

# Introduction to Accounting

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“Whether you are looking at a large multinational company like Apple or Starbucks or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening.”

## **Brief Contents**

**Chapter One:** Basic Accounting Concepts

**Chapter Two:** The Accounting Cycle

# **Chapter One**

## **Basic Accounting Concepts**

### **Learning objectives**

**After studying this chapter, you should be able to:**

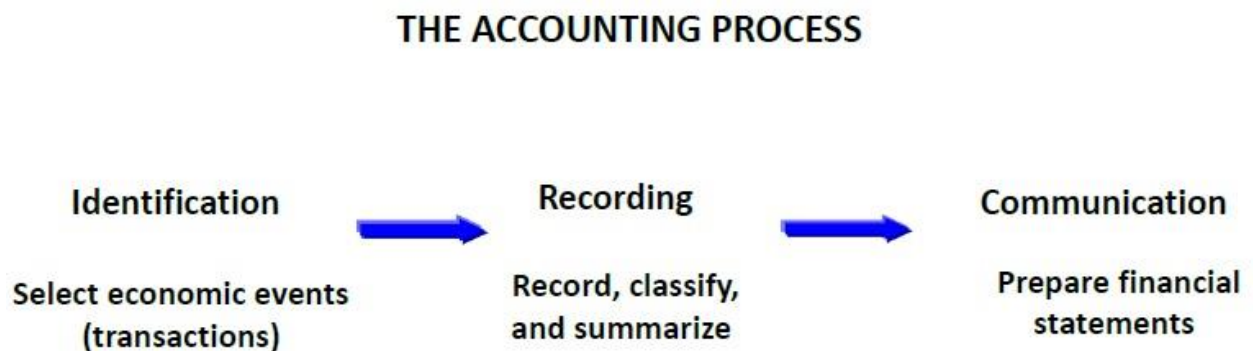
1. Explain what Accounting is.
2. Identify the users of Accounting Information.
3. Understand the various branches of the accounting studies.
4. Explain the Generally Accepted Accounting Principles (GAAP).
5. Determine a business entity results (Revenues and Expenses).
6. Understand what a financial position of a business entity is (Assets, Liabilities and Owner's Equity).
7. Identify the basic components of the Accounting Equation.

## 1. WHAT IS ACCOUNTING?

**Accounting** is an information system. It measures business activities, processes data into reports, and communicates results to people. Accounting is “the language of business.” The better you understand the language, the better you can manage your finances and operations.

Accounting consists of three basic activities - it **identifies**, **records**, and **communicates** the economic events (transactions) of an organization to **interested users**.

Accounting produces **financial statements**, which report information about a business entity. The financial statements measure performance and tell where a business stands in financial terms.



You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying, recording, and communicating economic events**.

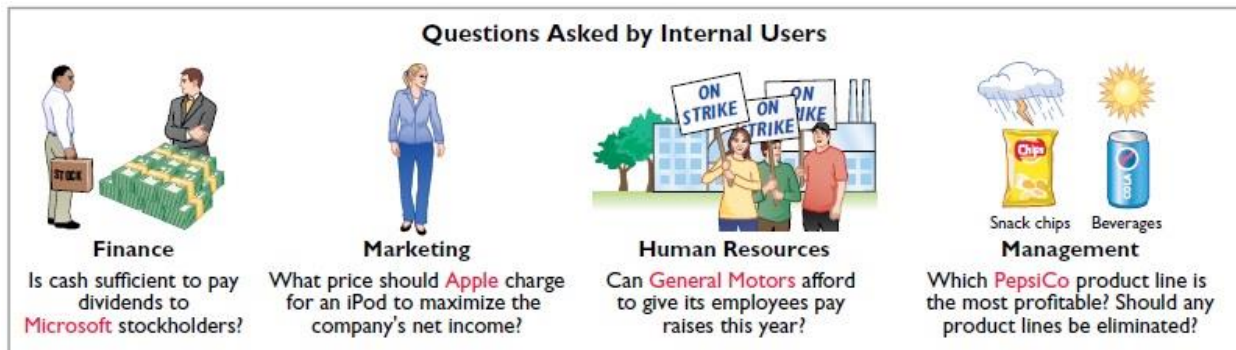
A vital element in communicating economic events is the accountant’s ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses, meaning, and limitations of reported data**.

## 2. WHO USES ACCOUNTING INFORMATION?

Decision makers need information, the information that a user of financial information needs depends upon the kinds of decisions the user makes. There are two broad groups of users of financial information: **internal** and **external users**.

## Internal users

Internal users of accounting information are those individuals inside a company who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, such as:

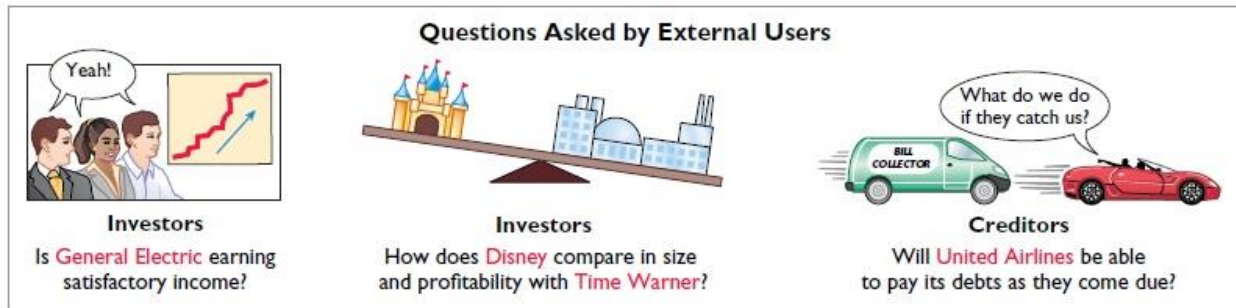


To answer these and other questions, internal users need detailed information on timely bases. **Management accounting** provides internal reports to help users make decisions about their companies.

