The Accounting Cycle

A Primer

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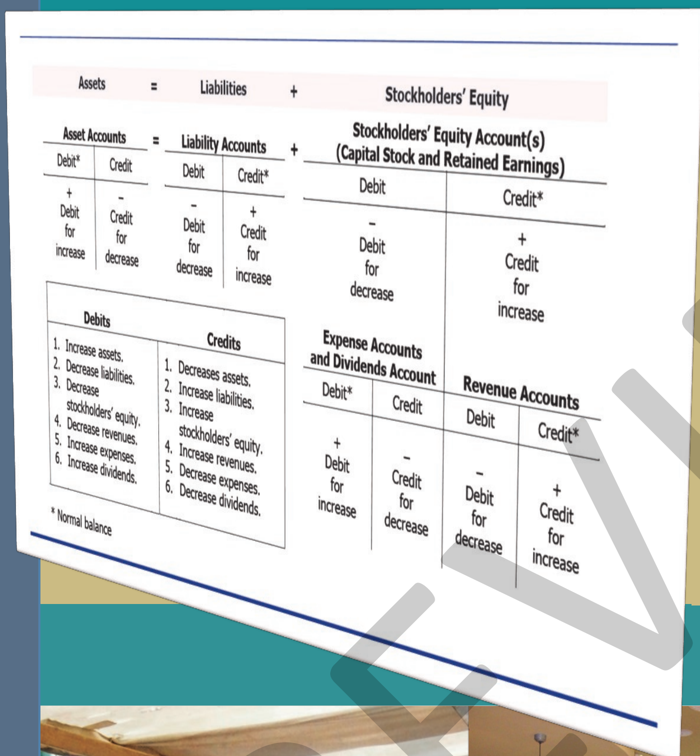

Assets = Liabilities + Stockholders' Equity

Asset Accounts = Liability Accounts + Stockholders' Equity Account(s) (Capital Stock and Retained Earnings)

Asset Accounts: Debit*	Asset Accounts: Credit	Liability Accounts: Debit	Liability Accounts: Credit*	Stockholders' Equity: Debit	Stockholders' Equity: Credit*
+ Debit for increase	- Credit for decrease	- Debit for decrease	+ Credit for increase	- Debit for decrease	+ Credit for increase

Debits	Credits
1. Increase assets.	1. Decreases assets.
2. Decrease liabilities.	2. Increase liabilities.
3. Decrease stockholders' equity.	3. Increase stockholders' equity.
4. Decrease revenues.	4. Increase revenues.
5. Increase expenses.	5. Decrease expenses.
6. Increase dividends.	6. Decrease dividends.

Expense Accounts and Dividends Account: Debit*	Expense Accounts and Dividends Account: Credit	Revenue Accounts: Debit	Revenue Accounts: Credit*
+ Debit for increase	- Credit for decrease	- Debit for decrease	+ Credit for increase

* Normal balance

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Careers in Accounting

A Career as an Entrepreneur

When today's college students are polled about their long-term career choice, a surprisingly large number respond that they wish to someday own and manage their own business. In fact, the aspiration to start a business, to be an entrepreneur, is nearly universal. It is widely acknowledged that a degree in accounting offers many advantages to a would-be entrepreneur. In fact, if you ask owners of small businesses which skill they wish they had more expertise in, they will very frequently reply "accounting." No matter what the business may be, the owner and/or manager must be able to understand the accounting and financial consequences of business decisions.

Most successful entrepreneurs have learned that it takes a lot more than a great marketing idea or product innovation to make a successful business. There are many steps involved before an idea becomes a successful and rewarding business. Entrepreneurs must be able to raise capital, either from banks or investors. Once a business has been launched, the entrepreneur must be a manager – a manager of people, inventory, facilities, customer relationships, and relationships with the very banks and investors that provided the capital. Business owners quickly learn that in order to survive they need to be well-rounded, savvy individuals who can successfully manage these diverse relationships. An accounting education is ideal for providing this versatile background.

In addition to providing a good foundation for entrepreneurship in any business, an accounting degree offers other ways of building your own business. For example, a large percentage of public accountants work as sole proprietors – building and managing their own professional practices. This can be a very rewarding career, working closely with individuals and small businesses. One advantage of this career is that you can establish your practice in virtually any location, ranging from large cities to rural settings. Finally, many accountants who have gained specialized expertise and experience in a particular field start their own practices as consultants. Expertise such as this, which may be in a field outside of traditional accounting practice, can generate billing rates well in excess of $100 an hour.

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Accounting and Its Use in Business Decisions

The Introduction to this text provided a background for your study of accounting. Now you are ready to learn about the forms of business organizations and the types of business activities they perform. This chapter presents the financial statements used by businesses. These financial statements show the results of decisions made by management. Investors, creditors, and managers use these statements in evaluating management's past decisions and as a basis for making future decisions.

