

# FUNDAMENTALS OF ACCOUNTANCY

## Introduction to Accounting

### Accounting

“Accounting is the process of IDENTIFYING, RECORDING, and COMMUNICATING economic events of an organization to interested users.” (Weygandt, J. et. al)

**IDENTIFYING** – this involves selecting economic events that are relevant to a particular business transaction

The economic events of an organization are referred to as transactions.

Examples of economic events or transactions - In a bakery business:

- sales of bread and other bakery products
- purchases of flour that will be used for baking
- purchases of trucks needed to deliver the products

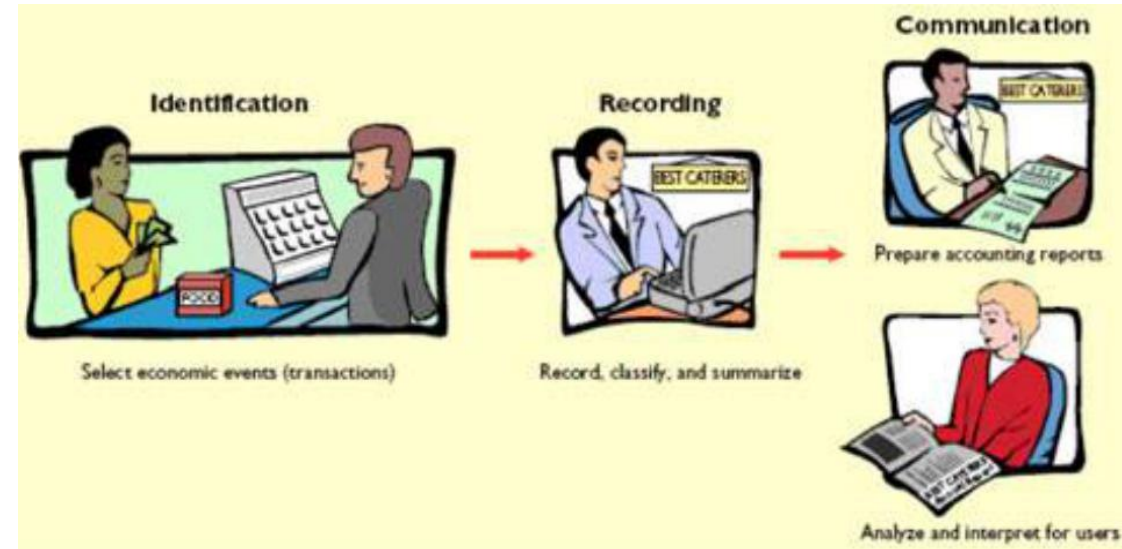
**RECORDING** The accounting profession in the 20th century developed around state requirements for financial statement audits. Beyond the industry's self-regulation, the government also sets accounting standards, through laws and agencies such as the Securities and Exchange Commission (SEC). As economies worldwide continued to globalize, accounting regulatory bodies required accounting practitioners to observe International Accounting Standards. This is to assure transparency and reliability, and to obtain greater confidence on accounting information used by global investors.

Nowadays, investors seek investment opportunities all over the world. To remain competitive, businesses everywhere feel the need to operate globally.

The trend now for accounting professionals is to observe one single set of global accounting standards in order to have greater transparency and comparability of financial data across borders.

– this involves keeping a chronological diary of events that are measured in pesos. The diary referred to in the definition are the journals and ledgers which will be discussed in future chapters.

**COMMUNICATING** – occurs through the preparation and distribution of financial and other accounting reports.



### Nature of accounting

According to Accounting Theory (<http://accountingtheory.weebly.com/nature-and-scope-of-accounting.html>): “Accounting is a systematic recording of financial transactions and the presentation of the related information to appropriate persons.” Based on this definition we can derive the following basic features of accounting:

- Accounting is a service activity. Accounting provides assistance to decision makers by providing them financial reports that will guide them in coming up with sound decisions.
- Accounting is a process: A process refers to the method of performing any specific job step by step according to the objectives or targets. Accounting is

identified as a process, as it performs the specific task of collecting, processing and communicating financial information. In doing so, it follows some definite steps like the collection, recording, classification, summarization, finalization, and reporting of financial data.

- Accounting is both an art and a discipline. Accounting is the art of recording, classifying, summarizing and finalizing financial data. The word ‘art’ refers to the way something is performed. It is behavioral knowledge involving a certain creativity and skill to help us attain some specific objectives. Accounting is a systematic method consisting of definite techniques and its proper application requires skill and expertise. So by nature, accounting is an art. And because it follows certain standards and professional ethics, it is also a discipline.
- Accounting deals with financial information and transactions: Accounting records financial transactions and data, classifies these and finalizes their results given for a specified period of time, as needed by their users. At every stage, from start to finish, accounting deals with financial information and financial information only. It does not deal with non-monetary or non-financial aspects of such information.
- Accounting is an information system: Accounting is recognized and characterized as a storehouse of information. As a service function, it collects processes and communicates financial information of any entity. This discipline of knowledge has evolved to meet the need for financial information as required by various interested groups.

### Function of accounting in business

Accounting is the means by which business information is communicated to business owners and stakeholders. The role of accounting in business is to provide information for managers and owners to use in operating the business. In addition, accounting information allows business owners to assess the efficiency and effectiveness of their business operations. Prepared accounting reports can be compared with industry standards or to a leading competitor to determine how the business is doing. Business owners may also use historical financial accounting statements to create trends for analyzing and forecasting future sales.

Accounting helps the users of these financial reports to see the true picture of the business in financial terms. In order for a business to survive, it is important that a business owner or manager be well-informed.

**Analysing the situation - function of accounting in business:** Mr. Juan is a retired government employee who is good at baking. One day he decided to put up a bakery shop in his barangay. He renovated a portion of his house to serve as the area for the production of bread. He purchased baking equipment and raw materials to produce five different types of bread. Mr. Juan also hired Jose to help him with the baking and, at the same time, to be in-charge of sales. Mr. Juan pays Jose on a weekly basis. Every day, Mr. Juan’s wife deposits the daily cash sales in their bank account at XY Savings Bank. With the help of accounting, what possible decisions or questions of Mr. Juan can accounting provide an answer to?

*Possible Answers:*

- *Is my business earning? (profitability)*
- *How much daily or monthly sales do I need in order to recover my fixed cost? (break-even)*
- *Do I need to hire additional workers to help me with my production?*
- *Can I afford to set up a new store in another place? Where do I get the funds?*
- *Can I afford to pay a bank loan?*

### History of accounting

Accounting is as old as civilization itself. It has evolved in response to various social and economic needs of men. Accounting started as a simple recording of repetitive exchanges. The history of accounting is often seen as indistinguishable from the history of finance and business. Following is the evolution of accounting:

- **The Cradle of Civilization**

Around 3600 B.C., record-keeping was already common from Mesopotamia, China and India to Central and South America. The oldest evidence of this practice was the “clay tablet” of Mesopotamia which dealt with commercial transactions at the time such as listing of accounts receivable and accounts payable.

- **14th Century - Double-Entry Bookkeeping**

The most important event in accounting history is generally considered to be the dissemination of double entry bookkeeping by Luca Pacioli ('The Father of Accounting') in 14th century Italy. Pacioli was much revered in his day, and was a friend and contemporary of Leonardo da Vinci. The Italians of the 14th to 16th centuries are widely acknowledged as the fathers of modern accounting and were the first to commonly use Arabic numerals, rather than Roman, for tracking business accounts. Luca Pacioli wrote Summa de Arithmetica, the first book published that contained a detailed chapter on double-entry bookkeeping.

- **French Revolution (1700s)**

The thorough study of accounting and development of accounting theory began during this period. Social upheavals affecting government, finances, laws, customs and business had greatly influenced the development of accounting.

- **The Industrial Revolution (1760-1830)**

Mass production and the great importance of fixed assets were given attention during this period.

- **19th Century – The Beginnings of Modern Accounting in Europe and America**

The modern, formal accounting profession emerged in Scotland in 1854 when Queen Victoria granted a Royal Charter to the Institute of Accountants in Glasgow, creating the profession of the Chartered Accountant (CA).

In the late 1800s, chartered accountants from Scotland and Britain came to the U.S. to audit British investments. Some of these accountants stayed in the U.S., setting up accounting practices and becoming the origins of several U.S. accounting firms. The first national U.S. accounting society was set up in 1887. The American Association of Public Accountants was the forerunner to the current American Institute of Certified Public Accountants (AICPA).

## **The Present - The Development of Modern Accounting Standards and Commerce**

In this period rapid changes in accounting practice and reports were made. Accounting standards to be observed by accounting professionals were promulgated. Notable practices such as mergers, acquisitions and growth of multinational corporations were developed. A merger is when one company takes over all the operations of another business entity resulting in the dissolution of another business. Businesses expanded by acquiring other companies. These types of transactions have challenged accounting professionals to develop new standards that will address accounting issues related to these business combinations.

## **Branches of Accounting**

According to Investopedia, <http://www.investopedia.com/university/accounting/accounting2.asp>: "Accounting is divided into several branches to better serve the needs of different users with varying information needs. These branches sometimes overlap and they are often closely intertwined."

### **Financial Accounting**

Financial accounting is the broadest branch and is focused on the needs of external users. Financial accounting is primarily concerned with the recognition, measurement and communication of economic activities. This information is communicated in a complete set of financial statements. It is assumed under this branch that the users have one common information need. Financial accounting conforms with accounting standards developed by standard-setting bodies. In the Philippines, there is a Council created to set these standards.

Examples of these financial reports include:

- the balance sheet (statement of financial condition)
- income statement (the profit and loss statement, or P&L)
- statement of cash flows

Financial accounting is primarily concerned with processing historical data. Although financial accounting generally meets the needs of external users, internal users of accounting information also use this information for their decision-making needs.

### **Management (or Managerial) Accounting**

Management accounting emphasizes the preparation and analysis of accounting information within the organization. The objective of managerial accounting is to provide timely and relevant information for those internal users of accounting information, such as the managers and employees in their decision-making needs. Oftentimes, these are sensitive information and is not distributed to those outside the business - for example, prices, plans to open up branches, customer list, etc.

Managerial accounting involves financial analysis, budgeting and forecasting, cost analysis, evaluation of business decisions, and similar areas.

### **Government Accounting**

Government accounting is the process of recording, analyzing, classifying, summarizing, communicating and interpreting financial information about the government in aggregate and in detail reflecting transactions and other economic events involving the receipt, spending, transfer, usability and disposition of assets and liabilities. This branch of accounting deals with how the funds of the government are recorded and reported.

Government accounting deals with these transactions, the recording of inflow and outflow of funds of the government.

### **Auditing**

There are two types of auditing: external and internal auditing. External auditing refers to the examination of financial statements by an independent CPA (Certified Public Accountant) with the purpose of expressing an opinion as to fairness of presentation and compliance with the generally accepted accounting principles (GAAP). The audit does not cover 100% of the

accounting records but the CPA reviews a selected sample of these records and issues an audit report.

Internal auditing deals with determining the operational efficiency of the company regarding the protection of the company's assets, accuracy and reliability of the accounting data, and adherence to certain management policies. It 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.

### **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.

Cost accounting will also help the owner set the selling price of his products. For example, if the cost accounting records show that the total cost to produce one can of sardines is PHP50, then the owner can set the selling price at PHP60.