## External users

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors who provide the money to finance the company. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell ownership shares of a company. Investors want to know how much income they can expect to earn on an investment. This requires accounting data. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money (for example, A banker decides who gets a loan).

Also, **Taxing authorities** want to know whether the company complies with tax laws. **Regulatory agencies**, such as Egyptian Stock Exchange Authority (EGX), want to know whether the company is operating within prescribed rules. External users must answer many important questions, such as:



**Financial accounting** answers these questions. It provides economic and financial information for investors, creditors, and other external users.

In brief, since there are *external users* and *internal users* of accounting information. We can therefore classify accounting into **two** branches:

- **Financial accounting:** provides information for people outside the firm, such as investors, bankers, government agencies, and the public. This information must meet standards of relevance and reliability.
- **Management accounting:** generates inside information for the managers of the companies. Management information doesn't have to meet external standards of reliability because only company employees use these data.

### 3. BRANCHES OF ACCOUNTING STUDIES:

The famous branches or types of accounting were mentioned earlier which are the Financial Accounting and the Management Accounting. However, as a result of economic, industrial, and technological developments, different specialized fields in accounting have emerged which include cost accounting, auditing, tax accounting, government accounting, accounting information systems (AIS), and forensic accounting.

- **Cost Accounting:** Sometimes considered as a subset of management accounting, cost accounting refers to the recording, presentation, and analysis of *manufacturing costs*. Cost accounting is very useful in manufacturing businesses since they have the most complicated costing process. Cost accountants also analyze actual and standard costs to help managers determine future courses of action regarding the company's operations.
- **Auditing:** *External auditing* refers to the examination of financial statements by an independent party with the purpose of expressing an opinion as to fairness of presentation and compliance with GAAP. *Internal auditing* focuses on evaluating the adequacy of a company's

internal control structure by testing segregation of duties, policies and procedures, degrees of authorization, and other controls implemented by management.

- **Tax Accounting:** Tax accounting helps clients follow rules set by tax authorities. It includes tax planning and preparation of tax returns. It also involves determination of income tax and other taxes, tax advisory services such as ways to minimize taxes legally, evaluation of the consequences of tax decisions, and other tax-related matters.
- **Government Accounting:** In the government environment, public sector entities have different goals, as opposed to the private sector entities' one main goal of gaining profit. Government accounting refers to the field of accounting that specifically finds application in the public sector or government.
- **Accounting Information Systems (AIS):** Accounting information systems (AIS) involves the development, installation, implementation, and monitoring of accounting procedures and systems used in the accounting process. It includes the employment of business forms, accounting personnel direction, and software management.
- **Forensic Accounting:** Forensic accounting involves court and litigation cases, fraud investigation, claims and dispute resolution, and other areas that involve legal matters. This is one of the popular trends in accounting today.

#### **4. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP):**

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called **Generally Accepted Accounting Principles (GAAP)**. These standards indicate how to report economic events.

Accountants follow these professional guidelines (**GAAP**) to meet the primary objective of financial reporting, which is to provide information useful for making investment and credit decisions.

**Egyptian Accounting Standards (EAS)** are developed by the Standards Committee of the Egyptian Society of Accountants and Auditors. A committee headed by the Minister of Investment reviews, approves, and issues the standards. The EASs comply with the **International Financial Reporting Standards (IFRSs)**, in all material respects, except in certain EASs where the differences are significant mainly due to the applicable Egyptian laws and regulations. Recently, the Minister of Investment Decree No. 110 of 2015 issued on 07/07/2015 issued the new Egyptian



accounting standards, which the third article of this law is effective from January 1, 2016, and its application to establishments whose financial year begins on or after this date.

## **5. ACCOUNTING PRINCIPLES AND ASSUMPTIONS:**

### **First. Measurement Principles**

GAAP generally uses one of two measurement principles, the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation. **Relevance** means that financial information can make a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

#### **The Historical Cost Principle:**

One important accounting principle is the cost principle. The **cost principle** states that assets and services should be recorded at their actual *historical cost*. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if a company purchases land for L.E50, 000, the company initially reports it in its accounting records at L.E50, 000. But what does the company do if, by the end of the next year, the land has increased in value to L.E60,000. Under the cost principle it continues to report the land at L.E50, 000.

#### **Fair Value Principle:**

The **fair value principle** states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). Fair value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at fair value.

### **Second. Assumptions**

Assumptions provide a foundation for the accounting process. The basic concepts/assumptions are like the pillars on which the structure of accounting is based.

#### **The Economic Entity assumption:**

The most basic accounting concept is the **entity**, which is any organization that stands part as a separate economic unit. Sharp boundaries are drawn around each entity so as not to confuse its affairs with those of others. An economic entity can be any organization or unit in society. The

economic entity assumption requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

### **The Going-Concern Assumption:**

The **going-concern concept** assumes that the entity will remain in operation long enough to use existing assets—land, buildings, supplies—for their intended purpose. Also known as ‘continuity assumption’.

### **The Stable-Monetary-Unit Assumption:**

The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in money terms. In Egypt, we record transactions in pounds because that is our medium of exchange. British accountants record transactions in pounds sterling, Japanese in yen, and Europeans in euros. This assumption enables accounting to quantify (measure) economic events.

## **6. DETERMINING THE FINANCIAL POSITION OF A BUSINESS:**

In order to evaluate the performance of a business entity, an accountant must be able to calculate the building blocks of the performance indicators. Those performance indicators are included in what is called the Accounting Equation.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. **Liabilities and owner’s equity** are the rights or claims against these resources.

### **The Basic Accounting Equation**

<b>Assets = Liabilities + Owner’s equity</b>
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This relationship is the **basic accounting equation**. Assets must equal the sum of liabilities and owner’s equity. Liabilities appear before owner’s equity in the basic accounting equation because they are paid first if a business is liquidated. The accounting equation applies to all economic entities regardless of size, nature of business, or form of business organization.

