

REVIEW SESSION – TEST #1

- Test #1 covers the following chapters: 1 – *Introducing Accounting in Business*; 2 – *Analyzing and Recording Transactions*; and 3 – *Adjusting Accounts, Financial Statements*. There are 37 true/false and multiple-choice questions.
- The test must be taken online through Homework Manager any time between Wednesday, October 15, and Sunday Midnight, October 19.
- This is a timed test. You will have 75 minutes to complete the test.

GENERAL STUDY TIPS –

1. Review the information for MODULE 1 on the Franklin ACCT 215 course web site. Focus on each of the fifteen Learning Outcomes listed for Module 1 to be sure you know how to do what the Learning Outcome says.
2. The wording on the exam is identical to that found in your textbook, so be familiar with “the language” of accounting.
3. All of the questions relate to key terminology, concepts, processes, and calculations covered in the textbook. One of the best items to focus on is the assigned exercises and problems for chapters 1, 2, and 3.
4. Questions tend to stress application and analysis, using the knowledge you have learned to apply to a given situation.
5. On a multiple-choice question, read the last sentence first so you know what the question is asking. That will help you pinpoint the information you need from the question to determine the answer (Sometimes, you will be given more information than necessary to answer the question).
6. On true-false questions, beware of statements which include “always” or “never”. There is usually an exception.
7. If you’re just not sure about an answer, GUESS, and remember: your first guess is usually your best one.
8. Answer all questions. Unanswered questions are graded “0” points.
9. You are asked to take the test “on your honor”, without notes or looking at the text. If you take time to look at notes or the textbook, you probably won’t have enough time to complete the exam.

CHAPTER REVIEW –

CH. 1. INTRODUCING ACCOUNTING IN BUSINESS

Managers need information to decide [1] how they will operate the business, [2] what kinds of investments to make, and [3] how to finance those investments. Investor-owners need information to help them make wise decisions about which investments to make. This chapter focuses on accounting terminology and the importance of the basic accounting equation.

[1]. – Use accounting vocabulary for decision making.

→ *Learning accounting is like learning a foreign language. It has its own vocabulary and specific ways to communicate information. Understanding **how accountants record, analyze, and report information** will help you understand the significance of that information better.*

Accounting information is used by: individuals, managers, investors, creditors, government, others

Information is classified into two general categories:

1. **FINANCIAL ACCOUNTING (external users – ACCT 215)**
2. **MANAGERIAL ACCOUNTING (internal users – ACCT 225)**

Types of business organizations. What are the characteristics of each?

1. **PROPRIETORSHIP**
2. **PARTNERSHIP**
3. **CORPORATION**

Importance of ethics. AICPA Code of Professional Conduct.

<http://www.aicpa.org/About/code/index.html>

[2]. – Analyze a business activity using accounting concepts and principles.

1. GAAP – Guidelines for measuring processing, and communicating financial information.
2. Primary objective of financial reporting: Provide information useful for making investment and lending decisions. Useful information is **RELEVANT, RELIABLE, and COMPARABLE**.
3. *Some accounting principles:*
 - ENTITY CONCEPT
 - RELIABILITY (OBJECTIVITY) PRINCIPLE
 - COST PRINCIPLE
 - GOING-CONCERN CONCEPT
 - STABLE-MONETARY-UNIT CONCEPT
 - REVENUE RECOGNITION PRINCIPLE (Ch. 3)
 - EXPENSE MATCHING PRINCIPLE (Ch. 3)

Review and answer questions about any of the assigned exercises and problems: E1-9, E1-10, P1-7A.

CH. 2 ANALYZING AND RECORDING TRANSACTIONS

Now we focus on the accounting process: how accountants analyze and record transactions, using proper accounting procedures. Be sure you understand the rules of Debiting and Crediting. Following those rules is critical to doing accounting correctly and accurately.

[1]. – Explain the steps in processing transactions.

→ A transaction is a record of a financial event in the organization. Every transaction affects the balance sheet equation, in a way that keeps it in balance. Every transaction affects at least TWO accounts.