### **Accounting Education**

This branch of accounting deals with developing future accountants by creating relevant accounting curriculum. Accounting professionals can become faculty members of educational institutions. Accounting educators contribute to the development of the profession through their effective teaching, publications of their research and influencing students to pursue careers in accounting.

Accounting teachers share their knowledge on accounting so that students are informed of the importance of accounting and its use in our daily lives.

### Accounting Research

Accounting research focuses on the search for new knowledge on the effects of economic events on the process of summarizing, analyzing, verifying, and reporting standardized financial information, and on the effects of reported information on economic events. Researchers typically choose a subject area and a methodology on which to focus their efforts. The subject matter of accounting research may include information systems, auditing and assurance, corporate governance, financials, managerial, and tax. Accounting research plays an essential part in creating new knowledge. Academic accounting research "addresses all aspects of the accounting profession" using a scientific method. Practicing accountants also conduct accounting research that focuses on solving problems for a client or group of clients. The Accounting research helps standard-setting bodies around the world to develop new standards that will address recent issues or trend in global business.

PRACTICE: Identify what branch of accounting renders the following services:

1. Preparation of general-purpose financial statements
2. Evaluation of the performance of a sales department
3. Develop standards to address a new business set up
4. Review tax compliance of the business
5. Evaluate whether a branch of the business complies with the collection and deposit policy of the company
6. Review whether the financial statements are presented fairly and in compliance with accounting standards
7. Report on the spending of government funds
8. Report on the total cost of materials and labor used in the production
9. Conducting lectures on accounting topics
10. Records the inflow and outflow of funds of the government.

## Users of Accounting information

"Who uses accounting data or information?"

There are two broad categories 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 users are directly involved in managing and operating the business. These include marketing managers, production supervisors, finance directors, company officers and owners

Internal users (Primary Users) of accounting information include the following:

- Management. Information need: income/earnings for the period, sales, available cash, production cost. Decisions supported: analyze the organization's performance and position and take appropriate measures to improve the company results. sufficiency of cash to pay dividends to stockholders; pricing decisions
- Employees. Information need: profit for the period, salaries paid to employees. Decisions supported: job security, consider staying in the employ of the company or look for other employment opportunities
- Owners. Information need: profit or income for the period, resources or assets of the business, liabilities of the business. Decisions supported : considerations regarding additional investment, expanding the business, borrowing funds to support any expansion plans.

Accounting information is presented to internal users usually in the form of management accounts, budgets, forecasts and financial statements. This information will support whatever decision of the internal users.

### EXTERNAL USERS

External users are individuals and organizations outside a company who want financial information about the company. These users are not directly involved in managing and operating the business. The two most common types of external users are potential investors and creditors. Potential Investors use accounting information to make decisions to buy shares of a company . Creditors (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money. Also included as external

users are government regulatory agencies such as Securities and Exchange Commission (SEC), Bureau of Internal Revenue (BIR), Department of Labor and Employment (DOLE), Social Security System (SSS), and Local Government Units (LGUs).

External users (Secondary Users) of accounting information include the following:

- Creditors: for determining the credit worthiness of an organization. Terms of credit are set by creditors according to the assessment of their customers' financial health. Creditors include suppliers as well as lenders of finance such as banks.
- Tax Authorities (BIR): for determining the credibility of the tax returns filed on behalf of a company.
- Investors: for analyzing the feasibility of investing in a company. Investors want to make sure they can earn a reasonable return on their investment before they commit any financial resources to a company.
- Customers: for assessing the financial position of its suppliers which is necessary for them to maintain a stable source of supply in the long term.
- Regulatory Authorities (SEC, DOLE): for ensuring that a company's disclosure of accounting information is in accordance with the rules and regulations set in order to protect the interests of the stakeholders who rely on such information in forming their decisions.

SUMMARY OF THE DIFFERENCES BETWEEN INTERNAL AND EXTERNAL USERS

Internal users of accounting information are those who are involved in planning, organizing and running the business. They need more detailed information on a timely basis in order to support their decisions. Examples of these internal users are managers, employees and owners.

The external users of accounting information are those individuals or organizations outside a company who are interested in its financial information. Examples of these external users are potential investors, suppliers and government agencies.

Accounting Concepts and Principles

Accounting is considered the language of business. In order for business entities to determine their financial performance, accounting is needed. There are

different forms of business entities according to its organization and operations. A business can be organized as a sole proprietorship, a partnership or corporation. A business can be operated as a service, merchandising and manufacturing entity. To determine the performance of a certain company and compare it to similar companies, there is a need to have a generally accepted rule for accounting.

The purpose of this session is to be able to identify the different concepts and principles of accounting and identify if a specific situation follows or violates an accounting principle.

Petness First Petshop

Juan dela Cruz opened his pet shop business called Petness First Petshop. He opened a bank account for his business and deposited PHP500,000. The business earned PHP50,000 but he had doubts with the recorded expense of PHP60,000. He is not sure if he should include the following items as expenses:

Salary expense	20,000
Rent expense	10,000
Utilities expense (at home)	15,000
Utilities expense (at the store)	10,000
Insurance expense	5,000
Withdrawals	10,000
TOTAL	60,000

What should not be included as expenses? Why?

**Business entity principle** – a business enterprise is separate and distinct from its owner or investor.

- If the owner has a barber shop, the cash of the barber shop should be reported separately from personal cash.
- The owner had a business meeting with a prospective client. The expenses that come with that meeting should be part of the company's expenses. If the owner paid for gas for his personal use, it should not be included as part of the company's expenses.

**Going concern principle** – business is expected to continue indefinitely.

- When preparing financial statements, you should assume that the entity will continue indefinitely.

**Time period principle** – financial statements are to be divided into specific time intervals.

- Philippine companies are required to report financial statements annually.
- The salary expenses from January to December 2015 should only be reported in 2015.

**Monetary unit principle** – amounts are stated into a single monetary unit

- Jollibee should report financial statements in pesos even if they have a store in the United States.
- IHOP should report financial statements in dollars even if they have a branch here in the Philippines

**Objectivity principle** – financial statements must be presented with supporting evidence.

- When the customer paid Jollibee for their order, Jollibee should have a copy of the receipt to represent as evidence.
- When a company incurred a transportation expense, a voucher should be prepared as evidence.

**Cost principle** – accounts should be recorded initially at cost.

- When Jollibee buys a cash register, it should record the cash register at its price when they bought it. o When a company purchases a laptop, it should be recorded at the price it was purchased.

**Accrual Accounting Principle** – revenue should be recognized when earned regardless of collection and expenses should be recognized when incurred regardless of payment. On the other hand, the cash basis principle in which revenue is recorded when collected and expenses should be recorded when paid. Cash basis is not the generally accepted principle today.

- When a barber finishes performing his services he should record it as revenue.
- When the barber shop receives an electricity bill, it should record it as an expense even if it is unpaid.

**Matching principle** – cost should be matched with the revenue generated.

- When you provide tutorial services to a customer and there is a transportation cost incurred related to the tutorial services, it should be recorded as an expense for that period.

**Disclosure principle** – all relevant and material information should be reported.

- The company should report all relevant information.

**Conservatism principle** – also known as prudence. In case of doubt, assets and income should not be overstated while liabilities and expenses should not be understated.

- In case of doubt, expenses should be recorded at a higher amount. Revenue should be recorded at a lower amount.

**Materiality principle** – in case of assets that are immaterial to make a difference in the financial statements, the company should instead record it as an expense.

- A school purchased an eraser with an estimated useful life of three years. Since an eraser is immaterial relative to assets, it should be recorded as an expense.

**A. Answer the following multiple choice questions:**

1. The accounting guideline that requires financial statement information to be supported by independent, unbiased evidence other than someone's belief or opinion is the:

- |                              |                            |
|------------------------------|----------------------------|
| a. Business entity principle | d. Monetary unit principle |
| b. Going-concern principle   | e. Cost principle          |
| c. Objectivity principle     |                            |

2. The principle that requires every business to be accounted for separately and distinctly from its owner or owners is known as the:

- |                            |                                  |
|----------------------------|----------------------------------|
| a. Objectivity principle   | d. Business entity principle     |
| b. Going-concern principle | e. Revenue recognition principle |
| c. Cost principle          |                                  |

3. The rule that requires financial statements to reflect the assumption that the business will continue operating instead of being closed or sold, unless evidence shows that it will not continue, is the:

- |                            |                              |
|----------------------------|------------------------------|
| a. Going-concern principle | d. Business entity principle |
| b. Objectivity principle   | e. Cost Principle            |
| c. Monetary unit principle |                              |



4. To include the personal assets and transactions of a business's owner in the records and reports of the business would be in conflict with the:

- |                                  |                            |
|----------------------------------|----------------------------|
| a. Objectivity principle         | d. Realization principle   |
| b. Business entity principle     | e. Going-concern principle |
| c. Revenue recognition principle |                            |

5. The objectivity principle:

- means that information is supported by independent, unbiased evidence
- means that information can be based on what the preparer thinks is true
- means that financial statements should contain information that is optimistic
- means that a business may not re-organize revenue until cash is received

6. Marian Mosely is the owner of Mosely Accounting Services. Which accounting principle requires Marian to keep her personal financial information separate from the financial information of Mosely Accounting Services?

- |                            |                              |
|----------------------------|------------------------------|
| a. Monetary unit principle | c. Going-concern principle   |
| b. Cost principle          | d. Business entity principle |

7. Which of the following accounting principles would require that all goods and services purchased be recorded at cost?

- |                            |                                 |
|----------------------------|---------------------------------|
| a. Going-concern principle | c. Continuing-concern principle |
| b. Cost principle          | d. Business entity principle    |

## B. Match the following words with their definition:

- |                                 |                          |                            |
|---------------------------------|--------------------------|----------------------------|
| a. Going concern principle      | e. Time period principle | h. Monetary unit principle |
| b. Objectivity principle        | f. Cost principle        | i. Materiality principle   |
| c. Matching principle           | g. Disclosure principle  | j. Conservatism principle  |
| d. Accrual accounting principle |                          |                            |

- |       |   |
|-------|---|
| _____ | 1. All relevant information should be included in the financial reports     |
| _____ | 2. In case of doubt, assets and income should not be overstated.            |
| _____ | 3. Assume that the company will continue indefinitely.                      |
| _____ | 4. All transactions should be supported by unbiased evidence.               |
| _____ | 5. Expenses should be recorded in the period when the revenue is generated. |
| _____ | 6. Minimal costs incurred should be recorded as an expense.                 |

\_\_\_\_\_ 7. A Philippine company should report financial statements in pesos.

\_\_\_\_\_ 8. A barber who performs services for a client should record revenue.

\_\_\_\_\_ 9. Statement of Financial position should be recorded as of December 31, 2015.

\_\_\_\_\_ 10. A company that purchases furniture should record it at its acquisition price.

Indicate which principles are violated

1. The owner-manager bought a computer for personal use. The invoice was given to the accountant who recorded it as an asset of the business.

2. The statement of financial position of a company included an equipment purchased from Japan for 350,000 yen. It was reported at that amount in the statement of financial position while all the other assets were reported in Philippine pesos.

3. No financial statements were prepared by Michael Go for his business. He explained that he will prepare the statements when he closes the business, which he predicts to take place after 20 years.

