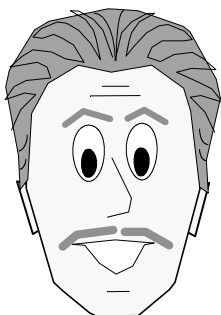


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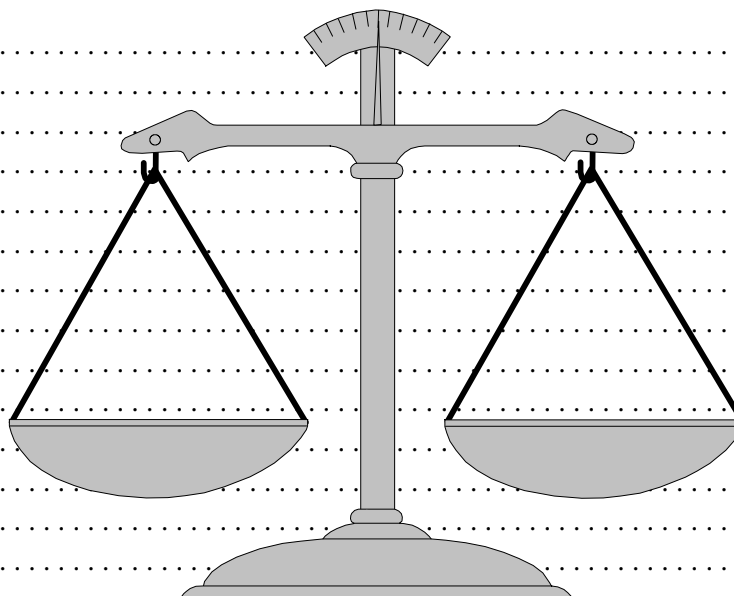
# ACCOUNTING



# BASICS

## Table of Contents

<b>The Financial Fourteen</b> .....	2
<b>Accounting Literacy</b> .....	3
<b>It's All About Transactions</b> .....	4
<b>Business Startup Activity (BSA)</b> .....	5
<b>Accounting Terms &amp; Concepts</b> .....	6
<b>Accounting Forms &amp; Books</b> .....	9
<b>Accounting Methods</b> .....	11
<b>Fundamental Accounting Equation</b> .....	12
<b>Transaction Analysis</b> .....	13
<b>Umbrella T-Accounting</b> .....	14
<b>The Balance Family</b> .....	16
<b>Balance Sheet Map</b> .....	17
<b>Error Checking</b> .....	22
<b>Correcting Entries</b> .....	23
<b>Adjustments</b> .....	24
<b>Trial Balance Worksheet: Profit &amp; Loss</b> .....	26
<b>Closing</b> .....	28
<b>The Subsidiary Ledger Bros.</b> .....	31
<b>A/R and A/P Controlling Accounts</b> .....	32
<b>Accounting Cycle AcroMap</b> .....	33
<b>Accounting Cycle Flowchart</b> .....	34



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# The Financial Fourteen

If you want to become accounting literate, make the Financial Fourteen (FF) terms part of your working vocabulary. FF definitions may differ from traditional ones because they attempt to answer the "why?" or "what good is it?" of each term. Keywords are *italicized* and abbreviations or acronyms are (parenthesized).

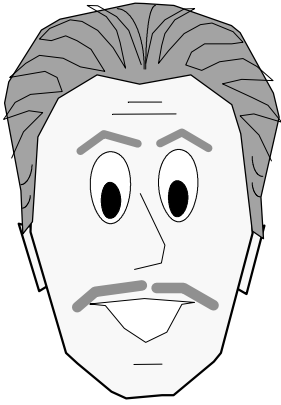
1. **ASSETS (A):** *items of value* used to create goods and services to sell.
  2. **LIABILITIES (L):** *debts* used to buy assets.  
**Trap!** The "b" in debts is silent. The word is pronounced DETS.
  3. **OWNERS EQUITY (OE):** *investments/profits* used to buy assets.  
**Tip:** Think OWNERS = adjective. An apostrophe was omitted because Owner's = Sole Proprietor; Owners' = Partnership/Corporation.
- 
4. **FUNDAMENTAL ACCOUNTING EQUATION (FAE):** Assets = Liabilities + Owners Equity (ALOE) which means items of value are funded from debts + investments/profits.
  5. **ACCOUNT (Acct):** *category* of business activity.
  6. **DEBIT (Dr):** *left* side of an account—it does NOT mean down or negative.  
**CREDIT (Cr):** *right* side of an account—it does NOT mean up or positive.
  7. **TRANSACTION:** *exchange of value* between accounts.
- 
8. **CHART OF ACCOUNTS (CofA):** *list* of all accounts used by a business.
  9. **GENERAL JOURNAL (G/J):** *diary* of transactions between accounts.
  10. **GENERAL LEDGER (G/L):** *book* with the *history and balance* of each account.
- 
11. **TRIAL BALANCE (TB):** shows Total G/L Debits = Total G/L Credits.
  12. **INCOME STATEMENT (IS):** shows Revenue – Expenses for an accounting *period*.
  13. **BALANCE SHEET (BS):** shows Assets = Liabilities + Owners Equity on a given *day*.
- 
14. **ACCOUNTING CYCLE**  
 Transactions: Source documents→Journal→Ledger→Trial Balance Worksheet→Financial statements (T:S-JLT-F).  
 Adjustments/Closing: Journal→Ledger→Trial Balance Worksheet (A/C:JLT).  
**Acrostic:** Terry Sue JiLTs Frank as the Air Conditioner JoLTs!

**To Do: Make flashcards with the term on one side and the definition on the other.  
 Carry them with you and study them in spare moments throughout the day.**

## Pronunciation Guide

Vowels			Consonants	
Long	Short	Other	Hard	Soft
aa = ate	a = act	ai=air ar=are	k = cat	s = ice
ee = eel	e/eh =		g = go	i = oem
ii = hi	i/ih = hid		s/ss = hiss	z = his
oh = no	aw = on	oo = book, or = for ow = how, oy = boy	ch = chin	sh=shin;
yu = use	u/uh = up	uu = too, ur = fur	th = thin	thh = this
			<b>Accent on:</b> UP-ur-KAASS	

# Accounting Literacy



Memorizing definitions like the Financial Fourteen on the preceding page isn't much fun. But after you read the following story of a good friend of mine who struggled to learn accounting, you'll see why it's worth the effort.

## My Accounting Education - by Max's Friend

### Introduction to Double-Entry Accounting

To get my MBA (Masters of Business Administration), I needed several core business classes. I decided to get a head start by taking a three-week summer session of Financial Accounting. I had been using single-entry accounting in my own small business, so I figured it wouldn't be that difficult to learn double-entry accounting in three weeks. Or so I thought.

### Class Nightmares

The Financial Accounting class met four hours per night, Monday through Thursday. During the last hour, on Thursday, the instructor tested us on *five* chapters, including the one we had covered that night! I didn't know a debit from a credit before I started the course, so for me, covering a 15-chapter book in three weeks was insane. With a good short-term memory, hours of cramming, and relatively easy multiple-choice tests, I got an A- in the class, but I really did not understand accounting.

Having passed the first course, I decided to continue the summer session with six weeks of Cost Accounting. I got even more confused but with generous grading managed to pass the class with a B. I did not feel confident about my accounting knowledge or abilities, but at least, I told myself, I had my accounting courses out of the way. After all, my chosen emphasis was Information Systems (computing), so I didn't think accounting would be that critical to my future. Little did I know.

### On The Job

A few months into the Fall semester of my MBA, I decided that I needed some on-the-job computer experience. So one Saturday morning I typed up my résumé, made copies, and hit the streets. At the seventh computer store I visited, the owner took me into the back room and looked over my qualifications. He saw that I had little computer experience to date, but what he really needed was a store manager. Having run my own business, he figured I could do it. We worked out a schedule around my classes, and I excitedly began my computing career.

The store needed a lot of attention, and I set to work enthusiastically, even coming in on my days off to clean and organize—without pay. Naturally, the owner was thrilled and let me have free rein with my ideas. However, after a few months, after the store was fixed up, he began to balk at my suggestions. It became a classic battle between the "school of hard knocks, I've tried that before and it didn't work" owner, and the "young, pie in the sky, thinks he knows it all" college student. We got into heated arguments over store policies—it's a wonder he didn't fire me! Most days I'd leave with a tension headache.

### Accounting Comeuppance

We had an outside bookkeeper, so my in-store accounting duties involved maintaining cash, ordering inventory, recording sales, and making bank deposits. No problem, but it seemed ludicrous to me to be using a tin cash box and hand-written receipts! My "old-school" boss was reluctant to automate, even though he expected me to sell computerized point-of-sale systems to business customers!

One day we got into a debate about accounting methods, and he mentioned the Chart of Accounts. I said, "What's that?" And he said, "You mean you're an MBA student and you don't know what a Chart of Accounts is?!" I blurted out something to cover my embarrassment, but I really did not know what he was talking about.

I rushed home that night, dug out my accounting textbook and found that I *did* know what a Chart of Accounts was, but I didn't remember it by its formal name. And that was the day I learned the importance of making basic accounting terminology part of my working vocabulary.

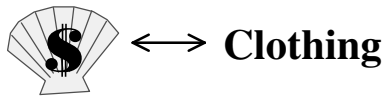
*Don't let what happened to my friend happen to you.  
Memorize the Financial Fourteen!*

# It's All About Transactions

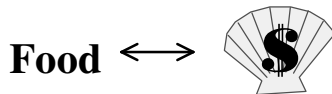
Once upon a Stone-Age time lived Drac, the leader of the Digging Clan, renowned growers of fine vegetables. Nearby lived Crac, head of the Clothing Clan, makers of fine flax garments. One spring, Drac's clan had a surplus of veggies but was short on shirts. Meanwhile, Crac's clan had plenty of shirts but was almost out of veggies. So Drac and Crac decided to swap food for clothing. This *exchange of value* was history's first *transaction*.

**Food ↔ Clothing**

**Item Transaction**

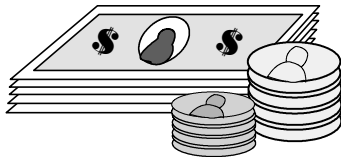
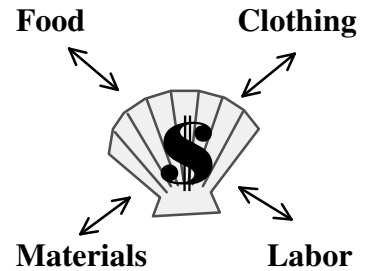


**"Money" Transactions**



The following spring Drac's Digging Clan had a bumper crop, so he went to see Crac's Clothing Clan about another exchange. Crac was agreeable, but his clan didn't need veggies at the moment. Eyeing an exotic seashell in Drac's belt, Crac agreed to give him five items of clothing for it. Later in the year, when the Clothing Clan needed food, Crac traded the seashell back to Drac for five bushels of veggies. By using the value of a neutral item (seashell) to represent value, Drac and Crac invented the concept of *money*.

The idea caught on and soon all clans were using seashells to represent items of value—not just food and clothing, but materials, labor, and countless other valuables. Clans with a special skill or technique labored to transform natural materials into desirable items. They then *sold* these items for seashell money, which they then used to *buy* what they needed from other clans. Seashells became the common *currency of exchange*.



Drac and Crac and their neighbors kept track of seashells and other items by counting them. Over the centuries, a written set of rules was developed for counting money and items of value. In honor of Drac and Crac, we call this set of rules **Debit/CRedit ACcounting!**

(In case there's any doubt, the preceding story is imaginary!)

Of course, nowadays instead of shells, we use coins and printed paper to represent items of value. Let's suppose you wanted to create something of value and sell it for money so you could buy whatever you wanted. Rather than work for someone else—exchanging your labor for wages—you decide to start your own business. Why would you want to? You may have several reasons: to bring a great idea or invention to the world, to provide a needed service, to be your own boss, to work your own hours. But whatever your motives, to remain in business, you must be able to *make* more money than you *spend*. In other words, you must earn a *profit*.