Steps in the accounting process:

- [1] **Analyze:** “Is it a transaction? (Measure in terms of money? Affect the balance sheet equation?) If “yes” to both, record it.
- [2] **Record in general journal** – the “book of original entry”, in chronological order. Every transaction must have at least two accounts. Total Debits must equal total Credits.
- [3] **Post to ledger accounts** – Transfer Debit or Credit amounts from the journal entry to the proper ledger record, update the Debit or Credit balance of each account.
- [4] **Prepare a trial balance** – a listing of the Debit OR Credit balances in each of the General Ledger accounts. Total Debits should equal total Credits. Used to prove the equality of Debit and Credit entries in the accounting system. Does not necessarily guarantee everything was done correctly.

Note that transactions are first recorded in the General Journal, the book of original entry.

[2]. – Describe source documents and their purpose.

SOURCE DOCUMENTS identify and describe transactions: sales tickets, purchase orders, supplier bills, employee earnings records, bank statements.

[3]. – Describe an account and its use in recording transactions.

An **ACCOUNT** is a record of increases and decreases in a specific asset, liability, equity, revenue, or expense item.

ASSET (resources) – Cash, A.R., N.R., Prepaid items, Supplies, Inventory, Equipment, Land, Buildings.

LIABILITY (owed to creditors) – A.P., N.P., other payables, Unearned Revenue, Bonds Payable, Long-term Debt.

EQUITY (owners’ residual interest) – Common Stock, Retained Earnings, *Dividends, Revenues, Expenses (subsidiary accounts)*

- *Permanent (balance sheet) accounts: Assets, Liabilities, Owners' Equity*
- *Nominal (temporary) accounts: Revenues, Expenses, Dividends (all subsidiary accounts of Retained Earnings)*

[4]. – Describe a ledger and the chart of accounts.

LEDGER – the collection of all accounts in a firm's accounting system.

CHART OF ACCOUNTS – numerical listing of all accounts in an accounting system.

[5]. – Define debits and credits and explain their role in double-entry accounting.

1. *T-ACCOUNT – used for instructional purposes to represent an account.*
2. DEBIT – entry on the LEFT SIDE of an account
3. CREDIT – entry on the RIGHT SIDE of an account
4. DOUBLE-ENTRY ACCOUNTING – first introduced in 1494 by Fra Luca Pacioli:
For every transaction, the amount is entered twice, one on the left side of an account, and one on the right side of another account. This provides a built-in check-and-balance.

MEMORIZE:

Accounts increased by Debits (LEFT)

ASSETS
EXPENSES
DIVIDENDS

Accounts increased by Credits (RIGHT)

LIABILITIES
OWNERS' EQUITY
REVENUES

[6]. – Record transactions in a journal and post entries to a ledger.

1. Proper form of a journal entry.
2. **POSTING** – transferring individual amounts in a journal entry to debit or credit column in the specific ledger accounts.
3. **BALANCING INDIVIDUAL LEDGER ACCOUNTS:** [1] add amounts in Debit and Credit columns, put at bottom, [2] calculate difference between Debit and Credit totals, [3] put difference on the side with the larger amount; this is the balance of the account.
4. **NORMAL BALANCE** = the side of the account where there is usually a balance (the side in which the account is increased):
 - a. **Debit (LEFT SIDE) – Assets, Expenses, Dividends**
 - b. **Credit (RIGHT SIDE) – Liabilities, Equities, Revenues**

[7]. – Prepare and explain the use of a trial balance.

1. **A TRIAL BALANCE is a listing of all accounts and their Debit OR Credit balances, in numerical order.**
2. Total Debits must equal total Credits, which indicates the accounting system is in balance.
3. It does NOT guarantee that everything has been recorded correctly.
4. **A trial balance is used by accountants at the end of an accounting period to check the equality of debit and credit amounts.**

5. Errors should be corrected with a correcting entry.

[8]. – Prepare financial statements from business transactions.

