

Part 1: Introduction to accounting

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The Accounting Cycle : Is a sequence of accounting steps of recording, classification and summarization of economic transactions of a business.

- **The accounting cycle** begins with the recording of economic transactions and ends with preparation of financial statements.

A transaction is any event that has a financial impact on the business and can be measured reliably.

- Every transaction has **two parties** :

1. One party **gives** a value (**the credit**).
2. Another party **receives** the same value (**the debit**).

- In accounting, **we always record both parties of a transaction.**

The terms **debit** and **credit** are used repeatedly in the recording process

- These terms do not mean increase or decrease.

An account : Is a separate record for each item that appears in the financial statements. It shows all increases and decreases in the item resulting from many transactions.

- In its simplest form an Account (T account) has three elements:

(1) A title.

(2) A left side (the debit side).

(3) A right side (the credit side).

By comparing (2) & (3) the result will be the **Balance**

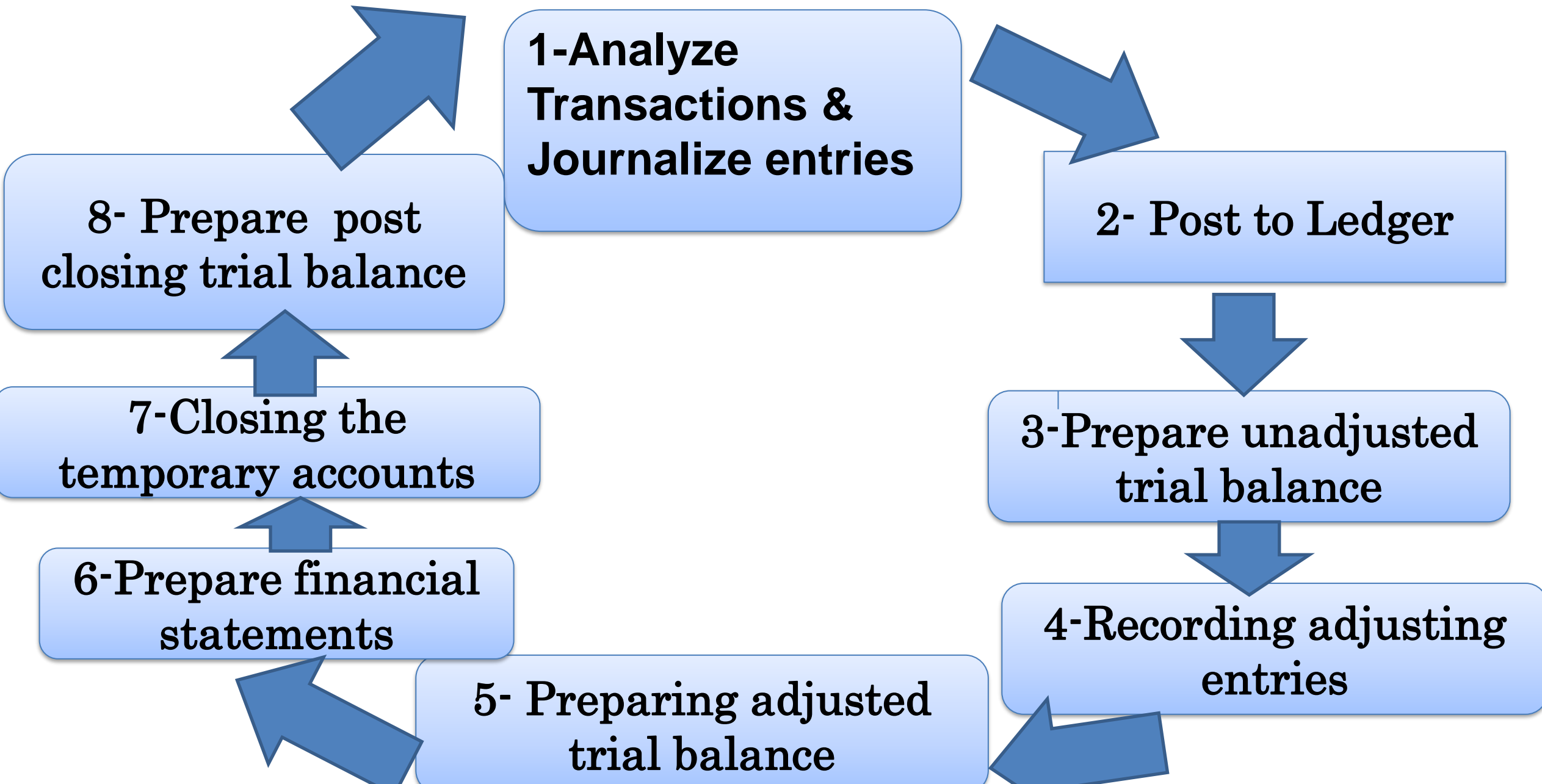
An account title	
Dr	Cr
Left side	Right side
Debt	Credit