What could you do or make that others would be willing to pay for? Perhaps you could perform tasks that people don't have time or desire to do themselves, like word processing. Perhaps you could take basic raw materials and add value to them by creating something new and useful, e.g., the car or bus you ride in was literally created from rocks and plants. Perhaps you could find a more efficient way to sell a product, e.g., by mail. Your choice of business would fall into one of the following categories, or a combination of both:

- **Service Business** earns profits by providing services that people are willing to pay for.
- **Merchandising Business** earns profits by manufacturing (wholesaler) and/or selling (retailer) products.

***On the next page you will get a chance to form your own business—on paper!***



# Accounting Terms & Concepts

One of the more frustrating aspects of accounting is the ambiguous use of terminology. Many terms that have a specific accounting meaning are used less clearly in everyday conversation. Even accounting textbooks and accounting firms don't always agree on terms. As we cover these terms it's important to remember to:

- Assume you are part of the firm, then define everything from your *firm's* Point of View (POV).
- Measure the value of everything in dollars.

## General Terms

**Firm:** (aka business, enterprise, going concern) commercial entity that you created to earn profits.

**Account:** *category* of business activity that you use to keep track of your firm's transactions.

**Debit:** *left* side of an Account—it does NOT mean down or negative.

**Credit:** *right* side of an Account—it does NOT mean up or positive.

**Trap!** A common misconception is that Debit = decrease and Credit = increase. Part of this stems from Checking Account Registers that have us record checks in the Debit (–) column and deposits in the Credit (+) column. From the bank's POV, your Check Register is actually their Loan Payable account. Deposits you "loan" to the bank increase its liability to you; checks you withdraw decrease it. Also consider that Debit cards immediately decrease your checking account balance, while Credit cards seem to increase it by giving you more money (actually increasing what you owe).

**Transaction:** *exchange of value* between accounts that normally results from buying or selling.

**Transaction Analysis:** The process of determining the debit and credit sides of a transaction.

**Period:** the month, quarter, or year that your firm totals and summarizes its accounting figures.

## ASSETS

**Items of value used to create goods and services to sell.**

- **CASH**—money you use to support your firm's activities.  
Cash is kept in a bank for safety and to earn interest. Typically, when you wish to exchange cash for other items of value or to pay debts, you write checks. For small items you may use actual cash (Petty Cash).
- **SUPPLIES**—*consumable* items you buy to support your firm's activities.  
Supplies have value since they can normally be returned to the store unused for a refund. To account for depleted supplies, your firm expenses them as they are used up; e.g., paper, pens, diskettes, toner, etc.
- **ACCOUNTS RECEIVABLE (A/R)**—represents money that your firm is entitled to receive from *customers*.  
In order to make more sales, you sell goods/services to your creditworthy customers "on account" in return for a promise to pay later; e.g., "Make No Payments for 30 Days!" The risk is that some of your customers, having already received the goods/services, fail to pay. A/Rs have value and can be sold outright to a collection firm, although at a reduced price, since the risk of non-payment transfers to the collection firm.  
**Note:** If a customer buys with a major credit card, your firm records it as a *Cash* sale since the credit card company owes you the money immediately (less any transaction fee). But your customer sees the transaction as a "sale on account." The difference is that the customer must eventually pay the credit card company instead of your firm.
- **EQUIPMENT**—*durable* items you buy to support your firm's activities.  
Equipment (e.g., computers, machinery, vehicles) has value since your firm can sell it at any time, although usually for less than the initial price. To account for wear, tear, and ultimately replacement costs, your firm depreciates (expenses) equipment as it is "used up."
- **INVENTORY**—raw materials or items you resell or use to create new goods for sale.  
Inventory has value because you can usually sell it for what you paid for it. The goal, however, is to process raw inventory into something with *more* value, that you can sell at a profit.  
**Note:** Whether an item is treated as inventory or supplies depends on how you use it. If you purchase it for resale, it's inventory. If you purchase it to use, it's supplies. For example, diskettes used to hold a program that your firm is selling would be counted as inventory. However, diskettes used by your firm for its own data storage needs would be considered supplies.
- **GOODWILL**—the value of a firm's reputation and/or the popularity of its brands.  
Goodwill has value because consumers buy from companies they trust and brands they know. Goodwill appears as an asset when a company is sold. Its value is whatever the seller and buyer agree it is.

# LIABILITIES

## *Debts used to buy assets.*

- **LOAN** (aka Note Payable)—money your firm borrows from a *creditor*.  
Your firm must pay back the loan within a certain time and with an extra charge, called interest.
- **ACCOUNTS PAYABLE (A/P)**—money your firm owes to a *vendor* for goods/services bought on account. Why would you buy on account? Because if you can obtain goods now, then pay later once those goods are resold and have earned you some money, you are more willing and able to do business. Vendors sell "on account" to increase their own sales, trusting that you'll pay them within a certain time period, say 30 days. Of course, if your firm declares bankruptcy, vendors risk not getting paid.  
**Distinction:** A loan involves borrowing *money*. A/P involves "borrowing" *goods/services*.
- **WAGES PAYABLE**—money your firm owes to employees.  
Each day that employees work, the firm owes them money. The money earned between paydays is accumulated in this account. If the period ends prior to payday, the balance in this account will be charged to Wages Expense so that profits won't be overstated.

# OWNERS EQUITY

## *Investments/profits used to buy assets.*

- **CAPITAL** (aka Owners Equity)—cash or other assets invested in your firm by an *owner* or *owners*.  
Owners (sole proprietors, partners, stockholders) invest in a firm in return for a share of the profits. Once owners invest, they release all rights to their money. A firm does NOT have to pay the owners back! If the firm goes bankrupt, owners could lose all or part of their investment as any value left in the firm is paid to creditors first.
- **DRAWING** or **DIVIDENDS**—money your firm pays to reward owners for investing.  
As a Sole Proprietor or Partner you *draw* cash out of the business, usually based on your percent of ownership. As a stockholder, you may be paid a cash *dividend* for every share of stock you own, usually based on a percent of profits. As a stock's price increases, stockholders may also profit by selling it, independently of anything the corporation does, to a willing third party, through the Stock Market. Of course, stockholders can lose money if the stock falls in value.
- **REVENUE** (aka **INCOME** or sales)—money your firm earns from sales of goods and services or from other sources like interest earned on a bank deposit, or dividends earned from stocks or mutual funds.
- **EXPENSE**—money you spend on your firm's activities (e.g., supplies, wages, rent, depreciation).
- **PURCHASES**—money you spend on Inventory items acquired for *resale*. (See Supplies vs. Inventory).
- **COGS** (Costs of Goods Sold, aka Cost of Merchandise Sold or Cost of Sales)—value of the inventory your firm *sold* during the accounting period. COGS, like an expense account, reduces profits.
- **GROSS PROFIT** (aka Gross Income): Revenue – COGS. The income your firm receives by selling goods is reduced by the initial cost of those goods.
- **NET INCOME** (aka Net Profit or Net Loss): Gross Income – Expenses. The income from selling goods is lowered by all other expenses incurred by your firm. This gives the firm's actual profit or loss. For example, you could have numerous sales and a high gross income, but if your expenses are high, you could end up losing money.

# Accounting Concepts

These ten concepts guide the field of accounting:

## 1. Business Entity

A business's financial information is recorded and reported separately from the owner's personal financial information.

## 2. Going Concern

Financial statements are prepared with the expectation that a business will remain in operation indefinitely.

## 3. Accounting Period Cycle

Changes in financial information are reported for a specific period of time in the form of financial statements.

## 4. Objective Evidence

Each transaction is described by a business document that proves the transaction did occur.

## 5. Unit of Measurement

All business transactions are recorded in a common unit of measurement—the dollar.

## 6. Realization of Revenue

Revenue from business transactions is recorded at the time goods or services are sold.

## 7. Matching Expenses With Revenue

Revenue from business activities/expenses associated with earning that revenue are recorded in the same accounting period.

## 8. Historical Cost

The actual amount paid or received is the amount recorded in accounting records.

## 9. Adequate Disclosure

Financial statements should contain all information necessary for a reader to understand a business's financial condition.

## 10. Consistent Reporting

In preparing financial statements, the *same* accounting concepts are applied in the *same* way in each accounting period.

# Accounting Occupations

Here are some of the career directions open to anyone with an interest in accounting:

## General Office Clerk

Types/files accounting reports.

## Accounting Clerk

Records, sorts, and files routine accounting information; e.g., Payroll clerk, A/R clerk.

## Bookkeeper

Records, summarizes, and analyzes accounting information. Prepares accounting reports.

## Accountant

Plans, summarizes, analyzes, and interprets financial information. Prepares accounting reports. Assists owners and managers in making financial decisions. Supervises other accounting workers.

## Private Accountant

Works for a private business, analyzing its records only.

## Public Accountant

Works for a Public Accounting firm that provides accounting services to other firms and/or individuals.

## Certified Public Accountant (CPA)

Designation granted to accountants who pass a rigorous state examination.

**To Do:** Do an Internet/textbook search and write down the words and meanings of the following:

GAAP—

FASB—



# Accounting Forms & Books

## CHART OF ACCOUNTS (CofA)

List of all accounts used by a business.

### Service Business Chart Of Accounts

A Service Business earns money by selling services (a pure Service Business does not make/sell goods). At the end of an accounting period, Revenue and Expenses are closed (reset to zero), and the resulting profit or loss is sent to Owners Equity. Adding Revenue minus Expenses to the FAE yields 5 numbered account areas:

$$[1] \text{ Assets} = [2] \text{ Liabilities} + [3] \text{ Owners Equity} + [4] \text{ Revenue} - [5] \text{ Expenses}$$

### Merchandising Business Chart of Accounts

A Merchandising Business makes and/or sells goods (and most likely services as well). To account for these goods we add an Inventory account, a Purchases account (if inventory is based on periodic physical counts, but not if inventory is perpetually updated when merchandise is bought or sold), and a Cost of Goods Sold (COGS) account (for both periodic and perpetual inventory systems). Numbering schemes vary, but Purchases and COGS are typically numbered in the [5] account area and Expenses are pushed out to the [6] account area.

$$[1] \text{ Assets} = [2] \text{ Liabilities} + [3] \text{ Owners Equity} + [4] \text{ Revenue} - [5] \text{ Purchases} - [6] \text{ Expenses}$$

### CHART OF ACCOUNTS

Service Business

#### 100 ASSETS

110-Cash  
120-Accounts Receivable  
130-Supplies  
140-Equipment  
141-Accumulated Depreciation

#### 200 LIABILITIES

210-Accounts Payable  
220-Loan Payable  
230-Wages Payable

#### 300 OWNERS EQUITY

310-Capital  
320-Drawing  
330-Income Summary

#### 400 REVENUE

410-Income  
420-Interest

#### 500 EXPENSES

510-Supplies Expense  
520-Depreciation Expense  
530-Wages Expense  
540-Miscellaneous Expense

### Account Names/numbers

- Each account area contains individually named and numbered accounts for the types of transaction that may occur in a particular business.
- Gaps are left between numbers so that new accounts may be added as needed.
- Some firms group Expenses and Purchases together.
- Some firms use 700, 800, 900 as account areas.
- Firms with numerous accounts use thousands instead of hundreds; e.g., 1000 Assets, 2000 Liabilities, etc.
- Account names vary; e.g., Owners Equity may be called Capital, Purchases may be called Cost of Sales, etc.

### CHART OF ACCOUNTS

Merchandising Business (differences)

#### 100 ASSETS

150-Inventory

#### 500 PURCHASES

510-Purchases  
520-Cost of Goods Sold  
530-Purchase Returns  
540-Freight

#### 600 EXPENSES

**As the layout of the following forms varies, refer to the forms you'll be using or an Accounting textbook for examples.**

## GENERAL JOURNAL (G/J)

**Diary of transactions between accounts.**

The G/J is the place you'd look to find out what transactions occurred on a specific date. In a personal financial diary, you keep a daily record of your spending on all items. In a G/J (*jour = day* in French), you keep a daily record of your firm's spending (transactions) on all items.