## 7. COMPONENTS OF THE ACCOUNTING EQUATION:

- **Assets:**

As noted above, assets are resources a business owns. The business uses its assets in carrying out such activities as production and sales. The common characteristic possessed by all assets is the **capacity to provide future services or benefits**. In a business, that service potential or future economic benefit eventually results in cash inflows (receipts).

- **Liabilities:**

Liabilities are claims against assets—that is, existing debts and obligations. Businesses of all sizes usually borrow money and purchase merchandise on credit.

- **Owner's Equity:**

The ownership claim on total assets is owner's equity. It is equal to total assets minus total liabilities. Here is why: The assets of a business are claimed by either creditors or owners. To find out what belongs to owners, we subtract the creditors' claims (the liabilities) from assets. The remainder is the owner's claim on the assets—the owner's equity. Since the claims of creditors must be paid **before** ownership claims, owner's equity is often referred to as **residual equity**.

<b>Basic Accounting Equation</b>	<b>Assets = Liabilities + Owner's equity</b>
<b>Expanded Accounting Equation</b>	<b>Assets = Liabilities + Owner's capital - Owner's drawings + Revenues - Expenses</b>

## 8. USING THE ACCOUNTING EQUATION:

Transactions (business transactions) are a business's economic events recorded by accountants. Transactions may be external or internal. **External transactions** involve economic events between the company and some outside enterprise. For example, a company purchases of equipment from a supplier, payment of monthly rent to the landlord, and sale of products to customers.

**Internal transactions** are economic events that occur entirely within one company. The use of supplies is internal transactions for the company. Companies carry on many activities that do not represent business transactions. Examples are hiring employees, and placing merchandise orders. Some of these activities may lead to business transactions: Employees will earn wages, and suppliers will deliver ordered merchandise. The company must analyze each event to find out if it

affects the components of the accounting equation. If it does, the company will record the transaction.

Each transaction must have a dual effect on the accounting equation. For example, if an asset is increased, there must be a corresponding (1) decrease in another asset, (2) increase in a specific liability, or (3) increase in owner's equity. Two or more items could be affected. For example, as one asset is increased LE 10,000, another asset could decrease LE 6,000 and a liability could increase LE 4,000. Any change in a liability or ownership claim is subject to similar analysis.

## KEY TERMS:

- **Accounting ( المحاسبة )** : The information system that identifies, records, and communicates the economic events (transactions) of an organization to interested users.
- **Business organizations ( المنظمات الهادفه للربح )**: The profit oriented organizations that designed to earn a return (profit) on investment for equity investors (owners), operate in a competitive market, and face liquidity concerns.
- **Business transactions ( التعاملات المالية )**: are a business's economic events recorded by accountants. Transactions may be external or internal.
- **Corporation ( شركة مساهمة )**: A business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock.
- **Drawings ( المسحوبات )**: Withdrawal of cash or other assets from an unincorporated business for the personal use of the owner(s).
- **External users of financial information ( المستخدم الخارجي للمعلومات المحاسبية )**: They are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors.
- **Financial accounting ( المحاسبة المالية )**: The field of accounting that provides economic and financial information for investors, creditors, and other external users.
- **Generally Accepted Accounting Principles (GAAP) ( المبادئ المحاسبية المتعارف عليها )**: Common standards that indicate how to report economic events.
- **Internal users of accounting information ( المستخدم الداخلي للمعلومات المحاسبية )** : They are those individuals inside a company who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers.
- **International Financial Reporting Standards (IFRS) ( المعايير الدولية للتقرير المالي )**: International accounting standards set by the International Accounting Standards Board (IASB).
- **Managerial accounting ( المحاسبة الإدارية )**: The field of accounting that provides internal reports to help users make decisions about their companies.

# **Chapter Two**

## **The Accounting Cycle**

### **Learning objectives**

**After studying this chapter, you should be able to:**

1. Describe how accounts, debits, and credits are used to record business transactions.
2. Identify the basic steps in the recording process.
3. Define what a journal is and how it helps in the recording process.
4. Define what a ledger is and how it helps in the recording process.
5. Explain what posting is and how it helps in the recording process.
6. Explain the purposes of a trial balance.
7. Explain the difference between accrual and cash basis of accounting.
8. Explain the reasons for adjusting entries and identify major types of adjusting entries
9. Describe nature and purpose of adjusted trial balance.
10. Prepare an adjusted trial balance.
11. Identify different types of financial statements.
12. Preparing the financial statements
13. Recording Closing Entries.
14. Preparing Post-Closing Trial Balance.

## THE ACCOUNT

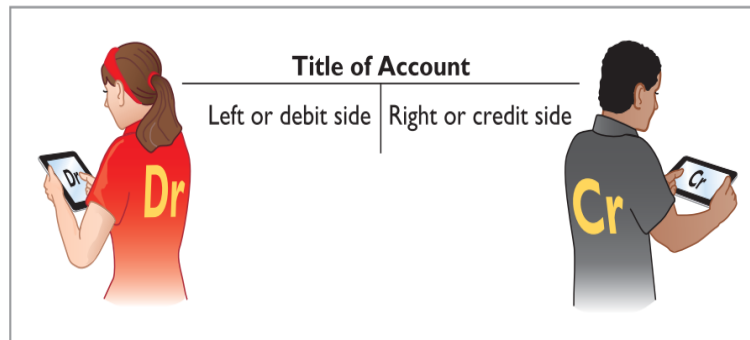
An **account** is an individual accounting record of increases and decreases in a specific asset, liability, or owner's equity item. An account consists of three parts (English accounting practice):

- (1) a title,
- (2) a left or debit side, and
- (3) a right or credit side.

Because the format of an account resembles the letter T, we refer to it as a T-account.

**Illustration 2-1** shows the basic form of an account.

**Illustration 2-1**  
Basic form of account



## DEBITS AND CREDITS

The term **debit** indicates the left side of an account, and **credit** indicates the right side. They are commonly abbreviated as **Dr.** for debit and **Cr.** for credit. They do not mean increase or decrease, as is commonly thought. We use the terms debit and credit repeatedly in the recording process to describe where entries are made in accounts.

