Accounting

Lecture 2: **Recording Business Transactions**

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Review Questions

Match the accounting terminology to the definition

Benefit	Definition
1. Certified management accountants	e. Certified professionals who work for a single company.
2. Accounting	a. The information system that measures business activities, processes that information into reports, and communicates the results to decision makers.
3. Managerial accounting	d. The field of accounting that focuses on providing information for internal decision makers.
4. Certified public accountants	b. Licensed professional accountants who serve the general public.
5. Financial accounting	f. The field of accounting that focuses on providing information for external decision makers.
6. Creditor	c. Any person or business to whom a business owes money.

Reviews

- **What is the Accounting?**

Accounting is an information process, which is related with collecting and recording financial information from business organizations, and communicating relevant financial information to stakeholders.

- **information process:** identifying, collecting, classifying, recording and communicating
- **stakeholders:** persons or entities have interest in the economic performance of the business. e.g. managers, creditors, bankers
- **Global and professional business language**

How to govern accounting?

I. Governing Organizations:

SEC in USA, FASB in USA, IASB in UK,

II. Guidelines for Accounting Information:

Generally Accepted Accounting Principles(GAAP), Sarbanes-Oxley Act(SOX), International Financial Report Standards(IFRS)

III. Basic Accounting Assumptions and Principles:

Economic Entity, Going Concern, and Monetary Unit assumption…

Comparison of FA and MA

	Financial Accounting	Managerial Accounting
1. Users	External persons who make financial decisions	Managers who plan for and control an organization
2. Time focus	Historical perspective	Future emphasis
3. Verifiability versus relevance	Emphasis on verifiability	Emphasis on relevance for planning and control
4. Precision versus timeliness	Emphasis on precision	Emphasis on timeliness
5. Subject	Primary focus is on the whole organization	Focuses on segments of an organization
6. GAAP	Must follow GAAP and prescribed formats	Need not follow GAAP or any prescribed format
7. Requirement	Mandatory for external reports	Not Mandatory

Learning Objective

- Describe five Elements of Accounts
- Use the accounting equation to analyze transactions
- Basic Accounting Principles : the accounting equation, Profit Determination and Double-entry bookkeeping

Account

- An account is a separate record of financial transactions ,which shows the increases and decreases in financial statement item <u>during a specific period</u>. e.g. inventory, purchases, sales and cash accounts
- Every account will have a debit and credit side.
- Often accounts are numbered.

  The numbers will usually be grouped by account type.

FASTFORWARD Balance Sheet December 31, 2009		
Assets		
Cash	$	4,350
Supplies		9,720
Prepaid insurance		2,400
Equipment		26,000
Total assets	$	42,470
Liabilities		
Accounts payable	$	6,200
Unearned revenue		3,000
Total liabilities		9,200
Equity		
C. Taylor, Capital	$	33,270
Total equity		33,270
Total liabilities and equity	$	42,470

Account Format

- Ledger account- formal format

Cash Account No. 101

Date	item	post ref.	debit	credit	balance
Mar 1	Cash received from customers	J1	240		240 Dr
Mar 3	Wages paid	J10		116	124 Dr
Mar 4	Cash received from customers	J23	300		424 Dr

- 'T' account- informal

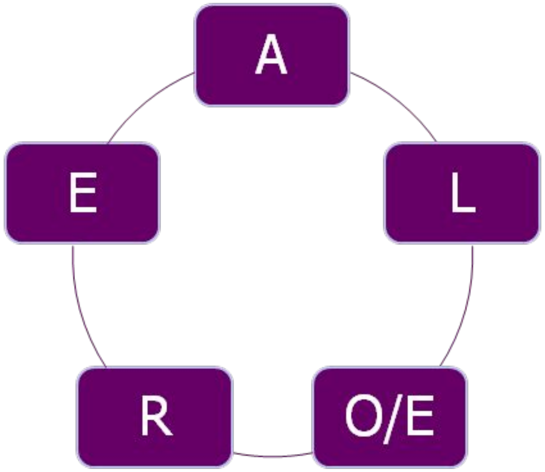
Debit: what comes in
Credit: what goes out

Account Name

Debit (DR)	Credit (CR)

Five Elements (Groups) of Accounts

- Assets (A)
- Liabilities (L)
- Owner's Equity (O/E)
- Revenue (R)
- Expenses (E)



- **Temporary accounts** : balances of accounts last only for one financial years (12 month). Revenue and Expenses accounts are always closed before the preparation of a balance sheet.—Income Statement
- **Permanent accounts:** Assets, Liabilities and Owner's Equity accounts keep the balances of accounts ,and leave them in the next financial year.– Balance Sheet

1. Assets (A)

- **Assets (A)** economic resources controlled by the entity as a result of past events and from which economic benefits are expected to follow into the entity.