4. Aside from owning a shoe store, Albert operates a canteen. The assets of the canteen are reported in the statement of financial position of the shoe store.

5. Purchased a hammer at a cost of PHP500. This was recorded as an asset and expense to decrease its value by PHP50 per year for 10 years.

6. A food company ordered a machine needed in the assembly line of its production department. Upon order, the machine was immediately listed as one of its assets.



# The Accounting Equation

## Assets invested by the owner

July 1 - Paolo Reyes started a delivery service on July 1, 2013. The following transactions occurred during the month of July. He invested PHP800,000 cash and Cars amounting to PHP200,000

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	PHP800,000				Reyes, Capital    PHP1,000,000
Cars	PHP200,000				

## Borrowings from the bank

July 2 – Reyes borrowed PHP100,000 cash from PNB for use in his business.

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	PHP900,000		Loans Payable    PHP100,000		Reyes, Capital    PHP1,000,000
Cars	PHP200,000				

## Asset purchased for cash

July 7 – Bought tables and chairs from Orocan and paid PHP45,000 cash

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	PHP855,000		Loans Payable    PHP100,000		Reyes, Capital    PHP1,000,000
Cars	PHP200,000				
Furnitures	PHP45,000				

## Assets purchased on account

July 15 – Various equipment were purchased on account from Fortune for PHP55,000

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	PHP855,000		Loans Payable    PHP100,000		Reyes, Capital    PHP1,000,000
Cars	PHP200,000		Accounts Payable    PHP55,000		
Furnitures	PHP45,000				
Equipment	PHP55,000				

## Cash withdrawal by the owner

July 18 – Reyes made a cash withdrawal of PHP5,000 for personal use

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	PHP850,000		Loans Payable    PHP100,000		Reyes, Capital    PHP1,000,000
Cars	PHP200,000		Accounts Payable    PHP55,000		Reyes, Drawing    (PHP5,000)
Furnitures	PHP45,000				
Equipment	PHP55,000				

## Payment of liability

July 20 – The account due to Fortune was paid in cash

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	PHP795,000		Loans Payable    PHP100,000		Reyes, Capital    PHP1,000,000
Cars	PHP200,000				Reyes, Drawing    (PHP5,000)
Furnitures	PHP45,000				
Equipment	PHP55,000				

Date	ASSETS					LIABILITIES		OWNER'S EQUITY	
	Cash	Cars	Furnitures	Equipment	Loans Payable	Accounts Payable	Reyes, Drawings	Reyes, Capital	
July									
1	800,000	200,000			100,000			1,000,000	
2	100,000				100,000			1,000,000	
Balances 7	900,000 (45,000)	200,000	45,000		100,000			1,000,000	
Balances 15	855,000	200,000	45,000	55,000	100,000	55,000		1,000,000	
Balances 18	855,000 (5,000)	200,000	45,000	55,000	100,000	55,000	(5,000)	1,000,000	
Balances 20	850,000 (55,000)	200,000	45,000	55,000	100,000	55,000 (55,000)	(5,000)	1,000,000	
Balances	795,000	200,000	45,000	55,000	100,000	0	(5,000)	1,000,000	
				1,095,000	1,095,000				

Determining profit through operation

- Accrual basis of accounting vs Cash basis of accounting – accrual basis recognizes revenue when earned and recognizes expenses when incurred
- Under the expense recognition principle, expenses can be recognized either as: (1) matching; (2) systematic allocation, or; (3) direct association.
- Profit measures the performance of the company. If the revenue exceeds expenses, then it is a net profit; otherwise, it is a net loss.

Received cash for revenue earned

July 21 – A customer hired the services of Reyes. Cash of PHP15,000 was received from the customers.

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY	
Cash	PHP15,000				Service Revenue	PHP15,000

Paid cash for expenses incurred

July 22 – Cash was paid for the following : gas and oil, PHP500 and car repairs, PHP1,000.

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY	
Cash	(PHP1,500)				Gas & Oil Repair Exp.	(PHP500) (PHP1,000)

Revenue rendered on account

July 24 – Another customer hired the services of Reyes and promised to pay PHP16,000 on July 31.

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY	
Accounts Receivable	PHP16,000				Service Revenue	PHP16,000

**Paid for expenses incurred**

July 25 – Paid PHP500 for telephone bill.

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	(PHP500)				Telephone Expense (PHP500)

**Revenue earned with a downpayment, balance on account**

July 27 – Another customer hired the services of Reyes. A bill was issued to them for PHP20,000, 50% of which was collected

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	PHP10,000				Service Revenue PHP20,000
Accounts Receivable	PHP10,000				

**Customer’s account collected in cash**

July 30 – The customer on July 24 paid 50% of his account in cash.

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	PHP8,000				
Accounts Receivable	(PHP8,000)				

**Paid cash for expenses incurred**

July 31 – Paid PHP10,000 for rental of office space, and salaries of PHP9,000

ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
Cash	(PHP19,000)				Rent Expense (PHP10,000) Salaries Expense (PHP9,000)

**PRACTICE**

For each transaction, tell whether the assets, liabilities and equity will increase (I), decrease (D) or is not affected (NE).

	A	L	E
1. The owner invests personal cash in the business.	—	—	—
2. The owner withdraws business assets for personal use.	—	—	—
3. The company receives cash from a bank loan.	—	—	—
4. The company repays the bank that had lent money.	—	—	—
5. The company purchases equipment with its cash.	—	—	—
6. The owner contributes her personal truck to the business.	—	—	—
7. The company purchases supplies on credit.	—	—	—
8. The company purchases land by paying half in cash and signing a note.	—	—	—
9. The owner withdraws cash for personal use.	—	—	—
10. The company repays the suppliers.	—	—	—

PRACTICE:

Jerome Garcia started a new business and completed these transactions during August:

- Aug. 1 Garcia invested PHP48,000 cash in the business.
- 1 Rented office space and paid PHP800 cash for the August rent.
- 3 Purchased exploration equipment for PHP22,000 by paying PHP12,000 cash and agreeing to pay the balance in 3 months.
- 5 Purchased office supplies by paying PHP1,500 cash.
- 6 Completed exploration work and immediately collected PHP420 cash for the work.
- 8 Purchased PHP1,350 of office equipment on credit.
- 15 Completed exploration work on credit in the amount of PHP8,000.
- 18 Purchased PHP700 of office supplies on credit.
- 20 Paid cash for the office equipment purchased on August 8.
- 24 Billed a client PHP2,400 for work completed; the balance is due in 30 days.
- 28 Received PHP5,000 cash for the work completed on August 15.
- 30 Paid the assistant’s salary of PHP1,100 cash for this month.
- 30 Paid PHP340 cash for this month’s utility bill.
- 30 Garcia withdrew PHP1,050 cash from the business for personal use.

Required

- 1. Arrange the following asset, liability, and equity titles in a table: Cash; Accounts Receivable; Office Supplies; Office Equipment; Exploration Equipment; Accounts Payable; Jerome Garcia, Capital; Jerome Garcia, Withdrawals; Revenues; and Expenses.
- 2. Use additions and subtractions to show the effects of each transaction on the accounts in the accounting equation. Show new balances after each transaction.

# Types of Major Accounts

Types of major accounts

- **Assets** are the resources owned and controlled by the firm.
- **Liabilities** are obligations of the firm arising from past events which are to be settled in the future.
- **Equity or Owner’s Equity** are the owner’s claims in the business. It is the residual interest in the assets of the enterprise after deducting all its liabilities.
- **Income** is the increase in economic benefits during the accounting period in the form of inflows of cash or other assets or decreases of liabilities that result in increase in equity. Income includes revenue and gains.
- **Expenses** are decreases in economic benefits during the accounting period in the form of outflows of assets or incidences of liabilities that result in decreases in equity.

Assets

Difference between Current vs. Non-Current Assets, and Tangible vs. Intangible Assets.

- **Current Assets** are assets that can be realized (collected, sold, used up) one year after year-end date. Examples include Cash, Accounts Receivable, Merchandise Inventory, Prepaid Expense, etc.
- **Non-current Assets** are assets that cannot be realized (collected, sold, used up) one year after year-end date. Examples include Property, Plant and Equipment (equipment, furniture, building, land), long term investments, etc.
- **Tangible Assets** are physical assets such as cash, supplies, and furniture and fixtures.
- **Intangible Assets** are non-physical assets such as patents and trademarks



Account titles used for Asset Accounts.

#### Current Assets

- **Cash** is money on hand, or in banks, and other items considered as medium of exchange in business transactions.
- **Accounts Receivable** are amounts due from customers arising from credit sales or credit services.
- **Notes Receivable** are amounts due from clients supported by promissory notes.
- **Inventories** are assets held for resale
- **Supplies** are items purchased by an enterprise which are unused as of the reporting date.
- **Prepaid Expenses** are expenses paid in advance. They are assets at the time of payment and become expenses through the passage of time.
- **Accrued Income** is revenue earned but not yet collected
- **Short term investments** are the investments made by the company that are intended to be sold immediately

#### Non-Current Assets

- **Property, Plant and Equipment** are long-lived assets which have been acquired for use in operations.
- **Long term Investments** are the investments made by the company for long-term purposes
- **Intangible Assets** are assets without a physical substance. Examples include franchise and copyright.

#### Liabilities

**Liabilities** are the debts and obligations of the company to another entity.

Differences of Current vs. Non-Current Liabilities.

**Current Liabilities.** Liabilities that fall due (paid, recognized as revenue) within one year after year-end date. Examples include Accounts Payable, Utilities Payable and Unearned Income.

**Non-current Assets** are liabilities that do not fall due (paid, recognized as revenue) within one year after year-end date. Examples include Notes Payable, Loans Payable, Mortgage Payable, etc.

Account Titles used for Liability Accounts.

#### Current Liabilities

Accounts Payable are amounts due, or payable to, suppliers for goods purchased on account or for services received on account.

Notes Payable are amounts due to third parties supported by promissory notes.

Accrued Expenses are expenses that are incurred but not yet paid (examples: salaries payable, taxes payable)

Unearned Income is cash collected in advance; the liability is the services to be performed or goods to be delivered in the future.

#### Non-Current Liabilities

Loans Payable

Mortgage Payable

#### Owner's Equity

**Owner's Equity** is the residual interest of the owner from the business. It can be derived by deducting liabilities from assets.

Account Titles used for Equity Account.

**Capital** is the value of cash and other assets invested in the business by the owner of the business.

**Drawing** is an account debited for assets withdrawn by the owner for personal use from the business.

**Income**

**Income** is the Increase in resources resulting from performance of service or selling of goods.

examples of Income Accounts. Service revenue for service entities, Sales for merchandising and manufacturing companies

**Expense**

**Expense** is the decrease in resources resulting from the operations of business

Examples of Expense Accounts: Salaries Expense, Interest Expense, Utilities Expense

Chart of Accounts.

- A chart of accounts is a listing of the accounts used by companies in their financial records.
- The chart of accounts helps to identify where the money is coming from and where it is going.
- The chart of accounts is the foundation of the financial statements.

Setting up a Chart of Accounts:

The following are the steps in the preparation of a basic chart of accounts:

1. Create two columns.
2. Prepare the assets first, then liabilities, then equity, then revenue and expenses.
3. List all assets, liabilities, equity, revenue and expenses account in the first column.
4. On the second column, choose an account code (discretion of the company).
5. On the third column, write the description for each account on when to use it.

