LIFEPAC®

Accounting

Student Book

Unit **2**

Alpha Omega Publications

ACCOUNTING LIFEPAC 2

STARTING AN ACCOUNTING SYSTEM

CONTENTS

Author: **Daniel L. Ritzman, B.S.**

Editors: Alan Christopherson, M.S.

Jennifer L. Davis, B.S.

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804 N. 2nd Ave. E., Rock Rapids, IA 51246-1759

ACCOUNTING LIFEPAC 2

STARTING AN ACCOUNTING SYSTEM

OVERVIEW

On a regular basis, detailed reports as to the financial condition of a business must be known by its owners and managers. The financial condition of any business can be found on the last line of any accounting equation. However, this is a very informal way of presenting business information. Because of rigid requirements by owners, banking institutions and government agencies, a formal system will be presented in this unit.

OBJECTIVES

When you have completed this LIFEPAC® you will be able to:

1. Define accounting terms associated with starting an accounting system.
2. Identify accounting concepts.
3. Understand the basic accounting equation.
4. Develop a formal balance sheet.
5. Prepare a beginning balance sheet.
6. Create a chart of accounts.
7. Understand the purpose of a general journal.
8. Create a general ledger.
9. Understand the purpose of a general ledger.
10. Record the opening entry.
11. Post the opening entry.

VOCABULARY

Account – a record that summarizes all the characteristics of a single item of the equation.

Account Balance – the computed balance of an account after all debits and credits have been posted.

Account Title – the name given to any account.

Asset – anything of value owned by a business.

Balance Sheet – a form that shows the financial position of a business on a specific date.

Beginning Balance Sheet – a balance sheet prepared on the day the business starts.

Basic Accounting Equation – Assets = Liabilities + Capital.

Book of Original Entry – any journal used in an accounting system.

Book of Secondary Entry – any ledger used in an accounting system.

Capital – the net worth of a business to its owner after all debts are paid.

Chart of Accounts – a list of all accounts used by an entity indicating the identifying number, the account title and classification of each accounting equation item.

Credit – refers to any entry made in the right-hand amount column of a general journal.

Creditor – anyone to whom a business owes money.

Debit – refers to any entry made in the left-hand amount column of a general journal.

Equities – claims against the business assets.

Entry – a transaction recorded in a journal.

General Ledger – contains all the accounts needed to prepare financial statements.

Journal – a business form used for recording accounting information in chronological order.

Journalizing – recording information in chronological order in the journal, using the source document as evidence of the business transaction.

Ledger – a group of accounts.

Liability – any amount of money owed to a creditor.

Liquidity – ease of converting an item to cash.

