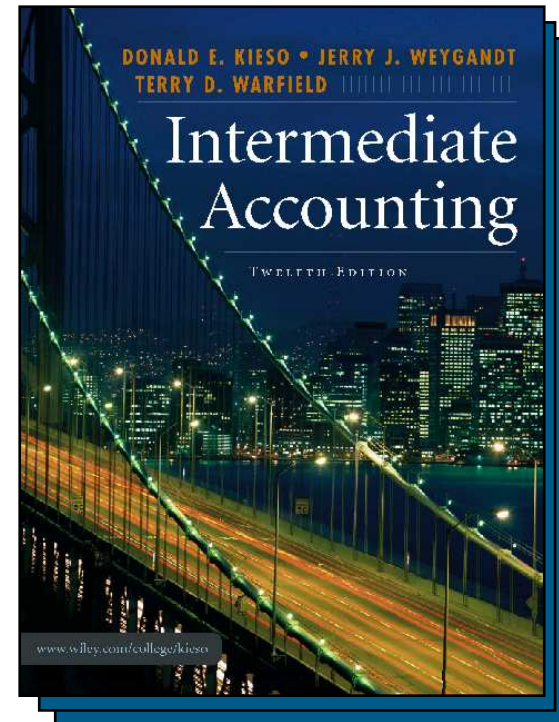


# *Understanding the Accounting Information System*

## Chapter 3

Intermediate Accounting  
12th Edition  
Kieso, Weygandt, and Warfield



## *Learning Objectives*

1. Understand basic accounting terminology.
2. Explain double-entry rules.
3. Identify steps in the accounting cycle.
4. Record transactions in journals, post to ledger accounts, and prepare a trial balance.
5. Explain the reasons for preparing adjusting entries.
6. Prepare financial statement from the adjusted trial balance.
7. Prepare closing entries.
8. Explain how to adjust inventory accounts at year-end.

# *Accounting Information System*

```
graph TD; A[Accounting Information System] --> B[Accounting Information System]; A --> C[The Accounting Cycle]; B --> B1[Basic terminology]; B --> B2[Debits and credits]; B --> B3[Basic equation]; B --> B4[Financial statements and ownership structure]; C --> C1[Identification and recording]; C --> C2[Journalizing]; C --> C3[Posting]; C --> C4[Trial balance]; C --> C5[Adjusting entries]; C --> C6[Adjusted trial balance]; C --> C7[Preparing financial statements]; C --> C8[Closing]; C --> C9[Post-closing trial balance]; C --> C10[Reversing entries]; C --> C11[Financial statements for merchandisers];
```

## **Accounting Information System**

- Basic terminology
- Debits and credits
- Basic equation
- Financial statements and ownership structure

## **The Accounting Cycle**

- Identification and recording
- Journalizing
- Posting
- Trial balance
- Adjusting entries
- Adjusted trial balance
- Preparing financial statements
- Closing
- Post-closing trial balance
- Reversing entries
- Financial statements for merchandisers

# *Accounting Information System*

## An Accounting Information System (AIS)

- collects and processes transaction data and
- disseminates the information to interested parties.

# *Accounting Information System*

Helps management answer such questions as:

- How much and what kind of debt is outstanding?
- Were sales higher this period than last?
- What assets do we have?
- What were our cash inflows and outflows?
- Did we make a profit last period?

## *Basic Terminology*

- Event
- Transaction
- Account
- Real Account
- Nominal Account
- Ledger
- Journal
- Posting
- Trial Balance
- Adjusting Entries
- Financial Statements
- Closing Entries

# Debits and Credits

- An **Account** shows the effect of transactions on a given asset, liability, equity, revenue, or expense account.
- **Double-entry** accounting system (two-sided effect).
- Recording done by debiting at least one account and crediting another.
- **DEBITS must equal CREDITS.**

# Debits and Credits

Account



- An arrangement that shows the effect of transactions on an account.
- Debit = "Left"
- Credit = "Right"

An Account can be illustrated in a T-Account form.



Account Name	
Debit / Dr.	Credit / Cr.



## Debits and Credits

If Debit entries are **greater than** Credit entries, the account will have a debit balance.

Account Name		
	Debit / Dr.	Credit / Cr.
Transaction #1	\$10,000	\$3,000
Transaction #3	8,000	
Balance	<b>\$15,000</b>	

Transaction #2

## Debits and Credits

If Credit entries are **greater than** Debit entries, the account will have a credit balance.



Account Name		
Debit / Dr.	Credit / Cr.	
Transaction #1	\$10,000	Transaction #2
	\$3,000	Transaction #3
	8,000	
Balance	\$1,000	

# Debits and Credits Summary



Normal  
Balance  
**Debit**

Normal  
Balance  
**Credit**

## Liabilities



Debit / Dr.	Credit / Cr.
	
	<b>Normal Balance</b>

## Assets

Debit / Dr.	Credit / Cr.
	
<b>Normal Balance</b>	



Chapter  
3-23

## Equity

Debit / Dr.	Credit / Cr.
	
	<b>Normal Balance</b>



Chapter  
3-25

## Expense

Debit / Dr.	Credit / Cr.
	
<b>Normal Balance</b>	

Chapter  
3-27

## Revenue

Debit / Dr.	Credit / Cr.
	