An example of a chart of accounts

Account	Account Code *may vary	Description
Cash	1000	Use for actual cash transactions
Accounts Receivable	1200	Use for customers who will pay in the future
Inventory	1300	Use for items held for sale
Prepaid Expenses	1400	Use for expenses paid in advance
Supplies	1500	Use for items to be used in the future
Office Equipment	1600	Use for equipment that are used in the office
Store Equipment	1700	Use for equipment that are used in the store
Land	1800	Use for land used in operations
Liabilities		
Accounts Payable	2000	Use for the debts of the company
Notes Payable	2100	Use for promissory notes issued by the company
Salaries Payable	2200	Use for salaries to be paid in the future
Capital		
Owner's, Capital	3000	
Owner's, Withdrawal	4000	
Service Revenue	5000	Use for earnings
Salaries Expense	6000	Use for salaries incurred, regardless of payment
Utilities Expense	6100	Use for electricity and water expenses

PRACTICE  
Matching Type

Assets

Liabilities

Owner's Equity

Accounts Receivable

Notes Receivable

Rent Expense

Intangible Assets

Property, Plant and Equipment

Cash

Prepaid Expense

\_\_\_\_\_

1. It is the obligations of the company payable in money, goods or services.

\_\_\_\_\_

2. These are non-current tangible assets.

\_\_\_\_\_

3. These assets are identifiable, non-monetary assets without physical substance.

\_\_\_\_\_

4. It is the claim of the owner also known as the capital.

\_\_\_\_\_

5. It is the most liquid asset and is the medium of exchange for business transactions.

\_\_\_\_\_

6. It is an expense for leased office space, equipment or assets rented from others.

\_\_\_\_\_

7. Examples of this are cash, account receivable and prepaid expenses.

\_\_\_\_\_

8. It is a written promise from the customer to pay his receivables on a certain future date.

**ENRICHMENT** Classify the following items into current asset and non-current asset, tangible and intangible.

- 1 Account Receivable

2 Building

3 Cash

4 Computer Equipment

5 Copyrights
- 6 Delivery Truck

7 Furniture & Fixtures

8 Store Supplies

9 Inventories

10 Land
- 11 Notes Receivable

12 Office Supplies

13 Accrued Income

14 Prepaid Insurance

15 Prepaid Rent

Indicate whether it is an increase (+), decrease (-), or no effect on the asset, liabilities and equity accounts.

	Assets	Liabilities	Equity
1	Investment of cash in the business		
2	Purchase of computer equipment for cash		
3	Billed a customer for services rendered		
4	Paid salaries		
5	Purchased office supplies on credit		
6	Paid advertising expense		
7	Paid rent in advance for 3 months		
8	Received cash from customers on account		
9	Withdrew cash for personal use		
10	Invested land into the company		

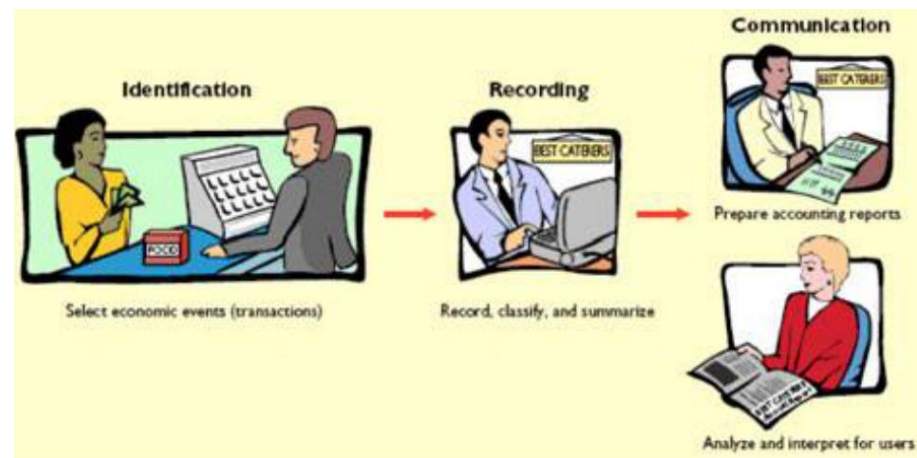
Identify if the account is an asset, liability, equity, income or expense and indicate its normal balance.

	Acct.	NB		Acct.	NB
1	Accounts Receivable		9	Delivery Truck	
2	Depreciation		10	Interest Payable	
3	Advertising Expense		11	Inventories	
4	Bonds Payable		12	Land	
5	Building		13	Mortgage Loans	
6	Cash		14	Notes Payable	
7	De Jesus, Capital		15	Notes Receivable	
8	De Jesus, Drawing		16	Office Supplies	



# Books of Accounts

“Accounting is the process of IDENTIFYING, RECORDING, and COMMUNICATING economic events of an organization to interested users.” (Weygandt et.al.)



From the definition, where do we record the transactions that we have identified? What are the tools that we use to document these transactions? How important are these records in accounting?”

The two major types of books of accounts are journal and ledger.

## THE JOURNAL

Companies initially record transactions and events 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.

There are two types of journals, the general journal and the special journal.

## GENERAL JOURNAL

The general journal is the most basic journal. Typically, a general journal has spaces for dates, account titles and explanations, references, and two amount columns.

The journal makes several significant contributions to the recording process:

- It discloses in one place the complete effects of a transaction.
- It provides a chronological record of transactions.
- It helps to prevent or locate errors because the debit and credit amounts for each entry can be easily compared.

Example of a general journal

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit

## Journalizing process

Entering transaction data in the journal is known as journalizing. Companies make separate journal entries for each transaction. A complete entry consists of:

- The date of the transaction which is entered in the Date column.
- The debit account title (that is, the account to be debited) which is entered first at the extreme left margin of the column headed “Account Titles and Explanation,” and the amount of the debit is recorded in the Debit column.
- The credit account title (that is, the account to be credited) which is indented and entered on the next line in the column headed “Account Titles and Explanation,” and the amount of the credit is recorded in the Credit column.
- A brief explanation of the transaction which appears on the line below the credit account title. A space is left between journal entries. The blank space

separates individual journal entries and makes the entire journal easier to read.

- The column titled Ref. (which stands for Reference) which is left blank when the journal entry is made. This column is used later when the journal entries are transferred to the ledger accounts.

To illustrate the recording of transactions in the general journal, let us use the following transactions as an example:

- September 1, 2015 Mr. Ben Mabait invested PHP500,000 in a restaurant business by opening an account with SuperBank.
- September 5, 2015 purchased kitchen appliances for his business amounting to PHP100,000 by issuing a check. September 6, 2015 started his operations a made a sales for that day amounting to PHP20,000.

We will now record the above transactions in the general journal. There are available books of this format that can be bought in a bookstore. All the learners have to do is to fill it up. They can use a two-column book for a general journal.

**General Journal**

Date	Account Title and Explanation	Ref	Debit	Credit
9/1/15	Cash  B. Mabait, Capital  To record investment of Mr. Ben Mabait		500,000	500,000
9/5/15	Kitchen Appliances  Cash  To record purchase of kitchen appliances		100,000	100,000
9/6/15	Cash  Sales To record sales for the day		20,000	20,000

- It is important to use correct and specific account titles in journalizing. The main criterion is that each title must appropriately describe the content of the account.
- Some practitioner or CPA uses “Description or Particulars” instead of Account Titles and Explanation.
- For every journal entry the total debits and credits should always be equal. If not, the entry is erroneous.

Some entries involve only two accounts, one debit and one credit. An entry like these is considered a simple entry. Some transactions, however, require more than two accounts in journalizing. An entry that requires three or more accounts is a compound entry. All of the transactions in the above examples are simple entries. An example of a compound entry is the following:

On September 7, 2015, Mr. Mabait purchased a motorcycle costing PHP80,000. He pays PHP30,000 cash and agrees to pay the remaining

PHP50,000 on account (to be paid later). The compound entry is as follows:

**General Journal**

Date	Account Title and Explanation	Ref	Debit	Credit
9/7/15	Transportation Equipment Cash Accounts Payable To record purchase of motorcycle by paying cash and the balance on account		80,000	30,000 50,000

**SPECIAL JOURNALS**

Some businesses encounter voluminous quantities of similar and recurring transactions which may create congestion if these transactions are recorded repeatedly in a single day or a month in the general journal. Take the case of our example above, if Mr. Mabait will record the sales per day using the Official Receipt or Cash Sales Invoice issued, it would be unnecessary and impractical to

credit “sales” account repeatedly. In order to facilitate efficient and practical recording of similar and recurring transactions, a special journal is used.

The following are the commonly used special journals:

- Cash Receipts Journal – used to record all cash that has been received
- Cash Disbursements Journal – used to record all transactions involving cash payments

Cash Receipts Journal

DATE	DESCRIPTION (PARTICULARS)	RE F	Debit	Credit	Credit	Credit
			Cash	Sales	Account Receivable	Sundry

- Sales Journal (Sales on Account Journal) – used to record all sales on credit (on account)
- Purchase Journal (Purchase on Account Journal) – used to record all purchases of inventory on credit (or on account)

Cash Receipts Journal is used to record transaction involving receipt or collection of cash. The following illustrate the format of a cash receipts journal:

- The date of the transaction is entered in the date column.
- A brief explanation of the transaction is entered in the description column.
- The column titled Ref. (which stands for Reference) which is left blank when the journal entry is made. This column is used later when the journal entries are transferred to the ledger accounts.
- The Debit Cash column represents the amount of cash received for a particular transaction.

- Major categories of receipts, such as cash sales and collection of accounts receivable are provided with separate columns. These transactions are frequent and repetitive items, therefore a separate column is provided.
- The column sundry is used for various miscellaneous and less regular items, such as capital investment, receipt of loan proceeds, among others.

The source document for this journal is the Official Receipts or Cash Receipts issued by the business.

Cash Disbursements Journal (CDJ)

The cash disbursements journal is the opposite of the cash receipts journal. It is the journal where all cash payments are recorded. An example of a cash disbursement journal is shown below:

Cash Disbursements Journal					
DATE	DESCRIPTION (PARTICULARS)	REF	Check or Voucher Number	Credit	Debit

- The date of the transaction is entered in the date column.
- A brief explanation of the transaction is entered in the description column.
- The column titled Ref. (which stands for Reference) which is left blank when the journal entry is made. This column is used later when the journal entries are transferred to the ledger accounts.
- The Check or Voucher number represents the identifying number of the check issued for the related cash payment. Most of the time, a check or

- cash voucher accompanies the disbursement. The voucher number may be used as the alternative for this column.
- The Debit Cash column represents the amount of cash received for a particular transaction.
  - Major categories of receipts, such cash sales and collection of accounts receivable are provided with separate columns. These transactions are frequent and repetitive items, therefore a separate column is provided.
  - The column sundry is used for various miscellaneous and less regular items, such as capital investment, receipt of loan proceeds, among others.

The source documents used to update this journal are the check voucher or cash voucher, cash receipts or official receipts from suppliers or vendors.

Sales Journal (Sales on Account Journal)

The Sales Journal or Sales on Account Journal is used in recording several sales transactions on account. The source document for this journal is the charge invoice or sales invoice (for credit transactions) to various customers or clients. An example of a sales journal is shown below:

Sales Journal					
DATE	DESCRIPTION (CUSTOMER NAME)	REF	Charge Invoice or Sales Invoice No.	Debit	Credit

The date of the transaction is entered in the date column.

