

Accounting is an information system that:

- Measures business activities
- Processes data into reports
- Communicates results to decision makers

Accounting is the language of communication in all businesses that individuals, investors, creditors and the public use to understand finances, businesses and investments in the best way possible.

There are two kinds of accounting:

### **FINANCIAL ACCOUNTING**

For decision makers outside the entity like:

- investors
- Creditors
- Government agencies
- Public

### **MANAGERIAL ACCOUNTING**

For insiders in order to develop:

- Budgets
- Forecasts
- Projections

Accounting is used in every type of business. A business generally takes one of the following forms:

#### ■ **Proprietorship**

Has a single owner, called the proprietor.

Proprietorships tend to be small retail stores or individual providers of professional services—physicians, attorneys, software programmers, or accountants.

The proprietor is personally liable for all the business's debts.

But for accounting purposes, a proprietorship is a distinct entity, separate from its proprietor. Thus, the business records should not include the proprietor's personal finances.

#### ■ **Partnership**

Has two or more parties as co-owners, and each owner is a partner, with its own percentage. They tend to be small or medium sized.

Individuals, corporations, partnerships, or other types of entities can be partners.

In general, a partnership is not a taxpaying entity.

Instead, each partner takes a proportionate share of the entity's taxable income and pays tax according to that partner's individual or corporate rate.

Partnerships are governed by agreement, usually spelled out in writing in the form of a contract between the partners.

General partnerships have mutual agency (rapporti reciproci) and unlimited liability, meaning that each partner may conduct business in the name of the entity and can make agreements that legally bind all partners without limit for the partnership's debts.

Therefore, partnerships are quite risky because an irresponsible partner can create large debts for the other general partners without their knowledge or authorization.

This led to the creation of **limited-liability partnerships (LLPs)** in which a partner cannot create a large liability for the other partners. In LLPs, each partner is liable for partnership debts only up to the extent of his or her investment in the partnership.

Each LLP, however, must have one general partner with unlimited liability for all partnership debts.

### ■ Corporation

A **corporation** is a business owned by the **shareholders**.

One of the major advantages of doing business in the corporate form is the ability to raise large capitals from by issuing shares to the public.

All types of entities (individuals, partnerships, corporations, or other types) may be shareholders in a corporation.

Unlike proprietorships and partnerships, a corporation is legally distinct from its owners. The shareholders have no personal obligation for the corporation's debts and have limited liability. But they elect the board of directors, which

- Sets policy
- Appoints management officers

such as the chief executive officer (CEO), chief operating officer (COO), and chief financial officer (CFO),

## ROLE OF ACCOUNTING STANDARDS

In accounting, we assign monetary amounts to represent elements of financial statements in accordance to some accounting standards.

### International Financial Reporting Standards (IFRS)

Formulated by the International Accounting Standards Board (IASB)

### Generally Accepted Accounting Principles (GAAP)

Formulated by the Financial Accounting Standards Board (FASB). In Italy such a task is completed by Organismo Italiano di Contabilità (OIC).

When talking about international financial reporting standards a wide set of principles are taken into consideration. This is called the **conceptual framework**.