	<b>Normal Balance</b>

Chapter  
3-26

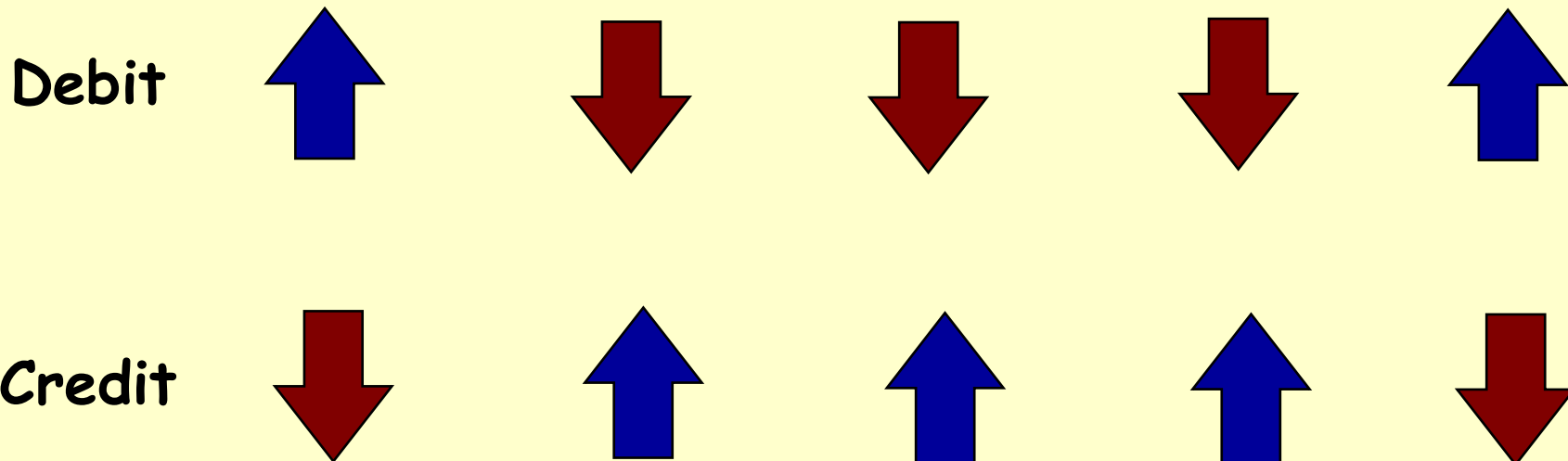
# Debits and Credits Summary

## Balance Sheet

## Income Statement

Asset = Liability + Equity

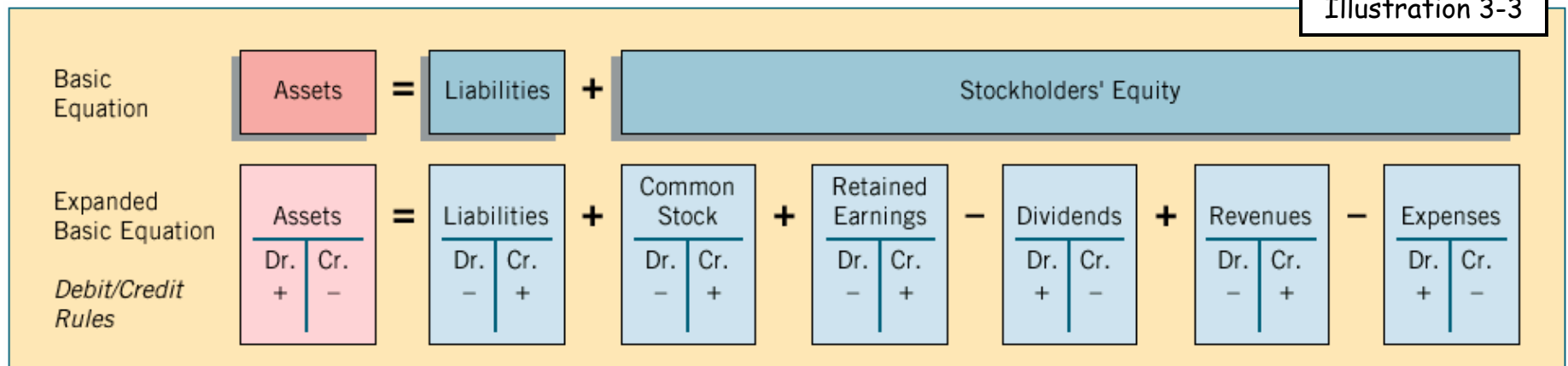
Revenue - Expense =



# Basic Accounting Equation

Relationship among the assets, liabilities and stockholders' equity of a business:

Illustration 3-3



The equation must be in balance after every transaction. For every **Debit** there must be a **Credit**.

