**CHAPTER 2**

The Accounting Information System and Financial Statements

In this chapter, we will discuss the underlying concepts behind any accounting system. We will also begin a discussion of the procedures that companies use to record information about business activities and how this information is ultimately transformed into financial statements. We will discuss the basic concepts and procedures that underlie accounting systems and how the completion of each accounting procedure moves the accounting system toward its end product—the financial statements.

**LEARNING OBJECTIVES**

**LO1. Describe the qualitative characteristics, assumptions, principles, and constraints that underlie accounting.**

* The fundamental qualitative characteristics of accounting information are:
  + Relevance—refers to whether information is capable of making a difference in the decision-making process. Relevant information is material that helps predict the future or provides feedback about prior expectations.
  + Faithful representation—refers to whether information faithfully represents the economic event it is intending to portray. Faithfully presented information should be complete, neutral, and free from error.
* The enhancing qualitative characteristics are:
  + Comparability—allows external users to identify similarities and differences between two or more items. Consistency can be achieved by a company applying the same accounting principles for the same items over time.
  + Verifiability—results when independent parties can reach a consensus on the measurement of an activity.
  + Timeliness—available to users before the information loses its ability to influence decisions.
  + Understandability—able to be comprehended (with reasonable effort) by users who have a reasonable knowledge of accounting and business.
* The four assumptions are:
  + Separate entity—each company is accounted for separately from its owners.
  + Continuity (going concern)—assumption that a company will continue to operate long enough to carry out its commitments.
  + Periodicity or time-period—allows the life of a company to be divided into artificial time periods.
  + Unit of measure or monetary unit—requires financial information to be reported in a national monetary unit.
* The three principles are:
  + Historical cost—requires a business activity to be recorded at the exchange price at the time the activity occurs.
  + Revenue recognition—requires revenue to be recognized when it is earned and cash collection is reasonably assured.
  + Full disclosure—requires that financial statements include all information required for the financial statement users to make informed decisions (e.g., notes to the financial statements).
* Constraints:
  + Cost—the benefit of users receiving information should exceed the cost of producing the information.
  + Prudence (conservatism)—assets and revenues should not be overstated and liabilities and expenses should not be understated.
* The elements of financial statements are:
  + Assets—economic resources of a business entity that are expected to provide future benefit.
  + Liabilities—existing obligations or debts of a business entity that will be satisfied by payment with assets or the provision of services.
  + Equity—capital provided to the company by its shareholders combined with undistributed earnings of the business entity.

**LO2. Explain the relationships among economic events, transactions, and the expanded basic accounting equation.**

* A company’s business activities (operating, investing, and financing) consist of many different economic events that are both external to the company and internal to the company. Accounting attempts to measure the economic effect of these events. However, not all events are recognized, or recorded, in the accounting system.
* A transaction is an economic event that is recognized in the financial statements. An accounting transaction causes the elements of the accounting equation (assets, liabilities, contributed capital, retained earnings, revenues, expenses, or dividends declared) to change in a way that maintains the equality of their relationship.

**LO3. Analyze the effect of business transactions on the basic accounting equation.**

* This is Step 1 of the accounting cycle.
* Transaction analysis is the process of determining the economic effects of a transaction on the elements of the accounting equation.
* Transaction analysis involves three steps:
  + Step 1: Write down the accounting equation (basic or expanded version).
  + Step 2: Identify the financial statement elements that are affected by the transaction.
  + Step 3: Determine whether the elements increased or decreased.
* Each transaction will have a dual effect on the accounting equation, and the accounting equation will remain in balance after the effects of the transaction are recorded.

**LO4. Discuss the role of accounts and show how debits and credits are used in the double-entry accounting system using T-accounts.**

* An account is a record of increases and decreases in each of the basic elements of the financial statements.
* Each financial statement element is made up of a number of different accounts.
* All transactions are recorded into accounts.
* The final account balance, after all changes are recorded, is used in the preparation of the financial statements.
* The left side of an account is referred to as a debit. The right side of an account is referred to as a credit.
* All accounts have a normal balance, which is a positive account balance. Assets, expenses, and dividends have a normal debit balance. Liabilities, shareholders’ equity, and revenues have a normal credit balance.
* Increases or decreases to an account are based on the normal balance of an account. Normal debit balance accounts (assets, expenses, and dividends declared) are increased with debits and decreased with credits. Normal credit balance accounts (liabilities, equity, and shareholders’ equity) are increased with credits and decreased with debits.

