The Accounting Process and Economic Events

Recall that the purpose of accounting is to provide useful information to people who make rational investment, credit and similar decisions.

The **accounting process** involves:

1. analyzing the economic events of a business and recording the effects of those events.
   The accounting process begins by analyzing a business's transactions to determine their effects on the accounting equation as in chapter 1. Those effects are recorded in the accounting records known as "the books." The printed documents that businesses use in the process of completing transactions are called business papers or source documents. Examples may include sales slips, invoices, checks, purchase orders, bank statements, or cash register tapes. Business papers are the starting point in the accounting process to provide evidence of completed transactions and the amount for which they should be recorded.
2. classifying and summarizing the recorded effects in reports or financial statements.

In accounting for a business, the different effects of its transactions must be recorded and stored in separate locations so that they can be sorted and combined when financial reports are prepared. These locations are called accounts.

A separate account summarizes the increases and decreases in each asset, liability and owner's equity item that appears on the balance sheet. Further, a separate account is used for each revenue and expense item that appears on the income statement. The specific account titles used by a business varies with the type of business.

Financial Statements

The reports prepared by accountants are called financial statements and they communicate financial information to managers and other decision makers. The three basic financial statements are the *Income Statement*, the *Balance Sheet*, and the *Statement of Changes in Owner's Equity*
These statements are the primary product (output) of the accounting process (the keeping of records). They are used to provide quantitative information that is useful in decision making.
In summary, financial statements describe the condition of the organization and the events that happened during the year.

A. Income statement= conveys a concise picture of *profitability for a specific period of time* and has the following parts:

1. Revenue = *inflows* of assets (cash or other properties) received in exchange for goods or services provided to customers as part of the major or central operations of the business. Represents the sales by a business of goods or services. INCOME IS NOT REVENUE!
2. Expenses = goods or services consumed in operating a business. Results from *outflows* or the using up of assets as a result of the major or central operations of a business. In general terms, this represents the money a business owner spent to operate a business.

B. Balance sheet --Conveys a concise picture of the *financial position on a specific date*. The balance sheet provides information that helps users understand the financial status of the business. Will the business be able to pay its debts? How much is the investment of the owner? The balance sheet must balance. The left side must equal the right side. How can the sides be made equal? What would the difference represent? The left side shows the assets owned by the business with a value. The right side shows who has a claim to the assets.

1. Assets = properties or economic resources owned by a business. Titles are used to identify assets. Examples:
   Accounts receivable= amounts owed to the business by its customers for goods or services sold on credit. Each charge customer would be called a *debtor*.
   Other assets= merchandise held for sale, supplies, equipment, buildings, land, copyright...
2. Liabilities = debts of a business. The title used indicates that money is owed for goods or services bought on credit. Each supplier is called a *creditor*.
   Examples: Accounts payable, Notes payable, Interest Payable, Taxes Payable...
3. Equity = The interest in the assets of an entity that remains after deducting its liabilities. The title used for the equity of the owner is the owner's name followed by the word CAPITAL.

C. Statement of Changes in Owner's Equity- shows what has happened to equity over the course of the accounting period. Has there been an increase or decrease in equity resulting from net income or loss? Has the owner(s) made any investments or withdrawals? Broadly, this statement follows the format:

1. Beginning owner's equity
2. Add net income and investments
3. Subtract net loss and withdrawals
4. Ending owner's equity

Balance Sheet Accounts

1. **Asset Account Titles** :
   - Cash --includes coins, currency, checks and money orders.
   - Accounts Receivable --Goods or services are commonly sold to customers on the basis of oral or implied promises of future payments (credit sales or sales on account).
   - Notes Receivable --A promissory note is an unconditional written promise to pay a definite sum of money on demand or on a defined future date.
   - Prepaid Expenses --When payments are made for an economic benefit that does not expire until later, the payments create assets called prepaid expenses. Examples include: prepaid insurance, office supplies (stamps, stationary, paper, pencils...), store supplies (wrapping paper, cartons, bags, tape...)
   - Office Equipment --desks, chairs, computers...
   - Store Equipment --counters, showcases, cash registers...
   - Buildings --store, garage, warehouse, factory...
   - Land --Land does not include buildings located on the land. Buildings wear out whereas the land does not.

2. **Liability Account Titles**
   - Accounts Payable --When purchases are made on the basis of oral or implied promises to pay (purchases such as merchandise, supplies, equipment, or services).
   - Note Payable --When a business makes a formal written promise to pay a definate sum of money on a defined future date.
   - Wages Payable
   - Taxes Payable

- Interest Payable
- Unearned Revenues --The **revenue recognition principle** states that you should not report revenues on the income statement until the revenues are earned. An unearned revenue is a liability that will be satisfied by delivering the product or service that was paid for in advance. Examples are subscriptions collected in advance, rent collected in advance, legal fees collected in advance.

Owner's Equity Account Titles Owner's Equity in a proprietorship is affected by owner investments, withdrawals, revenue, and expenses. There are separate accounts for each.

- Capital --The capital account should be used only for investments.
- Withdrawals --used to record cash or other items taken from the business by the owner for personal use. Note: in a proprietorship, the owner cannot draw a salary or be an employee, so the owner must withdraw money from the business. The owner and the business are not considered separate.

Income Statement Accounts

1. Revenue Accounts --There should be an account for each **type** of revenue: Commissions Earned, Legal Fees Earned, Rent Earned...
2. Expense Accounts --There should be an account for each **type** of expense: Office Salaries Expense, Rent Expense, Utilities Expense.

The Ledger and Chart of Accounts

The collection of accounts is called the ledger. A list of accounts used by a company is called a chart of accounts.

A **Trial Balance** lists all account balances (debit or credit) and is used to prove the equality of debits and credits in the ledger. It is not proof of complete accuracy.

Transaction Analysis

A *business transaction* is an exchange of goods or services that affects the balance sheet equation.

a. Effects of Transactions on the accounting equation.

1. Every transaction affects at least two items (*double entry accounting*)
2. The equation remains in balance after each transaction.
3. Owner's equity is *increased* by revenues and investments by the owner. Owner's equity is *decreased* by expenses and withdrawals by the owner.

b. The *Revenue Recognition Principle* requires that revenue be recognized at the time it is earned.

1. The inflow of assets associated with a revenue does not have to be in the form of cash.
2. Revenue is earned at the time services are rendered or at the time ownership to goods is transferred.
3. The amount of revenue equals cash received plus the cash equivalent of other assets received.