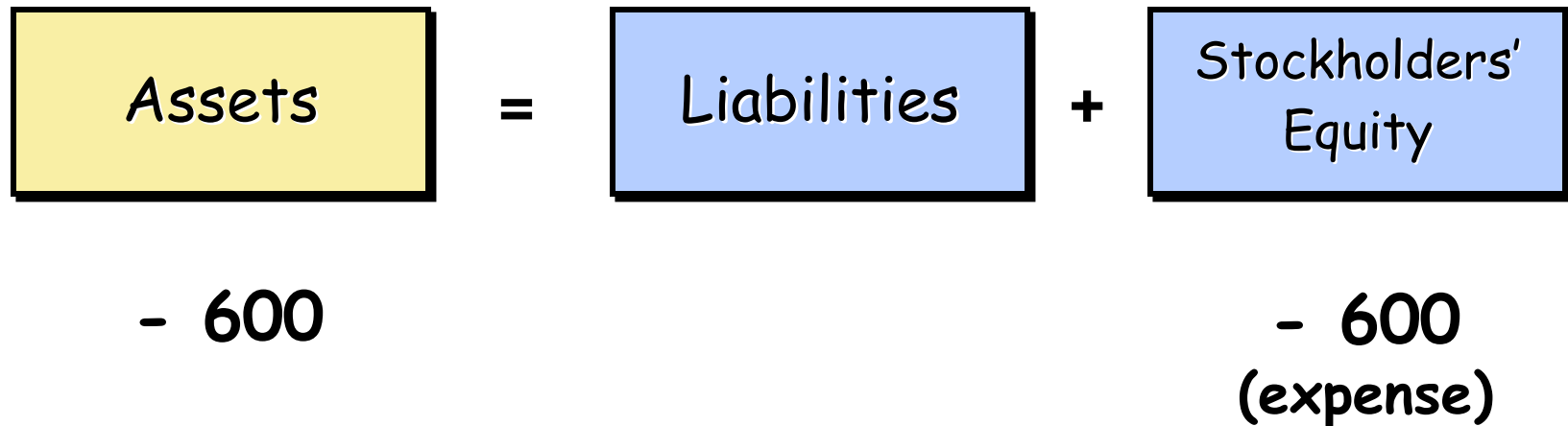
## *Double-Entry System Exercise*

1. Invested \$32,000 cash and equipment valued at \$14,000 in the business.

Assets	=	Liabilities	+	Stockholders' Equity
+ 32,000				+ 46,000
+ 14,000				

## *Double-Entry System Exercise*

2. Paid office rent of \$600 for the month.



## *Double-Entry System Exercise*

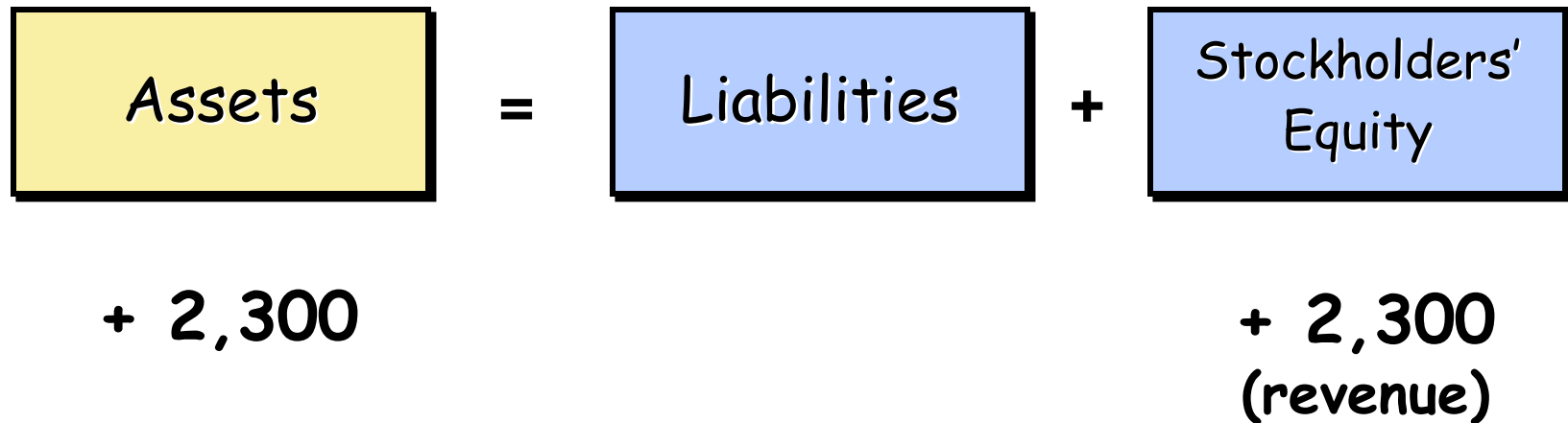
3. Received \$3,200 advance on a management consulting engagement.

