Basic Accounting

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Learning Objectives

• Define/differentiate the terms accounting, auditing and bookkeeping
• Define/differentiate the accrual and cash methods of recording transactions
• Define/differentiate revenue and expenses
• Define/recognize asset, liability and owner equity accounts
Learning Objectives

- Explain the fundamental accounting equation
- Record transactions in “T” accounts
- Define debit and credit
- Explain which transactions affect owners equity
Learning Objectives

- Journalize and post transactions
- Define/differentiate fixed and current assets
- Explain and perform adjusting entries
- Perform both unadjusted and adjusted trial balances
Learning Objectives

• Understand the measurement of income
• Describe the purpose of the income statement
• Name/recognize accounts in the income statement
• Name/describe the six sections of the income statement
Learning Objectives

- Explain why/when/how closing entries are made
- Describe the purpose of the balance sheet
- Name/recognize accounts in the balance sheet
- Name/recognize the five sections of the balance sheet
Accounting

The process of collecting, recording, summarizing, and using financial data
Auditing

A special area of accounting that deals with verifying the records that are kept and any computations that are made.
Bookkeeping

The process that documents the:

- Flow of resources ($, goods) into the business
- Flow of resources out of the business
- Claims of creditors and owners to those resources
Transactions

The fiscal/financial events that are recorded
Accounting Period

- The period of time over which transactions are recorded, at the end of which income is measured
- Most common accounting period: 1 year
- Calendar vs. fiscal
Methods of Recording Transactions

• Accrual
• Cash
Accrual

Transactions are recorded at the time they occur
Cash

Transactions are recorded when cash transfers hands
Illustration

Customer purchases an item on Dec. 10\textsuperscript{th} and plans to actually make payment on Jan. 10\textsuperscript{th}

Accrual
Cash

Dec.10  Dec.31  Jan.10
Illustration

Customer purchases an item on Dec. 10th and plans to actually make payment on Jan. 10th

<table>
<thead>
<tr>
<th>Date</th>
<th>Dec.10</th>
<th>Dec.31</th>
<th>Jan.10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrual</td>
<td>x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td>x</td>
</tr>
</tbody>
</table>
Illustration

Customer purchases an item on Dec. 10th and plans to actually make payment on Jan. 10th

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<tr>
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<th>Cash</th>
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</thead>
<tbody>
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<td>Dec. 10</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Dec. 31</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan. 10</td>
<td></td>
<td>x</td>
</tr>
</tbody>
</table>
Matching Principle

Use the accrual system because it matches revenue earned to expenses incurred to generate the revenue.
Illustration

Customer purchases an item on Dec. 10\textsuperscript{th} and plans to actually make payment on Jan. 10\textsuperscript{th}

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 10</td>
<td>Accrual</td>
</tr>
<tr>
<td>Dec. 31</td>
<td></td>
</tr>
<tr>
<td>Jan. 10</td>
<td>Cash</td>
</tr>
</tbody>
</table>

Dec. 10: x
Jan. 10: x
Revenue

The measurement of goods sold or services rendered for which the business receives “cash” or “the promise of cash” (or something else of value)
Expenses

The measurement of resources used up during a period of time in order to earn revenue
Types of Accounts

• Assets
• Liabilities
• Owner Equity
Assets

Resources owned by the business
Examples of Asset Accounts

- Cash
- Accounts receivable
- Building
- Inventory
- Equipment
- Prepaid insurance
Liabilities

Debts owed by the business to creditors
Liabilities Arise When the Business:

- Borrows cash (takes out a loan with the bank)
- Purchases goods (inventory or equipment) or services on credit
Examples of Liability Accounts

• Notes payable
• Accounts payable
Owners Equity

The claim of the owners to the assets of the business, after the creditors have been paid (also called NET WORTH)
OE = A - L
What Transactions Affect OE?