- A brief explanation of the transaction is entered in the description column or the name of the customer.
- The column titled Ref. (which stands for Reference) which is left blank when the journal entry is made. This column is used later when the journal entries are transferred to the ledger accounts.
- The Charge Invoice Number or Sales Invoice Number represents the identifying number of the source document issued to the customer when the sale was made.

- The Debit Accounts Receivable column represents the amount of the sale transactions indicated in the charge invoice.
- The Credit Sales column represents the amount of the sale transactions indicated in the charge invoice.

The source document for this journal is the Charge Invoice issued by the business.

Purchase Journal (Purchases on Account Journal)

The Purchase journal or the Purchases on Account Journal is used to record recurring transactions of purchases on account. The source documents for purchase journal are the invoices from the supplier of the company. An example of a Purchase Journal is shown below:

Purchase Journal					
DATE	DESCRIPTION (SUPPLIER'S NAME)	REF	Charge Invoice or SalesInvoice No. (from supplier)	Debit	Credit

- The date of the transaction is entered in the date column.
- A brief explanation of the transaction is entered in the description column or the name of the supplier
- The column titled Ref. (which stands for Reference) which is left blank when the journal entry is made. This column is used later when the journal entries are transferred to the ledger accounts.
- The Charge Invoice Number or Sales Invoice Number represents the identifying number of the source document issued by the supplier when the items, goods or merchandise were delivered to the company when the purchase was made.
- The Debit Purchases column represents the amount of the goods purchases as indicated in the charge invoice from the supplier

- The Credit Accounts Payable column represents the amount of the goods or items purchased on credit from the supplier. The amount is indicated in the charge invoice issued by the supplier.

The source document for this journal is the charge invoice from the supplier or vendor.

**the ledger**

The ledger refers to the accounting book in which the accounts and their related amounts as recorded in the journal are posted periodically. The ledger is also called the ‘book of final entry’ because all the balances in the ledger are used in the preparation of financial statements. This is also referred to as the T-Account because the basic form of a ledger is like the letter ‘T’.

There are two kinds of ledgers, namely; the general ledger and the subsidiary ledgers.

**GENERAL LEDGER**

The general ledger (commonly referred by accounting professionals as GL) is a grouping of all accounts used in the preparation of financial statements. The GL is a controlling account because it summarizes all the activities that have taken place as recorded in its subsidiary ledger. The format of a general ledger is shown below:

General Ledger					
Account: Cash			Account No.: 1000		
Date	Item	Ref	Debit	Credit	Balance

- The account portion refers to the account title for example: cash, accounts receivable.

- The account number is an assigned number for each account title to facilitate ease in recording and cross-referencing.
- The Date column identifies when the transaction happened.
- The item represents the source journal and the nature of the transactions
- The Reference identifies the page number of the general our special journal from which the information was taken.
- The Debit and Credit columns are used in recording the amount of transactions from the general journal or special journal.
- The Balance Column represents the running balance of the Account after considering the debit and credit amounts. If the running balance amount is positive, the account has a debit balance whereas if it has a negative running balance, the accounts has a credit balance.

**SUBSIDIARY LEDGER**

A subsidiary ledger is a group of like accounts that contains the independent data of a specific general ledger. A subsidiary ledger is created or maintained if individualized data is needed for a specific general ledger account. An example of a subsidiary ledger is the individual record of various payables to suppliers. The total amount of these subsidiary ledgers should equal the balance in the Accounts Payable general ledger.

example of a subsidiary ledger

Accounts Payable - Subsidiary Ledger					
Vendor/Supplier: Joy Food Corporation Address: Jose St, Sampaloc, Manila				Vendor No.: 201	
Date	Item	Ref	Debit	Credit	Balance

- The upper portion indicates the name and address of the vendor or supplier.

- The vendor number is an assigned number for each vendor as reference in keeping the records of a supplier.
- The Date column identifies when the transaction happened.
- The description column describes the nature of transaction.
- The Reference identifies the page number of the general or special journal from which the information was taken.
- The Debit and Credit columns reflect the various effects of every transaction to the record of the supplier or vendor.
- The Balance column provides the running balance of every supplier.

Take note that the total running balance for all subsidiary ledgers should equal the Accounts payable general ledger.

Identify what special journal that is applicable for the following transactions:

1. Collected PHP10,000 from a customer in payment of his account.
2. Bought 100 pieces of mugs to be sold in the store amounting to PHP1,500 on account.
3. Sold five pieces of mugs to X, PHP320 cash Answer: Cash Receipts Journal (the learner may answer Sales Journal (SJ), correct them as this transaction is a cash sale, SJ is applicable only to “on account” transactions.
4. Sold two pieces of mugs to Y, PHP112 cash
5. Purchased office supplies for cash, PHP500.
6. Paid PHP20,000 monthly rental.
7. Paid salary of staff, PHP15,000
8. Sold 100 pieces of mugs to Unicup, Inc., PHP5,600 on account
9. Sold 500 pieces of mugs to Bugsmore Corp. for PHP15,300 payable one month after delivery.
10. Purchase on account 1,000 pieces of mugs for PHP12,400

### Activity

Bring two-column and three-column worksheets. Using these columnar sheets, prepare the format of general journal, cash receipts journal, cash disbursement journal, sales journal, purchase journal, general ledger and subsidiary ledger.

### ENRICHMENT

Summarize the discussions made for Books of Accounts

1. Types of transactions recorded in the cash receipts journal:
  - cash received from a charge (on account) customer
  - cash received from a charges (on account) customer less a cash discount
  - cash sales
  - cash received from sale of other assets.
  - all other transactions that require the issuance of a Cash receipt or Official Receipt document
2. A sales journal is used when two conditions are met:
  - merchandise is sold
  - the sale is on account
3. A cash disbursements journal (cash payments journal) is used to record the following transactions:
  - purchase of merchandise for cash
  - payment to creditor, vendors or suppliers
  - all cash payments



# Business Transactions and Their Analysis as Applied to the Accounting Cycle of a Service Business

## Examples of Service Businesses

- barbershop
- offices of practicing doctors, lawyers and other professionals
- repairs of TV and other electrical equipment
- auto repair shop
- laundry shop
- dressmaker

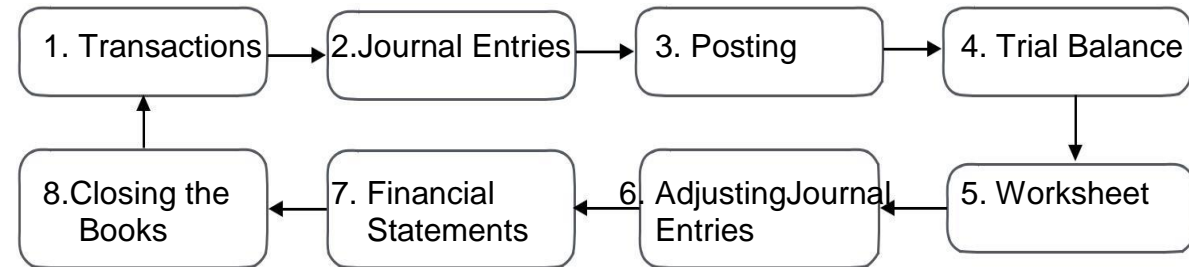
Review on five major accounts: assets, liabilities, equity (capital), income, expenses.

- Assets are resources owned by a business.
- Liabilities are claims against the assets of the business.
- Equity (capital) is the claim of the owner or owners.
- Income are increases in the equity or capital resulting from business activities entered into.
- Expenses are decreases in the equity or capital resulting from business activities. It may include assets or services consumed in the process of earning income

## Discuss the nature of a service business

A service business provides a needed service for a fee. In general, service businesses have no physical product sold to clients. Their services are designed to facilitate the work of clients and in return are paid. Service businesses include salons or barbershops, laundry services, car repairs, medical centers and services of professionals like lawyers and doctors. The revenue of a service business is usually realized once the service has been substantially completed. Aside from the minor supplies, the service business does not maintain a high level of inventory as compared to merchandising and manufacturing businesses. In relatively small service businesses, all transactions are on cash payments. This means sales are collected immediately while most expenses are paid outright in the form of cash or checks. The typical financial transactions recorded for a service company include collecting a deposit from the customer, providing the service and receiving payment.

## THE ACCOUNTING CYCLE



The accounting cycle is a continuous process of accumulating, summarizing and reporting financial information. The steps include:

### Step 1 - Transactions and/or Events

Identification and measurement of external transactions and internal events. At this stage, the documents used by the business are analyzed whether it has financial impact or effect. Recall the rule that only financial transactions are recorded and that the amount can be measured. These two conditions must exist in order that a particular transaction is recognized or recorded. As defined, financial transactions are those activities that change the value of an asset, liability or an equity.

Examples of financial transactions:



- Receipt of cash from a client as advance payment to repair a computer. In this case (asset) will increase. At the same time, the advances from client (liability) will also increase. The advances from client is a liability because the business has the obligation to render future service to the client.
- Payment of electric bill is a financial transaction. This will decrease the cash (asset) and reduce the income of the business at the same time.

Examples of non-financial transactions:

- hiring and termination of employees
- recognition from the government as most outstanding business
- death of owner

The information needed when recording transactions are taken from forms used to document these transactions. In a typical service business, the following are the business documents used:

### 1. Official Receipt or Cash Receipt

This document is used when a business receives money or a check. An Official Receipt or Cash Receipt is a document that acknowledges that money or a check have been received.

### 2. Charge Invoice or Sales Invoice

A charge invoice is a document used when a service has been rendered, but the client will be billed only after a certain number of days from the date of service. Often, a company will issue a statement of account to a customer, with the charge or sales invoice attached. For example: in a laundry business, a customer may avail of the services of the business. However, that customer and the owner of the business had a prior agreement that all services availed by the customer will be paid only after 30 days. In this case, a charge invoice is issued on the day the client availed of the services.

### 3. Check or Cash Voucher

The check voucher is a document used when a check is issued to pay a certain supplier or vendor. For example, in a laundry business, for the payment of monthly electricity bills, the business may pay either in cash or check. But the company must prepare a cash or check voucher to support this payment. This document will serve as a record of payment and, at the same time, as proof that payment has been made by the company.

## **Step 2 - Preparation of Journal Entries (journalization)**

Through the use of specialized journals (such as those for sales, purchases, cash receipts, and cash disbursements) and the general journal, transactions and events are entered into the accounting records. These are called the books of original entry.

Debits and Credits are an integral part of the journalization process. In accounting, debits or credits are abbreviated as DR and CR respectively. When to Debit and when to Credit: An increase in an asset account is called a **debit** and an increase in a liability or equity account is called a **credit**. Likewise, if we decrease an asset account we credit that account. On the other side of the equation, if we decrease a liability or equity account we debit those accounts.

Rules on Debits and Credits

- The name of the account to be debited is always listed first. The debited account is listed on the first line with the amount in the left side of the register.
- The credited account is listed on the second line and is usually indented. The credited amount is recorded on the right side of the register.
- The total amount of debit should always equal the total amount of credit.

## **Chart of Accounts**

The Chart of Accounts is a listing of all account titles used in the business to record all the transactions. It is arranged according to the order of their appearance in the financial statements.

