Sample Preview

Principles of Financial Accounting
Christine Jonick, Ed.D.

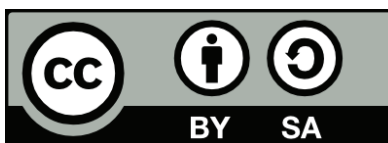University of North Georgia Press, 2018

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Accounting Cycle for the Service Business—Cash Basis

1.1 INTRODUCING ACCOUNTS AND BALANCES

Accounting may be defined as the process of analyzing, classifying, recording, summarizing, and interpreting business transactions. One of the key aspects of the process is keeping "running totals" of "things." Examples of items a business might keep track of include the amount of cash the business currently has, what a company has paid for utilities for the month, the amount of money it owes, its income for the entire year, and the total cost of all the equipment it has purchased. You want to always have these running totals up to date so they are readily available to you when you need the information. It is similar to checking what your cash balance in the bank is when deciding if you have enough money to make a purchase with your debit card.

We will now refer to these "running totals" as **balances** and these "things" as **accounts**. Any item that a business is interested in keeping track of in terms of a running dollar balance so it can determine *"how much right now?"* or *"how much so far?"* is set up as an account. There are five types, or categories, of accounts.

WHAT IS A CATEGORY?

A category is a classification that generally describes its contents. The table below shows three column headings in bold: **Planets**, **Colors**, and **Food**. These are sample categories.

PLANETS	COLORS	FOOD
Saturn	Red	Pizza
Venus	Green	Brownies
Mars	Yellow	Chicken
Earth	Blue	Eggplant

Below each column heading is a list of four items that are actual examples of items that fall into the respective category. If "Red" appeared under the "Planets" heading, you would immediately assume there was an error. It does not belong there.

There are many items that businesses keep records of. Each of these accounts fall into one of five **categories**.

1. **Assets:** Anything of value that a business owns
2. **Liabilities:** Debts that a business owes; claims on assets by outsiders
3. **Stockholders' equity:** Worth of the owners of a business; claims on assets by the owners
4. **Revenue:** Income that results when a business operates and generates sales
5. **Expenses:** Costs associated with earning revenue

Different accounts fall into different categories. **Cash** is an account that falls in the **asset** category. The Cash account keeps track of the amount of money a business has. Checks, money orders, and debit and credit cards are considered to be cash.

Other than *Cash*, we will begin by covering accounts that fall into the **revenue** and **expense** categories.

Revenue is income that results from a business engaging in the activities that it is set up to do. For example, a computer technician earns revenue when they repairs a computer for a customer. If the same computer technician sells a van that they no longer needs for his business, it is not considered revenue.

Fees Earned is an account name commonly used to record income generated from providing a service. In a service business, customers buy expertise, advice, action, or an experience but do not purchase a physical product. Consultants, dry cleaners, airlines, attorneys, and repair shops are service-oriented businesses. The *Fees Earned* account falls into the **revenue** category.

Expenses are bills and other costs a business must pay in order for it to operate and earn revenue. As the adage goes, "It takes money to make money."

Expense accounts differ from business to business, depending on individual company needs. The following are some common expenses that many businesses have:

Wages Expense	Cost of paying hourly employees
Rent Expense	Cost for the use of property that belongs to someone else
Utilities Expense	Costs such as electricity, water, phone, gas, cable TV, etc.
Supplies Expense	Cost of small items used to run a business
Insurance Expense	Cost of protection from liability, damage, injury, theft, etc.
Advertising Expense	Cost of promoting the business
Maintenance Expense	Costs related to repair and upkeep
Miscellaneous Expense	Costs that are minor and/or non-repetitive
ANY Expense	Any cost associated with earning revenue

A **chart of accounts** is a list of all accounts used by a business. Accounts are presented by category in the following order: (1) Assets, (2) Liabilities, (3) Stockholders' equity, (4) Revenue, and (5) Expenses.