**LO5. Prepare journal entries for transactions.**

* This is Step 2 of the accounting cycle.
* A journal entry represents the debit and credit effects of a transaction in the accounting records.
* A journal entry is prepared by following three steps:
  + Step 1: Analyzing the transaction.
  + Step 2: Determining which accounts are affected.
  + Step 3: Using the debit and credit procedures to record the effects of the transaction.
* A journal entry is recorded in chronological order and consists of the date of the transaction, the accounts affected, the amount of the transaction, and a brief explanation.

**LO6. Explain why transactions are posted to the general ledger.**

* This is Step 3 of the accounting cycle.
* To overcome the difficulty of determining account balances listed chronologically in the journal, information in the journal is transferred to the general ledger in a process called posting.
* As a result of posting, the general ledger accumulates the effects of transactions in individual financial statement accounts.

**LO7. Prepare a trial balance and explain its purpose.**

* This is Step 4 of the accounting cycle.
* The trial balance is a list of all active accounts, in the order they appear in the ledger (assets first, followed by liabilities, shareholders’ equity, revenue, and expenses), and each account’s debit or credit balance.
* The trial balance is used to prove the equality of debits and credits and helps uncover errors in journalizing or posting transactions.
* The trial balance is a useful tool in preparing the financial statements.

**Cornerstones**

*Cornerstone 2.1 Applying the conceptual framework*

*Cornerstone 2.2 Performing transaction analysis*

*Cornerstone 2.3 Determining increases or decreases to a statement of financial position account*

*Cornerstone 2.4 Determining increases or decreases to revenues, expenses, and dividends declared*

*Cornerstone 2.5 Preparing a journal entry*

*Cornerstone 2.6 Preparing a trial balance*

**CHAPTER OUTLINE**

*Discussion Question: After students read the opening George Weston Limited scenario, ask them whether a company should maintain a single accounting system for its diversified business. Also ask them how easy or difficult it is to maintain an accounting system and what measures could be taken to keep the accounting system error free.*

1. **fundamental Accounting concepts**

Reviewing financial statements means assessing a company’s performance, cash flows, and financial position, which in turn is called the accounting cycle.

The *accounting cycle* is a simple and orderly process, based on a series of steps and conventions. Proper operation of the accounting cycle is essential in order to present the effects of a company’s activities.

***A. The Conceptual Framework***

To make it easier to use financial statements over time and across companies, a common set of rules and conventions has been developed to guide the preparation of financial statements called Generally Accepted Accounting Principles (GAAP).

GAAP rests on a conceptual framework of accounting that derives from the fundamental objective of financial reporting, which is to provide information that is useful in making business and economic decisions.

The conceptual framework is designed to support the development of accounting standards and to provide a consistent body of thought for financial reporting that will help in understanding complex accounting standards by providing a logical structure to financial accounting.

***B. Qualitative Characteristics of Useful Information***

Relevance and faithful representation (the enhancing characteristics are comparability, verifiability, timeliness, and understandability). Two pervasive constraints are cost and prudence constraints.

***C. Assumptions***

Separate entity assumption, continuity (or going concern) assumption, periodicity (or time-period) assumption, and unit of measure (or monetary unit) assumption.