TABLE X. SAMPLE CHART OF ACCOUNTS

ACCOUNT CODE	ACCOUNT TITLE
Statement of Financial Position Accounts	
1000	Cash
1200	Accounts Receivable
1201	Allowance for Bad Debts
1300	Inventory
1400	Prepaid Expenses
1500	Supplies
1600	Office Equipment
1601	Accum Deprn - Off Eqpt
1650	Store Equipment
1651	Accum Deprn - Store Eqpt
1680	Transportation Equipment
1681	Accum Deprn - Trans Eqpt
1750	Building
1751	Accum Deprn - Building
1800	Land
1900	Intangible Assets

2000	Accounts Payable
2100	Notes Payable
2200	Accrued Expenses
2201	Salaries Payable
2202	Utilities Payable
2300	Income Taxes Payable
3000	Owner’s, Capital
3100	Owner’s, Withdrawal

ACCOUNT CODE	ACCOUNT TITLE
<b>Income</b>	
<b>Statement Accounts</b>	
4000	Service Revenue
4100	Sales
4101	Sales Returns and Allowances
4102	Sales Discounts
4150	Interest Income
5000	Cost of Sales
5100	Purchases
5101	Purchase Returns & Allowances
5102	Purchase Discounts
5103	Freight In
6100	Salaries Expense
6150	Supplies Expense
6200	Utilities Expense
6220	Communication Expense
6250	Travel Expense

6300	Rental Expense
6350	Fuel Expenses
6400	Advertising Expense
6410	Delivery Expense
6450	Commission Expense
6500	Depreciation Expense
6600	Taxes and Licenses
6700	Interest Expense

EXAMPLE: Pedro Matapang, a computer technician. Pedro decided to open his computer repair shop on **February 14, 2016**, naming it Matapang Computer Repairs. Pedro knows that business transactions should be separated from personal finances. Thus, he decided to invest PHP200,000 in this business. He deposited the amount with Nation Bank.

Entry:

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit
2/14/16	Cash		200,000	
	Matapang, Capital			200,000
	<i>To record the initial investment of owner P. Matapang</i>			

**February 15, 2016** - Pedro purchased one computer unit from XY Computer Store to be used for the business. He issued check number 001 amounting to PHP25,000.

Entry:

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit
2/15/16	Office Equipment		25,000	
	Cash			25,000
	<i>To record the purchase of one computer unit</i>			

**February 16, 2016** - Pedro hired Juana Magaling, an experienced secretary.

Entry: No entry. This is not a financial transaction.

**February 17, 2016** – Repaired the computer of Jean and collected PHP10,000

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit
2/17/16	Cash		10,000	
	Service Revenue			10,000
	<i>To record receipt of cash from customer</i>			

**February 18, 2016** – Repaired Mike’s computer. However, Mike will pay PHP15,000 on March 18, 2016

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit
2/18/16	Accounts Receivable		15,000	
	Service Revenue			15,000
	<i>To record services rendered to a customer on account</i>			

**February 19, 2016** – Pedro purchased Office Supplies from MM Merchandise amounting to PHP5,000 on account. Pedro will pay this on March 30, 2016.

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit
2/19/16	Supplies Expense		5,000	
	Accounts Payable			5,000
	<i>To record purchase of office supplies on account</i>			

**February 25, 2016** – Paid the salary of Juana amounting to PHP4,000

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit
2/25/16	Salaries Expense		4,000	
	Cash			4,000
	<i>To record payment of salary of Juana</i>			

Step 3 – Posting

The summary (in specialized journals) or individual transactions (in the general journal) are then posted from the journals to the general ledger (and subsidiary ledgers). Nothing should ever get posted to the ledgers without first being entered in a journal.

Recall the lesson on the general ledger. We will now post the previous transactions of Pedro to the general ledger. For purposes of discussion, we will be using the three-column ledger.

General Ledger

Account: Cash				Account No.: 1000	
Date	Item	Ref	Debit	Credit	Balance
2/14/2016	Investment of Owner		200,000		200,000
2/15/2016	Purchase of Computer			25,000	175,000
2/17/2016	Repair Income - Jean		10,000		185,000
2/25/2016	Payment of Juana salary			4,000	181,000

General Ledger

Account: Accounts Receivable				Account No.: 1200	
Date	Item	Ref	Debit	Credit	Balance
2/18/2016	Repair Income - Mike		15,000		15,000

General Ledger

Account: Office Equipment				Account No.: 1600	
Date	Item	Ref	Debit	Credit	Balance
2/15/2016	Purchase of Computer		25,000		25,000

General Ledger

Account: Accounts Payable				Account No.: 2000	
Date	Item	Ref	Debit	Credit	Balance
2/19/2016	Purchase - office supplies			5,000	5,000

General Ledger

Account: Matapang Capital				Account No.: 3000	
Date	Item	Ref	Debit	Credit	Balance
2/14/2016	Investment of Owner			200,000	200,000

General Ledger

Account: Service Revenue				Account No.: 4000	
Date	Item	Ref	Debit	Credit	Balance
2/17/2016	Repair Income - Jean			10,000	10,000
2/18/2016	Repair Income - Mike			15,000	25,000

General Ledger					
Account: Supplies Expense				Account No.: 6150	
Date	Item	Ref	Debit	Credit	Balance
2/19/2016	Purchase - office supplies		5,000		5,000

General Ledger					
Account: Salaries Expense				Account No.: 6100	
Date	Item	Ref	Debit	Credit	Balance
2/2/5/16	Payment of Juana's salary		4,000		4,000

Step 4 - Unadjusted Trial Balance

At the end of an accounting period (for example, one month or one year) the working trial balance is prepared. This involves copying each account name and account balance to a worksheet (working trial balance). The resulting first two columns of the worksheet are called the unadjusted trial balance.

In the preparation of the unadjusted trial balance, the balances in all the general ledgers at the end of the reporting date are forwarded to the appropriate column. The unadjusted trial balance for the transactions in our example from Step 3 is the following:  
Notice that all asset accounts are presented first, followed by liabilities, equity (or capital account), income accounts and lastly, expenses accounts.

ENRICHMENT  
Compound Journal Entry

What has been discussed in the above illustration required the learners to prepare a simple journal entry. A simple journal entry has one account title on the debit side and one account title on the credit side. However, there are instances where in one particular transaction, two or more accounts on either the debit or credit side are affected. In this case, the business may prepare a compound journal entry.  
A compound journal entry combines one or more accounts on the debit side or the credit side.

To illustrate, assume that Jose Magalang decided to open a barbershop business in Makati City. He invested his old computer and PHP25,000 for this venture with a fair value of PHP15,000 to start the business. Notice that two account titles, Office Equipment and Cash, were debited in this entry. On September 7, 2016, Jose purchased various store equipment to be used in the business. The total cost of the equipment is PHP150,000. The supplier required Jose to pay 30% as down payment, with the balance payable 30 days after. Notice that you have two account titles, Cash and Accounts Payable, affected on the credit side.

General Journal

Date	Account Title and Explanation	Ref	Debit	Credit
2/17/16	Office Equipment		15,000	
	Cash		25,000	
	J. Magalang Capital			40,000

General Journal

Date	Account Title and Explanation	Ref	Debit	Credit
2/17/16	Store Equipment		150,000	
	Cash			45,000
	Accounts Payable			105,000

**MATAPANG COMPUTER REPAIRS**  
**Unadjusted Trial Balance**  
**February 29, 2016**

Account Title	Debit	Credit
Balance Sheet Accounts		
Cash	181,000	
Accounts Receivable	15,000	
Office Equipment	25,000	
Accounts Payable		5,000
Matapang, Capital		200,000
Income Statement Accounts		
Service Revenue		25,000
Supplies Expense	5,000	
Salaries Expense	4,000	
	230,000	230,000

**Review of the Accounting Equation**

The basic accounting equation is what drives double-entry bookkeeping. The equation reflects the accounts reported in the balance sheet. The basic accounting equation is as follows:

ASSETS = LIABILITIES + OWNERS' EQUITY

This is a very simple algebraic equation that reflects how the assets of an entity must be supported by either debt or equity. As in algebra, if we add or subtract something from one side of the equation we must add or subtract the same amount from the other side. For example, if we were to increase cash (an asset) we might have to increase note payable (a liability account) so that the basic accounting equation remains in balance.

ASSETS = LIABILITIES + OWNERS' EQUITY  
 PHP 500 = PHP 500

Applying, the formula to our transactions in Step 3 above, the effects of these transactions to the equation are shown below:

DATE	TRANSACTIONS	ASSETS	=	LIABILITIES	+	EQUITY
2/14/2016	Investment of Owner, Pedro Matapang	+200,000				+200,000
2/15/2016	Purchase of computer	+25,000 -25,000				
2/17/2016	Repair the computer of customer Jean and collected the payment	+10,000				+10,000
2/18/2016	Repair the computer of Mike on account	+15,000				+15,000
2/19/2016	Purchase of office supplies on account			+5,000		-5,000
2/25/2016	Payment of salary of Juana	-4,000				-4,000



PRACTICE **Practice Set 1**

Mr. Laban Deyro opened his laundry business in Iloilo City on January 2, 2016. The following transactions occurred during the month of January 2016:

DATE	TRANSACTIONS
1/2/16	Invested PHP500,000 to his business. The trade name of the business was "MR. LABANDERO"
1/3/16	Hired Allan and Allie who will manage his business
1/4/16	Collections from various customers for the day - PHP3,000
1/5/16	Purchase store supplies from Labada Store - PHP10,000
1/7/16	Collections from various customers for the day - PHP8,000
1/8/16	MR. LABANDERO entered into an exclusive contract with Sikat Hotel where the business will do all the laundry of the hotel.
1/9/16	Sikat Hotel availed the services of MR. LABANDERO amounting to PHP15,000. Payment will be made on January 20, 2016.
1/10/16	Collections from various customers for the day - PHP12,000
1/12/16	Purchase a washing machine amounting to PHP50,000
1/15/16	Collections from various customers for the day - PHP20,000
1/19/16	Paid electricity bill for the month amounting to PHP18,000
1/20/16	Received payment from Sikat Hotel amounting to PHP15,000
1/21/16	Paid salaries of Allan and Allie - PHP15,000
1/22/16	Mr. Laban Deyro needed money for the hospitalization of his son. He withdrew PHP18,000 from the business.
1/25/16	Paid airfare ticket of PHP1,500 for the travel of Mr. Deyro to Manila to negotiate a contract with Sosyal Hotel
1/26/16	Paid taxes to the City of Iloilo, PHP4,000
1/27/16	Purchased office supplies amounting to PHP12,500
1/28/16	Collections from various customer for the day - PHP5,000
1/29/16	Sosyal Hotel availed the services of MR. LABANDERO amounting to PHP15,000 payable on Feb 25, 2016.

**Required Tasks**

- 1. Prepare the general journal entries for the above transactions
- 2. Post the following transactions to the general ledger.