All of the financial information on the trial balance is used to prepare financial statements, in this order:

1. Income Statement
2. Statement of Retained Earnings
3. Balance Sheet

Proper accounting form of statements.

[9]. Performance measure:

Debt Ratio = Total Liabilities / Total Assets

SOLVENCY RATIO: Measures the relationship (%) between the firm's total obligations to its creditors and the total resources of the firm.

Review end-of-chapter Discussion Questions, pg. 73: 1, 2, 7, 8, 10, 11, 13, 15.

Review and answer questions about any of the assigned exercises and problems: E2-4, E2-5, P2-3A.

RULES OF DEBITING AND CREDITING

→ It is a good idea to memorize this page:

Every accounting transaction affects the balance sheet equation, and it affects it in a way that keeps the equation always in balance.

Luca Pacioli's system of double-entry bookkeeping arranged accounts so that the dual-aspect present in every accounting transaction would be expressed by a debit (left side) amount and an equal and offsetting credit (right side) amount. Using the balance sheet equation,

$$\text{ASSETS} = \text{LIABILITIES} + \text{OWNERS' EQUITY}$$

He decided that, since assets were on the left side of the equation, they would be *increased* by an entry on the left side of an account, which meant that assets would be *decreased* by an entry on the right side. Liabilities and equities, on the right side of the equation, would be *increased* by an entry on the right side of an account and *decreased* by an entry on the left side.

Assets, Liabilities, and Equity accounts are the three *permanent*, or balance-sheet, accounts. The three *temporary*, or nominal, accounts are Revenues, Expenses, and Dividends. Since revenues increase owners' equity, a revenue account would be increased with an entry on the *right* side and decreased with an entry on the left side of the account. Expenses and dividends decrease owners' equity, so their entries would be the opposite: expenses and dividends are increased by an entry on the *left* side of an account and decreased with an entry on the right side.

+		-		-		+
	ASSETS				LIABILITIES	
	EXPENSES				OWNERS' EQUITY	
	DIVIDENDS				REVENUES	

(Increased by LEFT SIDE entry,
Decreased by RIGHT SIDE entry)

(Increased by RIGHT SIDE entry,
Decreased by LEFT SIDE entry)

- **THERE ARE ONLY SIX (6) TYPES OF ACCOUNTS IN ANY ACCOUNTING SYSTEM.**
- **THREE OF THEM (ASSETS, EXPENSES, DIVIDENDS) ARE INCREASED BY A LEFT SIDE (DEBIT) ENTRY.**
- **THREE OF THEM (LIABILITIES, OWNERS' EQUITY, REVENUES) ARE INCREASED BY A RIGHT SIDE (CREDIT) ENTRY.**
- **The NORMAL BALANCE of an account is the side where INCREASES are made.**

CH. 3 – ADJUSTING ACCOUNTS AND PREPARING FINANCIAL STATEMENTS

The purpose of adjusting accounts at the end of an accounting period is to make sure [1] the income statement correctly reflects the amount of revenues and expenses during the period, and [2] the balance sheet correctly reflects the resources and obligations of the firm at the end of the period.

[1]. – Explain the importance of periodic reporting and the time period principle.

The **time-period principle** assumes a firm's activities can be divided into specific time periods (month, quarter, year) for purposes of reporting revenues, expenses, and net income. Annual financial statements cover a **fiscal year**; shorter periods have interim financial statements.

A Fiscal year can be any 12-month period, usually begins and ends at a low level of activity.

[2]. – Explain accrual accounting and how it improves financial statements.

- **Cash basis** (personal finances) does not always give a good measure of net income in a particular time period because of timing of cash flows.
- **Accrual basis** matches expenses incurred in the process of earning revenue with the revenue earned during a period, *regardless of when cash comes in or goes out*.
Adjusting entries are needed to insure the income statement includes all revenues and expenses for the period, and that the balance sheet correctly reflects the firm's resources (assets) and obligations (liabilities) at the end of the period.
- **The two accounting principles for accrual accounting:**
 - REVENUE RECOGNITION PRINCIPLE
 - EXPENSE MATCHING PRINCIPLE

[3]. – Identify the types of adjustments and their purpose.

