

Principles of Financial Accounting - ACC111
Simplified Summary of Accounting
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Introduction

While accounting does have its complexities, the purpose of this tutorial is to give you enough of a background to get started quickly. Yet, at the same time of attempting simplification, there will be a bit of a learning curve in order to have your financial statements properly reflect the business transactions that have taken place in your enterprise.

The ultimate objective of any accounting system is to generate financial statements that present fairly the financial condition of the company and its results of operations. There are three primary financial statements: BALANCE SHEET, INCOME STATEMENT, and STATEMENT OF CASH FLOWS. The ACCOUNTING CYCLE is the process of identifying transactions that should be recorded, capturing those transactions as they occur, organizing the transactions by their nature or like-kind items, and finally, reporting them in the aforementioned statements. It sounds simple enough. Now let's get started, not at the beginning, but at the end; it will be easier to follow the route if you know where you are going!

The Accounting Equation and its Dynamics

Take off your business hat and put on your personal hat. Now think of a single large purchase you would make. Okay, how about a house? How much is the house? Let's say \$500,000. And you're going to pay cash for it, right? In your dreams! While some well-heeled individuals may have that ability, for the rest of us, we'll have to find another way. For illustration purposes, let's assume you have saved \$50,000. Now a simple question: If the house costs \$500,000 and you only have \$50,000, can you still buy it? I know you know the answer to this; yes, you can get a mortgage. Now for the high-end math question: How much will the mortgage be? You hesitate to say \$450,000 because the answer is so simple you thought it might be a trick question, but your quick thinking math skills were right; \$450,000 is the correct answer. You got that answer by the following logic:

$$\text{HOUSE} - \text{YOUR MONEY} = \text{MORTGAGE}$$

OR

$$\$500,000 - \$50,000 = \$450,000$$

In the above relationship, knowing any two of the three pieces you can figure the third. So, as an alternative to our scenario, if you were looking at a \$500,000 house and a mortgage broker determined you had the ability to handle a \$450,000 mortgage, you would then determine that you needed to come up with \$50,000 (\$500,000 house - \$450,000 mortgage = \$50,000 from you). Or, another alternative is that you know you

have \$50,000 and can handle a \$450,000 mortgage; well, you better be looking at houses in the \$500,000 range and put that 12-room beach house on hold! But seriously, looking at this last alternative, expressing it as an equation, it would look like this:

$$\text{HOUSE} = \text{MORTGAGE} + \text{YOUR MONEY}$$

OR

$$\$500,000 = \$450,000 + \$50,000$$

So far this is pretty simple and I chose the situation because I know that most people understand the relationships and are pretty comfortable with them. Now, I just want to substitute a few words. The house is something that you own, and things that we own in the business world are called **ASSETS**. The mortgage is something that you owe and things that we owe in the business world are called **LIABILITIES**. In the business world, your piece is called **EQUITY**, more commonly **OWNERS' EQUITY**. So, restating the above equation (that we readily understood), substituting our new words, we get the following formula:

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

This simple equation is the heart and soul of the accounting world. It is called **THE ACCOUNTING EQUATION**. Everything revolves around it, and just like your house purchase, every recorded business transaction needs to fit into it. There are no exceptions! Sometimes one asset will go up and another down (for example, if you purchase inventory for cash – the inventory asset rises and the cash asset falls). At other times, an asset and a liability will be affected (for example, you buy a piece of equipment on credit – the equipment asset rises and the equipment loan rises). If the owner puts assets into the business, they go up and so does the owners' equity. There are lots more transactions, but more on those later.

Now, if we were to create a report that summarizes all of the assets of the company, all of its liabilities and all of its owners' equity, that summary report is called the **BALANCE SHEET**. It is called that because it balances and it balances because of the application of the accounting equation. Okay, so mathematically it balances, but other than that, what's the point? Well, the balance sheet shows the financial condition of the company, the assets being the resources that are used to operate the business, the liabilities being the obligations that the company has to meet and the equity being the resulting financial interest that the owners have in the business. It is a measurement of financial strength, the ability to meet obligations when due and to operate the business. As individuals, we similarly measure our net worth, except that when doing so, we use the fair market value of the assets. For businesses, we don't typically use market values (although there are some exceptions); instead, we measure completed transactions.

Now, let's focus on only one part of the accounting equation and balance sheet, namely, the owners' equity section. While all transactions affect the balance sheet, only certain types of transactions impact the owners' equity section of the balance sheet. First, owners' equity will increase if the owner puts something into the company. For example,

if the owner puts \$10,000 cash into the company, the equity will rise by the same amount that the newly infused asset rises. In equation form, this transaction would appear as:

$$\text{Cash } \$10,000+ = \text{Owners' Equity } \$10,000+$$

The above owners' equity may be called different things depending on the form of the company. For example, if the company is a sole proprietorship or partnership, the owners' equity will be called CAPITAL. If the entity is a corporation, the owners' equity will be called CAPITAL STOCK.

The flip side of an infusion of equity occurs when the owner takes assets out of the company. Equity will decrease by the amount of the reduction in assets. Corporations call this a DIVIDEND. Unincorporated entities call this a DRAW, DRAWING or WITHDRAWAL.

That's enough about the impact on equity occurring from the owner putting assets into the company and taking assets out of the company. The next two items will not only impact the owners' equity and balance sheet, but they are important enough to be separately stated in their own financial statement. They are REVENUES and EXPENSES. Owners' equity will increase by revenues and decrease by expenses.