**BrainAid:** Journal = Join all—when a transaction occurs, you "join" all affected accounts together to ensure that debits to one are balanced by credits to the other.

**Headings:** Page, Date, Description, P.R., Debit, Credit.

**Entries:** *Date, Account1, Dr\$amount; Account2, Cr\$amount, Explanation; Post Reference (DAD-ACE-PR).*

## GENERAL LEDGER (G/L)

**Book with the history and balance of each account.**

The G/L is the place you'd look to find out the current balance of a particular account. Each page of the G/L typically contains only one account. In a personal financial account book, you'd total the amount you'd spent in each spending category; e.g., rent, food, gas, etc., with each category on a separate page.

**BrainAid:** Ledger = Liberate—the G/L "liberates" the debit and credit amounts from the G/J and "posts" them to their individual accounts. Each transaction for an account is listed by date, cross-referenced to the G/J so you can see which other account was affected. Each account's balance is calculated on its page.

**Headings:** #-Account, Date, Item, P.R., Dr, Cr, Balance.

**Entries:** *Date, Item (for adjusting/closing), \$amount, Balance, Post Reference (DI-\$-B-PR).*

## TRIAL BALANCE (TB)

**Shows Total G/L Debits = Total G/L Credits**

The TB verifies that all debit entries are balanced by equivalent credit entries, ensuring that the FAE stays balanced. Be aware, however, that if a debit or credit was placed into the *wrong* account, the TB would *not* indicate an error.

**Trap!** It's spelled T-r-i-a-l, not T-r-a-i-l.

## INCOME STATEMENT (IS)

**Shows Revenue – Expenses for an accounting period.**

The IS displays the Net Profit or Loss of a business over a period of time, usually a month.

**BrainAid:** incOme = periOd, usually a mOnth.

## BALANCE SHEET (BS)

**Shows Assets = Liabilities + Owners Equity on a given day.**

The BS displays the total value, both in terms of Assets and the money sources (Liabilities + Owners Equity) for those assets on a given day.

**BrainAid:** bAlance = dAy—Think of opening up your firm's warehouse doors and taking a snapshot of all assets inside.

# Accounting Methods

## CASH METHOD

With the Cash Method, you record transactions *only when cash changes hands*. You record revenue earned only when you actually *receive* the cash, even if you sold the goods/services earlier. You record expenses only when you actually *pay* them, even if you realized the expense earlier. Unfortunately, this doesn't always give a true picture of your company's value; e.g., you might show a big "profit" on the day you get paid, but have less money once you pay off your expenses. Despite this danger, many small businesses use the Cash method because it is simpler.

Cash Method Example:

- I agree to paint your house for \$1500, and you agree to pay in 10 days.
- I put \$500 worth of painting supplies on my 30-day charge card.
- I paint your house. So far, I've recorded nothing in my accounting books.
- 10 days later, you pay me and I record it as revenue. It appears I have a \$1500 profit, but it's not all mine to spend.
- On the 30th day, I pay for the painting supplies, record a \$500 expense, and find my true profit is only \$1000.

## ACCRUAL METHOD

With the Accrual Method, revenue is recorded on the day it is earned, *even if cash has not yet been received*. Similarly, expenses are recorded when they are incurred, *even if they have not yet been paid*. This makes accounting more complicated and requires the use of two intermediate accounts—Accounts Receivable and Accounts Payable. But it gives a truer picture of your company's value at any given moment, because the revenue and expenses for a sale are recorded together, yielding the true profit or loss. For this reason, medium and larger businesses typically use the Accrual Method.

Accrual Method Example:

- I agree to paint your house for \$1500, and you agree to pay in 10 days.
- I put \$500 worth of painting supplies on my 30-day charge card, which I immediately record as an expense.
- I paint your house and record revenue as \$1500, even though you won't pay me for 10 days.
- The same day, I calculate my true profit as \$1000, so I won't risk spending more money than I make.

## SINGLE-ENTRY ACCOUNTING

As the words "Single-Entry" imply, a transaction requires only *one* entry, into a Revenue category or an Expense category. At the end of the accounting period, total revenue minus total expenses gives you a Profit or Loss. This method works fine for small proprietorships with simple accounting needs. The drawback is that there is no built-in means to check that entries are being made accurately.

## DOUBLE-ENTRY ACCOUNTING

As the words "Double-Entry" imply, a transaction requires at least **TWO** entries into the accounting books—one entry for each affected account. Double-Entry accounting was designed to offer a built-in checking mechanism based on the Fundamental Accounting Equation (FAE) which states that:

$$\text{Assets} = \text{Liabilities} + \text{Owners Equity}$$

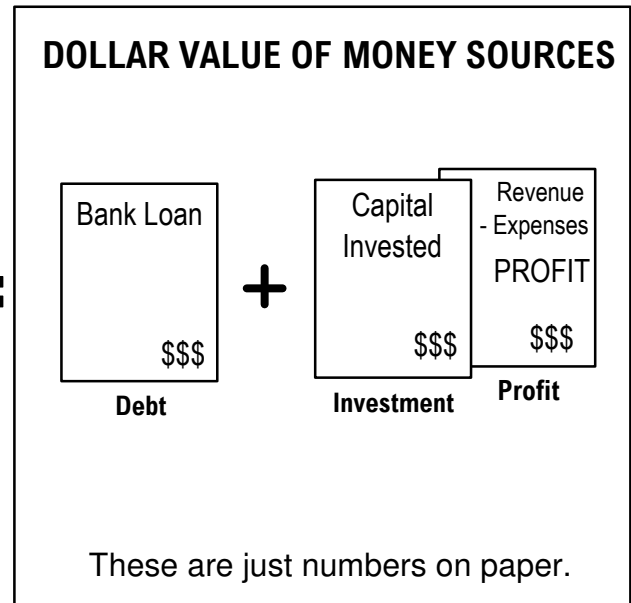
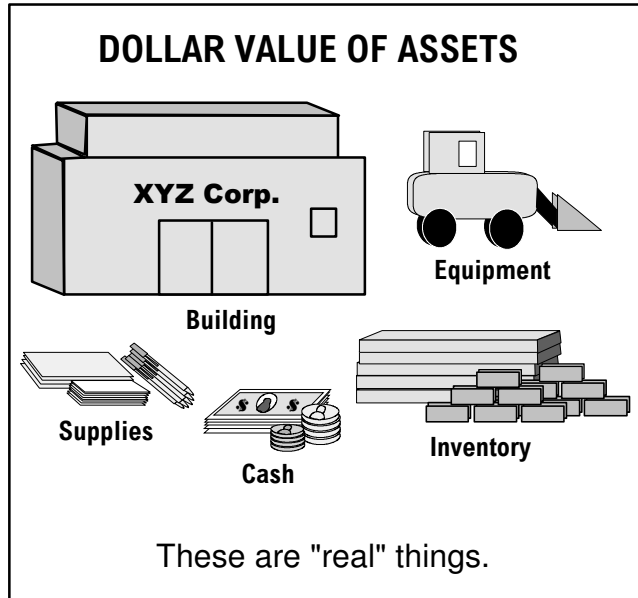
The general rule is that a change to one account in the FAE must be matched by a change to another account so that the equation stays balanced. For example, if the value of Assets increases by \$1000, the value of Liabilities and/or Owners Equity must increase by \$1000.

Double-Entry accounting is more complicated, but inherently more accurate, than Single Entry. Although Double-Entry doesn't provide an absolute guarantee of accuracy (you could still type a wrong number, or change the wrong account), it's more effective than Single-Entry for complex accounting needs. And with Double-Entry, if errors occur, several strategies (shown later) can be used to help find them.

# Fundamental Accounting Equation

$$\text{ASSETS} = \text{LIABILITIES} + \text{OWNERS EQUITY (FAE = ALOE)}$$

Items of value are funded from debts + investments/profits.



## DOLLAR VALUE

It would be difficult to compare *quantities* of items and the sources that funded them. So we measure all items and money sources by their DOLLAR value. Example: If a \$10,000 computer was funded from a \$2000 loan and an \$8000 investment, we wouldn't say that 1 computer equals 1 loan + 1 investment. We would say the *dollar value* of the computer is equaled by the *dollar value* of the loan plus the *dollar value* of the investment that funded it.

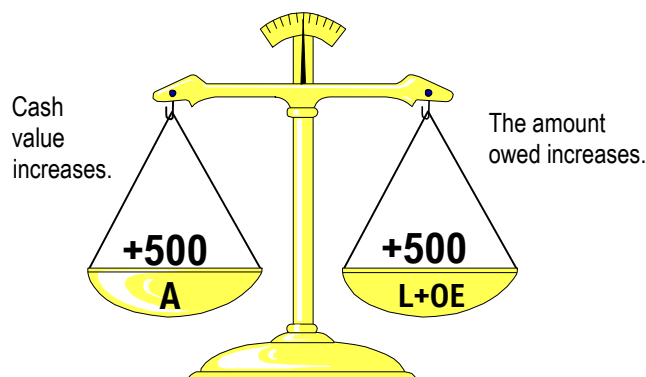
## WHAT REALLY EXISTS?

**Trap!** A common misconception is that everything exists TWICE, once on either side of the FAE. Physically, only Assets exist. Liabilities and Owners Equity are merely numbers on paper that represent sources of money used to acquire assets.

## BALANCE SCALE

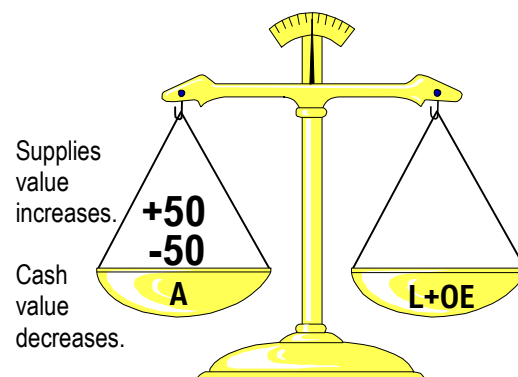
The FAE can be compared to a Balance Scale. To be in balance, any change that is made must be countered by an equal and opposite change, either opposite in side (left/right), or sign (+/-). Examples:

### Obtain \$500 loan.



Cash	500		
Loan		500	

### Pay \$50 cash for supplies.



Supplies	50		
Cash			50

# Transaction Analysis

Transaction Analysis (TA), the determination of the debit and credit sides of a transaction, is the BASIS of Double-Entry Accounting. Until you make the connection between real-world exchanges of value and the accounting used to record these exchanges, TA can be quite confusing. The good news is that once you master this skill, everything else is merely record keeping—simply placing values where they belong.

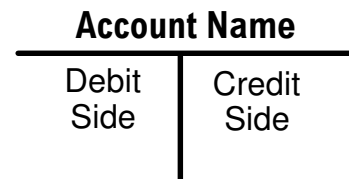
## T-ACCOUNTS

T-accounts are lines drawn on paper that *represent a G/L account*. They help you figure out transactions before entering them into a worksheet or computer program. When you write numbers to T-accounts, you are simultaneously journalizing (diary of transactions between Ts) and posting (transaction history of each T).

The T divides the account into an increase side and a decrease side. The real trick is knowing which side is which, because it differs for each account type.

- Debit (Dr) Type Accounts increase on the Left side.
- Credit (Cr) Type Accounts increase on the Right side.

The side an account increases on is called the "normal" side of that account.



The genius of the Double-Entry Accounting system is that if each Debit entry is matched by a Credit entry, the Fundamental Accounting Equation stays balanced!