• OE is increased when the owners make investments in the business
• OE is increased when revenue is earned
• OE is decreased when expenses are paid
Examples of OE Accounts

- Contributed capital
- Sales revenue
- Service revenue
- Expense accounts
Business Example

Assets

Cash 10,000
Other 100,000

-----------

110,000 (In dollars)

Liabilities

Truck note payable 1,000

-----------

1,000

OE

(OE=A-L)

= 109,000
Prior to Capital Contribution

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>OE (OE=A-L)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 10,000</td>
<td>Truck note payable 1,000</td>
<td>109,000</td>
</tr>
<tr>
<td>Other 100,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(OE = A - L\)

\(110,000 - 1,000 = 109,000\)
# Owner Puts $500 Into Business

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>OE (OE=A-L)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 10,500</td>
<td>Truck note payable 1,000</td>
<td></td>
</tr>
<tr>
<td>Other 100,000</td>
<td></td>
<td>-1,000</td>
</tr>
<tr>
<td>----------------</td>
<td>------------------------------</td>
<td>-------------</td>
</tr>
</tbody>
</table>
Owner Puts $500 Into Business

Assets

Cash 10,500
Other 100,000

-------------
110,500

Liabilities

Truck note payable 1,000

-------------
1,000

 OE (OE=A-L)

110,500 - 1,000 = 109,500
## Owner Puts $500 Into Business

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<td></td>
<td>109,500</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------------------</td>
<td>----------------</td>
</tr>
<tr>
<td></td>
<td></td>
<td>110,500 - 1,000=</td>
</tr>
</tbody>
</table>
Prior to Earning Sales Revenue

<table>
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<tr>
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<td></td>
</tr>
<tr>
<td>---------------</td>
<td>-----------------------</td>
<td>-------------</td>
</tr>
<tr>
<td>110,500</td>
<td>1,000</td>
<td>109,500</td>
</tr>
</tbody>
</table>

\[
OE = A - L = 110,500 - 1,000 = 109,500
\]
Earns Sales Revenue $500

**Assets**
- Cash: 11,000
- Other: 100,000

**Liabilities**
- Truck note payable: 1,000

**OE**

\[
\text{OE} = \text{A-L} = 1,000
\]
Earnings Sales Revenue $500

**Assets**
- Cash 11,000
- Other 100,000

**Liabilities**
- Truck note payable 1,000

**OE**

\[(OE = A - L)\]

\[
\begin{align*}
\text{Assets} & \quad \text{Liabilities} \\
111,000 & \quad - 1,000 \\
\hline
110,000 & = 0
\end{align*}
\]
**Earns Sales Revenue $500**

<table>
<thead>
<tr>
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</tr>
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<tbody>
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<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>111,000 - 1,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>= 110,000</td>
</tr>
</tbody>
</table>
Prior to Paying Expense

<table>
<thead>
<tr>
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<th>Liabilities</th>
<th>OE</th>
</tr>
</thead>
<tbody>
<tr>
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<td>Truck note</td>
<td></td>
</tr>
<tr>
<td>Other 100,000</td>
<td>payable 1,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>110,000</td>
</tr>
</tbody>
</table>

\(OE = A - L\)
Pays Phone Expense ($100)

Assets

Cash 10,900
Other 100,000

Liabilities

Truck note payable 1,000

OE (OE=A-L)

1,000

- 1,000 =
Pays Phone Expense ($100)

Assets

Cash 10,900
Other 100,000

-----------
110,900

Liabilities

Truck note payable 1,000

------------
1,000

OE

(\text{OE=A-L})

= 100
Pays Phone Expense ($100)

Assets

- Cash 10,900
- Other 100,000

= 110,900

Liabilities

- Truck note payable 1,000

= 1,000

OE (OE=A-L)

= 109,900
Commit to Memory

• OE is increased when the owners make investments in the business
• OE is increased when revenue is earned
• OE is decreased when expenses are paid
Accounting Equations

• Rearrange algebraically
  \[\text{OE} = \text{A} - \text{L}\]

• Fundamental accounting equation
  \[\text{A} = \text{L} + \text{OE}\]
Accounting Equations

\[ A = \text{L} + \text{OE} \]

- A: Assets
- L: Liabilities
- OE: Owners' Equity

Assets:
- Cash
- AR
- Fixture
- Inventory

Liabilities:
- Bank note payable
- Wholesaler AP
- Auto note payable

Owners' Equity:
- Contributed capital
- Sales Revenue
- Operating Expenses
Dual Effects of Accounting

Every time a transaction occurs, it has to be recorded in the proper accounts.
Buy Computer System for $28,000 Cash

\[ A = L + OE \]

\[ -28,000 \]

\[ +28,000 \]
Owner Invests $10,000 Cash in Business

\[ A = L + OE \]

\[ +10,000 \quad +10,000 \]
Business Borrows $5,000 from Bank

\[ A = L + OE + 5,000 + 5,000 \]
Cash Sales for the Day Total $1,000

\[ A = L + OE \]

+1,000 + 1,000
Credit Sales for the Day Total
$2,000

\[ A = L + OE \]

+2,000 +2,000
Do Assets Really Equal Liabilities Plus OE?