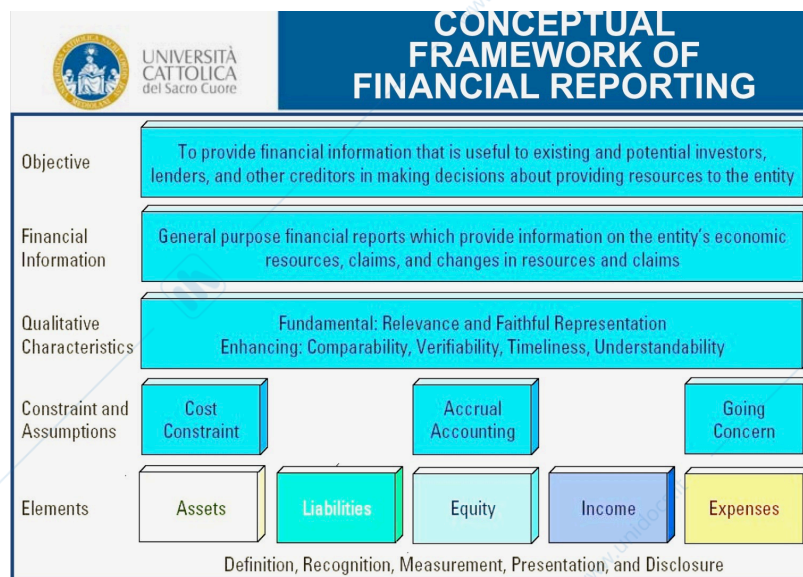
## CONCEPTUAL FRAMEWORK

It's a document that defines the "Why, Who, What, How" of financial reporting: It is a joint publication by the IASB and the FASB, used as a foundation for reviewing existing and developing new accounting standards.

- It lays the foundation for resolving the big issues in accounting
- prescribes the nature, function, and boundaries within which financial accounting and reporting operate

Many of these users rely on the financial statements as their major source of financial information.

The Conceptual Framework helps us answer the following questions:



### 1. Why Is Financial Reporting Important?

The *Conceptual Framework* states the **objective** of accounting according to the IASB, that is to provide financial information such as what is an asset, a liability and so on that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

This includes information about the entity's resources and claims to those resources, and the effects of transactions and other events and conditions that change those resources and claims. Users evaluate financial statements to make decisions like whether or not to make additional investments into the entity, provide credit and financing, or assess the management's efficiency and effectiveness in its use of the entity's resources.

While financial statements can be used to help users assess the financial health of an entity, as well as its strengths and weaknesses, they are not designed to show the "value" of an entity; that depends on many other factors besides financial statements, such as

general economic conditions and expectations, political events and climate, and industry and company outlook.

## 2. Who Are the Users of Financial Reports?

The main users of financial reports are:

Investors; employees; creditors; suppliers and the public:

It is important to notice that the *Conceptual Framework* focuses on primary users of financial statements, which includes existing and potential investors, lenders, and creditors.

The IASB uses the *Conceptual Framework* in setting accounting standards that provide an information set to meet the needs of the maximum number of primary users. Other non-primary users, such as government regulators, may find financial statements useful, but the financial statements are not primarily directed towards them.

## 3. What Makes Financial Information Useful?

The *Conceptual Framework* uses the term **qualitative characteristics** to describe the attributes that will most likely make the information provided in financial statements useful to users. The *Conceptual Framework* suggests that if financial information is to be useful, it must first be relevant and it must faithfully represent what it purports to represent—these are the “fundamental qualitative characteristics.” Information that is relevant and faithfully represented may be further enhanced if it is comparable, verifiable, timely, and understandable—these are the “enhancing qualitative characteristics.”

Enhancing qualitative characteristics will never make information that is not relevant become relevant, and similarly, will not make information that is not faithfully representative be so.

### **Fundamental Characteristic: Faithful Representation**

Financial statements represent **economic phenomena**, i.e., resources, claims to resources, and changes in resources and claims, in words and numbers. Such depiction should reflect the substance of an economic phenomenon rather than its legal form. Information that faithfully represents the underlying economic phenomenon should be complete, neutral, and free from error. Completeness means that the financial reports should include all necessary information for a user to understand the economic phenomenon being depicted, including all necessary descriptions and explanations. Neutrality means that the information must be depicted without bias. It is supported by the concept of prudence, i.e., the exercise of caution when making judgments under conditions of uncertainty. Freedom from error means that there are no erroneous depictions of economic phenomenon nor any omission. If you were to discover that Alibaba’s total expenses in 2016 were not complete or were riddled with errors, you would not rely on its financial statements.

### **Enhancing Characteristic: Comparability**

Users usually compare financial statements of an entity over a period to identify trends in its financial position and performance. Thus, it is important that the basis of preparation

and presentation remains comparable over time. For example, the comparison between Alibaba's sales in 2016 and 2015 only makes sense if you know that there has been no material change in the way sales are recognized in the financial statements. Similarly, you may want to compare Alibaba's performance to another retailer, and before drawing any conclusions you would want to be sure that net sales are derived in the same way for both companies. To be comparable, "like things must look alike, and different things must look different." Comparability does not force an entity to continue using the same accounting principles, policies, or estimates when more relevant and newer information surfaces.