CHART OF ACCOUNTS (PARTIAL)

The following table summarizes the categories and accounts discussed so far:

ASSETS	REVENUE	EXPENSES
Cash	Fees Earned	Wages Expense
		Rent Expense
		Utilities Expense
		Supplies Expense
		Insurance Expense
		Advertising Expense
		Miscellaneous Expense

1.2 NET INCOME—A CRITICAL AMOUNT

The difference between the total revenue and total expense amounts for a particular period (such as a month or year), assuming revenue is higher, is **profit.** We will now refer to profit as **net income**. The following is a key calculation in determining a business's operating results in dollars:

$$Revenue \ - \ Expenses \ = \ Net\ Income$$

Net income is determined by subtracting all expenses for a month (or year) from all revenue for that same month (or year). A **net loss** results if total expenses for a month (or year) exceed total revenue for the same period of time.

Net income is a result that business people are extremely interested in knowing since it represents the results of a firm's operations in a given period of time.

1.3 THE MECHANICS OF THE ACCOUNTING PROCESS

1.3.1 The Journal

Financial statements are key goals of the accounting process. In order to prepare them at the end of an accounting period, individual financial transactions must be analyzed, classified, and recorded all throughout the period. This initially takes place in a record book called the **journal**, where financial events called **transactions** are recorded as they happen, in chronological order.

When a transaction occurs, two or more accounts are affected. There is also a dollar amount associated with each of the accounts. Determining which accounts are impacted, and by how much, is the first step in making a journal entry.

This is a sample of a few rows in a journal. It has five columns: *Date, Account, Post. Ref., Debit, Credit.*

Date	Account		Debit	Credit

In the journal, the column heading **Debit** means "left" and **Credit** means "right." There are other familiar interpretations of these words, so don't be confused: the terms here only have to do with whether a dollar amount is entered in the left or the right number column.

These words may also be used as verbs: To "debit an account" means to enter its amount in the left column. To "credit an account" means to enter its amount in the right column.

1.3.2 Rules of Debit and Credit

Whether a particular account should be debited or credited is based on (1) the type of account it is and (2) whether the account is increasing or decreasing.

RULES OF DEBIT AND CREDIT

for *Cash* and Revenue and Expense accounts

Debit **CASH** when you receive it	Cash increases
Credit **CASH** when you pay it out	Cash decreases
Debit **EXPENSES** when you incur them	Expenses increase
Credit **REVENUE** when you earn it	Revenue increases

1.3.3 Journalizing Transactions

We now will come to one of the most important procedures in the recordkeeping process**: journal entries**. It involves analyzing and writing down financial transactions in a record book called a **journal**. Financial events are evaluated and translated into the language of accounting using the process of **journalizing**.

Select two accounts and, according to the rules of debit and credit for cash, revenue, and expense accounts, decide which account to debit (left column) and which to credit (right column). The debit entry is always listed first. No dollar signs are required in the journal.

Journalizing involves the following steps:

1. Select two (or more) accounts impacted by a transaction.

2. Determine how much, in dollars, each account is affected. Often times the amounts are given; other times the amounts must be calculated based on the information provided.

3. Based on the rules of debit and credit, decide which account(s) is debited and which is credited.

4. Enter the date on the first line of the transaction only.

5. Enter the account that will be **debited** on the **first line** of the transaction. Enter its amount in the Debit column on the same line.

6. Enter the account that will be **credited** on the **second line** of the transaction. Enter its amount in the Credit column on the same line. NOTE: Indent the credit account name three spaces.

SAMPLE TRANSACTION #1:

On 6/1, a company paid rent of $2,000 for the month of June.

Date	Account	Debit	Credit
6/1	Rent Expense	2,000	

PARTIAL TRANSACTION

▲ *Rent Expense* is an **expense** account that is **increasing**. Therefore, it is **debited**. The account with the debit amount is entered first.

Date	Account	Debit	Credit
6/1	Rent Expense	2,000	
	Cash		2,000

COMPLETE TRANSACTION

▼ *Cash* is an **asset** account that is **decreasing**. Therefore, it is **credited**. The account with the credit amount is entered next.