The procedure of recording debits and credits in an account is shown in **Illustration 2-2** for the transactions affecting the Cash account of a company.

**Illustration 2-2**  
Tabular summary and account form for Softbyte's Cash account

Tabular Summary		Account Form	
Cash		Cash	
\$15,000		(Debits) 15,000	(Credits) 7,000
-7,000		1,200	1,700
1,200		1,500	250
1,500		600	1,300
-1,700		Balance 8,050	
-250		(Debit)	
600			
-1,300			
<u>\$ 8,050</u>			

## TRANSACTIONS

Business activity is all about transactions. A **transaction** is any event that has a financial impact on the business and can be measured reliably. But not all events qualify as transactions. A transaction must occur before the company records anything. Transactions provide objective information about the financial impact on a company. Every transaction has two parties:

- (1) One party gives a value (the party is an asset or a liability or an owners' equity), and
- (2) Another party receives the same value (the other party is an asset or a liability or an owners' equity).

In accounting, we always record both parties of a transaction. And we must be able to measure the financial impact of the event on the business before recording it as a transaction. So, accounting transactions are economic events that must be recorded in the financial statements because they affect: Assets, Liabilities, and Shareholders' equity.

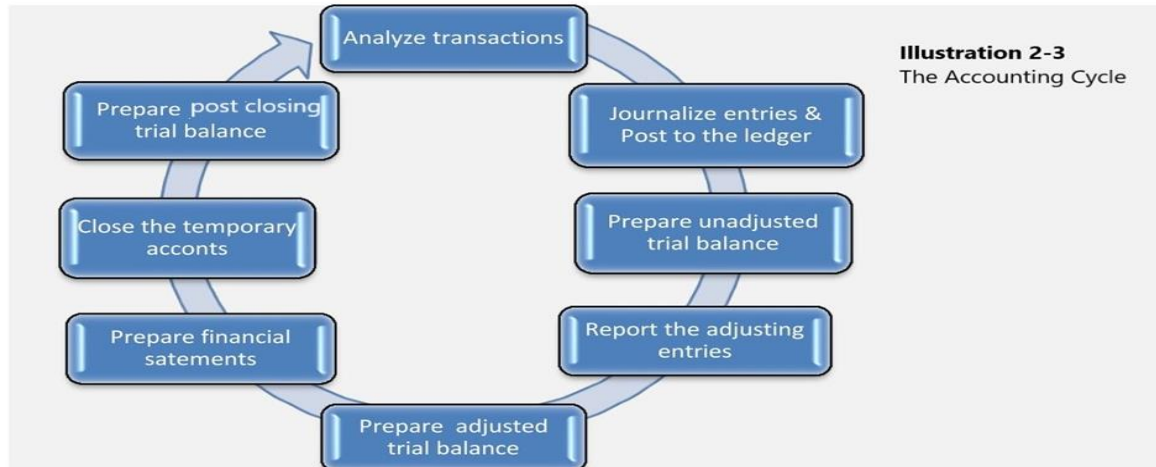
## THE ACCOUNTING CYCLE

**The Accounting Cycle** is a step-by-step process of recording, classification and summarization of economic transactions of a business. It generates useful financial information in the form of financial statements including income statement, balance sheet, and a cash flow statement.

The time period principle requires that a business should prepare its financial statements on periodic basis. Therefore, accounting cycle is followed once during each accounting period.



**Accounting Cycle** starts from the recording of individual transactions and ends on the preparation of financial statements and closing entries. **Illustration 2-3** shows the eight steps that constitute the accounting cycle.



Following are the major steps involved in the accounting cycle:

**(1) Analyzing and recording transactions in journals.**

Companies initially record transactions in chronological order (the order in which they occur). Thus, **the journal** is referred to as the book of original entry. For each transaction, the journal shows the debit and credit effects on specific accounts.

Entering transaction data in the journal is known as **journalizing**.

**Illustration 2-4** shows the journal for Pioneer Advertising for October.

**Illustration 2-4**  
General journal entries

GENERAL JOURNAL				PAGE J1
Date	Account Titles and Explanation	Ref.	Debit	Credit
2017				
Oct. 1	Cash	101	10,000	
	Owner's Capital	301		10,000
	(Owner's investment of cash in business)			
1	Equipment	157	5,000	
	Notes Payable	200		5,000
	(Issued 3-month, 12% note for office equipment)			
2	Cash	101	1,200	
	Unearned Service Revenue	209		1,200
	(Received cash from R. Knox for future service)			
3	Rent Expense	729	900	
	Cash	101		900
	(Paid October rent)			
4	Prepaid Insurance	130	600	
	Cash	101		600
	(Paid one-year policy; effective date October 1)			
5	Supplies	126	2,500	
	Accounts Payable	201		2,500
	(Purchased supplies on account from Aero Supply)			
20	Owner's Drawings	306	500	
	Cash	101		500
	(Withdrew cash for personal use)			
26	Salaries and Wages Expense	726	4,000	
	Cash	101		4,000
	(Paid salaries to date)			
31	Cash	101	10,000	
	Service Revenue	400		10,000
	(Received cash for services performed)			

**(2) Posting journal entries to ledger accounts.**

The **posting process** describes transferring entries from the **Journal** to the **Ledger accounts**. The *journal* is a chronological record of all company transactions listed by date. But the journal does not indicate how much cash or accounts receivable the business has. *The Ledger* is the entire group of accounts maintained by a company. The ledger provides the balance in each of the accounts as well as keeps track of changes in these balances.

Companies may use various kinds of ledgers, but every company has a general ledger. A **general ledger** contains all the asset, liability, and owner's equity accounts.

**Illustration 2-5** shows the ledger, with all balances in red.

**Posting** should be performed in chronological order. That is, the company should post all the debits and credits of one journal entry before proceeding to the next journal entry. Postings should be made on a timely basis to ensure that the ledger is up to date.