Assets	=	Liabilities	+	Stockholders' Equity
+ 3,200		+ 3,200		



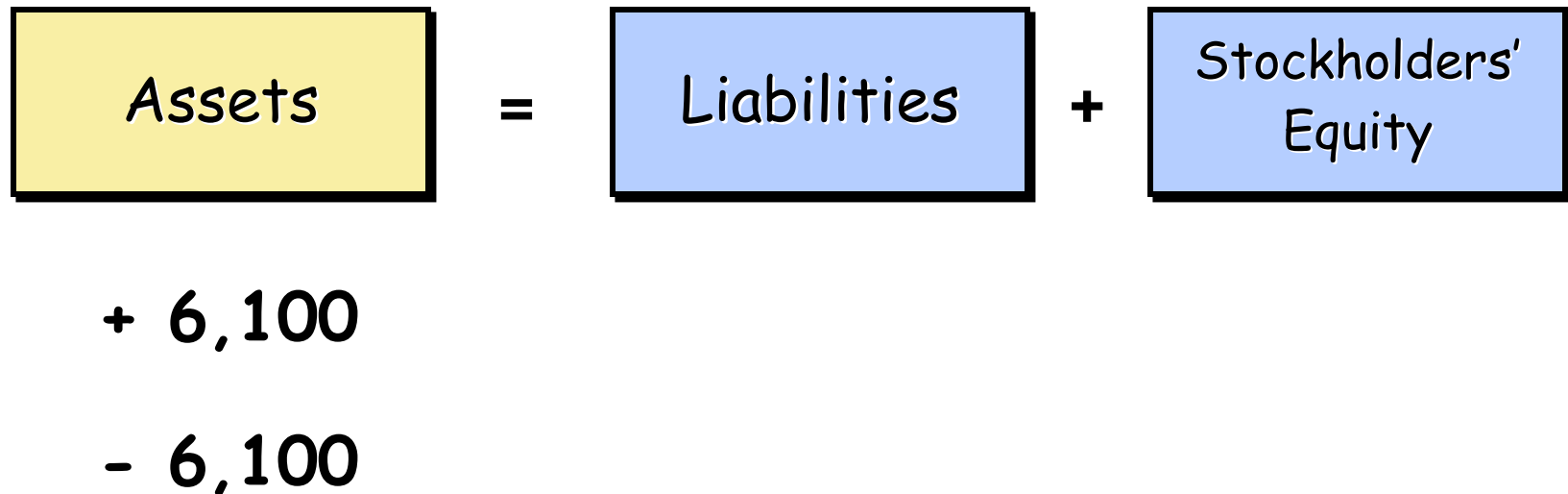
## Double-Entry System Exercise

4. Received cash of \$2,300 for services completed for Shuler Co.



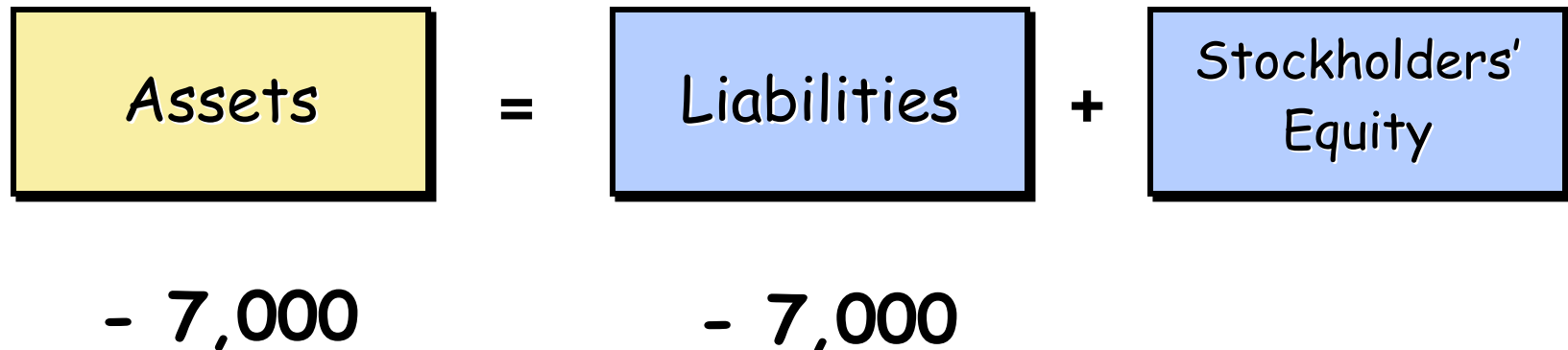
## *Double-Entry System Exercise*

5. Purchased a computer for \$6,100.



## *Double-Entry System Exercise*

6. Paid off liabilities of \$7,000.



## *Double-Entry System Exercise*

7. Declared a cash dividend of \$10,000.

Assets	=	Liabilities	+	Stockholders' Equity
		+ 10,000		- 10,000

Note that the accounting equation equality is maintained after recording each transaction.

# *Ownership Structure*

Ownership structure dictates the types of accounts that are part of the equity section.