Revenues have various names depending on the type of revenue. The most common is SALES REVENUE or simply called SALES, the term applied to revenue derived from selling merchandise and some services. Many service firms have their own terms for their revenues. For example, a law firm will call its revenues Professional Fees or Legal Fees; a real estate rental firm will call its revenues Rent Revenue or Rental Income; a bank will call its main source of revenue Interest Income. However, despite all the different names, revenues all act the same, for essentially, the same occurrence is being recorded: A customer (or client, or tenant) is laying upon the company an asset that it previously did not have. As a consequence, equity will rise.

For example, a customer purchases merchandise for \$250. In this case, the company either receives cash or an ACCOUNTS RECEIVABLE (a right to receive the cash at a future date; more on this later). Therefore, the asset received increases and the sales revenue causes owners' equity to correspondingly rise, as follows:

$$\text{Cash } \$250+ = \text{Sales (Owners' Equity) } \$250+$$

or

$$\text{Accounts Receivable } \$250+ = \text{Sales (Owners' Equity) } \$250+$$

Although it would be nice for customers to give you assets just because of your intelligence, good looks and great personality, we all know that there has been some kind of exchange, in this case, the customer bought merchandise and therefore you had to give the customer inventory. That brings us to expenses. An expense occurs where you relinquish an asset or incur a liability for which there is no asset received in return. Assume that in the above scenario, you gave the customer merchandise that you had that cost you \$150. The reduction of your inventory correspondingly reduces your equity as

an expense. There are many types of expenses; this one is called COST OF GOODS SOLD. The resultant transaction impacts the accounting equation as follows:

$$\text{Inventory } \$150- = \text{Cost of Goods Sold (Owners' Equity) } \$150-$$

An example of an incurred liability for which you have received no asset would be a utility bill. If you got an electric bill for \$75, your liability, called an ACCOUNTS PAYABLE would go up by \$75 and you would have a reduction in owners' equity for a Utilities Expense. So, owners' equity continues to rise and fall based upon every Revenue and Expense transaction. Now, if we create a separate financial statement carving out only those items that are either a revenue or expense, that statement is called the INCOME STATEMENT. The income statement shows the changes, over some period of time (year, month, quarter), resulting from activities of the company that produce revenue or incur expense. Unlike the balance sheet that shows financial condition as of a moment of time, the income statement shows the results of operations over some period of time. The performance of the company is being measured in the income statement, namely, increasing equity over a period of time by charging customers more than is being incurred for the expenses of operating the business.

Returning now to the issue of recording revenues prior to receiving the cash (as when we recorded the accounts receivable) or recording expenses prior to paying the cash (as when we recorded the accounts payable), there are two methods of accounting, the CASH METHOD and the ACCRUAL METHOD.

Under the cash method, revenues and expenses are only recorded when the cash is received or paid. Under the accrual method, revenues are recorded when the transaction occurs, regardless of when the cash is received or paid. For example, let's say you sell something in December but don't collect the money for it until January and you are about to prepare financial statements for the year-ended December 31. Under the cash method of accounting, that sale would not be included in the December year-end statements; it would be recorded when payment was received in January. Under the accrual method of accounting, the sale would be recorded in December and included in the financial statements; in January, when the cash is collected, the cash asset would increase and the accounts receivable would decrease, having no impact on the income statement.

Similarly, expenses are recorded when paid under the cash method of accounting and when incurred under the accrual method of accounting. Assume an electric utilities bill is received for December but not paid until the following year, maybe not even January or February but March. Under the cash method of accounting, the expense, for electricity consumed in December, would be recorded in March. Under the accrual method of accounting, the expense would be recorded in December and accounts payable would be increased. In March, when the bill is paid, the cash account will decrease and the accounts payable would be reduced.

For purposes of reporting the actual results of revenue and expense activities, the accrual basis will beat the pants off the cash basis every time; it is always a better measurement. The accrual basis is required to be in conformity with GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP). While the cash method of accounting does have some applications (for example, in some circumstances, it may be used for tax purposes and in some of those circumstances, it may be advantageous), for

purposes of the balance of this tutorial, we will stick to GAAP and use the accrual method of accounting. However, even though the accrual basis may be a better measurement of revenue and expense performance, cash is still a very important aspect of running a business and for this purpose, there is the third primary financial statement, the Statement of Cash Flows.

The Statement of Cash Flows keeps track of cash receipts and cash disbursements. Unlike the Income Statement, which tracks revenues and expenses on an accrual basis of accounting, the Statement of Cash Flows tracks incoming cash when received and payments when they made. Further, it breaks those payments into three categories, showing CASH FLOW from OPERATING ACTIVITIES, INVESTING ACTIVITIES and FINANCING ACTIVITIES. Most of the action is in Operating Activities, for the most part deriving from the prior recording of revenues and expenses. As stated in the name, these activities result from the operations of the business, the primary function of which is to produce revenues and control expenses.

Investing Activities are outside of operations and have to do with long-term assets such as new equipment whose acquisition will affect several periods of operations, not just the current year. Financing Activities are also outside of operations and have to do with the funding sources upon which the company relies; for example, cash from owners or cash borrowed from a bank. Ultimately, the bulk of cash flow should come from Operating Activities; it is very useful to users of financial statements to know the sources of cash for analyzing the performance of a company. For now, however, let's move on to getting transactions into our accounting system so we'll have the information necessary to prepare all three primary financial statements.

