Rules

Decrease in assets is credited to the asset accounts, decrease in owner's equity is recorded as debits.

January 29: John Miller receives and pay the utility bill, $100.

Cash

Jan.1	10,000	Jan.2	800
Jan.10	1,400	Jan.4	4,200
Jan.15	1,000	Jan.5	1,500
		Jan.8	480
		Jan.9	1,000
		Jan.12	600
		Jan.25	1,400
		Jan.26	600
		Jan.29	100

Utility Expense

Jan.29	100	

Rules

Decrease in assets is credited to the asset accounts, decrease in owner's equity is recorded as debits.

January 30: John Miller receives but not pay the telephone bill, $70.

Telephone Expense

Jan.30	70	

Account Payable

Jan.9	1,000	Jan.5	1,500
		Jan.6	2,600
		Jan.30	70

Rules

Increase in liabilities is credited, decrease in owner's equity is recorded as debits.

The usage of T accounts for recording the transactions is due to its simplicity and effectiveness. But;

- do not show the data of a transaction together (associated debits and credits are on separate T accounts)
- Not Chronological

Therefore, T accounts are only used for analyzing complex transactions in practice.

Formal process for recording the transactions:

1. Analyze the transactions from the source documents
2. Enter the transactions into the Journal
3. Transfer data from journal to the Ledger by debiting and crediting the particular accounts involved (called posting)

The General Journal

- All transactions are recorded to the Journal chronologically
  - identification of the individual transactions easy
  - debits and credits related with a transaction is entered same place
- A separate journal entry is used for each transaction
- Entries in the general journal include:
  - the date
    - year and month not repeated unless a new month or page
  - names of accounts debited and credited
    - first the debited accounts, next to left margin
    - after them the credited accounts, indented from left margin
  - amount of debits and credits made to the same line as the accounts
  - an explanation of the transaction
  - post reference is used to enter the ledger account number after posting from journal takes place for
    - convenient cross reference
    - indicating the transaction is already posted
  - a blank line is left after each journal entry

Let's see how two transactions for the John Miller Advertising Company would look like:

General Journal					Page 1
Date		Description	Post Ref.	Debit	Credit
2007 Jan.	*6*	*Art Supplies*		*1,800*	
		Office Supplies		*800*	
		Accounts Payable			*2,600*
		Purchase of art and office supplies on credit			
	8	*Prepaid Insurance*		*480*	
		Cash			*480*
		Paid one year life insurance premium			

The T account is a simple and direct way to update the accounts, but in practice a more complicated form of account is needed.

The General Ledger

- The name and number of the account appear at the top
- Date is entered similar to the journal
- The Post. Ref. section indicates the page of the journal where the original entry for the transaction recorded
- The balance is computed and entered after each entry
- The balance is always available (not in T accounts)

The accounts payable account in the ledger at the end of the month is given as:

General Ledger

Accounts Payable **Account No:212**

Date		Item	Post Ref.	Debit	Credit	Balance Debit	Balance Credit
2007 Jan.	*5*		*J1*		*1,500*		*1,500*
	6		*J1*		*2,600*		*4,100*
	9		*J1*	*1,000*			*3,100*
	30		*J2*		*70*		*3,170*

Posting

- Entries in the journal are transferred into the ledger regularly
- Debit (credit) amount in the journal is transferred into the debit (credit) column of the appropriate account in the ledger
- After the entry is done, account number is entered to the Post.Ref. column of the journal where the account is credited or debited.

General Journal					Page 2
Date		**Description**	**Post. Ref.**	**Debit**	**Credit**
2007 Jan.	30	*Telephone Expense*		70	
		Accounts Payable			70
		Received Bill for telephone expense			

In the ledger, locate the debit and credit accounts named in the journal

General Journal

Page 2

Date		Description	Post. Ref.	Debit	Credit
2007 Jan.	30	*Telephone Expense*		70	
		Accounts Payable			70
		Received Bill for telephone expense			

General Ledger

Accounts Payable — Account No. *212*

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2007 Jan.	*5*		*J1*		*1,500*		*1,500*
	6		*J1*		*2,600*		*4,100*
	9		*J1*	*1,000*			*3,100*

General Ledger

Telephone Expense — Account No. *513*

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2007 Jan.							

