Accounting 101U Script

Slide 1
(SCEIS Accounting 101U)
Welcome to SCEIS Accounting 101U. This class is designed to give a general overview of fundamental accounting principles, concepts and terminology used in organizations.

Slide 1A
(Accounting 101 Index)
The lessons in this course include General Accounting Overview and Fundamentals, Accounting Concepts and Methods, General Ledger Accounts and Account Structure, and the Accounting Cycle.

Slide 2
(Lesson 1)
Lesson 1: General Accounting Overview and Fundamentals

Slide 3
(Accounting Overview)
Accounting is the process used to identify, record and communicate finances and financial activities in businesses and organizations.

Accounting is often referred to as the "language of business".

<u>Slide 4</u>
<u>(Accounting Overview)</u>
Accounting records and tracks financial transactions and business events showing what a business owns and what it owes others.

Organizations analyze this information.

<u>Slide 5</u>
<u>(Accounting Overview)</u>
With the need to provide financial information to internal and external users, there becomes a logical division of accounting to help meet the needs of both types of users.

Financial Accounting is concerned with providing financial information and reporting to users outside the organization.

This is a diverse group and could include stockholders, government/tax authorities, customers, creditors and external auditors.

Since this reporting is distributed outside of the organization for external use it is subject to certain guidelines and standards so all users can interpret information equally.

Slide 6
(Accounting Overview)

The second division of accounting is Managerial Accounting which provides accounting information and reporting to internal users.

Managerial accounting is especially important to an organization's management team.

The internal users could consist of managers, owners and even employees.

This type of accounting information is important to internal users when monitoring and controlling the day to day operations and planning for the organization's future.

Managerial Accounting is used to prepare budgets, forecasting profit growth and any cost associated with their products costs. Managerial accountants provide analysis of product cost in relation to the change of volume or price and its effect on the organizations profits. Since this information is not generally reported externally, it is not subject to the same guidelines and standards as reports that are distributed externally.

Slide 7
(Accounting Standards and Principles)
There is a common set of accounting principles and guidelines organizations use regardless of the size or nature of the organization.

These principles are meant to help measure and report on financial activities in a dependable, relevant and comparable way.

In the United States, these financial accounting standards are guided by "GAAP" or Generally Accepted Accounting Principles.

These principles are primarily used by organizations that distribute financial statements to the public.

Slides 8-9
(Accounting Standards and Principles)
The SEC ultimately oversees the appropriate use of GAAP…

…but in 1973 the Financial Accounting Standards Board or "FASB" was given the authority to issue and set GAAP guidelines that govern the preparation of financial reporting by non-governmental organizations.

“GAAP” provides a foundation to prevent misunderstandings between those who prepare financial reports and those who use financial reports to make decisions for their organization.

Although the use of “GAAP” is not required by law for all companies, many organizations use these guidelines because of their need to obtain funding from outside sources such as banks and lenders.

Slide 10
(Accounting Standards and Principles)

The Governmental Accounting Standards Board or GASB is the independent organization that establishes and improves standards of accounting and financial reporting for state and local governments.

The standards help these governmental entities demonstrate their accountability over public resources to their constituents.

<u>Slide 11</u>
<u>(Basic Accounting Equation)</u>
Accounting is more about learning concepts and methods than about adding and subtracting numbers. If you understand the basics you'll be well on your way to understanding accounting.

There are a few basic accounting terms that are important to understand.

The first term is "account".

An account is a record in the accounting system used to collect and store business transactions.

Examples of accounts an organization may use are Sales,...

...Equipment,...

...Office Supplies,...

...Utilities,...

...and travel.

Slide 12
(Basic Accounting Equation)
Think of an account as a way to store like information.

For example, if you had a large container of quarters, dimes, nickels, and pennies to sort, each type of coin would be sorted into a slot that would represent its own account.

You would have one account for each type of coin. After you had emptied the large container of coins by sorting each coin into its bucket, or account, you could then total the amounts in each account. Then, you would know how many quarters, dimes, nickels, and pennies are in each account and could easily determine the cumulative amount of all accounts.

Slide 13
(Basic Accounting Equation)
Another important term is "transaction".

Transactions are events that effect an organization financially or cause some kind of financial change.

Examples of a transaction that an organization might record in their accounting system are the purchase of office supplies such as paper, or a payment to the utility company for the prior month's electric bill.

