FINANCIAL ACCOUNTING

- **Basic Concepts**

- **Some Mechanics**

BASIC CONCEPTS (1-4)

1 Expression in Monetary Terms

2 Entity

3 Going-Concern Assumption

4 Conservatism

BASIC CONCEPTS (5-8)

5 Realization

revenue is earned when goods or services are delivered or furnished

6 Accrual

expenses recorded when incurred, regardless of when paid for

7 Consistency

8 Materiality

Costs of obtaining accounting information should not exceed benefits of having it

SPECIFIC RULES

earnings per share

currency fluctuations

R&D expenses

leases

taxes

stock options

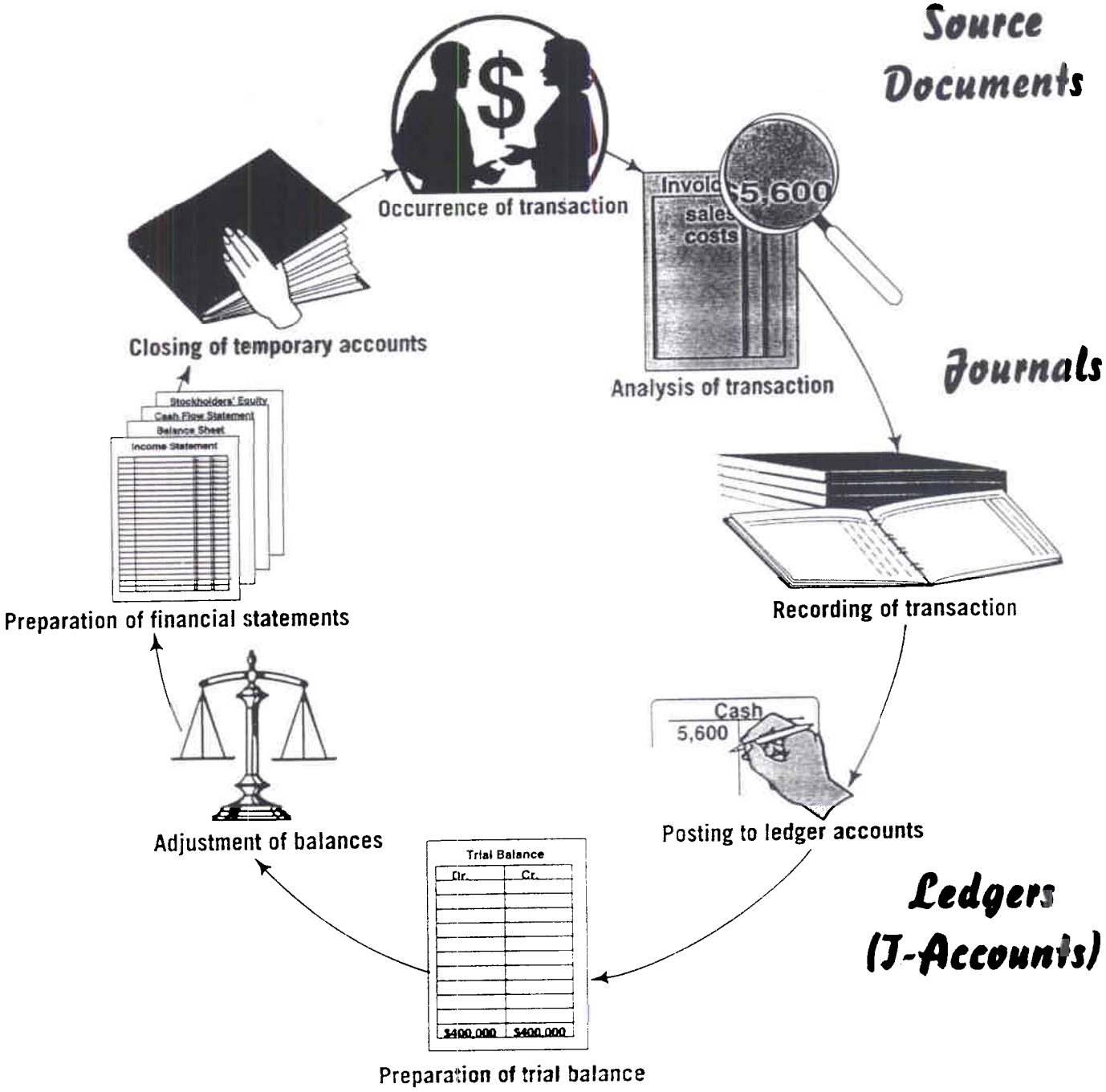
HOW GOOD ARE THE CONCEPTS AND RULES?