The Accounting Cycle

The Accounting Cycle describes the steps for going from business transactions through the creation of financial statements reflecting those transactions. We'll look at these steps one at a time, but here's the list:

- Identify the transactions
- Record the transaction chronologically
- Organize the chronologic information into like-kind items
- Check the mechanical accuracy of the accounting equation
- Make any adjustments, if necessary
- Recheck the accounting equation
- Prepare the financial statements
- Reset the accounting system for measurement of the next period

Identify the transactions

The vast majority of transactions are what we call EXCHANGE TRANSACTIONS. In an exchange transaction, the company gives something and the company gets something. For example, in a typical sales transaction, the company gives goods or services to the customer and receives either cash or accounts receivable (the

right to receive cash at a future date); in a purchase of inventory transaction, the company receives merchandise and gives cash or accounts payable (the obligation to pay cash at a future date).

Business activities are not recorded until the exchange takes place. For example, if you issue a purchase order to a **VENDOR**, that purchase order, while an important document, would not be recorded, since there has been no exchange. An exchange, and therefore a recordable accounting transaction, does not occur until you receive the merchandise.

Record the transaction chronologically

This is the first time a transaction is entered into the accounting records. The date of the transaction and the sequence number are recorded and enough other information, if required, so that we can go back to the transaction document for verification and clarification, if necessary. As an example, take off your business hats and put on your personal hats and think about your checkbook (even if you do online banking, you probably started with a manual checkbook).

When you write a check, the actual check is a document that instructs your bank, upon proper presentation, to take the funds out of your account and give it to the designee on the check. For your records, you write certain information in your checkbook, including the date, check number, payee, reason for the check and the amount. This is the chronological record and the first time that the transaction, evidenced by the check document, is brought into your personal books and records.

In the business world, this chronological document is called a **JOURNAL**, deriving from the Latin word for “daily.” It is also known as a **BOOK OF ORIGINAL ENTRY**, emphasizing that this is the first time the transaction is brought into the accounting records. There are several types of journals which will be addressed later.

Organize the chronologic information into like-kind items

In its existing form, the journal is not a very useful tool for understanding or analyzing the business. As previously stated, a journal’s only system of organization is by chronology and transaction sequence number. If you imagine your personal checkbook again, it’s a real jumble of unrelated transactions that follow no particular logic except the aforementioned sequencing. If you wanted to know total expenditures for any particular item over the course of the year, you would need to slowly scan the checkbook and pick out only those items that applied to whatever it was that you are trying to determine. To get a more useful categorization, each item in the journal (or journals, if using more than one), is transferred into its own **ACCOUNT**.

An account is a separate grouping of all items of a like-kind nature. Some accounts have apparent breaks; for example, I don’t think anyone would put inventory items into the same account as telephone expense. The latter two items are so naturally different that just about anyone would keep them separate. Beyond these natural breaks, a business can have as many or as few accounts that it needs to effectively keep track of things to manage the business. Let’s take telephone expenses; if this is a relatively insignificant expense for your business, you may keep it in a single account or even have

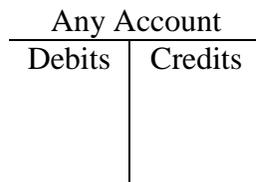
a single account for all utilities, including telephone expenses. However, if telephone expenses are a very significant expenditure in your business, you may set up separate accounts for land lines, cell phones, data, voice and so forth.

The accounts of the company are kept in a LEDGER. A ledger is any grouping of accounts. A general grouping of all accounts used by a business is called a GENERAL LEDGER. Remember: The journals are chronological and in transactional sequence while the general ledger is kept by account, or type. Every transaction in the journals must be POSTED to the accounts, posting being the process of taking information from one place and putting it into another place. In accounting, we do lots of posting, from transaction document to journal, from journal to ledger and lots of other places too. Before we go further, let's first discuss some accounting shorthand.

Up until now, we've mentioned increases or decreases in accounts. In the accounting environment, we use a shorthand system of DEBITS and CREDITS to describe the impact of transactions on the accounts. Like any other discipline-specific jargon, debits and credits might be a bit confusing at first, but as you get to use the language, it really is a shortcut.

The underlying rules of debits and credits are very simple. All assets increase with debits and decrease with credits. Notice the absoluteness of the previous sentence. It didn't say "almost all" or "all except;" it said "all." That means cash increases with debits and decreases with credits, receivables increase with debits and decrease with credits; inventory, machinery, land, buildings, patents and so forth are all treated the same way. Accounts on the other side of the accounting equation are affected in just the opposite way. Liabilities and Owners' Equity increase with credits and decrease with debits.

One graphic way to display this is by using T-accounts. A T-account looks like the following illustration:



As you can see, the horizontal and vertical bars appear like the letter "T," hence the name. T-accounts serve a couple of purposes. First, they represent the accounts that we use in ledgers, without the details of any particular print style or graphic presentations in the ledger; this is the way we will mostly use them here. Another use is to visualize the effects of a journal entry before we make it into the actual books and records.

When we fill-in a T-account, debits always go on the left side and credits always go on the right side. As we increase assets, we will debit them and when we decrease assets, we will credit them. The opposite is the case of liabilities; they increase with credits and decrease with debits. Overall, the same is the case with owners' equity accounts. Any account that increases owners' equity is a credit (owners' capital contribution to the company and all revenue accounts) and any account that decreases owners' equity is a debit (expenses and distributions to owners). The normal balance in any account (debit or credit) is based on how it is increased. So, all assets are expected to

normally have debit balances and all liabilities are expected to have credit balances. Owners' capital contributions and revenues will have credit balances because they increase equity; expenses and distribution accounts will have debit balances because they decrease equity.