SAMPLE TRANSACTION #2:

On 6/5, a customer paid $800 cash for services the company provided.

Date	Account	Debit	Credit
6/5	Cash	800	

PARTIAL TRANSACTION

▲ *Cash* is an **asset** account that is **increasing**. Therefore, it is **debited**. The account with the debit amount is entered first.

Date	Account	Debit	Credit
6/5	Cash	800	
	Fees Earned		800

COMPLETE TRANSACTION

▼ *Fees Earned* is a **revenue** account that is **increasing**. Therefore, it is **credited**. The account with the credit amount is entered next.

In practice, each transaction follows immediately after the previous one, as shown here.

Date	Account	Debit	Credit
6/1	Rent Expense	2,000	
	Cash		2,000
6/5	Cash	800	
	Fees Earned		800
6/8	Wages Expense	500	
	Cash		500
6/10	Cash	600	
	Fees Earned		600

The same journal continues on from period to period. You do not start a new journal for a new accounting period (month or year).

1.3.4 Ledger

The **ledger** is the second accounting record book that is a list of a company's individual accounts list in order of account category. While the journal lists all types of transactions chronologically, the ledgers separate this same information out by account and keep a running balance of each of these accounts.

Each account has its own ledger page. The account name appears across the top. The ledger form has six columns: *Date, Item, Debit, Credit, Debit, Credit*. The first set of Debit and Credit columns are where amounts from the journal transactions are **copied**. The second set of Debit and Credit columns are where the account's running total is maintained. An account's **running balance** typically appears in either the Debit or the Credit column, not both.

The following is a sample ledger for the Cash account.

Cash					
Date	Item	Debit	Credit	Debit	Credit
6/1		12,000		12,000	
6/2		2,000		14,000	
6/3			3,000	11,000	
		Copy amounts from journal (use either column)		BALANCE columns (use one of the two)	

IMPORTANT: Information entered in the ledger is always **copied** from what is already in the journal.

1.3.5 Posting

The process of copying from the journal to the ledger is called **posting**. It is done one line at a time from the journal. Here are step-by-step instructions for doing so.

1. Take note of the account name in the first line of the journal. Find that ledger account.
2. Copy the date from the journal to the first blank row in that ledger.
3. Leave the Item column blank in the ledger at this point.
4. Take note of the amount on the first line of the journal and the column it is in.
5. Copy that amount to the same column in the ledger on the same line where you entered the date.
6. Update the account's running balance. Take note of the previous balance in the last two columns of the ledger, if there is one. Do one of the following, based on the situation.
   a. If there is no previous balance and the entry is a Debit, enter the same amount in the Debit balance column.
   b. If there is no previous balance and the entry is a Credit, enter the same amount in the Credit balance column.
   c. If the previous balance is in the Debit column and the entry is a Debit, add the two amounts and enter the total in the Debit balance column.
   d. If the previous balance is in the Debit column and the entry is a Credit, subtract the credit amount from the balance and enter the difference in the Debit balance column. *
   e. If the previous balance is in the Credit column and the entry is

a Credit, add the two amounts and enter the total in the Credit balance column.

f. If the previous balance is in the Credit column and the entry is a Debit, subtract the debit amount from the balance and enter the difference in the Credit balance column. *

* Note: The only exception to the above is the rare occasion when one of the calculations above results in a negative number. No negative amounts should appear in the ledgers. Instead, the balance will appear in the opposite balance column.

7. Go back to the journal and enter an "x" or checkmark in the PR column to indicate that you have posted that line item.

8. Repeat the process for the next line in the journal.

Every time an account appears on a line in the journal, its amount is copied to the proper column in that account's ledger. A running total is maintained for each account and is updated every time an amount is posted.

