ACCOUNTING PRINCIPLES AND TERMINOLOGY

Paul Patterson and C. Wilson Gray

A. E. Extension Series 399

ACCOUNTING PRINCIPLES AND TERMINOLOGY

Paul Patterson[1]
and
C. Wilson Gray[2]

Accounting Defined

Accounting is the procedures used to measure and report in monetary terms the flow of resources through a business organization, both the resources they control and the claims against those resources. Accounting focuses on the collection, analysis, measurement, classification, summarization and communication of information on the flow of resources through a business. It is more than bookkeeping, which includes only the systematic recording of the financial operations of a business.

While a general definition does little to explain the specifics of what accounting does and what it is used for, it does provide a frame of reference and brings out two important points. The first is the use of the term "resource" and not just money. Accounting takes a broad view of a business and how it functions by looking at the entire resource base. The second point is the use of the word "business" when discussing who uses accounting. A business is organized and operated to make a profit. While many look on farming as a "way of life", it is also a business and must be operated as such if it's going to provide someone with a "way of life".

Functions of Accounting

Keeping accounting records serves two basic functions: 1) tax law requirements, and 2) financial analysis. These are separate and can be conflicting purposes. Federal tax laws specify the minimum requirements and standards, or specifies the available options. The type of ownership -- individual proprietorship, partnership, or corporation -- defines, to some degree, the available options. Regardless of the type of ownership, farmers

---

[1]Extension Economist, 1776 Science Center Drive, Idaho Falls, Idaho 83402.

[2]Extension Economist, 1330 Filer Avenue East, Twin Falls, Idaho 83301.

are allowed greater latitude in the accounting procedures they follow for tax purposes than other types of business.

Accounting serves a vital role in financial analysis by: 1) providing information for assessing the financial implications of decisions and alternatives, 2) measuring the financial effects of decisions already made through periodic financial statements, and 3) tracking the financial status of the business.

What type of accounting records are kept and how they are kept affects the accuracy of the financial position of the business because the bookkeeping records tie directly into the financial statements: 1) Balance Sheet, 2) Income Statement, and 3) Cash Flow Statement. The balance sheet is actually the starting point as well as the ending point for any accounting system.

Accounting Methodology

While accounting is a systematic process and follows generally accepted guidelines, there is some flexibility. There are three alternatives that are of particular importance to farmers: 1) selecting the appropriate accounting period, 2) choosing the basis -- cash or accrual, and 3) selecting between single or double entry accounting. There are important implications for each of these decisions and the business should fully understand this before committing to a particular type of accounting system.

Working with a knowledgeable accountant is highly recommended and can save both time and money. The IRS puts out several publications that provide answers to many of the common questions and that explain their regulations. The "Farmers Tax Guide" is probably the most useful to a farmer. Also, the University of Idaho has several useful publications. "Selection and Implementation of a Farm Record System", Bulletin No. 633, and "Selecting an Accounting System", Current Information Series No. 727 are two that deal directly with this issue.

The attached appendix provides definitions for many of the terms common to accounting and financial statements.

TERMS FOR ACCOUNTING AND FINANCIAL STATEMENTS

ACCOUNT--Stores transaction information from business operations in the form of debit and credit entries, and reports balances. A group of accounts is called a ledger. Three basic types of accounts are taken from the balance sheet: asset, liability and capital or proprietorship. Two other general accounts are found in any accounting system: income or revenue accounts, and expense accounts.

ACCOUNT CODES--Numeric codes assigned to each account maintained in the Account List. In a hand-kept system this number locates the account in the general ledger.

ACCOUNT TYPE--Accounts fall into five basic classificastions: asset, liability, capital or owner equity, income and expense.

ACCOUNTING PERIOD--A fixed twelve month period for tax purposes. The two available options include: 1) Calendar Year: January 1st - December 31st and 2) Fiscal Year: any other twelve month period.

ASSET--Any item of value controlled by the business that is available for current or future use. Assets are listed on the left side of a balance sheet.

BALANCE--1) The difference between debit and credit sides of an account. 2) To bring into agreement, i.e., to balance a checking account, or to bring general ledger accounts into balance, debits must equal credits.

BALANCE SHEET--A financial statement showing 1) what is owned, 2) what is owed, and 3) what a business is worth at a specific time; or, assets, liabilities and owners's equity or net worth.

BANK STATEMENT--The bank's status of a checking account. Usually includes cancelled checks, as well as a printed statement of all activity for a banking period.