<u>Slides 14-15</u>
<u>(Basic Accounting Equation)</u>
Assets, liabilities and equity are 3 accounting terms used to identify what an organization owns and what it owes others.

Assets are an organization’s resources or what it owns.

Liabilities are claims on the organization or what it owes others.

<u>Slide 16</u>
<u>(Basic Accounting Equation)</u>
The third category is **equity** or **capital**, which is also referred to as **net assets.**

Equity is what remains after all liabilities or debts of the organization are paid.

If you take the organization’s total assets and subtract its total liabilities you would then know how much equity remains.

Slide 17
(Basic Accounting Equation)
The Basic Accounting Equation is…

Assets...

...equal Liabilities...

...plus Equity.

This equation represents the relationship between these three categories. This basic equation guides organizations when recording and reporting their financial transactions.

If you are new to accounting it is important to memorize this fundamental concept.

Slide 18
(Basic Accounting Equation)
This basic equation provides a way to measure a company's profitability or lack of profitability.

It also states **assets** must always equal **liabilities** plus **equity**.

In accounting, this equation should always be followed and the rules of the equation should never be broken.

<u>Slide 19</u>
<u>(Basic Accounting Equation)</u>
To keep a scale in balance, items of equal weight must be placed on both sides of the scale.

The accounting equation works much in the same way. Equal values of a transaction must be placed on both sides of the equation using debits and credits to keep the equation in balance.

Also, if the transaction affects only one side of the accounting equation, the effects of the debits and credits would cancel each other out.

<u>Slide 20</u>
<u>(Basic Accounting Equation)</u>
Let's illustrate both scenarios.

The first scenario shows a transaction where equal values are placed on both sides of the equation.

The owner of Carolina Tees, a t-shirt company, deposits $25,000 into the company's checking account. The asset account "cash" is increased $25,000...

...and the Equity account "owner capital" is increased $25,000.

Slide 21
(Basic Accounting Equation)
The second scenario shows a transaction that affects only one side of the accounting equation.

In this situation there was an increase due to the purchase of equipment, or the asset, and the decrease of cash. So the asset transactions balanced the equation without any entries being made in Equity or Liability.

Slide 22
(Expanded Accounting Equation)
The Basic Accounting Equation can also be expanded to show how the four main Equity account categories affect the equation.

Assets and Liabilities remain the same in the expanded equation.

Slide 23
(Expanded Accounting Equation)
Let's look at Equity's four main account categories and their effect on the equation:

The first equity category is owner capital.

These accounts contain transactions where the owner has invested monetarily into the organization.

Slide 24
(Expanded Accounting Equation)
The next category is owner withdrawal.

These accounts contain transactions where the owner has received or withdrawn funds from the company.

Slide 25
(Expanded Accounting Equation)
The third equity category is income.

These accounts contain transactions for revenue and sales. Income accounts can also contain gains from other activities like selling equipment or short-term investments.

Slide 26
(Expanded Accounting Equation)
The final category is expense accounts.

These accounts hold transactions for money disbursed for the cost of doing business such as rent, salaries, office supplies and travel expenses.

<u>Slide 27</u>
<u>(Expanded Accounting Equation)</u>
The expanded equation follows the same rules as the basic equation.

It must always remain in balance, and the amount of change on the left side of the equation should always be equal to the amount of change on the right side.

<u>Slide 28</u>
<u>(Expanded Accounting Equation)</u>
Let’s look at a few transactions using the expanded equation:

In this example of Owner Capital the owner of Carolina Tees invests an additional $25,000 into his company.

The asset account “cash” is increased by $25,000...

...and the equity account for owner capital is increased by $25,000.

There is no affect on any liability accounts.

Slide 29
(Expanded Accounting Equation)
In this example of owner withdrawals the owner of Carolina Tees withdraws $5,000 from his company.

The asset account “cash” is decreased by $5,000.

The Equity account “owner withdrawals” is increased by $5,000...

...and no liability accounts are affected.

Slide 30
(Expanded Accounting Equation)
Now Carolina Tees receives $500 in cash for the sale of fifty t-shirts.

The income account “sales” is increased by $500...

...and the asset account “cash” is increased by $500.

This is an example of income.

Slide 31
(Expanded Accounting Equation)
In this Expense example, Carolina Tees spends $200 cash for office supplies.

The expense account “office supplies” is increased by $200...

...and the asset account “cash” is decreased by $200.

Slide 32
(Lesson 2)
Lesson 2: Accounting Concepts and methods

Slide 33
(Methods of Accounting)
There are two methods of bookkeeping used in accounting. The first method that we will review is the Double-entry method.