- Adjusting entries are necessary for transactions extending over more than one period.
- An adjusting entry usually includes one income statement account and one balance sheet account.
- **Types of adjusting entries:**
 - **DEFERRALS** – record cash in or out NOW, put off recognizing revenue or expense until later.
 - **ACCRUALS** – recognize (record) revenue or expense NOW, cash flow comes some other time.

[4]. – Prepare and explain adjusting entries.

Deferred revenue: DR Cash, CR Unearned Revenue

Deferred expense: DR Prepaid expense account, CR Cash

Accrued revenue: DR Accounts Receivable or Unearned Revenue, CR Revenue account

Accrued expense: DR Expense account, CR Accounts Payable or Prepaid expense account.

[5]. – Explain how accounting adjustments link to financial statements.

(Adjusting entries usually involve one income statement account and one balance sheet account.)
Some adjusting entries are necessary to correct previous errors in recording transactions.

[6]. – Explain and prepare an adjusted trial balance.

After adjusting entries have been recorded in the journal, posted to ledger accounts, and ledger account balances updated, an **Adjusted Trial Balance** is prepared. This document is used to prepare financial statements.

[7]. – Prepare financial statements from an adjusted trial balance.

Financial statements are prepared in a specific order:

1. Income statement
2. Statement of Retained Earnings
3. Balance Sheet
4. Statement of Cash Flows

[8]. – Explain why temporary accounts are closed each period.

The three nominal (temporary) accounts are: Revenues, Expenses, and Dividends. These accounts are subsidiary accounts of Retained Earnings and are used to accumulate changes in Retained Earnings during an accounting period. At the end of the period, the balances in these accounts are “closed”, i.e. transferred to Retained Earnings. The balances in the temporary accounts are re-set to -0- so they can begin accumulating amounts in the next period.

Closing procedure:

1. Credit balances in revenue accounts are closed to Income Summary:
DR revenue, CR Income Summary.
2. Debit balances in expense accounts are closed to Income Summary:
DR Income Summary, CR Expense.
3. Income Summary balance is closed to Retained Earnings.
4. Dividend account balance is closed to Retained Earnings:
DR Retained Earnings, CR Dividends.

[9]. – Explain and prepare a post-closing trial balance.

Because temporary accounts have been closed and now have zero balances, the only accounts appearing on a post-closing trial balance will be balance sheet (permanent) accounts.

[10]. – Steps in the accounting cycle (Chapters 2 and 3).

Chapter 2 –

1. Analyze events: transaction?
2. Record transaction in the journal.
3. Post amounts to ledger accounts, update balances of accounts.
4. Prepare trial balance.

Chapter 3 –

5. Journalize adjusting entries, post to ledger accounts, update balances of accounts.
6. Prepare adjusted trial balance.
7. Prepare financial statements.
8. (*Journalize closing entries, post to ledger accounts, update balances of accounts.*)
9. (*Prepare post-closing trial balance.*)

[11]. – Explain and prepare a classified balance sheet (Pg. 117, also pg. A-4 [Best Buy]).

ASSETS

Current assets
Long-term investments
Plant assets
Intangible assets

LIABILITIES

Current liabilities
Long-term liabilities

EQUITY

Contributed capital
Retained earnings

[12]. – Performance measures.

1. Profit margin = Net income / Net sales

PROFITABILITY RATIO: Measures the income a firm has earned as a percentage of sales revenue.

2. Current ratio = Current assets / Current liabilities

LIQUIDITY RATIO: Measures a firm's ability to pay current obligations out of current resources.

Review end-of-chapter Discussion Questions, pg. 127: 1, 2, 4, 5, 6, 7, 13, 14, 20, 23.

Review and answer questions about any of the assigned exercises and problems: E3-2, E3-7, E3-8, P3-1A, P3-2A.