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>=</th>
<th>L</th>
<th>+</th>
<th>OE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-28,000</td>
<td></td>
<td>+28,000</td>
<td></td>
<td>+10,000</td>
</tr>
<tr>
<td></td>
<td>+10,000</td>
<td></td>
<td>+10,000</td>
<td>+5,000</td>
<td>+1,000</td>
</tr>
<tr>
<td></td>
<td>+5,000</td>
<td></td>
<td></td>
<td>+5,000</td>
<td>+2,000</td>
</tr>
<tr>
<td></td>
<td>+1,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>+2,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>18,000</td>
<td>=</td>
<td>5,000</td>
<td>+</td>
<td>13,000</td>
</tr>
</tbody>
</table>
Commonly Asked Question

Why doesn’t the purchase of an Asset increase OE?

• OE = A – L
  ↑↓
• OE = A - L
  ↑  ↑
Commonly Asked Question

Why doesn’t decreasing a Liability increase OE?

- OE = A - L
Commonly Asked Question

Why isn’t an Expense a Liability?

Expenses are the measure of resources used up. They require the immediate payment of cash for the amount in full.
Summary

• Expenses paid in advance are resources and are classified under ASSETS

• Expense account titles appear under OE. When expenses occur, they are recorded in these accounts

• When expenses can’t be paid with cash we create a LIABILITY
Rules and Steps Involved in Recording Transactions
“T” Accounts

\[ A = L + OE \]

- Cash
- Bank Note Payable
- Accts Rec
- Cont Cap
- Sales Revenue
“T” Account

Debit (Left) | Credit (Right)
For Asset Accounts

- Increases to the account are placed on the debit side
- Decreases to the account are placed on the credit side

<table>
<thead>
<tr>
<th>Debit (Left)</th>
<th>Credit (Right)</th>
</tr>
</thead>
<tbody>
<tr>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>
For Liability and OE Accounts

- Increases are placed on the credit side
- Decreases are placed on the debit side

<table>
<thead>
<tr>
<th>-</th>
<th>+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit (Left)</td>
<td>Credit (Right)</td>
</tr>
</tbody>
</table>
Fundamental Accounting Equation

\[ A = L + OE \]
Balancing Feature

Debits = Credits
To Record Transactions, Ask:

1. What accounts are affected?
   Locate these accounts under their proper headings (A, L, or OE)

2. How is the heading (A, L, OE) affected?
   This tells you whether to place numbers on the debit or credit side of the account

3. After placing numbers in accounts, do debits = credits?
Typical Transactions

See Supplemental Materials
Transactions: a, b & c

\[ +A^- = -L^+ + -OE^+ \]

| Cash | | Sales Revenue |
|------|-----------------|
| a) 500 | a) 500 |
| c) 50 | b) 300 |

<table>
<thead>
<tr>
<th>Accounts Receivable</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>b) 300</td>
<td>c) 100</td>
</tr>
<tr>
<td>c) 50</td>
<td></td>
</tr>
</tbody>
</table>
Transactions: d, e & f

\[ +A^- = -L^+ + -OE^+ \]

- **Cash**: 
  - d) 100
  - f) 3,000

- **Salary Payable**: 
  - e) 3,000
  - f) 3,000

- **Phone Exp.**
  - d) 100

- **Salary Exp.**
  - e) 3,000
Transactions: g, h & i

\[\begin{align*}
\text{Cash} & \quad \text{Computer AP} \\
g) 5,000 & \quad h) 8,000 \\
i) 7,000 & \quad i) 7,000 \\
\text{Fixtures} & \quad \text{Auto AP} \\
g) 5,000 & \\
h) 8,000 & \\
\text{Computer} & \\
h) 8,000 & \\
\text{Automobile} & \\
i) 14,000 &
\end{align*}\]
Transactions: j & k

\[ +A^- = -L^+ + -OE^+ \]

\[
\begin{align*}
\text{Cash} & \quad \text{Bank Note Payable} \\
j) 50,000 & \quad j) 50,000 \\
k) 25,000 & \quad k) 25,000
\end{align*}
\]
Transactions: I

\[ +A^- = -L^+ + -OE^+ \]