The double-entry method is the basis of the accounting equation.

This is the standard method organizations use when recording their financial transactions.

When transactions are recorded using double-entry accounting they must affect at least two or more accounts.

This means each transaction will always have at least two parts reflecting the value given and the value received by the company.

For instance, when an organization purchases a new car they will record the value of the car they purchased and they will also record the cash they paid for the car.

Slide 34
(Methods of Accounting)

Although the double-entry accounting method is used by most organizations, some of us may be more familiar with single-entry accounting.

Single-entry in the most basic form is similar to our checkbook register.

In the single-entry method checks and deposits are recorded only once.

This method is fine for your personal expenses, but it would provide insufficient records for organizations that require audited financial statements.

Slide 35
(Debits and Credits)
The next requirement is that transactions are entered using debits and credits.

The debits and credits increase and decrease account balances. The total debits must equal the total credits.

Using this method provides a check and balance system.

Slide 36
(Debits and Credits)
It is important to have a clear understanding of the double-entry method when recording transactions.

In order to help visualize the effects transactions have on accounts, accounting professionals will often use a tool called a T-account.

The T-account structure represents three parts of an account.

The top of the "T" represents the account title.

The left side of the "T" represents a debit value to the account.

The right side of the "T" represents a credit value to the account.

Slide 37
(Debits and Credits)
Accounting gives some specific guidelines when entering transactions using debits and credits.

The **debit** amount is always entered on the left side of an account.

The **credit** amount is always entered on the right side of an account.

Debits and credits are used to indicate the increase and decrease in account balances.

Note that the terms debits and credits by themselves do not mean decrease or increase. In accounting, these terms must be associated with the account types to have meaning.

Slide 38
(Debits and Credits Using the T-account)
Let's look at each account type in the Expanded Accounting Equation using the T-account format and how debits and credits affect them.

Assets are what an organization owns.

Asset account balances are increased with a debit...

...and decreased with a credit.

Common examples of asset accounts are: cash, inventory, equipment, supplies, accounts receivable and buildings.

Slide 39
(Debits and Credits Using the T-account)
Liabilities are what the organization owes others.

Liability balances are debited to decrease the account...

...and credited to increase the account balance.

Liability accounts include accounts payable, salaries/wages, taxes, loans, bonds, and interest expense.

Slide 40
(Debits and Credits Using the T-account)
Equity or capital is often also referred to as net assets.

Equity accounts are debited to decrease the account balance...

...and credited to increase the account balance.

This is the value an organization has after all the liabilities or debts are paid.

Examples of equity accounts are: Capital, owner draws, common stock, dividends and retained earnings.

<u>Slide 41</u>
<u>(Debits and Credits Using the T-account)</u>
Revenue accounts are part of the extended accounting equation and directly affect the equity of the organization.

Revenue is earned from selling products or services.

Revenue account balances are decreased with a debit entry...

...and increased with a credit entry.

Some commonly used revenue accounts are: Sales, fees, rental revenue, and interest revenue.

<u>Slide 42</u>
<u>(Debits and Credits Using the T-account)</u>
Expense is the cost of doing business. Expense accounts decrease the overall equity of a company.

Expense account balances are increased with a debit...

...and decreased with a credit.

Examples of expense accounts are Utilities, Advertising, Supplies, Rent, Taxes, Fuel and Insurance.

Slide 43
(Account Category Normal Balance)
To enter transactions correctly it's important to know if a debit or credit increases or decreases the account's balance.

Learning the normal balance for each account type will help you with this process.

Slide 44
(Account Category Normal Balance)
All accounts have a "normal balance" which is either a credit balance or a debit balance.

This is the balance each account type is expected to have.

The normal balance also indicates how to increase the account balance.

Slide 45
(Account Category Normal Balance)
Look at the table of normal balances organized by account categories in the accounting equation.

Try to remember the account's normal balance column. The normal balance will increase the accounts balance. To decrease an account you would do the opposite.

<u>Slide 46</u>
<u>(Account Category Normal Balance)</u>
An **asset** account's normal balance is a debit balance.

To increase **asset** accounts, record a debit amount,...

...to decrease an **asset** account, record a credit amount.

<u>Slide 47</u>
<u>(Account Category Normal Balance)</u>
A **liability** account's normal balance is a credit balance.

To increase liability accounts, record a credit amount,...