- **Asset Recognition Criteria:**

-past events (or transactions)

-bring future economic benefit

-current control

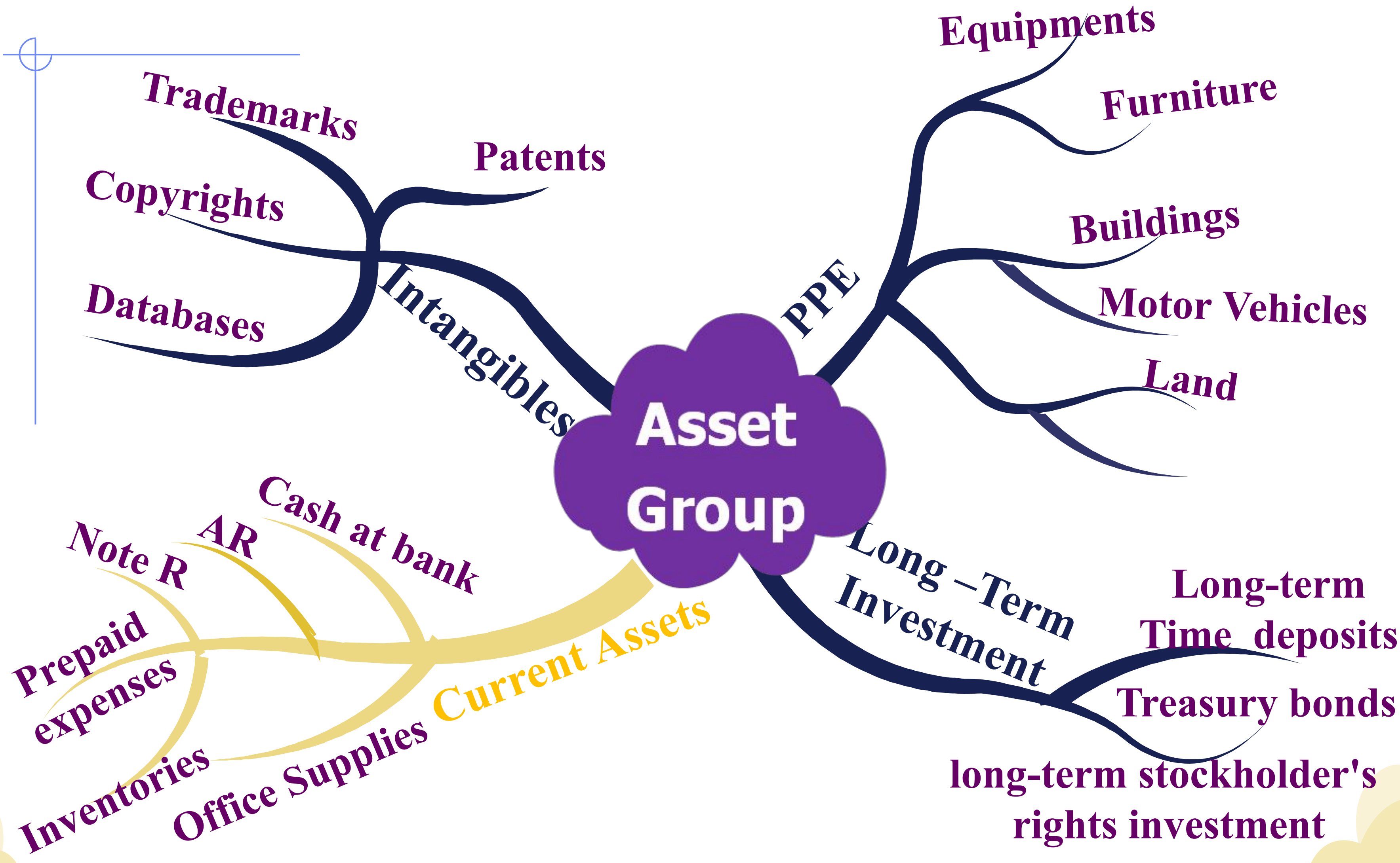
- **Current Asset:** Cash, Accounts Receivable(AR)…
- **Non-current Asset:** Property, Plant, and Equipment (PPE or EFF), land, long term investment, intangible assets (intangibles)