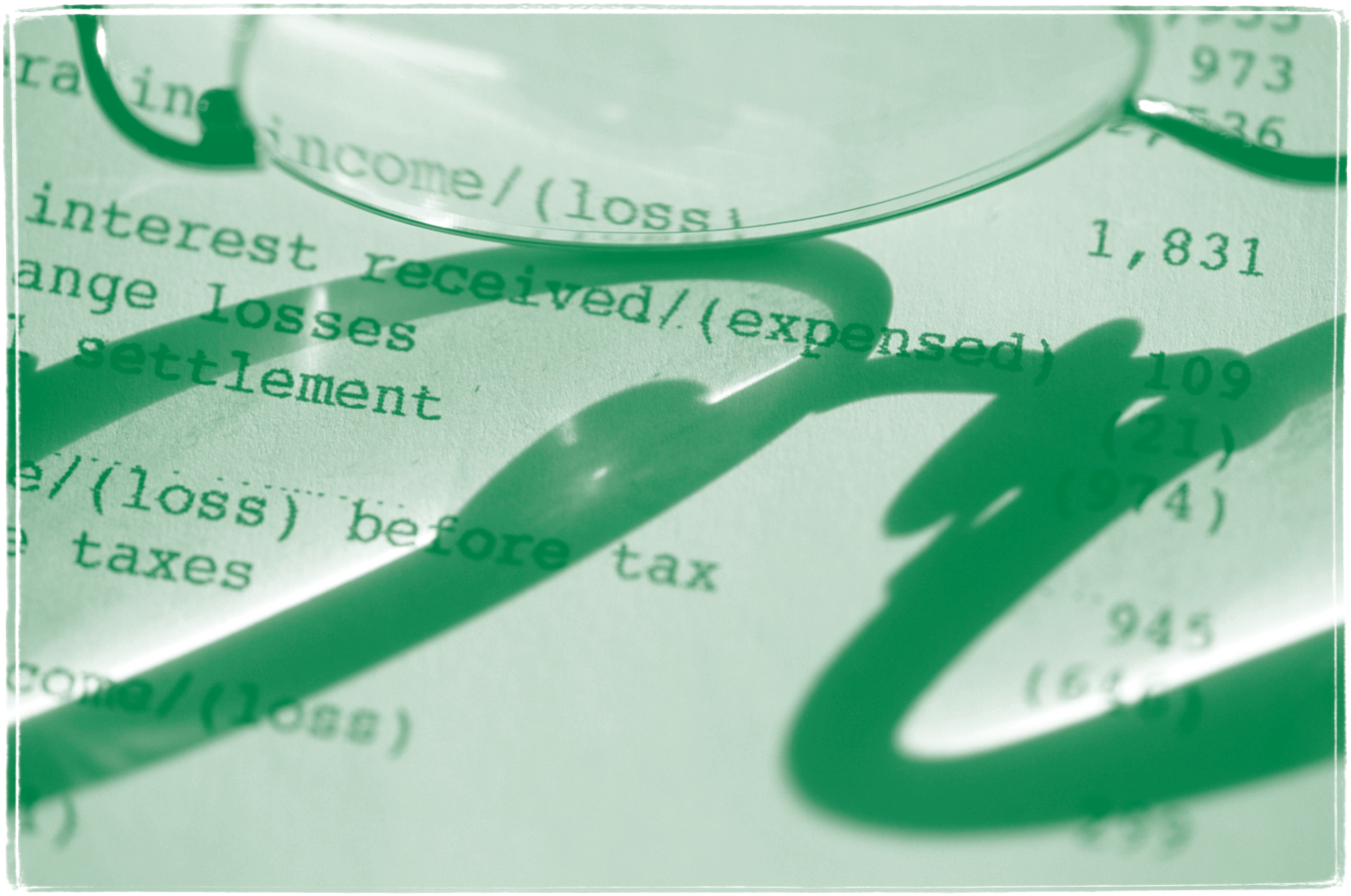
Opening an Account – writing the account name and number as the heading for the account.

Owner's Equity (Capital) – the financial interest of the owner of a business; determined by subtracting total assets from the total liabilities.

Posting – the process of transferring the information from a journal entry to the ledger accounts.

Source Document – a document that provides the necessary information to make a journal entry.

Transaction – an action that changes the value of the assets, liabilities and capital of a business entity.



SECTION I. DEVELOPING AN ACCOUNTING SYSTEM

As discussed in LIFEPAC 1, a business entity has many items of value, as well as claims against those items. The items are used to produce financial benefits to the business. One such item is an asset. An **asset** is anything of value owned or controlled by a business. Assets are valuable to a business because they are used to purchase other assets or they are used in the daily operation of the business in order to produce revenue.

Claims against assets are called **equities**. A business normally has two claims against its assets: (1) An equity is created when a business owes money. Anyone to whom a business owes money is referred to as a **creditor**. Any amount of money owed to a creditor is called a **liability**. (2) The owner's equity (**capital**) is created when the owner invests in the assets of the business. Since the owner invests in the business, he/she earns the right to decide how the assets are used. The owner's equity is found by applying the accounting equation to analyze changes that occur during daily business operations. By using the accounting equation, the owner's equity is determined by subtracting the total assets from total liabilities.

In order to explain the relationship between assets, liabilities and capital, the **basic accounting equation** was created. This equation (Assets = Liabilities + Capital) must always be in balance. That is, the totals on the left side must always equal the totals on the right side. These totals are changed by normal, day-to-day business transactions. A **transaction** changes the value of the assets, liabilities and capital of a business entity.

Every day a business will engage in hundreds of business transactions involving all types of assets, liabilities and equity. Most of these activities occur several times a day during normal business hours. Since these transactions are repetitive, they can be grouped in categories with common characteristics.

A record that summarizes all the characteristics of a single item of the accounting equation is called an **account**. The name given to any account is called an **account title**. As an example, a business will have many transactions involving the receipt or payment of cash. The bookkeeper or accountant will set up an account entitled "Cash." By doing this, the accountant, bookkeeper or owner need only look in this account to answer any questions concerning cash transactions that might arise during an accounting period. The **account balance** is determined by summarizing the changes to any single account, comparing increases and decreases and bringing forward the total debit balance or credit balance.