The example that follows shows a journal with five transactions that involve *Cash*. On each row where *Cash* appears in the journal, the amount on the same line is copied to the same column in the *Cash* ledger, in either the first Debit or the first Credit column. Superscripts are used here to match each Cash amount in the journal to its posting in the ledger. For example, the first debit to Cash in the journal for $6,000 is copied to the debit column in the ledger (#1). The next time Cash appears in the journal is a credit for $2,000, so that is copied to the first credit column in the ledger (#2).

JOURNAL

Date	Account		Debit	Credit
6/1	**Cash**	x	6,000[1]	
	Fees Earned			6,000
6/2	Rent Expense		2,000	
	Cash	x		2,000[2]
6/3	Wages Expense		1,000	
	Cash	x		1,000[3]
6/4	**Cash**	x	5,000[4]	
	Fees Earned			5,000
6/5	Wages Expense		1,000	
	Cash	x		1,000[5]

LEDGER

		Cash			
Date	Item	Debit	Credit	Debit	Credit
6/1		6,000[1]		6,000	
6/2			2,000[2]	4,000	
6/3			1,000[3]	3,000	
6/4		5,000[4]		8,000	
6/5			1,000[5]	7,000	

As shown in the previous example, the first entry in the ledger indicates which of the two final columns will normally be used to maintain the accounts running

balance. For the *Cash* account, the first entry is in the first Debit column, so the running balance begins accumulating in the second Debit column. On the first row, the amounts in the two Debit columns will be the same. In this case, the amount is $6,000 in both. After the first entry in the ledger, subsequent debit entries are added to the previous debit balance, and subsequent credit entries are deducted from the previous debit balance.

GETTING THE JOB DONE

You can go to an ATM to withdraw cash from your checking account. The first steps are to insert your debit card into the ATM machine and select the amount you would like to receive. If that is all you do, no money will come out no matter how long you stand there. In order to get the job done, you also need to enter your PIN. The goal is to withdraw cash, and if you do not complete that step, it is not going to happen.

Similarly, there is a goal to preparing the journal and ledgers – to maintain a running balance of each account your business has. If you enter a transaction in the journal, you are off to a good start, but if you don't complete the step of posting the journal entry to the ledgers, the correct balances are not going to happen.

1.3.6 Normal Balance

The last two Debit and Credit columns in the ledger are where a running total (balance) is maintained for each account. An account's running balance will accumulate in EITHER the Debit balance column OR Credit balance column (two far right columns), but rarely both. The **normal balance** is also whatever it takes to increase that type of account, either Debit or Credit. The normal balance for an account is the column in which its running total is maintained.

An example of a journal and ledgers follows. Try to follow how the numbers from the journal on the left appear in the ledgers on the right and how the running balances in the ledgers are determined.

JOURNAL

Date	Account		Debit	Credit
6/1	Cash	x	2,000	
	Fees Earned	x		2,000
6/2	Supplies Expense	x	300	
	Cash	x		300
6/3	Cash	x	500	
	Fees Earned	x		500
6/4	Supplies Expense	x	200	
	Cash	x		200
6/5	Cash	x	800	
	Fees Earned	x		800
6/6	Supplies Expense	x	400	
	Cash	x		400
6/7	Cash	x	600	
	Fees Earned	x		600

LEDGERS

Cash

Date	Item	Debit	Credit	Debit	Credit
6/1		2,000		2,000	
6/2			300	1,700	
6/3		500		2,200	
6/4			200	2,000	
6/5		800		2,800	
6/6			400	2,400	
6/7		600		3,000	

Fees Earned

Date	Item	Debit	Credit	Debit	Credit
6/1			2,000		2,000
6/3			500		2,500
6/5			800		3,300
6/7			600		3,900

Supplies Expense

Date	Item	Debit	Credit	Debit	Credit
6/2		300		300	
6/4		200		500	
6/6		400		900	

The first entry in each ledger, either Debit or Credit, dictates whether the running balance will appear in the Debit or the Credit balance column. If the first entry is a Debit, the running balance accumulates in the Debit balance column. A debit is the "positive" for this type of account; any subsequent debit entries are added and credit entries are subtracted from the running balance. Conversely, if the first entry is a Credit, the running balance accumulates in the Credit balance column. A credit is the "positive" for this type of account; any subsequent credit entries are added and debit entries are subtracted from the running balance.