Estimates

Skepticism

SOME MECHANICS

The Accounting Cycle



SOURCE DOCUMENTS

invoices

time cards

purchase orders

cash register receipts

checks

JOURNALS
(REGISTERS)

		Debit	Credit
2.	Debit: Cash	$13,000	
	Accounts receivable	2,000	
	Credit: Sales		$15,000
	Notation: Sales for the month of January, 1973.		
3a.	Debit: Utilities expense	$ 100	
	Credit: Cash		$ 100
	Notation: Utilities bill for the month of January, 1973.		

LEDGERS
(T-ACCOUNTS)

BALANCE SHEET ACCOUNTS

Cash

Debit		Credit	
Bal.	2,000	(1)	$ 1,000
(2)	13,000	(3a)	100
		(3b)	1,080
		(3c)	2,000
		(3d)	500
		(3e)	100
		(3f)	600
		(5)	7,000
		(6)	1,000
		(7)	118
	$15,000		$13,498
Bal.	$1,502		

Accounts Receivable

Debit		Credit
(2)	$ 2,000	

Inventory

Debit		Credit
Bal.	$13,000	
(4)	9,000	
Bal.	$22,000	

INCOME STATEMENT ACCOUNTS

Sales

Debit		Credit	
		(2)	$15,000

Advertising Expenses

Debit		Credit
(3d)	$ 500	

Rent Expense

Debit		Credit
(1)	$ 1,000	

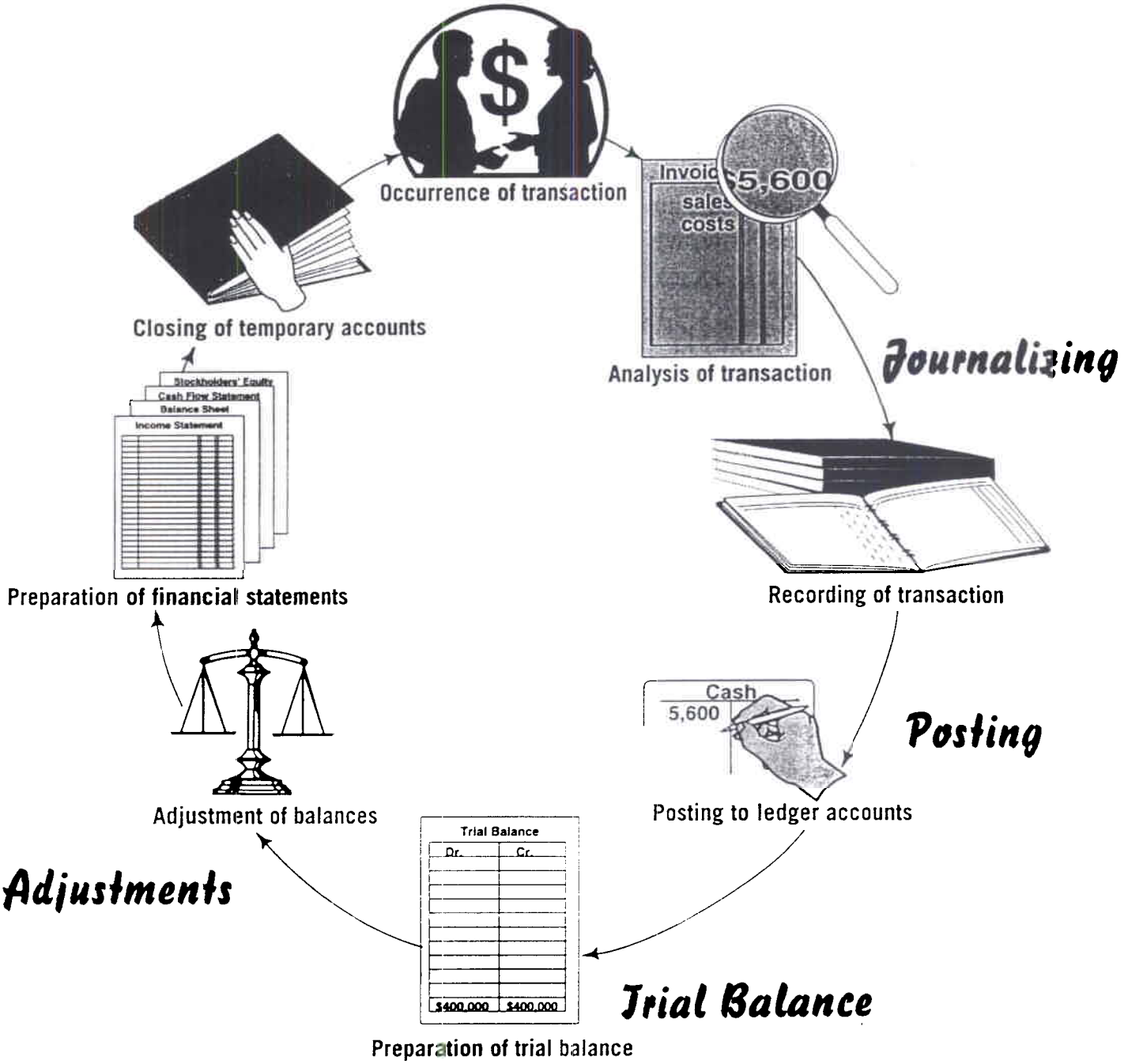
Telephone Expense

Debit		Credit
(3e)	$ 100	

CHART of ACCOUNTS

Account Number	Account Name
101–149	Current Assets
101	Petty Cash
105	Cash (Checking)—First Bank
107	Cash (Savings)—Provident Savings and Loan
111	Accounts Receivable—Trade
112	Allowance for Doubtful Accounts—Trade
113	Accounts Receivable—Other
115	Notes Receivable—Trade
117	Notes Receivable—Other
118	Travel Advances—Employees
121	Inventory—Raw Material
125	Inventory—In-process
131	Inventory—Finished Good
141	Prepaid Expenses
145	Other Current Assets
147	Freight Clearing
300–349	Revenue (Sales
301	Sales—Pro
305	Sa
321	
329	

The Accounting Cycle



page 110, #5.3: Even when a company is following the cost value method, accepted accounting procedures require that the company value inventory at the lower of cost or market value. What is the justification for imposing this lower of cost or market rule? What effects would this policy have in times of high inflation?

Justification for "lower of cost or market:" accounting concept of conservatism, requiring that the accountant lean in the direction of understating revenues and assets and overstating expenses and liabilities.

"Lower of cost or market" is typically applied to such assets as marketable securities, inventory (other than LIFO), and investments.

Two effects typical in times of inflation:

- ***Assets on Balance Sheet are valued for less than their worth, which decreases Owners' Equity***

- ***Income taxes are greater than they should be, since an item that is sold cannot be replaced at the lower cost. This is a particular problem with inventory.***

page 110, #5.6: Some manufacturing companies treat property taxes as a part of cost-of-goods-sold expense, while others treat them as operating expenses. Does this difference in practice violate the principle of consistency? If so, under what conditions?