...to decrease a liability account, record a debit amount.

<u>Slide 48</u>
<u>(Account Category Normal Balance)</u>
An **equity/capital** account's normal balance is a credit balance.

To increase **capital** accounts, record a credit amount,...

...to decrease a **capital** account, record a debit amount.

Slide 49
(Account Category Normal Balance)
An **equity/withdrawal** account's normal balance is a debit balance.

To increase a **withdrawal** account, record a debit amount,...

...to decrease a **withdrawal** account, record a credit amount.

Slide 50
(Account Category Normal Balance)
A **revenue** account's normal balance is a credit balance.

To increase **revenue** accounts, record a credit amount,...

...to decrease **revenue** accounts, record a debit amount.

Slide 51
(Account Category Normal Balance)
An **expense** account's normal balance is a debit balance.

To increase **expense** accounts, record a debit amount,...

...to **decrease** an expense account, record a credit amount.

Slide 52
(Cash vs. Accrual Method of Accounting)
Organizations must choose how and when they will report their income and expenses.

Slide 53
(Cash vs. Accrual Method of Accounting)
Officially there are two types of accounting methods which may be used to record financial transactions, the cash method and the accrual method.

The basic difference between the two methods is the timing of when transactions are recorded.

Slide 54
(Cash vs. Accrual Method of Accounting)
The Cash method, even though not compliant with GAAP standards, is used by small businesses that do not have to act in accordance with GAAP standards.

The cash basis records revenue only when cash is received from customers.

The cash method records expenses only when cash is paid to vendors and employees.

Slide 55
(Cash vs. Accrual Method of Accounting)
The basis of the accrual method is that transactions are recorded when they occur, regardless of when the cash changes hands.

This means revenue is recorded when it’s earned, regardless of when the cash is received...

...and expenses are recorded when incurred, regardless of when the business pays for them.

Slide 56
(Accrued Revenue)
An example of accrued revenue is when Carolina Tees sells 300 T-shirts for $1,000 on April 1 and receives payment from the customer on April 15.

On April 1, Carolina Tees would invoice the customer for the 300 t-shirts.

That transaction will debit their accounts receivable account for $1,000...

...and credit the sales account $1,000.

Slide 57
(Accrued Revenue)
On April 15, Carolina Tees receives the cash payment from the customer.

They will then debit their cash account for $1,000...

...and credit their accounts receivable account for $1,000.

Slide 58
(Accrued Revenue)
By showing this same transaction using the accrual method vs the cash method we can see the effect on the bottom line is the same but the timing of when the company records their revenue for the sale is different.

The end result is that cash and sales accounts are increased by $1,000.

Slide 59
(Accrued Expenses)
An example of accrued expense is when Carolina Tees rents office space for $1,000 a month. The rental payment for May is due June 5. The accrual method requires this expense to be recorded in the month it occurred regardless of when the business will pay.

Slide 60
(Accrued Expenses)
On May 31, Carolina Tees creates a transaction to debit their rental expense account for $1,000...

...and credit their rent payable account for $1,000.

This transaction records the rental expense in the correct month, although payment will occur in the following month.

On June 5, the company cuts a check to pay the rental expense.

This transaction will debit their rent payable account...

...and credit their cash account.

<u>Slide 61</u>
<u>(Lesson 3)</u>
Lesson 3: General Ledger Accounts and Account Structure

<u>Slide 62</u>
<u>(Chart of Accounts)</u>
Organizations can use thousands of accounts to record and store their financial data. The chart of accounts provides a way to easily organize and maintain these accounts.

The chart of accounts is a list of all account names and descriptions categorized by account types.
Typically this chart is organized into general categories based on the accounting equation.

It also includes a corresponding account number used to record transactions in the accounting system.

Organizations can tailor the chart of accounts to best suit their business needs.

No chart of accounts will be exactly the same since no organization is exactly the same.

<u>Slide 63</u>
<u>(Chart of Accounts)</u>

Typical chart of accounts categories are:

Assets...

...Liabilities...

...Equity...

...Operating Revenues or Income...

...and Operating Expenses.

<u>Slide 64</u>
<u>(The General Ledger)</u>

The collection of all accounts and account balances stored in a financial system represents an organizations general ledger.

The financial data in the general ledger is used to produce the financial reports.

The chart of accounts is used to provide organization and structure for the general ledger.

Slide 65
(The General Ledger)
The general ledger, or simply ledger, is often referred to as “the books.”