1.Typical **Asset** Accounts (A)

Exhibit 2-1 | **Asset Accounts**

Account Name	Explanation
Cash	A business's money. Includes bank balances, bills, coins, and checks.
Accounts Receivable	A customer's promise to pay in the future for services or goods sold. Often described as "On Account."
Notes Receivable	A *written* promise that a customer will pay a fixed amount of money and *interest* by a certain date in the future. Usually more formal than an Accounts Receivable.
Prepaid Expense	A payment of an expense in advance. It is considered an asset because the prepayment provides a benefit in the future. Examples of prepaid expenses are *Prepaid Rent*, *Prepaid Insurance*, and *Office Supplies*.
Equipment, Furniture, and Fixtures	The cost of equipment, furniture, and fixtures (such as light fixtures and shelving). A business has a separate asset account for each type.
Building	The cost of an office building, a store, or a warehouse.
Land	The cost of land a business uses in operations.

1. Assets (A)


Trademarks
Patents
Copyrights
Databases
Intangibles
Equipments
Furniture
Buildings
Motor Vehicles
Land
PPE
Asset Group
Cash at bank
AR
Note R
Prepaid expenses
Inventories
Office Supplies
Current Assets
Long –Term Investment
Long-term Time deposits
Treasury bonds
long-term stockholder's rights investment

2. Liabilities (L)

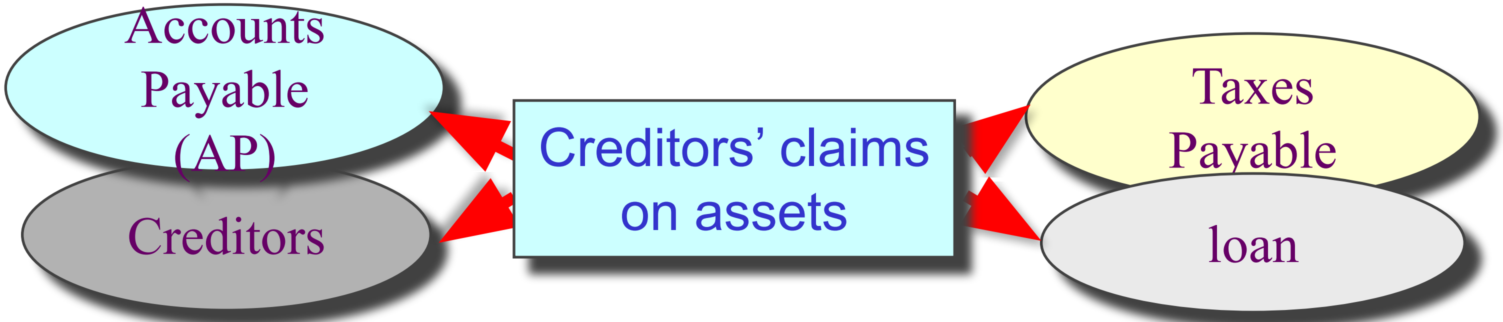
- **Liabilities (L)** present obligations that legally binds an individual or company to settle a debt.
- **Liability Recognition Criteria:**

-probable future sacrifice of economic benefit

-present obligation

-past transaction or event

- **Current Liabilities:** sacrifice will occur within a year. AP, creditors
- **Non-current Liabilities:** long-term bonds, loan



2.Typical **Liability** Accounts (L)

Exhibit 2-2 | Liability Accounts

Account Name	Explanation
Accounts Payable	A promise made by the business to pay a debt in the future. Arises from a credit purchase.
Notes Payable	A *written* promise made by the business to pay a debt, usually involving *interest*, in the future.
Accrued Liability	An amount owed but not paid. A specific type of payable such as *Taxes Payable*, *Rent Payable*, and *Salaries Payable*.
Unearned Revenue	Occurs when a company receives cash from a customer but has not provided the product or service. The promise to provide services or deliver goods in the future.