One reason for confusion on debits and credits derives from the perspective from which the naming occurs. Everyone's debit is someone else's credit and vice versa. Your account receivable (debit) is someone else's account payable (credit); your account payable (credit) is someone else's account receivable (debit). When a bank charges you a service fee, it issues a debit memo on your account, reducing its liability to you for the money you have on deposit. When this happens, you need to credit your cash account because it just got reduced.

While empathy, altruism and largesse are always encouraged for societal interactions as a whole, for debit and credit purposes, being a bit egocentric is helpful. Regardless of how a debit and credit is treated on someone else's books, just look at it from the perspective of your books and accounting life will be easier.

Previously mentioned was that many different types of journals may be used; one that will always be used is the GENERAL JOURNAL where any recording that doesn't fit into a more specialized journal will be made. Recordings here are called GENERAL JOURNAL ENTRIES or just JOURNAL ENTRIES. Say you performed a service for a customer on January 15, 2015 and gave the customer an invoice for \$800 for payment at a future date. Here is what the journal entry would look like:

1/15/15	Accounts receivable	800	
	Service revenue		800
	<i>To record invoice #xxxxx</i>		

There is a whole story in the preceding journal entry. First, it tells the transaction date. Next, it shows the accounts being affected and the amounts. Note that the accounts are offset, with Service revenue starting a bit to the right of Accounts receivable. It is tradition to list the account(s) being debited first, then, slightly indented, the account(s) being credited. The amounts are listed in two columns, the left being a debit and the right being a credit. So, stating the story verbally, on January 15, 2009, Accounts receivable is being debited for \$800 and Service revenue is being credited for \$800. Finally, the italicized note tells the purpose of the journal entry. This explanation may be as simple or elaborate as required to track the journal entry back to the original transaction. This is important to do in every case, because even if the journal entry is obvious at the time that it is being made, that may not be the case when researching why it was made at a later date, sometimes months or even years in the future.

Journal entries are made as transactions occur, but usually posted to the accounts less frequently, monthly being common. After posting this single entry, here's what the accounts would look like, assuming there were no beginning balances or other entries:

Accounts receivable		Service revenue	
1/15	800		1/15 800

Some accounts are very active and may have multiple postings from journal entries. For example, Accounts receivable would have a debit for all sales, so if multiple sales were posted, it could have lots of debits. As collections are received from customers, cash would increase (so you would debit your Cash account) and the related account receivable would decrease (so you would credit your Accounts receivable). Imagine an Accounts receivable account that had multiple debits and multiple credits posted to it as follows:

Accounts Receivable			
1/1	7,000	1/8	4,000
1/6	3,000	1/15	3,800
1/15	800	1/30	1,800
1/27	<u>1,300</u>		
Sub-total	12,100	Sub-total	<u>9,600</u>
Balance 1/31	2,500		

In this example, there are several postings to the accounts receivable account during the month of January. At the end of the month, all the debits are sub-totaled and all the credits are sub-totaled. The account balance at the end of the month is the difference between all the debits and all the credits. Since this is an asset account, there are more debits than credits and the balance, therefore, is a debit. If this had been a liability account, the opposite would be true and the balance would have been a credit balance.

The above procedure is done for every account that the business uses. Typically, the postings and summaries of the account balances are done when financial statements are going to be issued. So, if the financial statements are issued monthly, striking an account balance for each account would be done on a monthly basis.

Note that in our examples, we've used individual postings from general journal entries. If there are repetitive transactions, specialized journals can be used to accumulate information and a single posting can be made from that journal. For example, a common repetitive transaction would be sales to customers. Rather than recording each separate sale as a general journal entry, all sales can be entered in a sales journal and the total of all sales in the journal can be posted in summary form at the end of the month. Common specialized journals include a sales journal, cash receipts journal, purchases journal and cash disbursements journal.

Check the mechanical accuracy of the accounting equation

Before preparation of the financial statements, the mechanical accuracy of the recordings and postings needs to be checked. Since all transactions have been recorded with debits equaling credits and then posted to the accounts as debits equaling credits, we just want to make sure that we haven't made any mechanical errors in the postings. Common types of errors include:

- Mistakenly posting a debit as a credit or vice versa.
- Truncating a number, particularly when dealing with multiple zeroes. An example would be posting an entry for \$1,000 as \$100.
- Adding digits during the posting process. An example would be posting an entry for \$98 as \$988.
- Transposition errors. This is where numbers are switched in sequence, as for example, posting \$5,362 as \$5,632.

While other errors can be made, the above types are very common. So, before we proceed with the preparation of the financial statements, a TRIAL BALANCE is prepared. The trial balance is simply a one-line listing of all the debits and credits to make sure that the books and records are in balance. It is a check on mechanical accuracy. While it is possible that the trial balance may be in balance and that there are still errors (for example, posting a debit as a debit but to the incorrect account), if the trial balance is not in balance, then something is definitely wrong and it needs to be corrected before proceeding to the financial statements. The following is an example of a trial balance:

Whatever Company
Trial Balance
December 31, 2015

	Debits	Credits
Cash	\$11,400	
Accounts Receivable	9,200	
Inventory	15,000	
Equipment	36,000	
Accounts Payable		\$8,000
Loan Payable		25,000
Capital Stock		15,000
Retained Earnings		12,000
Sales Revenue		43,000
Cost of Goods Sold	17,000	
Salaries Expense	10,600	
Utilities Expense	2,600	
Other expense	1,200	
Totals	\$103,000	\$103,000

If the trial balance is not in balance, the postings need to be checked until the problem is located and the mechanical accuracy fixed. If we are satisfied that the trial balance is accurate, we need to check to see if any ADJUSTMENTS need to be made prior to preparation of the financial statements.