In the ledger, enter the date and journal page to post. ref.

General Journal

Page 2

Date		Description	Post. Ref.	Debit	Credit
2007 Jan.	30	*Telephone Expense* *Accounts Payable* *Received Bill for telephone expense*		70	70

General Ledger

Accounts Payable — Account No. *212*

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2007 Jan.	*5*		*J1*		*1,500*		*1,500*
	6		*J1*		*2,600*		*4,100*
	9		*J1*	*1,000*			*3,100*
	30		*J2*				

General Ledger

Telephone Expense — Account No. *513*

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2007 Jan.	*30*		*J2*				

In the ledger, transfer the debit and credits amounts from journal

General Journal

Page 2

Date		Description	Post. Ref.	Debit	Credit
2007 Jan.	30	*Telephone Expense* *Accounts Payable* *Received Bill for telephone expense*		70	70

General Ledger

Accounts Payable — Account No. *212*

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2007 Jan.	*5*		*J1*		*1,500*		*1,500*
	6		*J1*		*2,600*		*4,100*
	9		*J1*	*1,000*			*3,100*
	30		*J2*		*70*		

General Ledger

Telephone Expense — Account No. *513*

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2007 Jan.	*30*		*J2*	*70*			

In the ledger, calculate the account balances in balance columns

General Journal					Page 2
Date		Description	Post. Ref.	Debit	Credit
2007 Jan.	30	*Telephone Expense* *Accounts Payable* *Received Bill for telephone expense*		70	70

General Ledger

Accounts Payable						Account No. *212*	
						Balance	
Date		Item	Post. Ref.	Debit	Credit	Debit	Credit
2007 Jan.	*5*		*J1*		*1,500*		*1,500*
	6		*J1*		*2,600*		*4,100*
	9		*J1*	*1,000*			*3,100*
	30		*J2*		*70*		*3,170*

General Ledger

Telephone Expense						Account No. *513*	
						Balance	
Date		Item	Post. Ref.	Debit	Credit	Debit	Credit
2007 Jan.	*30*		*J2*	*70*		*70*	

In the journal, in post. ref. enter the account numbers from ledger

General Journal

Page 2

Date		Description	Post. Ref.	Debit	Credit
2007 Jan.	30	*Telephone Expense*	*513*	70	
		Accounts Payable	*212*		70
		Received Bill for telephone expense			

General Ledger

Accounts Payable — Account No. *212*

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2007 Jan.	*5*		*J1*		*1,500*		*1,500*
	6		*J1*		*2,600*		*4,100*
	9		*J1*	*1,000*			*3,100*
	30		*J2*		*70*		*3,170*

General Ledger

Telephone Expense — Account No. *513*

Date		Item	Post. Ref.	Debit	Credit	Balance Debit	Balance Credit
2007 Jan.	*30*		*J2*	*70*		*70*	

For every amount debited in the ledger, an equal amount must be credited. Which means the total of debits must be equal to the total of the credits. This is tested periodically by preparing a trial balance.

The steps in preparing a trial balance:

1. List each account that has a balance; debit balances entered into the left column, credit balances into the right.
2. Add each column.
3. Left and right columns must equal each other.

CAUTION!

- Trial balance proves whether or not the ledger is in balance
- Does not prove that the transactions were analyzed and recorded in proper accounts

Let's see the trial balance for the John Miller Advertising Company at the end of January.

John Miller Advertising Company
Trial Balance
January 31, 2007

Cash	$1,720	
Accounts Receivable	2,800	
Art Supplies	1,800	
Office Supplies	800	
Prepaid Rent	800	
Prepaid Insurance	480	
Art Equipment	4,200	
Office Equipment	3,000	
Accounts Payable		$3,170
Unearned Art Fees		1,000
John Miller, Capital		10,000
John Miller, Withdrawals	1,400	
Advertising Fees Earned		4,200
Wages Expense	1,200	
Utility Expense	100	