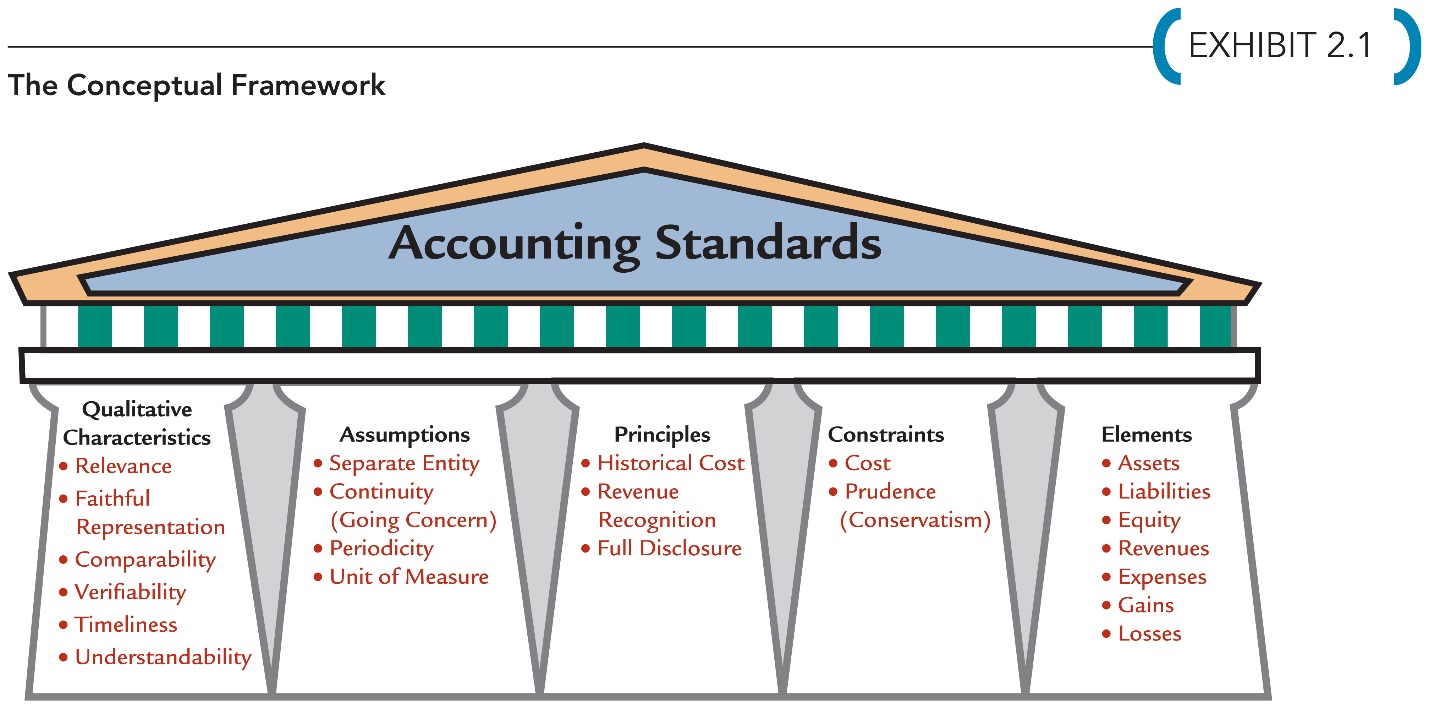
***D. Principles***

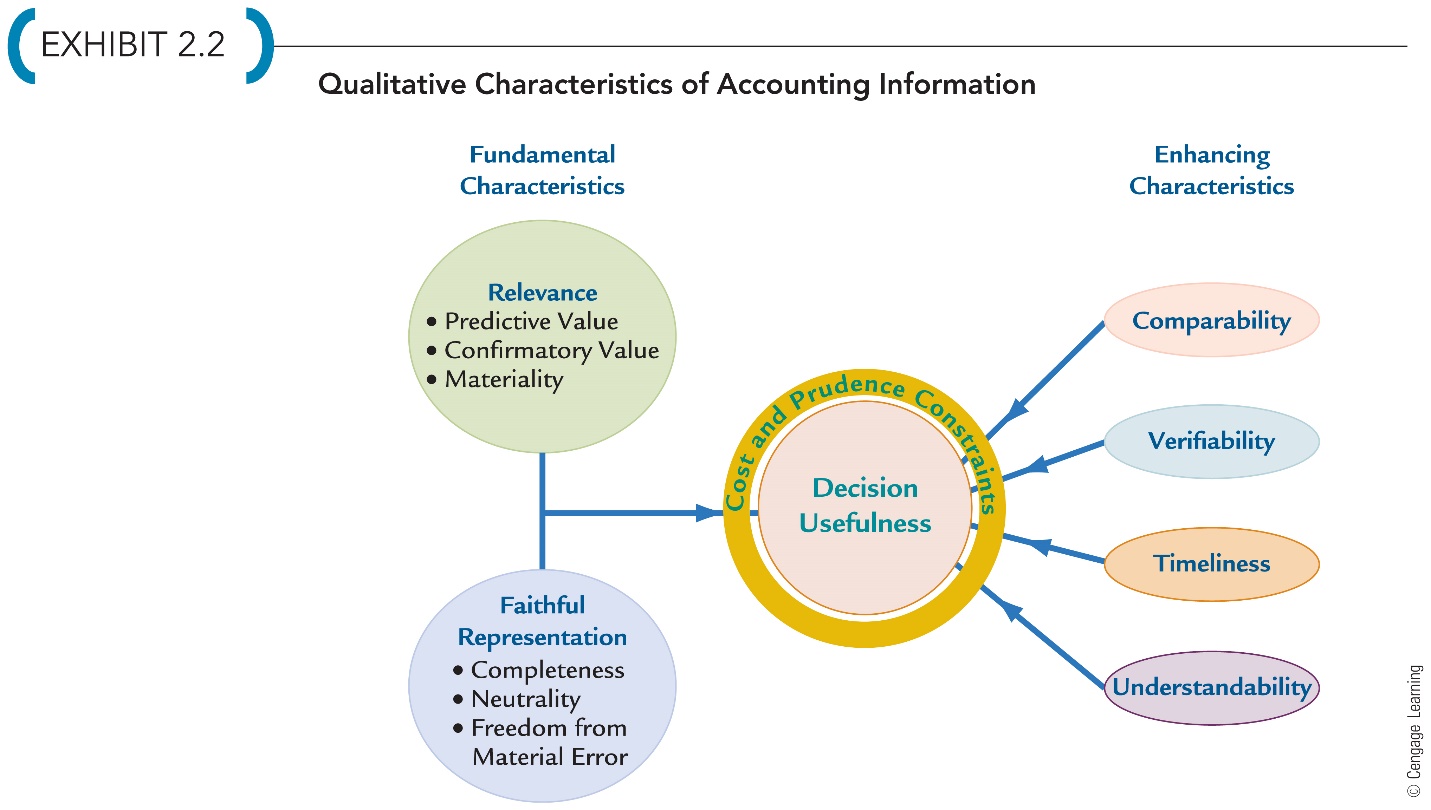
Historical cost principle, revenue recognition principle, full disclosure principle, and prudence (conservatism) principle.