Slide 66
(The General Ledger)
If you were to picture the ledger as a book, each account would have its own page. This is where you would track and record transactions that effect accounts.

Accounts within the ledger have a beginning balance and ending balance.

Transactions can increase, decrease or have no effect on the account’s balance.

Companies usually calculate the account’s ending balance on a monthly basis for reporting.

Slide 67
(The General Ledger)
Depending on the size and complexity of the organization's finances, sub-ledgers may be used.

A sub-ledger is a supplemental ledger for a specific account or control account in a general ledger.

These sub-ledgers are grouped by specific types of transactions. Sub-ledgers are used to limit the amount of information stored in the general ledger.

Slide 68
(The General Ledger)
Good examples of commonly used sub-ledgers are accounts receivable and accounts payable.

These sub-ledgers maintain transactional details and balances for each customer...

...and individual supplier.

The sub-ledger total is posted to the corresponding control account within the general ledger. A control account summarizes the sub-ledgers detail data.

Slide 69
(Lesson 4)
Lesson 4: The Accounting Cycle

Slide 70
(Accounting Cycle)

Today most organizations, both large and small, use automated accounting systems or software that records their transaction's data instantly into the general ledger.

It's no longer necessary to manually create entries for every transaction.

Transactions such as sales invoices, purchase orders, checks and other financial events are automatically processed and stored.

<u>Slide 71</u>
<u>(Accounting Cycle)</u>
Advances in technology have impacted accounting in many positive ways.

It has also improved accuracy while reducing time, effort, and costs.

The best computer and accounting software is only as good as its users and their understanding of accounting.

<u>Slide 72</u>
<u>(Accounting Cycle)</u>
Accounting experts are still required to direct the organizations financial processes.

Accounting professionals use a series of steps called "The Accounting Cycle" as a guide for recording, summarizing, and reporting the company's business events.

The cycle is essential to the preparation of financial statements.

The cycle beginning and ending is based on the reporting period of each company.

Slide 73
(Accounting Cycle)

The Accounting Cycle is a method of recording and processing the accounting events of a company. The cycle begins when a transaction occurs and ends when the organization's financial books are closed. This process, or cycle, is repeated each reporting period in order to prepare financial statements.

Although organizations may vary on when they prepare financial statements the cycle is repeated each time in the same order.

The number of steps in the accounting cycle may also vary depending on the organization's type of business or the complexity of their finances.

Slide 74
(Accounting Cycle – Step 1)

Let's look at a basic Accounting Cycle to get a better understanding of this process.

Step 1 in the accounting process is identifying and analyzing transactions.

Documents related to a transaction are called source documents.

Examples of source documents are receipts, bank statements, checks, invoices from suppliers, travel receipts, employee timecards and more.

These documents describe the transaction's purpose and are used for documentation.

Slide 75
(Accounting Cycle – Step 1)
After source documents are compiled, it is necessary to review them and decide what effect they will have on account balances.

Ask the following questions when analyzing transactions and how account balances are affected:

What accounts are affected?

Will each account increase or decrease?
And how much will they increase or decrease?

Slide 76
(Accounting Cycle – Step 2)

Step 2: Journal or Record the effects of the transactions.
In step two of the Accounting Cycle transactions are recorded in the general ledger.

A journal is often referred to as the book of original entry.

The journal is the first place details of a transaction are recorded.

A journal includes the date,...

...accounts affected,...

...the amount...

...and a description or explanation of the transaction.

The fundamentals of this concept come from a time when everything was done manually with pencil and paper. Today's accounting systems still use the identical concept and information but the process has been automated.

<u>Slide 77</u>
<u>(Accounting Cycle – Step 2)</u>
Journals are recorded in order by date.

The double-entry method is used to record amounts by account.

Each transaction will affect at least two accounts with one debit and one credit and should follow all of the rules of the accounting equation.

<u>Slide 78</u>
<u>(Accounting Cycle – Step 2)</u>
There may be times when a compound journal entry is needed and one transaction will have more than one debit and one credit.

Whatever the combination, your debits and credits must still balance or equal each other.

<u>Slide 79</u>
<u>(Accounting Cycle – Step 2)</u>
Organizations use different types of journals to enter their transactions.

All organizations have a general journal.

The general journal is a master journal where any transactions can be recorded.
<u>Slide 80</u>
<u>(Accounting Cycle – Step 2)</u>

Organizations with a high volume of transactions do not find it effective to record every transaction in a general journal so they also use special journals.