In LIFEPAC 1, you balanced the accounting equation every time a transaction was recorded. Preparing a new equation (A = L + C) after each transaction is cumbersome and costly, especially considering a business has a great many transactions in an accounting period. Also, information for a specific account such as cash would be lost as successive business transactions were recorded. Any information concerning an account from the accounting equation could be obtained by going back and summarizing each transaction. This would be very time-consuming and the accuracy of the results would be in question.

It is important to design a systematic method of identifying and locating each account used in the accounting equation. A list of all accounts used by an entity indicating the identifying number, the account title and classification of each account is called the **chart of accounts.**

The design of an account numbering system should provide adequate flexibility to permit expansion without having to revise the basic system. Generally, blocks of numbers are assigned to various groups of accounts such as assets, liabilities and capital.

An example of a system designed for a service business might appear as follows:

Assets accounts	110 through 199
Liability accounts	210 through 299
Capital accounts	310 through 399
Revenue accounts	410 through 499
Expense accounts	510 through 599

The first digit indicates the classification of the account and the second or third number indicates the position of that account in the category.

The chart of accounts of any entity is based on two formal reports that must be prepared at the end of every accounting cycle. These two reports are the **balance sheet** and the income statement. The balance sheet will be discussed in the next section. The income statement will be discussed in Accounting LIFEPAC 5.

Creating a Chart of Accounts

1. Use the accounting equation for the basis of the chart of accounts.

Assets	**=**	**Liabilities**	**+**	**Capital**
Left side of an equal sign		*Right side of an equal sign*		

2. Assets are listed in order of **liquidity**. Liquidity is the ease in which asset accounts can be converted to cash.
3. Liabilities are listed in alphabetical order.
4. Owner's equity is listed by investment (Capital), withdrawals (Drawing) and summary accounts.
5. Number the accounts using increments of ten (10). This allows flexibility to add accounts without revising the entire numbering system.

Listed on the following chart are the accounts used by **Pet Groomers**, a business owned by Janet Jones. The accounts are: **Cash**; **Accounts Receivable**; **Supplies**; **Prepaid Insurance**; **Equipment**; **Building**; **Accounts Payable**; **Notes Payable**; **Janet Jones Capital**; and **Janet Jones, Drawing**.

Pet Groomers
Chart of Accounts

ASSETS		LIABILITIES	
Cash	110	Accounts Payable	210
Accounts Receivable	120	Notes Payable	220
Supplies	130		
Prepaid Insurance	140	**CAPITAL**	
Equipment	150	Janet Jones, Capital	310
Building	160	Janet Jones, Drawing	320

The first digit of the account number denotes the *division* on the chart of accounts. The second digit denotes the *position* of the account in the division. For example, since we are counting in increments of 10, the number 110 represents the first account in the asset division.

Match each numbered account with the correct description.

1.1	________	Cash (110)	a. Asset section, second account
1.2	________	Accounts Receivable (120)	b. Capital section, first account
1.3	________	Supplies (130)	c. Liability section, second account
1.4	________	Prepaid Insurance (140)	d. Asset section, fourth account
1.5	________	Equipment (150)	e. Asset section, first account
1.6	________	Building (160)	f. Capital section, second account
1.7	________	Accounts Payable (210)	g. Liability section, first account
1.8	________	Notes Payable (220)	h. Asset section, third account
1.9	________	Janet Jones, Capital (310)	i. Asset section, sixth account
1.10	________	Janet Jones, Drawing (320)	j. Asset section, fifth account

Using the example on the previous page, create a chart of accounts for The Beauty Chateau.

The **Beauty Chateau** is owned by Mary Murphy. She used the following accounts: **Cash**; **Beauty Supplies**; **Prepaid Insurance**; **Shop Equipment**; **Accounts Payable**; **Notes Payable**; **Sales Tax Payable**; **Mary Murphy, Capital**; and **Mary Murphy, Drawing.**

1.11

The Beauty Chateau Chart of Accounts	
a.	f.
b.	g.
c.	h.
d.	i.
e.	
	j.
	k.
	l.