### **Enhancing Characteristic: Verifiability**

Verifiability helps assure users that information faithfully represents the economic phenomenon it purports to represent. It means that given the same economic phenomenon and its depiction, two different knowledgeable and independent parties can come to a consensus that the depiction is a faithful representation of the economic phenomenon.

### **Enhancing Characteristic: Timeliness**

Timeliness means that the information must be made available to users early enough to help them make decisions, thus, making the information more relevant to their needs. By providing information about its financial position and performance to the users of the financial statement in a timely

manner, Alibaba allows investors to readily make decisions about their investments in the company. Normally, the stock exchange on which a company is listed will determine how often and how quickly a company must publish its financial results.

### **Enhancing Characteristic: Understandability**

We discussed earlier that accounting is the language of business. And just like any language, you will need some basic knowledge before you can converse, read, or write about it. Understandability means that financial information must be classified, characterized, and presented clearly and concisely. The framework assumes that users have a reasonable knowledge of business, economic activities and accounting, and a willingness to study the information with reasonable diligence. Thus, whilst you may not have the knowledge right now, by the end of this course you will be able to understand the accounting vocabulary and use financial information for decision making.

#### **4. What Constraints Do We Face in Providing Useful Information?**

In providing information that can be useful to our users, a pervasive constraint we face is cost. Financial information is not produced without costs; for example, cost of data collection, cost of data processing, and cost of verifying and disseminating the information. Naturally, higher costs result in lower returns to shareholders. Businesses

will need to assess whether the benefits of reporting particular information are likely to outweigh the costs incurred in providing or using the information.

### 5. What Are Our Assumptions in Financial Reporting?

The *Conceptual Framework* states that in order to meet the objectives of financial reporting, there are assumptions that we need to make. Firstly, we prepare our financial statements on an **accrual basis**. In short, this means that transactions and other events are recognized when they occur and not when cash is received or paid.

In measuring and reporting financial information, we also assume that the entity will continue to operate long enough to use existing assets like land, buildings, equipment, and supplies for its intended purposes. In other words, the business has neither the intention nor the need to liquidate or curtail the scale of its operations. This is called the **going concern** assumption that would normally apply to most entities. This is how a business can buy assets with expectations to derive benefits from the use of the assets beyond the current financial period. An entity that is not continuing would be accounted for very differently from one that is a going concern.

### What are we accounting for?

The building blocks, the elements of the financial statement are:

- **Assets**= are economic resources controlled by the entity that are expected to produce a benefit in the future. Examples of assets include cash, inventory, account receivables (money owed to the entity by its debtors), machinery, equipment, and properties.
- **Liabilities** are present obligations of the entity that are expected to result in an outflow of economic benefits from the entity, i.e., something the company owes (to a party outside the company). Examples of liabilities include bank loans, accounts payable (money owed by the entity to its creditors), and other obligations.
- **Equity (capitale sociale)** what's left of the assets after deducting liabilities; it represents shareholder's residual claim to the entity's assets. You will find two major sub-parts in the equity section: **share capital (capitale azionario)** and **retained earnings (utili non distribuiti)**. Share capital is the amount shareholders have invested in the entity (by purchasing shares or stock), and retained earnings is a percentage of net income that is *retained* by the company for reinvestment or debt payment.
- **Income** refers to increases in economic benefits during an accounting period. The *Conceptual Framework* further separates income into **revenue** and **gains**. Revenue arises from the ordinary course of business (such as sales revenue), whereas gains are typically outside the ordinary course of business (such as gain on disposal of a subsidiary).

- **Expenses** are decreases in economic benefits during an accounting period. Similarly, expenses can be incurred in the ordinary course of business (such as salaries and wages, rent, and other expenses), whereas **losses** may or may not be in the ordinary course of business, such as loss on disposal of a long-term asset. Similar to gains, losses are reported on a net basis.

The *Conceptual Framework* essentially provides guidance on how and when to recognize items on financial statements. An item is recognizable if

- it is probable that any future economic benefit associated with the item will flow to or from the entity;
- the item has a cost or value that can be measured with reliability.