*Make any adjustments, if necessary and
Recheck the accounting equation*

Most journal entries are for EXCHANGE TRANSACTIONS. In an exchange transaction, the company gets something and the company gives something, usually represented by a document evidencing a commercial transaction. For example, if you sell something on credit, the exchange is the relinquishment of whatever the customer bought for your right to receive cash at some future date, all documented in an invoice. By far, exchange transactions represent the bulk of all journal entries. So, what are the journal entries not represented by exchanges? These are called adjustments.

Adjustments are internal entries, not represented by an exchange. One type of journal entry would be for the expiration of an asset over a period of time. For example, let's say you purchase an insurance policy and pay for the coverage of one year's premium. That would be an exchange transaction for an asset (Prepaid insurance) for which you relinquish another asset (Cash). If you did that on January 1, 2015, the journal entry would be as follows:

1/1/15 Prepaid insurance	1,200	
Cash		1,200
<i>To record purchase of property insurance for the year 2015</i>		

Now suppose you were to prepare financial statements at the end of the month of January. Showing \$1,200 as the amount of the Prepaid insurance asset would not be correct because you used a month of it and as of the end of January, you only have 11 months worth of coverage available, or Prepaid insurance asset of \$1,100. Yet, there has been no exchange between you and the insurance company or anyone else. The journal entry to reduce the asset and record the amount of its expiration as an expense is a typical type of adjusting journal entry that must be made. In this particular case, the adjustment would be as follows:

1/31/15 Insurance expense	100	
Prepaid insurance		100
<i>To record expiration of one-month's coverage</i>		

This journal entry and other adjustments would be made after the first trial balance and then posted to the accounts. After all adjustments are made, a new ADJUSTED TRIAL BALANCE is prepared and the financial statements are prepared from this adjusted trial balance.

Among more typical adjusting journal entries are the following types:

- Expiration of prepaid assets such as prepaid insurance, prepaid rent, prepaid taxes
- Use of supplies which are originally entered into an asset account (called Supplies) and then compared with the actual amount on-hand at the end of the accounting period. The difference is recorded as a Supplies Expense and a reduction of the Supplies account

- Depreciation, which is the apportionment of the cost of long-term assets to their periods of use (more on this later)
- Recording expenses and liabilities which have been incurred but for which no document (such as an invoice from a vendor) has been received
- Recording revenues that have been earned but not yet received or for which payment has been received prior to being earned

Each adjustment is made as a separate journal entry and entries are then posted to their appropriate accounts. Just to make sure everything is still in balance, an ADJUSTED TRIAL BALANCE is prepared. It is from this Adjusted Trial Balance that the financial statements are prepared. To avoid a lot of extra writing of account names, it is easier to just add some columns to the trial balance showing the initial balances, adjustments and resulting adjusted trial balance. Column headings would look something like this:

<u>Account</u>	<u>Trial Balance</u>		<u>Adjustments</u>		<u>Adjusted Trial Balance</u>	
	<u>Debit</u>	<u>Credit</u>	<u>Debit</u>	<u>Credit</u>	<u>Debit</u>	<u>Credit</u>

Prepare the financial statements

Now the financial statements can be generated. The income statement is prepared first because we will need information from this statement to update the balance sheet. Remember that the income statement has only revenue and expense accounts. The end result, or NET INCOME, is all revenues minus all expenses. However, to present an income statement in good form, some sub-totals and interim balances are in order.

The first subtotal is GROSS PROFIT or sales revenue minus COST OF GOODS SOLD. Cost of goods sold includes costs associated with the product that you are selling, without consideration of any selling or general and administrative expenses. In a merchandising firm, it would be the cost of the inventory that you gave to a customer in exchange for the sale. Gross profit is a key indicator of the success of the business, in that you must have sufficient gross profit to provide for all other expenses of the business and the net income.

The operating expenses of the business, including selling, general and administrative expenses are then deducted from gross profit to arrive at INCOME FROM OPERATIONS. Note that interest income, interest expense and income taxes are not considered in determining the income from operations. These latter three items are not related to the operating efficiency or effectiveness of performance by the company.

Interest income is then added to, and interest expense is deducted from, income from operations to arrive at INCOME BEFORE TAXES. Interest income derives from an excess of cash that is invested by the company to earn revenue and interest expense is incurred because the company needed to borrow money to finance its operations. Neither of these items has to do with the performance of the business.

Finally, income taxes are deducted in arriving at the net income. Income taxes have nothing to do with the performance of the business; rather, they are a function of the

form of business ownership (such as sole proprietorship, partnership, LLC, C-Corporation or S-Corporation).