These special journals are used for recording transactions of a similar type. This keeps the general journal from becoming too large and cumbersome to manage.

Four types of Special Journals are Sales Journal,...

...Cash Receipts Journal,...

...Purchases Journal...

...and Cash Payments Journal.

<u>Slide 81</u>
<u>(Accounting Cycle – Step 3)</u>
Step 3 in the accounting cycle: Post journal entries to the ledger

In this step of the accounting cycle, the journal entry which contains the transaction's detail information is transferred or recorded in the general ledger accounts.

Transferring these journals to the general ledger is referred to as posting.
Posting journal entries to a general ledger is typically automated by most accounting systems, but there is always a

need for manual journal entries to prepare financial statements.

Slide 82
(Accounting Cycle – Step 3)
Once transactions are posted to the general ledger, account balances can now be analyzed.

Slide 83
(Accounting Cycle – Step 4)
Before financial statements can be created, the data posted in the general ledger must be confirmed for accuracy.

To complete this task effectively, a Trial Balance report is prepared.

A Trial Balance is an internal report. It lists all accounts from the general ledger with their account balances for the reporting period.

Slide 84
(Accounting Cycle – Step 4)
It contains a debit column and credit column.

Asset and expense accounts appear on the debit side of the report.

Liabilities, capital and income accounts appear on the credit side.

Both debit and credit accounts are totaled to prove they are equal.

Slide 85
(Accounting Cycle – Step 4)
This report does not guarantee journal entries are without errors.

The trial balance cannot detect if a correct dollar amount was mistakenly entered into an incorrect account.

It only confirms that all debit balances match all credit balances.

If errors are discovered, then correcting entries are made to rectify or reverse their effects.

Once these entries are made the Trial Balance can be re-run to confirm both debit and credit columns are balanced.

<u>Slide 86</u>

<u>(Accounting Cycle – Step 5)</u>

Step 5: Adjusting entries

Once the Trial Balance is correct adjusting entries will be made.

Adjusting entries are typically made just prior to preparing financial statements.

The accrual basis of accounting uses the adjusting process to accurately report income and expense in the correct period.

Any expenses incurred or income earned but not recorded in the books requires an adjusting entry.

<u>Slide 87</u>

<u>(Accounting Cycle – Step 5)</u>

The typical categories of adjusting entries are:

Prepaid or Deferred Expense,...

...Depreciation Expense,...

...Unearned or Deferred Revenue,...

...Accrued Expense...

...and Accrued Revenue

Slide 88
(Accounting Cycle – Step 5)

A Prepaid or Deferred Expense is an entry that refers to goods or services purchased in advance.

In accrual accounting, this entry is made to follow the matching principle.

The matching principle requires organizations to record expenses in the period when they occur regardless of when cash is exchanged.

This is to match the cause and effect a transaction has on the organization's financials during the right reporting period.

Prepaid expenses are viewed as assets until they are used, then their cost becomes expense.

A common example of prepaid expense is vehicle insurance. Initially, this expense is an asset because the expense is paid in advance. As the insurance benefit expires over time, it will become an expense.

Slide 89
(Accounting Cycle – Step 5)
For example, on February 15 Carolina Tees pays their vehicle insurance premium of $6,000. This payment covers the months of March, April and May. Carolina Tees must recognize the prepaid insurance as an asset in the February reporting period.

The following two entries are recorded on February 15:

A $6,000 debit is recorded to the prepaid insurance account...

...and a $6,000 credit is recorded to the cash account.

This transaction records the initial insurance payment as an asset in the prepaid insurance account until the insurance is utilized. The transaction also records a reduction to the cash account for the outgoing payment.

Slide 90
(Accounting Cycle – Step 5)
As each month passes, Carolina Tees records adjusting entries that reduce prepaid insurance by the amount of insurance expense consumed.

This reflects expense utilized for each reporting period.

To calculate the amount of the monthly adjusting entry, divide the total premium by the periods of coverage.

The total premium of $6,000 is divided by the 3 month premium period.

The monthly adjusting entry is $2,000.

The first month of expired insurance expense is recorded on March 31.

The first entry will debit the insurance expense account $2,000

The second entry will the credit the prepaid insurance account $2,000

On April 30 the second month of expired insurance is recorded:

The first entry will debit the insurance expense account $2,000

The second entry will credit the prepaid insurance account $2,000

On May 31 the final month of expired insurance is recorded:

The first entry will debit the insurance expense account $2,000

The second entry will credit the prepaid insurance account $2,000

Slide 91
(Accounting Cycle – Step 5)
After all adjustments are recorded, the total insurance payment of $6,000 is accounted for as vehicle insurance expense...