BEGINNING BALANCE--The beginning balance of one period is the same as the ending balance of the preceeding period. The beginning account balances are posted from the general ledger.

BUDGET--A financial plan for all or part of a business' operations, for a specific period, expressing the business' objectives in financial terms and used to monitor the business' operational expenditures.

CHART OF ACCOUNTS--A list of a business' accounts, forming a system of classifying the assets, liabilities and owner equity or capital required for financial statements. In addition, income and expense accounts are included to show the impact of business operations on the owner equity or capital accounts.

CLOSING--The act of ending an accounting year. Closing entries transfer the balances of income and expense accounts to an Income and Expense Summary Account and transfer net income or net loss to the Capital Account. Journal entries are made to transfer the balances from the income and expense accounts to the Income and Expense Summary Account.

CREDIT--The right-hand side of an account. Entries are credit entries if they decrease assets, increase liabilities on equity, or record income. An account is credited when amounts are recorded in the account's credit column.

CURRENT--Pertaining or belonging to the present accounting period, normally defined as the twelve months following the date on the balance sheet. See also: current asset and current liability.

CURRENT ASSETS--Cash or any other asset that will normally be converted into cash, sold or consumed during the next year. Converting these assets to cash will not disrupt the business.

CURRENT LIABILITIES--A Financial obligation that will become due within the next year that is expected to be paid with curent assets, including contingent tax liabilities on the sale of current assets.

DEBIT--The left-hand side of an account. A transaction is a debit transaction if it increases assets, decreases liability or equity, or is used to record expenses. An account is debited when amounts are recorded in the account's debit column.

DEPRECIATION--A non-cash expense that records the reduction in value of a long-lived asset over time, caused either by wear and tear or obsolescence.

DOUBLE-ENTRY ACCOUNTING--Recording both the debit and credit of each transaction, i.e., an expense is recorded as a debit because it increases the expense account, while the cash (or checking) account is credited because it reduces an asset account.

ENDING BALANCE--The net result of the transactions for a period when offset against the beginning balance, i.e., the beginning check book balance for July, plus money deposited, minus checks written, equals the ending balance. Also see Beginning Balance.

ENTRY--A transaction. Remember that a transaction for double entry accounting requires both a credit and a debit which balance. Entries can be complex or simple, as long as total debits for the entry equal total credits.

EXPENSES--A decrease in owner equity (or capital accounts) resulting from business operations.

INCOME--An increase in owner equity or capital accounts resulting from business operations.

INCOME STATEMENT--A financial statement showing the revenues earned (income) and the expenses incurred by a business for a specific period.

INCOME SUMMARY--Net income before taxes. The balance sheet item for income minus expenses.

INTERMEDIATE ASSETS--Assets that are not normally converted into cash within a year, but either wear out or are sold within the next 10 years, working assets.

INTERMEDIATE LIABILITIES--Financial obligations scheduled to be repayed over a period greater than one year but within ten years, including contingent tax liabilities on the sale of intermediate assets.

JOURNAL--A listing of transactions by date of occurrence expressed in terms of debits and credits to particular accounts in the ledger. The recorded debits and credits are posted to appropriate accounts on the general ledger.

LEDGER--A group of accounts.

LIABILITY--An amount that is owed. Liabilities are listed on the right side of a balance sheet.

LONG-TERM ASSETS--An asset having a useful life longer than ten years and not intended for resale. Converting them into cash would have a detrimental effect on the business.

LONG-TERM LIABILITIES--A financial obligation spread over more than ten years, including contingent tax liabilities from the sale of long-term assets.

NET WORTH --See owner's equity.

OWNER'S EQUITY--The value of assets initially invested by owners in a business' total assets plus additional investment or retained earnings, calculated as total assets less total liabilities.

POSTING--The entry of individual debit and credit amounts (transactions) and aggregate debit and credit totals (activity entries) into the appropriate accounts of a general ledger. The process of transferring the journal entries to the appropriate accounts in the general ledger.

RECONCILIATION--The act of bringing an account into agreement, i.e., comparing the record of a checking account with the bank's record of the same account to determine the correct balance.

RETAINED EARNINGS--Net inocme that has not been removed from the business and is available to be invested (retained) in the business.

TRIAL BALANCE--A financial report listing account titles with the appropriate debit or credit balance. Summing the debit and credit columns will show whether the accounting system is in balance. Indicates whether posting was done accurately.

YEAR-TO-DATE--The remaining balance of an account, after computing all account activity for the current year.