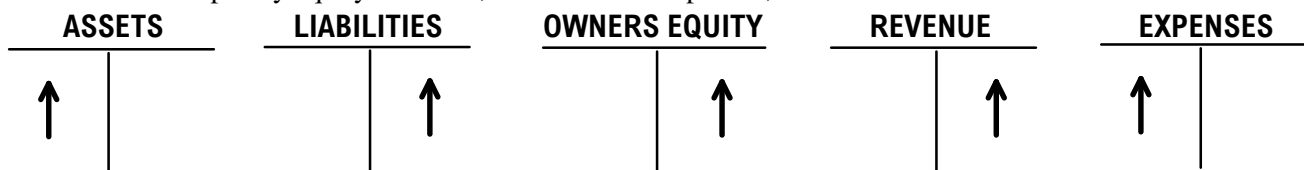
## TA-ADS

**BrainAid:** Each time you perform TA, ask the ADS questions:

1. Accounts?—Which Accounts are affected?
2. Direction?—Do they go up or down in value?
3. Side?—Which side goes up or down?

## TRADITIONAL T-ACCOUNT DIAGRAM

With traditional T-accounting, the main category Ts are put in Fundamental Accounting Equation order with the addition of the temporary equity accounts, Revenue and Expenses, tacked on to the end as follows:



You then draw the specific T-accounts involved beneath each respective category. In the diagram above, an Up arrow indicates the normal (increase) side of each account category.

**Problem:** This traditional T-Account diagram provides a good starting point for TA, but it has several deficiencies that can cause confusion. First, as drawn, the Revenue and Expenses Ts appear to be independent of the Owners Equity T, when actually they are temporary equity accounts which close into the Income Summary account (which is not shown), which along with the Drawing account (which is also not shown) closes into the Capital account (which is also not shown). Furthermore, Drawing, which is a *debit* account, falls under Owners Equity, a *credit* account.

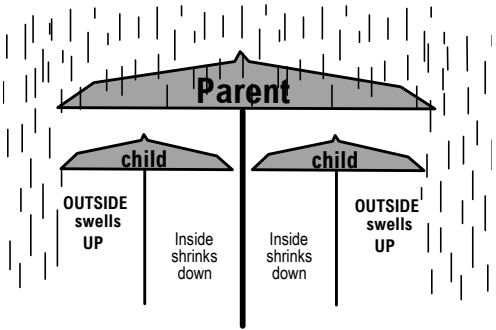
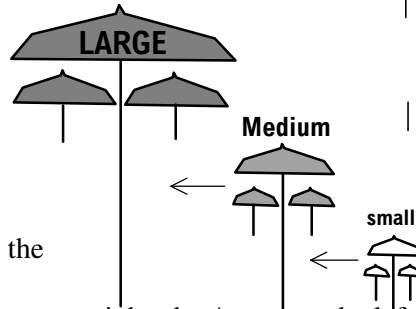
**Partial Solution:** The acronym, **DEA-LOR**, can help you remember that **D**rawing/**E**xpenses/**A**ssets (DEA is on the *left* of DEA-LOR) are normal debit accounts, and that **L**iability/**O**wners Equity/**R**evenue (LOR is on the *right* side of DEA-LOR) are normal credit accounts.

**Complete Solution:** Umbrella T-Accounts and the Balance Sheet Map (following).

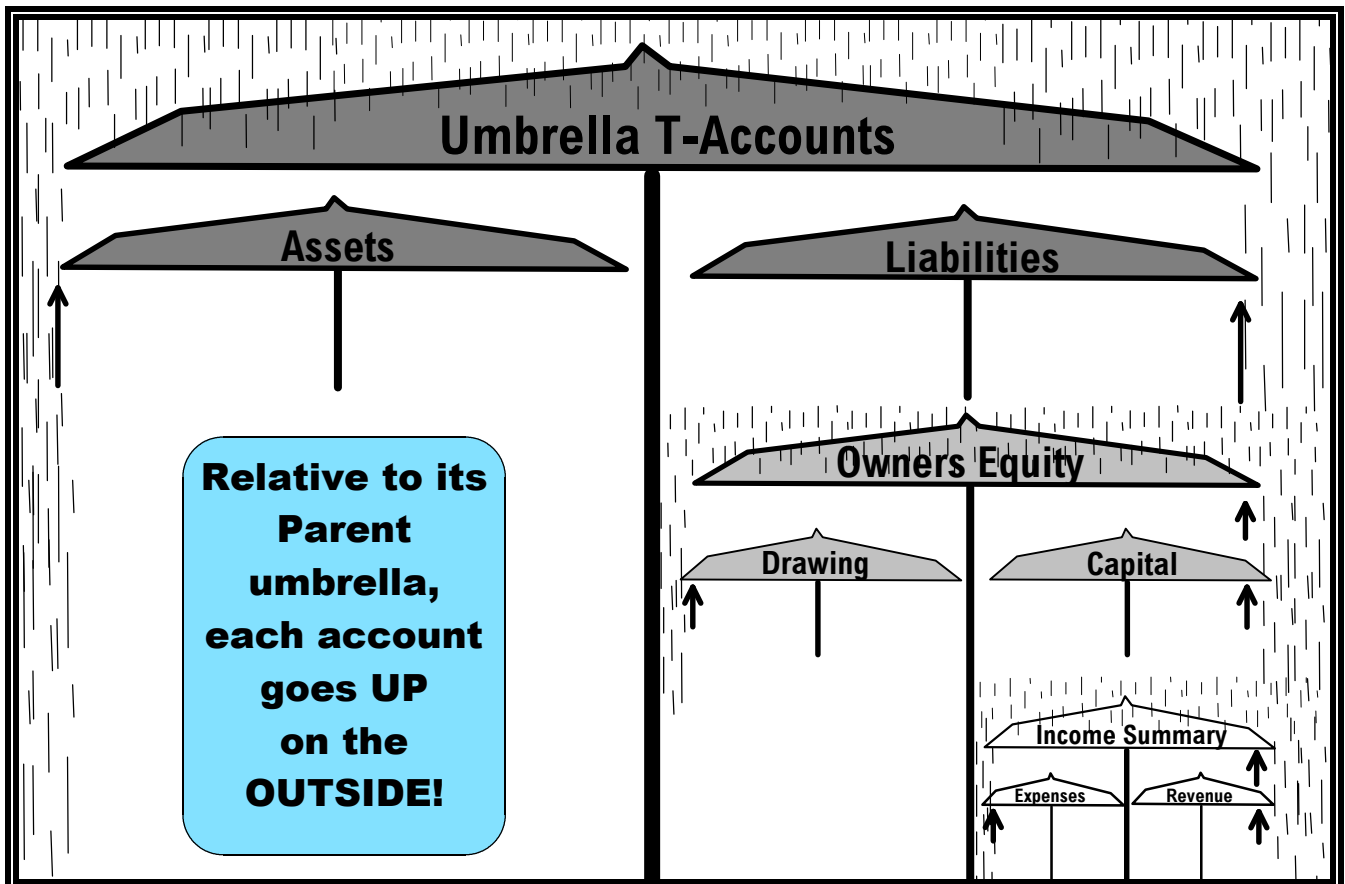
# Umbrella T-Accounting

A novel approach to T-accounting is to imagine the Ts as a hierarchy of Parent and child umbrellas. In the diagram to the right, as the rain pours down, anything on the "outside" of a child umbrella gets wet and swells UP; anything on the "inside" of a child umbrella dries out and shrinks.

Three Parent/child umbrella sets (LARGE, Medium, and small) are needed to represent the major account categories. Each smaller set wants to nestle beneath the right side of the larger set to its left.



Umbrella T-accounting (below) shows the true relationships of *all* major account categories. If our umbrella system is to stay upright, the Assets on the left must stay equal to Liabilities plus Owners Equity on the right:  $A = L + OE$ . Beneath Owners Equity are the four temporary equity accounts: DRAWING, INCOME SUMMARY, REVENUE, and EXPENSES. At the end of the accounting period, these temporary accounts are closed (reset to zero dollars) so they can start recording new values for the next period (businesses like to know how much they spent/earned *each* period). Their combined balances are transferred into the CAPITAL account, yielding a single balance for Owners Equity. Note: Separate owners require individual Capital accounts.



Umbrella T-accounting takes the guesswork out of "which side goes up?" Relative to its Parent T, the *outside* of a child account is the increase side. Assets, Drawing, Expenses (ADE) are normal debit accounts. Liabilities, Owners Equity, Capital, Income Summary, Revenue (LOCIR) are normal credit accounts.

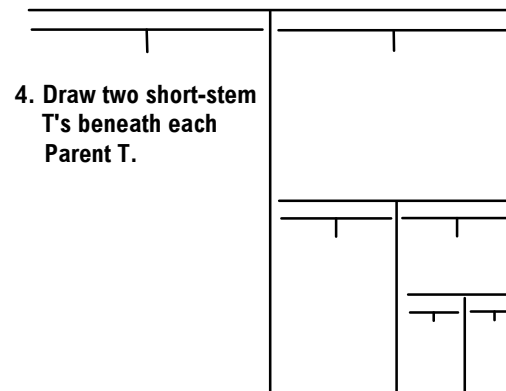
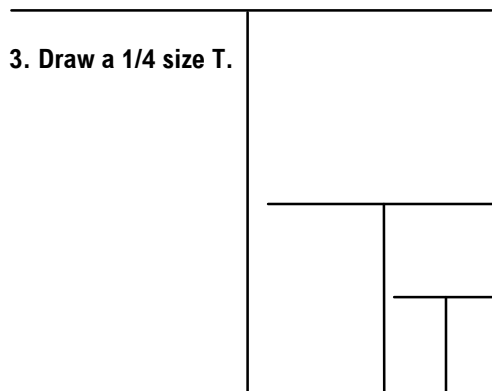
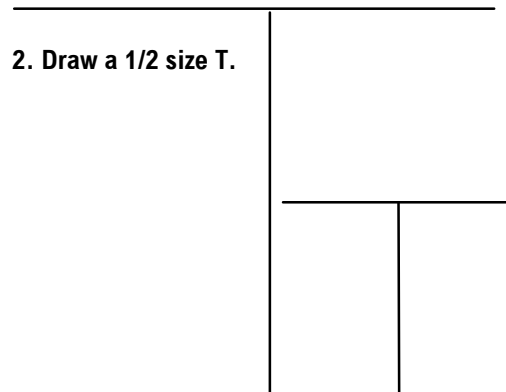
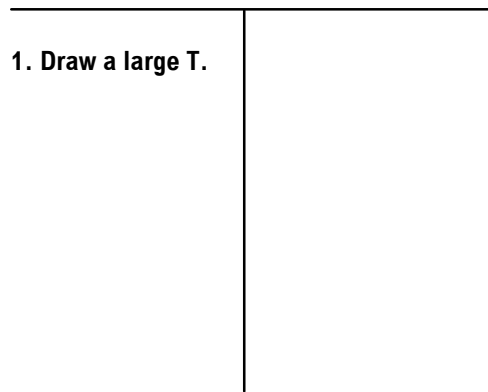
**To Do:** Fill in the parent of: 1. Revenue \_\_\_\_\_ 2. Income Summary \_\_\_\_\_  
3. Capital \_\_\_\_\_ 4. Owners Equity \_\_\_\_\_

Answers: 1. Income Summary; 2. Owners Equity (*not* Capital); 3. Owners Equity; 4. Umbrella T-Accounts (*not* Liabilities).

# DRAWING UMBRELLA TS

To do Umbrella T-Accounting, you won't draw actual umbrellas, just Ts arranged like umbrellas.