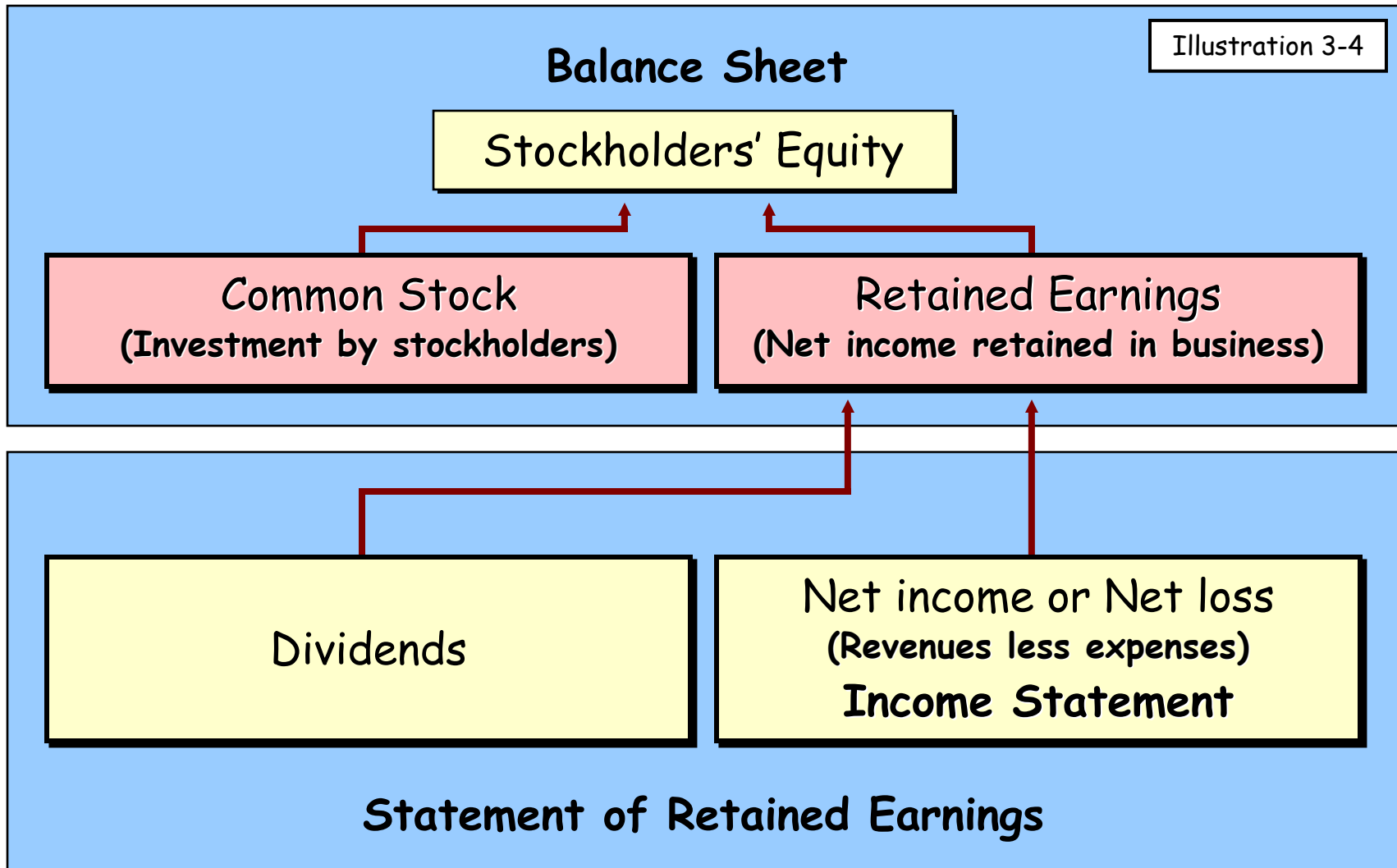
## Proprietorship or Partnership

- Capital Account
- Drawing Account

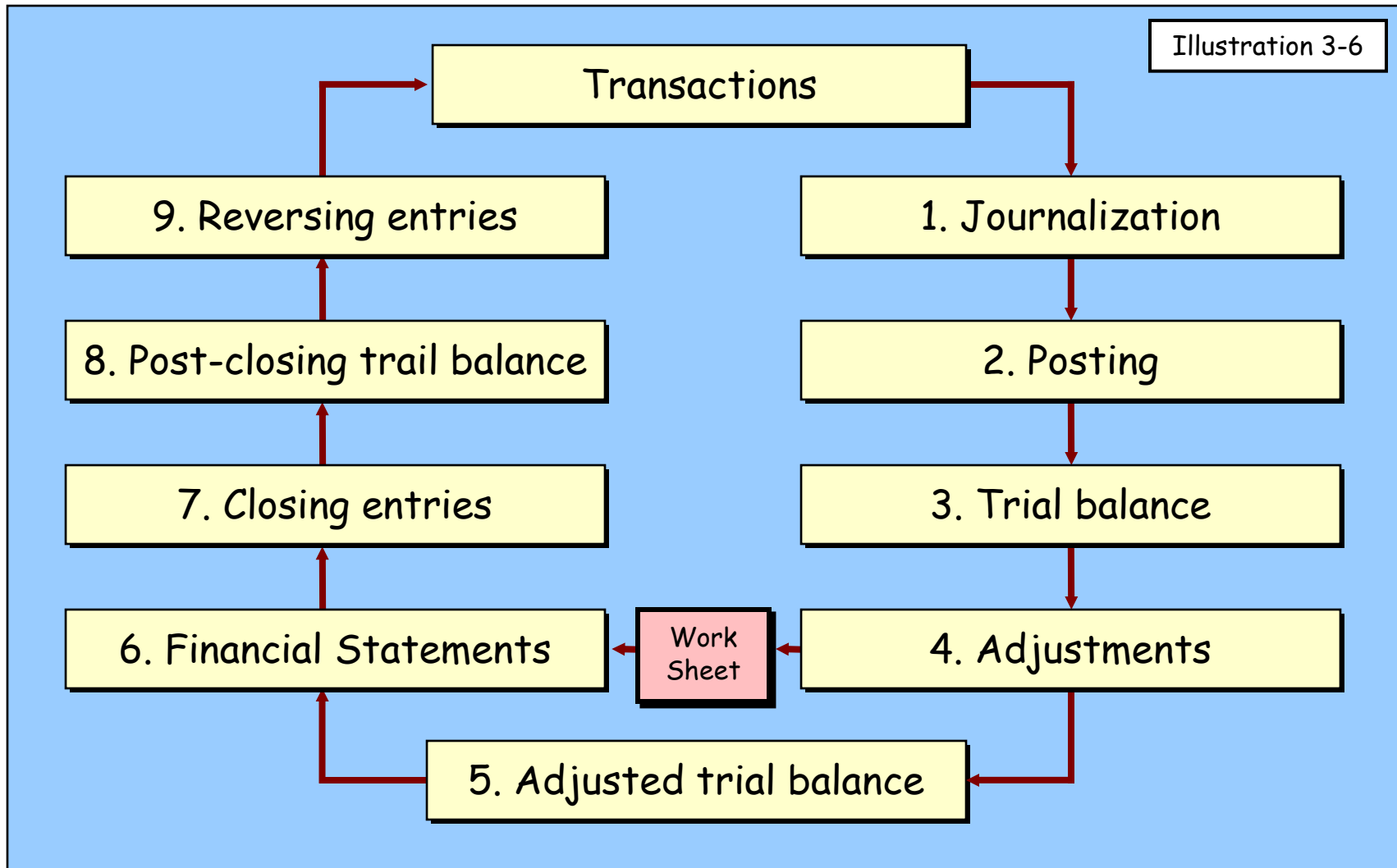
## Corporation

- Common Stock
- Additional Paid-in Capital
- Dividends Declared
- Retained Earnings

# Corporation Ownership Structure



# The Accounting Cycle



# *Transactions and Events*

## **What to Record?**

FASB states, "transactions and other events and circumstances that affect a business enterprise."