***E. Elements of the Financial Statements***

* ***Assets—***Assets are economic resources of a business entity that are controlled by a business entity and are expected to provide a future benefit.
* ***Liabilities—***Liabilities are existing obligations or debts of a business entity that will be satisfied by payment with assets or the provision of services.
* ***Equity—***Shareholders’ equity in a corporation consists of the capital provided to the company by its shareholders combined with undistributed earnings of the company.

The elements of revenues, expenses, gains, and losses are discussed in Chapters 3 and 4.



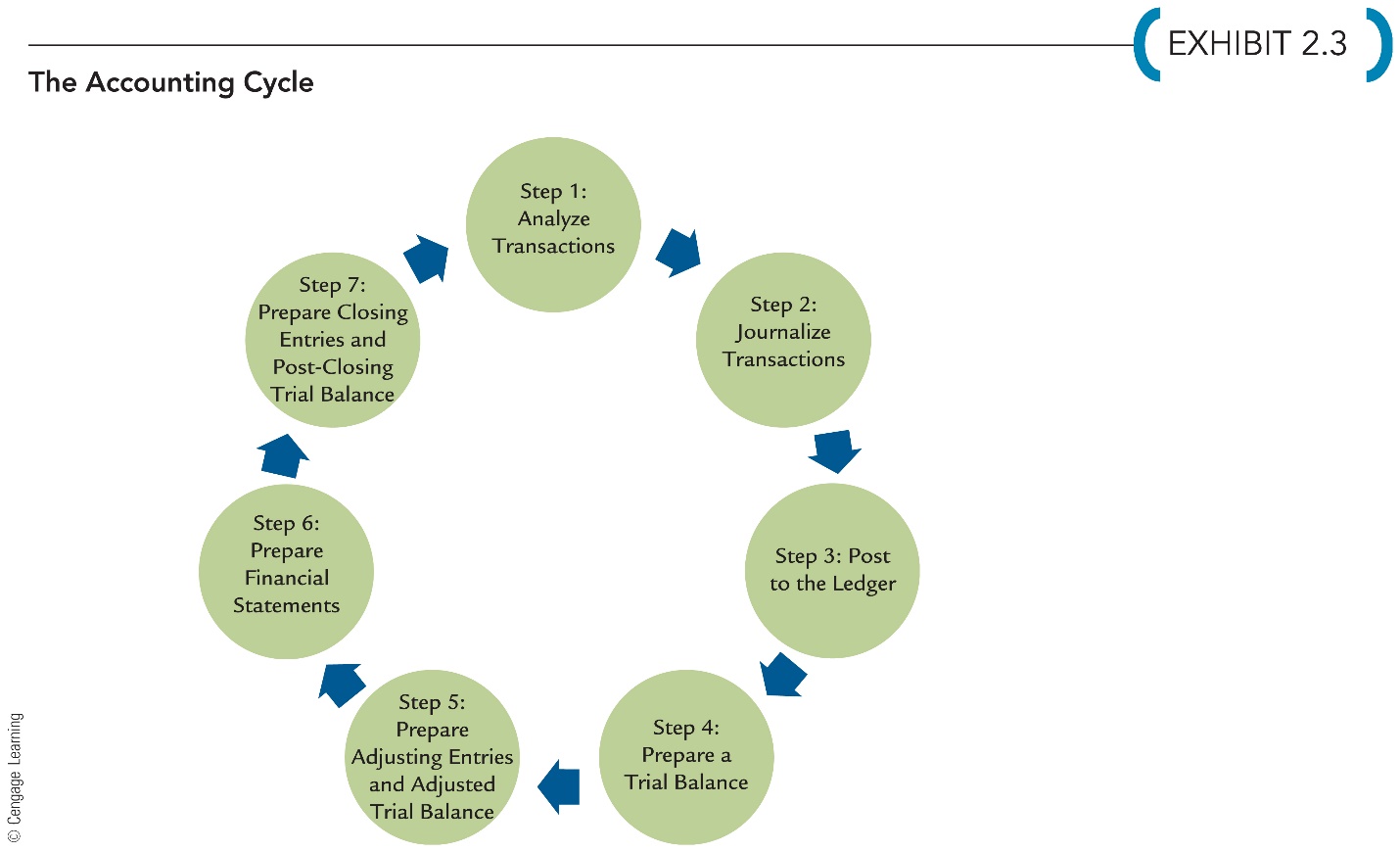
****

## Cornerstone 2.1: Applying the Conceptual Framework

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.1 in the *Cornerstones* text as an example in class.