**To Do:** Trace over each T in the four-step T-building process shown below.

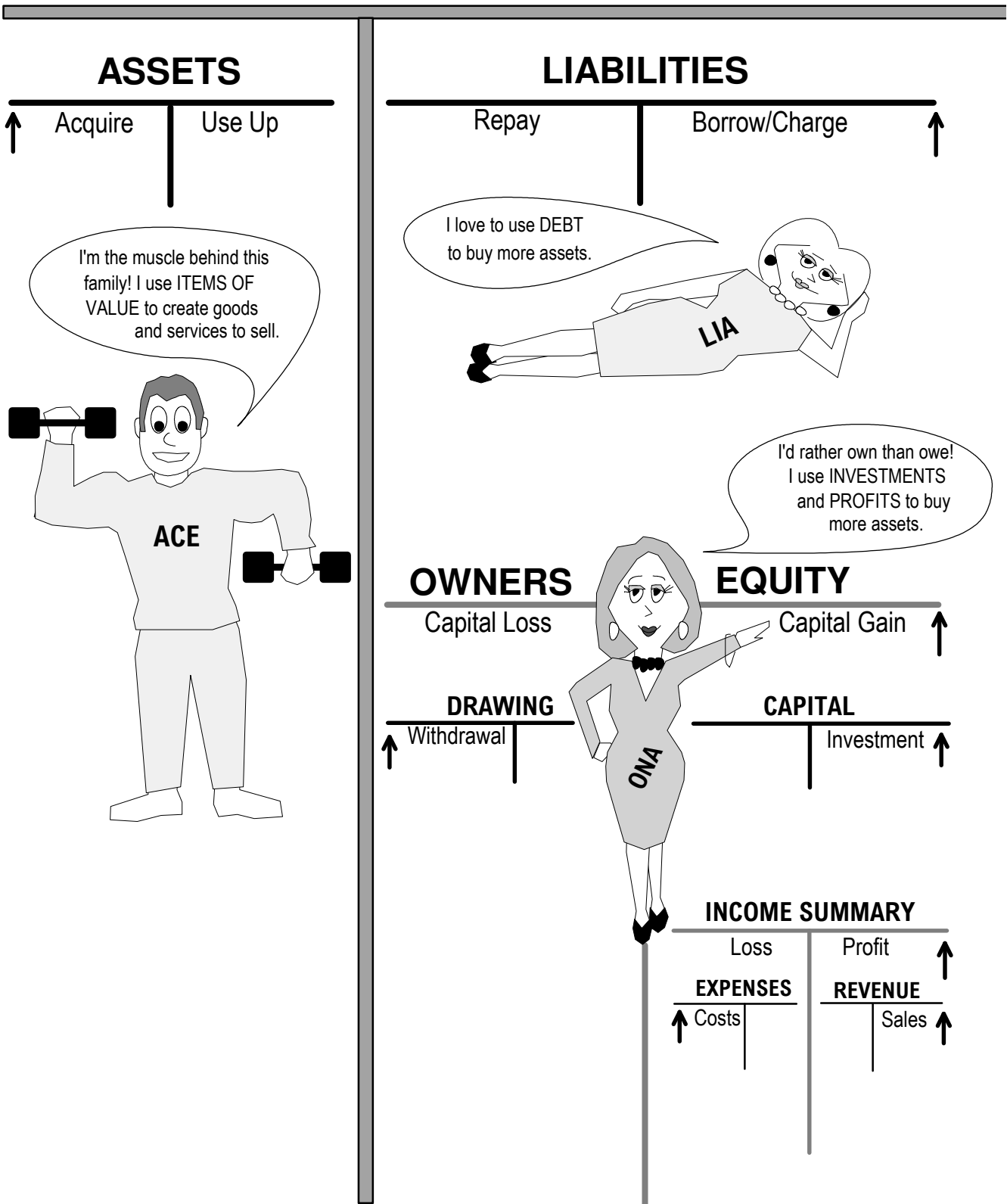


**To Do:** Draw the 9 Umbrella Ts in the box below.

Draw the 9 Ts in the box below *from memory*.

# The Balance Family

Here's another way to look at the Umbrella T-account hierarchy. Can you find the three sets of "umbrellas?"





# Balance Sheet Map

## A Multipurpose Accounting Worksheet!

A Balance Sheet Map (BSM) can help you navigate the complicated maze of double-entry accounting by letting you verify transactions before entering them into paper or computerized accounting forms.

### Building a Balance Sheet Map (BSM)

- Start with the Umbrella T-account diagram and write in the numbered accounts, e.g., 1-Assets.
- Write DR to the left of the 3 debit accounts (go up on the Left side).
- Write CR to right of the 5 credit accounts (go up on the Right side).

### Numbering Accounts

It's important to include the category number with the account name. For example, if the account name was simply "Rent," you couldn't be sure if it was an income or expense account. But with "4-Rent" it's unquestionably income (rent you receive from a renter), as "4" signifies a Revenue account. On the other hand, "5-Rent" is an expense account (rent you pay to a landlord).

**To Do:** Label each T below with the proper account category. Check your answers on the next page.

<p><b>1-</b></p> <p>DR _____</p>	<p><b>2-</b></p> <p>_____ CR</p>	
	<p><b>3-</b></p> <p>_____ CR</p>	
	<p><b>3-</b></p> <p>DR _____</p>	<p><b>3-</b></p> <p>_____ CR</p>
		<p><b>3-</b></p> <p>_____ CR</p>
	<p><b>5-</b></p> <p>DR _____</p>	<p><b>4-</b></p> <p>_____ CR</p>

### Completing the BSM

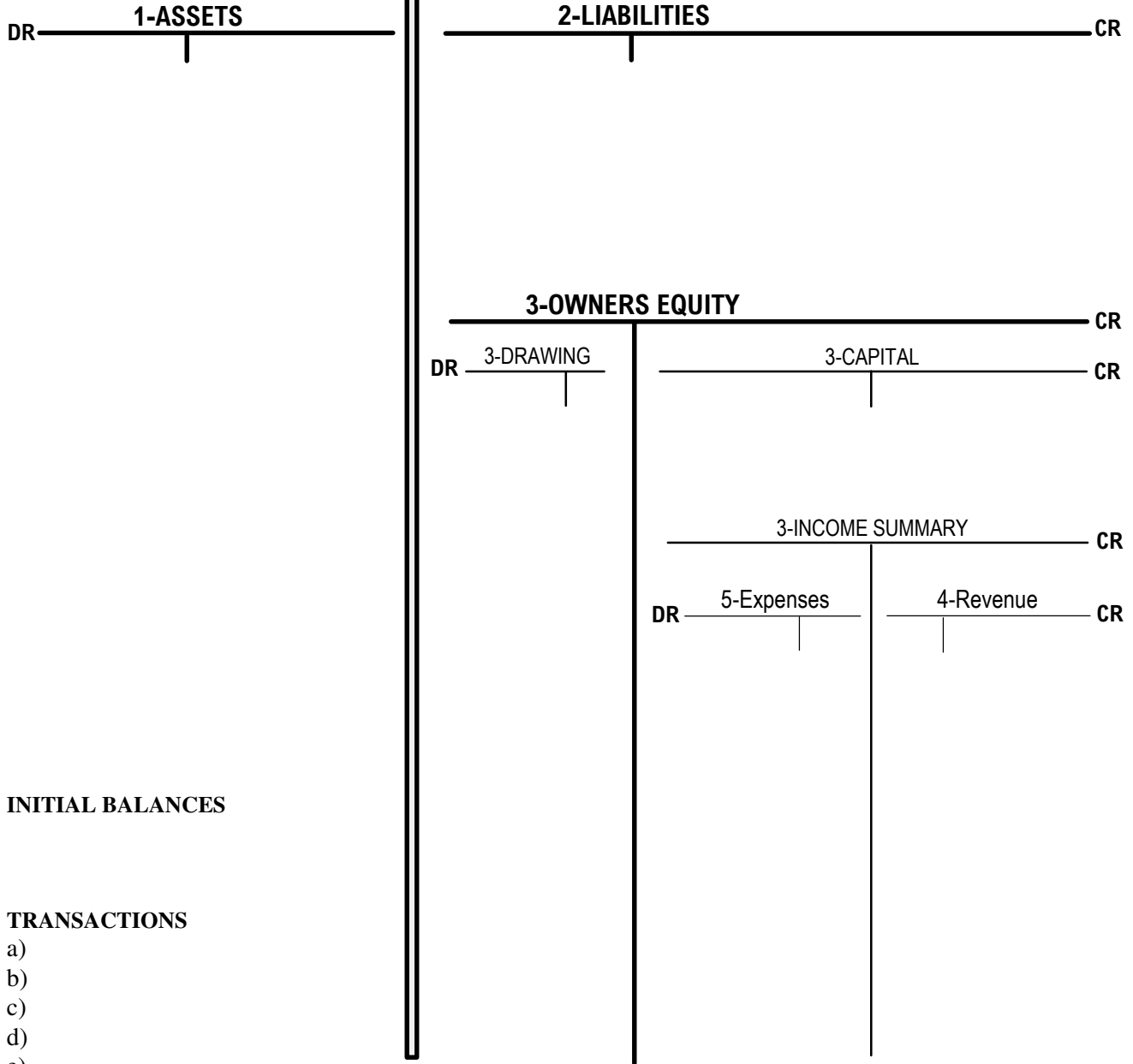
With the following additions, the BSM can be used to perform journal (G/J), post (G/L), trial balance (TB), income (IS), and balancing (BS) activities.

- Initial Balances and Transactions
- Trial Balance table
- Equations

**To Do:** See a complete BSM on the next page. Print some copies to use as worksheets.

# Balance Sheet Map

Draw T's Post transactions Account balance Trial balance Equations



INITIAL BALANCES

TRANSACTIONS

- a)
- b)
- c)
- d)
- e)

## Trial Balance

#-Account	Debit	Credit
Balance		

Carryover		
Balance		

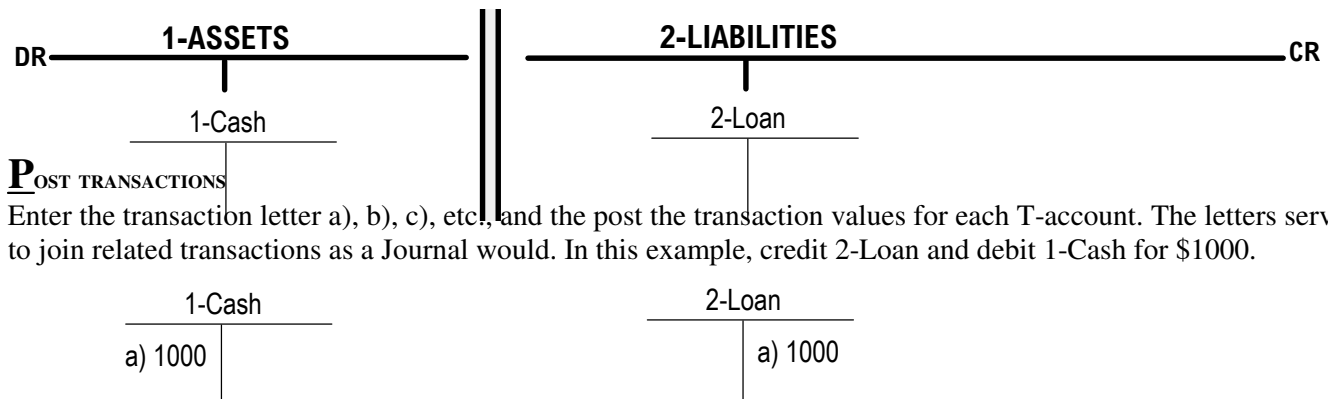
Rev: \_\_\_\_\_ - Exp: \_\_\_\_\_ = Net Income: \_\_\_\_\_. Assets: \_\_\_\_\_ = Liabilities: \_\_\_\_\_ + Owners Equity: \_\_\_\_\_.

# Using the Balance Sheet Map (DPATE)

Follow the five DPATE (dee-paat) steps to journalize transactions (G/J), post ledger balances (G/L), perform a trial balance (TB), calculate income (IS), and verify balances (BS).