**Illustration 2-5**  
General ledger

GENERAL LEDGER					
Cash No. 101					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 1		J1	10,000		10,000
2		J1	1,200		11,200
3		J1		900	10,300
4		J1		600	9,700
20		J1		500	9,200
26		J1		4,000	5,200
31		J1	10,000		<b>15,200</b>
Supplies No. 126					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 5		J1	2,500		<b>2,500</b>
Prepaid Insurance No. 130					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 4		J1	600		<b>600</b>
Equipment No. 157					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 1		J1	5,000		<b>5,000</b>
Notes Payable No. 200					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 1		J1		5,000	<b>5,000</b>
Accounts Payable No. 201					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 5		J1		2,500	<b>2,500</b>
Unearned Service Revenue No. 209					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 2		J1		1,200	<b>1,200</b>
Owner's Capital No. 301					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 1		J1		10,000	<b>10,000</b>
Owner's Drawings No. 306					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 20		J1	500		<b>500</b>
Service Revenue No. 400					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 31		J1		10,000	<b>10,000</b>
Salaries and Wages Expense No. 726					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 26		J1	4,000		<b>4,000</b>
Rent Expense No. 729					
Date	Explanation	Ref.	Debit	Credit	Balance
2017					
Oct. 3		J1	900		<b>900</b>

Most companies have a **chart of accounts**. This chart lists the accounts and the account numbers that identify their location in the ledger. The numbering system that identifies the accounts usually starts with the balance sheet accounts and follows with the income statement accounts. **Illustration 2-6** shows Pioneer's chart of accounts:

**Illustration 2-6**  
Chart of accounts

 <b>PIONEER ADVERTISING</b> Chart of Accounts	
Assets	Owner's Equity
101 Cash	301 Owner's Capital
112 Accounts Receivable	306 Owner's Drawings
126 Supplies	350 Income Summary
130 Prepaid Insurance	
157 Equipment	<b>Revenues</b>
158 Accumulated Depreciation—Equipment	400 Service Revenue
Liabilities	Expenses
200 Notes Payable	631 Supplies Expense
201 Accounts Payable	711 Depreciation Expense
209 Unearned Service Revenue	722 Insurance Expense
212 Salaries and Wages Payable	726 Salaries and Wages Expense
230 Interest Payable	729 Rent Expense
	732 Utilities Expense
	905 Interest Expense

### (3) Preparing unadjusted trial balance.

A **trial balance** is a list of accounts and their balances at a given time. Customarily, companies prepare a trial balance at the end of an accounting period. They list accounts in the order in which they appear in the ledger. Debit balances appear in the left column and credit balances in the right column.

The steps for preparing a trial balance are:

- (1) List the account titles and their balances in the appropriate debit or credit column.
- (2) Total the debit and credit columns.
- (3) Prove the equality of the two columns.


**Illustration 2-7** shows the trial balance prepared from Pioneer Advertising's ledger. Note that the total debits equal the total credits.

**Illustration 2-7**  
A trial balance

**Helpful Hint**

Note that the order of presentation in the trial balance is:

- Assets
- Liabilities
- Owner's equity
- Revenues
- Expenses

 <b>PIONEER ADVERTISING</b> Trial Balance October 31, 2017		
	<u>Debit</u>	<u>Credit</u>
Cash	\$ 15,200	
Supplies	2,500	
Prepaid Insurance	600	
Equipment	5,000	
Notes Payable		\$ 5,000
Accounts Payable		2,500
Unearned Service Revenue		1,200
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	900	
	<u><b>\$28,700</b></u>	<u><b>\$28,700</b></u>

#### **(4) Recording Adjusting Entries**

There are two bases of recording transactions in accounting. **The cash basis of accounting**, in which companies record revenue when they receive cash. They record an expense when they pay out cash. The cash basis seems appealing due to its simplicity, but it often produces misleading financial statements. It fails to record revenue for a company that has performed services but for which the company has not received the cash, and also fails to record expense when a service is used but not paid for yet. As a result, the cash basis does not match expenses with revenues.

**The accrual basis of accounting** requires that companies record revenues when service is performed or goods sold, and expenses recorded when the service is used regardless of receiving or paying cash. Accrual-basis of accounting is the basis recommended by **Generally Accepted Accounting Principles (GAAP)**.

#### **Recognizing Revenues and Expenses (Accrual- basis of accounting)**

It can be difficult to determine when to report revenues and expenses. The revenue recognition principle and the expense recognition principle help in this task.

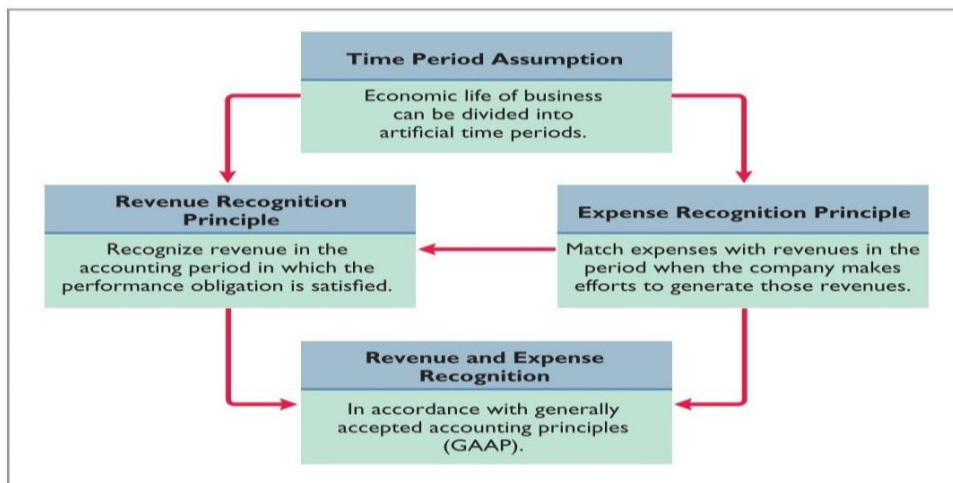
##### **Revenue Recognition Principle**

When a company agrees to perform a service or sell a product to a customer, it has a performance obligation. When the company meets this performance obligation, it recognizes

revenue. The revenue recognition principle therefore requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied.