...and the prepaid insurance account reflects a zero balance since the asset has been consumed.

Slide 92
(Accounting Cycle – Step 5)
Depreciation expense is another category of prepaid expenses.

When long-term tangible assets are acquired that will provide a benefit greater than one year, but will not last indefinitely, they are depreciated.

Fixed assets that can be considered for depreciation are buildings, machinery, equipment, furniture, computers, cars, and trucks.

Land is the exception and cannot be depreciated.

Adjusting entries for depreciation are required because of the matching principle. Matching a portion of the fixed assets cost with the revenue it generates in the same reporting period gives organizations a complete picture of the effect on profitability.

Slide 93
(Accounting Cycle – Step 5)
The fixed asset initial cost or purchase amount is recorded as an asset.

It can be difficult to directly link a fixed asset with revenue so the asset's cost is typically depreciated or allocated to expense over the periods of its life expectancy.

There is more than one way to calculate the depreciation of an organization's assets.

The most common method of depreciation is the Straight Line Method. This method spreads the assets cost evenly over its life-span.

Slide 94
(Accounting Cycle – Step 5)
Let's look at a simplified example of how a fixed asset is depreciated using the Straight Line method.

Carolina Tees purchases a screen printer for $18,000. The estimated useful life of the printer is 3 years. The deprecation is reported evenly over the 3-year life of the printer. There is no residual value meaning the printer will have no value at the end of its 3 year life expectancy.

To calculate the annual depreciation expense, divide the net cost of $18,000 by the 3 years of useful life.

The annual depreciation expense is $6,000.

This is recorded at the end of each year in the depreciation expense account.

Slide 95
(Accounting Cycle – Step 5)
The organization also needs to be aware of the full cost of the asset and its depreciation.

The accumulated depreciation account records the cumulative depreciation for the fixed asset.

Accumulated Depreciation is a contra account.

Contra accounts are linked to another account and used when there is a need to offset the other account's balance.

Slide 96
(Accounting Cycle – Step 5)
This account contains the total of all depreciation expense over all periods for which the asset was used. The sum of the asset account and the accumulated depreciation account will reflect the net or book value of the asset.

<u>Slide 97</u>
<u>(Accounting Cycle – Step 5)</u>
An Unearned or Deferred Revenue adjusting entry is used when a customer pays an organization before goods or services are provided.

Unearned revenue is a liability to the organization.

<u>Slide 98</u>
<u>(Accounting Cycle – Step 5)</u>
If an organization accepts cash, it then obligates itself to provide the good or service to the customer.

When the customer receives the good or service, the unearned revenue will be recorded as earned revenue.

<u>Slide 99</u>
<u>(Accounting Cycle – Step 5)</u>
In this example of unearned revenue, Carolina Tees receives an order for fifty custom designed T-shirts two months in advance.

The customer pays $500 at the time they place the order.

Carolina Tees is now obligated to the customer until the t-shirts are delivered.

The $500 cash payment will be recorded initially as unearned revenue, which is a liability account.

Slide 100
(Accounting Cycle – Step 5)
On March 15, two months later, the order is delivered to the customer.

At that time another entry is recorded to move the unearned revenue...

...to earned revenue.

Slide 101
(Accounting Cycle – Step 5)
Accrued expense is a cost the organization has incurred but has not paid or recorded during the current reporting period.

Under the accrual method of accounting, expenses are recorded when they occur, even if payment is not made at the same time.

Expenses such as wages, salaries, utilities, rent and interest on loans are examples of accrued expenses.

<u>Slide 102</u>
<u>(Accounting Cycle – Step 5)</u>
These expenses are a liability or debt owed by the company that will be paid at a later date.

The adjusting entry ensures expenses are not understated on financial reports which would make profitability look better than it should.

<u>Slide 103</u>
<u>(Accounting Cycle – Step 5)</u>
An example of the accrued expense adjusting entry is when Carolina Tees receives an invoice on January 31 for the $3,000 January rent payment due by February 5.

A check will not be issued for the rent expense until it's due in February.

<u>Slide 104</u>
<u>(Accounting Cycle – Step 5)</u>
For the January financials to be reported accurately the adjusting entry to accrue rent expense in January is required.