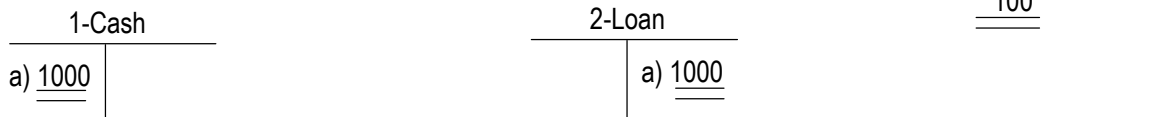
## DRAW Ts

From the Initial Balances and Transactions listed on the BSM, draw and label the necessary T-accounts beneath their Parent Ts. For example, for the transaction “a) Obtain \$1000 loan” draw a 2-Loan account under 2-Liabilities and a 1-Cash account under 1-Assets. Align the vertical stems of the child Ts for easier readability.



## ACCOUNT BALANCES

For each T, total the debit and credit sides and combine them to produce a single debit or credit total for the account. Draw a double line below *each* account balance even if there is only one number under a T. Count the number of double-lined balances so that you can match the total to the number of Trial Balance entries.



## TRIAL BALANCE

In 1,2,3... account order, transfer each account and its double line balance to the Trial Balance table. Carry over the Debit/Credit totals in column 1 to column 2 if needed. *Total Debits must equal Total Credits.*

#-Account	Debit	Credit	Carryover		
1- Cash	1,000				
2- Loan		1,000			
Balance	1,000	1,000			

## EQUATIONS

Rev: \_\_\_\_\_ – Exp: \_\_\_\_\_ = Net Income: \_\_\_\_\_.

- Enter the double line Revenue balance.
- Enter the double line Expenses balance.
- Subtract to calculate Net Income. If less than zero, i.e., a loss, put the result in (parentheses).

Assets: \_\_\_\_\_ = Liabilities: \_\_\_\_\_ + Owners Equity: \_\_\_\_\_.

- Combine all double line Asset balances into a single debit total.
- Combine all double line Liability balances into a single credit total.
- Combine all double line Owners Equity balances (Drawing, Capital, Expenses, Revenue) into a single credit total.

*Total Assets must equal Total Liabilities + Total Owners Equity.*

**To Do:** DPATE the Startup Transactions on the next page. Check your work on the page that follows.





# Error Checking

When the Total Debits from all posted ledger accounts do NOT match the Total Credits, use these "tricks" to help track down the error. You can even use this approach when reconciling your checkbook!

## Analyze the difference

On the Trial Balance, subtract the Total Debits from the Total Credits.  
Match the *difference* to one of the following situations.

**1A**

Difference is a single 1 to any decimal place. (.01, .1, 1, 10, etc.).  
Likely cause: Addition error. Didn't carry 1.

Total Dr	Total Cr	Difference
126.00	125.00	<b>1.00</b>

Trial Balance		
Acct	Debit	Credit
110	26.00	
220		99.02
330	100.00	
440	.	26.98
Totals	126.00	125.00

**9TS**

Difference is evenly divisible by 9.  
Likely cause: Transposition and/or Slide.

Total Dr	Total Cr	Difference	
21.00	12.00	<b>9.00</b>	Transposition (reversed digits)
100.00	10.00	<b>90.00</b>	Slide (moved decimal point)
210.00	12.00	<b>198.00</b>	Trans-Slide

Tip: If the sum of the digits of the difference is divisible by 9, the difference itself is evenly divisible by 9.  
Example: The sum of the digits of 198 is 1+9+8 = 18, which is divisible by 9, so 198 is also evenly divisible by 9.

**O**

Difference is *equal* to a Journal entry.  
Likely cause: Omitted posting.  
Example: Received \$40 loan. Debited Cash, didn't post Loan.  
Difference = 40

<b>1-CASH</b>	40	
<b>2-LOAN</b>		0
	40	0
	<b>Difference = 40</b>	

**D**

Difference is equal to *twice* a Journal entry.  
Likely cause: Double debited or double credited.  
Example: Received \$40 loan. Debited Cash, debited Loan.  
Difference = 80

<b>1-CASH</b>	40	
<b>2-LOAN</b>		0
	80	0
	<b>Difference = 80</b>	

N/A

If none of the above apply:

- 1) Recheck Journal entries against Source documents.
- 2) Recheck Ledger postings against Journal entries.
- 3) Recheck math.

**To Do:** Memorize the error checker's personalized license plate:

1A-9TS-O-D

**To Do**

If a journal entry was 45.38, given the following TB differences, fill in the most likely cause: 1A, 9TS, O, D, N/A.

45.38 \_\_\_\_\_      90.76 \_\_\_\_\_      278.10 \_\_\_\_\_      100.00 \_\_\_\_\_      90.53 \_\_\_\_\_

Ans. O, D, 9TS, 1A, N/A

# Correcting Entries

To maintain an audit trail for the IRS and to prevent embezzling, a firm should either not allow posted entries to be altered, or keep a record of all changes made. Early computerized accounting programs prohibited changes after posting. An error had to be fixed with a correcting entry. Some newer programs are more forgiving and let you unpost, delete/edit, then repost as desired, or simply change entries at any time. But this freedom can be dangerous. To uncover fraud, you must first enable an Audit Trail feature that tracks all transactions and changes made. In any case, it's useful to know how to make correcting entries the traditional way. Try using "filters."

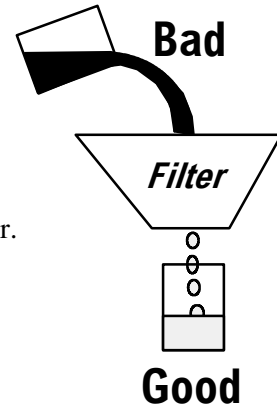
## Journal

You journalize an incorrect entry. . . . . Bad Water

You journalize a correcting entry. . . . . + Filter

The combined result (**Trap!** Don't journalize this.) Good Water

## Analogy



**To Do:** Fill in the "filters" below to correct the wrong entries.

For clarity when filtering, keep accounts in ascending number vs. debit-first order.

## Posted Low

Transaction: Received loan for \$5000. Posted \$500.

1-CASH	500	
2-LOAN		500
<b>1-CASH</b>	—	
<b>2-LOAN</b>		—
1-CASH	5000	
2-LOAN		5000

<b>Filter: Add \$\$ to each account.</b>			
1-Cash		2-Loan	
500		500	
<u>5000</u>		<u>5000</u>	

## Posted High

Transaction: Owner invested \$100. Posted \$1000.

1-CASH	1000	
3-CAPITAL		1000
<b>1-CASH</b>	—	
<b>3-CAPITAL</b>		—
1-CASH	100	
3-CAPITAL		100

<b>Filter: Subtract \$\$ from each account.</b>			
1-Cash		3-Capital	
1000		1000	
<u>100</u>		<u>100</u>	

**Trap!**  
Journalize *only* the Filter entry. Don't journalize the Good Water entry—it's what comes out of the filter.

## Posted Reverse

Transaction: Bought supplies for \$200. Reverse posted Cash & Supplies.

1-CASH	200	
1-SUPPLIES		200
<b>1-CASH</b>	—	
<b>1-SUPPLIES</b>		—
1-CASH	200	
1-SUPPLIES		200

<b>Filter: Double reverse \$\$ to each -or- Reverse to zero out; reverse to correct.</b>								
1-Cash		1-Supplies			1-Cash		1-Supplies	
200		200			200		200	
<u>200</u>		<u>200</u>			<u>200</u>		<u>200</u>	

## Posted Wrong

Transaction: Earned \$300 Account Receivable. Posted to Cash.

1-CASH	300	
4-INCOME		300
<b>1-CASH</b>	—	
<b>1-A/R</b>		—
1-A/R	300	
4-INCOME		300

<b>Filter: Zero out wrong account; add \$\$ to right account.</b>			
1-Cash		1-A/R	4-Income
300			
<u>0</u>		<u>300</u>	<u>300</u>

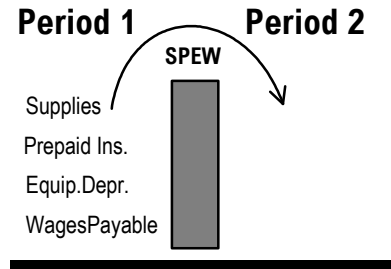
**ERRORS**  
Low  
High  
Reverse  
Wrong

Answers: Low: 4500; High: 900; Reverse: 400; Wrong: 300

# Adjustments

Some accounts have balances that "span" a period and must be updated or adjusted to accurately reflect their true value. Four of the most commonly adjusted accounts are Supplies, Prepaid Insurance, Equipment, Wages (SPEW).

**BrainAid:** Imagine accounts SPEWing over a wall that separates periods.



## SUPPLIES → SUPPLIES EXPENSE

◆ **Supplies are expensed as they are used up.**

Supplies used during month are estimated, then subtracted from beginning supplies.

Example:

Beginning Supplies Value	500
Supplies Used Up	<u>-200</u>
Ending Supplies Value	<u>300</u>

<b>1-Supplies</b>		<b>5-Supplies Exp.</b>	
500	s)200	s)200	
<u>300</u>			

**IMPORTANT!**  
Adjustments are first recorded on the TB Worksheet, but not journalized and posted until the *end* of the period.

## PREPAID INSURANCE → INSURANCE EXPENSE

◆ **Prepaid Insurance is expensed as it is used up.**

Remaining insurance is an asset because its value can be recovered if the policy is canceled.

Example:

12-month Insurance Policy	1200
Used up each Month	<u>-100</u>
Remaining Insurance	<u>1100</u>

<b>1-PPI Insurance</b>		<b>5-PPI Expense</b>	
1200	p)100	p)100	
<u>1100</u>			

## EQUIPMENT: ACCUMULATED DEPRECIATION → DEPRECIATION EXPENSE

◆ **Equipment is expensed or depreciated as it is "used up."**

To maximize taxable income and discourage high-priced purchases merely to reduce taxes, the IRS requires certain assets (equipment/buildings/vehicles...) to be expensed over their useful life instead of all at once (Exception: Section 179 permits direct expense deductions up to a certain dollar amount). So that the IRS can determine taxable gain/loss if a depreciable asset is sold, the original price **MUST** remain on the books (if the asset is sold for more than it was depreciated, the excess depreciation must be "recaptured" or paid back to the IRS). Therefore, to show depreciation, a contra-asset account (Accumulated Depreciation) is attached to each depreciable asset. "Contra" means "opposite"—the normal balance sides are reversed.

<b>1-Equipment</b>			
2600			
<b>1-Acc. Depr. Equip.</b>		<b>5-Depr. Expense</b>	
	e)100	e)100	

**BrainAid:** Imagine that the asset and contra-asset are "joined at the hip." Put a dashed box around them.

Example:

Original Price	\$2600	Estimated useful life is 24 months (before replacement needed).
Salvage Value	<u>-200</u>	Estimated value at end of useful life (if you were to sell it).
Depreciable Amount	2400	\$2400 / 24 months = \$100/mONTH.

## WAGES PAYABLE → WAGES EXPENSE

◆ **Unpaid Wages are expensed as they are "Used up."**

To prevent overstating profits for a period, unpaid wages are expensed in the period they are earned by employees.

Example:

Mon	Tue	Wed	Thu	Fri
24	25	26	27	28
31	1	2	3	4

- Paydays are each Friday.
- This month the period closes on Monday the 31st.
- \$600 wages are earned on Monday the 31st.
- This money won't actually be paid until Friday the 4th.