### Expense Recognition Principle

Accountants follow a simple rule in recognizing expenses: “Let the expenses follow the revenues.” Thus, expense recognition is tied to revenue recognition. The critical issue in expense recognition is when the expense makes its contribution to revenue. This may or may not be the same period in which the expense is paid. This practice of expense recognition is referred to as the expense recognition principle (often referred to as the matching principle). It dictates that efforts (expenses) be matched with results (revenues). **Illustration 2-8** summarizes the revenue and expense recognition principles.



**Illustration 2-8**  
GAAP relationships in revenue  
and expense recognition

## The Need for Adjusting Entries

For revenues to be recorded in the period in which services are performed and for expenses to be recognized in the period in which they are incurred, companies make adjusting entries. **Adjusting entries** ensure that the revenue recognition and expense recognition principles are followed. **Adjusting entries** are required every time a company prepares financial statements. The company analyzes each account in the trial balance to determine whether it is complete and up-to-date for financial statement purposes. Every adjusting entry will include one income statement account and one balance sheet account.

## Types of Adjusting Entries

Adjusting entries are classified as either **deferrals** or **accruals**.

### A. *Deferrals*:

- 1) Prepaid expenses: Expenses paid in cash before they are used or consumed. A common example of prepaid expenses is office supplies and depreciation.
- 2) Unearned revenues: Cash received before services are performed.

### B. *Accruals*:

- 1) Accrued revenues: Revenues for services performed but not yet received in cash or recorded.
- 2) Accrued expenses: Expenses incurred but not yet paid in cash or recorded. A good example of accrued expenses is wages paid to employees.

**Illustrations 2-9 and 2-10** show the journalizing and posting of adjusting entries for Pioneer Advertising on October 31.



GENERAL JOURNAL					J2
Date	Account Titles and Explanation	Ref.	Debit	Credit	
2017	<u>Adjusting Entries</u>				
Oct. 31	Supplies Expense	631	1,500		
	Supplies	126		1,500	
	(To record supplies used)				
31	Insurance Expense	722	50		
	Prepaid Insurance	130		50	
	(To record insurance expired)				
31	Depreciation Expense	711	40		
	Accumulated Depreciation—Equipment	158		40	
	(To record monthly depreciation)				
31	Unearned Service Revenue	209	400		
	Service Revenue	400		400	
	(To record revenue for services performed)				
31	Accounts Receivable	112	200		
	Service Revenue	400		200	
	(To record revenue for services performed)				
31	Interest Expense	905	50		
	Interest Payable	230		50	
	(To record interest on notes payable)				
31	Salaries and Wages Expense	726	1,200		
	Salaries and Wages Payable	212		1,200	
	(To record accrued salaries and wages)				

### Illustration 2-9

General journal showing adjusting entries

#### Helpful Hint

(1) Adjusting entries should not involve debits or credits to Cash.  
 (2) Evaluate whether the adjustment makes sense. For example, an adjustment to recognize supplies used should increase Supplies Expense.  
 (3) Double-check all computations.  
 (4) Each adjusting entry affects one balance sheet account and one income statement account.



## Illustration 2-10

### GENERAL LEDGER

Cash No. 101				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 1		J1	10,000	10,000
2		J1	1,200	11,200
3		J1		10,300
4		J1		9,700
20		J1		9,200
26		J1	4,000	5,200
31		J1	10,000	15,200

Accounts Receivable No. 112				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 31	Adj. entry	J2	200	200

Supplies No. 126				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 5		J1	2,500	2,500
31	Adj. entry	J2	1,500	1,000

Prepaid Insurance No. 130				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 4		J1	600	600
31	Adj. entry	J2	50	550

Equipment No. 157				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 1		J1	5,000	5,000

Accumulated Depreciation—Equipment No. 158				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 31	Adj. entry	J2	40	40

Notes Payable No. 200				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 1		J1		5,000

Accounts Payable No. 201				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 5		J1		2,500

Unearned Service Revenue No. 209				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 2		J1		1,200
31	Adj. entry	J2	400	800

Salaries and Wages Payable No. 212				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 31	Adj. entry	J2	1,200	1,200

Interest Payable No. 230				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 31	Adj. entry	J2		50

Owner's Capital No. 301				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 1		J1		10,000

Owner's Drawings No. 306				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 20		J1	500	500

Service Revenue No. 400				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 31		J1		10,000
31	Adj. entry	J2		400
31	Adj. entry	J2		200

Supplies Expense No. 631				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 31	Adj. entry	J2	1,500	1,500

Depreciation Expense No. 711				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 31	Adj. entry	J2	40	40

Insurance Expense No. 722				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 31	Adj. entry	J2	50	50

Salaries and Wages Expense No. 726				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 26		J1	4,000	4,000
31	Adj. entry	J2	1,200	5,200

Rent Expense No. 729				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 3		J1	900	900

Interest Expense No. 905				
Date	Explanation	Ref.	Debit	Credit Balance
2017				
Oct. 31	Adj. entry	J2	50	50

**(5) Preparing the Adjusted Trial Balance.**

After a company has journalized and posted all adjusting entries, it prepares another trial balance from the ledger accounts. This trial balance is called an adjusted trial balance. It shows the balances of all accounts, including those adjusted, at the end of the accounting period.

**Illustration 2-11** presents the adjusted trial balance for Pioneer Advertising prepared from the ledger accounts in Illustration 2-10.