2. Use Exercises 2-18, 2-19, 2-20, and 2-21 as demo, in-class exercises. Students can work the exercises individually or in teams.
3. Discuss Concept Q&A. Companies assume they are going concerns. Wouldn’t the valuation of a company’s assets be more relevant if this assumption were relaxed and the net assets valued at their current selling values?
4. **measuring business activities: the accounting cycle**

The accounting cycle is a sequence of procedures used by companies to transform the effects of business activities into financial statements.

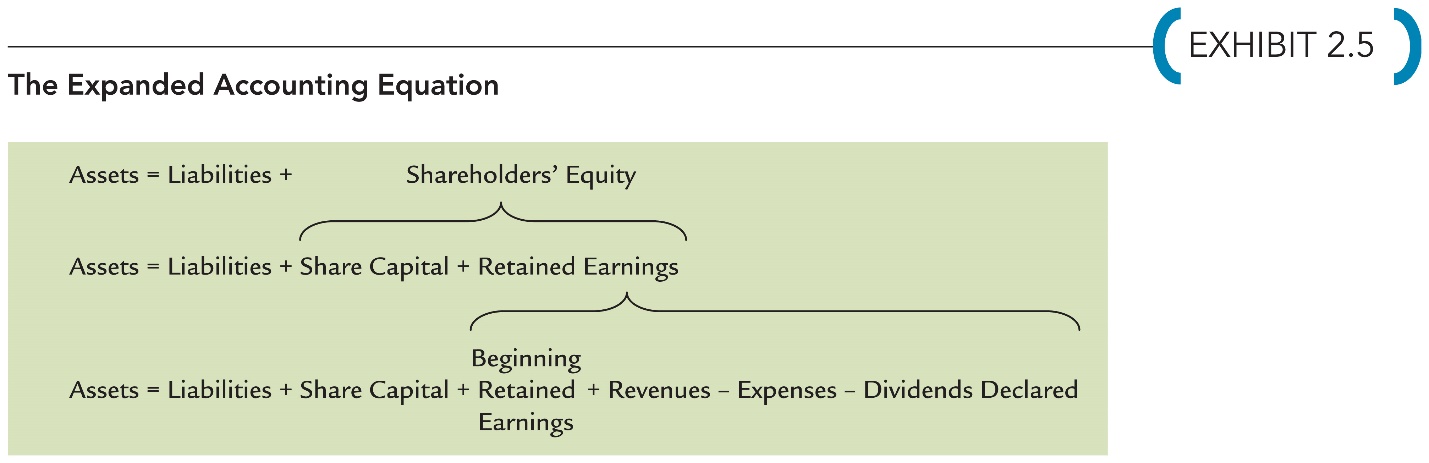


* 1. ***Economic Events***

An objective of accounting is to measure the effects of events that influence a company and incorporate these events into the accounting system and, ultimately, the financial statements. However, not every event that affects a company is recorded in the accounting records.