**Practice Set 2**

On June 1, Maya Cruz opened the Ganda Beauty Salon. During the first month, the following selected transactions occurred:

- 1. Deposited PHP5,000 cash in the City Bank in the name of the business
- 2. Paid PHP800 cash for beauty supplies
- 3. Purchased equipment at a cost of PHP12,000 paying PHP2,000 in cash and the balance on account
- 4. Received PHP1,200 cash for services rendered
- 5. Paid PHP500 cash as a salary to a beautician
- 6. Withdrew PHP400 cash for personal expenses

Required Task  
Using the following format, identify the effects of above transactions to the accounting equation:

ASSETS = LIABILITIES + OWNERS' EQUITY

Example:

ASSETS = LIABILITIES + OWNERS' EQUITY

+200 = + 200

**Indicate in each independent case whether the account is to be debited (DR) or to be credited (CR)**

- 1. increase in Accounts Payable
- 2. Decrease in Capital account
- 3. Increase in Service Revenue
- 4. Increase in Cash
- 5. Decrease in Accounts Receivable
- 6. Increase in Salaries Expense
- 7. Increase in Office Equipment
- 8. Increase in unpaid Salaries
- 9. Increase in Owner's drawing Account
- 10. Increase in Interest Income

# Steps 5 to 8 of the Accounting Cycle

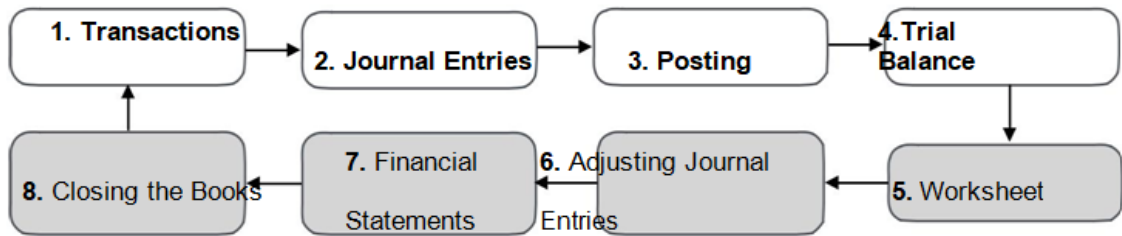
Prepare the entries to record the following independent transactions with explanations.

- On Jan 4, 2016, received PHP20,000 from a customer in payment for services rendered.
- Payment to X Supplier amounting to PHP4,000 for office supplies purchased on Jan 3, 2016.
- Maria invested PHP60,000 on Jan 18, 2016 to start a barbershop in Iligan City.
- On Jan 3, 2016 paid PHP10,000 rental amount for the month of Jan 2016,.
- On Jan 15, 2016, Peter Pawn withdrew PHP30,000 from his business to pay for the tuition of his son.
- Collected PHP20,000 of the accounts receivable from Malakas Company on Jan 17, 2016.
- Paid the salary of the office secretary amounting to PHP15,000 on Jan 18, 2016.
- Purchased office equipment worth PHP20,000 by paying 40% down payment and the balance on account.
- Paid PHP2,000 of the accounts payable on Jan 28, 2016.
- Rendered services to clients on Jan 18, 2016 amounting to PHP15,600.

Fill up the missing amount for each.

- Asset = 120,000 Liabilities = 15,000 Equity = ?
- Asset = ? Liabilities = 18,250 Equity = 98,360
- Asset = 1,000,000 Liabilities = 370,000 Equity = ?
- Asset = 780,508 Liabilities = ? Equity = 619,000

THE ACCOUNTING CYCLE



## Step 5 - Worksheet

This step is simply about plotting the items in the unadjusted trial balance on the worksheet.

In a manual accounting system, a worksheet is a large columnar sheet of paper specifically designed to conveniently arrange all the accounting information required at the end of a period. The worksheet is used to check whether ledger accounts are balanced and adjusted. The satisfactory completion of a worksheet provides assurance that all the details of the end-of-period accounting procedures were properly brought together. The worksheet serves as the source in the preparation of financial statements and other closing and adjusting entries. The body of the worksheet contains five pairs of money columns. A sample of a worksheet is shown below:

**Name of the Company**  
**Worksheet**

For the period (monthly/year) ended _____, 20__	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance		Statement of Income		Statement of Financial Position	
	DR	CR	DR	CR	DR	CR	DR	CR	DR	CR
<b>Statement of Financial Position Accounts</b>										
Cash										
Accounts Receivable										
Inventory										
Office Equipment										
Accum Depn - Off Eqpt										
Land										
Intangible Assets										
Accounts Payable										
Owner's, Capital										
Owner's, Withdrawal										
<b>Income Statement Accounts</b>										
Sales										
Sales Returns and Allowances										
Sales Discounts										
Interest Income										
Purchases										
Purchase Returns and Allowances										
Freight In										
Salaries Expense										
Supplies Expense										
Utilities Expense										

## Step 6 – Adjusting Entries

At the end of the accounting period, some accounts in the general ledger would require updating. The journal entries that bring the accounts up to date are called adjusting entries. One purpose of adjusting entries is for income and expenses to be reported in the correct period.

Adjusting entries ensure that both the revenue recognition and matching principles are followed.

Prior to your lecture, recall the previous discussion on accounting principles and concepts, specifically the matching principle.

Revenue Recognition – accounting standards require that revenue is recognized when it is earned and the amount can be measured reliably. To illustrate:

- Assume that you are preparing the financial statements for Feb 2016. Matapang Computer Repairs rendered services amounting to PHP25,000 for the repair of the computer units of Mr. Tamad on Feb 26, 2016. However, the payment for these services of Matapang will be made on Mar 15, 2016.

Question: when should you recognize the PHP25,000 as revenue or income, in February or March? Applying the revenue recognition principle, it should be reported as revenue for February 2016.

- Assume that you are preparing the financial statements for February 2016. On February 28, 2016, Matapang Repairs received payment from Mr. Tamad amounting to PHP25,000. This payment is for the repair of the computer units of Mr. Tamad on March 5, 2016.

Question: when should you recognize the PHP25,000 as revenue or income, in February or March? Applying the revenue recognition principle, it should be reported as revenue in March 2016. Take note that since the service will be rendered in March, the revenue should also be earned in March. What about February 2016? The amount is recorded as a liability because Matapang Repairs has the obligation to render this service in the future.

Matching Principle - this principle directs a business to report an expense on its income statement within the same period as its related income. To illustrate:

- Assume that you are preparing the financial statements for February 2016. The business gives a commission of 10% service income to its employees. The commission is paid the following month. On February 2016, the total service income for the month is PHP100,000. Thus, the employees are entitled to a commission of PHP10,000.

This amount will be paid on March 12, 2016. Question: when should the commission expense be recorded in the book of accounts of the business, in March or in February? Applying the matching principle, the answer is in February.

Adjusting entries are made at the end of each accounting period. Adjusting entries make it possible to report correct amounts on the statement of financial position and on the income statement. All adjusting entries affect at least one income statement account and one statement of financial position account. Thus, an adjusting entry will always involve an income or an expense account and an asset or a liability account. There are five basic sources of adjusting entries:

- Depreciation expense
- Deferred expenses or prepaid expenses
- Deferred Income or unearned income
- Accrued expenses or accrued liabilities
- Accrued income or accrued assets

#1 Depreciation. Depreciation is a method of allocating the cost of an asset to an expense over the accounting periods that make up the asset’s useful life. Examples of assets subject to depreciation are: Store, Office, Building, and Transportation equipment. These types of assets lose their ability to provide useful service as time passes. Depreciation can also be referred to as the decrease in the usefulness of these types of assets. Take note that Land is not subject to depreciation because the value of land mostly increases as time passes.

### Exercise on Adjusting entries to record Depreciation

Recall that Matapang acquired office equipment on February 15, 2016 for his repair shop business. The cost of the equipment is PHP25,000. It was estimated to have a useful life of five years. It is estimated that after five years, the office equipment can be sold at a scrap value of PHP1,000. The company uses the straight line method of depreciation.

Depreciation is a means of allocating the cost of an asset to an expense over the accounting period that will benefit the use of the asset. In the exercise above, the equipment will be used by Matapang for five years. Proper accounting procedures dictates that the cost of PHP25,000 should be spread over five years.

There are several methods or formulas to compute the amount of depreciation. The simplest is the straight line method. The formula is Annual Depreciation : ( Acquisition Cost – Salvage or Residual Value) / Useful Life. Applying this formula to the exercise:

$$\text{Annual Depreciation} = (25,000-1,000) / 5$$

$$= \text{PHP}4,800$$

If the accounting period being reported by Matapang is for the month ending February 29, 2016, the adjusting entry to record this depreciation in the books of Matapang is:

General Journal				
Date	Account Title and Explanation	Ref	Deb it	Credit
2/29/16	Depreciation Expense		200	
	Accumulated Depreciation-Office Eqpt			200

The depreciation expense of PHP200 was derived by computing the monthly depreciation of PHP400 (Annual Depreciation of PHP4,800/12 months) and multiplying the PHP400 by one-half since the equipment was acquired in the middle of February.

#2 Deferred Expenses or Prepaid Expenses. These are items that have been initially recorded as assets but are expected to become expenses over time or through the operations of the business.

Exercise - Adjusting entries to record deferred expenses or prepaid expenses

Recall that on February 19, 2016 Matapang purchased PHP5,000 worth of office supplies on account.

By the end of the month, PHP2,000 worth of these supplies are still unused.

The February 19, 2016 entry to record the purchase on the account of office supplies was already posted to the general ledger and included in the balances, as shown in the unadjusted trial balance above. The entry was shown only for illustration purposes.

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit
2/19/16	Supplies Expense		5,000	
	Accounts Payable			5,000
	To record the purchased of office supplies on account			
2/29/16	Supplies		2,000	
	Supplies Expense			2,000
	To set-up the value of unused supplies			

The “Supplies” account debited on February 29, 2016 above is an asset account and represents the value of supplies unused as of the end of February 2016. If these journal entries are posted to the general ledger, the following should be the balance of each account:

Account Title	Debit	Credit
Supplies	2,000	
Accounts Payable		5,000
Supplies Expense	3,000	

The alternative entries to record the above transactions are:

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit
2/19/16	Supplies		5,000	
	Accounts Payable			5,000
	To record the purchased of office supplies			
2/29/16	Supplies Expense		3,000	
	Supplies			3,000
	To set up the value of unused supplies			

If these entries are posted in the general ledger, the following should be the balances of each account:

Account Title	Debit	Credit
Supplies	2,000	
Accounts Payable		5,000
Supplies Expense	3,000	



Even with the different approaches in recording the transactions in the journal entries, the balances in the general ledger will always be the same whether you used the first approach or the second approach.

#3 Deferred Income or Unearned Income. These are items that have been initially recorded as liabilities but are expected to become income over time or through the operations of the business.

Exercise – Adjusting entries to record deferred or unearned income

On February 15, 2016 Matapang entered into a contract with Makisig to maintain the computers of Makisig for two months starting on February 15, 2016 up to April 15, 2016. On the same date, Makisig paid the total contract amount of PHP40,000 in full. The entries to record and adjust the books are:

In the February 29, 2016 entry above, as of end of February 2016, Matapang has already earned the service revenue for the first 15 days, thus an adjusting entry is recorded.

General Journal

Date	Account Title and Explanation	Ref	Debit	Credit
2/15/16	Cash		40,000	
	Unearned Service Revenue			40,000
	To record receipt of full payment for the two-month service contract with Makisig			
2/29/16	Unearned Service Revenue		10,000	
	Service Revenue			10,000
	To record service income earned from Feb 15-29, 2016; P40,000 x (1/2 month /2 months)			

#4 Accrued Expenses or Accrued Liabilities. These are items of expenses that have been incurred but have not been recorded and paid.