- The act of entering an amount **on** :
- **the left side** of an account is called **debiting** the account,
- **on the right side** is called **crediting** the account.
- When the totals of the two sides are compared:
- if the total of the debit amounts **exceeds** the credits, an account will have a debit balance and
- if the total of credit amounts **exceeds** the debits. an account will have a credit balance .

▪ **The debit/ credit rules and effects on each type of account** are illustrated as follows:

	When it debited	When it credited	Normal balance
Asset	+Increases	-Decreases	Debit
liability	-decreases	+Increases	Credit
Capital	-decreases	+Increases	Credit
Drawing	+Increases	-decreases	Debit
Revenues	-decreases	+Increases	Credit
Expenses	+Increases	-decreases	Debit

2- The major steps involved in the accounting cycle:



1. Analyzing and recording transactions in journals:

- Each transaction is analyzed to its two parties (debit & credit) to be recorded in chronological order in the book of original entry called “**The Journal**”

For example: the following transactions in XYZ Co.

Oct 1: Started business with L.E 500,000 cash.

Oct 2: Purchased office equipment , of L.E 30.000 cash.

Oct10:Bought machinery L.E 20,000 on account from the AB company.

Oct 12:Paid the amount owing to the AB Company cash.

Oct. 15: Paid Rent expense of Oct. L.E 1200.

Oct. 20: Received Revenue cash L.E 5000 for service performed.

Oct. 25:Drew L.E 2000 cash for his own use.

Date	Accounts	DR.	Cr.
Oct. 1	Cash Capital (Owner's investment of cash)	500.000	500.000
6	Office equipment Cash (Purchased office equipment)	30.000	30.000
10	Machinery Accounts payable (AB Co.) (Purchased machinery on credit)	20.000	20.000
12	Accounts Payable (AB Co.) Cash (Paid creditors)	20.000	20.000
15	Rent Expense Cash	1200	1200
20	Cash Service Revenue	5000	5000
25	Withdrawals Cash	2000	2000

2- Posting entries to Ledger accounts:

- The **posting** process describes transferring entries from the Journal to the Ledger accounts.
- 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.

Cash

Date	Explanation	Dr.	Cr.	Balance
Oct.1	Capital Investment	500.000		500.000
6	Equipment purchased		30.000	470.000
12	Paid AB co		20.000	450.000
15	Pay rent expense		1200	448800
20	Collect service revenue	5000		453800
25	Cash withdrawals		2000	451800 Dr.

Capital

Oct. 1	Investment		500.000	500.000 Cr.
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Office Equipment

Oct.6	Equipment purchased	30.000		30.000 Dr.
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Machinery

Oct.10	Machinery bought	20.000		20.000 Dr.
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<u>AB Co.</u>				
		Dr	Cr	balance
Oct.10	Purchased on credit		20000	20000
12	Paying creditors	20000		-
<u>Rent Exp.</u>				
15	Rent expense	1200	-	1200 Dr.
<u>Service Rev.</u>				
20	Service revenue	-	5000	5000 Cr.
Withdrawals				
Oct.25	withdrawals	2000		2000 Dr.

- **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.

3- Preparing unadjusted trial balance

A trial balance is a list of all accounts in ledger and their balances at a given time. It's prepared at the end of an accounting period.

- Debit balances appear in the left column and credit balances in the right column.
- The total of the accounts with debit balances must be equal to the total of the accounts with credit balances.

Trial Balance

<u>Account</u>	<u>Dr.</u>	<u>Cr.</u>
Cash	451800	---
Capital	---	500.000
Office equipment	30.000	---
Machinery	20.000	---
AB Co.	---	---
Rent Exp.	1200	
Service Rev.	---	5000
Withdrawals	2000	---
	505.000	505.000

4-Recording Adjusting Entries:

➤ There are two bases of recording transactions in accounting:

The cash basis

- According to this basis, companies record revenue when they receive cash, and record an expense when they pay out cash.