In this chapter, you also study the accounting process (or accounting cycle) that accountants use to prepare those financial statements. This accounting process uses financial data such as the records of sales made to customers and purchases made from suppliers. In a systematic manner, accountants analyze, record, classify, summarize, and finally report these data in the financial statements of businesses. As you study this chapter, you will begin to understand the unique, systematic nature of accounting—the language of business.

Learning Objectives

After studying this chapter, you should be able to:

1. Identify and describe the three basic forms of business organizations.
2. Distinguish among the three types of activities performed by business organizations.
3. Describe the content and purposes of the income statement, statement of retained earnings, balance sheet, and statement of cash flows.
4. State the basic accounting equation and describe its relationship to the balance sheet.

(continued)

Forms of Business Organizations

Accountants frequently refer to a business organization as an *accounting entity* or a *business entity*. A business entity is any business organization, such as a hardware store or grocery store, that exists as an economic unit. For accounting purposes, each business organization or **entity** has an existence separate from its owner(s), creditors, employees, customers, and other businesses.[1] This separate existence of the business organization is known as the **business entity concept**. Thus, in the accounting records of the business entity, the activities of each business should be kept separate from the activities of other businesses and from the personal financial activities of the owner(s).

[1] When first studying any discipline, students encounter new terms. Usually these terms are set in boldface color and defined at their first occurrence. The boldface color terms are also listed and defined at the end of each chapter (see pages 34–35 in this chapter). After the definition of the term in the term list, a page number in parentheses indicates where the term is discussed in the chapter.

Objectives

5. Using the underlying assumptions or concepts, analyze business transactions and determine their effects on items in the financial statements.
6. Prepare an income statement, a statement of retained earnings, and a balance sheet.
7. Analyze and use the financial results—the equity ratio.

Assume, for example, that you own two businesses, a physical fitness center and a horse stable. According to the business entity concept, you would consider each business as an independent business unit. Thus, you would normally keep separate accounting records for each business. Now assume your physical fitness center is unprofitable because you are not charging enough for the use of your exercise equipment. You can determine this fact because you are treating your physical fitness center and horse stable as two separate business entities. You must also keep your personal financial activities separate from your two businesses. Therefore, you cannot include the car you drive only for personal use as a business activity of your physical fitness center or your horse stable. However, the use of your truck to pick up feed for your horse stable is a business activity of your horse stable.

As you will see shortly, the business entity concept applies to the three forms of businesses—single proprietorships, partnerships, and corporations. Thus, for accounting purposes, all three business forms are separate from other business entities and from their owner(s). Since most large businesses are corporations, we use the corporate approach in this text and include only a brief discussion of single proprietorships and partnerships.

Single Proprietorship

Objective 1
Identify and describe the three basic forms of business organizations.[2]

A **single proprietorship** (or "sole proprietorship") is an unincorporated business owned by an individual and often managed by that same person. Single proprietors include physicians, lawyers, electricians, and other people in business for themselves. Many small service businesses and retail establishments are also single proprietorships. No legal formalities are necessary to organize such businesses, and usually business operations can begin with only a limited investment.

In a single proprietorship, the owner is solely responsible for all debts of the business. For accounting purposes, however, the business is a separate entity from the owner. Thus, single proprietors must keep the financial activities of the business, such as the receipt of fees from selling services to the public, separate from their personal financial activities. For example, owners of single proprietorships should not enter the cost of personal houses or car payments in the financial records of their businesses.

Partnership

A **partnership** is an unincorporated business owned by two or more persons associated as partners. Often the same persons who own the business also manage the business. Many small retail establishments and professional practices, such as dentists, physicians, attorneys, and many CPA firms, are partnerships.

A partnership begins with a verbal or written agreement. A written agreement is preferable because it provides a permanent record of the terms of the partnership. These terms include the initial investment of each partner, the duties of each partner, the means of dividing profits or losses between the partners each year, and the settlement after the death or withdrawal of a partner. Each partner may be held liable for all the debts of the partnership and for the actions of each partner within the scope of the business. However, as with the single proprietorship, for accounting purposes, the partnership is a separate business entity.

Corporation

A **corporation** is a business incorporated under the laws of a state and owned by a few stockholders or by thousands of stockholders. Almost all large businesses and many small businesses are incorporated.

The corporation is unique in that it is a separate legal business entity. The owners of the corporation are **stockholders**, or **shareholders**. They buy shares of stock, which are units of ownership, in the corporation. Should the corporation fail, the

[2]After reading a portion of text material that covers a certain learning objective, some students immediately want to work an exercise that illustrates that material. The exercises at the end of each chapter are labeled with the learning objective to which they pertain. For instance, turn to pages 37–43 to see which learning objective(s) each exercise covers in Chapter 1. Also, "Reinforcing Problems," referring to specific exercises or problems that relate to the concepts being discussed, are mentioned in the margin of the text (e.g., see page 15).