The grayed column above in each ledger represents the balance column that will normally remain blank.

The total of all the Debit balances in the ledgers MUST EQUAL the total of all the Credit balances in the ledgers. If this is not the case, there is a recording error

that must be located and corrected. In the example above, the ledgers balance: 3,000 + 900 (debit balances) = 3,900 (credit balance).

The same ledgers continue on from period to period. You do not start new ledgers for a new accounting period (month or year).

To summarize the two record books, the journal first records all types of transactions chronologically, in time sequence order. The ledgers separate the same information out by account and keep a balance for each of these accounts.

IMPORTANT: If you are making entries in the ledgers, you must be COPYING from the journal.

CAN I HAVE THE RECIPE?

I have a great recipe for chocolate chip cookies. Here are the ingredients
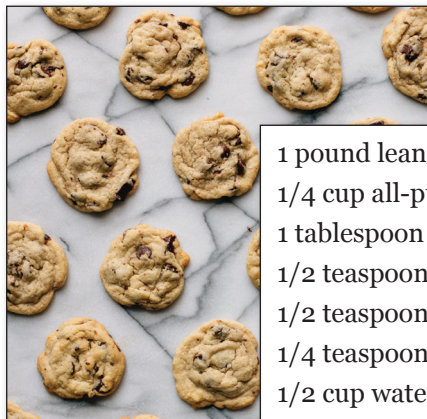
1 pound lean ground beef
1/4 cup all-purpose flour
1 tablespoon chili powder
1/2 teaspoon dried minced onion
1/2 teaspoon paprika
1/4 teaspoon onion powder
1/2 cup water
12 taco shells
2 cups shredded lettuce
1 cup shredded cheddar cheese

At this point you must be confused, or think I am crazy. The cookies could not possibly be the result of those ingredients—the input does not match the output. Anyone who knows anything about cookies can see that.

It is the same with the accounting process. It is not possible to have a correct ledger and/or financial statement balances if the input in the journal has errors. Yet some students "know," or copy from others, what the correct results should be in spite of incorrect journal entries. This violates the process of posting to the ledgers, which is carrying over what is in the journal.

It is more correct for an error to carry through to all parts than for one part to be incorrect and subsequent parts to be correct. To your accounting instructor, a correct balance based on a faulty journal is as unlikely an outcome as is chocolate chip cookies from taco ingredients. It just can't happen!

If there is an error in the journal, procedurally the mistake should carry through to the ledgers and the financial statements.

1.3.7 Trial Balance

The total of all the debit balances in a company's ledger accounts must always equal the total of all the credit balances. A **trial balance** is a list of all a business's accounts and its current ledger balances (copied over from the ledger accounts). A trial balance may be generated at any time to test whether total debits equals total credits. It is simply a worksheet to check for accuracy before preparing financial statements. If both of the Total columns do not equal, there is an error that must be found and corrected.

The example that follows is for a company with only four accounts. The trial balance on the left lists these accounts and their corresponding balances at the end of the month, which are copied over from the ledgers on the right.

TRIAL BALANCE June 30, 2018		
Account	**Debit**	**Credit**
Cash	3,000	
Common Stock		2,000
Fees Earned		1,900
Supplies Expense	900	
TOTAL	3,900	3,900

LEDGERS

Cash					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
6/1		2,000		2,000	
6/2			300	1,700	
6/3		500		2,200	
6/4			200	2,000	
6/5		800		2,800	
6/6			400	2,400	
6/7		600		3,000	

Fees Earned					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
6/3			500		500
6/5			800		1,300
6/7			600		1,900

Supplies Expense					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
6/2		300		300	
6/4		200		500	
6/6		400		900	

Common Stock					
Date	**Item**	**Debit**	**Credit**	**Debit**	**Credit**
6/1			2,000		2,000