 Accounts Receivable
  2,000
  I) 1,000

 Cash
  I) 1,000

 Sales Revenue
  2,000
Transaction: m

\[ +A - = -L + \]

Cash

\[
\text{m)} 10,000
\]

Contributed Capital

\[
\text{m)} 10,000
\]
Steps for Recording Transactions

1. Mental analysis
2. Journalizing
3. Posting
4. Trial balance
For the “Typical Transactions”

1. Mental analysis
2. Journalizing
3. Posting
4. Trial balance
Jones Pharmaceutical Center

1. Mental analysis
2. Journalizing
3. Posting
4. Trial balance
a. Dr. Jones invested $25,000 in the pharmaceutical center

\[ +A- = -L+ + -OE+ \]
b. Paid one month’s rent of $1,200 on the building

\[ +A- = -L+ + -OE+ \]
c. Paid $4,000 for a computer

\[ +A- = -L+ + -OE+ \]
d. Purchased fixture (product display case) for cash ($1,200)

\[ +A- = -L+ + -OE+ \]
e. Purchased more fixtures (counseling area walls/furniture, etc.) on account in the amount of $3,150 from Pharmacy Equipment Company

+\(A^{-}\) = -\(L^{+}\) + -\(OE^{+}\)
f. Paid pharmacy equipment company $400

\[ +A^- = -L^+ + -OE^+ \]
g. Bought $9,600 in drugs (inventory) from United States Drugs and paid cash for the total

\[ +A- = -L+ + -OE+ \]
h. Recorded cash sales of $200

\[ +A- = -L+ + -OE+ \]
Recorded charge sales of $600

\[+A- = -L+ + -OE+\]
j. Paid telephone bill of $120

\[+A- = -L+ + -OE+\]
k. Billed third parties for cognitive services totaling $400

\[ +A- = -L+ + -OE+ \]
Jones Pharmaceutical Center

1. Mental analysis
2. Journalizing
3. Posting
4. Trial balance
<table>
<thead>
<tr>
<th>Date</th>
<th>Account title &amp; explanation</th>
<th>Folio</th>
<th>Db</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/1</td>
<td>Cash</td>
<td>101</td>
<td>25,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Jones, Capital investment</td>
<td>501</td>
<td></td>
<td>25,000</td>
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</table>

Owner investment in the business
## Journal Entry

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Jones, Capital investment 501 25,000

Owner investment in the business
**Journal Entry**

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**Owner investment in the business**
Jones Pharmaceutical Center

1. Mental analysis
2. Journalizing
3. Posting
4. Trial balance
Jones Pharmaceutical Center

1. Mental analysis
2. Journalizing
3. Posting
4. Trial balance
Taking a Trial Balance

• Take the balance of each T account
• Note whether each balance is on the debit or credit side
# Sample Account Balance
(Jones Pharmaceutical Center)

<table>
<thead>
<tr>
<th>Cash</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a)</td>
<td>25,000</td>
</tr>
<tr>
<td>h)</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td>25,200</td>
</tr>
<tr>
<td>b)</td>
<td>1200</td>
</tr>
<tr>
<td>c)</td>
<td>4000</td>
</tr>
<tr>
<td>d)</td>
<td>1200</td>
</tr>
<tr>
<td>e)</td>
<td>400</td>
</tr>
<tr>
<td>g)</td>
<td>960</td>
</tr>
<tr>
<td>j)</td>
<td>120</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>8,680</td>
</tr>
<tr>
<td></td>
<td>16,520</td>
</tr>
</tbody>
</table>
## Unadjusted Trial Balance
Jones Pharmaceutical Center

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>8,680</td>
<td></td>
</tr>
<tr>
<td>Computer</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Fixtures</td>
<td>4,350</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>9,600</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
<td>2,750</td>
</tr>
<tr>
<td>Jones, capital investment</td>
<td></td>
<td>25,000</td>
</tr>
<tr>
<td>Rent expense</td>
<td>1,200</td>
<td></td>
</tr>
<tr>
<td>Sales revenue</td>
<td></td>
<td>800</td>
</tr>
<tr>
<td>Service revenue</td>
<td></td>
<td>400</td>
</tr>
<tr>
<td>Telephone expense</td>
<td>120</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>28,950</td>
<td>28,950</td>
</tr>
</tbody>
</table>
Unadjusted Trial Balance