Information about financial position (assets, liabilities, and equity) is primarily provided in a **Balance Sheet (bilancio)**, whereas information about financial performance (income and expenses) is primarily provided in an **Income Statement (conto economico)**

### Parole chiave (per quello ch c'è scritto sotto):

**Revenues (fatturato) /income**= ricavi - valore monetario totale delle entrate resources generated by the business.

**Net income**= it is profit generated by income - expenses

**Gains**= guadagni - differenza tra ricavi e costi REVENUES - COSTS

**Expenses**= spese uscita/usc di risorse a causa del costo delle operazioni ??

**Costs**= costi - importo che deve essere pagato per acquisire qualcosa

**Dividends**= dividendi

### ACCOUNTING EQUATION

The basic **accounting equation** shows the relationship that exists among assets, liabilities, and equity. They are presented on the balance sheet, the financial statement that shows what the company owns and owes at the end of the reporting period.

Assets appear on the left side, and liabilities and owners' equity appear on the right. The accounting equation can be written as:

$$\begin{aligned} \text{ASSETS} &= \text{LIABILITIES} + \text{EQUITY} \\ &\text{or} \\ \text{ASSETS} - \text{LIABILITIES} &= \text{EQUITY} \end{aligned}$$

The two sides must be equal. This is the underlying premise of the **double-entry system** of bookkeeping where total debits will always equal total credits.

ex. the entity's assets of \$1,000 are financed by liabilities of \$600 and equity of \$400

**Assets**= resources expected to produce future benefit

- cash
- equipment, property

**Liabilities**= debts to outsiders

- income taxes payable
- accounts payable
- long term debt

**Shareholders' equity**= insider claims, shareholders' interest in the assets, what's left after subtracting liabilities from assets

Corporation's equity is called stockholders' equity and it has two parts

1. **Paid-in capital:** The invested in the business amount shareholders have

2- **Retained earnings:** s a percentage of net income that is *retained* by the company for reinvestment or debt payment.

## SECOND ACCOUNTING EQUATION

There is a **second accounting equation** that relates to the calculation of profits earned by an entity during a financial period.

$$\text{REVENUES} - \text{EXPENSES} = \text{NET INCOME OR NET LOSS}$$

Profit is simply Income (Revenue and Gains) less Expenses (Expenses and Losses).

When total revenues exceed total expenses, the result is called **net income**, or **net profit**, that increases share holders equity , so there is an increase in retained earnings.

When expenses exceed revenues, the result is called **net loss** and there is a decrease in share holders equity, so there is a decrease in retained earnings.

In accounting, the word net refers to an amount after a subtraction. Net income is, thus, the profit left over after subtract- ing expenses and losses from revenues and gains.

A successful business usually pays **dividends** to shareholders (when there is an increase in retained earnings) as a return on their investments, usually in the form of cash.

Dividends are recorded as direct reductions/ decrease of retained earnings.

So dividends also a decrease share holder's equity.

Remember that just as capital contribution from shareholders to the company is not income, dividend distribution is not an expense and will never affect net income.

$$(\text{REVENUES} - \text{EXPENSES} = \text{NET INCOME OR NET LOSS})$$

$$\rightarrow \text{OPENING BALANCE OF RETAINED EARNINGS}$$

$$+ 0 -$$

$$\text{NET INCOME OR NET LOSS}$$

$$-$$

$$\text{DIVIDENDS}$$

$$=$$

$$\text{CLOSING BALANCE OF RETAINED EARNINGS}$$

### ***Where do I find financial information?***

#### **1. How well did the company perform during the year? Was it successful?**

Look in the **income statement** if you want to understand the flows of resources consumed and acquired during the reporting period look in there. MA QUINDI SI PARLA DI MONEY O RESOURCES?

It shows expenses and revenues.

#### **2. What is the company's financial position at the end of the financial year?**

Look at the **balance sheet** if you want to know the inflows and outflows of money during the reporting period. We are talking about specific date MA IN CHE SENSO???? MA QUINDI SI PARLA DI MONEY O RESOURCES

It shows assets liabilities and shareholders equity.

#### **3. Why did the company's equity change during the year?**

Look in the **statement of changes in equity**, it is a focus on the shareholder's equity, it breaks down capital and retained earnings

It shows a focus on the shareholder's equity, a breakdown in specific items:

- **paid in capital** = money the shareholder invested in the company
- **retained earnings**= a percentage of net income that is *retained* by the company for reinvestment or debt payment.