<b>2-Wages Payable</b>	
	w)600
<hr/>	
<b>5-Wages Expense</b>	
	w)600

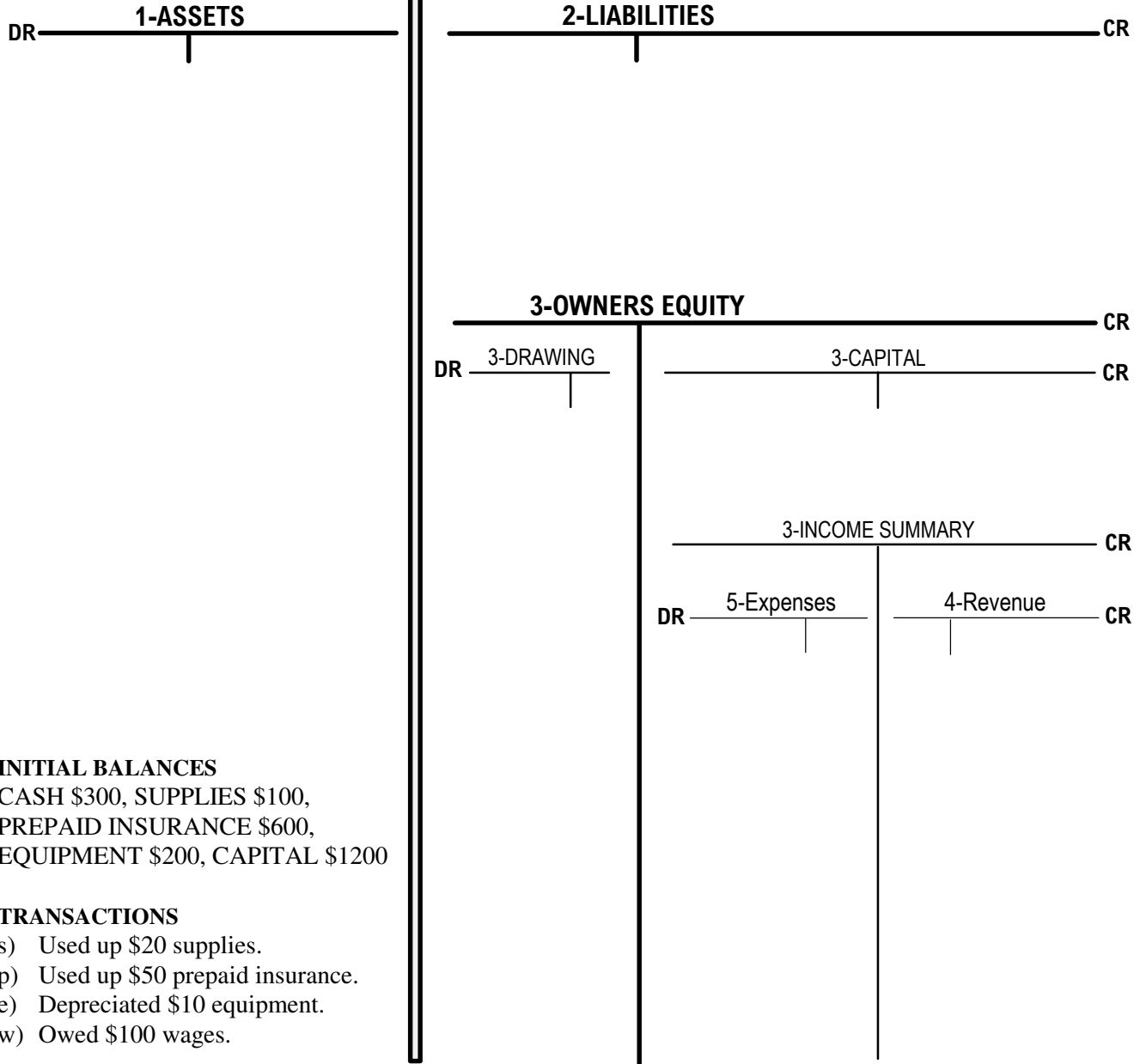
**To Do:** DPATE the Adjustments BSM on the next page. Check answers on the page that follows.



# Balance Sheet Map

## Adjustments

Draw T's Post transactions Account balance Trial balance Equations



**INITIAL BALANCES**

CASH \$300, SUPPLIES \$100,  
 PREPAID INSURANCE \$600,  
 EQUIPMENT \$200, CAPITAL \$1200

**TRANSACTIONS**

- s) Used up \$20 supplies.
- p) Used up \$50 prepaid insurance.
- e) Depreciated \$10 equipment.
- w) Owed \$100 wages.

**Trial Balance**

#-Account	Debit	Credit
Balance		

Carryover		
Balance		

Rev: \_\_\_\_\_ - Exp: \_\_\_\_\_ = Net Income: \_\_\_\_\_. Assets: \_\_\_\_\_ = Liabilities: \_\_\_\_\_ + Owners Equity: \_\_\_\_\_.



# Trial Balance Worksheet: Profit & Loss

A Trial Balance Worksheet (TBW) is used to verify G/L balances, record adjustments, and prepare financial statements. Columns: TB=Trial Balance, Adj=Adjustments, (Some TBWs have a redundant Adjusted Trial Balance column that combines the TB and Adj columns), IS=Income Statement, BS=Balance Sheet.

**Trap!** IS and BS entries can often seem backwards as described below.

	TB		Adj		IS		BS	
	Dr	Cr	Dr	Cr	Dr	Cr	Dr	Cr
1-Assets								
2-Liab								
3-OE								
4-Rev								
5-Exp								
	##	##	##	##	##	##	##	##

## IS Columns

Account categories 4-Revenue and 5-Expense flow from the TB to the IS columns.

**Profit/Loss:** A Profit is recorded in the Dr (Expense) column. A Loss is recorded in the Cr (Revenue) column.

**Explanation:** With a Profit, revenue exceeds expenses, so the profit must be added to the expense column to balance both columns. With a Loss, expenses exceed revenue, so the loss must be added to the revenue column to balance both columns.

Expense	Revenue	Expense	Revenue
150	200	300	120
<u>50 Profit</u>			<u>180 Loss</u>
<u>200</u>	<u>200</u>	<u>300</u>	<u>300</u>

## BS Columns

Account categories 1-Assets, 2-Liabilities, and 3-Owners Equity flow from the TB to the BS columns.

**Profit/Loss:** A Profit is recorded in the Cr (L+OE) column, and a Loss is recorded in the Dr (Asset) column.

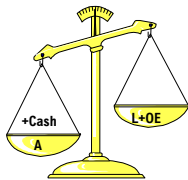
**Explanation:** With a Profit, cash increases, making the Asset column total greater than the L+OE column. The profit must be added to the L+OE column to balance both columns. With a Loss, cash decreases, making the Asset column total less than the L+OE column. The loss must be added to the Asset column to balance both columns.

Asset	OE	Asset	OE
500	200	350	400
	<u>300 Profit</u>	<u>50 Loss</u>	
<u>500</u>	<u>500</u>	<u>400</u>	<u>400</u>

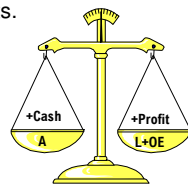
## Net Income/Loss

### Net Income Scenario

Revenue > Expenses  
+Cash increases Assets.  
Out of Balance.



Rev-Exp=Profit  
Profit is ADDED to L+OE.  
Balanced.

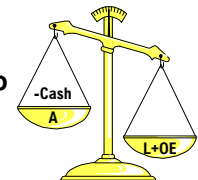


Income Stmt.		Balance Sheet	
Dr	Cr	Dr	Cr
			1-Asset
			2-Liability
			3-Owners Equity
	4-Revenue		
5-Expense			
Sum	Sum	Sum	Sum
Profit	Loss	+Loss	+Profit
Total = Total		Total = Total	

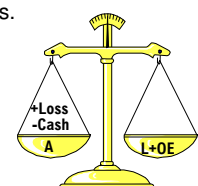
Acronym: PLLP (PuLLuP)

### Net Loss Scenario

Revenue < Expenses  
-Cash decreases Assets.  
Out of Balance.



Rev-Exp=Loss  
Loss is ADDED to Assets.  
Balanced.



**On the IS:**  
If Profit, why add it to Expense side?  
If Loss, why add it to Revenue side?

**OBSERVE!**  
BS = 1, 2, and 3 Accounts only.  
IS = 4 and 5 Accounts only.

**BrainAid:** In transferring Profit or Loss from the IS column to the BS column, observe that a Profit transfers on the outside and a Loss transfers on the inside. Acronym: PLLP (pronounced PuLLuP). From the TBW columns, the actual IS and BS are created. Then the adjustments and profit or loss are journalized and posted so the actual Owners Equity accounts reflect the firm's true financial condition.

# Closing

Businesses want to know how much profit they make each period. To do so, they must "close" or zero out the four temporary accounts—revenues, expenses, income summary, drawing (REID). The combined REID balances are then transferred to the Capital account to determine the overall increase/decrease in Owners Equity.

## Closing Procedure

An account is "closed" by posting an amount exactly equal to and opposite the current balance; e.g., if the account has a \$500 credit balance, it is closed by entering a \$500 debit.

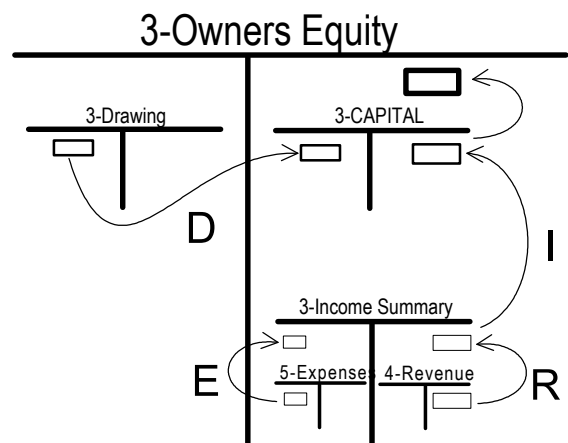
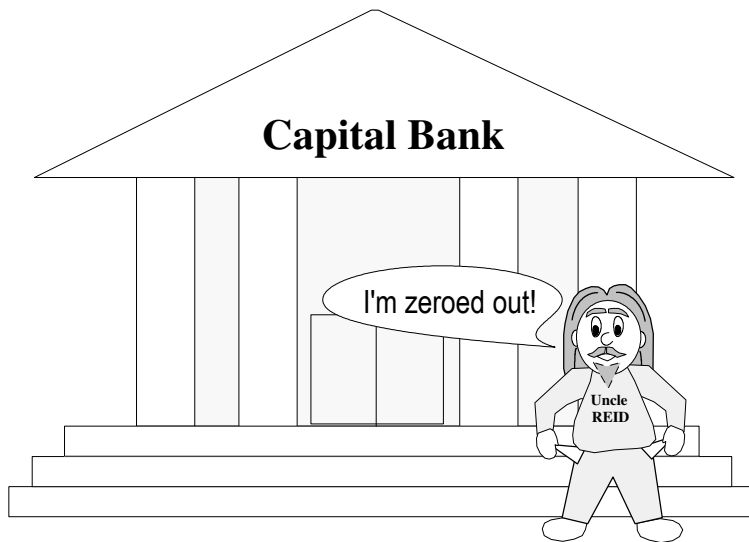
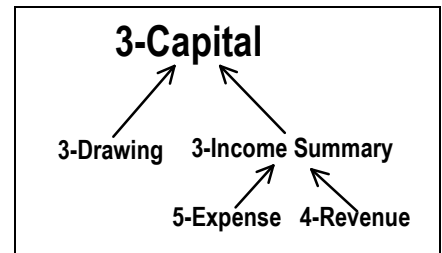
- 4-REVENUE is closed to 3-INCOME SUMMARY.
- 5-EXPENSES is closed to 3-INCOME SUMMARY.
- Income Summary is totaled, indicating a net profit (credit) or loss (debit).
- 3-INCOME SUMMARY is closed to 3-CAPITAL.
- 3-DRAWING is closed to 3-CAPITAL.

The Capital Account is totaled, indicating an increase (credit) or decrease (debit) in Owners Equity.

An increase in OE rewards owners for investing in the business, whereas a decrease is the risk owners assume.

## BrainAid

Imagine your Uncle REID going up the steps into the Capital Bank and emptying (zeroing) out his pockets.



Does this show a Profit or a Loss?

