**CHAPTER 2**

**REVIEW OF THE ACCOUNTING PROCESS**

**Overview**

Chapter 1 explained that the primary means of conveying financial information to investors, creditors, and other external users is through financial statements and related notes. The purpose of this chapter is to *review* the fundamental *accounting process* used to produce the financial statements. This review establishes a framework for the study of the concepts covered in intermediate accounting.

Actual accounting systems differ significantly from company to company. This chapter focuses on the many features that tend to be common to any accounting system.

**Learning Objectives**

**LO2–1** Analyze routine economic events—transactions—and record their effects on a company’s financial position using the accounting equation format.

**LO2–2** Record transactions using the general journal format.

**LO2–3** Post the effects of journal entries to general ledger accounts and prepare an unadjusted trial balance.

**LO2–4** Identify and describe the different types of adjusting journal entries.

**LO2–5** Record adjusting journal entries in general journal format, post entries, and prepare an adjusted trial balance.

**LO2–6** Describe the basic financial statements.

**LO2–7** Explain the closing process.

**LO2–8** Convert from cash basis net income to accrual basis net income.

**Lecture Outline**

**I. The Basic Model**

A. External events involve an exchange between the company and another entity; internal transactions do not involve an exchange transaction but do affect financial position.

B. The accounting equation underlies the process used to capture the effect of economic events (transactions):

**Assets = Liabilities + Owners' Equity**

C. Each transaction has a dual effect on the accounting equation.

D. Owners' equity for a corporation, called shareholders' equity, is classified *by source* as either paid-in capital or retained earnings.

E. The double-entry system is used to process transactions.

1. Elements of the accounting equation are represented by accounts in a general ledger.

2. In the double-entry system, *debit* means left side of an account, and *credit* means right side of an account.

1. Asset *increases* are entered on the *debit* side of accounts and *decreases* are entered on the *credit* side. Liability and equity account *increases* are *credits* and *decreases* are *debits*.

**II. The Accounting Processing Cycle**

A. **Step 1.** Obtain information about transactions from source documents.

B. **Step 2.** Transaction analysis is the process of reviewing source documents to determine

the dual effect on the accounting equation and the specific elements involved.

C. **Step 3.** Record the transaction in a journal. For most external transactions,

special journals (discussed in Appendix 2C) are used to capture the dual effect

of the transaction in debit/credit form.

D. **Step 4.** Post from the journal to the general ledger accounts. In addition to

general ledger control accounts, a subsidiary ledger (discussed in Appendix 2C)

contains a group of subsidiary accounts associated with particular general

ledger control accounts.

E. **Step 5.** Prepare an unadjusted trial balance. A worksheet (discussed in

Appendix 2A) can be used as a tool after and instead of step 5 in the

processing cycle.

**III. Adjusting Entries**

A. **Step 6.** Record adjusting entries and post to the ledger accounts.

B. Prepayments are transactions in which the cash flow *precedes* expense of revenue recognition.

1. **Prepaid expenses** represent assets recorded when a cash disbursement creates benefits beyond the current reporting period.

2. **Deferred revenues** represent liabilities recorded when cash is received from customers in advance of providing a good or service.

C. Accruals involve transactions where the cash outflow or inflow takes place in a period subsequent to expense or revenue recognition.

1. **Accrued liabilities** represent liabilities recorded when an expense has been incurred prior to cash payment.

2. **Accrued receivables** involve situations when the revenue is recognized in a period prior to the cash receipt.

D. Estimates often are made to comply with the accrual accounting model.

1. Most estimates involve either prepayments or accruals.

2. One situation involving an estimate that does not fit neatly into either the prepayment or accrual classification is accounting for bad debts.

E. **Step 7.** Preparation of an adjusted trial balance.

F. Accountants sometimes use reversing entries (discussed in Appendix 2B) in conjunction with adjusting entries.

**IV. Step 8. Prepare Financial Statements**

1. The income statement

B. The statement of comprehensive income

C. The balance sheet

D. The statement of cash flows

E. The statement of shareholders' equity

**V. Step 9. Close the Temporary Accounts**

A. Close the revenue accounts to income summary.

B. Close the expense accounts to income summary.

C. Close the income summary account to retained earnings.

D. **Step 10.** Prepare a post-closing trial balance.

**VI. Conversion from Cash Basis to Accrual Basis**

A. Add (deduct) increases (decreases) in assets. For example, an increase in accounts receivable means that the company recognized more revenue than cash collected.