2. Liabilities (L)

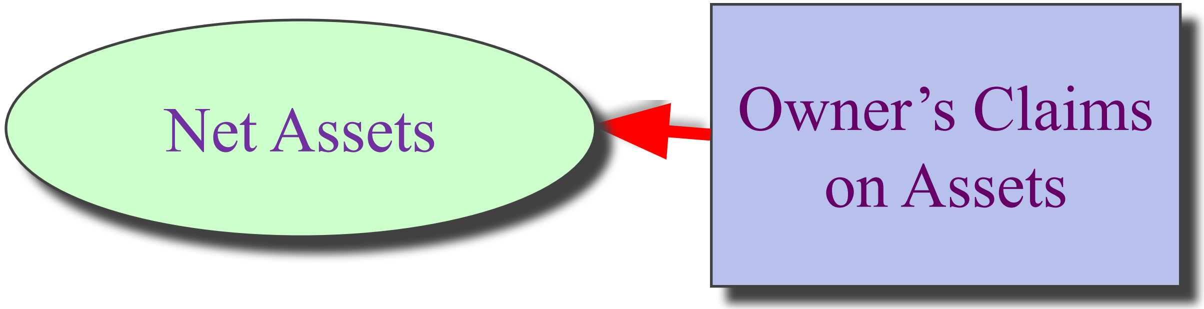
3. Owner's Equity (O/E)

- **Owner’s Equity (O/E)** the amount of ownership an individual or company has in an asset. It is the total difference between total assets and total liabilities.

Total assets - Total liabilities=Net Assets

= Owner's Equity

e.g. capital (beginning balance), additional paid-in capital, return earnings, common stock, net income



3.Typical **Equity** Accounts (O/E)

Exhibit 2-3 **Equity Accounts**

Account Name	Explanation
Capital	Represents the net contributions of the owner in the business. Increases equity.
Owner Withdrawals	Distributions of cash or other assets to the owner. Decreases equity.
Revenues	Earnings that result from delivering goods or services to customers. Increases equity. Examples include *Service Revenue* and *Rent Revenue*.
Expenses	The cost of selling goods or services. Decreases equity. Examples include *Rent Expense*, *Wages Expense*, and *Utilities Expense*.

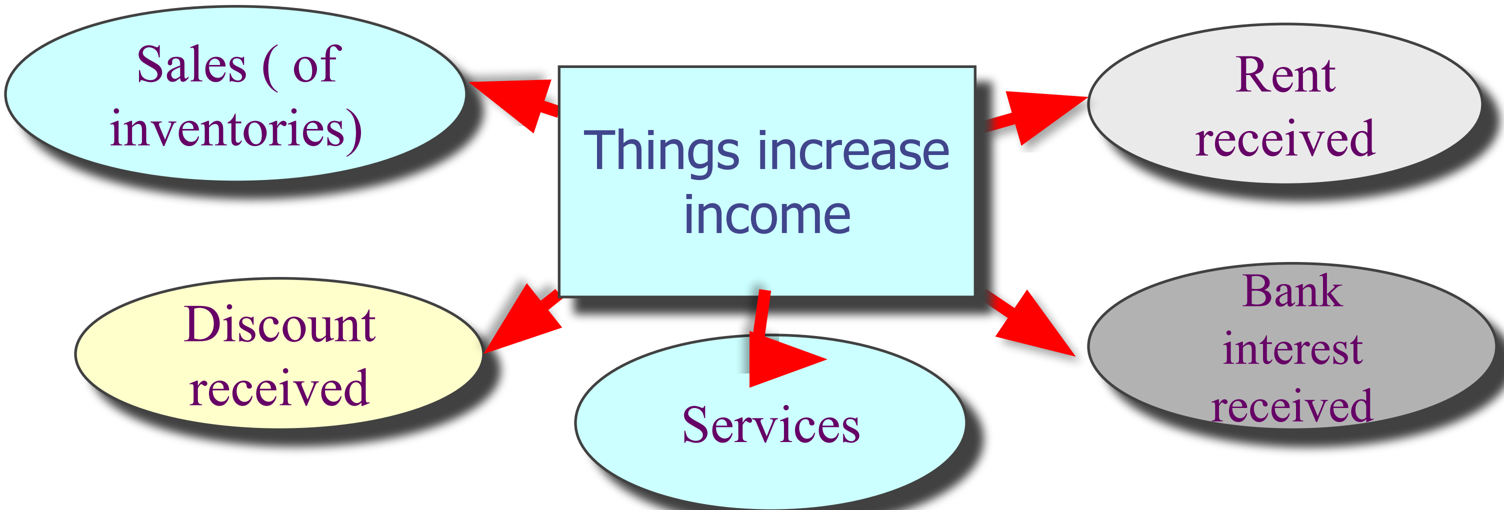
4. Revenue (R)