#### **4. How much cash did the company generate and spend during the year?**

Look at the **statement of cash flows**.

It only shows money inflows and outflows.

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When we talk about financial reports we talk about a document that contains all of them.

### **THE INCOME STATEMENT**

The Income Statement, which is part of the **Statement of Comprehensive Income**, reports revenues and expenses for the period. The bottom line is net income or net loss for the period.

On the right we have the end date of the fiscal year ex. 31 March

### **METTI SLIDE**

**INCOME** : First line is revenues which is related to operations regarding the core business.

Revenues do not always carry the word "revenue" in their titles. For example, net sales revenue is often abbreviated as net sales. Net sales means sales revenue after subtracting all the goods customers have returned to the company.

Other income items may consist of peripheral income generation activities, such as financial and travel services, rental income, and royalty fees.

**EXPENSES:** Similarly, not all expenses have the word “expense” in their title. They are related to the production process and are called **cost of revenue** (also said cost of goods sold or merchandising costs). It is the number of expenses that the company has to face to manufacture finished goods or to provide services.

Subtracting cost of goods sold (or costs of revenues) from revenues you get the **gross profit**, it represents the degree of effectiveness of the company in manufacturing goods or providing services.

Additionally you can find all other expenses that are called **operating expense** because they relate to the ordinary course of the business. These are: Product development expenses; sales and marketing expenses, general administrative expenses...

**PROFIT:** Income Statements may show a few variations of profit. If you subtract expenses and cost of revenues from revenues we have **operating income/profit**, it represents the ability of the company to generate profit just referring to its core activities.

Non-operating income and expenses come next  
The “bottom line” here would be the net profit

So we have:

Revenues

Expenses related to the production or to providing services

Other operating expenses

We may gross profit

We may have operating

Expenses and revenues related to daily activity

Income before taxes

Taxes

Net income

Then we have the data relating different years so that we can see trends, the situation can be compared with the previous one to see how the organisation is going if it is efficient and effective.

## **THE BALANCE SHEET**

A company's Balance Sheet, also called the Statement of Financial Position, reports three assets, liabilities and shareholders' equity. Financial position is always for a specific point in time, unlike an Income Statement, which covers a period of time.

## ASSETS

There are two main categories of assets: current and non-current (sometimes referred to as long-term) assets. It depends on the length of time in which we expect to consume.

**Current assets:** assets that are expected to be converted to cash, sold, or consumed during the next 12 months. They include cash, the most liquid asset; cash equivalents (ex. bank accounts), short-term investments, receivables (money we expect to collect from 3 parties), inventory and prepaid expenses.

**Long-term or non-current assets:** they are divided into three main categories: property, plant and equipment (PPE) (tangible assets) (line 9), long-term investments (line 10), intangible assets (line 11), and other non-current assets. ex. land use rights, buildings, equipment

PPE conveys economic benefits over the useful lives (longer than 12 months or 5 years) of its components, and their acquisition costs are allocated systematically throughout their useful lives. This process is called depreciation.

Long-term investments include investments in its affiliates and associates, as well as investments in other forms of financial assets.

Intangibles are assets with no physical form, such as patents, trademarks, intellectual property.

## LIABILITIES

Liabilities are also divided into current and non-current categories.

**Current liabilities** (lines 20–23) are obligations or debts payable within **one** year, they include accounts such as accounts payable, taxes payable, and other liabilities like short-term notes payable and salaries/wages payable, deposits and unearned revenues (subscriptions, you receive money before using a service)

**Non-current liabilities** are obligations that are likely to require an outflow of economic benefits after one financial year that include long-term bank borrowings.

## SHAREHOLDERS' EQUITY

It represents the shareholders' ownership of the business' assets.

ex. Paid-in capital, earnings, stock

## STATEMENT OF CHANGES IN EQUITY

Equity is the owner's residual interest in the entity after deducting liabilities

There is the starting amount (starting balance, the Total amount of the previous year that is the starting amount of the next year)

## STATEMENT OF CASH FLOWS

It shows a flow of money resources, flows and outflows are divided into 3 different classes, depending on the business activity that generated them.