B. Add (deduct) decreases (increases) in accrued liabilities. For example, a decrease in interest payable means that the company incurred less interest expense than the cash interest paid, requiring the addition to cash basis-income.

**PowerPoint Slides**

Three PowerPoint presentations of the chapter are available in the Connect Library:

1. With “Concept Checks” useful for classroom presentation, permitting the instructor to intersperse in the presentation short exercises students can be asked to solve individually or in small groups before the solution is “revealed” by the instructor. {These are available only within Instructor Resources.}

2. Without the “Concept Checks” so students don’t have the solutions before being asked to solve individually or in small groups.

3. **Accessible PowerPoint Presentations.** Accessibility is becoming even more important in the education marketplace. Students and instructors with disabilities use many different assistive technologies, and McGraw-Hill Education is working to increase compatibility and access that will not only help those with disabilities achieve better learning outcomes, but also serve the institutions that are teaching these students. Accessible PowerPoint allows slide content to be read by a screen reader and provides alternative text descriptions for any image files used that enrich the learning experience. Accessible PowerPoint is also designed with high-contrast color palettes and uses texture when possible, instead of color to denote different aspects of the imagery used within the slide.

**Note:** The slides are intended to provide comprehensive coverage of the chapter, but they can be easily edited to allow instructors to change numbers and content in illustrations or to delete slides pertaining to topics they choose to omit or deemphasize. (Using your students’ names for company names in the Concept Checks or Illustrations can be fun.)

**Suggestions for Class Activities**

**1. Spreadsheet Activities**

In addition to Exercise 2–20 and Problem 2–13, the requirements for Problems 2–2, 2–4, 2–6, 2–8, and 2–10 can be modified to include the use of software such as Excel.

**2. Professional Skills Development Activities**

The following are suggested assignments from the end-of-chapter material that will help your students develop their communication, analysis and judgment skills.

**Communication Skills.** In addition to Communication Case 2–3, Judgment Cases 2–1 and 2–2 can be adapted to ask students to write a memo. These Judgment Cases also do well as group assignments and create good class discussions.

**Analysis Skills.** The “Broaden Your Perspective” section includes Analysis Cases that direct students to gather, assemble, organize, process, or interpret data to provide options for making business and investment decisions. Exercises 2–15, 2–18 and Problems 2–7, 2–9 provide opportunities to develop and sharpen analytical skills.

**Judgment Skills.** The “Broaden Your Perspective” section includes Judgment Cases that require students to critically analyze issues to apply concepts learned to business situations in order to evaluate options for decision-making and provide an appropriate conclusion. This chapter includes Judgment Cases 2–1 and 2–2.

**Assignment Chart**

**Learning Est. time  
 Questions Objective(s) Topic (min.)**

|  |  |  |  |
| --- | --- | --- | --- |
| 2–1 | 1 | External and internal events | 5 |
| 2–2 | 1 | Dual effect of transactions on financial position | 5 |
| 2–3 | 2,3 | Purpose of journal and ledger | 5 |
| 2–4 | 3 | Permanent and temporary accounts | 5 |
| 2–5 | 2,3 | Debits and credits | 5 |
| 2–6 | 2,3 | Debits and credits | 5 |
| 2–7 | 1,2,3 | Accounting processing cycle | 5 |
| 2–8 | 1,2,3 | Transaction analysis | 5 |
| 2–9 | 3 | Posting | 5 |
| 2–10 | 2 | Journal entries | 5 |
| 2–11 | 3,5 | Trial balance | 5 |
| 2–12 | 4 | Adjusting entries | 5 |
| 2–13 | 7 | Closing entries | 5 |
| 2–14 | 4 | Adjusting entries—prepaid expenses | 5 |
| 2–15 | 4 | Adjusting entries—deferred revenue | 5 |
| 2–16 | 4 | Adjusting entries—accrued liabilities | 5 |
| 2–17 | 6 | Financial statements | 5 |
| 2–18 | A | Worksheet [Based on Appendix 2A] | 5 |
| 2–19 | B | Reversing entries [Based on Appendix 2B] | 5 |
| 2–20 | C | Special journals [Based on Appendix 2C] | 5 |
| 2–21 | C | Subsidiary ledger [Based on Appendix 2C] | 5 |