The following is an example of an income statement in good form:

Izdthissacompany, Inc.			
Income Statement			
For the Month Ended January 31, 2015			
Sales revenue			\$98,000
Cost of goods sold	.		32,500
Gross profit			\$65,500
Operating expenses:			
Selling expenses:			
Sales salaries expense	\$21,000		
Advertising	.	8,000	
Insurance expense		1,000	
Rent expense		1,000	
Payroll tax expense		900	
Delivery expense	.	100	
Entertainment expense		500	\$32,500
General and administrative expenses:			
Administrative salaries expense	.	\$10,000	
Office supplies expense		500	
Utilities expense		600	
Insurance expense		500	11,600
Total operating expenses	.		44,100
Income from operations			\$21,400
Other revenues and expenses:			
Interest revenue		\$600	
Interest expense	.	(4,000)	(3,600)
Income before income taxes			\$17,800
Income taxes			3,500
Net income			\$14,300

Now that the net income has been determined, the balance sheet can be prepared. Remember, the balance sheet has only assets, liabilities and owners' equity accounts. However, if you simply "drop" all of the revenue and expense accounts out of the accounting equation, the remaining accounts won't balance. In order to avoid this from happening, the RETAINED EARNINGS account (an owners' equity account) must be updated to include the net income.

The following is a typical balance sheet, in CLASSIFIED form:

Wutchammicallit, Inc.
Balance Sheet
June 30, 2015

Assets			
Current assets:			
Cash	\$5,600		
Accounts receivable	10,500		
Inventory	7,800		
Prepaid insurance	4,000		
Total current assets			\$27,900
Long-term assets:			
Equipment	\$23,000		
Furniture	6,000		
Total long-term assets			29,000
Total assets			\$56,900
Liabilities and Owners' Equity			
Current liabilities:			
Accounts payable	\$12,600		
Other current liabilities	3,000		
Total current liabilities			\$15,600
Long-term liabilities:			
Equipment loan payable	\$15,000		
Other loan payable	10,000		
Total long-term liabilities			25,000
Total liabilities			\$40,600
Owners' equity:			
Capital stock	\$10,000		
Retained earnings	6,300		
Total owners' equity			\$16,300
Total liabilities and owners' equity			\$56,900

Current assets include cash plus assets that will convert into cash or expire in one year or less. These are listed on the balance sheet in their order of liquidity. In the above example cash is first, followed by accounts receivable (one step from being converted into cash), then by inventory (which must be sold before it can be collected). Any asset that is not a current asset is long-term, including equipment, furniture, land and buildings. Current liabilities include obligations that need to be paid in one year or less. Any liability that is not a current liability is long-term, such as notes payable, where the maturity is more than a year away, mortgages and the like.

The reason for the differentiation between current and long-term items is to enable better financial statement analysis. Current assets and current liabilities involve transactions that take place frequently and represent the bulk of the operations of a business. The business is constantly buying on credit, selling and collecting and then paying vendors. The relationship of current assets to current liabilities is key to maintaining sufficient cash to meet obligations as they become due. Transactions involving long-term assets or long-term liabilities occur much less frequently, and while still important to the business, do not represent the daily urgency that a business has with sales, collections, purchases and payments in the ordinary course of business.

The final primary financial statement that must be prepared is the statement of cash flows. Instead of using the accrual basis as done in the income statement, the statement of cash flows measures cash receipts and cash disbursements. Cash flow from each activity shows the excess (or shortfall) of cash receipts over cash disbursements. Separate cash flow is shown by Operating Activities, Investing Activities and Financing Activities, with most of transactions involving Operating Activities mainly from collections of cash sales or accounts receivable and payments of accounts payable and other regular business expenses.

Investing Activities involve long-term assets such as new equipment. Financing Activities are related to the funding sources upon which the company relies. Borrowing or repaying a loan would fall under this category, as would cash invested by an owner.

The sum of the separate cash flows, positive or negative, results the overall cash flow. When this amount is added to or subtracted from the cash at the beginning of the period, it will equal the cash flow at the end of the period.

The analysis of cash flow and its components can be complex. For example, while any kind of negative cash flow may not sound like it is good, investing activities in a company that is growing would normally have a negative cash flow from the amounts expended on assets for use in that growth. Note the negative cash flow from investing activities in the following illustration, even though overall cash flow is positive:

Ewe-think-so, Inc.
Statement of Cash Flows
For the Year Ended December, 2015

Cash Flows from Operating Activities		
Cash inflows from:		
Customer sales		\$105,000
Cash outflows from:		
Payment of operating expenses	\$48,000	
Payment of salaries	26,500	
Other expenses	<u>11,000</u>	<u>85,500</u>
Net cash provided by operating activities		\$19,500
Cash Flows from Investing Activities		
Investments in equipment	<u>\$(16,300)</u>	
Net cash used by investing activities		(16,300)
Cash Flows from Financing Activities		
Proceeds from bank loan	\$25,000	
Distributions to owners	<u>(6,000)</u>	
Net cash provided by financing activities		<u>19,000</u>
Net increase in cash		\$22,200
Cash at beginning of year		<u>8,300</u>
Cash at end of year.....		<u>\$30,500</u>

Reset the accounting system for measurement of the next period

The last step in the accounting cycle is called the CLOSING process. The purpose of CLOSING JOURNAL ENTRIES is to reset revenue, expense and distribution accounts to zero for counting those activities in the next period. Think of bowling scores. Suppose you are playing two or more games. At the end of each game, you wouldn't carry over your score to the next game. No, you reset everything to zero before you begin. When we measure revenues, expenses and distributions to owners, they are done for a particular period. If, for example, someone were to ask what your sales for the month of August were, you wouldn't include anything prior to August 1 in that figure.