## Accounting for Owners Equity (OE)

**Sole Proprietorship:**  $OE = CAPITAL$

With one owner, there is need for only one 3-Capital Account and one 3-Drawing Account. The 3-Capital Account contains the owner's total investment and 100% of the business's profit/loss (less any 3-Drawing Account balance).

**Partnership:**  $OE = CAPITAL P1 + CAPITAL P2...$

Each partner (P#) has a separate 3-Capital and a separate 3-Drawing Account to keep track of investments, earnings, and withdrawals. These accounts contain each partners' total investment and a percentage of the business profit or loss; e.g., a 30% owner gets 30% of the profit/loss; a 70% owner gets 70% of the profit/loss.

**Corporation:**  $OE = CAPITAL STOCK + RETAINED EARNINGS$

3-Capital Stock—Records amount of investments from stock sales to shareholders.

3-Retained Earnings—Records amount of profit/loss made by the corporation (since its founding), minus any dividends paid to reward shareholders.

**To Do:** DPATE the Closing BSM (next page) as your instructor demonstrates on an overhead transparency.





# The Subsidiary Ledger Bros.

Since cash transactions are simpler, why bother with Accounts Receivable (A/R) and Accounts Payable (A/P)? Because buyers don't always have readily-available cash. To make more sales, sellers offer credit—the buyer gets the desired item today, deferring payment until later. A/R and A/P keep business transactions flowing, regardless of cash availability.

## Problem

- Firms make *sales* and accept *receipts*—from customers. However, vendors make *sales* & accept *receipts*—from firms. When you say "sales" or "receipts" are you speaking of firms, or vendors?
- Firms make *purchases* & send *payments*—to vendors. But customers also make *purchases* & send *payments*—to firms. When you say "purchases" or "payments" are you speaking of firms, or customers?

## Solution

For accounting purposes, always speak of Sales/Receipts/Purchases/Payments from your *firm's* point of view.

## BrainAid

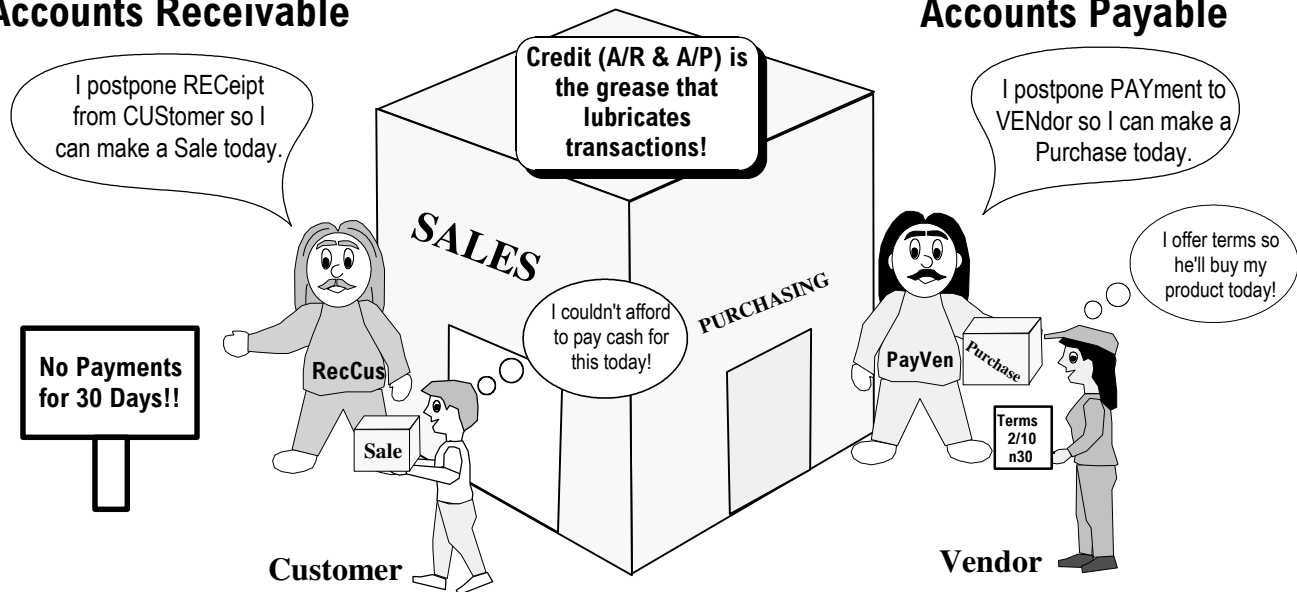
Imagine you have two uncles:

Uncle RecCus (REEK-us) sells; **RecCus = Receivables Customers**.

Uncle PayVen (pAA-ven) purchases; **PayVen = Payables Vendors**.

## Accounts Receivable

## Accounts Payable



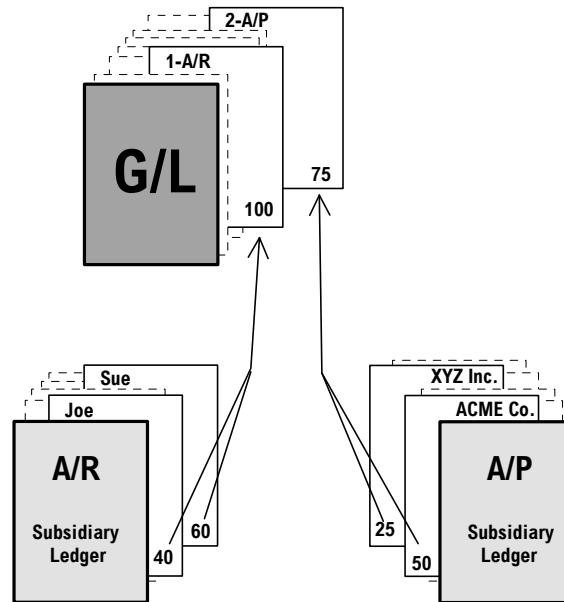
## To Do:

When you have transactions dealing with customers, which uncle will you call? \_\_\_\_\_.

When you have transactions dealing with vendors, which uncle will you call? \_\_\_\_\_.

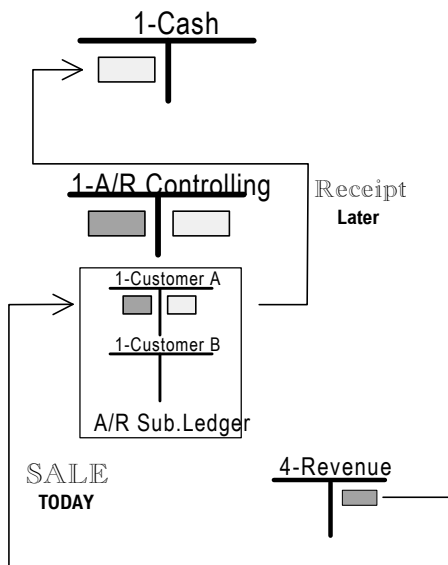
# A/R and A/P Controlling Accounts

A Controlling Account shows the total of its Subsidiary Accounts.



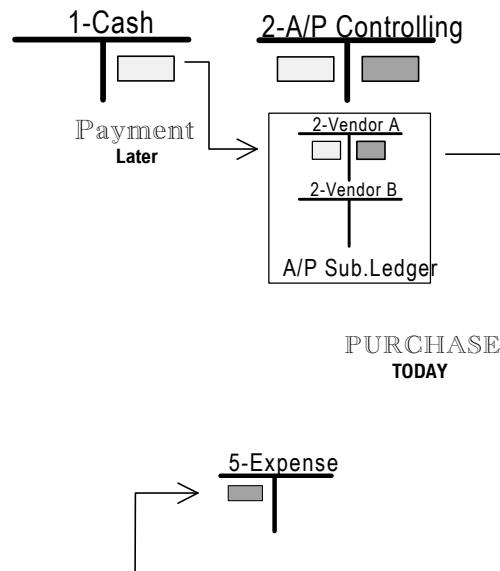
The Subsidiary Ledgers keep track of which Customer or Vendor made which transaction and how much money is due or owed.

## Accounts Receivable



A/R creates a temporary time delay between making a SALE TODAY and receiving Cash.   
 TODAY   
 Later

## Accounts Payable



A/P creates a temporary time delay between making a PURCHASE TODAY and paying Cash.   
 TODAY   
 Later



# Accounting Cycle AcroMap

The Accounting Cycle defines the sequence of operations that occur each accounting period. This AcroMap (a diagram of acronyms) illustrates an 8-step Accounting Cycle and the entries made or forms filled in at each step.

**Acronym:** T:S-JLT-F A/C:JLT

**Acrostic:** Terry Sue JiLTs Frank as the Air Conditioner JoLTs!

**To Do:** Memorize and practice drawing this AcroMap.

## Transactions

**SOURCE DOCUMENTS** (TRICM—Trick 'em)

Collect documents that verify transactions:

Tapes (cash register), **R**eceipts, **I**nvoices, **C**hecks, **M**emos.

**JOURNAL ENTRY** (DAD-ACE-PR—Dad was an ace pro)

**Date**, **Account1**, **Dr**\$amount

**Account2**, **Cr**\$amount, **Explanation**

**Post Reference** (Ledger Account #).

GENERAL JOURNAL				PAGE #
<u>Date</u>	<u>Description</u>	<u>P.R.</u>	<u>Dr</u>	<u>Cr</u>
<i>Date</i>	<i>Account1</i>	<i>LA#</i>	<i>\$</i>	
	<i>Account2</i>	<i>LA#</i>		<i>\$</i>
	<i>Explanation</i>			

**LEDGER POSTING** (DI-\$-B-PR—Di buys a beeper)

**Date**, **Item**(optional); **\$**amount, **B**alance; **P**ost **R**eference (Journal Page #).

GENERAL LEDGER ACCOUNT: ###				
<u>Date</u>	<u>Item</u>	<u>P.R.</u>	<u>Dr</u>	<u>Cr</u>
<i>Date</i>	<i>Item</i>	<i>JP#</i>	<i>\$</i>	
<b>Totals</b>			_____	_____
<b>Balance</b>			<i>Balance</i>	

**TRIAL BALANCE WORKSHEET** (Dr=Cr, 1A-9TS-O-D, SPEW, IS, BS—Driver of car license 1A-9TS-O-D spew? Is bus?)

Trial Balance column: Ensure Total Dr=Total Cr (Dr=Cr). If not, analyze difference with 1A-9TS-O-D.

Adjustments column: Transfer remaining value of items spanning the period (SPEW).

Income Statement (IS) column: 4-Revenue – 5-Expenses = Net Profit/Loss

Balance Sheet (BS) column: 1-Assets = 2-Liabilities + 3-Owners Equity +/- Net Profit/Loss

**FINANCIAL STATEMENTS** (IS, BS—Is bus)

Income Statement (IS): Revenue–Expenses=Net Income for the period (usually one month).

Balance Sheet (BS): Assets=Liabilities+Owners Equity = Value of firm on a given day (snapshot of assets).

**Note:** Businesses with a 1-year accounting period prepare monthly (interim) financial statements even though they adjust/close their books only once, at the end of the year.

## ADJUSTMENTS/CLOSING

**JOURNAL ENTRY** (DAD-ACE-PR)

Adjusting entries from the Trial Balance Worksheet (SPEW).

Closing entries to zero out temporary accounts (Uncle REID).

**LEDGER POSTING** (DI-\$-B-PR)

Post Adjusting and Closing Entries.

**TRIAL BALANCE POST CLOSE**

Ensure that Adjusting and Closing Total Dr = Total Cr (Dr=Cr). If not, analyze difference with 1A-9TS-O-D.

## Accounting Cycle AcroMap

### TRANSACTIONS

S—TRICM

J—DAD-ACE-PR

L—DI-\$-B-PR

T—Dr=Cr, 1A-9TS-O-D, SPEW, IS, BS

F—IS, BS

### ADJUSTMENTS/CLOSING

J—DAD-ACE-PR, SPEW, REID

L—DI-\$-B-PR

T—Dr=Cr, 1A-9TS-O-D

# Accounting Cycle Flowchart