- **Revenue (R) :** are increases in net assets resulting from operations over a period time.
- **Revenue Recognition Criteria:**

-earning process is complete

-exchange has taken place

-amount of the revenue can be measured reasonably



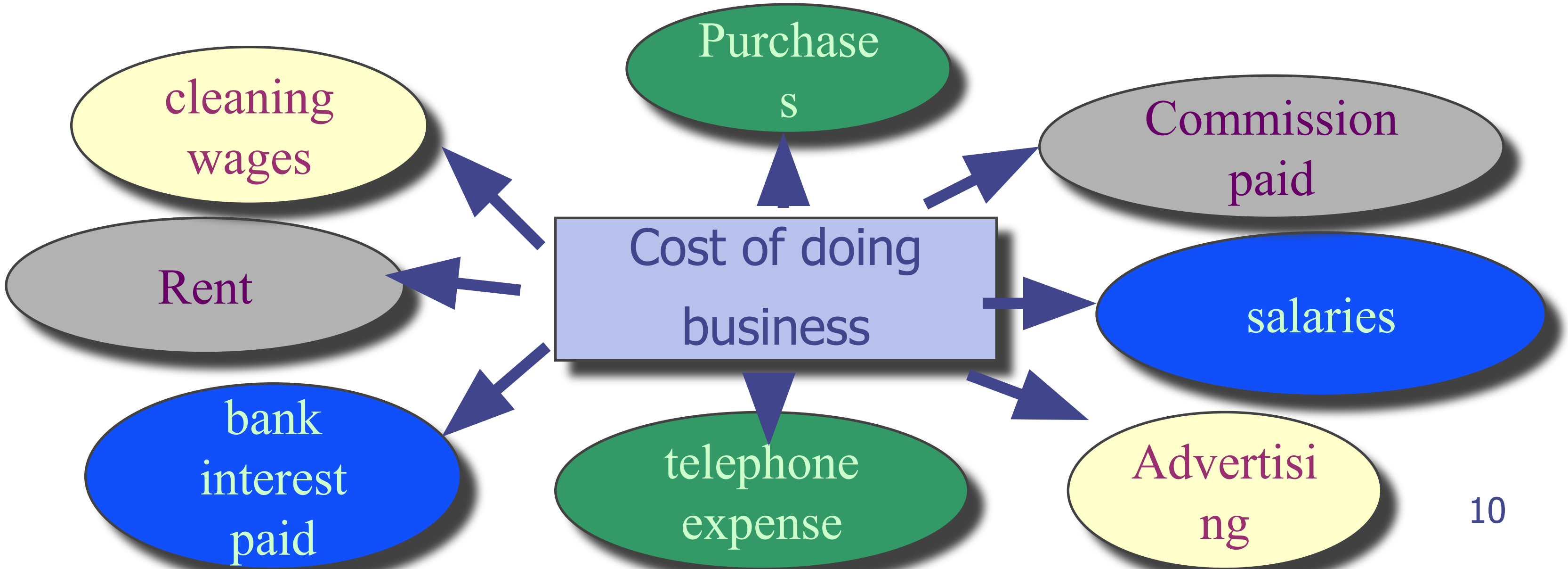
5. Expenses (E)

Expense (E) Money spent or cost incurred in an organization, representing the cost of doing business.

Expenses Recognition Criteria:

-All expenses are recorded when they are incurred during the period.

- Expenses are matched against the revenues of the period.