Exercise – Adjusting entries to record Accrued expenses or accrued liabilities

On February 29, 2016, Matapang received the electric bill for the month of February amounting to PHP3,800. Matapang will pay this bill on March 2016.

The electric bill represents the cost of electricity used (or incurred) for February. Although the said bill is still unpaid and thus was not recorded, the matching principle and accrual basis of accounting dictates that the same should be recorded in February. Otherwise, your expense will be understated and thus the company will be reporting an overstated income (or an erroneous income). Needless to say, erroneous information may lead to wrong decisions.

The entry to record the accrual of this expense is:

General Journal

Date	Account Title and Explanation	Ref	Debit	Credit
2/29/16	Utilities Expense		3,800	
	Utilities Payable			3,800
	To accrue the cost of electricity incurred for the month of February.			

#5 Accrued Income or Accrued Assets

These are income items that have been earned but have not been recorded and paid by the customer.

In short, these are receivables of the business.

Exercise – Adjusting entries to record accrued income or accrued assets

On February 28, 2016, Matapang repaired the computer of Pedro for PHP15,000. Pedro was on an out-of-town trip so he could not pay Matapang . He told Matapang that he will pay for their services on March 1, 2016.

Matapang has already earned the PHP15,000 but was not paid as of the end of February 2016. Therefore, an income should be properly recognized in February 2016 for this transaction. The entry to record this is:

General Journal

Date	Account Title and Explanation	Ref	Debit	Credit
2/29/16	Accounts Receivable		15,000	
	Service Income			15,000
	To accrue the cost of electricity incurred for the month of February.			

Enter all adjustments to the worksheet:  
 Matapang Computer Repairs  
 Worksheet

For the month ending February 29, 2016	Unadjusted Trial Balance		Adjustments		Adjusted Trial Balance Position	
	DR	CR	DR	CR	DR	CR
<b>Balance Sheet Accounts</b>						
Cash	221,000				221,000	
Accounts Receivable	15,000		15,000		30,000	
Supplies			2,000		2,000	
Office Equipment	25,000				25,000	
Accum. Deprn-Off Eqpt				200		200
Accounts Payable		5,000				5,000
Utilities Payable				3,800		3,800
Revenue		40,000	10,000			30,000
Matapang, Capital		200,000				200,000
<b>Income Statement Accounts</b>						
Service Revenue		25,000		25,000		50,000
Supplies Expense	5,000			2,000	3,000	
Salaries Expense	4,000				4,000	
Utilities Expense			3,800		3,800	
Depreciation Expense			200		200	
	270,000	270,000	31,000	31,000	289,000	289,000

**Step 7 - Preparation of the Financial Statements.**

Using the information from the worksheet, the financial statements are prepared.

The following are the financial statements to be prepared:

1. Statement of Financial Position (SFP) - Also known as the balance sheet. This statement includes the amounts of the company's total assets, liabilities and owner's equity which in totality provides the financial position of the company on a specific date.
2. Statement of Comprehensive Income (SCI) – Also known as the income statement. Contains the results of the company's operations for a specific period of time. This can be prepared on a monthly, quarterly or yearly basis.
3. Statement of Changes in Equity (SCE) - This statement is prepared prior to preparation of the Statement of Financial Position in order to obtain the ending balance of the equity to be used in the SFP. All changes, whether

increases or decreases to the owner's interest on the company during the period, are reported here.

4. Cash Flow Statement - Provides an analysis of inflows and/or outflows of cash from/to operating, investing and financing activities.

The income statement is prepared first so that net income can then be recorded in the statement of changes in equity. The statement of changes in equity is then prepared to determine the ending balance of equity or capital account. Once the ending balance is determined, the statement of financial position is prepared. The cash flow statement is prepared last. Based on the worksheet on the right, the income statement of Matapang for February 2016 should appear as follows:

For the month ending February 29, 2016	Adjusted Trial Balance		Income Statement	
	DR	CR	DR	CR
<b>Balance Sheet Accounts</b>				
Cash	221,000			
Accounts Receivable	30,000			
Supplies	2,000			
Office Equipment	25,000			
Accum. Deprn-Off Eqpt		200		
Accounts Payable		5,000		
Utilities Payable		3,800		
Revenue		30,000		
Matapang, Capital		200,000		
<b>Income Statement Accounts</b>				
Service Revenue		50,000		50,000
Supplies Expense	3,000		3,000	
Salaries Expense	4,000		4,000	
Utilities Expense	3,800		3,800	
Depreciation Expense	200		200	
			11,000	50,000
<b>Net Income</b>				39,000



**Matapang Computer Repairs**  
**Statement of Comprehensive**  
**Income**  
**For the month ended February 29,**  
**2016**

SERVICE REVENUE	50,000
LESS: EXPENSES	
Supplies Expense	3,000
Salaries Expense	4,000
Utilities Expense	3,800
Depreciation Expense	200
Total Expenses	11,000
<hr/>	
NET INCOME	39,000

**Step 8 - Journalize the Closing Journal Entries**

The income, expense, withdrawal (equity) accounts are called temporary accounts or nominal accounts. They are called temporary because they accumulate the transactions of only one accounting period. At the end of this accounting period, the changes in owner's equity accumulated in these temporary accounts are transferred into the owner's capital account. This process serves two purposes: (1) to update the balance of the owner's capital; and (2) it returns the balance of the temporary accounts to zero, so that they are ready to measure the income, expenses and drawings of the next accounting period again. The owner's capital account and other statement of financial position accounts are referred to as permanent or real accounts because their balances continue to exist beyond the current accounting period. Closing the books is the process of transferring the balances of the temporary accounts to the owner's permanent capital account.

The closing journal entries should consist of the following:

- All of the nominal revenue accounts should be closed to the income summary account by a Debit to revenue and a Credit to income summary.

- All of the nominal expense accounts should be closed to the income summary by a Credit to expense and a Debit to income summary.
- The balance in the income summary account should now reflect the net income for the accounting period. The next journal entry should close the income summary account to the equity or capital account. If there is a net profit this entry will be a Debit to income summary and a Credit to owner's capital account.
- Once the closing journal entries have been entered into the general journal, the information should be posted to the general ledger. When this is accomplished, all of the nominal accounts in the general ledger should have zero balances. To double check on this, we should prepare another trial balance based on the new balances in the general ledger. If we have any nominal accounts with positive balances, a mistake was made along the way and will need to be corrected before proceeding to the next accounting period.

**General Journal**

Date	Account Title and Explanation	Ref	Debit	Credit
2/29/16	Service Revenue		50,000	
	Income Summary			50,000
	To close nominal revenue accounts			
	Income Summary		11,000	
	Supplies Expense			3,000
	Salaries Expense			4,000
	Utilities Expense			3,800
	Depreciation Expense			200

After the above entries, the balance for these accounts are:

Supplies Expense		Salaries Expense		Utilities Expense		Depreciation Expense		Revenue Accounts		Income Summary	
Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
PHP3,000	PHP3,000	PHP4,000	PHP4,000	PHP3,800	PHP3,800	PHP200	PHP200	PHP50,000	PHP50,000	PHP11,000	PHP50,000
PHP 0		PHP 0		PHP 0		PHP 0		PHP 0		PHP39,000	

The ending balance of the Income Summary Account amounting to PHP39,000 credit represents the net income for the period of Matapang. The balance of the Income Summary Account is then closed to the Capital Account.

General Journal				
Date	Account Title and Explanation	Ref	Debit	Credit
	Income Summary		39,000	
	Matapang, Capital			39,000

PRACTICE (80 MIN)

Exercise 1

Spencer Company has a fiscal year-end of June 30th. The following adjusting journal entries must be prepared in order to bring the accounting records up to date for the preparation of year-end financial statements.

Interest on notes payable of PHP400 is accrued.

Fees earned but unbilled total PHP1,400.

Salaries earned by employees of PHP700 have not been recorded.  
Bad debt expense for year is PHP900.

Each adjustment is journalized (using general journal format) as follows:

General Journal				
Date	Account Title and Explanation		Debit	Credit
6/30/016	Interest expense		PHP400	
	Interest payable			PHP400
	To accrue interest on note payable through June 30, 2016			
6/30/16	Accounts receivable		PHP1,400	
	Service revenue			PHP1,400
	To record service revenue for services unbilled at year-end			

General Journal			
Date	Account Title and Explanation	Debit	Credit
6/30/16	Salaries expense	PHP700	
	Salaries payable		PHP700
	To accrue salaries through June 30, 2016.		
6/30/16	Bad debt expense	PHP900	
	Allowance for doubtful accounts		PHP900
	To record bad debt expense for the year-ended June 30, 2016.		

Exercise 2 (Depreciation)

Compute the depreciation expense for the following independent cases. Use the straight line method of depreciation.

- Pedro Reyes purchased a delivery vehicle on January 1, 2016 amounting to PHP250,000. It is estimated that the vehicle will be useful for 10 years. The vehicle can be sold for PHP10,000 at the end of its useful life. If the accounting period being reported by Pedro is one (1) year from January – December 2016, how much is the depreciation expense?
- Pedro Reyes purchased a delivery vehicle on April 1, 2016 amounting to PHP250,000. It is estimated that the vehicle will be useful for 10 years. The vehicle can be sold for PHP10,000 at the end of its useful life. If the accounting period being reported by Pedro is one (1) year from January-December 2016, how much is the depreciation expense?
- Pedro Reyes purchased a delivery vehicle on January 1, 2016 amounting to PHP250,000. It is estimated that the vehicle will be useful for 10 years. The vehicle can be sold for PHP10,000 at the end of its useful life. If the accounting period being reported by Pedro is one (1) month (January 2016), how much is the depreciation expense for the month?

Exercise 3

For each of the following items, write the journal entry first (if one is needed) to record the transactions; and then the adjusting entry, if any is required, for the

end of the accounting year of Ron Car Rental Company on December 31, 2016.

- 1. On December 1, borrowed PHP300,000 cash from Nation Bank by issuing a promissory note with an interest of 12% per annum payable in three months.
- 2. On December 1, paid rental for six months beginning December 1, 2016 to May 31, 2017, at PHP3,000 per month.
- 3. On December 31, 2016, received telephone bills for the month December amounting to PHP5,600. The bill will be paid on January 2017.

ENRICHMENT: Kay Travel was organized on September 1, 2016. Assume that the accounts are closed and financial statements are prepared each month. The company occupies rented office space but owns office equipment estimated to have a useful life of 10 years from date of acquisition, September 1, 2016. The unadjusted trial balance for Kay at November 30, 2016 is shown below

Account Title and Explanation	Unadjusted Trial Balance	
	Debit	Credit
Cash	1,750	
Accounts Receivable	1,210	
Office Equipment	4,800	
Accum. Deprn-Off Eqpt		80
Accounts Payable		1,640
Kay, Capital		7,490
Kay, Withdrawal	500	
Service Revenue		4,220
Advertising Expense	800	
Salaries Expense	3,600	
Rent Expense	770	
	13,430	13,430

Additional Information:

The rent expense amounting to PHP770 covers rental for the month of November and December 2016

Instructions:

- 1. Prepare the adjusting entries necessary for the above problem
- 2. Prepare an adjusted trial balance
- 3. Prepare an income statement ending November 30, 2016
- 4. Prepare closing entries