For an event to be recorded, or recognized, in the accounting system, the items making up the event must have an impact on a financial statement element (asset, liability, shareholders’ equity, revenue, or expense) and be a faithful representation of the event.

## The Expanded Basic Accounting Equation

****

1. **Step 1: Analyze Transactions**

Transaction analysis is the process of determining the economic effects of a transaction on the elements of the accounting equation. It usually begins with the gathering of source documents that describe business activities.

Source documents can be internally or externally prepared and include items such as purchase orders, cash register tapes, and invoices. After gathering the source documents, accountants must analyze these business activities to determine which transactions meet the criteria for recognition in the accounting records.

For a transaction to be recorded in the accounting records it must be reliably measured and must affect a financial statement element.

Two underlying principles of transaction analysis:

1. There was a dual effect on the accounting equation.

2. The accounting equation remained in balance (assets equalled liabilities plus shareholders’ equity after the transaction).

## Cornerstone 2.2: Performing Transaction Analysis

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.2 in the *Cornerstones* text as an example in class.

2. Use Exercises 2-22, 2-23, and 2-24 as demo, in-class exercises. Students can work the exercises individually or in teams.

1. **double-Entry accounting**

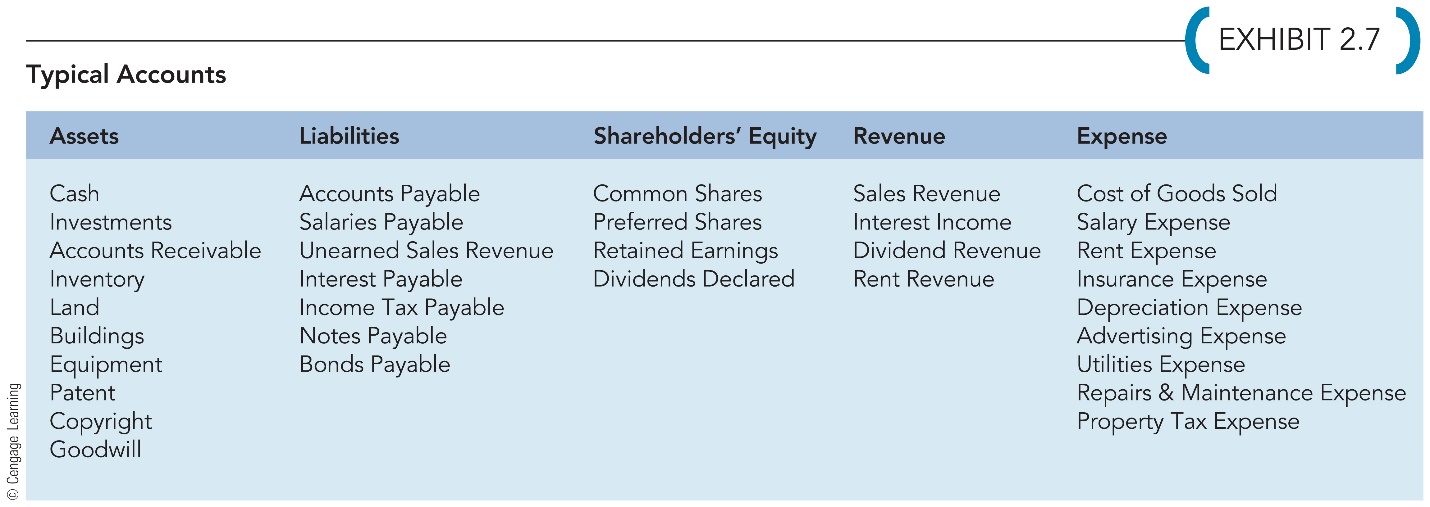
Describes the system used by companies to record the effects of transactions on the accounting equation. Effects of transactions are recorded in accounts; each transaction affects at least two accounts.