Closing journal entries are among the easiest journal entries to make, but first, let's go through a few preliminaries. All balance sheet accounts are called REAL accounts and none of them are closed. That's "none," period. Any account that appears in the income statement is called a NOMINAL or TEMPORARY account and all of them close. That's "all," period. In addition to income statement accounts, any accounts that reduce retained earnings as a distribution to the owner are also nominal.

Each period, the nominal accounts are used to update retained earnings. You may recall that when we prepared the balance sheet, we had to update retained earnings by the amount of net income. If there had been a distribution to the owner, such as a DIVIDEND, that would have also been included in the retained earnings update. (These

distributions are called by different names, depending on whether the company is a corporation or unincorporated entity, but the effect on retained earnings is the same. For the present purpose, let's assume we are a corporation; therefore, distributions to owners are called dividends.)

Closing entries mechanically adjust the books to reflect the updated balance sheet by transferring the balances from all nominal accounts to retained earnings, which is a real account. At the end of the process, retained earnings and the balance sheet are updated and all nominal accounts will have a zero balance.

For closing entries, just use the opposite "sign" of the balance in each account and use retained earnings as the "catcher" account. In other words, if a nominal account has a debit balance, you must credit it to close it; if a nominal account has a credit balance, you must debit it to close it. The resulting debit or credit goes to retained earnings. The best way to do these closing journal entries is to do a separate journal entry for each of category of revenues, expenses and distributions. Shown below is the following adjusted trial balance as of the end of July, 2015, are the three closing journal entries:

Yeah-right Company, Inc.
Adjusted Trial Balance
July 31, 2015

	Debits	Credits
Cash	\$11,400	
Accounts Receivable	9,200	
Inventory	15,000	
Equipment	36,000	
Accounts Payable		\$8,000
Loan Payable		25,000
Capital Stock		15,000
Retained Earnings		12,000
Sales Revenue		43,000
Cost of Goods Sold	17,000	
Salaries Expense	10,600	
Utilities Expense	2,600	
Dividends	1,200	
Totals	\$103,000	\$103,000

CLOSING JOURNAL ENTRIES

7/31/15	Sales revenue	43,000	
	Retained Earnings	43,000	
	<i>To close revenue account(s) to retained earnings</i>		

7/31/15	Retained Earnings	30,200	
	Cost of Goods Sold		17,000
	Salaries Expense		10,600
	Utilities Expense		2,600
	<i>To close expense accounts to retained earnings</i>		

7/31/15	Retained Earnings	1,200	
	Dividends		1,200
	<i>To close dividends to retained earnings</i>		

After the above journal entries are made and posted to the accounts, retained earnings will be updated to match the balance sheet and all nominal accounts will be reset to zero. Just to make sure, a POST-CLOSING TRIAL BALANCE is prepared. The post-closing trial balance represents the beginning balances for the next period as well as the updated ending balances for the current period. The post-closing trial balance has only real accounts and no nominal accounts.

Congratulation! You have completed the accounting cycle and are all set to do it again. You will do it for each and every period.

Subsidiary Ledgers

Up to this point, only one ledger has been used, the general ledger. As previously mentioned, a ledger is any grouping of accounts. The general ledger is grouping of all accounts used by a business to generate its financial statements. A subsidiary ledger is a grouping of all of one type of account whose total equals the balance of the account in the general ledger. A general ledger account that has a subsidiary ledger is called a CONTROL account. These can be very useful, even necessary, for certain types of accounts.

When we sell to customers on credit, we enter that transaction as an increase to accounts receivable. When cash is collected against accounts receivable, it is reduced. So, if you were to look at the accounts receivable in the general ledger, the net result is what all customers combined owe the company. But what if you wanted to call a particular customer to ask for collection? What if a customer asks how much it owes you? For these purposes, the control account is not useful at all; we need the details of that control account. So, we would create an ACCOUNTS RECEIVABLE SUBSIDIARY LEDGER. Each customer would have its own account in such a ledger and the sum of all the subsidiary ledger accounts would equal the amount in the control accounts receivable account.

While you can have many subsidiary ledgers, some common ones that are used are for accounts receivable, accounts payable and inventory. Remember, for any account that has a subsidiary ledger, both accounts have to be posted for any transactions that affect it. Otherwise, the control account and the subsidiary ledger sum will be out of balance.

Specialized Journals

Any journal entry can be made in the general journal as a standalone entry. However, there is a better way to handle repetitive transaction by the use of specialized journals. You can set up a specialized journal any time you find repetitive transactions. Common ones are SALES JOURNAL, PURCHASES JOURNAL, CASH RECEIPTS JOURNAL, CASH DISBURSEMENTS JOURNAL and PAYROLL JOURNAL. In a specialized journal, all transactions of a like-kind are entered as one line entries. The journal can have as many columns as necessary, common columns being headed by the account affected. For example, let's say you have both cash sales and credit sales. Every cash sale is a debit to cash and credit to sales revenue. Every credit sale is a debit to accounts receivable and credit to sales revenue. A simple specialized sales journal would have three posting columns, as follows:

			<u>Cash</u>	<u>Accounts Receivable</u>	<u>Sales Revenue</u>
<u>Date</u>	<u>Customer Name</u>	<u>Invoice Number</u>	<u>Debit</u>	<u>Debit</u>	<u>Credit</u>

In the above example, each sales transaction would be entered as a separate line, but it is only necessary to post the totals of the cash, accounts receivable and sales revenue accounts to the general ledger at the end of the month. Of course, for any account that involves a subsidiary ledger (in this instance, accounts receivable, a separate posting for each transaction would need to go to the customer account in the subsidiary ledger.