III. Basic Accounting Assumption and Principle

1. Economic Entity Assumption
2. Goning Concern Assumption
3. Monetary Unit assumptiom
4. The Cost principle
5. Profit Determination
6. The Accounting Equation
7. Double-entry bookkeeping (cash or credit)
8. Matching principle
9. Reporting Principle

5. Profit Determination

- **The Profit Formula:**

Revenues – Expenses = Profit (or Loss)

Revenues: amounts earned from delivering goods or services to customers

Expenses: the costing of selling goods or services

Profit: The surplus remaining after total costs are deducted from total revenue

Multiple Choices 2mins

Svelte Living Inc. sold goods on account for $75,000, incurred and paid expenses of $25,000. Calculate net income or net loss.

A. Net income of $50,000
B. Net loss of $50,000
C. Net income of $75,000
D. Net loss of $75,000

6. The Accounting Equation

- The basic,vital tool of accounting, measuring the resources of a business(what the business owns or has controlled) and the claiming to those resources (what the business owes to creditors and the owners)

Assets = Liabilities + Owner’s Equity

A = L + O/E

A – L = O/E

Assets: is an economic resource that is expected to benefit the business in the future. It owned or controlled by the entity

Liabilities: debts that owed to creditors

Owner’s Equity: the rights of the owners or shareholders

6. The Accounting Equation

Assets = **Liabilities** + **Equity**

Rule: The Balance Sheet Equation must ALWAYS be in balance.

6. The Accounting Equation (cont)

Assets = **Liabilities** + **Equity**

Owner's Capital
– Owner's Withdrawals
+ Revenues
- Expenses

Using the expanded accounting equation, solve for the missing amount.

Assets	$ 71,288
Liabilities	2,260
Owner's Capital	?
Owner's Withdrawal	14,420
Revenues	53,085
Expenses	28,675

Assets	=	Liabilities	+	Equity						
				Owner's Capital	−	Owner's Withdrawals	+	Revenues	−	Expenses
$71,288		$2,260	+	?	−	$14,420	+	$53,085	−	$28,675
$71,288		$2,260	+	$59,038	−	$14,420	+	$53,085	−	$28,675

Business Transaction

Think of a transaction as a very special kind of historical event.

1. It involves the exchange of economic resources.
2. We must be able to measure the economic impact in monetary units.

Is it a transaction?

✔ **Buying a copying machine for the office for $4,000 cash.**

X **Meeting with a potential customer.**

How do we analyze a transaction?

- Three steps:

Step 1: identify the accounts and account type (5 elements)

Step 2: decide whether each account increases or decreases

Step 3: determine whether the account equations in balance

- The accounting equation MUST remain in balance after each transaction.

How Do You Analyze A Transaction?

Sheena Bright starts a new business named Smart Touch. She puts $30,000 into the business. How does this impact the Accounting Equation?

	Assets	=	Liabilities	+	Equity
	Cash				Bright, Capital
(1)	+30,000				+30,000

Note: You can make the analysis easier if the first question you ask is whether cash exchanged hands.

Multiple Choices 2mins

Viva Inc. produces and sells coffee beans. This month it earned $500 by selling coffee beans to Jeffery Inc. The $500 received by Viva is its:

A. revenue.
B. assets.
C. expenses.
D. liabilities.

How Do You Analyze A Transaction?

Next, Smart Touch purchases land for $20,000 cash.

	Assets			=	Liabilities	+	Equity
	Cash	+	Land			+	Bright, Capital
Bal.	$30,000						$30,000
(2)	−20,000		+20,000				
Bal.	$10,000	+	$20,000				$30,000

In this transaction, all the change occurred on the left side of the equation. One asset was converted into a different asset.

How Do You Analyze A Transaction?

In Transaction #3, Smart Touch buys $500 of office supplies, offering to pay in 30 days.

	Assets					=	Liabilities	+	Equity
	Cash	+	Office Supplies	+	Land		Accounts Payable	+	Bright, Capital
Bal.	$10,000			+	$20,000				$30,000
(3)			+500				+500		
Bal.	$10,000	+	$500	+	$20,000		$500	+	$30,000

Remember, in business it is quite common for a business to purchase something now, and pay for it later.

How Do You Analyze A Transaction?