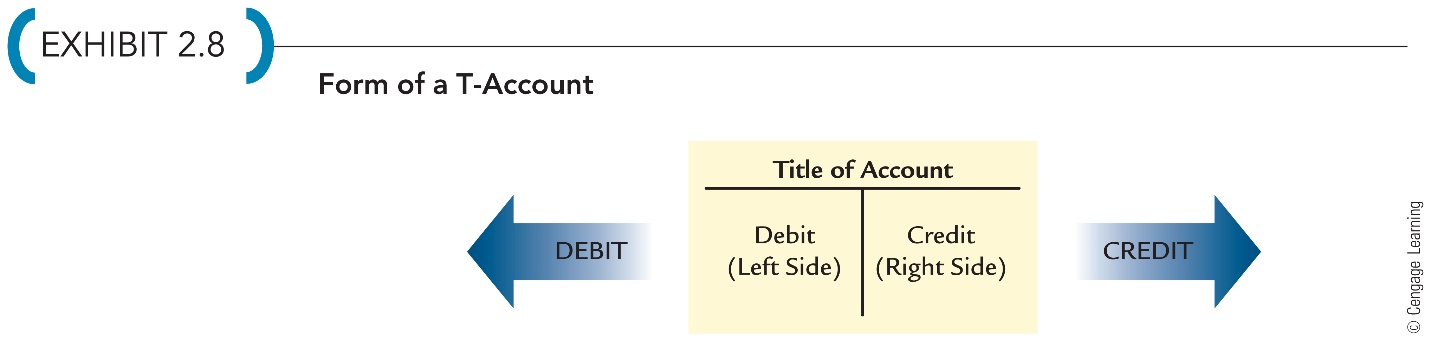
In this section, we will explore accounts and the process by which transactions get reflected in specific accounts.

***A. Accounts***

An account is a record of increases and decreases in each of the basic elements of the financial statements.

The list of accounts used by the company is termed a chart of accounts.





***B. Debit and Credit Procedures***

Using the accounting equation, we can incorporate debits and credits in order to determine how balance sheet accounts increase or decrease. This procedure is shown in Cornerstone 2.3.

## Cornerstone 2.3: Determining Increases or Decreases to a Statement of Financial Position Account

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.3 in the *Cornerstones* text as an example in class.
2. Use Exercise 2-25 as a demo, in-class exercise. Students can work the exercise individually or in teams.
3. Discuss Concept Q&A. Why must the accounting equation always remain in balance?

## Cornerstone 2.4: Determining Increases or Decreases to Revenues, Expenses, and Dividends Declared

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.4 in the *Cornerstones* text as an example in class.
2. Use Exercise 2-25 as a demo, in-class exercise. Students can work the exercise individually or in teams.
3. **Step 2: Journalize Transactions**

A journal is a chronological record showing the debit and credit effects of transactions on a company.

The process of making a journal entry is often referred to as journalizing a transaction. Because a transaction first enters the accounting records through journal entries, the journal is often referred to as the book of original entry.

A journal entry consists of three parts:

1. Date of the transaction
2. Accounts and amounts to be increased or decreased
3. A brief explanation of the transaction

## Cornerstone 2.5: Preparing a Journal Entry

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.5 in the *Cornerstones* text as an example in class.
2. Use Exercises 2-26 and 2-27 as demo, in-class exercises. Students can work the exercises individually or in teams.
3. Discuss Concept Q&A. On a bank statement, a credit to a person’s account means the account has increased. Similarly, a debit means the account has decreased. Why don’t credit and debit always mean “add” and “subtract”?
4. **Step 3: post to the ledger**

A general ledger is a collection of all the individual financial statement accounts that a company uses. In a manual accounting system, a ledger could be as simple as a notebook with a separate page for each account.

Ledger accounts are often shown using the T-account format or the column-balance format. The process of transferring the information from the journalized transaction to the general ledger is called posting.

1. **Step 4: prepare a trial balance**

To aid in the preparation of financial statements, some companies will prepare a trial balance before they prepare financial statements.

It is a list of all active accounts and each account’s debit or credit balance. The accounts are listed in the order they appear in the ledger—assets first, then liabilities, shareholders’ equity, revenues, and expenses.

It is used to prove the equality of debits and credits. If debits did not equal credits, the accountant would quickly know that an error had been made.