**Illustration 2-11**  
Adjusted trial balance

PIONEER ADVERTISING Adjusted Trial Balance October 31, 2017		
	Debit	Credit
Cash	\$ 15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		\$ 40
Notes Payable		5,000
Accounts Payable		2,500
Interest Payable		50
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Owner's Capital		10,000
Owner's Drawings	500	
Service Revenue		10,600
Salaries and Wages Expense	5,200	
Supplies Expense	1,500	
Rent Expense	900	
Insurance Expense	50	
Interest Expense	50	
Depreciation Expense	40	
	<u>\$30,190</u>	<u>\$30,190</u>

**(6) Preparing Financial Statements (Proprietorship or single owner business)**

**Financial statements** are reports prepared and issued by company management to give investors and creditors additional information about a company's performance and financial standings. The four general purpose financial statements include:


- *Income Statement:* The income statement is a report that shows the income, expenses, and resulting profits or losses of a company during a specific time period.
- *Statement of Owners' Equity:* The statement of owner's equity is usually prepared after the income statement because the net income or net loss for the period must be reported on this

statement. Similarly, it is prepared before the balance sheet, since the owner's equity at the end of the period must be reported on the balance sheet.

- *Balance Sheet:* The balance sheet, also called the statement of financial position, reports a company's assets, liabilities, and equity at a single moment in time. Unlike the income statement, the balance sheet does not report activities over a specific period.
- *Statement of Cash Flows:* The statement of cash flows, also called the cash flow statement, summarizes how changes in balance sheet accounts affect the cash account during the accounting period.


**Illustration 2-12** shows the financial statements prepared by Pioneer Advertising.

These financial statements are prepared in this order and are issued to the public as a full set of statements. This means they are not only published together, but they are also designed and intended to be read and used together. The purpose of these reports is to provide useful financial information to users outside of the company.

 <b>PIONEER ADVERTISING</b> Income Statement For the Month Ended October 31, 2017		
Revenues		
Service revenue		\$10,600
Expenses		
Salaries and wages expense	\$5,200	
Supplies expense	1,500	
Rent expense	900	
Insurance expense	50	
Interest expense	50	
Depreciation expense	40	
Total expenses		<u>7,740</u>
Net income		<u>\$ 2,860</u>

**Illustration 2-12**  
Financial statements from a worksheet

 <b>PIONEER ADVERTISING</b> Owner's Equity Statement For the Month Ended October 31, 2017		
Owner's capital, October 1		\$ -0-
Add: Investments	\$10,000	
Net income	<u>2,860</u>	<u>12,860</u>
		12,860
Less: Drawings		<u>500</u>
Owner's capital, October 31		<u>\$12,360</u>

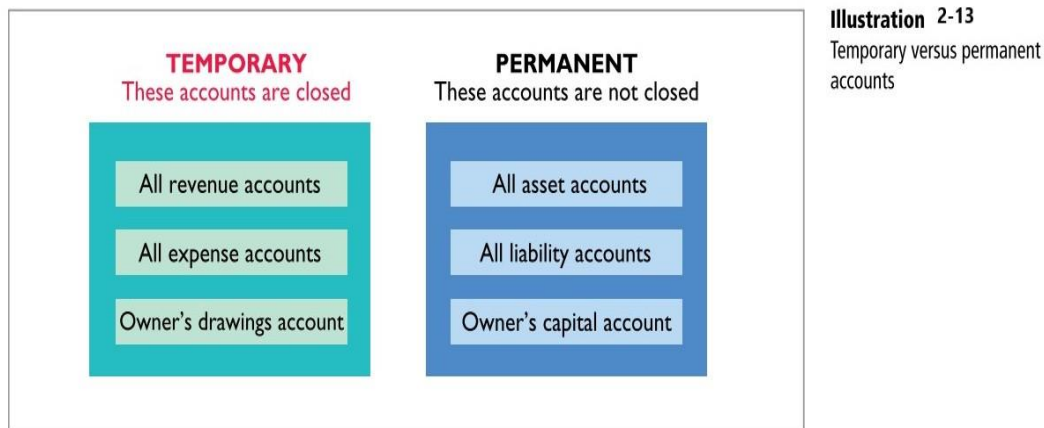
 <b>PIONEER ADVERTISING</b> Balance Sheet October 31, 2017		
<b>Assets</b>		
Cash		\$15,200
Accounts receivable		200
Supplies		1,000
Prepaid insurance		550
Equipment	\$5,000	
Less: Accumulated depreciation—equipment	<u>40</u>	<u>4,960</u>
Total assets		<u>\$21,910</u>
<b>Liabilities and Owner's Equity</b>		
Liabilities		
Notes payable	\$5,000	
Accounts payable	2,500	
Interest payable	50	
Unearned service revenue	800	
Salaries and wages payable	<u>1,200</u>	
Total liabilities		\$ 9,550
Owner's equity		
Owner's capital		<u>12,360</u>
Total liabilities and owner's equity		<u>\$21,910</u>

### (7) Recording Closing Entries.

At the end of the accounting period, the company makes the accounts ready for the next period. This is called closing the books. In closing the books, the company distinguishes between temporary and permanent accounts.

**Temporary accounts** relate only to a given accounting period. They include all income statement accounts and the owner's drawings account. The company closes all temporary accounts at the end of the period.

In contrast, **permanent accounts** relate to one or more future accounting periods. They consist of all balance sheet accounts, including the owner's capital account. Permanent accounts are not closed from period to period. Instead, the company carries forward the balances of permanent accounts into the next accounting period. Illustration 2-13 identifies the accounts in each category.

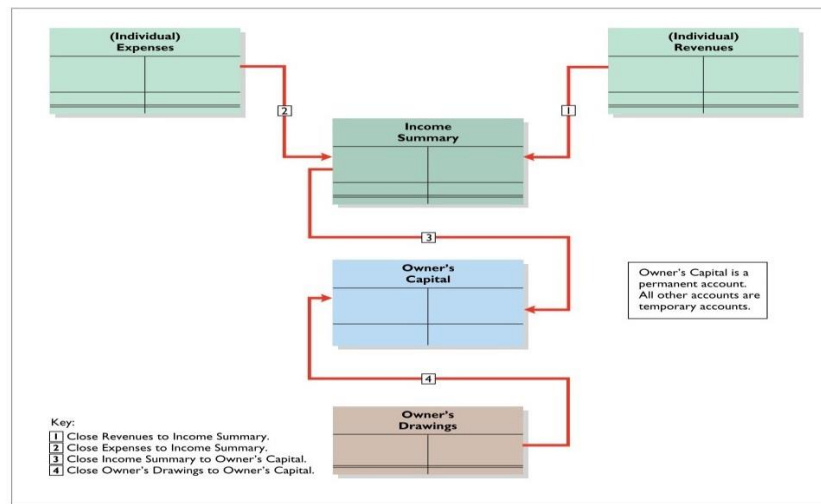


At the end of the accounting period, the company transfers temporary account balances to the permanent owner's equity account, Owner's Capital, by means of closing entries.