The accrual basis

- According to this basis 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)**.

➤ Adjusting Entries:

• **Adjusting entries** ensure that the **revenue recognition** and **expense recognition** principles are followed when the company prepares its financial statements.

Revenue recognition principle requires that companies recognize revenue in the accounting period in which the performance obligation is satisfied with /without receiving cash

Expense recognition is when the expense makes its contribution to revenue.

Adjusting entries are classified as either:

Deferrals

1. **Prepaid expenses**: Expenses paid in cash before they are used or consumed.

2. **Unearned revenues**: Cash received before services are performed.

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.

5-Preparing the Adjusted Trial Balance

After a company has journalized all adjusting entries, It posts them to ledger accounts and adjust their balances.

Adjusted trial balance shows the balances of all accounts, including those adjusted, at the end of the accounting period.

6-Preparing Financial Statements

Financial statements : are reports prepared and issued by company management to give external users information about a company's performance and financial standings.

The principal financial statements are:

Income Statement

Statement of Owner's Equity

Balance sheet

Statement of Cash Flows

. A CLASSIFIED 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.

There are two income statement formats that are generally prepared

1.The Single-step income statement

Only shows one category of income and one category of expenses.

Paul's Guitar Shop, Inc. Income Statement For the Year Ended December 31, 2015	
Revenues:	200000
—	
Expenses:	(150000)
Net income =	50000

2.The Multi-step income statement

2.The Multi-step income statement

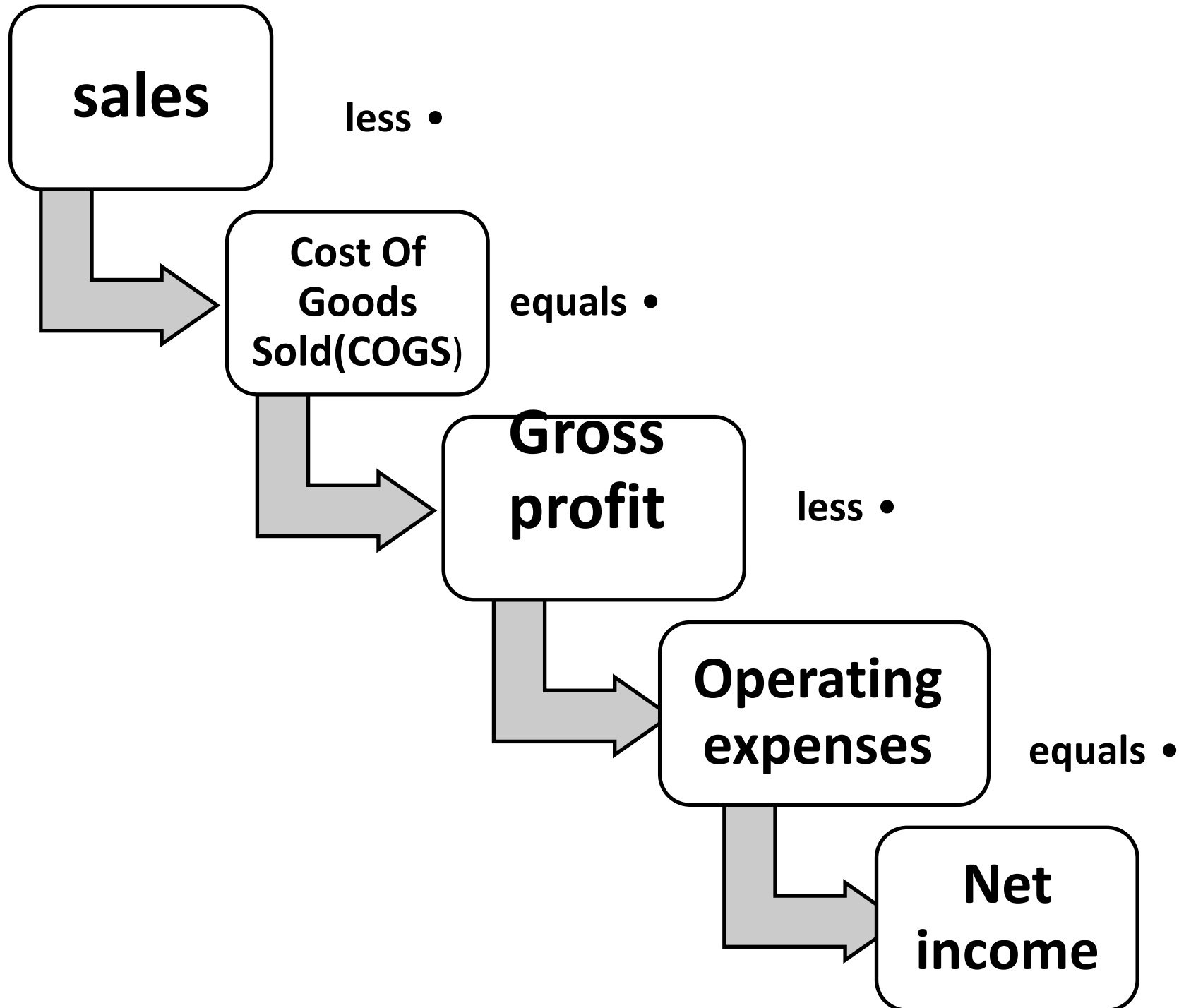
1- Compute Gross Profit (loss) = Net sales – Cost of goods sold