## **Types of Events:**

- **External** - between a business and its environment.
- **Internal** - event occurring entirely within a business.



## *Review "Transactions and Events"*

External

Internal

Not Recorded

1. A supplier of a company's raw material is paid an amount owed on account.
2. A customer pays its open account.
3. A new chief executive officer is hired.
4. The biweekly payroll is paid.
5. Raw materials are entered into production.
6. A new advertising agency is hired.
7. The accountant determines the federal income taxes owed based on the income earned.

External

External

Not Recorded

External

Internal

Not Recorded

Internal

# 1. Journalizing

**General Journal** - a chronological record of transactions.  
**Journal Entries** are recorded in the journal.

General Journal				
Date	Account Title	Ref.	Debit	Credit
Jan. 3	Cash	100	100,000	
	Common stock	300		100,000
10	Building	130	150,000	
	Note payable	220		150,000

## 2. Posting

**Posting** - the process of transferring amounts from the journal to the ledger accounts.

General Journal				GJ1
Date	Account Title	Ref.	Debit	Credit
Jan. 3	Cash	100	100,000	
	Common stock			100,000

General Ledger

Cash

Acct. No. 100

Date	Explanation	Ref.	Debit	Credit	Balance
Jan. 3	Sale of stock	GJ1	100,000		100,000

### 3. Trial Balance

**Trial Balance** - a list of each account and its balance; used to prove equality of debit and credit balances.

Acct. No.	Account	Debit	Credit
100	Cash	\$ 140,000	
105	Accounts receivable	35,000	
110	Inventory	30,000	
130	Building	150,000	
200	Accounts payable		\$ 60,000
220	Note payable		150,000
300	Common stock		100,000
330	Retained earnings		
400	Sales		75,000
500	Cost of goods sold	30,000	
		<u>\$ 385,000</u>	<u>\$ 385,000</u>

## 4. *Adjusting Entries*

- **Revenues** - recorded in the period in which they are earned.
- **Expenses** - recognized in the period in which they are incurred.
- **Adjusting entries** - needed to ensure that the revenue recognition and matching principles are followed.

# *Classes of Adjusting Entries*

Illustration 3-20

## Prepayments

1. **Prepaid Expenses.**  
Expenses paid in cash and recorded as assets before they are used or consumed.
2. **Unearned Revenues.**  
Revenues received in cash and recorded as liabilities before they are earned.

## Accruals

3. **Accrued Revenues.**  
Revenues earned but not yet received in cash or recorded.
4. **Accrued Expenses.**  
Expenses incurred but not yet paid in cash or recorded.

## *Adjusting Entries - "Prepaid Expenses"*

Payment of cash that is recorded as an asset because service or benefit will be received in the future.

Cash Payment

**BEFORE**

Expense Recorded

Prepayments often occur in regard to:

- insurance
- supplies
- advertising
- rent
- maintenance on equipment
- fixed assets

## Adjusting Entries - "Prepaid Expenses"

**Example:** On Jan. 1<sup>st</sup>, Phoenix Corp. paid \$12,000 for 12 months of insurance coverage. Show the journal entry to record the payment on Jan. 1<sup>st</sup>.

Jan. 1	Prepaid insurance	12,000	
	Cash		12,000

Prepaid Insurance		Cash	
Debit	Credit	Debit	Credit
12,000			12,000



## *Adjusting Entries - "Prepaid Expenses"*

**Example:** On Jan. 1<sup>st</sup>, Phoenix Corp. paid \$12,000 for 12 months of insurance coverage. Show the **adjusting journal entry** required at Jan. 31<sup>st</sup>.

Jan. 31	Insurance expense	1,000	
	Prepaid insurance		1,000

Prepaid Insurance		Insurance expense	
Debit	Credit	Debit	Credit
12,000	1,000	1,000	
11,000			

## *Adjusting Entries - "Unearned Revenues"*

Receipt of cash that is recorded as a liability because the revenue has not been earned.

Cash Receipt

**BEFORE**

Revenue Recorded

Unearned revenues often occur in regard to:

- rent
- airline tickets
- school tuition
- magazine subscriptions
- customer deposits

## Adjusting Entries - "Unearned Revenues"

**Example:** On Nov. 1<sup>st</sup>, Phoenix Corp. received \$24,000 from Arcadia High School for 3 months rent in advance. Show the journal entry to record the receipt on Nov. 1<sup>st</sup>.

Nov. 1	Cash	24,000	
	Unearned rent revenue		24,000

Cash		Unearned Rent Revenue	
Debit	Credit	Debit	Credit
24,000			24,000

## Adjusting Entries - "Unearned Revenues"

**Example:** On Nov. 1<sup>st</sup>, Phoenix Corp. received \$24,000 from Arcadia High School for 3 months rent in advance. Show the **adjusting journal entry** required on Nov. 30<sup>th</sup>.