Companies generally prepare closing entries directly from the adjusted balances in the ledger. They could prepare separate closing entries for each nominal account, but the following four entries accomplish the desired result more efficiently:

1. Debit each revenue account for its balance, and credit Income Summary for total revenues.
2. Debit Income Summary for total expenses, and credit each expense account for its balance.
3. Debit Income Summary and credit Owner's Capital for the amount of net income.
4. Debit Owner's Capital for the balance in the Owner's Drawings account, and credit Owner's Drawings for the same amount.


**Illustration 2-14** presents a diagram of the closing process. In it, the boxed numbers refer to the four entries required in the closing process.



**Illustration 2-14**  
Diagram of closing process—  
proprietorship

## 5. Preparing Post-Closing Trial Balance.

After journalizing and posting all closing entries, another trial balance, called a post-closing trial balance, should be prepared from the ledger. The post-closing trial balance lists permanent accounts and their balances after the journalizing and posting of closing entries. The purpose of the post-closing trial balance is to prove the equality of the permanent account balances carried forward into the next accounting period. Since all temporary accounts will have zero balances, the post-closing trial balance will contain only permanent—balance sheet—accounts. **Illustration 2-15** shows the post-closing trial balance for Pioneer Advertising.

 <b>PIONEER ADVERTISING</b> Post-Closing Trial Balance October 31, 2017		
	Debit	Credit
Cash	\$ 15,200	
Accounts Receivable	200	
Supplies	1,000	
Prepaid Insurance	550	
Equipment	5,000	
Accumulated Depreciation—Equipment		\$ 40
Notes Payable		5,000
Accounts Payable		2,500
Unearned Service Revenue		800
Salaries and Wages Payable		1,200
Interest Payable		50
Owner's Capital		12,360
	<b>\$21,950</b>	<b>\$21,950</b>

**Illustration 2-15**  
Post-closing trial balance



## KEY TERMS:

- **Account (الحساب):** The record of the changes that have occurred in a particular asset, liability, or stockholders' equity during a period. The basic summary device of accounting.
- **Accrual basis (اساس الاستحقاقات):** An accounting method in which an expense is recorded when it is incurred, and revenue is recorded when it is earned. It is the basis of accounting in which transactions that change a company's financial statements are recorded in the periods in which the events occur.
- **Accruals (استحقاقات):** Expenses incurred, and revenue earned in the current accounting period but not recorded as of the end of the period. To accrue means to build up or to accumulate.
- **Accrued Expenses (مصروفات مستحقة):** Expenses incurred but not yet paid in cash or recorded.
- **Accrued Revenues (ايرادات مستحقة):** Revenues earned but not yet received in cash or recorded.
- **Assets (الاصول):** Economic resources owned by a business.
- **Balance Sheet (قائمة المركز المالي):** A business' balance sheet gives a snapshot of the company's financial situation at a given moment. This includes the cash it has on hand, the notes payable it has outstanding and owner(s) equity in the business.
- **Cash basis (الاساس النقدي):** An accounting method in which an expense is recorded when cash is paid and revenue is recorded when cash is received.
- **Cash Flow (التدفق النقدي):** Shows the overall movement of funds through the business each month, including income and expenses.
- **Cash Flow Statement (قائمة التدفقات النقدية):** Shows the money that entered and exited a business during a specific period.
- **Chart of accounts (دليل الحسابات):** List of a company's accounts and their account numbers.
- **Closing entries (قيود اقفال):** Entries that transfer the revenue, expense, and drawing balances to the Capital account.
- **Credit (الجانب الدائن من الحساب):** The right side of an account.
- **Debit (الجانب المدين من الحساب):** The left side of an account.

- **Deferrals (تأجيلات):** Expenses and revenues that have been recorded in the current accounting period but are not incurred or earned until a future period. To defer means to put off or to postpone.
- **Expenses (المصروفات):** Business expenses are the costs the company incurs each month in order to operate.
- **Income Statement (قائمة الدخل):** Also known as a “profit and loss statement,” an income statement shows the profitability of a business during a period. The income statement looks at a business’ revenues and expenses through all its activities.
- **Journal (دفتر اليومية):** The chronological accounting record of an entity’s transactions.
- **Ledger (دفتر الأستاذ):** The book of accounts and their balances.
- **Liabilities (الخصوم):** This includes any debt accrued by a business in the course of starting, growing and maintaining its operations. Liabilities can be divided into two major types: current, which refers to immediate debts (e.g. money owed to suppliers), and long-term debt, which refers to liabilities (e.g. loans and accounts payable).
- **Post-closing trial balance (ميزان المراجعة بعد الاقفال):** A statement that lists all the assets and liabilities accounts in addition to the capital account at the end of the period after journalizing and posting the closing entries.
- **Posting (الترحيل):** Copy amounts from the journal to the ledger.
- **Prepaid Expenses (مصاريف مدفوعة مقدما):** Expenses paid in cash and recorded as assets before they are used or consumed. Depreciation of plant assets falls into this category.
- **Transaction (العملية المحاسبية):** Any event that has a financial impact on the business and can be measured reliably.
- **Trial balance (ميزان المراجعة):** A list of all the ledger accounts with their balances.
- **Unearned Revenues (ايرادات مؤجلة):** Cash received and recorded as liabilities before revenue is earned.