In Transaction #4, Smart Touch provides training services to customers for $5,500 cash

	Assets						=	Liabilities	+	Equity		
	Cash	+	Office Supplies	+	Land			Accounts Payable	+	Bright, Capital	+	Service Revenue
Bal.	$10,000	+	$500	+	$20,000			$500	+	$30,000		
(4)	+5,500											+5,500
Bal.	$15,500	+	$500	+	$20,000			$500	+	$30,000	+	$5,500

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How Do You Analyze A Transaction?

In Transaction #5, Smart Touch performs $3,000 of services for a customer who will pay in one month.

	Assets				=	Liabilities	+	Equity	
	Cash	+ Accounts Receivable	+ Office Supplies	+ Land		Accounts Payable	+	Bright, Capital	+ Service Revenue
Bal.	$15,500		+ $500	+ $20,000		$500	+	$30,000	+ $5,500
(5)		+3,000							+3,000
Bal.	$15,500	+ $3,000	+ $500	+ $20,000		$500	+	$30,000	+ $8,500

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How Do You Analyze A Transaction?

In Transaction #6, Smart Touch pays $3,200 in cash expenses; $2,000 for office rent and $1,200 for employee salaries.

	Assets								=	Liabilities +		Equity							
	Cash	+	Accounts Receivable	+	Office Supplies	+	Land			Accounts Payable	+	Bright, Capital	+	Service Revenue	−	Rent Expense	−	Salaries Expense
Bal.	$15,500	+	$3,000	+	$500	+	$20,000			$500	+	$30,000	+	$8,500				
(6)	−3,200															−2,000		−1,200
Bal.	$12,300	+	$3,000	+	$500	+	$20,000			$500	+	$30,000	+	$8,500	−	$2,000	−	$1,200

How Do You Analyze A Transaction?

In Transaction #7, Smart Touch pays $300 to the store from which it purchased office supplies in Transaction #3.

	Assets							=	Liabilities +	Equity							
	Cash	+	Accounts Receivable	+	Office Supplies	+	Land		Accounts Payable	+	Bright, Capital	+	Service Revenue	−	Rent Expense	−	Salaries Expense
Bal.	$12,300	+	$3,000	+	$500	+	$20,000	=	$500	+	$30,000	+	$8,500	−	$2,000	−	$1,200
(7)	−300								−300								
Bal.	$12,000	+	$3,000	+	$500	+	$20,000		$200	+	$30,000	+	$8,500	−	$2,000	−	$1,200

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How Do You Analyze A Transaction?

In Transaction #8, Smart Touch collects $2,000 from the client for which Smart Touch performed services in Transaction #5.

	Assets							=	Liabilities	+	Equity						
	Cash	+	Accounts Receivable	+	Office Supplies	+	Land		Accounts Payable	+	Bright, Capital	+	Service Revenue	−	Rent Expense	−	Salaries Expense
Bal.	$12,000	+	$3,000	+	$500	+	$20,000	=	$200	+	$30,000	+	$8,500	−	$2,000	−	$1,200
(8)	+2,000		−2,000														
Bal.	$14,000	+	$1,000	+	$500	+	$20,000		$200	+	$30,000	+	$8,500	−	$2,000	−	$1,200

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Homework

Wega Inc. sold watches to a retailer on account for $50,000. Ignore cost of goods sold. How would this transaction affect Wega's accounting equation?

A. Increase in both assets and owner's equity by $50,000
B. Decrease in both liabilities and owner's equity by $50,000
C. Decrease in both liabilities and stockholders' equity by $50,000
D. Decrease in both assets and liabilities by $50,000

Homework

5. Fashion Fusion is famous for fashion wristwatches and leather goods. At the end of the year, it had total assets of $380,000 and owner's equity of $250,000.
   How much were Fashion Fusion's liabilities?

A. $120,000
B. $380,000
C. $130,000
D. $250,000

True or False Questions 3 mins

1. The total of amount of assets that a business possesses, may or may not equal the total of liabilities and equity of the business.
2. Equity increases when revenues are earned.
3. Owner's withdrawals are the expenses of a business.

Homework-Abbreviation

FR- Financial Reports FS-Financial Statements

MA- GAAP-

FA- IFRS-

A- AR- PPE-

L- AP-

O/E- W- C-

R- G&S

E-