Nov. 30      Unearned rent revenue                      8,000  
                                  Rent revenue    8,000

Rent Revenue		Unearned Rent Revenue	
Debit	Credit	Debit	Credit
	8,000	8,000	24,000
			16,000

## *Adjusting Entries - "Accrued Revenues"*

Revenues earned but not yet received in cash or recorded.

Adjusting entry results in:

Revenue Recorded

**BEFORE**

Cash Receipt

Accrued revenues often occur in regard to:

- rent
- interest
- services performed

## Adjusting Entries - "Accrued Revenues"

**Example:** On July 1<sup>st</sup>, Phoenix Corp. invested \$300,000 in securities that return 5% interest per year. Show the journal entry to record the investment on July 1<sup>st</sup>.

July 1	Investments	300,000	
	Cash		300,000

Investments		Cash	
Debit	Credit	Debit	Credit
300,000			300,000

## Adjusting Entries - "Accrued Revenues"

**Example:** On July 1<sup>st</sup>, Phoenix Corp. invested \$300,000 in securities that return 5% interest per year. Show the adjusting journal entry required on July 31<sup>st</sup>.

July 31	Interest receivable	1,250	
	Interest revenue		1,250

Interest Receivable		Interest Revenue	
Debit	Credit	Debit	Credit
1,250			1,250

# *Adjusting Entries - "Accrued Expenses"*

Expenses incurred but not yet paid in cash or recorded.

Adjusting entry results in:

Expense Recorded

**BEFORE**

Cash Payment, if any\*

Accrued expenses often occur in regard to:

- rent
- interest
- taxes
- salaries
- bad debts\*



## *Adjusting Entries - "Accrued Expenses"*

**Example:** On Feb. 2<sup>nd</sup>, Phoenix Corp. borrowed \$200,000 at a rate of 9% per year. Interest is due on first of each month. Show the journal entry to record the borrowing on Feb. 2<sup>nd</sup>.

Feb. 2	Cash	200,000	
	Notes payable		200,000

Cash		Notes Payable	
Debit	Credit	Debit	Credit
200,000			200,000

## Adjusting Entries - "Accrued Expenses"

**Example:** On Feb. 2<sup>nd</sup>, Phoenix Corp. borrowed \$200,000 at a rate of 9% per year. Interest is due on first of each month. Show the **adjusting journal entry** required on Feb. 28<sup>th</sup>.

Feb. 28	Interest expense	1,500	
	Interest payable		1,500

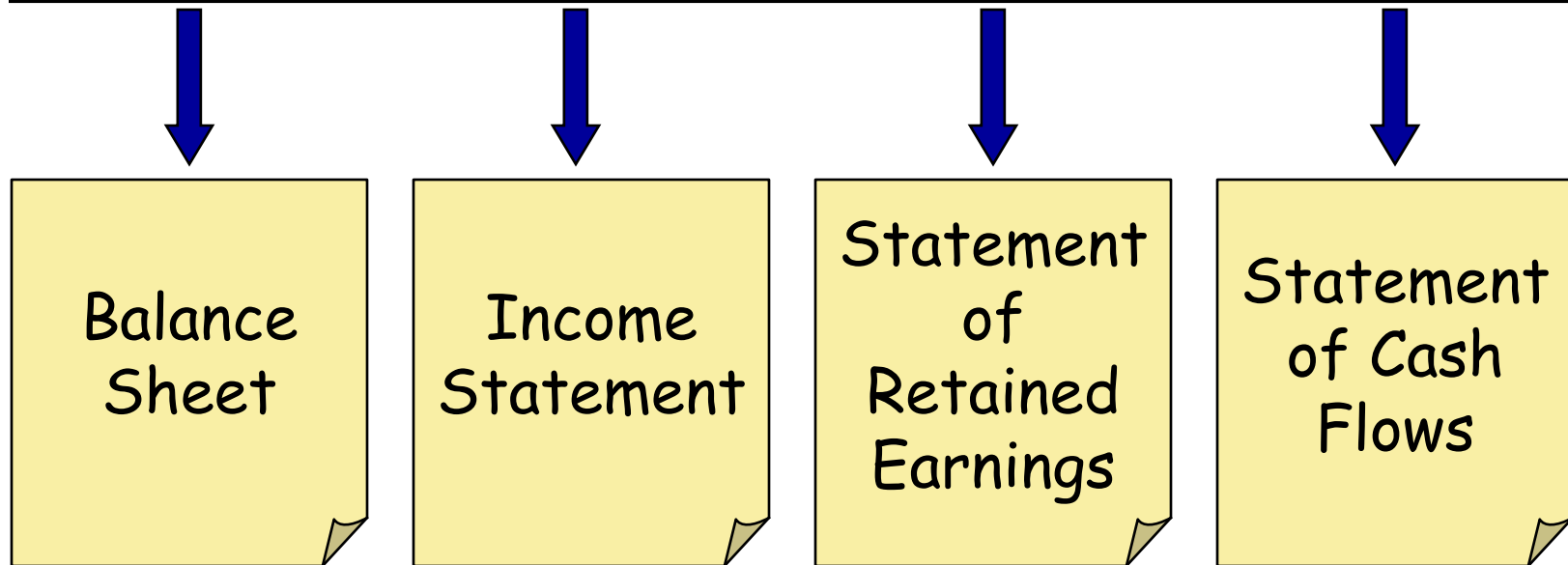
Interest Expense		Interest Payable	
Debit	Credit	Debit	Credit
1,500			1,500

## ***5. Adjusted Trial Balance***

Shows the balance of all accounts, after adjusting entries, at the end of the accounting period.