The column headings in specialized journals are not cast in stone and can be changed any time it makes life easier for the business. For example, suppose after using the above example for a while in a business that does not sell things subject to sales tax, you change your business to add taxable items. In that case, change the sales journal to accommodate the business, as follows:

			<u>Cash</u>	<u>Accounts Receivable</u>	<u>Sales Revenue</u>	<u>Sales Tax</u>
<u>Date</u>	<u>Customer Name</u>	<u>Invoice Number</u>	<u>Debit</u>	<u>Debit</u>	<u>Credit</u>	<u>Credit</u>

It is usually a good idea to add a general section for description and account designation to specialized journals such as the cash disbursements journal for miscellaneous items that do not warrant a separate column. Just remember that anything entered in such a column needs to be separately posted to the general journal.

Payroll

Payroll involves two separate parts plus, of course, payment of any liabilities resulting from the recording of either of the parts. The first part is to record the payroll, resulting from the calculation of each paycheck. Payroll is unique in that the amount

recorded as an expense is not paid to a single party. Rather, items that are withheld from the employee by the employer are paid to government agencies, insurance companies and so forth.

For purposes of illustration, let's assume a company has only one employee that is paid a \$500 weekly salary and the only withholdings from the employee's paycheck are for federal income taxes (for this example, assume 15%), state withholding taxes (for this example assume 5%) and FICA, which includes social security and Medicare (for this example, we'll use the current real rate of 7.65%). The journal entry to record this payroll would be:

Payroll (or Salaries Expense)	500.00	
Federal Income Taxes Payable		75.00
State Income Taxes Payable		25.00
FICA Taxes Payable		38.25
Salaries Payable		361.75
<i>To record payroll for the period xx/xx/xx</i>		

Note that none of the deductions from the employee's paycheck change the amount of the expense for this part of the payroll. They simply determine who gets it. Besides the above statutory deductions, there may be other deductions such as healthcare insurance, life insurance, pension plans, union dues, charitable contributions, saving plans and more. Each of these would be set up as a separate liability. Of course, upon payment of each liability, simply debit the liability and credit cash.

The other part of payroll is for additional expenses paid by the employer as a result of the above payroll. These additional expenses are not included in the \$500 and need to be recorded separately, together with related liabilities. One that is always there is what is commonly known as the FICA match. For whatever amount is deducted from the employee's paycheck, the employer must match it. So, in the above example, where employee FICA is \$38.25, the employer must match it with an additional \$38.25 and pay \$76.50 to the government. For this illustration, assume the only additional employer related expenses are for federal and state unemployment taxes, which, for simplicity, we'll assume are at rates of .8% and 3.5%, respectively. The resultant entry is:

Payroll Tax Expense	59.75	
FICA Taxes Payable		75.00
Federal Unemployment Taxes Payable		4.00
State Unemployment Taxes Payable		17.50
<i>To record payroll tax expenses for the period xx/xx/xx</i>		

As with withholdings from the employee, there may be many more employer expenses related to payroll, such as healthcare insurance, life insurance, pension plans, workers compensation insurance, dental plans and so forth. Also, as with the withholdings, each of these additional items would be set up as a separate liability and subsequently paid.

Depreciation

An adjusting entry for DEPRECIATION is made for long-term assets, also known as FIXED ASSETS, which will be consumed over a period of time. Depreciation does not measure market values, but, rather, is the apportionment of the cost of a fixed asset to its periods of use. There are various methods of depreciation but we'll stick to just one, known as STRAIGHT-LINE DEPRECIATION.

Under the straight-line method, the DEPRECIABLE BASE of an asset is divided by its ESTIMATED USEFUL LIFE. The depreciable base is equal to the asset's cost minus SALVAGE VALUE, which is an estimate of any remaining value of the asset after the company has used it for the estimated useful life. Note the two estimates that are used here. This is a case where the expression "better to be approximately correct than precisely wrong" comes into play, since any alternative to apportionment to periods of use based on these estimates, while perhaps more exact, will nonetheless be incorrect from an accounting perspective.

Let's look at an example based on equipment with some assumed data as follows:

Original Cost	\$8,000
Estimated salvage value	2,000
Estimated useful life	5 years

Using the above data, the depreciable base would be \$6,000 (or \$8,000 original cost minus \$2,000 salvage value). Annual depreciation would be:

$$\$6,000 \div 5 \text{ years} = \$1,200 \text{ per year}$$

For monthly depreciation, simply divide by 12 for \$100 per month.

Now, let's talk about the journal entry. The expense is easy; just debit depreciation expense. As far as the credit is concerned, while logic might have you simply reduce the cost of the asset, tradition does this in an indirect manner, through the use of a CONTRA account. A contra account is an account which goes against, or offsets, another account and the two of them together would be the same result as if you used a single account. Contra accounts always have a "sign" opposite their related main account. So, since all assets have debit balances, a contra account against an asset would have credit balance. The contra account for depreciation is called ACCUMULATED DEPRECIATION. This is not an expense account; it is the account that reduces the asset. Combined with the asset account, the result is called the NET BOOK VALUE. So, the journal entry for one month would be:

1/31/15	Depreciation expense	100	
	Accumulated depreciation – Equipment		100
	<i>To record depreciation for the month of xx/xx/xx</i>		

As accumulated depreciation rises, the net book value will decline. When the net book value equals the salvage value, depreciation is halted.