The last day of the accounting period has not been reached
Income

Income = Revenue - Expenses
Typical Adjusting Entries

- Inventory
- Salary
- Depreciation
- Prepaid expenses
Adjusting Entry for Inventory

• Throughout the accounting period, we have recorded inventory flowing into the business, but not inventory leaving the business
• The inventory that was sold was an expense (a resource used up)
• This expense must be recorded
Scenario

\[ +A- = -L+ + -OE+ \]

<table>
<thead>
<tr>
<th>Inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1) 5,000</td>
</tr>
<tr>
<td>3/1) 2,000</td>
</tr>
<tr>
<td>5/1) 2,000</td>
</tr>
<tr>
<td>7/1) 5,000</td>
</tr>
<tr>
<td>9/1) 2,000</td>
</tr>
<tr>
<td>11/1) 2,000</td>
</tr>
<tr>
<td>18,000</td>
</tr>
</tbody>
</table>
Cost of Goods on Hand

- On the last day of the accounting period, we conduct a physical inventory to determine the cost of goods on hand, i.e., the cost of the inventory that was not sold.
- Computer systems can provide the cost of goods on hand amount because they keep a perpetual inventory.
- Scenario: Cost of Goods on Hand = $3,000
How to Calculate Cost of Goods Sold (Inventory Expense)

Balance of the Inventory Account  ($18,000)
(minus)
Cost of Goods on Hand  ($3,000)

Cost of the Goods Sold  ($15,000)
Recording Cost of Goods Sold (Inventory Expense)

\[ +A- = -L+ + -OE+ \]

<table>
<thead>
<tr>
<th>Inventory</th>
<th>Inventory Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1) 5,000</td>
<td>12/31) 15,000</td>
</tr>
<tr>
<td>3/1) 2,000</td>
<td></td>
</tr>
<tr>
<td>5/1) 2,000</td>
<td></td>
</tr>
<tr>
<td>7/1) 5,000</td>
<td></td>
</tr>
<tr>
<td>9/1) 2,000</td>
<td></td>
</tr>
<tr>
<td>11/1) 2,000</td>
<td></td>
</tr>
<tr>
<td><strong>3,000</strong></td>
<td></td>
</tr>
</tbody>
</table>
Adjusting Entry for Salary

- Salary is an expense the business incurs to generate revenue
- Often the end of an accounting period falls in the middle of a pay period
- The amount of salary owed employees on the last day of the accounting period must be recorded
### Recording Salary Expense

\[
+A- = -L+ + -OE+
\]

<table>
<thead>
<tr>
<th></th>
<th>Salary Payable</th>
<th>Salary Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31) 1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>
Two Types of Assets

• Fixed Assets: Tangible, long-lived resources used in the operation of the business (Bldg, Machinery, Fixtures, Equipment)

• Current Assets: Resources owned by the business which are expected to be realized in cash, sold, or consumed in one year (Cash, Accounts Receivable, Inventory)
Adjusting Entry for Depreciation

- Businesses are allowed to consider the wear and tear that occurs on fixed assets as an expense called depreciation expense.
- With the exception of land, fixed assets are depreciated over their useful life.
Depreciation Can Be Calculated in Different Ways:

- Figure greater wear/tear in early life of the asset
- Figure greater wear/tear in later life of the asset
- Straight-line depreciation: equal wear/tear each year of useful life
Scenario

\[ +A- = -L+ + -OE+ \]

\[
\begin{align*}
\text{Cash} & \quad 1/1)100,000 \\
\text{Fixtures} & \quad 1/1)100,000
\end{align*}
\]
Recording Depreciation Expense

\[+A- = -L+ + -OE+\]

<table>
<thead>
<tr>
<th>Description</th>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1/1</td>
<td>100,000</td>
</tr>
<tr>
<td>Fixtures</td>
<td>1/1</td>
<td>100,000</td>
</tr>
<tr>
<td>Acc. Dep. Fixtures</td>
<td>12/31</td>
<td>1,000</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>12/31</td>
<td>1,000</td>
</tr>
</tbody>
</table>
Contra Accounts

- Contra (offset) accounts reside directly below the fixed asset account to which they pertain.
- For depreciating fixed assets, contra accounts should be used for the credit entry so that the balance in the fixed asset account will retain its initial value.
Adjusting Entry for Prepaid Expenses