**Brief Learning Est. time  
 Exercises Objective(s) Topic (min.)**

|  |  |  |  |
| --- | --- | --- | --- |
| 2–1 | 1 | Transaction analysis | 10 |
| 2–2 | 2 | Journal entries | 10 |
| 2–3 | 3 | T-accounts | 15 |
| 2–4 | 2 | Journal entries | 15 |
| 2–5 | 5 | Adjusting entries | 15 |
| 2–6 | 4,5 | Adjusting entries; income determination | 15 |
| 2–7 | 5 | Adjusting entries | 15 |
| 2–8 | 4 | Income determination | 15 |
| 2–9 | 5 | Adjusting entries | 10 |
| 2–10 | 6 | Financial statements | 10 |
| 2–11 | 6 | Financial statements | 10 |
| 2–12 | 7 | Closing entries | 10 |
| 2–13 | 8 | Cash versus accrual accounting | 15 |

**Learning Est. time  
 Exercises Objective(s) Topic (min.)**

|  |  |  |  |
| --- | --- | --- | --- |
| 2–1 | 1 | Transaction analysis | 15 |
| 2–2 | 2 | Journal entries | 15 |
| 2–3 | 3 | T-accounts and trial balance | 15 |
| 2–4 | 2 | Journal entries | 20 |
| 2–5 | 2,3,4,5,6,7 | The accounting processing cycle | 15 |
| 2–6 | 2 | Debits and credits | 15 |
| 2–7 | 2 | Transaction analysis; debits and credits | 15 |
| 2–8 | 5 | Adjusting entries | 15 |
| 2–9 | 5 | Adjusting entries | 15 |
| 2–10 | 4,5 | Adjusting entries; solving for unknowns | 15 |
| 2–11 | 5 | Adjusting entries | 15 |
| 2–12 | 6,7 | Financial statements and closing entries | 20 |
| 2–13 | 7 | Closing entries | 10 |
| 2–14 | 7 | Closing entries | 10 |
| 2–15 | 4,5,8 | Cash versus accrual accounting; adjusting entries | 15 |
| 2–16 | 2,5 | External transactions and adjusting entries | 15 |
| 2–17 | 4,8 | Accrual accounting income determination | 15 |
| 2–18 | 8 | Cash versus accrual accounting | 20 |
| 2–19 | 8 | Cash versus accrual accounting | 20 |
| 2–20 | A | Worksheet [Based on Appendix 2A] | 35 |
| 2–21 | B | Reversing entries [Based on Appendix 2B] | 10 |
| 2–22 | B | Reversing entries [Based on Appendix 2B] | 10 |
| 2–23 | B | Reversing entries [Based on Appendix 2B] | 10 |
| 2–24 | C | Special journals [Based on Appendix 2C] | 15 |
| 2–25 | C | Special journals [Based on Appendix 2C] | 15 |

**Learning Est. time  
 Problems Objective(s) Topic (min.)**

|  |  |  |  |
| --- | --- | --- | --- |
| 2–1 | 2,3 | Accounting cycle through unadjusted trial balance | 40 |
| 2–2 | 2,3 | Accounting cycle through unadjusted trial balance | 40 |
| 2–3 | 5 | Adjusting entries | 20 |
| 2–4 | 3,5,6,7 | Accounting cycle; adjusting entries through post-closing trial balance | 60 |
| 2–5 | 5 | Adjusting entries | 20 |
| ✯ 2–6 | 2,3,4,5,6,7 | Accounting cycle | 75 |
| 2–7 | 2,5 | Adjusting entries and income effects | 20 |
| 2–8 | 5 | Adjusting entries | 20 |
| 2–9 | 3,5,7 | Accounting cycle; unadjusted trial balance through closing | 45 |
| ✯ 2–10 | 4,6,8 | Accrual accounting; financial statements | 30 |
| 2–11 | 8 | Cash versus accrual accounting | 15 |
| ✯ 2–12 | 8 | Cash versus accrual accounting | 40 |
| 2–13 | A | Worksheet [Based on Appendix 2A] | 40 |

✯ Star Problems

**Learning Est. time  
 Cases Objective(s) Topic (min.)**

|  |  |  |  |
| --- | --- | --- | --- |
| Judgment Case 2–1 | 4,8 | Cash versus accrual accounting; adjusting entries | 20 |
| Judgment Case 2–2 | 8 | Cash versus accrual accounting | 30 |
| Communication Case 2–3 | 4 | Adjusting entries | 20 |
| **Target Case** | 4,6 | Target | 30 |
| **Air France–KLM Case** | 9 | IFRS; Air France–KLM | 30 |