**Operating activities:** cash flows from **selling goods** and services to customers

**Investing activities:** cash flows from **purchasing and selling long-term assets**

**Financing activities:** cash flows from **borrowing or repaying funds** or equity transactions

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## **RECORDING BUSINESS TRANSACTIONS**

Accounting records transaction, that is any event that has a financial impact on the business and can be measured reliably. A transaction occurs when a firm: • Gives something to third parties • Receives something from third parties

Accounting records both sides of the transactions and provides objective information about the financial impact on an exchange

The accounting equation represents the starting point when recording the effects of transactions, as it expresses the basic relationship of accounting:

### **TRANSACTIONS AND ACCOUNTS**

The accounting equation represents the starting point when recording the effects of transactions, as it expresses the basic relationship of accounting:

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

Assets are basically all the investments made by an entity to carry out all the production processes related to its core business

Liabilities summarize all the entity's obligations, i.e. what the entity owes to third parties

Shareholders' equity represents what will be left of the entity's assets once all obligations will be settled- Hence, another version of the accounting equation is:

$$\text{ASSETS} - \text{LIABILITIES} = \text{SHAREHOLDERS' EQUITY}$$

Based on the accounting equation financial accounting records all the changes occurred to an entity's assets and liabilities due to transactions.

To do so, accounts are used, i.e. records of changes occurred in a specific asset, liability or in shareholders' equity items during the reporting period.

In accounting, we call this "item of interest" an account. An **account** is the record of all the changes in a particular asset, liability, or shareholders' equity during a period.

Thus, an account is a basic summary device.

### **DIFFERENT TYPES OF ACCOUNTS USE TO RECORD BUSINESS TRANSACTIONS**

## ASSETS

They are economic resources that provide a future benefit for a business. Most firms use the following asset accounts:

**Cash:** Cash is money including bank account balances, paper currency, coins, certificates of deposit, and checks.

**Accounts Receivable:** promise for future collection of cash for goods and services.

**Notes Receivable:** Promissory note, specifying and interest rate signed by a customer to payoff a certain day.

**Inventory:** Goods the company sells to customers

**Prepaid Expenses:** Expenses paid in advance, as insurance or rent

**Property, Plant and Equipment(PPE):** Cost of the land, buildings and equipment owned by a company.

## LIABILITIES

They are debts or payables

**Accounts payable:** Promise to pay debt.

**Notes payable:** Signed notes promising to pay a future amount, generally specifying an interest rate.

**Accrued liabilities:** Liability for an expense you have not yet paid.

## EQUITY

It is the owner's claims to the assets of the company, i.e. what the entity's owners hold after paying off all debts.

**Share capital:** Owner's investment in the corporation through shares.

**Retained earnings:** Cumulative net income minus net losses and dividends over the company's life.

**Dividends:** Distribution of the company's earnings to its shareholders.

**Income:** Increase in shareholder's equity from delivering goods or services to customers.

**Expenses:** Decrease in shareholder's equity due to the cost of operating a business.

## THE IMPACT OF BUSINESS TRANSACTIONS ON ACCOUNTS

Accounting is based on two coexisting tools:

### Journal entries

- Double-entry system that records dual effects of each transaction and have at least two accounts in each transaction.

## THE T-ACCOUNT

It records increases and decreases in a specific asset, liability, revenue or expense.

You have debit on the left side and credit on the right side.

Knowing the beginning and ending balances of a specific T-account helps understanding what happened during the reporting period.

The type of account determines how to record increases and decreases: usually,

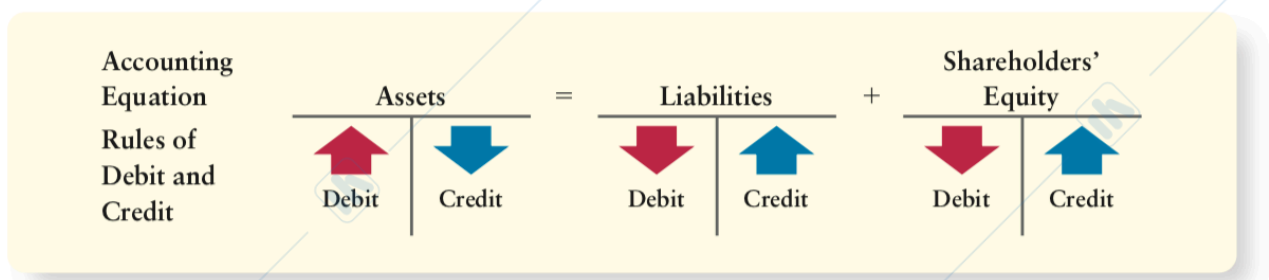
the debit side records increases

the credit side records decreases in the entity's resources hence:

- **Assets increases** have to be recorded on the **debit side** (and decreases on the credit side)
- **Liabilities' increases** have to be recorded on the **credit side** (and decreases on the debit side)

**QUICK TIP:** Looking at the accounting equation, items on the left side increase on the debit side and vice versa.

**Exhibit 2-3** | Accounting Equation and the Rules of Debit and Credit



The amount remaining in an account, after netting the sum of the left-hand side with the sum of the right-hand side of the T account, is called its *balance*.

## ADDITIONAL SHAREHOLDERS' EQUITY ACCOUNTS: INCOME & EXPENSES

Two categories of income statement accounts:

- **Revenues:** result from delivering goods/services  
They increase shareholders' equity and increase in an asset

When selling finished goods, those resources are delivered to customers (outflow called revenue). In return, the entity will collect money (inflow of cash, i.e. an asset)

- **Expenses:** cost of operating the business, it decreases shareholders equity and decrease in an asset

When paying for utilities, those resources are consumed by the entity (inflow called expense). At the same time the entity pays cash (outflow of cash, i.e. an asset).

Revenues and expenses are not money, they represent inflows and outflows of production resources.

Liabilities and shareholders' equity are the opposite.

- A credit increases a liability, as well as a shareholders' equity account.
- A debit decreases a liability, as well as a shareholders' equity account.
  
- A credit increases income, which will ultimately increase equity.
- A debit decreases income, which will ultimately reduce equity.
- A debit increases dividend and expense, which will ultimately reduce equity.
- A credit decreases dividend and expense, which will ultimately increase equity.

## FINAL FORM OF THE RULES OF DEBIT AND CREDIT

As revenues increase Shareholder's Equity, their increase has to be recorded on the credit side of Revenues T-account (outflow of resources)

As Expenses decrease Shareholder's Equity, their increase has to be recorded on the debit side of Expenses T-account (inflow of resources)

## RECORD (JOURNALIZE AND POST TRANSACTIONS IN THE BOOKS

Accountants use a chronological record of transactions called a **journal**, also known as the *book of original entry*. The journalizing process follows three steps:

1. Specify each account affected by the transaction and classify each account by type (asset, liability, shareholders' equity, income, or expense).
2. Determine whether each account is increased or decreased by the transaction. Use the rules of debit and credit to increase or decrease each account.
3. Record the transaction in the journal, including a brief explanation. The debit side is always listed first, entered in the left margin, and the credit side follows and is shown indented to the right.

Typically, it is easiest to identify cash effects. When analyzing a transaction, first pinpoint the effects (if any) on cash. Did cash increase or decrease? If cash increased as a result of the transaction, that's your Debit entry. If cash decreased, then it needs a Credit entry. Then identify the effects on the other accounts.

The **journal** shows the **chronological sequence of transactions**, but doesn't provide information on the final balance of the accounts.

The **ledger** shows the **final balance of every T-account**, but does not provide information on the chronological sequence of business transactions.

Accounting data are firstly recorded in the journal, and then copied to the ledger.

They provide complementary information.

## **TRIAL BALANCE**

A **trial balance** lists all accounts with their balances—assets first, then liabilities and share- holders' equity. The trial balance summarizes all the account balances for the financial statements and *shows whether total debits equal total credits*.

- Lists all accounts with their balances
- Assets listed first, then liabilities and shareholders' equity
- Shows that debits equal credits
- Usually prepared at the end of the period
- Facilitates preparation of the financial statements

Note that the last line of the trial balance provides proof of the equality of debits and credits we have entered into the accounting records

## **CHAPTER 3**