• Prepaid expenses are assets because they are resources (owned by the business) that have not yet been used up

• On the last day of the accounting period, the amount of a prepaid expense that has been used must be determined and recorded as an expense
Scenario

\[ +A - = -L + + -OE + \]

<table>
<thead>
<tr>
<th>Cash</th>
<th>1/1)2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid Insurance</td>
<td>1/1)2,000</td>
</tr>
</tbody>
</table>
## Recording of Prepaid Expense Used Up

\[ +A- = -L+ + -OE+ \]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepaid Insurance</td>
<td>1,000 12/31</td>
</tr>
<tr>
<td>Insurance Expense</td>
<td>1,000 12/31</td>
</tr>
</tbody>
</table>
Stone Drug Co.

- Adjusting entries
- One month accounting period
Stone Drug Co.: Inventory in Stock Amounts to $5800

\[+A- \quad = \quad -L+ \quad + \quad -OE+\]

<table>
<thead>
<tr>
<th>Inventory</th>
<th>Inventory Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/31)16,000</td>
<td>1/31)16,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Inventory</th>
<th>21,800</th>
</tr>
</thead>
<tbody>
<tr>
<td>4,000</td>
<td>- 5,800</td>
</tr>
<tr>
<td>9,000</td>
<td></td>
</tr>
<tr>
<td>7,000</td>
<td>16,000</td>
</tr>
<tr>
<td>+ 1,800</td>
<td></td>
</tr>
<tr>
<td>21,800</td>
<td></td>
</tr>
</tbody>
</table>
Stone Drug Co.: Owe $800 Salary to an Employee

\[ +A- = -L+ + -OE+ \]

Salary Payable
1/31) 800

Salary Expense
1/31) 800
Stone Drug Co.: Used Up $1/12^{th}$ of the Prepaid Insurance

\[ +A- = -L+ + -OE+ \]

\begin{align*}
\text{Prepaid Insurance} & \quad 1/31) \quad 83 \\
\text{Insurance Expense} & \quad 1/31) \quad 83
\end{align*}
Stone Drug Co.: Record 1/12\textsuperscript{th} of Building’s Yearly Depreciation

\[ +A - = -L + + -OE + \]

<table>
<thead>
<tr>
<th>Bldg.</th>
<th>Dep. Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>100,000</td>
<td>1/31) 83</td>
</tr>
<tr>
<td>Acc. Dep. Bldg.</td>
<td>1/31) 83</td>
</tr>
</tbody>
</table>
Stone Drug Co.

Adjusted Trial Balance
(see Supplemental Materials)
The Last Day of the Accounting Period

- Income statement
- Recording of closing entries
- Construction of the balance sheet
# Example: Fictitious Business

\[
\begin{align*}
\text{+A-} & \quad = \quad -\text{L+} & \quad + & \quad -\text{OE+} \\
\text{Cash} & \quad 20,000 & \quad 9,000 & \quad \text{Note Payable} & \quad 20,000 \\
40,000 & \quad & \quad & \quad & \quad \text{Cont. Capital} & \quad 20,000 \\
\text{Accts. Receivables} & \quad 10,000 & \quad & \quad & \quad \text{Sales Revenue} & \quad 50,000 \\
\text{Fixtures} & \quad 22,000 & \quad & \quad & \quad \text{Operating Expenses} & \quad 9,000 \\
\text{Acc. Dep. Fixtures} & \quad 1,000 & \quad & \quad & \quad \text{Depreciation Expense} & \quad 1,000 \\
\text{Income} & \quad 50,000 \quad - \quad (9,000 + 1,000) & \quad = \quad 40,000
\end{align*}
\]
Financial Statements

- Income statement
- Balance sheet
Income Statement

• Summary of income earned during accounting period
• The result of operations for the accounting period
• To construct, use revenue and expense account balances
Income Statement

• Six sections
• Example: Stone Drug Company
Heading

Stone Drug Co.
Income Statement
Month ending January 31st, current year
# Revenue

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$20,650</td>
<td></td>
</tr>
<tr>
<td>Service</td>
<td>$ 8,600</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>$29,250</td>
</tr>
</tbody>
</table>
Cost of Goods Sold