The consistency concept simply requires that, having once decided how to account for a particular transaction within a particular company, that method must be consistently employed for all similar transactions within that company.

Difficulties:

- ***if a firm is acquired by another one that accounts for property taxes differently***
- ***if a firm changes its accounting practices***
- ***inclusion as part of cost-of-goods-sold can be problematic as to the types of management information produced***

page 111, #5.10: In certain instances, companies may treat research and development expenditures for new products as an asset (typically referred to as capitalizing research and development) rather than as an expense. In terms of the accounting concepts discussed, what are the arguments in favor of such treatment? What are the opposing arguments?

IN FAVOR: Expenditures on research and development are meant to benefit the profits of future periods, not the current accounting period. Since it is considered to be desirable to match revenues against their proper costs, the situation suggests that research and development should be capitalized.

AGAINST: The future revenues (and profits) resulting from research and development expenditures cannot be known until the product or service is delivered to the marketplace. Therefore, the conservative approach is to "write off" research and development expenditures as they are incurred.

page 135, #6.16: The following questions relate to specialized journals:

a) In a check register, the credit entry is typically to what account?

Cash

c) In a sales journal, what account is most frequently debited?

Accounts Receivable

e) How can a sales journal be used to classify and summarize accounting information in ways that might be useful to management?

Sales can be summarized by type of product, by geography, by responsible salesperson, etc.

f) Why is a separate payroll journal frequently used, rather than including salary and wages expenses with other expenses in an expense journal?

Payrolls are complicated, involve many accounts (e.g., withholdings, employment taxes), and are subject to strict governmental regulation

page 135, #6.5: The following are entries appearing in a general journal. Describe the event or condition that probably caused the accountant to make each entry.

a)	**Dr Bad debt expense**	**$ 300**	
	Cr Accounts receivable		**$ 300**

Recognition that a customer will not pay an amount due

c)	**Dr Cash**	**$ 7,000**	
	Cr Marketable securities		**$ 7,000**

Marketable securities were sold for cash

e)	**Dr Interest expense**	**$ 60**	
	Dr Installment payable	**$ 1,400**	
	Cr Cash		**$ 1,460**

Paid a regular installment on a loan, a portion of which represents interest and a portion of which represents principle

g)	**Dr Retained earnings**	**$ 1,100**	
	Cr Cash		**$ 1,100**

Paid $1,100 in dividends in cash or payout to partners