## 6. *Preparing Financial Statements*

Financial Statements are prepared directly from the Adjusted Trial Balance.



## 6. Preparing Financial Statements

Assume the following  
Adjusted Trial Balance

### Balance Sheet

Adjusted Trial Balance	Debit	Credit
Cash	\$ 140,000	→
Accounts receivable	35,000	→
Building	190,000	→
Note payable		\$ 150,000 →
Common stock		100,000 →
Retained earnings		38,000
Dividends declared	10,000	
Sales		185,000
Interest income		17,000
Cost of goods sold	47,000	
Salary expense	25,000	
Depreciation expense	43,000	
	<u>\$ 490,000</u>	<u>\$ 490,000</u>

Balance Sheet	
<b>Assets</b>	
Cash	\$ 140,000
Accounts receivable	35,000
Building	190,000
Total assets	<u>\$ 365,000</u>
<b>Liabilities</b>	
Note payable	150,000
<b>Stockholders' equity</b>	
Common stock	100,000
Retained earnings	115,000
Total liab. & equity	<u>\$ 365,000</u>

## 6. Preparing Financial Statements

Assume the following  
Adjusted Trial Balance

Adjusted Trial Balance	Debit	Credit
Cash	\$ 140,000	
Accounts receivable	35,000	
Building	190,000	
Note payable		\$ 150,000
Common stock		100,000
Retained earnings		38,000
Dividends declared	10,000	
Sales		185,000
Interest income		17,000
Cost of goods sold	47,000	
Salary expense	25,000	
Depreciation expense	43,000	
	<u>\$ 490,000</u>	<u>\$ 490,000</u>

### Income Statement

Income Statement	
<b>Revenues:</b>	
Sales	\$ 185,000
Interest income	17,000
Total revenue	<u>202,000</u>
<b>Expenses:</b>	
Cost of goods sold	47,000
Salary expense	25,000
Depreciation expense	43,000
Total expenses	<u>115,000</u>
Net income	<u>\$ 87,000</u>

## 6. Preparing Financial Statements

Assume the following  
Adjusted Trial Balance

Statement of  
Retained Earnings

Adjusted Trial Balance	Debit	Credit
Cash	\$ 140,000	
Accounts receivable	35,000	
Building	190,000	
Note payable		\$ 150,000
Common stock		100,000
Retained earnings		38,000
Dividends declared	10,000	
Sales		185,000
Interest income		17,000
Cost of goods sold	47,000	
Salary expense	25,000	
Depreciation expense	43,000	
	<u>\$ 490,000</u>	<u>\$ 490,000</u>

### Statement of Retained Earnings

Beginning balance	\$ 38,000
+ Net income	87,000
- Dividends	<u>(10,000)</u>
Ending balance	<u><u>115,000</u></u>

## 7. Closing Entries

- To reduce the balance of the income statement (**revenue** and **expense**) accounts to zero.
- To transfer net income or net loss to owner's equity.
- Balance sheet (**asset**, **liability**, and **equity**) accounts are not closed.
- Dividends are closed directly to the Retained Earnings account.



## 7. Closing Entries

**Example:** Assume the following Adjusted Trial Balance

Acct. No.	Account	Debit	Credit
100	Cash	\$ 140,000	
105	Accounts receivable	35,000	
130	Building	190,000	
220	Note payable		\$ 150,000
300	Common stock		100,000
330	Retained earnings		38,000
380	Dividends declared	10,000	
400	Sales		185,000
430	Interest income		17,000
500	Cost of goods sold	47,000	
520	Salary expense	25,000	
550	Depreciation expense	43,000	
		<u>\$ 490,000</u>	<u>\$ 490,000</u>

## 7. Closing Entries

**Example:** Prepare the **Closing journal entry** from the adjusted trial balance on the previous slide.

Sales	185,000	
Interest income	17,000	
Income summary		202,000
Income summary	115,000	
Cost of goods sold		47,000
Salary expense		25,000
Depreciation expense		43,000
Income summary	87,000	
Retained earnings		87,000
Retained earnings	10,000	
Dividends declared		10,000

## ***8. Post-Closing Trial Balance***

**Example** continued:

Acct. No.	Account	Debit	Credit
100	Cash	\$ 140,000	
105	Accounts receivable	35,000	
130	Building	190,000	
220	Note payable		\$ 150,000
300	Common stock		100,000
330	Retained earnings		115,000
380	Dividends declared	-	
400	Sales		-
430	Interest income		-
500	Cost of goods sold	-	
520	Salary expense	-	
550	Depreciation expense	-	
		<u>\$ 365,000</u>	<u>\$ 365,000</u>

## *9. Reversing Entries*

Reversing entries is an **optional step** that a company may perform at the beginning of the next accounting period.

## *Perpetual Inventory System*

- Inventory account increased with each purchase.
- Inventory account reduced and Cost of Goods Sold account increased with each sale.
- Balance in Inventory account should equal inventory amount on hand.
- No Adjusting Entries should be needed.
- Physical inventory performed to confirm balance in Inventory account.

## *Periodic Inventory System*

- Inventory account remains unchanged during period.
- Purchases account increased with each purchase.

At end of accounting period:

- Purchases account closed.
- Inventory account adjusted to physical count.

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