Inventory expense $16,000
Transportation expense $600

$16,600
Gross Margin

Gross Margin $12,650

\[ \text{Gross Margin} = \text{Revenue} - \text{COGS} \]
(29,250 – 16,600)
## Remaining Expenses

### Expenses

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary expense</td>
<td>$2,800</td>
</tr>
<tr>
<td>Advertising expense</td>
<td>$400</td>
</tr>
<tr>
<td>Phone expense</td>
<td>$75</td>
</tr>
<tr>
<td>Insurance expense</td>
<td>$83</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>$83</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$3,441</strong></td>
</tr>
</tbody>
</table>
Net Profit, i.e., Income

Net Profit $9,209

Revenue – All Expenses
29,250 – (16,600 + 3,441)

Gross Margin – Remaining Expenses
12,650 – 3,441
Net Profit vs. Net Income

• Net = final
• Corporations pay income tax
  \[ \text{Net profit} - \text{income tax} = \text{net income} \]
• Sole proprietorships and partnerships do not pay income tax
  \[ \text{Net profit} = \text{Net income} \]
Closing Entries

• Made after income measured, i.e., after income statement made
• Empty out revenue and expense accounts
• Transfer income to retained earnings, an OE account
• Dated last day of accounting period
Closing Entries

Are made to empty out revenue and expense accounts so that the business can begin measuring income for the new accounting period
Mechanics of Closing Entries – Step 1

\[ +A - = -L + + -OE + \]

Take the balance of each revenue and expense account

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Revenue</td>
<td>50,000</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>9,000</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>1,000</td>
</tr>
</tbody>
</table>
Mechanics of Closing Entries – Step 2

\[ +A - = -L+ + -OE+ \]

If account has a credit balance, debit the account for that amount, and credit retained earnings for that amount.

- **Sales Revenue**
  - 12/31 50,000

- **Operating Expenses**
  - 9,000

- **Depreciation Expense**
  - 1,000

- **Retained Earnings**
  - 12/31 50,000
### Mechanics of Closing Entries – Step 3

\[ +A - = -L+ + -OE+ \]

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Revenue</td>
<td>$50,000</td>
<td>12/31</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>$9,000</td>
<td>12/31</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>$1,000</td>
<td>12/31</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$50,000</td>
<td>12/31</td>
</tr>
<tr>
<td></td>
<td>$9,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$1,000</td>
<td></td>
</tr>
</tbody>
</table>

If account has a debit balance, credit the account for that amount, and debit retained earnings for that amount.
Closing Entries Transfer Income to Retained Earnings

\[ +A- = -L+ + -OE+ \]

- **Sales Revenue**
  - 12/31 50,000
- **Operating Expenses**
  - 9,000 12/31 9,000
- **Depreciation Expense**
  - 1,000 12/31 1,000
- **Retained Earnings**
  - 12/31 50,000
  - 12/31 9,000
  - 12/31 1,000

\[ +A- = -L+ + -OE+ = 40,000 \]
Closing Entries for Stone Drug Co.

See Supplemental Materials
Balance Sheet

• Presents the financial position of a business at a particular point in time
• To construct use all asset accounts, all liability accounts, and OE accounts of contributed capital and retained earnings (The revenue and expense accounts have been closed)
Balance Sheet

• Five sections
• Example: Stone Drug Company
Assets

Current assets:

- Cash $21,125
- Accounts receivable $5,250
- Inventory $5,800
- Prepaid Insurance $917

TOTAL CURRENT ASSETS $33,092

Fixed assets:

- Building $100,000
- Less Accum. Depr. $83

TOTAL FIXED ASSETS $99,917

TOTAL ASSETS $133,009
Liabilities

Current liabilities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary payable</td>
<td>$ 800</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$3,000</td>
</tr>
<tr>
<td><strong>TOTAL CURRENT LIABILITIES</strong></td>
<td><strong>$3,800</strong></td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES</strong></td>
<td><strong>$3,800</strong></td>
</tr>
</tbody>
</table>
Owners Equity

Contributed capital, Stone $120,000
Retained earnings $  9,209
Total Owners Equity     $129,209
Liabilities + OE

Total Liabilities
and Owners Equity  133,009
Retained Earnings

Link between income statement and balance sheet
Accounting Cycle

Throughout accounting period:

1. Record transactions

Last day of accounting period:

2. Adjusting entries
3. Income statement
4. Closing entries
5. Balance sheet