2- Compute Income from Operations =Gross profit – operating expenses

3-Compute Net Income (loss)=Income from operations

+ Other revenues and others

– non-operating expenses



PW AUDIO SUPPLY
Income Statement
For the Year Ended December 31, 2017

Calculation of gross profit	Sales		
	Sales revenue		\$480,000
	Less: Sales returns and allowances	\$12,000	
	Sales discounts	<u>8,000</u>	<u>20,000</u>
	Net sales		460,000
Calculation of income from operations	Cost of goods sold		<u>316,000</u>
	Gross profit		144,000
	Operating expenses		
	Salaries and wages expense	64,000	
	Utilities expense	17,000	
	Advertising expense	16,000	
	Depreciation expense	8,000	
	Freight-out	7,000	
	Insurance expense	<u>2,000</u>	
	Total operating expenses		<u>114,000</u>
Results of nonoperating activities	Income from operations		30,000
	Other revenues and gains		
	Interest revenue	3,000	
	Gain on disposal of plant assets	<u>600</u>	3,600
	Other expenses and losses		
	Interest expense		2000
	Net income		<u><u>\$ 31,600</u></u>

➤ **Statement of Owner's Equity:** It is usually prepared after the income statement because the net income or net loss for the period must be reported on this statement.

■ 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.

At owner's equity statement:

Capital can be **increased** by (+) Investment and net income can be **decreased** by (-) : Withdrawals and net loss.

Owner's Equity Statement On Dec.31,2018		
Capital		500000
+Net Income	50000	
- Withdrawals	(15000)	35000
Owner's Equity		535000

➤ **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, but at a specific time.

■ Balance Sheet has no balance; It must be balanced. (Assets = Liabilities + owner's equity)

SOFBYTE

Balance Sheet

September 30, 2020

Assets:		
Cash		
Accounts receivable		
Supplies		
Equipment		
Total assets		
Liabilities:		
Accounts Payable		
Owner's Equity:		
Capital		
+ net income		
Total Liabilities and Owner's Equity		

Statement of Cash Flows: It summarizes how changes in balance sheet accounts affect the cash account during the accounting period.

➤ 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.

7-Recording Closing Entries.

- At the end of the accounting period, the company makes the accounts ready for the next period. (Closing the books)
- In closing the books, the company distinguishes between:

Temporary Accounts

Permanent Accounts

Temporary Accounts

- relate only to a given accounting period.
- They include all income statement accounts and the owner's drawings account..
- all temporary accounts are closed at the end of the period.
- 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:

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.

<p>1. Dr: revenues accounts Cr: Income Summary</p>
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<p>2. Dr: Income Summary Cr: expenses accounts</p>
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<p>3. Dr: Income Summary Cr: Owner's Capital (net income)</p>

<p>or</p>

<p>Dr: Owner's Capital Cr: Income Summary (net loss)</p>
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<p>4. Dr: Owner's Capital Cr: withdrawals</p>

8- 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 (all temporary accounts are closed) 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.



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Post-Closing Trial Balance

October 31, 2017

	<u>Debit</u>	<u>Credit</u>
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
	<u>\$21,950</u>	<u>\$21,950</u>