Points to Remember

1. The numbering system must be flexible.
2. Usually accounts are numbered by 10's.
3. If assets exceed nine accounts, the next asset account number to follow 190 would be 1100. It cannot be numbered 200 because that denotes the liability section.
4. The chart of accounts is designed to fit the accounting equation with assets on the left of the equal sign and liabilities and capital on the right.

Accounting Concepts

Adequate Disclosure: To provide all necessary information on the financial statements of a business so a reader can determine the financial condition of that business.

Basic Accounting Equation: The three elements of any entity are assets, liabilities and capital. The relationship between these elements is expressed by the **basic accounting equation**: Assets = Liabilities + Capital. **Assets** are resources (items owned by a business) that will be used to generate future income. **Liabilities** are debts (something owed) that will transfer assets to others. **Capital** is the net worth of a business to its owner after all debts are paid.

Business Transactions: Every time a business transaction takes place, changes are made within the accounting equation. Every business transaction changes at least two different accounts in the equation.

Going Concern: Every financial report is prepared as if the business will exist forever.

Objective Evidence: Providing a document that supports a business transaction before it is recorded in the accounting system.

Units of Measurement: Applying a value to a business transaction that is represented by a common unit of measurement. In the United States that common value is represented by dollars and cents.

Accounting Practices

Any written item is spelled out completely when space permits. You can abbreviate only if there is not enough space available to write out the entire word.

It is not necessary to use decimal points, commas, a dollar sign or a cent sign when using ruled accounting paper. Columns are usually provided on all accounting paper for the dollars and cents, separating them by lines or shading.

The zeros are written in the cents column for an even amount. Entering the zeros will eliminate confusion at a later date.

Since accounting records are permanent records, all entries should be made in ink. An erasure on an entry or financial report might give the impression that the data has been changed to hide the mishandling of funds.

To correct errors, a single line is drawn through the error and the correct amount or correct title is written above the mistake. This is done to prevent confusion later. All errors should be corrected in a manner that leaves no doubt as to what has occurred.

Accounts Receivable ~~Accounts Payable~~	

6930 ~~6390~~	00 ~~00~~

Single lines under a column of numbers are used to indicate addition or subtraction.

Double lines are used to indicate that the work is complete and accurate.

Neatness is extremely important when entering information in accounting records. Many mistakes are made when numbers are not written legibly. It is advisable to use rulers to draw lines and to use non-smear pens.

Review the material in this section in preparation for the Self Test. The Self Test will check your mastery of this particular section. The items missed on this Self Test will indicate specific areas where restudy is needed for mastery.

SELF TEST 1

Fill in the blanks (each answer, 5 points).

1.01 A record that summarizes all the changes of a single item of the accounting equation is called a/an ______________________________ .

1.02 The net worth of a business to its owner after all the debts are paid is called ______________________ .

1.03 Claims against assets are called ______________________________ .

1.04 The ease with which assets can be converted to cash is called ________________________ .

1.05 A list of accounts used by a business indicating the account number, title and classification is called a ____ .

Match the following accounting terms with their definitions (each answer, 5 points).

1.06 ________ anything of value owned by a business

1.07 ________ Assets = Liabilities + Capital

1.08 ________ denotes the division on the chart of accounts

1.09 ________ used to indicate addition or subtraction

1.010 ________ used to indicate that the work is complete and accurate

1.011 ________ denotes the position of the account within the division

1.012 ________ any amount owed

1.013 ________ financial records and reports are completed as if the business will exist forever

1.014 ________ three elements of any entity

1.015 ________ anyone to whom a business owes money

a. first digit in an account number

b. a single line

c. health, wealth, happiness

d. the Going Concern concept

e. assets, liabilities, capital

f. liability

g. assets

h. creditor

i. accounting equation

j. second and third digits in an account number

k. a double line

Answer *true* **or** *false* (each answer, 5 points).

1.016 ______________ When using ruled accounting paper, it is not necessary to use zeroes in the cents column when the amounts are even.

1.017 ______________ Providing a document that supports every business transaction is called the concept of adequate disclosure.

1.018 ______________ Neatness is extremely important when entering information in accounting records.

1.019 ______________ A double line is drawn through any error and the correct amount or correct title is written above it.

1.020 ______________ Dollar signs are not required when using ruled accounting paper.

80/100

Score ______________

Adult Check ______________
Initial Date