When payment is made in February, another entry is recorded to reflect the $3,000 payment and remove the liability from the books.

<u>Slide 105</u>
<u>(Accounting Cycle – Step 5)</u>
Accrued Revenue is revenue that is earned in the current period but not collected until a later period.

This could mean that a service or good was sold to a customer but no payment was received and no invoice was generated.

<u>Slide 106</u>
<u>(Accounting Cycle – Step 5)</u>
Since there is no record of the sale in the system an adjusting entry is made.

<u>Slide 107</u>
<u>(Accounting Cycle – Step 5)</u>
On March 31, Carolina Tees performs $500 worth of printing services for a client.

The printing service is not invoiced and no fees are collected until April 5.

In March Carolina Tees must record the adjusting entry to recognize this service income already earned.

Slide 108
(Accounting Cycle – Step 5)
On April 5, they will record a second adjusting entry for the receipt of payment for services provided in March.

Adjusting entries are very important to ensure accurate financial statements. If income or expenses are over or understated on the financial statements, it gives a distorted view of the company's income and expense.

Once all adjusting entries are made, the Trial Balance is re-run to ensure there are no errors prior to preparing financial statements.

Slide 109
(Accounting Cycle – Step 6)
Step 6: Preparing Financial Statements

Financial Statements are the end product of the Accounting Cycle.

They provide a picture of the organizations financial condition for a specific period or point in time.

They are vital to decision makers when planning for the future.

Slide 110
(Accounting Cycle – Step 6)
Financial Statements are prepared using information from the organization’s general ledger accounts.

Usually these Statements refer to four reports.

The reports are interrelated and are prepared in a specific sequence as some data in one statement is needed for use in another statement.

These reports include the Income Statement, Statement of Owner's Equity, Balance Sheet, and the Statement of Cash Flows.

Slide 111
(Accounting Cycle – Step 6)
Let’s briefly look at the Statements in the order they would be prepared.

The Income Statement, also known as the Profit and Loss Statement, presents the organization’s revenues or income and expenses over a particular period of time.

This statement shows the resulting net income or net loss for the organization over that period.

Slide 112
(Accounting Cycle – Step 6)
The Statement of Owner's Equity, also referred to as the Statement of Retained Earnings, shows movement or changes in the organization's equity.

This statement reflects any changes that occurred during the reporting period and the resulting ending balance.

This statement presents the company's income and how it's affected positively or negatively.

Slide 113
(Accounting Cycle – Step 6)
The Balance Sheet reports the organization's financial condition at a specific point in time.

This statement is also commonly referred to as the Statement of Financial Position.

This report follows the accounting equation format and summarizes assets, liabilities and equity.

Like the accounting equation, the report must demonstrate assets in balance with liabilities and equity.

Slide 114
(Accounting Cycle – Step 6)
The Statement of Cash Flows reports the inflow and outflow of cash during a specific period of time.

It presents the beginning cash balance, the changes that occurred during the period and the cash balance at the end of the period.

This report has three main sections: operating, investing and financing.

Slide 115
(Accounting Cycle – Step 6)
The operating activities section is related to the cash flow of business operations.

This section reports cash inflows and outflows from the organization's revenue generating activities and operating activities.

Slide 116
(Accounting Cycle – Step 6)
The investing activities section reports cash inflows and outflows from investing activities that generate income.

Slide 117
(Accounting Cycle – Step 6)
The financing activities section includes cash invested from owners or from proceeds received from bank loans.

This section also reports owner payments or withdrawals and loan payments.

The bottom line of this report shows if the organization's cash has increased or decreased over the specific period.

It shows if the organization has enough cash on hand to pay expenses or purchase assets.

Slide 118
(Accounting Cycle – Step 7)
Step 7: Closing the Books

The final step in the accounting cycle is closing the books.

This means that Financial Statements are final and you are officially ending the accounting period so you can begin the next period.

This is an important step in the accounting cycle to prepare accounts for recording transactions in the next period.

Slide 119
(Basic Accounting Principles and SCEIS)

Thank you for completing Accounting 101U to learn more about accounting concepts and accrual based accounting.

Additional SCEIS Finance classes which you complete may include basic accounting and accrual based accounting concepts. This Accounting 101 class will serve as a good reference for future classes and your daily work in SCEIS.

To access other SCEIS resources, visit the links page of this course.

Please also fill in the SCEIS Training Completion Survey to indicate that you have taken this course.