## Cornerstone 2.6: Preparing a Trial Balance

The Cornerstones can be implemented in your classes in several different ways:

1. Demonstrate Cornerstone 2.6 in the *Cornerstones* text as an example in class.
2. Use Exercise 2-28 as a demo, in-class exercise. Students can work the exercise individually or in teams.

## ANALYTICAL THINKING

Extra analytical thinking exercises for the chapter that may be directed to the students for discussion include the following:

* Why do we need a conceptual framework in accounting?
  + *The conceptual framework can be defined as “a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards.” It is not the rules but guidelines. The “accounting rules” are set in the accounting standards, which are formulated from the framework but take precedence over the framework when there is a conflict of interpretation. The conceptual framework also assists preparers in analyzing new transactions where there is not a particular standard to guide users on the proper treatment of the situation.*
* Define a transaction and give an example of each of the two types of events that are considered to be transactions.
  + *A transaction is an exchange or event that has a direct and measurable financial effect on the assets, liabilities, or shareholders’ equity of a business. A transaction is recorded in the accounting records of the company if it changes a financial statement element (assets, liabilities, shareholders’ equity, revenues, expenses), and if the transaction/event can be reliably measured. Transactions include two different types of events: (1) external exchanges and (2) internal events. An example of an external exchange is the sale of goods or services to customers or the purchase of goods or services from suppliers. An example of an internal event is the company using up the benefits of assets owned by the company such as equipment through the recording of depreciation.*
* What is meant by the term *double-entry accounting system*?
  + *Because there are two or more accounts affected by every transaction, the accounting system is referred to as double-entry accounting.*
* To obtain financing for her expanding massage therapy practice, Trudy asked you to prepare a statement of financial position for her business. When she sees it, she is disappointed that you did not include a value for the list of loyal, long-term, valuable, and repeat customers who use her massage therapy services regularly. She demands that you explain why this “asset” has been omitted from the statement of financial position. What should you tell her? Also, knowing this, what should she tell her banker in the meeting that they have scheduled for next week?
  + *Because the customer list was not purchased by her massage therapy (it was developed internally over many years of business operation), her massage therapy business does not report it on the statement of financial position. Knowing this, she should be sure to advise her banker that the massage therapy practice has established a loyal group of customers that holds considerable value for generating future service revenues (but is excluded from the statement of financial position for accounting reasons since it was internally generated over time and it would be difficult to obtain an objective, reliable, and verifiable value for the loyal customer list).*
* Faizon believes that the term *debit* means increase and *credit* means decrease. Is Faizon correct?
  + *In accounting terms, debit means “left” side of the T-account and credit means “right” side of the T-account. Assets and expenses have a normal debit balance, whereas liabilities, shareholders’ equity, and revenues have a normal credit balance. The accounts increase when a transaction is posted on their “normal” balance side, and decrease when a transaction is posted on the other side.*
* Mohammad was reviewing the steps in the accounting cycle and suggested eliminating the general journal and recording and summarizing transactions directly into the general ledger instead, as it seemed like a duplication of effort. Comment on this suggestion.
  + *This would not be efficient because the journal provides a record that shows both “sides” of the transaction along with a description of the transaction. This information is essential to the understanding of the transaction. Furthermore, in practice, if there is a large volume of transactions, a company will not post individual transactions to the general ledger; instead, totals of transactions will be posted as batches or groups of transactions so that the detail can only been seen in the journals.*
* If total debits do not equal total credits on the trial balance, list some of the errors that may have occurred.
  + *Some errors that may cause total debits to not equal credits on a trial balance are preparing unbalanced journal entries, posting the correct dollar amount of a transaction from the journal entry to the T-account/general ledger account, errors in calculating the ending balance in an account after posting the transactions, errors in copying the ending balance of an account from the general ledger to the trial balance, and errors in calculating the sum of total debits and total credits in the trial balance.*

## APPLICATIONS

Applications for the chapter include the following:

1. *In-Class Group Practice Tests.* See the end-of-chapter multiple-choice questions provided in the text for an in-class, group test or for use with a personal response system. With a group test, each student takes the quiz or test individually. Then ask students to break into teams of four or five to grade the test and discuss answers.
2. *End-of-Chapter Exercises, Problems, and Cases.* See the end-of-chapter exercises, problems, and cases provided in the text to further enhance the concepts demonstrated in the chapter.